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Procedures, Methods, and Techniques of Auditing a Bank

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PROCEDURES, METHODS, AND TECHNIQUES OF AUDITING A BANK

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INTRODUCTION

"Audit programs and procedures must be adopted which will result in reasonable assurance that all assets, liabilities, incomes, and expenses are properly recorded and included in accordance with the appropriate accepted principles of accounting; the representations of management must be supported by evidence and by a review of the accounting procedures in effect."[1]

Although the intent of this paper is to describe the procedures, methods, and techniques of auditing accounts peculiar to a bank, the foregoing auditing principle, general as it is, seems to be the gist of any audit--including a bank audit. This can be noted throughout the pages which follow.

I should also mention that the greatest portion of research done for the writing of this paper was concentrated on one bank whose activities and affairs I had the opportunity to observe and to participate in in many ways over a four year period.

Although most of my research was done within this one bank, I feel justified in presenting a paper based on these findings because this bank is one of some one hundred other banks which are all controlled by a single holding company. Furthermore, these banks are located in five different states and range in size from 1 to 400 million dollars in resources. I feel that the following methods, procedures, and techniques outlined can be applied to all.

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[1] Holmes, Arthur W., Auditing Principles and Procedures, Richard D. Irwin, Inc., Homewood, Ill., 1959, p. 146.

GENERAL

One of the first requirements in auditing a bank is that the auditor in charge have a broad knowledge of the banking business. It would be preferable for the entire audit staff to have a general understanding of banking operations, but for the auditor in charge such knowledge is an absolute must. The success of an examination depends entirely on direction and guidance.[2]

This first requirement is so basic yet it cannot be overemphasized. For example, were the fact known by the auditor that a bank is one of the most government regulated and scrutinized institutions in the United States, it may change much of his audit program. It is also important to know that banks have to adhere to many laws and regulations which other financial institutions do not.

Just as it is a prelude to any audit, the testing of internal control applies to auditing a bank as well--probably even more so since so many of a bank's activities and transactions involve cash or some other highly liquid asset. The increased temptation almost demands a corresponding decrease in opportunity by highly preventive internal control. It seems that those who have the general misconception that an auditor is out to catch crooks are probably as close to the truth as they will ever be if they are referring to the audit of a bank. The tables on the following pages were of much interest to me. Note that the figures given are actual amounts. No estimate or mention is made of losses not discovered or repaid misappropriations and embezzlements.

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[2] Corns, Marshall C., <u>How to Audit a Bank</u>, Bankers Publishing Co., Boston, 1956, p.27.

Losses from embezzlement of $10,000 or over for 1947-1948, reported by the Surety Association of America.[3]

Length of Concealment of Crime	Number of Losses	Dollar Amount
One Year or Less	9	$641,296.00
2 Years	4	85,921.00
3 Years	5	339,527.00
4 Years	1	35,000.00
5 Years	4	496,524.00
6 Years	1	52,843.00
7 Years	3	68,377.00
8 Years	2	136,000.00
9 Years	1	245,400.00
10 Years	4	339,332.00
11 Years	0	-0-
12 Years	4	216,601.00
13 Years	2	50,000.00
14 Years	1	40,220.00
15 Years	2	170,649.00
16 Years	0	-0-
17 Years	1	139,030.00
18 Years	2	199,000.00
19 Years	0	-0-
20 Years	3	314,707.00
21 Years	0	-0-
22 Years	0	-0-
23 Years	1	44,121.00
Unclassified	5	701,841.00
Total	55	$4,316,389.00

[3]Bulletin Issued by the National Association of Bank Auditors and Comptrollers, Chicago, 1949, p. 1.

Although an expression of an opinion as to the fairness of financial statements is still the primary objective of nearly every bank audit, it appears that the auditor should be more concerned with uncovering fraud, defalcations, and embezzlements while auditing a bank than when auditing a textile factory.

Since nearly all audits can be materially affected by the results of test checks of internal control, and since I feel there are few peculiarities to internal controls in banks as opposed to other industries, I am obliged to leave the detailed discussion of this subject for some later course.

In general, one of the greatest assurances an independent auditor can have that a sound system of internal control is in effect is the existence of a competently staffed and well organized internal auditing department. "Frequent and efficient internal audits are a basic requirement. Where a bank has no internal auditing, an independent qualified Certified Public Accountant should be engaged to install and supervise internal auditing and thereby provide many necessary safeguards."[6] For it is the internal auditor who is familiar with the details of every type of transaction, who is in constant proximity to all activities, and who is responsible for the safeguarding of assets, the accuracy and reliability of its accounting data, and who promotes operational efficiency within the bank.

By far the most satisfactory type of service is that type of audit undertaken by the bank's own audit staff, where the auditor: (1) is responsible to the board of directors alone;

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[6] Sjienkiewicz, Casimir A., "Problems of Bank Accounting & Auditing", The Journal of Accountancy, Oct 1957, p. 38.

The asset accounts normally included on a bank balance sheet which in some ways are strictly peculiar to bank operations, are grouped under the following sections and accounts: Cash; Balances Due from Correspondent Banks; Reserve Fund with Federal Reserve Bank; Investments and Securities; Overdrafts; Loans and Discounts; Accrued Interest Earned.

Naturally, more conventional accounts are also included, but they need not be mentioned in this paper.

Under the cash section are three major accounts: Cash; Cash Items; and Clearings.

Cash. Although the cash account is not characteristic of only banks, the procedures used to examine this account usually are. This is because actual cash on hand is a sizable amount--sizable not in relation to total assets but very sizable in relation to stockholders equity. The ratio of this relationship is generally about 20% depending on the velocity of money in the area.

Since the surprise element is more important to the examination of the cash account then to any other asset account, it is generally the first step in the physical examining process. There are a few major problems involved in this examination which should be considered.

First, it is an absolute must that working cash be available to tellers during bank business hours. It is also necessary that cash and all related cash accounts be examined simultaneously or at least that all such assets be under the control of the auditors during the entire cash examination. The fact that cash may be spread out among from 6 to 18 tellers does not simplify things.

For these purposes, then, it would be wise to arrange the audit to begin in the morning at an hour that will allow sufficient time for a proper verification of teller working cash before the start of bank business hours. In order to retain the surprise element, the audit date should be known only to the board of directors or bank president. The announcement of a morning cash audit can then be made to the tellers on the prior afternoon but AFTER all cash is under time lock. This will enable the tellers to be present at the time the cash vault is opened.

For the protection of both the auditor and the teller, the cash should not be counted or handled except in the presence of the teller responsible. All cash should be detail counted--i.e. counting by bundle cannot be relied on.

The total cash of each teller is then proved with the total of the teller's cash blotter of the previous day. It is then resealed in the teller's cash box until vault cash has been counted and all cash sheets are totaled and proved to the general ledger control.

During this time, cash related assets should have been under full control of the auditors.

Clearings. The clearings account represents all the checks drawn on other LOCAL banks which have been deposited or cashed during the day at the bank being audited. These checks will be exchanged for cash or its equivalent during the current or following day.

The items carried in clearings should be listed and proved to the general ledger control. They should then be sealed in an envelope along with a request to the drawee bank to send any return items directly to the auditor.

Cash Items. This account represents the total amount of items which cash has been exchanged for and which are temporarilly being held (because special handling is necessary) for exchange into cash or its equivalent in the next day or so. This includes such items as bond coupons, checks previously cashed for a non-depositor which have been returned for insufficient funds etc.

A list of all such items should be made and proved with the general ledger control. A description of each item, such as date, drawee, drawer, endorsers, date entered as a cash item, etc. should be included with the list of amounts. They should then be checked off on this list as each item is exchanged for cash in the next few days.

Also included in cash items are checks drawn on correspondent and other banks not local. These checks are put in transit, by mail generally, to the other banks for collection. Such items should be listed and proved in the same way clearings items are handled.

Under the second section of assets--Balances Due from Correspondent Banks--is an account for each correspondent bank. Direct confirmation should be made of every such balance. At the same time, statements for a period which goes 3 or 4 days beyond the audit date should be requested to be mailed directly to the auditor in charge. A bank reconciliation should be made of each account. All exceptions should be investigated and final disposition traced.

The Reserve Fund with Federal Reserve Bank section is much the same as the correspondent bank section, a distinction being made because of regulations involving required average reserve balances to be maintained. These accounts should be examined in the same manner as correspondent bank accounts with the additional verification that reserve requirements have been met.

The Investments and Securities section includes accounts for such items as city warrants and bonds, other municiple obligations, treasury bills, treasury notes, U.S. government bonds, etc.

The investment records should be totaled and proved to the general ledger controls. The bond or other instrument should then be physically examined and compared with the investment records. Direct verification must be made of any instruments being held in a correspondent bank for safekeeping.

The Overdrafts section represents the total outstanding balances of debit balances in customer checking accounts. This account is in the nature of a loan and is shown on the balance sheet between Investments and Securities, and Loans and discounts.

Overdraft balances should be listed at the same time credit balances in customer accounts are listed but a separate total for each is necessary. After the overdraft total is proved with the general ledger control, the amounts should be compared with the items listed on the bookkeepers daily list of such balances. Further examination may be necessary if some balances are large or of long standing.

Also, consideration should be given to the relative size of total overdrafts to total customer credit balances. Direct confirmation may be made of all customer balances at the same time.

The necessity of extending audit procedures in the examination of the Overdrafts account would depend on the quality of internal control.

The Loans and Discounts section comprises about 50% of total assets and from this viewpoint, is of major audit importance.

Included in this section are such accounts as: Commercial Loans, which includes all types of simple interest loans--i.e. time or demand loans, secured or unsecured loans, farm or merchant loans, etc.; Budget Loans, which include all discounted direct personal installment loans; Consumer Finance Loans, which includes all discounted indirect personal installment loans made on a conditional sales contract basis--the majority of which are auto loans; Real Estate Loans-Conventional, which includes all regular loans on real estate property made directly to the customer; FHA Title I Loans, which is the total of loans made to home owners for the repair, improvement or alteration of their homes. These loans are 90% guaranteed by the Federal Housing Administration under Title I of the National Housing Act; and

Veterans Loans, which represents the sum of loans made to veterans under the G.I. Bill of Rights for the purpose of purchasing or repairing of homes, business properties, farms, etc. These loans are guaranteed by the Veterans Administration.

Commercial Loans. The commercial notes should be listed and proved with the general ledger control account. Subsidiary liability ledgers which give total outstanding loan information per borrower, should also be listed and proved in the same manner.

The next step is to physically examine the notes to verify that each: (1) is a promise to pay; (2) is dated; (3) bears a customer's signature and a loan officer's initials--in handwriting; (4) is the original instrument or the originals existence can be verified; (5) is not past due; (6) and does not bear interest beyond legal interest rates. After these mechanics have been completed, the next and most important step is to determine the validity and soundness of each loan.

The total amounts of secured and unsecured loans should be determined. After allowing for materiality, the existence of collateral on secured notes should be verified. All large loans should be given a detailed examination. Also, loans totaling a large amount to a single borrower should be closely examined. Comment sheets and credit files may give much aid in this instance.

Direct confirmation should at least be made of all loan balances of relatively large amounts. If possible, every loan balance should be directly confirmed with the borrower.

Other things to be alert for while examining notes are: paid or renewed notes which are not clearly marked or stamped as such; notes signed in blank by a customer in anticipation of future borrowings; bank officer and director loans; and notes on which interest is long past due.

All real estate loans--Conventional, FHA and GI--are examined in approximately the same manner. Since FHA and GI loans are guaranteed, however, their examination would entail less emphasis on soundness. Verifying authenticity would be the major audit purpose. Many of the commercial loans audit procedures could be followed.

Since both Consumer Finance and Budget Loans are relatively small in amount, the accent in auditing is once more on the authenticity of the notes rather than their soundness. The audit procedure for commercial loans could be applied to both.

Again, the evaluation of internal control would play a major role in designing an audit program for these two accounts.

The Accrued Interest Earned account represents all interest earned on notes, bonds, and warrants but not yet collected. Debits to this account are normally determined by maintaining accrual ledgers for each rate of interest on which a running balance of both principal and accrued interest is kept. This is possible by daily debiting the principal balance of the appropriate rate for all new notes and crediting it for all payments. All interest payments are credited to the accrued

The liability section of a bank balance sheet generally include: Outstanding Checks and Drafts accounts; Demand Deposit accounts; Time Deposit accounts; and Dormant accounts. Only one account is included for accrued interest payable.

The Interest Accrued Not Paid account represents the total amounts of accrued interest owed on both demand and time savings deposits--i.e. regular savings accounts and certificates of deposit.

This account should be examined in the same manner as the accrued interest receivable account. There is one exception.

Since interest is paid each quarter on all savings accounts, a percentage of total savings can be substituted for a detailed inventory of the accrued interest payable. It is nearly as accurate.

Included in the Outstanding Checks and Drafts section are accounts such as: Cashier's Checks; Certified Checks; Expense Checks; Savings Department Interest Checks; and Personal Money Orders.

All of these accounts would be examined in the same way, however, the degree of auditor reliance on internal control would dictate the extent and detail of the audit program.

Unpaid register copies of each account should be listed and proved to the general ledger control. Those which are large in amount or long outstanding should be given close examination. Registers as well as the checks should be prenumbered and maintained in numeric order. There should be a paid and cancelled check or draft for each number for which there is NO unpaid register. Paid checks and drafts should be examined for authorized signatures, proper endorsements, and a stamped or perforated bank cancellation.

Demand Deposits include customer savings and checking accounts. Both should be listed and proved with the general ledger control accounts. Direct confirmation should be made in each case--for all balances if possible, but at least a good sample should be confirmed. It is even more important to confirm savings balances since no periodic statement is mailed the customer and there is also much less activity in a savings account than in checking.

All ledgers with large or frequent deposits or withdrawals should command the auditors attention--especially on the accounts of employees. Employees accounts should be examined in detail in any case.

Time Deposits are accounts such as Certificates of Deposit. This is nothing more than a savings account with a maturity date and represented by a certificate in place of a passbook.

No special auditing procedures seem to be necessary beyond those mentioned above for the audit of demand savings.

Under the Dormant Accounts section are included all demand savings and checking account balances which have had no activity (deposits or withdrawals) for a relatively long period of time--such as 5 years.

It is of utmost importance that such accounts be segregated from active accounts and be kept under lock and key by an officer of the bank. Long standing balances are of great temptation to a potential embezzler.

After proving the total of these balances to the appropriate general ledger control accounts, a detailed analysis should be made of each individual account. Every entry made to these general ledger accounts since the last audit should be traced and verified in detail. Direct confirmation should be made on each account.

Accounts within the capital section of a bank balance sheet seem to have no peculiarities from those of other industries and for that reason will not be mentioned in this paper beyond these remarks.

The only bank expense account which is of a peculiar nature is Interest Expense. This account should have been examined in conjunction with the examination of the Interest Accrued Not Paid account. Little would be necessary at this point if this had been done. In any case, all debits to expense covering Interest Paid on deposits should be verified by comparing the amount of interest expense with the corresponding credit to the Accrued Interest Payable account.

SUMMARY

There is no doubt that basic auditing principles and procedures apply to the audit of a bank as well as a clothing store. However, there does seem to be two questions which any public accounting firm anticipating the audit of a bank should ask themselves--i.e. (1) Do we have an audit staff with the necessary knowledge of banking? and (2) Does the bank have an internal audit department? A "yes" answer to both of these questions is the important "first mile" in auditing a bank.

At many points in this paper I have mentioned that direct verification is highly preferable or even a must in some auditing procedures. I have done so because in many cases this is the only possible method of verification--limited as it is.

Yet, it has only been recently that bankers have began to accept such verification as a normal and necessary auditing procedure.

One sample indicated that the direct confirmation method was used in about 60% of bank audits. If this is an accurate sample, and if this is due to the reluctance of bank management to allow the use of the direct verification method, then the independent auditor has another challenge to meet which could be the discourse of another research paper.

This research paper, submitted by James J. Miller, in partial fulfillment of the requirements for the Degree of Master of Science at the University of North Dakota, is hereby approved by the Committee of Instruction under whom the work has been done.

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