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BANK ACCOUNTING, AUDITING, EXAMINING - A JOINT CHALLENGE FOR A NEW AGE OF FINANCE

By

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When I was asked to come here to speak to you at this opening session of your Convention, my chief apprehension was with the problem of saying something useful and interesting. I think we can all agree that it is sometimes too easy for principal convention speeches to be tired, endless, and replete with profound platitudes.

I assure you that I shall try, at least, to spare you inordinate length and platitudes. I am not really sure I can promise more. For some people think -- certainly not in this distinguished audience! -- that it is hardly likely anything can ever be said about accounting and auditing that is really very new, very interesting, or very exciting. And yet, if you examine this proposition, you see immediately how shallow and superficial it is. For the truth is that accounts constitute the single most important source of information about the economic affairs and activities of a nation; that they are indispensible to individuals, to business, and to governments; that interest in almost anything you can imagine, unless it is superficial, requires interest ultimately with accounts. It is a plain fact that accounts mirror the dynamics of economic forces and are certainly the well-spring of financial knowledge in any modern society.

So, in this broader context, while all of us who are concerned with accounting and reporting might at times go unapplauded, we, at least, appreciate our vital role and obtain satisfaction from it.

What I would like most of all now is to review with you briefly just a few of the rapid changes taking place in banking today -- and to think through with you the effects and implications of these changes on accounting and auditing and on the relationship between bankers and bank supervisors -- particularly those of us in the Federal Deposit Insurance Corporation.

It is no profound observation to note that times change. It is noteworthy that the processes have now become so accelerated that, at best, we can only hope to keep fully abreast of new phenomena and developments in a single industry. Let us take a look, for example, just at the expansion that has taken place in the banking industry. I doubt if many of us have fully realized that total loans and investments of commercial banks at the end of this year could well reach $300 billion. At the end of 1960, just five years ago, they amounted to some $200 billion, and in 1950 they stood at less than $125 billion. This is certainly indicative of economic growth and change in our time, and all other data support this obvious conclusion.

Bankers are still primary lenders to individuals, industry, and commerce, for the purposes of buying land, building factories, and carrying on trade. But they also are involved in all the new activities and financial techniques and instruments that are part of a society and economy which is immeasurably and increasingly complex. Equipment leasing, accounts receivable financing, mortgage warehousing, and international trade credit are all integral parts of finance in these times. Banking services offered today were not even contemplated only a few years ago - staff counseling specialists, expanding trust services in areas of corporate and union pension funds, services as go-betweens for customers and differenct sectors of money markets, and

computer services to customers in maintaining payrolls, bookkeeping, and check reconciliation are all familiar on the banking scene today. New functions and activities appear each day.

But, what does this changing economy and changing structure mean to bank accounting and reporting? Simply stated, it means that principles and procedures which might have served adequately in the past no longer do so. Management demands become more exacting for meaningful, current information; and financial analysts and investor groups clamor for detailed information and financial reporting in terms that may be compared to other industries and alternative investment opportunities. We see evidences of these changing demands all around us in our work, and I'm sure you in the banks are getting some feeling of it too.

What it all means, I suppose, is that all of us in the industry -- bankers, auditors, supervisors -- must pool our talents and exert all our efforts more intensively than ever before to meet these challenges with which we are being confronted.

We have spent a great deal of time at the Federal Deposit Insurance Corporation in recent months examining questions pertaining to bank accounting and reporting, to the desirability and feasibility of audit of banks by independent public accountants, to the effectiveness of the examination process by supervisory agencies, and to other issues bearing upon the improved functioning and operation of the banking system.

This current introspection, if you will, really began, I suppose, when my good friend Joe Barr and I came to the Corporation some 18 months ago. Though we were new to the work of the Corporation, we sensed that the time

was right for a fresh look at bank supervision. But more specifically than that, we felt also the time was right for a close look at the fundamental role that the Federal Deposit Insurance Corporation has to play in the industry -- and particularly at the effectiveness with which it was discharging its responsibilities in this role. I might say that numerous changes have already been made and there will be others -- more on that a little later.

First though, I want to say something about the relationships between independent audit and the bank examination process. Then, I want to use the time remaining to discuss what is certainly of even greater importance to us, the efficient and effective day-to-day operation of each individual bank.

In the past, our Corporation and others have drawn a rather sharp distinction between an independent audit and a supervisory examination. I think sometimes that perhaps too much has been made of this distinction. Owing largely to separate historical development of the two processes, there certainly are differences in purpose, approach, and procedures. But there are also a great many similarities which are seldom stressed. Some of these are: controlling, accounting for and reconciling cash, cash items, and exchanges; verifying and reconciling accounts due to and from banks, and other institutions; checking, proving, and confirming investment securities; checking and proving loans, loan collateral, and mortgages; reviewing income, expenses, and the system of accrual, where it exists; verifying records of transactions, inspecting vouchers and documents; reviewing the system of

internal control and adequacy of internal audit; reconciling capital and capital reserves; remaining alert to evidences of kiting, overdrafts, to handling of return items, certified and official checks, dormant accounts, and unrecorded contingencies; and reviewing minutes of meetings, and compliance with banking laws and regulations.

Independent accountants, in general, spend more time in checking the authenticity of asset and liability accounts, of income and expense transactions, and efficient operations; and, of course, they are obliged to invoke direct confirmation. Examiners, in general, spend more time on investment portfolios and policy, detailed credit analyses of loans, appraising the effectiveness of management, and determining the adequacy of banking services to the community.

This listing is not complete by any means, but the point I want to make is that, while there are differences in approach and in methods, both examiners and auditors, in their own way, are engaged in appraising the condition and results of operations in banking institutions. And they are each involved in ascertaining whether banks are being managed in a competent and satisfactory manner. Perhaps, therefore, we should spend less time emphasizing differences and direct more of our attention to the ways in which independent audits and examinations complement each other -- both in furthering desirable practices and in improving the overall operation of the banking system.

If this is done, considering that there are so many similarities in examination and audit procedures, it is natural to presume that as more and

more banks engage independent auditors for periodic audits, and as accounting, internal control, and reporting improve the procedures of examiners might be relaxed, at least in those areas more thoroughly covered by the independent auditor. Conversely, where there is no independent audit and procedures and controls are questionable, more extensive supervisory examination procedures might be necessary.

It seems to me that this is simply an inherent possibility as both examination and auditing techniques are improved. It does not mean that the Federal Deposit Insurance Corporation has ambitions to convert the examination process into one of bank auditing. Nor are we inclined to spearhead a campaign to impose compulsory independent audits on all banks. Instead, we will continue to improve the bank examination process -- and we will continue to support the concept that every bank able to do so should provide itself with competent and independent audit services.

Let me turn now to a subject that is of even more interest to the Federal Deposit Insurance Corporation than whatever conditions might exist on a day that an examiner or an auditor happens to visit a particular bank. This involves the healthy day-in and day-out functioning and operation of the bank -- a basic issue of primary concern and interest to me.

One area to which all of us must direct more of our attention is the development of principles and standards underlying a more uniform system of accounting and reporting. In that connection, I think that the recent amendments to the Securities Acts, although applicable to only a few hundred banks, have certainly contributed to advancing standards for all banking. I believe it is inevitable that all banks, whether subject to these new

statutes or not, must move in the direction of standardization and uniformity of accounting and reporting.

But precisely what are some of the major complaints that we hear leveled against bank accounting and reporting? I suppose a most basic one has to do with the formulation and reporting of net income. Many of the smaller banks do not publish a statement of earnings, but whether they do or not there are many transactions carried directly to undivided profits which, it is alleged, more properly should enter into the determination of net income. Accounting for and reporting on capital assets, in many instances, are unsatisfactory. Sometimes these assets are written off, not systematically over their useful lives, but varyingly with an eye on the profits, resulting in a condition and earnings report that is incorrect on both counts to this extent. In reporting banking facilities, the basis for valuation is frequently not stated, and the nature and amount of the related reserves are not netted out and are rarely disclosed.

Another complaint often heard pertains to the handling of reserves. It is possible through these reserves, as you know, to provide in prosperity for losses that come in less auspicious times, and neither the losses nor the provision for them need appear in the earnings statement. Not often is it possible from published statements to trace activities that have taken place in the reserve accounts.

Then too, there is the whole area of accrual accounting. Many banks, some rather large, continue on the cash basis, which frequently casts serious doubt that resulting figures have any meaning whatever to those

attempting to ascertain the financial condition of the bank or the results of its operations.

I do not need to elaborate on this array of deficiencies before this informed audience. Nor do I wish to assess blame. Some of it -- as I may as well acknowledge -- rests with the agency which I head and with the other Federal and State supervisory authorities. But this does not mean we are committed to the same course for all time, and that we cannot improve our own standards now and in the future.

An area in which we are making more progress perhaps than with accounting standards and principles involves accounting procedures. I am thinking now primarily about internal control and internal audit.

There has been a great deal of progress in this field in recent years, owing in no small measure to the persistent efforts of your committees and your NABAC organization. Our agency plans to continue its efforts to persuade bank managements to improve their existing internal programs. Examiners will place added emphasis on internal control and internal audit, including direct verification of loans and deposits. A bank with only two employees can have a reasonably satisfactory system of internal control. It might not be quite as foolproof as one with say five employees, but it can be made acceptable for safeguarding depositors and capital resources.

In the last six months, we have been experimenting in four of our twelve districts, assigning trained auditors to regular examining teams in appraising internal routines and systems of control, and in developing better methods for examining these particular aspects of bank operations. We expect

before very long to have resident auditors in each district to assist in any way possible in this important area of internal control.

We are also experimenting with the idea of making these trained auditors -- who now function simply as an extension of the examination process in these critical areas that are demanding more attention -- available on a selective basis to insured banks to assist in any reasonable way that might be helpful. This service would be offered without cost and only on request to help primarily with developing and installing improved accounting and control procedures, audit techniques, and the like. Many banks, particularly those that are very small, simply do not have this kind of staff assistance available to them. Here again, we have no intention of moving wholesale into the business of bank accounting. But we do feel that we can supplement a very fine program of your organization and be of some assistance to certain banks in greatest need.

Overriding our total program, I like to think of the whole relationship between bankers and the bank supervisory agencies as one of trust and mutual helpfulness in making the banking system function as effectively as we possibly can. I think the idea of a bank examiner cast only in the role of an investigator, or the "gumshoe" approach that has prevailed at times in the past, have no place at all in our modern financial world. All of us -- whether bank controllers, public auditors, or bank examiners -- have increasingly difficult and complex problems thrust at us every day. Our demands, our responsibilities, and loyalties differ widely, of course. I am certain, nevertheless, that strong and continuing cooperative effort has the best

liklihood of moving us in the direction we want to go.

I want to assure you that the Federal Deposit Insurance Corporation is interested in working with you and helping where we can to make your bank and all banks the kind of healthy institutions that all of us would like to see. I am convinced we will need not only improved standards and methods but a new and stronger working relationship. Consequently, when you have problems we can help you with, I hope you will come to us with them -- for the simple reason that we are convinced our most important job lies in cooperative service rather than in detached investigation.