

[CAs and Bank Regulators]

Remarks By

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GOOD MORNING.

IT GIVES ME A GREAT DEAL OF PLEASURE TO SPEAK WITH THE AICPA'S TWELFTH NATIONAL BANKING CONFERENCE.

IT HAS BEEN AN INTERESTING YEAR IN FINANCE. THE EVENTS OF THE LAST MONTH ON WALL STREET PROVE THE MAXIM THAT "NOTHING RECEDES LIKE SUCCESS." HE ALSO SAID THE REPUBLICANS WILL BENEFIT -- THEY'VE BEEN CRITIZED FOR MAKING THE POOR POORER -- NOW THEY'VE MADE THE RICH POORER, OR AS MY MOTHER USE TO SAY -- HOW THE MIGHTY HAVE FALLEN. HERB STEIN RECENTLY POINTED OUT WHAT MIGHT BE A LASTING LESSON ON THOSE EVENTS WHEN HE OBSERVED: "THE AMERICAN ECONOMY IS HIGHLY ADAPTABLE, AND THE AMERICAN ECONOMIST EVEN MORE SO."

MY SUBJECT THIS MORNING IS CPA'S AND BANK REGULATORS -- HOW CAN WE WORK TOGETHER? LET'S START WITH BANK FAILURES, AND THEIR RELATIONSHIP TO AUDIT ACTIVITY AND REQUIREMENTS.

WE'VE SEEN A RECORD NUMBER OF BANK FAILURES THIS YEAR. A GREAT NUMBER OF THESE FAILURES CAN BE ATTRIBUTED TO POOR REGIONAL BUSINESS CONDITIONS, OFTEN COMBINED WITH POOR -- BUT HONEST -- BUSINESS PRACTICES.

BUT IN AS MANY AS ONE THIRD OF THE BANKS THAT FAIL, WE ARE SEEING EVIDENCE OF INSIDER ABUSE AND FRAUD IN A BANK'S DEMISE.

THE "AUTOPSIES" THE FDIC CONDUCTS IN THE WAKE OF BANK FAILURES ALSO SHOW THAT OUTRIGHT CRIMINAL ACTIVITY IS A FACTOR IN NEARLY 15 PERCENT OF RECENT FAILURES.

FROM JANUARY 1985 THROUGH JUNE 1987, 98 OF THE 354 BANKS THAT FAILED WERE CITED BY EXAMINERS AS HAVING AT LEAST SOME ELEMENT OF FRAUD OR INSIDER ABUSE. THESE 98 BANKS HAD ASSETS OF \$2.70 BILLION AND THE COST TO THE FDIC OF THESE FAILURES IS ESTIMATED TO BE NEARLY \$676 MILLION.

I'D LIKE TO REPEAT THAT I DON'T THINK THAT BANK FRAUD, WHILE AN IMPORTANT SUBJECT, IS AT SUCH A LEVEL THAT IT IMPERILS THE SAFETY OF THE BANKING SYSTEM.

BUT AT THE SAME TIME, THE RISING LEVEL OF FAILURES, AND THE INCREASED COST OF ABUSES OR FRAUDULENT BEHAVIOR, RAISE ISSUES THAT WE, BOTH AS REGULATOR AND AUDITOR, NEED TO EXPLORE. AFTER ALL, AUDITORS ALSO SUFFER WHEN YOUR CLIENTS SUFFER.

WHAT IS, OR BETTER YET, WHAT SHOULD BE THE ROLE OF THE BANK AUDITOR WITH REGARD TO BANK REGULATORS?

AS MANY OF YOU KNOW, THE BANK OF ENGLAND, AS PART OF THEIR RECENT EFFORT AT REGULATORY RESTRUCTURING, (KNOWN AS THE "BIG BANG"), REQUIRES AUDITORS AND REPORTING ACCOUNTANTS TO COMMUNICATE DIRECTLY WITH THE CENTRAL BANK "...WHEN IT IS EXPEDIENT TO DO SO TO PROTECT THE DEPOSITORS BECAUSE THERE EXISTS A SIGNIFICANT RISK OF MATERIAL LOSS."

NEXT WEEK THE FDIC WILL BE TESTIFYING BEFORE CONGRESSMAN BARNARD'S MONETARY AFFAIRS SUBCOMMITTEE. THE QUESTIONS THE CONGRESSMAN HAS ASKED THE FDIC TO ANSWER INCLUDE:

- o WHERE WE STAND ON PROPOSALS TO REQUIRE INDEPENDENT AUDITS OF BANKS;
- o HOW WE FEEL ABOUT A REQUIREMENT THAT BANK AUDITS BE FORWARDED TO THE FDIC; AND
- o WHAT WE THINK ABOUT A REQUIREMENT THAT BANKS SHOW THEIR EXAM REPORTS TO THEIR OUTSIDE AUDITORS.

IT SEEMS THAT CONGRESSMAN BARNARD HAS SHOWN A HEALTHY AND INFORMED INTEREST IN A NUMBER OF AREAS OF CONCERN TO US ALL. AS MOST OF YOU MAY KNOW, HE ALSO HAS EXPRESSED A STRONG INTEREST IN THE NEED FOR STANDARDS FOR THE APPRAISAL INDUSTRY. GOOD APPRAISALS MAKE BOTH AN AUDITOR'S AND A BANK REGULATOR'S JOB EASIER.

WITH REGARD TO A REGULATOR REQUIRING AN OUTSIDE AUDIT, LET ME GIVE YOU SOME BACKGROUND. FIRST WE ESTIMATE THAT SOMEWHERE AROUND TWO THIRDS OF THE BANKS IN THIS COUNTRY ALREADY GET OPINION AUDITS. AS YOU WOULD EXPECT, THE LARGER THE BANKING ORGANIZATION, THE MORE LIKELY THE AUDIT. BUT EVEN SO, ABOUT HALF THE BANKS UNDER \$50 MILLION IN ASSETS GET OUTSIDE AUDITS.

NEVERTHELESS, MORE SMALLER BANKS WOULD BE IMPACTED BY AN AUDIT REQUIREMENT THAN LARGER BANKS. AND, THE SMALLER THE BANK, THE MORE DIFFICULT A QUALITY AUDIT BECOMES.

WE NEED TO RESOLVE TWO ISSUES.

-- THE FUNDAMENTAL ONE IS WHETHER AUDITS PROVIDE VALUE TO US AS REGULATORS; ARE THEY WORTH IT FOR OUR RESPONSIBILITY?

-- THE NEXT IS, WHAT CAN BE DONE FOR THE SMALLER BANKS IF FULL OPINION AUDITS ARE NOT COST EFFECTIVE?

WE HAVE REVIEWED ABOUT 250 OF THE BANKS THAT FAILED IN 1986 AND THROUGH THE FIRST NINE MONTHS OF 1987. WE FOUND THAT ONLY 40 PERCENT OF THOSE BANKS HAD AN OUTSIDE AUDIT WRITTEN DURING THE TWO YEARS PRIOR TO FAILURE.

IN OTHER WORDS, IT APPEARS THAT DEEPLY TROUBLED BANKS ARE MUCH LESS LIKELY TO HAVE AN OUTSIDE AUDIT. WE ALSO FOUND THAT ABOUT 40 PERCENT OF THE FAILED BANKS, WITH OPINION AUDITS, HAD RECEIVED QUALIFIED OPINIONS FROM THEIR AUDITORS. CLEARLY, THIS WOULD HAVE PROVIDED INFORMATION THAT COULD HAVE BEEN USED BY BANK SUPERVISORS.

HERE'S THE STATUS OF A POSSIBLE PROPOSAL BY THE FDIC FOR REQUIRING AUDITS.

UNDER OUR DRAFT, WE WOULD REQUIRE EACH STATE NONMEMBER BANK ABOVE A THRESHOLD SIZE TO:

-- ENGAGE AN INDEPENDENT PUBLIC ACCOUNTANT TO PERFORM AN OPINION AUDIT EACH CALENDAR YEAR.

-- HAVE THE BANK'S BOARD OF DIRECTORS PERFORM A TIMELY REVIEW OF THE AUDITORS REPORT AND THE MANAGEMENT LETTER, WITH SUCH REVIEW NOTED ON THE BANK'S BOARD MINUTES. THE BANK WOULD BE REQUIRED TO SEND COPIES OF THESE REPORTS TO THE FDIC.

-- AND, WE WOULD ASK THE BANK TO NOTIFY THE FDIC WHEN THE BANK CHANGES ITS INDEPENDENT AUDITOR.

WE ARE ALSO CONSIDERING CONGRESSMAN BARNARD'S THOUGHT OF REQUIRING BANKS TO SHOW THEIR AUDITORS THEIR BANK EXAMINER'S REPORT.

GIVEN OUR DESIRE TO USE CPA'S TO HELP US, LET ME TELL YOU WHERE WE ARE NOW. WE APPEAR TO BE NEAR AGREEMENT WITH THE OTHER BANK REGULATORS ON REQUIRING ANNUAL AUDITS FOR ALL BANKS OVER A CERTAIN ASSET SIZE THRESHOLD. CURRENTLY, WE ARE CONSIDERING A THRESHOLD IN THE RANGE OF \$100 TO \$150 MILLION IN ASSETS.

I'D ALSO LIKE TO NOTE THAT WE HAVE TALKED WITH AN AICPA COMMITTEE ON THE POSSIBILITY OF DEVELOPING SOMETHING LESS THAN AN AUDIT FOR SMALLER BANKS -- UNDER THE \$100 MILLION ASSET SIZE.

THIS WOULD BE IN THE NATURE OF PROVIDING A "CHECKUP" RATHER THAN A "COMPLETE PHYSICAL" THAT SMALLER BANKS WOULD FIND AFFORDABLE, IT WOULD FOCUS ON POTENTIAL PROBLEM AREAS SUCH AS INTERNAL CONTROLS AND INSIDER ABUSE.

AS OF THIS TIME, AICPA HAS NOT SUGGESTED A LIMITED EXAMINATION THEY WOULD SUPPORT, EVEN THOUGH SUCH A LIMITED EXAM WOULD BE DESIRABLE FROM THE FDIC'S STANDPOINT.

IN OTHER WORDS, THE BALL IS IN THE CPA COURT. WE WOULD BE PLEASED TO HAVE YOU SUGGEST WHAT YOU CAN DO TO HELP US WITH SMALLER BANKS -- IF OPINION AUDITS ARE NOT COST EFFECTIVE -- AND WE BELIEVE THEY ARE NOT. PERHAPS THERE'S THOUSANDS OF BANKS THAT COULD BE HELPED BY LIMITED EXAMINATIONS.

IN OUR VIEW, IT IS UP TO YOU TO DEFINE ITS SCOPE AND RESPONSIBILITY. OBVIOUSLY, WE CAN'T OR WON'T REQUIRE A LIMITED EXAM UNLESS YOU CPA'S PUT IT FORWARD AS YOUR PRODUCT, WHICH YOU ENDORSE.

LET ME CONCLUDE IN SAYING THAT I BELIEVE OUTSIDE AUDITS CAN BENEFIT THE SUPERVISORY PROCESS, AS WELL AS THE INTERNAL OPERATIONS OF INSURED BANKS.

HOWEVER, I DO NOT WANT TO LEAVE YOU WITH THE IMPRESSION THAT THERE IS NOT ROOM FOR IMPROVEMENT IN THE AUDIT PROCESS. THE STATISTICS I QUOTED EARLIER SHOW THAT INFORMATION FROM OUTSIDE AUDITORS CAN HELP IN THE IDENTIFICATION OF PROBLEM AREAS. BUT THE STATISTICS ALSO SHOW THAT PROBLEMS AREAS OFTEN GO UNDETECTED. WE NEED TO WORK TOGETHER TO IMPROVE THE RECORD. MAY I SUGGEST THAT IMPROVED COMMUNICATIONS BETWEEN OUTSIDE AUDITORS AND BANK SUPERVISORS WILL GO A LONG WAY TOWARD GIVING US A MEANS TO ACHIEVE THE IMPROVEMENT WE ALL DESIRE.

THANK YOU.