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Auditing and Other Services for Banks

Except for specialized banking publications, little has been published on bank accounting in current periodicals. This article describes various types of banks and the kinds of services performed for them by CPAs, pointing out special audit problems and techniques.

Classification of Banks

Banks may be classified into two broad groups: (1) commercial and (2) noncommercial or "thrift" institutions. Thrift institutions include savings banks, credit unions, and savings and loan associations. Their business is normally oriented to the local community, the individual consumer (retail banking) and smaller commercial financing. While credit unions and savings and loan associations are technically not banks, they have very similar characteristics and operations and are referred to as such for the purpose of this article. Commercial banks on the other hand are oriented to large commercial financing (wholesale banking), often have both domestic and international operations and primarily service corporate customers. The various subsidiary corporations (such as Edge Act Corporations, leasing subsidiaries, etc.) often formed by commercial banks are included in the category of banks for the purpose of this article.

Size of Banks

Large banks (i.e. those with deposits between $500 million to $1 billion and over) usually have the following characteristics:

- Either or both retail and wholesale operations;
- Subsidiaries specializing in leasing, mortgage servicing, etc.;
- Internal audit departments (and audit committees);
- Large departments with distinct operating functions and internal accounting control systems;
- Sophisticated internal reporting systems;
- Most operational and accounting applications on a computerized basis (probably through an in-house computer); and
- Centralized accounting systems.

Medium size banks (having deposits between $100 million and $500 million) would also have many large bank characteristics.

Small banks (i.e. those with deposits between $1 million and $100 million) usually have the following characteristics:

- Either or both wholesale and retail operations;
- No subsidiaries;
- Small or no internal audit departments;
- "Departmentalization" to varying degrees with separate operating functions and internal accounting control systems;
- Basic internal reporting systems;
- Operational applications which are semi-automated or computerized to the extent of using outside service bureaus or time sharing computers; and
- Either centralized or noncentralized accounting systems.

Origin—Domestic and Foreign

A domestic bank is one that is organized under a state or federal charter. State chartered banks include commercial banks, savings banks, credit unions, and savings and loan associations. These banks are supervised by the various state banking departments. Federally chartered banks include national banks, federal savings and loan associations, and credit unions. National banks are supervised by the Comptroller of the Currency. Federal savings and loan associations are supervised by the Federal Home Loan Bank Board and are supervised by the Board of Governors of the

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Federal Reserve System. If any type of bank has its deposits insured by the Federal Deposit Insurance Corporation (FDIC), it would be supervised by that agency also. Domestic banks tend to have both corporate and noncorporate customers, wholesale and retail operations, and large and small transactions.

A branch or agency of a foreign bank doing business in the United States must obtain a license granted by the state in which it operates. Each state has primary jurisdiction over whether foreign banks will be allowed to operate and the various state banking departments have supervisory authority over them. At the time of this writing, however, federal legislation is in process, which if passed, would have the federal government assume some of the regulatory powers over foreign banks in the United States. This legislation generally places controls over interstate branching and the obtaining of deposit insurance similar to those controls placed on domestic banks.

In the past, foreign banks, unlike domestic banks, were not barred by the McFadden Act from establishing branches in other states, and they were not barred by the Glass Stegall Act from having certain "nonbanking" subsidiaries. (Nonbanking subsidiaries are those subsidiaries which are engaged in business which the regulations of the Board of Governors of Federal Reserve have defined as outside the scope of financing or normal banking business, e.g. a securities underwriting subsidiary.) Under the new federal legislation, foreign banks would be barred from establishing any new subsidiary of this type.

The expansion of foreign branches and agencies in the United States conforms to the pattern followed by the bank expansion abroad during the 1950's. During that period, domestic banks followed their U. S. corporation customers, who were expanding abroad, to give them better service on a global basis and to participate in the overseas capital and money markets. Similarly, in the late 1960's, foreign banks expanded to the U. S. in the form of branches and agencies to service the influx of newly-formed U. S. subsidiaries of foreign corporations, which had themselves expanded to the U. S. and to participate in the U. S. capital market. Branches and agencies of foreign banks, therefore, are mainly involved in financing of international transactions. In many cases, they function similarly to the international departments of large commercial banks in that they deal heavily in letters of credit, acceptance financing, foreign exchange, and short and medium term domestic and foreign lending. Their operations are primarily wholesale and commercial in nature and therefore usually they do not include such retail functions as branching and consumer lending. Small foreign branches and agencies tend initially in many cases to deal primarily in the short-term/high turnover money market activities of federal funds, and Euro and U. S. dollar placements. In addition, foreign branches and agencies act as "clearing" vehicles for U. S. transactions of head offices.

Audits of Banks

Why Have an Audit?

Except for the financial statements of bank holding companies of certain commercial banks which come under the jurisdiction of the SEC, domestic banks are generally not required to be audited. Bank holding companies, having securities registered with the SEC, are required by the SEC to have CPAs annually certify the financial statements for the bank holding company itself, the underlying bank and any other subsidiary defined as "significant" in the SEC regulations. Bank holding companies, not having securities registered with the SEC, (those with less than 500 stockholders) are subject to the regulations of the Board of Governors of the Federal Reserve System and require, under certain circumstances, independent audits of the bank holding company and the underlying bank. Domestic banks are, however, examined by the regulatory authority which supervised them, that is, the state banking departments, the Comptroller of the Currency, the Board of Governers of the Federal Reserve or the FDIC. In addition, directors or trustees of domestic banks are usually required to perform annual examinations of their banks either themselves, or with the aid of internal auditors or independent CPAs. Similarly financial statements of branches and agencies of foreign banks are not required to be audited by CPAs. They are, however, examined by the regulatory authority which supervises them; namely, the banking department of the states in which they operate.

Management of banks not required to be audited by CPAs may nevertheless elect to have annual CPA audits because they recognize the value of independent audits.

In many cases, regulatory agency examiners reduce the scope of their examinations when banks have

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been audited by CPAs. In other cases, local CPAs will be asked by parent organizations to perform audits of their branches or major subsidiaries to aid in controlling or monitoring these physically remote entities. Requests for audits may also originate from independent auditors of the foreign parent bank who consider the entity to be material to the scope of their examination of the parent bank or for other particular reasons.

Control Considerations in Audits

The banking industry has certain characteristics that present substantial control problems to the independent auditor. Banking is a business which deals with a high volume and large dollar amount of transactions involving a highly liquid and fungible commodity; namely, money.

The liquid nature of account balances to be audited presents special control problems. For example, because of the highly liquid and fungible nature of funds, a bank employee can embezzle large amounts of money by merely juggling the accounts with less chance of being "observed" than employees in other organizations. This inherent risk requires the auditor to pay particularly close attention to the controls over bank assets—to ensure that the system of approvals and authorizations surrounding bank funds is adequate and functioning.

Assets of the bank (and those trust assets which are not assets of the bank) often consist of negotiable instruments, such as stocks, bonds and certificates of deposits held in vaults. In addition, banks have numerous other types of negotiable instruments in the various departments needed to transact business. Such instruments include official checks, teller's checks, traveler's checks, passbooks, foreign exchange contracts, letters of credit and savings bonds. To protect the bank from loss due to theft or unauthorized use, adequate physical and authorization controls must be in existence and functioning at all times.

Transactions take place between the customers of banks and between other banks at tremendous volume and speed. Corporate customer accounts and the bank's accounts with other banks turn over drastically from day to day. This situation makes computerization, of one form or another, almost a necessity. Because computers are usually necessary to handle the volume and rate of activity, audit trails and physical audit evidence are somewhat limited and can take very different forms than found in other industries. A large portion of audit evidence consists of volumes of bookkeeping tickets, transaction documents and computer runs which are often difficult to interpret because of the number of parties and banks involved in each banking transaction. This, therefore, requires a sharp "audit eye." The auditor must be able to look behind the paper work "maze" to the substance of transaction or account activity.

Surprise Audits

One method of testing the effectiveness of the internal controls surrounding liquid and negotiable assets and transaction accounting is the surprise audit. A surprise audit begins on a date and at a time selected by the auditor and is unknown to the officers and employees of the bank. It starts by simply walking into a bank, branch or agency and taking control over selected assets, documents and bookkeeping records. Gaining access to the bank will usually take place prior to commencement of the day's operations to permit the auditor the ability to perform his audit tests unhampered by bank operations and to minimize disturbance to bank employees and customers. (Of course, an open letter, authorizing access to the bank entity, is obtained from an officer who can authorize such an audit and whose signature will be readily recognized by other bank officers and employees. Usually this person will be the president or comparable officer.)

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Taking control of such records as the general ledgers and certain major subsidiary ledgers allows the auditor to test to see that the general ledger, as of the close of business of the previous day, is in proof. In light of the high volume of large dollar transactions and the fungible nature of money transactions, it is important that all transactions be processed and the ledgers be balanced at the end of each day. Any "balancing items" or suspense items must be investigated to ensure that they constitute only items which are temporarily "in process" and which will be cleared out the next day or in the very near future. Where a manual system is in place, proving that the ledgers are in balance can be accomplished by actually taping the ledger cards. Proving, of course, should be accomplished as soon as possible so that bank records can be released and bank operations will not be hampered to any unnecessary degree. If the bank is automated, the auditor will normally take control of the significant computer files and perform similar reconciliation

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checks. The auditors may obtain duplicate tapes or files of bank records. By capturing bank records in this manner, the auditor is free to perform his audit tests at his convenience, in any detail, and with minimum inconvenience to computer operations.

In addition to controlling manual or automated records of the bank, bank vaults (where negotiable instruments such as securities, traveler's checks and official checks, and other instruments are kept) must also be controlled. There is usually one main vault and various department vaults used to control and protect securities in process and working supplies of negotiable instruments. In addition to vaults, there may be other devices such as cash boxes and locked cabinets which may also have to be controlled.

Vaults and vault-like devices are controlled in order to permit the auditor to count or account for their contents, and compare the results against the records of the bank. Numerical sequence of bank instruments will also be checked against bank records to ensure that they have been properly accounted for. For example, the first number on the official checks counted by the auditor should be the number subsequent to the number of the last official check issued and recorded as of the previous day. The auditor will also ensure that the unused supplies of negotiable instruments (like official checks) are being properly controlled and accounted for—that none is missing which might mean an unauthorized transaction may have occurred. Counts can be either on a 100 percent or test basis depending on the circumstances. These surprise examination procedures allow the auditor to check to see that such negotiables are adequately protected both physically and by a sound system of authorization, accounting and procedural controls. Again it is important to complete this phase quickly and release controlled items to allow bank operations to begin as soon as possible.

Because of the number of areas that must be controlled the first day of a surprise examination, and the initial proofs that must be performed, a relatively large number of auditors are typically required during that first day and possibly on subsequent days. Smaller CPA firms with limited personnel may have to obtain personnel from other audits or even outside personnel for the planning stage, and the first few days of a surprise audit. Typically, after this initial period, the audit team is substantially reduced to a much smaller core of audit personnel.

Examination by Regulatory Authorities Versus Audits by CPAs

Examinations by bank regulatory authorities (the state banking departments, the FDIC, Federal Reserve, Comptroller of the Currency, FHLBB and NCUA) are different from and similar to audits performed by CPAs. Examinations by bank regulatory authorities do not report on financial position or results of operations. Examinations are mainly directed toward the determination that the bank is competently managed and the value of bank assets affords adequate protection to depositors. Such examinations also concern themselves with ensuring that the bank complies with banking law primarily as to limits on lending to individual borrowers (lending limits), maintenance of a sufficient liquid reserve of assets to meet day-to-day deposit withdrawals and other cash outflows (reserve requirements), and the adequacy of capital to enable the bank to withstand moderate economic shocks.

Audits by CPAs on the other hand are usually directed toward the expression of an opinion on bank financial statements. There are, however, many variations in the types of financial statements audited, the scope of audit procedures applied and auditors' reports.

Examinations and audits have similarities too. Like audits, examinations may vary in scope from full examinations to limited scope examinations where for instance, only the credit worthiness of loan portfolios are examined or where only certain internal controls are reviewed.

By and large, for full surprise examinations by regulatory authorities, the same "first day" control procedures of controlling and counting negotiables and proving bank ledgers are performed, as are performed during audits by CPAs. Most full examinations are conducted on a surprise basis, but this depends on practical considerations. For very large banks, surprise examinations cannot be performed. In fact, in many cases, advanced notice must be given to large banks to ensure that necessary schedules are available to the examiners for their needs.

Both audits and examinations normally include similar audit procedures in the areas of collectibility of assets (mainly investments and loans), bank liquidity, foreign exchange exposure, review of the coverage of internal auditor's program, adequacy of records, detailed tests of balance sheet and income and expense accounts, and certain other analytical tests and comparisons. Examinations and audits both also normally include reviews and tests of internal controls, procedures and policies. However, the approach and objectives are somewhat different. In an audit, identification and tests of general and specific controls generally are aimed at determining the degree of internal controls and the extent that audit tests should be performed to render an opinion on the financial statements of the bank. In an examination, the examiner will try to formulate a conclusion on the adequacy of internal controls as it relates to the general soundness of the bank and as it relates to the degree of protection it gives to depositors and the banking system.

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Since regulatory examiners are independent of the bank in a similar way to outside auditors, it is, therefore, important for the independent auditor to consider the results obtained from regulatory examinations in determining the scope of his audit. Official regulatory reports are, however, confidential in nature and the regulatory authority may strictly enforce its right to prohibit banks from disclosing their content to anyone, even the independent auditor. If, however, such information is available, it can be meaningful to the independent auditor. Where two regulatory authorities have supervisory responsibility over a bank, their examinations are often coordinated and in fact conducted jointly. For example, a state chartered bank with deposits insured by the FDIC may be examined jointly by the state banking department and the FDIC and a joint report issued.

The timing of the regulatory examinations and independent audits is often coordinated to minimize the burden on banks and maximize examination/audit coverage. Although not common, meetings between the regulatory examiners and the independent auditors to discuss common audit considerations can aid both in improving their audit effectiveness.

Internal Controls

Like large and small commercial corporations, large banks generally have more levels of internal control than smaller banks. In large banks certain bank functions such as lending, deposit taking, etc., tend to be departmentalized or separated from other functions with each department having its own system of internal control. Furthermore, departmental duties themselves are also separated. In addition large departments often will have within their own structure both managerial and clerical supervisory levels of controls.

In smaller banks, on the other hand, detailed separation of duties is not often possible. When auditing small banks, therefore, the auditor must take this into account. Of course, during audits of both large and small banks, the possibility of management overriding the system of internal controls must also be recognized.

In branches, agencies and bank subsidiaries, an additional level of control may exist; that is the supervisory controls that the parent or the head office places over them. For example, approvals for certain large or specific transactions may lie outside their authority and rest at the parent or head office level.

Daily reporting by branches of customer activity to the head office is another control frequently used to ensure that customers' accounts are not overdrawn and credit limits not exceeded. These additional "interfacing" levels of supervisory control should be taken into account in the auditor's evaluation of the overall effectiveness of internal control.

EDP Considerations

It is particularly important for the independent auditor to fully understand the concepts of EDP environment in both a small and a large bank because most banks have, to some degree, computerized their systems. In a large bank, the EDP function will probably be in the form of a separate department which can almost be considered a service center. In this case, some of the guidelines established in the AICPA Audit Industry Guide, "Audits of Service-Center-Produced Records," should be considered for their applicability. This department is usually considered a very significant control area by the independent auditor in his evaluation of the overall system of internal control, because it interfaces with most operating and accounting functions. Many large CPA firms have developed computer audit software packages to aid in auditing "through" the computer rather than "around" it.

In a small bank environment where there may be only a mini-computer, the review of such controls would be approached differently. In some small banks the various department personnel may even process their own work instead of having it processed by designated EDP personnel. In this environment, where the EDP function can be considered as part of an operating department itself, and not as a separate unit, the auditor would have to evaluate the controls within the user departments which surround the data processing function. A small bank may use an outside service center to process certain types of activities or to perform all its accounting procedures. In this case, of course, the AICPA Audit Guide would definitely have applicability.

Year-Round Auditing and Coordination with Internal Auditors

The trend in auditing banks has been to have more frequent audit involvement throughout the year. For audits of large banks, like for audits of larger commercial companies, it is usually not feasible or effective to "cram" all audit work into the latter part of a reporting period. Accordingly, an audit approach based on coordination with the internal audit effort has developed as an effective way to "uncram" audit work. Like other large corporations, large banks usually have their own internal auditing departments and they are usually independent from other departments in that they do not have any operational duties. (These departments normally report independently to an audit or examining committee. In the case of branches or subsidiaries, the internal auditor may report directly to the branch manager or subsidiary president as well as to the head office or parent company.)

Participation by the outside auditor in the planning, scheduling, performance and reporting phases of inter-

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nal audits is an effective way to maximize audit coverage, avoid duplication of work, and improve audit effectiveness, and generally avoid higher audit costs.

Internal auditors can also serve as valuable "catch up" sources of information or serve as "eyes and ears" to some degree for independent auditors during their absence from the bank. The continuous contact with the bank by the internal auditors, provides a valuable tool for the outside auditor in planning an audit and better ensures that all significant audit areas are covered. If coordination cannot be arranged, to any sophisticated degree, the independent auditor should always review the progress of the internal auditor's schedule and evaluate significant findings prior to commencement of his audit (or at least during his field work). The independent auditor should also review selected internal audit reports and follow up the status of significant internal control comments to determine their impact on the audit approach.

Other Categories of CPA Services

In addition to audits, there are a number of other areas where CPAs can be of service:

Establishment/Set-up

Banks about to be organized often will request CPA firms which have the experience and expertise to aid in feasibility studies regarding type of office, location, market, profiles of competition, determination of gross space needs, layout plans, equipment selection, managerial and clerical staffing needs, compensation packages and employee benefit plans.

One of the most important services the CPA can perform for banks or branches is in designing operating and accounting systems. Having the proper operating and accounting system is particularly critical for banks because of their high volume of large dollar transactions and the liquid nature of such transactions and resulting balances.

CPA firms can also be of value to domestic and foreign banks in preparing the pro-forma financial statements forecasts required in their applications to state or federal regulatory authorities for new branches, agencies or subsidiary banks.

Reviews of Systems and Procedures

Periodic special reviews of operating and accounting systems and procedures by CPAs can be useful. Systems often need to be upgraded quickly, for example, from a manual system in the first few years, to an accounting machine or mini-computer system a few years later, to a time sharing computer and then perhaps finally to an in-house computer system. Because large banks are highly computerized, changing technology increases the need for banks to upgrade their systems in order to remain competitive. Banks also experience rapid growth in deposit size, and volume or types of transactions, which can make systems obsolete or cumbersome very quickly.

With each new system or system change, there is a need to modify existing procedures. Without procedures adequately matched to the system, or with procedures improperly documented and promulgated for all pertinent personnel, a good system could be ineffective. Having effective accounting and operating systems and related procedures is especially important, because a high turnover in bank personnel has become an increasing factor in both large and small banks. Ω

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