5-1968

National Bank Examinations: Do They Provide Adequate Protection?

Arthur A. Hiltner

NATIONAL BANK EXAMINATIONS: DO THEY PROVIDE ADEQUATE PROTECTION?

by

Arthur A. Hiltner

B.S.B.A., University of North Dakota 1967

An Independent Study

Submitted to the Faculty

of the

University of North Dakota

in partial fulfillment of the requirements

for the Degree of

Master of Science

Grand Forks, North Dakota

May
1968

This Independent Study submitted by Arthur A. Hiltner in partial fulfillment of the requirements for the Degree of Master of Science from the University of North Dakota is hereby approved by the Faculty Advisory Committee under whom the work has been done.

Lyle E. Steinmeier
(Chairman)

R. D. Koppenhaver

Ludwik Kulas

A. William Johnson
Dean of the Graduate School

Permission

Title National Bank Examinations: Do They Provide Adequate Protection?

Department Accounting

Degree Master of Science

In presenting this independent study in partial fulfillment of the requirements for a graduate degree from the University of North Dakota, I agree that the Library of this University shall make it freely available for inspection. I further agree that permission for extensive copying for scholarly purposes may be granted by the professor who supervised my independent study work or, in his absence, by the Chairman of the Department or the Dean of the College in which my independent study work was done. It is understood that any copying or publication or other use of this independent study or part thereof for financial gain shall not be allowed without my written permission. It is also understood that due recognition shall be given to me and to the University of North Dakota in any scholarly use which may be made of any material in my independent study.

Signature Arthur A. Holthe

Date May 21, 1968

ACKNOWLEDGEMENTS

The writer wishes to extend his sincere thanks and appreciation to Lyle C. Steinmeier, Associate Professor of Accounting, for his helpful criticisms, guidance, and generous assistance in the development of this study.

TABLE OF CONTENTS

ABSTRACT

The banking system is essential to the economy of the United States. The industry is a dual system and is composed of state and national banks with the national banks controlling the majority of the assets. The banks are subject to a variety of examinations by different federal and state authorities. Due to the importance of the banking industry, a question has arisen as to the adequacy of the protection afforded the banks' stockholders by these examinations. In addition, the suggestion has been presented that banks should be required to have an independent audit by a Certified Public Accountant.

As national banks control the majority of the assets of the banking system, the national bank examination is presented here with its strengths and weaknesses. In addition, areas where an independent audit would be valuable are pointed out.

Bank examinations are depositor oriented and provide adequate protection for them. In addition, the examiners work to determine the liquidity and solvency of the bank. While the results are valuable and informative to management, they provide little information to the banks' stockholders. It is in this

area of weakness, protection for the stockholders, that a CPA audit would provide the most assistance. Bank stockholders should be entitled to the same amount and type of protection as shareholders in other industries.

Therefore, as bank audits and examinations have separate purposes, they may be used to supplement each other. As the bank examination does not provide information to the stockholders, an independent audit is needed.

INTRODUCTION

The banking industry is an essential part of the economy of the United States. It is an industry that affects almost every adult person in the country who has a checking or savings account. Banks present the public with a variety of services and are unique as most of their business is in the safekeeping of their depositors' money. In very few other industries is the public's welfare so directly tied to the industry.

To safeguard the public's interest in the banking system, the government (federal and state) has set forth regulations to govern the actions of banks. In addition to governing the actions of the banks, the regulatory bodies have the right and the duty to examine the individual banks. These examinations are made at varying times during the year and are on a surprise or unannounced basis.

The regulatory bodies having authority to examine banks are the Comptroller of the Currency, the Federal Reserve System, Federal Deposit Insurance Corporation, and the States' Banking Departments. These bodies have arranged to accept each other's examinations to prevent an almost continuous examination and to avoid duplication of effort.

This paper will look into the examinations conducted by the Comptroller of the Currency on National Banks. As national banks have by far the majority of the deposits and assets of the banking system, this will include the majority of bank assets. In looking at this examination, areas of strength and weakness will be observed, and areas where an audit by a Certified Public Accountant would be beneficial will be pointed out. As banking is a large and important industry, controversy has arisen over whether or not banks should be required to have an independent audit by a CPA. This would provide protection for the bank's stockholders and additional protection for the bank's depositors.

The comptroller has set forth examination policy guidelines for the National Bank Examiners. These guidelines present the major areas for emphasis in the performance of the examination. It is these policy guidelines that will be presented here.

National bank examinations are intended to determine the operation, performance, and condition of the national banks. The various aspects of the examination have as their end result the determination of the liquidity and solvency of the bank. In addition, the examinations attempt to discover the legality of the bank's acts.

The scope of the examination may vary from bank to bank depending on the condition of the bank and the areas which are especially important to each individual bank. The Regional Comptrollers of the Currency have the responsibility of deciding the scope of a given examination. Therefore, the Regional Comptroller must insure that examinations are made in sufficient detail to uncover any policy or practice, or the absence of a policy or practice, that could be detrimental to the bank. Flexibility in the scope of the examination according to the history of each bank is necessary to allow maximum utilization of the bank examiners.[1]

---

[1] U.S., Treasury Department, Comptroller's Policy Guidelines for National Bank Directors, September 1964, p. iii.

CHAPTER I

THE NATIONAL BANK EXAMINATION

The Comptroller of the Currency, with the approval of the Secretary of the Treasury, has the authority to appoint examiners. These examiners will examine every national bank twice in each calendar year. The comptroller may waive one of these examinations. However, this waiver may only be exercised once during any two year period. Therefore, during any two year period, each national bank must be examined at least three times. While the examination is being conducted, the examiner has the power to make a thorough review of all the affairs of the bank. In conjunction with the review, the examiner has the power to administer oaths and to examine the officers and employees under oath. Upon completion of the examination, the examiner must make a full and detailed report of the condition of the bank to the Comptroller of the Currency.[2]

To assist the examiner in making a complete and valid examination, the comptroller has set forth a number of guidelines. In addition, as the examination

---

[2]U.S., Congress, House, Federal Reserve Act, H.R. 7837, 63rd Cong., 1st sess., 1913, p. 70.

of a national bank covers many areas, it requires personnel who are well versed in banking.

Loans and Discounts

Loans and discounts represent a significant part of a bank's assets. The evaluation of these assets is one of the most important parts of a bank examination. A large part of the examiner's decision on the condition of the bank, its management, and its service to the community, is based on his appraisal of the loan account.[3]

While appraising the loan account, the examiner makes a comprehensive analysis of the lending and collecting policies and practices of the bank. These policies should be clearly set forth in order to provide for effective supervision by the directors and the bank officers. The areas of authority and responsibility should be clearly established. Specific areas an examiner must consider during the examination include:

1) Does the bank have a program of sound lending policies?

2) Does the bank's overall lending policies indicate an awareness of the bank's responsibility to meeting the legitimate credit needs of the community?

3) Does the bank diversify the loans in its portfolio?

---

[3] Comptroller's Policy Guidelines, p. 1.

4) Does bank management recognize the need for complete and reliable credit information?

5) Does the bank set up realistic schedules for repayment of loans when the loans are made?

6) Does the bank enforce the repayment schedule?

7) Has the bank a program to periodically review the loan after disbursing the funds?

8) Does the bank actively attempt to salvage charged off loans?[4]

The examiner will not normally review all of the current loans. Instead a minimum line of credit will be reviewed depending on the size and general condition of the bank. A flexibility in determining the size of the minimum line is desired. For example, on occasion the examiner may want to avoid the large, well secured line and concentrate on the smaller unsecured notes. Normally all notes past due and any fixed credits are automatically reviewed regardless of their size. When the working of a minimum line does not cover a large amount of the loans, a random but representative sampling method may be used.

Guidelines set forth to aid the examiner to decide on the minimum size loan to be worked are:

1) Direct loans.

 a) When the total assets of the bank are less than 25 million, any line of credit equal to or exceeding ¾ of 1% of the gross capital structure should be reviewed.

---

[4]Ibid.

b) When the total assets exceed 25 million, lines of ½ of 1% or $500,000 which ever is less, must be reviewed.

2) Indirect loans.

a) The minimum line again depends on the size and general condition of the bank. Usually lines equal to or exceeding twice the amount of the direct lines should be reviewed.[5]

Sometimes in reviewing the loans, an excessive number of past due notes is encountered. These may be indications of poor credit selection, lax collection procedures, or depressed economic conditions. The examiner should comment when he encounters an excessive number of past due accounts. The Report of Examination has two classes of past due notes, statutory bad debts and other past due accounts. In determining the status of a note the examiner will refer to its repayment terms. Policies set forth by the Comptroller include:

1) Single payment notes - The principal balance is considered past due on the day after maturity.

2) Demand notes - The principal is considered past due when interest is due and unpaid for fifteen days.

3) Installment notes - Consumer, mortgage, or term business loans are considered to be completely past due when one installment is thirty days delinquent.[6]

An area that should be reviewed in conjunction with the review of past due notes is the bank's renewal policy. Renewal policy should attempt to achieve an

---

[5] Ibid. p. 2.

[6] Ibid.

orderly repayment of the loans and not merely a low ratio of past due notes by extending their maturity dates.[7]

Past due notes usually have a reason for being past due. These reasons may be due to the borrower or to weak credit administration or management on the part of the bank. Some of the common errors by the banks are:

1) Requiring incomplete credit information.

2) Technical incompetence of management.

3) A failure to arrange or to enforce repayment agreements.

4) Complacency by the bank shown by:

   a) Inadequate supervision of old customers.

   b) Depending on oral financial data.

   c) Optimistic views on known credit deficiencies.

5) Compromising established credit principles.

6) Loans made to known credit risks.

   a) Excessive loans to establish a business.

   b) Loans which are based on potential and not on existing net worth.

   c) Collateral loans without a sufficient margin of safety.

   d) Loans based on questionable security.

   e) Loans which are granted to poor moral risks.[8]

National banks will generally divide their loans by the type of credit involved. This division includes

---

[7] Ibid.

[8] Ibid. p. 3.

real estate loans, local loans, and timepay loans and is usually made according to the type of collateral, terms, and the purpose of the loan. While there is no set formula for these divisions, they do recognize basic differences in lending techniques with which the examiner should be familiar.[9]

In reviewing loans for business purposes or for agriculture, several credit factors must be examined. Among these are: financial statements, earnings, collateral, repayment terms, general economic conditions, trends, use of competent tax and accounting counsel, and providing for a continuity of management for the business.

Review of the consumer finance loan department emphasizes the performance of the paper and controls to prevent fraud. Performance of the paper refers to the manner in which the loan is being repaid and the loan's current status. The bank should have a program to verify all loans made or purchased. In addition, the practice of permitting dealers to receive payments on notes and contracts sold to the bank, unless rigidly controlled, should be discouraged. Any past due notes and repossession experience should be noted and carefully reviewed according to the dealer's financial position and any dealer reserves which are available for the bank's protection. The terms of dealer agreements, including delinquencies and repurchase agreements should

---

[9] Ibid. p. 5.

be carefully noted. A second area usually supervised by the consumer finance department is the financing of floor plans. Floor plans are financial agreements in which the dealer pledges the merchandise on his sales floor to secure bank loans to purchase the merchandise. Review of this type of lending usually involves a determination as to the credit soundness, terms, and the sufficiency of the inspection procedures.

The right to use the third loan classification, real estate loans, is vested in the bank. However, certain minimum documents should be maintained by the bank. These documents should include a certificate of appraisal, insurance, and evidence that the bank's interest in the form of a recorded mortgage, deed of trust or comparable instrument, does in fact represent a valid lien on the property. The credit review of a real estate loan includes the borrower's capacity to repay the loan as well as an appraisal of the security.

After performing a careful review of the classes of loans previously mentioned, the examiner can, with a discussion of loans and discounts with management, assess the credit lines. The examiner assigns these loans a classification based on his best judgment in regard to the degree of risk and the probability of orderly repayment.

In arriving at an unsatisfactory classification for the loans, the examiner should also consider factors other than those applying to each individual risk. These additional factors include: familiarity of management with current circumstances, the bank's loan loss record, ability of management to work out problem credits, and the relationship of the number of extra risk loans to reserves and to capital. Therefore, identical risks in different banks may call for a different treatment in each bank due to one of these additional factors. The unsatisfactory loan classifications the examiners use are substandard, doubtful, and loss.[10]

In order to be classified substandard, the loan must have some positive and well defined weakness or weaknesses which endanger the repayment of the debt. The loan must not be sufficiently protected by either the sound worth and paying capacity of the obligor or of the collateral pledged. A weakness which is potential but not realized is not sufficient cause for use of the substandard classification.[11]

The second classification, that of being a doubtful loan, has all of the weaknesses of the substandard loan. In addition, knowledge obtained from currently available information indicates that the weaknesses are of a serious nature and that repayment of the loan is doubtful. The probability of a total loss is high, but there are some outside factors which may strengthen the loan's status.

---

[10] Ibid. p. 6.

[11] Ibid.

The last classification, that of a loss, is used only when the loan is considered to be uncollectable. Its status is such that it does not warrant the bank's carrying it as an asset. When a note is classified in this category, it must be charged off by the bank. However, this classification does not mean the loan has no salvageable value, but just that its current status does not warrant continuing to carry it as an asset.[12]

An area which is examined in conjunction with the loans, is the interest rates charged on these loans. Bank examiners must be continually alert to any unlawful practices the bank may be engaged in. This applies especially to the amount of interest the bank contracts for or receives from its customers.

Internal Control

A national bank examination also includes an extensive review of the bank's existing internal controls. To assist the examiner, the comptroller has developed an extensive questionaire as a part of the report of examination. This questionaire is the basic examining tool in the area of internal control. Care should be taken in using the questionaire and any deficiencies revealed should be reviewed with management for corrective action.[13]

---

[12] Ibid. p. 7.

[13] Ibid. p. 31.

The comptroller has issued additional instructions to national bank examiners who find internal controls to be lacking. These instructions include:

1) Verify, on a negative basis, at least 20% of deposit accounts.

2) At least 20 % of the notes (based on the number of notes) should also be verified on a negative basis.

3) Audit all income and expenses of the bank for a period not exceeding 30 days to determine that all income has been correctly recorded and that all expenses are proper.[14]

If the bank has no internal audit program, the examiner should recommend that audit help be obtained. In banks having a full time auditor, the examiner should request a copy of the internal audit program and review the auditing performance against the program stated to be in effect.[15]

Fidelity bonds are a necessary protection for banks, but their importance is secondary to a good internal audit program. Fidelity coverage should be used as a supplement to an internal audit program and not as a substitute for it.

The bank auditor has the responsibility to protect the assets of the bank and to insure that the expenses, liabilities, and income are all properly recorded and collected. The introduction of data processing machines does not relieve the auditor of his responsibilities.

---

[14]"News Reports," The Journal of Accountancy, CXXII (October, 1966), p. 18.

[15]Comptroller's Policy Guidelines, p. 31.

Even though his procedures must be adapted to the new methods of record keeping, the auditor must still fulfill his obligations to the board of directors. The examiner has to make a review to ascertain whether the auditor and his department are fulfilling their function. When reviewing the bank records, if audit controls seem to be sufficient, the examiner should not hesitate to accept data produced by the automated equipment.[16]

Securities

Another area the examiner must be familiar with is the investment securities. The examiner must be aware of the principles of prudent investment, liquidity requirements, trading, and underwriting, as well as with the technical laws and regulations.

In analyzing bank investments, the examiner must be able to distinguish between investments and loans. An investment security must be marketable or negotiable in form and easily salable at a price in line with its value. While loans are usually negotiated directly with the borrower, investments are usually purchased through a third party or a broker.

Before purchasing investment securities, a careful credit analysis of the securities is as important as in making loans. In addition, a bank cannot delegate its responsibility for prudent management to a correspondent, brokerage house, or rating service. Each

---

[16] Ibid. p. 41.

bank is required to maintain a complete credit file for each type of security it holds. Public securities, omitting United States Government and Federal Agency Obligations, are included under the requirement above.

In examining the investment account, the examiner should decide the quality, market value, and liquidity of the investment. In addition, he must determine whether or not the bank is in compliance with the related laws and regulations.[17] Subject to reasonable bank judgment, a bank may underwrite and deal in public securities. Public securities of any one obligor may be held in excess of 10% of its capital and surplus. However, any securities held by the bank in excess of 10% of its capital and surplus must be public securities.

Normally banks are not permitted to purchase stocks for their own account. However, specific exemptions are granted for stocks of corporations engaged in safe deposit business, holding bank premises, international operations, providing bank services, small business investments, and others as authorized by the Comptroller of the Currency. An investment in the stock of the Federal Reserve Bank is required.[18]

The examiner must, in addition to evaluating the quality and market value of the investment account, consider the account's maturity position. A known

---

[17] Ibid. p. 13.

[18] Ibid. p. 15.

fact of investment is that credit and interest rate risks increase with the length of the maturity of the securities. Generally, the securities should be purchased to provide a reasonable proportion in short and medium term maturities and fewer long term maturities.[19]

In addition, an investment account should be adequately diversified. Concentration in securities of a company, industry, or municipality, violates a sound investment principle. The examiner must report all undue concentrations in the examination report. However, a concentration in securities of the United States Government is not subject to criticism as a credit risk.[20]

Fixed Assets

After completing his analysis of the investment account, the examiner will turn his attention to the bank's fixed assets. These fixed assets should not appear on the statement in excess of their fair value. If in the examiner's judgment, a write down of these assets is indicated, he may work out a program with management to achieve the desired results as soon as possible. Included in the furniture and fixtures account should be assets such as the bank's equipment, car, and advertising signs.[21]

---

[19] Ibid. p. 15.

[20] Ibid.

[21] Ibid. p. 21.

The current trend in banking appears to be toward leasing rather than buying bank premises. While no rigid formula is available to analyze the lease agreement, the examiner should carefully examine the provisions of the lease. He should study these in respect to the demonstrated and potential earning power of the bank and also compare the lease's terms and costs with other similar leases in the area.[22]

During the examination of the fixed assets, the examiner should direct his attention to the insurance. The insurance which should be carried includes coverage for fire, natural hazards and for public liability. In judging the adequacy of insurance, the examiner should relate the fixed assets to the replacement cost and not the book value. If in the examiner's opinion the insurance is insufficient, he should state this in his report.[23]

While national banks may finance the leasing of personal property, any property purchased for lease must have been acquired to fulfill an existing agreement. In addition, the examiner should look to see that the bank has plans for the releasing or disposition of the property after the current lease expires.[24]

---

[22] Ibid.

[23] Ibid.

[24] Ibid.

Kiting

The possibility of check kiting presents a threat to almost all banks. As this is a significant hazard, management must be continually on guard to prevent this practice. Kiting is when a depositor manipulates two or more checking accounts in different banks. The kite uses the time required for a check to clear the bank to gain an unauthorized loan from the bank without having to pay any interest. An example of a kite is when a depositor writes a check on bank "A" in excess of the money he has on deposit. He then deposits this check in bank "B" and draws a check on bank "B" in excess of his balance to be deposited in bank "A". This cycle is then continued and repeated over and over. The depositor must have calculated the exact number of days it takes his checks to clear the banks. If he does not, an overdraft will occur and one of the banks will be put on notice and will uncover the fraud.

Therefore, during the course of his examination, the examiner should ascertain if the bank's management has taken steps to uncover and prevent kiting operation. Policies the bank should have in effect include:

1) A general policy not to pay any checks against funds which are not yet collected from the other banks.

2) Establish a regular procedure to examine checking deposits when the check being deposited is signed by a party to the account.

3) The bookkeepers should be trained to recognize the kiting characteristics.

4) The bookkeepers should be instructed to report all suspicious activity in the accounts.

5) When the bank uses automated deposit equipment, checks should be built into the program to display uncollected funds.[25]

Earnings and Profits

In addition to reviewing the various assets of the bank, the examiner will look to the earnings and profits. These are indications of a sound and well managed bank. In appraising the condition of a bank, the earnings record is as important as in appraising an application for a loan. Therefore, analyzing the bank's earnings record can provide the examiner with a clearer view of the bank's management and condition. Items an examiner will look for in examining the bank's earnings include:

1) Are the earnings sufficient to support salaries and employee benefits to attract and maintain an adequate staff?

2) Is the bank able to pay competitive interest rates to depositors?

3) Can the bank pay large enough dividends to maintain confidence in and to assure a market for its stock?

4) Does the bank generate sufficient retained profits to allow the bank the capital growth to serve the community?

5) Do the earnings permit acquisition of a modern building and furnishings?[26]

---

[25] Ibid. p. 25.

[26] Ibid. p. 29.

Capital Structure

While looking at the earnings and profits of the bank, the examiner will also review the adequacy of the capital structure. In arriving at a judgment on the capital structure, the examiner should consider the following:

1) The general quality of management.
2) The liquidity of the various bank assets.
3) The earning history of the business and the amounts retained.
4) The character and the quality of ownership.
5) The amount of day to day expenses.
6) The degree of volatility of the deposit classes.
7) The general quality of operating procedures set forth by management.
8) The ability of the bank to meet the current and future credit needs of its trade area giving consideration to the amount of competition it faces.

When the examiner believes an increase in the bank's capital is necessary, this information should be sent to the Comptroller of the Currency by a separate communication.[27]

The last major area reviewed by bank examiners involves borrowing by the banks. Sometimes borrowing by the bank is necessary to permit them to meet the credit needs of the community. However, when borrowing results from poor management of the bank's assets, it

---

[27] Ibid. p. 30.

is subject to criticism. Borrowing is not considered to be involved, when the bank participates in the federal fund market. This is to be considered a purchase and sale of assets and not borrowing. The type of borrowing concerning the examiner is in the form of bills payable, rediscounts, bonds borrowed, or notes made by the directors or officers of the bank for the sole benefit of the bank.[28]

[28] Ibid. p. 27.

CHAPTER II

PURPOSE AND STRENGTHS OF THE EXAMINATION

A copy of the Report of Examination is furnished to the directors of the bank and a form is provided on which the directors must acknowledge receipt of the report. The report contains the result of the examination, suggestions, and required changes if any. The examination provides valuable information to the directors and to management on the condition of the bank. In addition, these examinations always have the element of surprise working on their side. These examinations, which usually start on a Friday evening or a Monday morning, are never announced in advance.

To take advantage of the element of surprise, the examination begins with a large number of examiners to assure control of all of the bank's liquid assets and to verify them as quickly as possible. This speed is also essential to the operation of the bank, because to tie up its cash, travelers checks, etc. for any extended period would be a considerable handicap to its operation. Therefore, as the examination proceeds, the unneeded men can be assigned to duties at other banks or returned to the home office.

The examination provides a valuable supplement to the bank's system of internal control. While a bank's internal control is quite extensive and comprehensive, the examination provides the bank's depositors with an extra safeguard of their deposits. In addition, the examination provides shareholders additional assurance of the quality of the management of the business they own. Due in part to the surprise nature of the examination, temptation and opportunity for defalcation by the employees are substantially reduced. The bank's management receives the benefit of assessment by an outside observer of its operations, policies, and practices which the bank may be planning to expand, curtail, or to continue.[29]

Bank examinations are designed specifically:

1) To review and appraise the bank's assets, as shown on the statement of condition at the close of the bank on the date of the examination.

2) To substantiate the nature and extent of the bank's liabilities.

3) To appraise the capital account as to its adequacy to protect the depositors and in serving the credit needs of the community.

4) To uncover any violation of the legal requirements.

5) To evaluate management and the soundness of its policies.

---

[29] William B. Camp, "Importance of Bank Examinations," Banking, LVII (July 1965), p. 38.

6) To offer suggestions and to initiate corrective actions.[30]

Therefore, in a broad sense, bank examinations are made to review the condition, performance, and operations of the bank. The primary purpose of the examination, whether it is appraising assets and internal control or evaluating management policies, is to determine the liquidity and solvency of the bank. This liquidity is both present and prospective. In addition, stress is also placed on the legality of the bank's acts. The scope of an examination may vary. It may include every phase of operation of a bank or it may place its stress in areas which deserve more emphasis due to their relatively greater importance to the condition of the bank.[31] The bank examination involves an exhaustive review of the bank's assets and policies and provides valuable information for the bank's management.

In 1967, the Comptroller of the Currency published in the Federal Register, a proposed regulation relating to bank accounting and reporting to stockholders. In the proposal, minimum requirements for banks reporting to stockholders, are set forth. These requirements include a balance sheet, earnings statement, reconciliation of capital accounts, and a reconciliation of reserve accounts. The Comptroller believes that the

---

[30]Herbert Bratter, "Do Bank Exams Replace Audits?" Banking, LVII (July 1965), p. 40.

[31]Camp, "Importance of Bank Examinations," p. 38.

proper reporting of the results are best achieved when the reported results are placed in the hands of the bank stockholders.[32] Therefore, if this regulation is put into force, bank reporting to stockholders would be comparable to that of other industries, except that at this time the reports need not be certified by an independent CPA.

---

[32] Ibid. p. 137.

CHAPTER III

CPA AUDITS

The use of CPA audits by bankers does not seem to be very extensive at this time. In fact, many of the smaller bankers believe their annual or semi-annual examinations substitute for audits. While these examinations are useful, a CPA audit would add to and expand the techniques applied. This would provide these bankers with additional assurances on the condition of their banks.[33]

Bank examinations and audits are not the same. Bank examinations are intended to protect the depositor, rather than the stockholder. While they review the assets and certain liabilities, they usually do not evaluate the results of operations. In addition, they generally do not use many of the procedures that independent certified public accountants would apply in arriving at an unqualified opinion.[34] A vice-president with one of the banks in Grand Forks, believes that CPA audits could assist the bank by tracing of income

---

[33]K.A. Randall, "The Importance of Bank Audits," The Journal of Accountancy, CXX (July, 1965), p. 21.

[34]Eugene L. Larkin, Jr., "Certification of Bank Financial Statements," The Journal of Accountancy, CXVIII (December, 1964), p. 60.

and employee transactions, reviewing expense checks and their vouchers, and by performing a confirmation of the notes receivable as an outside observer. He believes that the examinations which the bank is now subject to do not cover these areas in significant detail. For example: they very seldom confirm any of the notes receivable. Bank examinations stress solvency and the legality of the banks acts. However, the scope of the examinations seldom include a direct verification of the bank liability accounts. This verification is a normal part of a CPA audit.[35]

Normally bank examinations are conducted to protect the depositors and they are different in function from an audit. A bank audit is primarily to ascertain whether or not the books of the bank are kept in a manner that correctly reflects its financial condition. An audit seeks to establish that assets, liabilities, incomes and expenses of the bank are correctly recorded in accordance with recognized sound bank accounting principles.[36]

A bank audit is a quantitative analysis of the bank's assets, liabilities, income, and expenses to determine what does and what does not belong on the books. In addition, it is an evaluation of whether or

---

[35]R.M. Sommerfeld, "The Need for Bank Audits," The Journal of Accountancy, CXVII (May, 1967), p. 49.

[36]Bratter, "Do Exams Replace Audits?" p. 40.

not these various transactions are accurately shown in the banks records. However, an examination is primarily a qualitative analysis. Its primary purpose is to develop the value of the bank's holdings, their soundness, the legality of the bank's acts, the soundness of the capital, and the quality of management. The examiner and auditor have somewhat different objectives. Therefore, they often do not approach their tasks in the same manner. In addition they have both been trained to look at the same loan portfolio or the same deposit ledger from different viewpoints.[37] Therefore, it appears that the examination and the audit would supplement rather than replace or be replaced by each other. Each seems to have its place and its significant values.

However, there are inherent areas in banking which present problems to the CPA when he enters the banking field.

1) As banking is a highly specialized field of endeavor, the accountants entering this field must be equipped to handle these engagements.

2) Bank accounting utilizes a flow of information and a vocabulary which is peculiar to itself. It is not something to be learned overnight.

3) There are particular hazards involved in the audit which affect the rendering of an opinion. Items involving an ability to evaluate collateral in securing a loan.[38]

---

[37]Larkin, "Certification of Statements," p. 21.

[38]Sommerfeld, "Bank Audits," p. 52.

While these areas pose problems, they are not insurmountable, but they are problems which the CPA must consider.

An additional problem exists in overcoming the considerable amount of bankers resistance that currently exists. A recent survey taken by the Iowa society of CPA's in which a questionaire was sent out to 630 banks in Iowa, had enlightening results. Some of the more pertinent questions and their results were:

1) Does your bank engage CPA's to perform income tax services? Yes: 72%, No: 28%.

2) Does your bank engage CPA's to perform examinations or auditing services? Yes: 13%, No: 87%.

3) Does your bank engage CPA's to perform other services? Yes: 10%, No: 90%.[39]

From question number one it is apparent that bankers are aware of the abilities of CPA's. However, from questions two and three, (at least in Iowa), the bankers are making very little use of CPA's for other than tax work.

Also included in the Iowa survey was a request for reasons why CPA audits were not used. The reasons most often given were that the services were not necessary due to the supervisory and directors examination and that CPA audits were prohibitively costly. Other reasons given included: the possibility of adverse

---

[39]Ibid. p. 51.

reaction from the depositors, tried with unsuccessful results, feeling that the internal control was adequate, and lastly a belief that the CPA audit could not be substituted for the directors' examination.[40] This last objection is no longer valid as the CPA's audit can now be substituted for the directors' examination in all national banks. In addition, some of the other reasons given seem to be based on rather weak assumptions.

However, the issue of expense is raised by many bankers, in and out of Iowa. Bankers tend to believe that they are currently spending enough money on internal control and auditing. Therefore, they cannot see assuming the added expense that will result from an outside audit. Many CPA's would answer this objection by saying that it is just a cost of operation the banker must assume. However, as in most areas, the benefits to be obtained must be sufficient to justify the expense necessary to obtain the benefits. Other arguments against CPA audits are: banks are currently following good accounting principles as set forth by supervisory bodies and that the accounting profession does not have the capacity or the personnel knowledgeable in banking to handle the number of banks involved.[41] Most of the reasons given are not so great as to be impossible to

---

[40] Ibid. p. 52.

[41] "Independent Audits for Banks Debated as Deadline Draws Near," The Journal of Accounting, CXVIII (November, 1964), p. 24.

overcome. By contrast probably the majority of them would not be too hard to conquer. While those relating to the cost of the audit would seem to raise a formidable objection, these also could be handled if the value of the audit can be shown to outweigh its cost.

CHAPTER IV

CONCLUSIONS

The bank examination is a useful tool for providing information to control bank activities. It is designed to place its primary emphasis on the protection of the depositors. Therefore, due to this inherent bias in favor of the depositors, the shareholders of the bank are not given all the protection available.

The CPA audit is necessary to provide the bank's stockholders with needed information. The natural result of an independent audit is an assurance to the interested parties that in the auditor's opinion, the financial statements of the bank present fairly the financial position and the results of operations. Therefore, as the bank examination does not provide the stockholders with the information they need, CPA audits are needed to provide this additional information.

In addition, the national bank is not allowed to make public or release any of the information contained in the bank's report of examination. Therefore, if the bankers are required to or desire to give any information to their shareholders, it would have to be by the use of an audit rather than an examination.

It is difficult to understand why banks are not subject to the same disclosure acts as other industries. Perhaps it is due to the amount of supervision they are subject to and also the fact that the interests of the depositors in any bank overshadow by far the interests of the shareholders in the same bank. It is interesting to note that the majority of the arguments in favor of requiring certification of bank statements appeared to neglect or pass over lightly these facts. Banks are tightly regulated, controlled, and examined. In addition, the reason a bank examination is depositor oriented is due to the much larger interest of the depositors than the stockholders in the bank.

Thus while bank audits concern themselves with correct and honest record keeping and the review of these records; a bank examination is intended to promote and to maintain sound bank operating policies. Bank audits and bank examinations serve distinct and separate purposes which in effect complement each other. They both aid in protecting the interests of the depositors, the shareholders, and the integrity of the banking system.[42]

Therefore, while the bank examination serves its purposes, there is also room for the CPA's audit to serve its purposes. However, there is still the problem of the bankers' resistance to the CPA audits. This

---

[42]Bratter, "Do Bank Exams Replace Audits?" p. 40.

resistance will not be removed by simply telling the banker that this is another cost of doing business. The banker should be shown that the cost of an audit is more than offset by the benefits it brings. When the banker realizes that he can obtain more information and additional assurances on the condition of his bank, then he will accept the CPA audits without the need for legal coercion in the form of legislation.

BIBLIOGRAPHY

GOVERNMENT PUBLICATIONS

U.S. Treasury Department. Comptroller's Policy Guidelines for National Bank Directors. September 1964.

U.S. Congress. House. Federal Reserve Act. H.R. 7837, 63rd Cong., 1st sess., 1913.

PERIODICALS

Bratter, Herbert. "Do Bank Exams Replace Audits?," Banking, LVII July, 1965), 41.

Camp, William B. "Importance of Bank Examinations," Banking, LIX (April, 1967), 38.

"Independent Audits for Banks Debated as Deadline Draws Near," The Journal of Accountancy, CXVIII (November, 1964), 22.

Larkin, Eugene L. Jr. "Certification of Bank Financial Statements," The Journal of Accountancy, CXVIII (December, 1964), 59-61.

"News Reports," The Journal of Accountancy, CXXII (October, 1966), 18.

Randall, K.A. "The Importance of Bank Audits," The Journal of Accountancy, CXX (July, 1965), 21-22.

Sommerfeld, R.M. "The Need for Bank Audits," The Journal of Accountancy, CXVII (May, 1967), 49-53.