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Suggestions are made for audit frequencies and internal controls for some of the most vulnerable areas in the banking industry.

Avoiding Fraud and Irregularities in Financial Institutions:

A Control-oriented Approach

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The wave of bank fraud in recent years has changed the public perception of auditors. In the first half of 1992 alone, four of the "Big Six" accounting firms have been sued, and/or hit with record award, in association with their alleged negligence of collapsed thrifts[1]. While the "deep pocket" concept inevitably may have been adopted by creditors and government agencies in pursuing accountants — and law firms, in some cases — to recover losses, the prevalence of such claims in courts suggests that the perceived responsibility of auditors is ever increasing. Auditors now must demonstrate "due dilligence", both implicitly and explicitly during the audit process, in deterring and detecting fraud as their defence against potential negligence law suits.

While most of such increased expectation seems to be on external auditors, internal auditors are not escaping responsibilities in the process. The Foreign Corrupt Practices Act of 1977 emphasizes the importance of internal control system and coincidentally recognizes internal auditors as a key element of such systems[2]. The National Commission on Fraudulent Financial Reporting — commonly known as the Treadway Commission — further establishes that an effective internal audit function is a strong deterrent to fraudulent financial reporting[3]. The committee made two specific recommendations on internal audit activities:

(1) Internal auditors should consider the results of non-financial audits on the company's financial statements; and
(2) Internal auditors should have involvement in financial audits at the corporate level[3, p. 39].

Internal auditors, especially those in financial institutions, are now brought under the spotlight of public attention and are viewed as "the first line of defence in fraud"[4].

What comes with increased attention is increased responsibility — both moral and legal. The external auditors' responsibility for the detection of fraud arises from *Statements of Auditing Standards* (SAS) No. 53, "The Auditor's Responsibility to Detect and Report Errors and Irregularities", and No. 54 "Illegal Acts by Clients". As internal auditors do not attest financial reports to the public, they have only nominal *direct* legal responsibility. Nevertheless, there is implied *indirect* legal responsibility. Statement on Internal Auditing Standards (SIAS) No. 3, "Deterrence, Detection, Investigation, and Reporting of Fraud", defines internal auditors' general responsibility in fraud-related matters — especially when a material control weakness is encountered during assignments. It has been observed that an internal auditor who fails to notice or investigate indicators of fraud — which consequently leads to shareholder losses — could be held negligent in court[5].

The Committee of Sponsoring Organizations of the Treadway Commission has developed an "integrated framework of internal controls" to provide criteria of assessing and improving internal controls[6]. This document establishes that an entity must maintain an internal control system and that components of such a system should be "formally evaluated" on a regular basis[6, p. 35].

As the list of sponsoring organizations includes the largest and most influential accounting organizations — the American Institute of Certified Public Accountants (AICPA); the American

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Accounting Association; the Institute of Internal Auditors; the Institute of Management Accountants, and the Financial Executive Institute — it is conceivable that the requirements contained in the framework will be given significant weights in many court decisions. Thus, an audit department could substantiate its efforts of "due dilligence" by identifying basic elements of internal controls and conducting routine audits in vulnerable areas. Such substantiation will be particularly important in financial institutions as the public demand for their scrutiny tends to be higher than in other organizations.

The definition of internal control is broad in the framework and there are no specific current standards on audit frequencies. However, as the results of extensive discussions and interviews with federal examiners and external auditors, this article presents a "preferred" list of audit frequencies — as well as specific internal controls — for operating functions of financial institutions. This list should be useful to internal auditing departments of these institutions in planning and scheduling their audit activities.

Audit Frequencies

Based on the potential risk exposures of operation areas and their various individual characteristics, four audit frequencies are recommended: monthly, quarterly, semi-annually and annually. Table I is a summary of audit areas and their suggested audit frequencies. These frequencies are considered to be minimal requirements and should be strictly maintained. The auditees should be made aware of such intention of constant monitoring to maximize the deterrence effect. However, audits should be conducted on a surprise basis, and more often at times, to optimize the possibility of detecting errors and irregularities.

Basic Internal Controls

The AICPA industry audit guide *Audit on Banks* contains general internal controls that should be of concern to external auditors. Financial areas requiring only an annual internal audit review have similar controls to those prescribed in the audit guide. However, internal auditors have an operational focus. They also must interface with state and federal regulators and meet their requirements and imposed limitations. More specifc internal controls are thus needed for internal audit areas that are repetitively performed during a year. Following, are control recommendations for audits with monthly, quarterly and semi-annual frequencies.

Table I. *Summary of Audit Frequencies*

Timing of audits	Areas of audits
Monthly	Loans Compliance
Quarterly	Daily balancing Investments Due from banks Allowance for loan losses
Semi-annually	Overdrafts Other real estates owned/Repossessed assets Official cheques
Annually	Prepaid expenses Safekeeping Payroll Participations sold Purchased Expense cheques Bank premises, furniture, fixtures and equipment Travellers cheques Series EE bonds Collateral Treasury tax and loan Savings deposits Demand deposits Wire transfers

Loans

Loans in general represent the largest asset of the bank. There are four categories of loans: time and demand loans; real estate mortgage loans; retail credit and other consumer loans, and lease financing. The following controls are considered essential:

(1) A number control is maintained and a unique number is assigned to every new or renewed loan.

(2) Loan officers have definite loan limits, established by the Board of Directors.

(3) Notes are initialled by the loan officer making the loan.

(4) Note proceeds are always made by credits to accounts or by official cheques — not by cash.

(5) Notes signed in blank are never held in the bank.

(6) Notes that are paid or renewed are cancelled and returned promptly to the borrowers.

(7) Maturity notices and coupon books are mailed by a person other than the officer making the loan or holding the records.

(8) The Loan Committee of the Board reviews weekly all loans made, past due, and/or charged-off. The Board will review monthly loans over a material amount, e.g. $75,000.

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(9) All loans are reviewed for documentation before funding, and all new loans are reviewed and graded daily.
(10) Loans are made only in accordance with established policies approved by the Board.
(11) Credit reports are required on all loans.
(12) Notes, collateral and supporting documents are physically protected.
(13) Loans are reviewed periodically for collectability, and graded as to collectability and collateral coverage.

Compliance

Most financial institutions have specific compliance officers and/or a compliance department. Internal auditors thus would have only a secondary responsibility in monitoring compliance. Nevertheless, a key control objective exists in assuring the quality of compliance activities with various statutory and regulatory requirements, specifically:

(1) Record retention periods are set and reviewed at least anually to meet the various statutory and regulatory requirements.
(2) The bank maintains an updated bank policy manual covering personnel practices, lending policies and operating procedures.
(3) The bank has a disaster recvovery plan in place.
(4) The bank displays current FDIC insurance signs, equal housing lender sign, and community reinvestment map in the bank lobby.
(5) The bank has a employee education programme and maintains records of attendance in such programmes.
(6) The bank maintains and reviews dormant and inactive accounts.
(7) The bank follows specifications contained in the current *Comptroller's Handbook for National Bank Examiners* (for national banks) and/or Federal Reserve System's *Commercial Bank Examination Manual.*

Daily Balancing

This area, while important, has only two necessary controls:

(1) Balancing is performed daily.
(2) Identification and reconciliation of out-of-balance items are performed and cleared on a timely basis.

Investments

The type of securities that may be purchased by a bank are controlled by law and government agencies. Investment securities include corporate bonds and instruments issued by federal, state, and local government. Thus, the controls will include:

(1) Securities are kept in safekeeping with the Federal Reserve Bank or correspondent banks.
(2) All purchases and sales of securities are approved by a committee consiting of members of the Board.
(3) Monthly subsidiary records are balanced to the general ledger principal and interest-earned accounts.
(4) Monthly balancing and general ledger entries functions are performed separately by those not engaging in buying and selling functions of such securities.

Due from Banks

Due from banks are balances that arise from transactions related to cheque collection and other banking services between banks. Related internal controls are:

(1) Separation of the reconciliation and authorization functions.
(2) Reconciliations are prepared immediately after each bank statement is received and approved by a senior financial officer.
(3) A permanent reconcilement record is maintained on each bank.
(4) All entries to due from bank accounts must be approved by an officer.
(5) Reconciling items are followed up and cleared on a timely basis.

Allowances for Loan Losses

The allowance for loan losses is the estimated amount of losses in a bank's portfolio and is maintained by charges against operating expenses. Thus, the correctness of this account not only affects the presentation of the financial condition of the bank, but also its operation results. The importance of the four listed controls can not be overemphasized.

(1) All loans charged-off are reviewed and approved by the Board and reflected in the minutes.
(2) The allowance is reconciled monthly, showing charge-offs, recoveries, provisions, and is reviewed by the Board.
(3) Collection efforts are continued for loans charged off until the recovery potential is exhausted.
(4) Management and the Board review the adequacy of the reserve quarterly based on loan grades.

Overdrafts

There are four major internal controls that should be established with overdrafts:

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(1) Overdrafts are maintained as a separate account on the general ledger.
(2) Overdrafts under a certain amount, e.g. $5, are automatically paid with no NSF charges. Officer approval is required on all overdrafts over such amount.
(3) A daily subsidiary record is maintained of all insufficient fund items showing name, amount and date created. This list is reviewed by all officers each morning, and approval noted by book keeping. The following day, any uncovered items are shown on the overdraft report showing name, amount and date created. After ten days, a letter is sent demanding payment within five days.
(4) Overdrafts created by service charges are charged off at regular intervals. Accounts overdrawn for 30 days or more are charged off. Charge-offs of more than $25 are sent to a collection agency.

Other Real Estate Owned/Repossessed Assets

Other real estate owned may include both foreclosed properties held pending disposition and real estate other than bank premises. Real estate acquired through foreclosure should be valued at lower of its fair market value or the recorded investment amount. At foreclosure, if the fair market value is less than the recorded amount, a write-down would be recognized. There are five recommended controls:

(1) Subsidiary records on other real estate owned and repossessed assets are maintained.
(2) Supporting documents are maintained for all entries to this account.
(3) All acquisitions and disposals of such assets are reported to the Board.
(4) Proper insurance coverage should be maintained on properties carried in this account.
(5) All properties should be appraised at least annually.

Official Cheques

Official cheques, commonly referred to as cashier's cheques are cheques issued by banks and drawn on themselves for a variety of purposes. They should be controlled with these objectives:

(1) Separate general ledger accounts are maintained for each type of official cheque.
(2) Every type of official cheque is serially pre-numbered and the reserve stock of unissued cheques is kept under joint custodianship.
(3) A sign-out sheet is maintained for each official cheque issued.
(4) Keys to facsimile signing equipment are removed at the end of the day and secured overnight.
(5) A log list of facsimile should be kept and reviewed daily.
(6) Paid official cheques are balanced and filed daily.

Conclusions

Substantiating audit "due diligence" in a banking environment is no small task. However, the benefits of a systematic audit effort, such as the one mapped out in this paper, go far bayond the establishment of defence for auditors. As the judicial system is allowing shareholders more leeway to sue banks for negligence[7] the management would genuinely appreciate the positive assurance that could be brought forth by the internal audit function. Moreover, as the recently released SAS No. 65, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements", increases the requirements and responsibility of external auditors in evaluating and reperforming all facets of internal audit work, a competent and active internal department could also mean big audit fee savings for the management. There may be no better indicator for the existence of such a department than a rigorous and thorough audit plan with well spelt-out objectives and necessary coverage frequencies to monitor critical areas.

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