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Dan P. Fulton

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CPA's Assistance in Bank Directors' Examinations

by DAN P. FULTON
In-Charge Accountant, Houston Office

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BANK defalcations are not uncommon if we can accept recent newspapers as a criterion. Bank depositors and stockholders alike cannot help but wonder why some of the more publicized bank irregularities were not detected much earlier than they were. Contrary to popular belief, examinations by federal and state examiners do not have as their purpose the detection of fraud or correction of internal control weaknesses, but rather are conducted to determine the bank's financial position, or solvency, and compliance with appropriate laws and regulations.

Many bank shortages of significance could be detected, and even prevented, by an active examining committee composed of the bank's directors. Although there is no statutory requirement, federal or state, that bank directors make periodic examinations of either national or state banks in Texas, except as may be required under the by-laws of the bank, the directors have a real and moral responsibility to the bank's depositors and stockholders to see to it that the bank's assets are properly safeguarded and the possibility of losses to depositors and stockholders reduced to a minimum.

If a committee of any sort is to be successful it must have guidance and the knowledge that it is getting somewhere; this is especially true of a bank directors' examining committee. For the most part, examining committees are composed of individuals from various walks of life. Such committees might be composed of any combination of business men and representatives of other professions, few of whom may have had any training as accountants or auditors or have knowledge of banking and the internal operations of a bank. Without professional supervision and guidance the committee's time is apt to be spent on a fruitless maze of details and in laborious effort, with the possibility of existing irregularities going undetected (and consequently uncorrected), and of the bank's employees becoming convinced that the directors' examining committee knows little about the details of banking and less about bank examinations. One way to obtain the guidance and professional skill so vital to the examining

committee's undertaking is to engage an experienced Certified Public Accountant.

The Certified Public Accountant can lend the director his tools, so to speak, by establishing controls that are paramount in an examination of a bank, by recommending good audit procedures to be followed, and in general by extending his accounting training and experience for the use of the committee. With these essential tools the examining directors' time will be efficiently and rewardingly spent, and the bank employees' time utilized to much greater advantage.

Let us consider the various phases of the directors' examination and how the CPA can steer them successfully through the undertaking.

PLANNING THE EXAMINATION

At the outset the directors' examining committee should be headed by a chairman who can assume the responsibilities of getting the job done. His fellow directors on the committee should dedicate themselves to the task, and be willing to assist the chairman wholeheartedly from the beginning of the cash count through the writing of the examination report.

The date of the examination must be set, and it is extremely important that this date be known only to the examining directors. Whether the examination is to begin when the bank opens its doors for business in the morning or at the close of business in the afternoon is a matter to be determined by the directors' examining committee. The examination should be focused on the records as of the close of business of the day before if the cash count is to be made in the morning. If the cash count and examination are to commence at the close of business on a particular day, then the examination should be directed toward verification as of the close of that day's business. Examinations commencing in the middle of a day's business are not considered too practicable. Whichever time is chosen, morning or afternoon, the day as of the close of which the bank's assets and liabilities are to be examined will be referred to hereinafter as the verification date.

Assuming that the services of a Certified Public Accountant have been obtained, a meeting of the directors on the examining committee and the CPA should be arranged prior to the date set for the examination. At this meeting the scope of the examination, the amount of time the directors are going to be able to contribute, the extent of

the CPA's services required, and any special features to be covered should be determined. Further, the meeting will be beneficial in that the CPA can give preliminary instructions concerning the examination and brief the directors on how control should be maintained. The CPA also has an opportunity to appraise the group somewhat and determine the particular phases of the examination that may be best suited for each individual director. For instance, it might prove disastrous to assign the task of preparing adding machine listings of loan or deposit accounts and balancing the total to the control to a person who is unfamiliar with adding machines.

The extent to which the bank's employees may be utilized in the examination may also be reviewed with the CPA. He can give consideration to the various employees' duties and recommend certain clerical operations which, if completely divorced from their daily routine duties, might be performed best by such employees. The listing of outstanding money orders, savings bonds redeemed, time, savings, and deposit accounts, and numerous other tasks may be performed by employees who do not maintain such records, have custody of the basic documents, or participate in the original transaction so long as over-all control is maintained by the examining committee or the CPA. Such a division of duties is not possible in small country banks and is not necessarily probable in larger banks. The CPA can determine how the bank's employees may best be utilized after he has given consideration to their regular responsibilities and daily routines.

CASH COUNT AND CONTROL

At the designated time the directors' examining committee, accompanied by the CPA, should enter the bank and inform the appropriate personnel that the examination is in progress and that the assets and records are to be controlled by the directors' examining committee. Punctuality on the part of the directors is vital and cannot be overemphasized. Late arrival of one or several of the directors can jeopardize the entire examination because complete control of cash, marketable assets, and all records must be established at the moment the examination is commenced.

Under the direction of the CPA all cash in the possession of the tellers and in the vault should be sealed. Depending on the number of directors participating in the examination, a certain amount of the cash may be sealed after count if it is possible to begin counting immediately on entering the bank. Sealing the cash is more essential

when fewer directors participate in the cash count or assist in controlling the cash and is a *must* when all of the bank's cash cannot be controlled otherwise. The possibility of substitution must be completely eliminated, and the CPA will see to it that the directors maintain complete control during the count.

At this point a distinction should be made between custody and control. While custody implies having control, it is not necessary to take an asset (cash for example) into custody in order to control it for audit purposes. The CPA will admonish the directors to control the cash and count it in the presence of its custodians but not to take physical custody of it at any time or to allow it out of the custody of the appropriate bank personnel. As a consequence, there should never be a necessity for the directors to obtain a receipt for the cash after it has been counted, as such an act may weaken a case for proving a shortage should one develop, and the director himself might be put in an embarrassing position.

The CPA can either take part in the cash count or serve strictly as a supervisor or control observer. In either capacity, the latter being the more desirable for purposes of over-all effectiveness, he can instruct the directors on how to test-count currency and silver, be instrumental in solving problems of tallying out counts with the records, and control transfers from vault to tellers, which sometimes must occur during a count if business is being conducted by the bank; he can also prevent innumerable small problems from becoming large ones during a critical few hours of cash verification, where no second chance is usually afforded and the slightest oversight can prove to be the greatest mistake.

CASH ITEMS AND CLEARINGS

Cash items are comprised of checks or other instruments received that are payable by the bank or payable by other banks.

The examining committee should examine the cash items and, if possible, one member of the committee should accompany the messenger and the cash items to the local clearing house or local paying banks to witness the exchange and determine that no items are abstracted or substituted. Items for out-of-town banks may be controlled to the post office by a director and the messenger, if feasible. Whether it is practicable to control cash items to the clearing houses, banks, or post office or not, they should be confirmed directly with the clearing houses or banks, and the CPA can instruct the directors on

how to review and examine the cash items and how best to confirm the clearing of such items.

To further determine the authenticity of the cash items sent to clearing houses and other banks, the CPA will advise the directors' examining committee to arrange for their examination of returned items from clearing houses and banks for several days subsequent to the verification date.

INVESTMENTS

If securities in custody of the bank cannot be examined simultaneously with the cash and cash items, the vault or vault compartment in which they are kept should be sealed until such time as they can be examined and listed in the presence of their custodian. The CPA will either perform the sealing operation or will direct or assist a member of the examining committee in the process.

The appropriate securities record should be obtained and a list prepared therefrom by a director, or a list prepared by bank personnel should be verified against the record by a director. The total of the list should be proved by a director and checked to the general ledger control and all securities represented by the list examined in the presence of their custodian.

Any securities for any reason not on hand (held by other banks as custodian, pledged, in process of being sold or redeemed, etc.) should be confirmed directly with the alleged custodian as to all particulars, including unclipped interest coupons. In addition, any securities held in trust by the bank should be examined and checked to the appropriate records inasmuch as such securities could be substituted for the bank's own securities and a shortage thus concealed.

Cost and current market price should be determined and investment income checked to the appropriate records in the bank's accounts.

The assisting CPA may supervise the directors in the examination of the securities, perform the examination himself, or assist as the need arises.

DUE FROM BANKS

The CPA will suggest to the examining directors that arrangements be made for their obtaining the bank statements and other mail, unopened, from correspondent banks for about a week subsequent to the verification date. He will instruct the directors on how

they should examine returned items, follow through on the clearance of items in transit as of the verification date, and establish the validity of outstanding checks, etc., as reflected on the reconcilements. The directors will also be instructed in arranging for banks that do not furnish daily statements to furnish the directors with cut-off statements.

All balances with correspondent banks and with Federal Reserve Bank should be reconciled with statements from the banks. The appropriate bank personnel may prepare the reconcilements, and either the directors or the CPA may verify them. If internal control is very poor, it may be preferable for either the CPA or the directors to prepare the reconcilements from bank statements obtained unopened, which are usually received a day or two following the verification date.

Certification of deposit balances and any possible liabilities should be obtained from all correspondent banks and Federal Reserve Bank. The preferable procedure for obtaining confirmation of deposit balances, liabilities, securities, and other confirmations to be covered later, is to rent a post office box in the name of the directors' examining committee, and request that all confirmations be returned to this post office box. The CPA will instruct the examining directors as to the importance of allowing no one outside of the committee to have access to the box. Further, he will explain why the box number should be shown in the upper left corner of all envelopes used to mail confirmations so as to have all unclaimed letters returned directly to the examining committee.

LOANS AND DISCOUNTS

This account normally represents the most sizeable portion of a bank's assets and consequently warrants a considerable amount of the examining directors' attention. Simultaneous with the cash count, control over the notes and collateral should be established and maintained until such notes and collateral have been examined and checked to loan ledgers. The examination may be performed on a test basis, depending on the number of loans, relative amounts, types of loans, etc. The CPA, by his experience, will be able to scan the note ledgers, or lists, and suggest an effective sampling procedure for the directors to follow.

While the CPA may assist in the examination of notes and their collateral, he may better spend his time on supervision or other audit

functions inasmuch as the directors are usually more familiar with the borrowers, their occupations, reputation, quality of real estate pledged as collateral, etc., and consequently may be able to appraise the loans more effectively. In addition to collateral examination, the CPA will advise the directors to examine the borrowers' credit files. This can possibly lead to interesting discoveries such as insolvent or bankrupt borrowers having significant loans.

Listings of the loan ledgers may be prepared by the examining directors or by certain bank employees if they meet the qualifications described earlier. If the listings are prepared by the latter, test-checks may be made of the listings to the loan ledgers by either the directors or the CPA, totals of the listings proved, and the totals checked to subsidiary ledger and general ledger controls as of the verification date.

All past-due loans or overdue instalments, loans in excess of the legal amount, loans without sufficient collateral, unrecorded mortgages, alterations, erasures, and any other irregularities noted should be listed by the directors and followed through to a conclusion.

The examination of loans and discounts will not be complete unless a representative number are confirmed directly by the borrowers. The CPA will offer suggestions on how to select the loans to be confirmed (larger balances with a test of smaller, all loans over a specified amount, or other effective selections). The CPA will also advise the examining directors on how to control the preparation of the confirmations.

Interest and discounts may be tested for propriety of computation, actual receipt, and recording in the accounts. The CPA can determine the method of recording (cash or accrual basis, etc.) and demonstrate procedures to be followed in the verification process.

The reserve for loan losses should be reviewed for the period since the last directors' examination. The CPA can assist the directors in determining the amount of loans charged against the reserve and establishing ratios of write-offs to loan balances, comparison of such ratios with percentages of loss provisions, etc. The CPA will also advise the directors to determine the adequacy of the reserve balance and instruct them to examine write-offs.

LAND, BUILDINGS, AND EQUIPMENT

The bank's property records should be reviewed and additions and retirements since the last directors' examination verified by

scrutiny of cash vouchers and other documents supporting the property transactions. If it is the initial examination, the directors should examine deeds to the property. Current tax receipts and insurance policies should also be reviewed and determined to be in order.

The method of depreciation should be reviewed and consistency with prior periods determined. Depreciation policies and sales and exchanges of property and equipment should also be considered and determined to be recorded properly for inclusion in the bank's federal income tax return. The CPA can be especially helpful in the area of federal income tax and may see ways to reduce the bank's tax liability by applying his knowledge of accelerated depreciation and review of gain or losses arising out of property transactions.

DEMAND DEPOSITS

Customers' demand deposit accounts constitute the bank's largest liability. It is usually impracticable to delay the posting of the voluminous transactions in the deposit accounts, and the examining directors have an immediate problem facing them on their arrival to commence the examination. The assisting CPA can be instrumental in establishing control over the deposit ledgers by suggesting that a director observe the posting operation, allow no one to remove the posting media from the vicinity of the posting area until such media are examined, demand rotation of the posting clerks for the posting of the day's transactions preceding the verification date, and in general control the deposit ledgers and posting media until their examination is complete.

The various sections of the deposit ledgers should be listed (by adding or posting machine) and checked to the sub-controls and to the general ledger as of the verification date. Either the directors or the bank's employees may prepare the listings from the deposit accounts. If the employees perform the operation, the directors or the CPA should check or test the lists back to the deposit accounts and prove the totals of the listings to the extent necessary—and this depends on how remote the listing operation may be from the particular bank employee's normal duties.

The day's posting media may be examined and tested to the postings in the deposit accounts to the extent appropriate to determine procedures employed, internal control, and regularity and propriety of the media and postings.

Confirming demand deposit accounts can be problematical if the

verification date is at an interim date during a month. Care and diligence must be exercised in selecting the accounts to be confirmed as of an interim verification date more so than when verification is as of a month end or on a regular statement date. The CPA can determine the latest statement date and recommend procedures to be followed in the confirmation process. If bank statements are being mailed out as of the verification date, confirmation of selected accounts (as suggested by the CPA) may be effectively requested as of that date. If statements have been mailed out a week or two prior to the verification date, the CPA may recommend confirmation as of the statement date with a test of transactions in the deposit accounts selected for confirmation from the statement date to the directors' verification date. This confirmation problem exists because few companies or individuals would be in a position to confirm their accounts without first reconciling the bank statements to their records.

Whatever the statement or verification date, the CPA will recommend direct confirmation from depositors on a systematic basis. All accounts over \$1,000 with one hundred per cent of all accounts in selected sections, every fifth or tenth account, and various other methods of selection are means that the CPA has used and found to be effective. Under no circumstances should the directors allow the bank's employees to make the selections for confirmation.

Whether dormant accounts are carried in a separate ledger and under a general ledger control or within the demand deposit accounts, the entries in such accounts should be scrutinized, checks examined, and reviewed with an appropriate officer of the bank.

SAVINGS DEPOSITS AND CLUB ACCOUNTS

Listings of savings deposit and club accounts should be prepared in much the same manner as listings of demand deposit accounts, and such lists should, of course, be agreed to the general ledger controls. The accounts should also be reviewed and confirmed in a systematic manner. Additionally, all passbooks presented or mailed to the savings or club account tellers for a specific period (three to five days, for example) should be examined by a member of the examining committee and compared to the bank's records.

In addition to the foregoing verification, the interest paid should be checked by examining credits and proving computations in individual accounts on a test basis and by proving interest paid on an over-all basis for six months or a year. The authorized interest rate

should also be verified from the minutes of the board of directors. The CPA can demonstrate the mechanics of the interest calculation and the method by which it is entered both in the individual accounts and in the expense accounts of the bank.

DUE TO BANKS

Balances due to other banks should be listed and agreed to the general ledger control account or accounts as of the verification date. The banks concerned should be requested to furnish the examining directors with reconcilements of the accounts as of the verification date. The CPA will instruct and assist the directors on the propriety of the reconciling items and explain how such items should be verified in the bank's records.

CERTIFICATES OF DEPOSIT

The outstanding certificates of deposit should be listed from the certificates ledger by the directors or such a list should be prepared by the bank's employees and checked to the certificate ledger by either the directors or the assisting CPA. Dates of issue and maturity, interest rate, and amount should be included in the list, as well as the names of the payees. The total of the list should, of course, agree with the general ledger control as of the verification date.

Direct confirmation of certificates of deposit should be obtained from the payees and interest paid should be tested on an individual basis and in total for six months or a year, or since the last directors' examination. Redeemed certificates since the last examination should be examined and compared with the certificate ledger or register or both as to all details. Unissued certificates should be examined and numbers accounted for (if pre-numbered) to determine that no certificates other than those recorded are outstanding.

The CPA will instruct, supervise, or help the directors in any way in the verification of certificates of deposit, depending on the particular need or situation.

CERTIFIED CHECKS, BANK MONEY ORDERS, ETC.

The CPA will advise the examining directors to prepare or obtain and check a list of outstanding checks or bank money orders or both as of the verification date and reconcile such lists to the controlling accounts in the general ledger. The CPA will further advise the directors to obtain such checks daily as they are received in the mail

for a few days subsequent, examine them and compare them to the bank's check register (or carbon copy of such check retained for use as register) and to the lists of outstanding checks.

In addition, the CPA will instruct the examining directors to determine that no overdrafts resulted from the issue of certified checks or bank money orders.

CAPITAL STOCK AND SURPLUS

The capital stock ledger (or register) should be examined with respect to capital stock issued and unissued. The outstanding stock should be listed and agreed to the general ledger control and all unissued stock should be accounted for by examination of the unissued certificates and serial numbers.

Transactions in the capital stock account since the last directors' examination should be examined as to propriety, canceled stock certificates examined, etc. The CPA can supervise or assist in the verification of capital stock as the chairman of the examining directors deems appropriate.

Surplus accounts since the last examination should be reviewed and transactions vouched as to approval and arithmetic accuracy. These accounts may be discussed with the CPA concerning what accounting principles are generally accepted as to credits and charges to surplus accounts and whether or not the bank's entries in the accounts appear proper. The CPA, on reviewing the accounts, can also determine what verification procedures should be followed.

UNDIVIDED PROFITS

Undivided profits is an account in a bank's general ledger that is considered as a part of the capital of that bank. The undivided profits account represents the bank's earnings that have never been declared as dividends or transferred to surplus accounts. The net income of the bank (gross income less expenses, loan losses, taxes, etc.) is credited to the undivided profits account. Dividends, which may be declared by the board of directors, are charged to the account. The CPA can either analyze the changes in the undivided profits account since the last directors' examination or instruct the directors in the preparation of such an analysis. Generally, the account should include the net income of the bank (income less operating expenses, loan losses, taxes, etc.) reduced by dividends declared.

The income and expense accounts should be tested sufficiently by

the directors to give reasonable assurance that the net income is properly reflected in the accounts. The CPA will be very instrumental in giving the directors ways and means of performing tests and making analytic reviews of the accounts concerned so as to enable them to determine the reasonable accuracy of the income and expense accounts.

The CPA will also advise the directors to examine any dividends declared and paid and to examine the authorization for the dividends by the board of directors and regulatory agencies. Further, the CPA will advise the examining directors to investigate other direct charges and credits in the undivided profits account and establish their propriety.

OTHER SERVICES

While we have covered the major accounts common to all banks, and considered how the examining directors and the CPA can work together in the verification of these accounts, there are many other phases of the directors' examination in which the CPA can lend helpful services. Evaluation of internal control, for example, is a matter that the CPA seriously considers in all of his audit engagements, and his constant scrutiny of internal control enables him to recognize weaknesses, which frequently are easily corrected when analyzed. This can be an effective tool to the examining directors. The CPA can also be of service in reviewing the bank's accounting policies and procedures and suggesting and recommending changes that can result in more accurate reporting and improved record-keeping.

Directors' examinations, properly conducted and supervised, can be successful. Indeed, on their success may well depend the safety of the bank's assets and the future of the bank, which the depositors and stockholders alike have entrusted to the directors. Periodic examinations made in a proficient manner serve not only to detect existing irregularities but also tend to prevent their occurrence in the first place. The return on the investment of the examining directors' time will be the satisfaction that they have invested their time well and fulfilled their obligations to all concerned.