NEWS RELEASE

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AUDIT AS A MANAGEMENT TOOL

An Address By

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FEDERAL DEPOSIT INSURANCE CORPORATION

Washington, D. C.

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of the

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AUDIT AS A MANAGEMENT TOOL

Banks today are operating in an intensively competitive environment. An environment of dynamic growth and change. Banking techniques and banking services are changing and adapting to new conditions. The demands upon the banking industry have been increasing as never before in history.

Every bank can meet these demands, if management is willing. One major element is the necessity of proper control of bank operations. The advantages of audit procedures are many, yet it is all too true that many banks still do not utilize them. Important work is being done to foster development of audit, especially by NABAC, The Association for Bank Audit, Control, and Operation, but the supervisory authorities, state and national, are also concerned with the need to broaden audit programs. In our time today, I would like to outline for you some reasons for this push for audit. The use of audit is a management, and an ownership responsibility.

The demand for credit, the pressure for continued economic growth, has sparked the emergence of new banking techniques. The use of amortized loans in all fields of lending, development of leaseback services, broader agricultural lending services, going far beyond the traditional cash crop loan, broadened consumer credit techniques, floor planning for more and more goods, have required new methods of operation, which even small banks must to a degree master if they are to service the needs of their communities and remain competitive.

The cost-price squeeze affecting the banking industry has emphasized new approaches. Non-loan services, which do not require the use of costly deposits, are being developed. Travel service, bookkeeping arrangements, and other services are becoming commonplace.

More sophisticated banking methods are being utilized. Automation itself is opening up a host of new services, and new techniques.

Competition has sharpened tremendously, not only within the banking industry, but from other financial institutions. All financial institutions are broadening their own basis of service and blurring the lines of separation between them.

There is a great interaction of other economic factors, affecting the activities of all banks. They have become more and more important. Balance of payments problems, fiscal and monetary policies, and the nation's large commitment in space, assistance to other nations, and the military budget, all play an important role in the decisions which affect bank actions. None of these factors can be ignored.

A bank charter carries with it broad responsibility. The bank must serve its community, and must conduct its affairs to develop the community's credit resources to the community's best advantage. Unimaginative management, which fails to appreciate the world in which it operates, can weaken the community's growth. Conversely, bank management which utilizes its resources intelligently, and assists its community to keep pace with changing conditions, is fulfilling its basic charter responsibilities.

These responsibilities emphasize the need for every bank manager not only to meet routine requirements, but to assure through proper controls the safety and stability of his bank, and its continued ability to function. Additionally, for survival and continued service to a community, the bank manager should be in a position to utilize new techniques and new services. This requires a degree of knowledge of the capabilities of the bank.

The goal, of safe operation permitting a full range of service, can best be accomplished where the bank uses a program of day-by-day internal control, concurrent with proper accounting techniques, backed and supervised by an audit program, including verification procedures.

Some banks, especially smaller ones, seem to feel that supervisory examinations can take the place of audit programs. This is not true! An examination does utilize some audit techniques, but it is not an audit. The examiner approaches his task from a different viewpoint than the auditor. This is right and necessary, and it is essential that the bank manager understand the difference in approach. An understanding of this difference will serve to help the manager make the proper use of examination reports.

Broadly speaking, the examination is primarily a qualitative process, developing the value of a bank's holdings, their soundness, the legality of the bank's actions, the soundness of capital, and the quality of management. The audit, on the other hand, is a quantitative process, analysing 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. An audit does not analyse a bank's management, except indirectly by showing, through figures, what the results are. It will determine whether or not staff is adhering to management policies.

No supervisor wants to undertake an audit role, except as an incidental part of the examination process. I feel most strongly that audit is an ownership and a management responsibility. No supervisor wants to or properly can exercise the functions of management. The supervisor can only urge management to do what it should do, and in the examination process evaluate the ability of management to discharge its responsibilities.

There are certain things any supervisor looks for in an audit and control program.

The supervisor looks for a program of internal controls, structured permanently into the bank's operating procedures, on a routine and constant basis. Among these controls are:

--Structuring operations so that no one person controls a transaction from origin to posting.

--Mandatory vacations for all personnel, including senior management, to assure that every employee has a minimum of two weeks away from the bank, on consecutive business days, and without entry to the bank during that period.

--Dual controls in sensitive areas, such as securities.

--Rotation of assignments, especially among those employees handling records or assets vulnerable to alteration or misappropriation.

--Periodic surprise checks, especially in the same areas where assignments should be rotated. For example, periodic checks of the cash letters as they come in, by an auditor, or by senior management, and a comparison of the items in the cash letters against ledger sheets.

The supervisor looks for a proper audit program. In our view, and internal auditor, as free as possible from other assignments, is essential to any completely satisfactory audit program. However, the use of audit committees by the board of directors is a large step in the right direction, and the periodic use on a surprise basis of outside independent auditors also helps, although it does not give the day by day safety of a full internal program.

Among the assignments the supervisor considers necessary for a proper audit program -- and this presupposes an internal 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.

--Auditing accounts systematically with a view toward protecting and safeguarding the bank's assets, and determining 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.

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

To the examiner and the well-trained auditor, the process of direct verification remains the single strongest tool to prevent or disclose irregularities. The frequency of verification, and its scope, are important elements in its successful use. We feel strongly that even in banks which do not have a full-time auditor, direct verification through an outside auditor or through a board of directors committee is essential as a control. Verification should be directed to deposit accounts, including dormant accounts, and to loans, especially including purchased paper such as dealer loans.

The supervisory agencies have always checked carefully every bank's controls and audit program as a major part of their examination. Our examiners at the Federal Deposit Insurance Corporation are instructed to give careful consideration to one-man banks, to carelessly run institutions, to banks without mandatory vacation policies or with serious deficiencies in internal controls, and to banks without audit procedures.

We at FDIC feel most strongly the need for further activity in this area. Accordingly, we are undertaking a three-pronged approach.

First: We have instructed all our examiners to check carefully for use of direct verification, and, where verification is not being used, to urge managements to embark on such a program. We are paying especial care to the area of verification of purchased paper.

Second: We have placed ourselves on record as favoring an approach to more uniform accounting techniques. The regulations we issued to implement the Securities Act Amendments of 1964 require more uniform accounting techniques.

While these regulations affect only larger banks at present, we feel that as they are accepted by the public and by the industry, they will help to develop more uniform techniques for all banks. It is hoped that this uniformity will lower auditing costs.

Third: We are considering a new program at FDIC. This is the possibility of developing an advisory service for banks that lack audit programs. It would be a voluntary program, designed to assist banks in developing techniques.

As we presently see it, this would lead to a program where field auditors trained in bank auditing techniques and in teaching methods, would at the bank's request be able to assist banks. The degree of assistance would depend upon the bank's needs and its skills at the time they sought assistance.

While we are not committed formally to this program, it is under careful study, and a pilot group is being trained. This group currently is being used to intensify and extend the audit phase of our examinations, but they may become the basis for this new program.

There are some substantial benefits, in our opinion, which justify the costs of good auditing.

Proper use of audit programs, including verification, assures as far as possible staff honesty. It provides a better working climate through the proper use of rotation techniques, which develop staff skills and personnel development.

Direct verification can be used effectively as a means of developing better public relations. Fears that it will disturb a bank's customers are unfounded. What customer is going to be disturbed by the thought that his bank is trying to protect him and keep his records in accurate balance? Instead, the use of verification programs can be made to pay positive dividends in creating an impression of a bank which cares for and protects its customers. This can be used as a selling tool.

Such audit programs, limiting sharply exposure to fraud, can lower blanket bond and fidelity bond costs.

Finally, auditing provides an excellent tool for cost accounting, cost controls, and development of a realistic price structure, related to actual costs.

Failure of a banker to utilize to the fullest the credit resources of his community, as represented by his own institution, is a failure of a trust imposed as an essential part of the bank charter under which he operates. Failure to do what the bank can do and should do harms the community. Failure to exercise controls to assure safety of his institution is an even greater failure of his trust; it is inexcusable and can be disastrous to the community.

It is the responsibility of bank ownership, the board of directors and senior management, to utilize all possible techniques to preserve the safety and to enhance the ability of the bank. Accounting and audit together constitute a major means of fulfilling this responsibility.

We feel most strongly that the benefits to be derived from such a program are so large that no bank can properly ignore them. This is a fast moving world. The bank which is equipped to safeguard itself, and to understand itself through sound accounting and auditing techniques, is the bank which will master new techniques, serve its community, and justify its continued existence. This is a challenge to all of us. Fortunately, the history of this nation's banking system is a continued history of response to challenges, and a continuing development of better banks and better techniques. With a continued willingness to meet such challenges, the banking industry can look to the future with confidence.

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