The Review of Internal Control of Savings Banks by Independent Public Accountants

By JOHN S. MOORE, CPA

Auditors and controllers give much time and thought to the vital concept of internal control in their banks. The following views on internal control in your savings bank are presented from the viewpoint of a non-banker, the outside accounting firm engaged to assist in the regular trustees' examination of your bank.

WHAT IS INTERNAL CONTROL?

Internal control has been defined as "the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies."[1]

This definition is broader than we sometimes think of it because it goes beyond accounting and financial functions. As you can see, the questions as to whether, say, reserve cash is under dual control or whether all officers and employees must take annual vacations deal only with one of the above mentioned four objectives—the safeguarding of assets. But, other objectives are achieved by means of periodic operating reports, statistical analyses, employee training programs, and internal audit. In manufacturing companies, particularly, internal control would include standard costs, time and motion studies, and product quality controls.

The system of internal control is the sum of many component parts. No bank has perfect internal control. No bank is without internal control. As a matter of fact, when a sole proprietor hires one employee, the enterprise will have some degree of internal control. Most banks have some particularly good control features; most banks have some weak spots.

Evaluation of internal control is an appraisal of the entire plan of organization and all coordinate procedures. This appraisal is expressed in terms that the over-all system is good, adequate, fair—almost always with some suggestions for improvements.

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[1] "Internal control," a special report by the Committee on Auditing Procedure of the American Institute of Certified Public Accountants, 1949.

THE NEED FOR GOOD INTERNAL CONTROL

Savings banks have grown to such a size, transactions are handled in such volume, and the organizations are so complex and spread out, that management must depend upon the reliability of reports and analyses in order to control operations effectively. Internal control is designed, among other objectives, to insure the reliability of accounting data so that management can control effectively.

Management is responsible for the prevention and detection of errors and fraud. It cannot know first-hand that errors and fraud do not exist but must rely upon a system of internal control to insure the likelihood that they will be prevented, or, if not prevented, that they will be detected. We might underscore these objectives of internal control: the prevention and detection of errors and fraud.

Without good internal control in your banks, outside examiners assisting in the trustees' examination would have to make detailed checks of many transactions. Because of the great volume of transactions made by your institutions, this would be a costly undertaking, so we make sufficient tests to determine the extent to which we can rely upon the accounting controls. The quality of internal control has a direct effect upon the amount of testing your outside accountant must do and, it follows, this has a bearing on the amount of his fee. When your internal control is good, he can be satisfied with a smaller volume of test checks.

Several sections of the New York State Savings Bank Law have been wisely conceived so as to require that certain important controls are built into the plan of organization and operation of every savings bank. Controls of this sort are not all required in the general corporate laws governing non-banking enterprises.

STATUTORY REQUIREMENTS

Section 246 of the Banking Law provides that "The board of trustees shall have the entire management and control of the affairs of the bank. . . ." Section 251 provides, in part, that "The board may . . . make by-laws, rules and regulations . . . for the election and appointment of officers and committees, and for their respective powers and duties . . . and generally for the transaction and management of the affairs of the savings bank." Clearly, the law places on the board of trustees responsibility for a system of internal control.

Section 235-6(e) provides that no investment may be made in any bond and mortgage except upon the written and signed certificate of two or more persons appointed by the board of trustees stating that the real estate affords adequate security for such investment.

Section 252 of the Banking Law requires that at least monthly a report of the purchases and sales of securities and the acquisition of every loan equal to or greater than a reportable amount made or acquired by the bank shall be presented at a regular meeting of the board or to each member of an executive committee of at least five members of the board. These requirements of the law for a periodic review of actions of the officers with respect to securities and mortgage investments provide an excellent form of internal check for the plan of organization of every New York State savings bank.

In addition, internal review is required by Section 254 which provides that once in each calendar year a committee of not less than three trustees, none of whom shall be officers or salaried employees, shall examine the bank for the purpose of determining its true financial condition. In the conduct of such examination, inquiry shall be made into the policies of management for the purpose of determining whether such policies are sound and consistent with the requirements of law and whether adequate protection is afforded to depositors. The Section 254 committee examination includes a review of all activities of the bank, including actions of the board itself. This is part of the plan of organization.

WHAT ARE SOME OF THE CHARACTERISTICS OF A GOOD SYSTEM OF INTERNAL CONTROL?

The characteristics of a good system of internal control include:

- a plan of organization
- a system of authorization and record procedures
- sound operating practices
- adequate personnel

These characteristics are interrelated and each is essential. Omission of any one characteristic would result in a poor system of internal control. For example, a good plan of organization would fail to provide control if the bank is staffed with personnel not qualified to carry out prescribed procedures.

The *plan of organization* should provide for appropriate segregation of functional responsibilities. The plan should indicate a clear-cut definition of responsibilities, without overlapping of functions amongst officers, departments, or individuals.

Thus, the legislators have prescribed in the Banking Law important features of internal control for the plan of organization of every savings bank. It is expected that the boards of trustees and managements of the banks will provide for controls along similar lines in completing the plan of organization in more detail. The by-laws will specify the responsibilities of the officers but the complete plan of organization, some of it formalized in writing, but a great deal not in writing, will go into further detail as to the duties of the section heads and other employees of the several departments —all with the objectives of being definite, orderly, and offering adequate checks.

A good plan of organization will provide for clear separation of the functions of operations (not limited to banking floor operations), custodianship, controllership, and auditing. For example, a separation of operations from custodianship would require the separation of the functions of purchasing securities from receiving and custody of them. A good plan would separate from either of these functions the controllership responsibility of accounting for and reporting the transactions. Entirely separate from each of these functions is the protection against error and fraud afforded by the internal auditor.

Each of these types of departments —operations, custodianship, controllership, and auditing—should be responsible to a higher level of management, never to one another.

The same principles would apply within departments. For example, there would be separation in the mortgage department of the acquisition of mortgage loans from the servicing of the loans. If the acquisition of a loan were to be fraudulent, the servicing of the loan by another section in the mortgage department is likely to bring to light the defalcation.

The second characteristic of a good system of internal control would be a *system of authorization and record* *procedures* adequate to provide reasonable accounting control over assets, liabilities, revenues, and expenses. The system would include records and forms for the control of operations and transactions, and for the classification of data in a system of accounts. It is highly advantageous that the forms and procedures be prescribed formally in procedure manuals. The classification of data for tabulation in the accounting system should be controlled in a formal manner in a carefully devised chart of accounts in which is described what shall be contained in each account.

Third, a good system of internal control includes *sound practices* as to controls in the organization. This primarily requires a division of duties departmentally as well as individually. This is equally applicable to officers and non-officers. Briefly, no person should be in the position of both authorizing a transaction and recording it or having custody of the asset.

Fourth, good internal control requires having *adequate personnel*. Employees should be carefully selected initially and properly instructed in the procedures to be followed. The work should be reviewed and effectively controlled by supervisors.

WHY DOES THE OUTSIDE ACCOUNTANT REVIEW INTERNAL CONTROL?

You will recall that Section 254 provides that the examining committee must determine whether adequate protection is afforded the depositors. Adequate protection means more than, say, sound investment policy, adequate liquidity, or sufficient insurance coverage. It also encompasses good internal control.

This aspect of the Section 254 examination is underscored each year by the deputy superintendent of banks in his letter to the examining committees of all savings banks. He lists among the matters for special consideration of the committee the adequacy of internal control and internal audit program.

In addition, we CPAs have our own professional law in the form of nine auditing standards approved by the general membership of the American Institute of Certified Public Accountants. One of the standards, a standard of field work, requires that "There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted."

Thus, our review of internal control is required both by Section 254 of the Banking Law, emphasized each year by the deputy superintendent of banks, and by one of our own professional standards.

HOW DOES THE OUTSIDE ACCOUNTANT REVIEW INTERNAL CONTROL?

Our audit working papers are divided into two files (1) the current working papers which constitute analyses, signed program sheets and other evidences to support the opinions we render in our report on examination, and (2) the permanent, or carry-forward, file. As its name implies, this file includes all material of continuing interest; for example, the bank's organization chart, copy of by-laws of the bank, our copy of your procedure manuals, and procedure write-ups prepared by us.

These procedure write-ups are prepared by us for all significant phases of your operations which are not formally written up in a procedure manual of the bank. Some of the activities for which we would have procedure write-ups include, for example, those of the safe deposit department, mortgage acquisition section, mortgage servicing section, life insurance department, and banking floor operations.

In our procedure write-ups we would record the bank's policies, procedures, forms, and personnel, together with our notations of particularly weak aspects of internal control and what recommendations we may have made to correct the weaknesses. We also might highlight particularly strong aspects of internal control.

When our examiner audits a sector of your operations he knows from your procedure manual or our procedure write-ups, and from a preliminary discussion with your supervisor, how your system is *supposed to be* operating. By making test checks of transactions, records, and files he learns how the system *is* operating. At the conclusion, he is required to bring the procedure write-ups up to date and make such comments as are appropriate.

We base our opinion as to the adequacy of the entire system of internal control on the review by the examiner-in-charge and partner or manager, of the procedure reviews by our assistants of all significant activities. If any controls are known to be weak, or if any areas present unusual control problems, further investigation will be made by the examiner-in-charge, manager, or partner. Where special experience on our part is required, in the case of machine accounting, for example, we would assign a staff member with special qualifications.

THE CONTROLLER'S FUNCTION

A key figure in internal control is the controller of the bank. An alert controller with lively imagination and energy can do much to strengthen the bank and help it grow. As you know, his functions can be classified as between accounting functions and the interpretive and control functions. I would stress the latter for effective controllership. They would include interpretation of financial facts, forecasting future results and requirements, development of standards of performance and procedure, checking adherence to established principles, policies, and laws, appraisal of policies, and origination of proposals for betterment.

The controller should report directly to the chief executive officer of the bank, thus insuring his independence of thought and action. He should have no operating or custodianship responsibilities. If he did, he could not very well provide effective control on his own actions. In my experience, the function of controllership is pretty well segregated in New York State savings banks, although occasionally one hears of a bank where one person has the title of vice president and controller and has both operating and controllership responsibilities. This can, of course, be weak.

Several years ago, NABAC issued a statement of principle entitled "The Functions of Control in a Bank." The statement refers to the officer in charge of the general functions of control as being responsible for accounting, interpretation, and internal auditing. By including auditing and controllership under one control officer this NABAC statement probably reflected the most common practice in all banks, commercial and savings, throughout the country. It is the most common practice in non-banking enterprises.

I believe that there is a slow but gradual trend toward making the internal auditor independent of the controller.

Happily, New York State savings banks are well in advance of the trend. A great deal of credit is due to the

New York State Banking Department, which has worked steadily to improve the effectiveness of internal auditing by recommending the appointment of the auditor by the board and the direct reporting to the board by the auditor.

THE INTERNAL AUDITOR'S FUNCTION

A great deal depends upon the internal auditor, the watchdog of internal control. He should have a natural liking for reviewing the work of others as opposed to doing original productive work. People who by their nature like to produce a product, so to speak, whether it be closing a mortgage loan, reappraising mortgaged property, or preparing financial statements, may not be suitable as internal auditors. An internal auditor can never be effective unless he has a natural liking for review work and unless he is fully aware of the importance of this function.

A good internal auditor must also have the personality qualities of being curious, objective, and persevering. When he comes across documents, transactions, or procedures that do not look quite right, he must have within himself a driving curiosity to find the explanation. He must have the courage to give his honest opinion —to insist on fulfilling what he considers to be his duty at the risk of being unpopular at times. A person who thrives on the goodwill and approval of his fellow bank employees (and there are many people who are built that way) might make a poor auditor.

When we review the work of an internal auditor during several examinations we get to know his ability and we have varying degrees of confidence in the many auditors we work with. Where we have confidence in the internal auditor, we can, of course, have that much more confidence in the records.

HOW DO WE EVALUATE THE EFFECTIVENESS OF A BANK'S INTERNAL AUDIT?

We like to find that the internal auditor is appointed by and responsible to the board of trustees. We like to find that the board knows him and invites him to meet with them at appropriate times. When we can with propriety, we try to aid in this connection by proposing that he be present with the controller when we have meetings with management and the examining committee. We like to see him make good periodic reports to the board—such reports not merely to be a dull recital of counting cash, examing withdrawal slips, etc., but a report that may simply state that the official (in some banks, approved) audit program has been carried out, together with an indication of his findings as to the number and types of exceptions, and what is being done to eliminate faults that give rise to exceptions. We like to observe that the auditor makes suggestions for improvements in operating procedures as to efficiency or control. We like to see replies from management as to suggestions being adopted or, if not being adopted, reasons why management did not agree with the auditor. Too often we see routine reports from the internal auditor from period to period without a word about exceptions found or suggestions for improvement.

In checking the internal audit department, we review the audit program, frequency check-off list, and, most important, the underlying work papers. The internal auditor's files should show positive evidence of work done. This would include analysis sheets and reconciliations dated and initialled by the auditor who did the work. The frequency check-off list should be dated and initialled by the auditor who did the work, not merely ticked off by the head of the audit department. Tapes of withdrawal slips, mortgage ledger cards, or depositors' ledger cards should be dated, initialled, and filed until after the dates of the subsequent Banking Department and the trustees' examinations. Specific steps in subsidiary audit program sheets should be signed as an evidence of just what the audit assistant did when, say, he tested withdrawal slips or reconciled a bank account. Our objective is to acquire sufficient evidential material to enable us to form an opinion as to whether the bank is, in fact, being audited effectively.

SOME DEFICIENCIES IN INTERNAL AUDITS

1. In many savings banks, the internal auditors need all available man hours to complete the steps in the formal audit program. This means that the staff is constantly working hard to keep on schedule. The work is done rapidly and tends to be done in routine fashion. It might be better in some banks if the volume of tests were reduced on some frequently-scheduled audit procedures so that the formal program requires 90 to 95% of available man hours. The time gained could be used to maintain sound over-all audit coverage by having special audit reviews of operations not regularly covered in the audit program. For example, if the withdrawal slips are examined for two days selected at random in each week and if the exceptions have not been significant, the scope might be reduced to one day in some weeks and the time used for an on-the-scene observation of procedures in the safe deposit department with the object of determining whether the bank is protected against fraudulent claims of losses by box lessees. A somewhat less concentrated work load might make possible a broader coverage of the bank's operations.

2. I recall one bank where the so-called surprise cash counts were always made between the first business day of the month and the date of the meeting of the board of trustees during the third week of the month. This scheduling enabled the auditing committee of the board to report a recent cash count at each monthly meeting of the board. Recently, I noticed that one auditor usually made a "surprise" cash count on the last Wednesday or Thursday of each month. A dishonest teller could take advantage of regular audit patterns. The auditor should make his tests with unpredictable and unorthodox timing from the viewpoint of operating employees. If Monday morning is an inconvenient time to count cash because the bank opens one-half hour early on Mondays, it might be a good time for an occasional surprise cash count.

3. Sometimes we see a lack of balance in budgeting audit time. Perhaps an auditor spends proportionately too much time checking floor operations at the main office as compared with the branches. The proper proportion for budgeting audit time might be the ratio among the offices of the number of accounts or the number of transactions with due allowance for past experience as to exceptions or losses and for quality of floor supervision.

We might find that the auditor examines documents for all new conventional mortgage loans and for no out-of-state insured or partially guaranteed loans. Audit attention should be budgeted with consideration of the dollar amount of loss potential and the likelihood of loss.

4. Sometimes we find that the internal auditor, being a highly respected and experienced employee having no access to cash, might be given custody of inactive depositors' ledger cards, might validate signature cards, might have responsibility for making all corrections at the tellers' window machines, or might maintain the depositors' ledger daily controls. Any of these activities, coupled with the access the auditor has to all bank records, might make the internal auditor, himself, the most dangerous employee in the bank with respect to ability to perpetrate fraud. The internal auditor should have no operating functions whatever. The test is—the audit staff should be able to leave the bank for a couple of weeks without hampering bank operations.

5. Sometimes an auditor will pre-audit; that is, approve a transaction before its execution. For example, perhaps no bills are to be paid unless first approved by him. If this is so, the chances are he will not examine bills after they are paid; and he would not catch an improper change in the payee's name, account charge, or amount. Auditing should be done after the fact, not before.

6. You might not agree with me, but I believe that a member of the auditing department who spends full time reconciling bank accounts should be classified as operating personnel, not auditing. The activity is too regular, too routine, and is 100% coverage. It would be better to have this work done in the controller's department and have the auditor do it occasionally but thoroughly on a surprise basis. If the auditor examines every check, why doesn't he examine every withdrawal slip?

The savings banker sometimes says to the outside accountant, "Your ideas on internal control are too rich for us. We can't afford it." We believe that a bank cannot afford not to have good internal control. Many times additional employees are not needed—simply reassignment of work. A large audit staff is not needed—simply a well-conceived program of testing with broad coverage and the element of surprise.

On the whole, internal control in New York State savings banks is good. With strong persuasion by the Banking Department, the internal auditors of all savings banks with which I am familiar are appointed by the board of trustees and, in practice as well as in form, have direct communication with the board of trustees. In this respect, the savings banks industry is more progressive than non banking enterprises where the internal auditor, more often than not, reports to the chief financial officer. Where savings banks have suffered significant losses from defalcations, a contributing factor has been weak internal control.

THE END
