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Report to Congressional Committees

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FAILED BANKS

Accounting and Auditing Reforms Urgently Needed

GAO

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Comptroller General
of the United States

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The Honorable Donald W. Riegle, Jr.
Chairman
The Honorable Jake Garn
Ranking Minority Member
Committee on Banking, Housing
and Urban Affairs
United States Senate

The Honorable Henry B. Gonzalez
Chairman
The Honorable Chalmers P. Wylie
Ranking Minority Member
Committee on Banking, Finance and
Urban Affairs
House of Representatives

We found that internal control weaknesses continue to be a significant cause of bank failures and that the regulatory early warning system to identify troubled banks is seriously flawed. Accounting and auditing reforms are urgently needed and should be part of any plans to reform deposit insurance or recapitalize the Bank Insurance Fund.

Our recently issued report Deposit Insurance: A Strategy for Reform (GAO/GGD-91-26, March 4, 1991) contains a comprehensive set of proposals to strengthen the regulatory environment and the banking industry. This report, along with our report on regulatory enforcement entitled, Bank Supervision: Prompt and Forceful Regulatory Actions Needed (GAO/GGD-91-69, April 15, 1991) provides the analytical basis for the recommendations included in our comprehensive report on deposit insurance reform.

We are sending copies of this report to all members of the Banking Committees as well as to other appropriate congressional committees, federal banking and thrift agencies, the President of the American Institute of Certified Public Accountants, the Chairman of the Financial Accounting Standards Board, and other interested parties.

This report was prepared under the direction of Robert W. Gramling, Director, Corporate Financial Audits, who can be reached on (202) 275-9406 if you or your staffs have any questions. Major contributors are listed in appendix I.

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Executive Summary

Purpose

GAO has estimated that resolving troubled thrifts could cost $500 billion—much of which will come from taxpayers. In addition, the Bank Insurance Fund's reserves are dangerously low and the Fund needs to be recapitalized to avoid the need for taxpayer assistance. Accounting and internal control problems have contributed greatly to bank and thrift failures. If the expanded banking powers that the Congress is now considering are enacted without accounting and internal control reforms, losses to the Fund are likely to seriously worsen. This report analyzes financial reports prepared by bank management and regulators' examination reports for 39 banks that failed in 1988 and 1989 to identify (1) the impact of accounting and internal control weaknesses on those failures and (2) the critical need for reforms to minimize future losses to the Fund and taxpayers.

Background

During 1988 and 1989, 13,139 and 12,712 commercial banks, respectively, were subject to periodic examination by the three federal bank regulators—the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System. FDIC also serves as the insurer for the nation's banking system.

Bank management submits Quarterly Consolidated Reports of Condition and Income, known as call reports, to the regulators. These reports consist of unaudited financial information which is required to be prepared in accordance with federal regulatory requirements, which are generally consistent with historical cost-based generally accepted accounting principles (GAAP). Call reports serve as an early warning system between examinations. They are a principal means that regulators use to assess the financial condition of banks and to decide on the timing and extent of examinations. The reliability of the reports is vital to successful bank supervision.

Accounting, internal control, and auditing elements of the system of corporate governance are essential for a successful regulatory process. In our society, government regulation must complement, not replace, private sector efforts to ensure the soundness of the banking system.

Bank management and, in particular, boards of directors have a responsibility to operate banks in a safe and sound manner. Effective corporate governance requires internal controls, including bank directors' supervision of operations and preparation of reliable financial reports.

Internal controls serve as checks and balances against undesired actions and are essential for banks to operate in a safe and sound manner.

Banks subject to Securities and Exchange Commission regulation are required by law to maintain an effective system of internal controls and to prepare annual financial statements that are audited by an independent public accountant. Financial statement audits attest to the fair presentation of the financial statements in accordance with GAAP. Historically, these audits have not been used to help improve federal bank examination.

Despite the federal regulatory system of supervision and examination and private sector corporate governance, banks have been failing at record numbers. During the 46-year period from 1934, the year the FDIC was created, through 1979, 558 federally insured banks failed. During the 10-year period from 1980 to 1989, 1,085 banks failed or received assistance. In 1988 and 1989 alone, 427 banks failed. The large number of bank failures continued in 1990 with 169 banks failing.

Results in Brief

The early warning system provided by bank call reports is seriously flawed. The 39 failed banks' call reports did not provide the regulators with advance warning of the true magnitude of deterioration in the banks' financial condition. As a result of the asset valuations FDIC prepared after these banks failed, loss reserves increased from $2.1 billion to $9.4 billion. A major portion of the $7.3 billion deterioration in asset values was not previously reported because deficiencies in GAAP allowed bank management to unduly delay the recognition of losses and mask the need for early regulatory intervention that could have minimized losses to the Bank Insurance Fund.

The key to successful bank regulation is knowing what banks are really worth. The 39 bank failures are expected to cost the Fund $8.9 billion, including losses of $7.5 billion by 4 banks with assets over $1 billion. Large banks present a major threat to the solvency of the Bank Insurance Fund and need closer scrutiny.

The corporate governance system upon which successful regulation depends is also seriously flawed. Of the 39 banks, 33 had serious internal control problems which regulators cited as contributing significantly to their failure. Had these problems been corrected, the banks might not have failed or their failure could have been less expensive to the Fund.

Many of the 39 failed banks did not obtain an independent audit in their last year prior to failure. Without an audit, a troubled institution's management can more easily conceal its financial difficulties.

Audits would enhance both the corporate governance and regulatory functions. In addition, the roles of both management and the auditors would be strengthened if they were required to assume responsibility for assessing and reporting on the condition of internal controls, a significant cause of bank failures.

Principal Findings

Call Reports Failed to Provide Early Warning of Impaired Asset Values

For the 39 banks, FDIC found that call reports prepared an average of 6 months prior to the banks' failure overstated the values for loans—the banks' single largest asset category—by $5.2 billion. FDIC also determined that banks reported values of repossessed collateral substantially in excess of market value and adjusted these asset values down by $0.8 billion after failure. The loans and repossessed collateral accounted for $8.1 billion of the total $9.4 billion loss that FDIC found after the banks failed. (See pp. 19 to 25.)

Accounting rules are flawed in that they allow bank management considerable latitude in determining carrying amounts for problem loans and repossessed collateral. Recognizing decreases from historical cost to market value has an adverse effect on a bank's reported financial condition. This gives bank management an incentive to use the latitude in accounting rules to delay loss recognition as long as possible. As a result, inaccurate call reports impede early warning of troubled banks and add to insurance losses.

Historically, accounting rules for determining losses were adopted to keep management from creating contingent reserves to cover up actual losses and manipulate the income statement. These rules stipulated that a loss had to be "probable" and "reasonably estimable" in order to be recognized. Ironically, an accounting principle created to prevent an abuse of the income statement has, in the case of banks, prompted an abuse of the balance sheet—specifically, of the amount shown for bank capital. Different judgments in determining when it is "probable" that a loan is impaired contribute to or allow varying degrees of results among banks.

In addition, for the 39 failed banks, application of accounting rules by bank management was more liberal for valuing troubled assets than that applied by regulators in the course of examining the banks. Accounting rules used by bank management in preparing call reports permit the use of asset values based upon presumptions of a normal market and that the seller is not compelled to sell. Market values realized by regulators when disposing of failed banks' assets were usually obtained under existing market conditions and were much lower as a result. (See pp. 25 to 28.)

Because FDIC consistently found that carrying values of problem loans and other real estate owned were overstated on the books of the failed banks, other banks have probably also overstated these asset values.

Also, if the Congress allows financial institutions expanded powers to engage in nonbanking activities through subsidiaries of a holding company, transactions between the insured institution and its parent and other affiliates should be closely monitored. Expanded powers are likely to result in significantly more related-party transactions between the insured institution subsidiary and the rest of the holding company structure.

There is uncertainty whether GAAP requires that transactions between related parties be accounted for based on their economic substance when it differs from the transaction's legal form. Further, the accounting rules for these transactions do not currently state how the economic substance of such transactions should be determined to guard against the insured institutions' resources being used to fund nonbanking activities through fictitious transactions. (See p. 30.)

Pervasive Internal Control Weaknesses Are a Major Cause of Bank Failures

GAO previously reported that internal control weaknesses contributed significantly to banks that failed in 1987 as well as for failed thrifts. In reviewing 39 banks that failed in 1988 and 1989, GAO has found that the same weaknesses were a major cause of bank failure. The weaknesses show serious breakdowns in corporate governance. (See pp. 34 and 35.)

Of the 39 banks, regulators reported 21 for board of director inadequacies. For example, a director ignored a regulatory cease and desist order and drained $255 million of bank capital to a mortgage company he controlled. The director's actions ultimately caused the bank to fail. Also, directors in some banks authorized dividend payments even though the banks were incurring losses. In some cases, the directors were the major stockholders and received a substantial portion of the dividends. (See pp. 35 to 37.)

Regulators also cited (1) 30 banks for deficient operating management, such as the lack of competent management and staff, (2) 13 banks for regulatory violations, such as kiting schemes and money laundering, (3) 35 banks for loan portfolio weaknesses, such as liberal lending practices, lack of loan policies, and missing documentation (including appraisals and financial disclosures), and (4) 31 banks for inadequate loan loss reserves. (See pp. 37 to 41.)

Internal control weaknesses also lead to inaccurate call reports. Regulators reported that 22 of the 39 failed banks filed call reports containing significant errors or irregularities. The misstatements included understating loan loss reserves and improper recognition of income. (See p. 41.)

Failing Banks Often Forgo an Independent Audit

Pervasive internal control weaknesses are exacerbated by the lack of a mandatory audit requirement for all banks. Of the 39 failed banks, 4 were never audited—the largest bank had total assets of $400 million prior to failure. In the year preceding failure, 23 of the banks were not audited. Also, 6 of the 23 were not audited in the second year preceding failure. Twenty-one of the 23 banks did not issue financial statements during these years and 2 issued unaudited financial statements. Without the discipline of an audit, troubled institutions are more able to cover up their financial difficulties. (See pp. 41 and 42.)

Improved Independent Audits Can Strengthen Bank Internal Controls

Independent audits are a critical component of corporate governance and can enhance the effectiveness of the examination and supervision process. However, these audits need to comprehensively evaluate internal controls to improve their usefulness to bank management and the regulators. The audits can be aided by requirements for truly independent audit committees to enhance the reliability of financial reporting. As the Report of the National Commission on Fraudulent Financial Reporting stated: "The mere existence of an audit committee is not enough. The audit committee must be vigilant, informed, diligent, and probing in fulfilling its oversight responsibilities." Auditor peer review is another quality control measure that has widespread acceptance and should be mandatory for all independent accounting firms that audit banks. (See pp. 43, 46, and 49.)

Auditor independence in fact and appearance also affects the credibility of audits. Criticism relating to auditor independence has focused on ineffective audit committees, the concept of privity of the auditor/client relationship, long-standing audit relationships spanning several decades, auditor judgement being compromised by economic pressures to maintain clients, opinion shopping, hiring by clients of senior audit personnel, and the range of auditors' consulting services apparently inconsistent with an independent relationship. Confidence in the independent auditors can be enhanced by effective audit committees and peer reviews. However, regulators need more direct assurances of auditor effectiveness considering the huge exposure of depository institutions, especially large banks. (See pp. 48 to 50.)

Although annual independent audits can lead to strengthened internal controls, bank management is responsible for fostering sound operating practices to comply with laws and regulations and to guard against internal fraud and abuse. Management should be held accountable through an annual report on the condition of internal controls. (See pp. 43 to 45.)

Large Bank Exposure Demands Closer Scrutiny

The failure of large banks causes significant losses to the Bank Insurance Fund: Continental Illinois National Bank—$1.1 billion; First RepublicBank—$2.9 billion; 20 MCorp subsidiary banks—$2.7 billion; and, recently, the Bank of New England—$2.3 billion. In contrast, the failure of smaller banks has not been as damaging to the Fund. In 1989, the Fund incurred losses of $2 billion from the failure of 161 smaller banks. (See p. 47.)

It is particularly important that regulators have timely and accurate data on the condition of banks, especially large banks, to provide for early intervention and minimize losses to the Bank Insurance Fund. Although quarterly call reports are a critical component of the early warning system, they are unaudited and GAO has found they are not always reliable. For large banks, the independent auditor could review the accuracy of these reports and report the results to the regulators. Also, as part of corporate governance, bank management could annually assess the bank's ability to continue for the next year. The independent auditor could review this assessment as part of the annual audit. Finally, if regulators worked more closely with the independent auditors they could better utilize and ensure the quality of auditors' services. (See pp. 47 and 48.)

Recommendations to the Congress and Accounting Authorities

These recommendations are a vital component of deposit insurance reform and, with the exception of accounting rule changes which the standard setting bodies should be given the opportunity to revise, should be enacted into legislation by the Congress.

To make the early warning system effective:

- Accounting principles for identifying and measuring loss contingencies should be revised to obtain prompt recognition of the value of banks' problem assets based on existing market conditions. (See p. 32.)
- Special accounting rules and audit procedures need to be developed to further clarify that affiliate transactions are required to be accounted for and reported based on their economic substance. (See p. 33.)
- All banks should be audited annually by independent public accountants and receive full-scope examinations by the regulators. (See p. 51.)
- Compliance with early warning measures such as those GAO has recommended in its companion report on deposit insurance reform should be audited. (See p. 51.)

To strengthen the system of corporate governance so that it serves the needs of regulators:

- Fully independent audit committees should be appointed, and they should be charged with reviewing reports to regulators. (See p. 52.)
- All financial institutions should be made subject to internal control requirements like those added to the Securities Exchange Act of 1934 by the Foreign Corrupt Practices Act of 1977, and bank management should be required annually to publicly report on compliance with those requirements. (See p. 51.)
- The adequacy of internal accounting controls and compliance with safety and soundness laws should be audited by independent public accountants. (See p. 52.)

To deal with the extraordinary risks to the Bank Insurance Fund from large banks:

- The quarterly call reports should be reviewed by independent public accountants. (See p. 53.)
- An institution's management should prepare an annual financial forecast that should be reviewed by independent public accountants. (See p. 53.)
- Audit committee membership should be enhanced to ensure appropriate expertise. (See p. 53.)

- The institution's independent auditor, regulator, and audit committee should meet periodically and review the results of financial reporting and internal control assessments and related needed improvements. (See p. 53.)
- The regulator should periodically review the independent accountant's audit and request additional audit procedures if needed to ensure regulatory objectives are being met. (See p. 53.)
- The regulator should biennially report to the Congress on the effectiveness of the auditing and management reforms GAO recommended, and GAO should review the evaluation and report to the Congress. (See p. 53.)

To accomplish this expansion of auditing activities, the resources of the public accounting profession should be used, subject to the following conditions:

- Regulators are promptly informed of internal control weaknesses and noncompliance with laws and regulations. (See p. 52.)
- Only independent public accounting firms that are subject to the accounting profession's peer review program should be permitted to audit banks. (See p. 53.)
- Regulators have the authority to remove the institution's independent auditor for cause with appropriate procedures. (See p. 53.)

The major problems that have surfaced in the banking industry along with the unprecedented cost for resolving the thrift crisis are evidence of the urgent need for accounting and auditing reforms. GAO's 1989 reports on banks that failed in 1987 and on failed savings and loans showed that internal control weaknesses contributed significantly to their failure. The savings and loan insurance fund has been depleted and bank failures now threaten to deplete the Bank Insurance Fund.

Reforms that GAO previously recommended to deal with internal control breakdowns were not implemented. This report on banks that failed in 1988 and 1989 shows pervasive internal control problems continue. It is absolutely essential that any legislation for deposit insurance reform, expanding banking powers, or recapitalization of the Bank Insurance Fund include the accounting and auditing reforms needed to address the continuing correctable problems that significantly contribute to bank failures and losses to the Fund.

Contents

Abbreviations

AICPA	American Institute of Certified Public Accountants
CAMEL	capital adequacy, asset quality, management, earnings, and liquidity
FASB	Financial Accounting Standards Board
FDIC	Federal Deposit Insurance Corporation
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act of 1989
FRB	Board of Governors of the Federal Reserve System
GAAP	generally accepted accounting principles
GAAS	generally accepted auditing standards
GAO	General Accounting Office
OCC	Office of the Comptroller of the Currency
SEC	Securities and Exchange Commission
TAPA	Total Asset Purchase and Assumption

Introduction

In 1989, we issued two reports addressing the alarming increase in insured bank and thrift failures in recent years and the serious internal control weaknesses that contributed significantly to those failures.[1] During the 46-year period from 1934, the year the Federal Deposit Insurance Corporation (FDIC) was created, through 1979, 558 insured banks failed. During the 10-year period from 1980 to 1989, 1,085 insured banks failed or received assistance. In 1988 and 1989, 427 banks with total assets of over $79 billion failed, at an estimated cost to the Bank Insurance Fund of over $11 billion. In 1990, 169 banks failed. Our reports cited problems with management competence and integrity, serious weaknesses in internal control systems, and violations of laws and regulations. We made recommendations to address the problems discussed in these reports and in subsequent testimony before cognizant congressional committees.[2] However, these recommendations were not adopted.

In September 1990, we reported that our review of 39 banks that failed in 1988 and 1989 found that their external financial reports did not alert users to the serious problems they confronted during the period preceding their failure.[3] The report contained recommendations to correct these deficiencies and improve the accuracy and timeliness of the banks' financial reports. Our subsequent testimony before the Senate Committee on Banking, Housing and Urban Affairs, and related letters to that Committee and to the House Committee on Banking, Finance and Urban Affairs, provided additional, specific recommendations as well as draft legislation at the close of the last session of Congress to address the issues we reported in 1989 and 1990.[4] The recommendation that had been adopted at the time of this review was the removal of restrictions on premium rates to help restore the Bank Insurance Fund.

[1] Bank Failures: Independent Audits Needed to Strengthen Internal Control and Bank Management (GAO/AFMD-89-25, May 31, 1989) and Thrift Failures: Costly Failures Resulted From Regulatory Violations and Unsafe Practices (GAO/AFMD-89-62, June 16, 1989).

[2] Financial Condition of the Federal Deposit Insurance Corporation's Bank Insurance Fund (GAO/T-AFMD-89-15, September 19, 1989) and Prevention, Detection, and Reporting of Financial Irregularities (GAO/T-AFMD-90-27, August 2, 1990).

[3] Bank Insurance Fund: Additional Reserves and Reforms Needed to Strengthen the Fund (GAO/AFMD-90-100, September 11, 1990).

[4] Additional Reserves and Reforms are Needed to Strengthen the Bank Insurance Fund (GAO/T-AFMD-90-28, September 11, 1990), letter to the Chairman, Senate Committee on Banking, Housing and Urban Affairs (B-114831, September 13, 1990), and letter to the Chairman and Ranking Minority Member, House Committee on Banking, Finance and Urban Affairs (B-114831, September 21, 1990).

When banks fail, FDIC as insurer usually conducts a Total Asset Purchase and Assumption (TAPA) review and always prepares a cost-test report. During the TAPA review, FDIC estimates the amount it can realize from the sale of the bank's assets. TAPA reviews are not prepared for all failed banks. If a failing bank receives FDIC assistance and remains open or if FDIC is unable to develop meaningful asset value estimates in a failed bank, it will not conduct a TAPA review. However, FDIC will prepare a cost-test report which estimates its net outlays without an estimate of asset values.

Objectives, Scope, and Methodology

Our review was conducted to address congressional and public concerns that the external reports prepared by banks, both annual financial statements and call reports, do not always alert users to the troubled financial condition of banks in a timely manner. Specifically, our objectives were to

- assess the adequacy of GAAP as a mechanism for insuring that the financial reports of banks accurately report their financial condition and, in the case of troubled banks, alert users to the true extent of their deterioration and
- summarize and analyze data for a sample of failed banks during 1988 and 1989 to determine why they failed and to assess the adequacy of generally accepted auditing standards (GAAS), which are the standards for independent audits, in addressing the factors that contributed to bank failures.

From the total 427 banks that failed during 1988 and 1989, the most recent years for which complete data were available, we judgmentally selected 39 for review. For purposes of analysis, we divided the sample into large banks ($1 billion in assets or more) and small banks (below $1 billion in assets). Our sample consisted of 19 banks that failed in 1988 and 20 banks that failed in 1989, including all 4 of the large banks that failed during these 2 years. Collectively, these 39 banks were located in 11 different states and accounted for more than 87 percent of the total assets and more than 86 percent of the total deposits of all banks that failed nationwide during these 2 years.

For each of the 39 banks selected, we obtained and reviewed key documents from FDIC, OCC, and FRB. These documents included recent call reports and audited financial statements prepared by bank management, and reports of examination and TAPA reviews prepared by the regulators. We reviewed each of these reports, summarized and analyzed

This report presents the detailed findings from our review of the 39 banks that failed during 1988 and 1989. In this review, we found the same types of internal control weaknesses regulators reported for banks that failed in 1987 were present in the 39 banks. We found that call reports issued by these banks during the last few years preceding failure failed to alert users to their deteriorating financial condition. In many cases, regulators cited internal control weaknesses as a major factor in the bank failures. This report presents specific examples of the internal control weaknesses cited and relates them to the failed banks' financial reports and to the huge insurance claims paid by FDIC. This report also includes a more detailed analysis of the weaknesses in generally accepted accounting principles (GAAP) previously reported to the Congress.

The Regulatory Process

Three federal regulators have supervision and examination responsibilities for banks. The Office of the Comptroller of the Currency (OCC) regulates nationally chartered banks, the Board of Governors of the Federal Reserve System (FRB) regulates state-chartered banks that are members of the Federal Reserve System and bank holding companies, and FDIC (the insurer for all banks) regulates state-chartered banks that are not members of the Federal Reserve System.

These agencies exercise their regulatory supervision and examination duties through on-site and off-site evaluations of bank financial condition and safety and soundness practices. On-site evaluations are done through periodic bank examinations. These typically include inquiries of bank management personnel, reviews of bank financial accounting records, some verification of data reported in bank prepared call reports[5] and a review of bank operating policies and procedures. The culmination of a bank examination is a composite CAMEL rating (the acronym CAMEL refers to the examiner's assessment of capital adequacy, asset quality, management, earnings, and liquidity) that reflects the regulators' view of the bank's operations and condition. Banks receive a composite rating of 1 to 5, with a 1 representing a strong institution and a 5 representing an institution with a high probability of failure. Off-site monitoring involves the review and analysis of bank-prepared quarterly call reports and other information requested by the regulator, as deemed necessary.

[5]Call reports consist of a balance sheet, income statement, and various supporting detailed analyses of balances and related activity.

their contents, and compared them to determine if financial reports provided adequate and timely disclosure of the true nature of the banks' financial condition prior to failure. In making these comparisons, we used the findings contained in the TAPA reviews as the primary basis for measuring the banks' actual financial condition. The banks' asset values as stated in the TAPA reviews were closest to the amount actually realized in the sale of these assets.

We did not review the specific application of GAAS by independent auditors in reaching their opinions on the financial statements of these banks. Nor did we review the standards or procedures used by the regulators in performing their examinations and TAPA reviews. Accordingly, the results included in this report are confined to summarizing, analyzing, and comparing the data as they appeared in the reports mentioned.

In summarizing the results of our review for this report, the universe of banks used as a basis for each test varied based upon the availability and comparability of relevant documents. For example, the banks selected included four bank holding companies (the large banks). In tabulating the number of banks in our sample, we counted each bank holding company as one bank. However, they are actually corporate entities that own numerous subsidiary banks. Taken together, these four holding companies owned 150 subsidiary banks at the time they failed and accounted for about 90 percent of the assets included in our sample. One of these holding companies received open bank assistance, and, accordingly, a TAPA review was not prepared. For two of the three remaining holding companies, we obtained TAPA reviews for the two largest subsidiary banks only. In addition, TAPA reviews were not prepared for two other small banks because regulators were unable to establish asset values. Accordingly, the universe sizes for tests involving data from the TAPA reviews appearing in this report have been adjusted to allow for these exceptions and include about 51 percent of the total assets of all banks failing during 1988 and 1989.

We reviewed relevant laws and regulations, as well as applicable GAAP, to evaluate the adequacy of and degree of compliance with the requirements. In addition, we reviewed applicable GAAP and market value accounting and reporting in order to evaluate their role in the problems we identified. While we studied the theory of market value accounting as used in GAAP and by the regulators, we did not address broader issues, such as full application of market value accounting and reporting and related implementation problems.

Many of the accounting and auditing issues presented in this report were in our previous reports on bank and thrift failures and on the Bank Insurance Fund, and these issues were reviewed with the regulators. In this review, we primarily discussed our positions with the accounting and auditing standards setting bodies to also consider their views in developing our positions on the adequacy of GAAP and GAAS as applied to the bank industry.

We conducted our review between January 1990 and November 1990 in accordance with generally accepted government auditing standards.

Chapter 2 of this report discusses the weaknesses in GAAP that contributed to banks' financial reports not disclosing the true magnitude of their deteriorating financial condition. Chapter 3 discusses the internal control weaknesses that contributed to the failure of these banks and how independent audits can be used and enhanced to strengthen internal controls. Chapter 4 discusses the regulatory enforcement actions resulting from the 39 failed banks and problems that are hindering enforcement actions.

Bank Accounting and Reporting Impedes Early Warning System of Asset Devaluation

Domestic and international changes in the banking industry, which have given rise to current regulatory and deposit insurance reform initiatives, have also engendered a need to reassess bank accounting principles and internal control systems. Bank accounting principles and internal control systems have not kept pace with the evolution of banking and the increased risk to the Bank Insurance Fund. Practices only marginally acceptable, at best, during periods of banking stability, now seriously degrade the usefulness of call reports—a critical component of our nation's early warning system for bank supervision. Inadequate call reports impair regulatory decision-making, resulting in continued operation and losses by unsafe and unsound banks, at considerable cost to the Bank Insurance Fund.

Our review of 39 banks that failed in 1988 and 1989 showed that examinations and TAPA reviews reflected dramatically lower asset values than the failed banks' most recent call reports prepared by the institutions' management. These management reports were purported to be presented in accordance with generally accepted accounting principles. However, they did not provide an accurate picture of the institutions' true financial condition immediately prior to failure. The accounting principles used in call reports and other financial statements for these banks as implemented by bank management provided no early warning to the regulators of the severe deterioration of the banks' financial conditions, and therefore undoubtedly contributed to the heavy losses absorbed by the Bank Insurance Fund.

Objectives of Financial Reporting

In considering the adequacy of existing financial reporting for banks, we noted the objectives of financial reporting as articulated by the Financial Accounting Standards Board.

"The role of financial reporting in the economy is to provide information that is useful in making business and economic decisions, not to determine what those decisions should be . . . . To the extent that financial reporting provides information that helps identify relatively efficient and inefficient users of resources, aids in assessing relative returns and risks of investment opportunities, or otherwise assists in promoting efficient functioning of capital and other markets, it helps to create a favorable environment for capital formation decisions . . . and it is not a function of financial reporting to try to determine or influence the outcomes of those decisions. The role of financial reporting requires it to provide evenhanded, neutral, or unbiased information."[1]

[1]Statement of Financial Accounting Concepts No. 1, Objectives of Financial Reporting by Business Enterprises, Financial Accounting Standards Board.

Fostering accurate and relevant financial reporting can assist financial statement users, including regulators, in making decisions. It is important to note that the process of preparing more useful information need not lead to a more restrictive regulatory environment or result in actions by banks and regulators not otherwise merited. Intervention, regulatory forbearance, and bank asset management are actions that should be taken on the basis of accurate and relevant accounting information.

Call Reports Are a Critical Component of the Regulatory Early Warning System

Regulators identify potential problem banks through off-site monitoring on the basis of the financial information submitted by banks. These reports are critical in apprising regulators of the financial condition of insured banks. They alert regulators to developing problems and allow them to concentrate their limited supervisory resources where they are needed most. Accordingly, it is vitally important that the financial reports of banks accurately communicate the financial condition of banks in a timely manner.

Quarterly, banks submit to regulators unaudited financial information known as call reports. These reports consist of a Report of Condition (balance sheet), Report of Income, and related supporting schedules. These schedules provide additional details relating to major line items such as cash, securities, loans, and equity. Call reports are required to be prepared in accordance with bank regulations promulgated by the banking regulators, which for the most part are consistent with GAAP.

Other than on-site examinations by the regulators, call reports are the principal means by which the financial condition of a bank is assessed by the regulators. The regulators use this data for off-site monitoring of banks' financial condition and performance during the periods between on-site examinations and as a means of identifying adverse trends in a bank or the industry. The data are often used in deciding the frequency, timing, and scope of on-site examinations. In addition, four of the five components of the bank rating system (capital, asset quality, earnings, and liquidity) are, in part, assessed using call report data. Consequently, regulators must be able to rely on the accuracy of the information in call reports. Therefore, the call reports should be reviewed to be certain that the information obtained facilitates implementation of an effective regulatory early warning system. In short, the key to successful bank regulation is knowing what banks are really worth. That requires good accounting.

TAPA Reports Provide Estimated Economic Worth of Failed Banks

When OCC or a state regulatory agency declares a bank insolvent and decides to close it, it informs FDIC. Upon receipt of this notification, FDIC initiates an examination by its Division of Bank Supervision. In addition, staff from FDIC's Division of Liquidation begin a review. This procedure is conducted without informing the bank, often under the guise of a regular bank examination. The TAPA review is the process by which FDIC estimates the amount it can realize from the sale of the bank's assets. As such, the TAPA review provides the first clear indication of the realizable value of the bank's assets and the cost of the bank's failure to the Bank Insurance Fund. In estimating the losses incurred due to reductions in asset value, FDIC measures the realizable value against the recorded book value, which is reported in call reports and financial statements.

Because of the significance of the realizable values of the loan portfolio to a bank's financial health, FDIC attaches a great deal of importance to it. However, unlike GAAP-based call reports or financial statements, the TAPA review is not prepared on a going concern basis. TAPA reviews are prepared only for failed banks, and the presumption of future existence is not present. Accordingly, the methodology regulators follow in establishing loan market values for a TAPA review is different than the historical cost method used by banks for call reports or financial statements. It also appears to be different than the methodology that regulators use in their regular bank examinations when they sometimes write down assets based on their application of GAAP. One major difference is that regulators, in conducting a TAPA review, value loans based upon their salability rather than collectibility. They concentrate on factors that directly affect the loans' market value, such as recent performance, collateral values, current market rates, interest rates, and past experience with similar loans.

TAPA reviews consistently arrive at asset values substantially below those recorded by banks because the valuation methodology used recognizes market value decreases. This is especially true of performing loans. A TAPA review will often yield lower values on performing loans than those recorded under GAAP and regulatory requirements. This occurs because of the market value effect of comparing the loans' contractual interest rate to the then current market interest rate and a more conservative and current assessment of the credit quality of the loan. The TAPA and bank recorded values for nonperforming loans and other real estate owned (assets acquired through foreclosure actions) theoretically should be more comparable because GAAP and regulatory requirements direct that these assets also be recorded at market value. However, substantial differences arise because the TAPA review focuses on salability and current realizable values. Market value determinations for going concerns presently permit a good deal of judgment on when to account for losses on such loans and the amounts to be recorded.

TAPA and Examination Reports Found Banks' Condition Worse Than Management's Call Reports

Our study of the 39 failed banks found that when management's call reports were compared to TAPA and examination reports, the largest differences in asset values were reported in valuations of loans and other real estate owned. The TAPA and examination reports consistently reflected values for assets that were substantially lower than amounts reflected in call reports by bank management issued immediately prior to these regulatory reports. However, the examination reports often only described the difference and did not indicate the exact amount of the differences. Therefore, we used TAPA reports and call reports to determine specific differences in asset values. The TAPA reviews reported differences in asset values that were greater in total dollar amount for large banks but, on a percentage of total assets basis, the differences were greater for small banks that failed than for large banks.

We compared call reports prepared on average 6 months prior to failure to the TAPA reviews prepared immediately after failure and found an overall increase in total loss reserves of $7.3 billion (348 percent) from $2.1 billion reported in call reports prior to failure to $9.4 billion reported in TAPA reviews for the banks in our sample. Devaluations in the loan and other real estate owned categories were $6.0 billion (82 percent) of the total $7.3 billion increase in the loss reserve estimate as a result of the TAPA review. The total $9.4 billion TAPA review loss reserve estimate consisted of losses on loans of $7.3 billion (78 percent), other real estate owned of $0.8 billion (9 percent), investments of $0.3 billion (3 percent), fixed assets of $0.5 billion (5 percent), and other assets of $0.5 billion (5 percent). The losses on loans were 25 percent of the $29.5 billion loan portfolio and losses on other real estate owned were 46 percent of their $1.8 billion gross value.

The total loss reserves in the small banks, as last reported prior to failure, were $0.2 billion compared to $1.5 billion as reported in the TAPA reviews, an increase of $1.3 billion (650 percent). The large bank total loss reserves were $1.9 billion prior to failure compared to $7.9 billion as reported in the TAPA review, an increase of $6.0 billion (315 percent).

TAPA reserves are prepared using a salability under current market conditions and current-sale approach. The fact that the TAPA reserves were based on more current information should not be used to substantially discount the importance of this information. Bank asset portfolios typically do not change substantially in the short run. Nor, as government resolution actions show, can they be disposed of in the short run. Therefore, substantially the same assets were valued differently by bank management prior to the banks' failure as compared to the values assigned by the regulators after failure. Further, although market conditions affecting the assets do change, 6 months is not enough time to have this dramatic an impact over this large a number of banks. The point is that banks do not crash overnight and there should have been some warning of the huge losses that had to be taken and, for the most part, absorbed by the Bank Insurance Fund. The framework of accounting rules provided by GAAP does not foster the early warning needed in call reports to allow the regulators to take timely intervention to minimize insurance losses.

The Dallas bank subsidiary of First RepublicBank is a good example of the contrast in call report versus TAPA data. This subsidiary bank represented approximately $19 billion of the failed bank's $32 billion in assets and was the largest single bank in our study. This TAPA review was done by approximately 100 employees from FDIC's Division of Liquidation, beginning on June 15, 1988, with the results reported July 1, 1988, for balances as of June 13, 1988. The scope and results of this TAPA review are shown in table 2.1.

Table 2.1: TAPA Review Results of the Dallas Subsidiary of First RepublicBank as of June 13, 1988

Dollars in thousands

Assets	Gross book value	TAPA amount reviewed/ percent reviewed		Loss amount/percent of gross loss	
Real estate loans	$4,340,465	$3,727,862	86%	$1,794,966	40%
Multinational loans	2,723,579	2,545,423	93%	684,025	15%
Energy loans	1,220,305	1,007,153	83%	127,630	3%
Corporate loans	2,742,468	2,496,006	91%	382,130	8%
General banking loans	1,928,130	1,079,666	56%	271,134	6%
Special credit loans	616,221	545,383	89%	284,996	6%
Loss on unfunded loan commitments and letters of credit				341,094	8%
Subtotal	**13,571,168**	**11,401,493**	**84%**	**3,885,975**	**86%**
All other assets	5,384,654	5,138,737	97%	646,125	14%
Total	**$18,955,822**	**$16,540,230**	**88%**	**$4,532,100**	**100%**

Losses from loans represented 86 percent of the total estimated loss in this TAPA report. Recorded loss reserves on this bank's records were $844 million for the loan portfolio compared to loss reserves of $3.9 billion estimated by the TAPA review. Other real estate owned, which is included in the "all other assets" category in table 2.1, represented 5 percent of the total estimated loss for the bank and 38 percent of the loss for all other assets. There were no loss reserves recorded for other real estate owned, compared to the TAPA review estimate of $245 million. At about 2 percent of the total estimated loss and 16 percent of the loss for "all other assets" reserves needed to mark the bank's investment securities to market comprise the second smallest other component of all other assets.

Some examples of the explanations given for the losses found by the personnel assigned to this TAPA review include the following.

- Real Estate Loans: The TAPA review reported lower values because FDIC found (1) borrowers were highly leveraged and unable to meet current expenditures, (2) borrower financial statements were predominately supported by unrealistic valuations of real estate and high inappropriate expectations for a market improvement, (3) loans on income producing properties with extremely low occupancy rates, (4) loans for speculative purchase of raw land—the source of repayment for which was the future sale at a profit, (5) losses due to advances on development loans without adequate collateral value, and (6) loans noted in items 3, 4, and 5 above that were being repaid under terms that allowed for capitalization of interest due (added to loan principal) and through other loan commitments made by the bank to the borrower.
- Multinational Loans: Most of the $0.7 billion decreased value of these loans as reported by the TAPA review were related to overvalued nonperforming loans to Latin American borrowers.
- Other Real Estate Owned: The TAPA report identified unrealistic appraisals as the primary cause of devaluation.[2]

The TAPA review found that many of the loans in the real estate portfolio had not been transferred (properly classified) to the bank's special credit group and accordingly written down. Based on the identified

[2]Consistent with this devaluation in other real estate owned, we found the same problem because of unrealistic appraisal assumptions used by appraisers in our 1989 audit of the Bank Insurance Fund entitled, Bank Insurance Fund: Additional Reserves and Reforms Needed to Strengthen the Fund (GAO/AFMD-90-100, September 11, 1990). In that report, we noted that in determining a value based on a normal market where the seller is not compelled to sell, appraisers often made assumptions that were inappropriate for the current market environment.

causes for the losses found in real estate loans mentioned above, it is likely that many of the loans were carried by the bank in a performing status because the loans were thought to be collectible and thus under generally accepted accounting principles were recorded at historical cost without specific reserves.

Generally Accepted Accounting Principles Rely Too Much on Management Judgment

Generally accepted accounting principles for loans and other real estate owned give bank management and auditors too much latitude in applying the accounting rules. Our study, which included evaluation of these rules, identified these likely reasons for significant differences in the determined value of these 39 failed banks' assets by regulators compared to values assigned by bank management and their independent public accountants.

- As compared to the regulators, bank management more liberally applies (1) the provisions of accounting guidance in identifying problem loans, and (2) in-substance foreclosure guidance in determining the timing and amount of the writedown to the recoverable value of problem loans.
- Bank management for troubled banks is not always motivated to reflect known losses from writedowns of problem loans and other real estate owned to fair market value at a time when it is struggling to preserve the institution and its control over it, and oversight by a bank's board of directors may not be sufficient to prevent misstatements of asset values.
- Bank loan administration functions, related information systems, and other elements of bank internal controls for troubled banks were often inadequate, such that the bank was unable to determine when an asset should be reclassified and subjected to specific reserves or written down from cost to fair market value.

Weaknesses in internal controls cited by regulators for the failed banks, including related management weaknesses, are discussed in chapter 3. A discussion of the weaknesses in accounting rules follows.

Generally accepted accounting principles ordinarily require that loans be accounted for at historical cost adjusted for principal repayments as received. If there is no basis for concluding that a loan is a problem loan, historical cost-based accounting, with general reserves recognized to reflect estimation errors and losses inherent in the loan portfolio, should yield a result which reflects the value of the loan in the absence of interest rate fluctuations. Under GAAP, to the extent a loss on the repayment of a loan is deemed to be "probable" to occur and the loss is reasonably estimable, a loss reserve for the specific loan should be recorded to reflect the impairment in value. The "probable" requirement as it is sometimes applied has unduly delayed the loss recognition resulting from the writedown of problem assets from historical cost to fair market value. The probable criteria is often applied differently in practice by banks, due to management judgments required. The different judgments in determining when a loan is impaired and a loss is probable contribute to or allow varying degrees of results reported by banks.

The greatest losses in the loan category recognized in the TAPA reviews were in connection with loans that were not repaying based on their contractual loan terms (that is, problem loans). In this study we found a number of examples where examiners identified loans for which collection was doubtful, and bank management should have recorded reserves to write down the loans and recognize the losses. These loans were carried at historical cost because, based on bank management's judgment, the potential losses on these loans did not meet the accounting criteria of "probable" that would have required writedown to fair value.

GAAP for loss recognition are derived from Financial Accounting Standards Board (FASB) Statement No. 5. The reason for FASB 5 was an accounting abuse of years ago whereby commercial and industrial companies established contingent reserves and used them to cover up actual losses when they occurred, thereby reducing the usefulness of periodic income statements. The requirement that a loss be "probable" before it is reserved has, in the case of banks, come to mean "virtually certain" rather than "more likely than not." This result is unfortunate when the most important concern addressed by bank financial statements today is the adequacy of its capital. It is ironic that an accounting principle adopted to prevent an abuse of the income statement has, in the case of the banks, become an abuse of the balance sheet, specifically the amount shown for bank capital.

The interpretation of "probable" made by the preparers of bank financial statements and accepted by the independent public accountants has been reinforced and taken a step further by specific GAAP for banks relating to in-substance foreclosed assets. When it is probable that a financial institution will not collect all the promised payments on a collateralized loan, the financial institution is required to determine whether the loan has been in-substance foreclosed in order to apply the provisions of FASB 15. The pertinent accounting guidance states that a loan should be considered in-substance foreclosed if all of the following criteria are met.

- The debtor has little or no equity in the collateral considering the current fair value of the collateral.
- Proceeds for repayment of the loan can be expected to come only from the operation or sale of the collateral.
- The debtor has either (1) formally or effectively abandoned control of the collateral to the creditor or (2) retained control of the collateral but, because of the current financial condition of the debtor, or the economic prospects for the debtor and/or the collateral in the foreseeable future, it is doubtful that the debtor will be able to rebuild equity in the collateral or otherwise repay the loan in the foreseeable future.

Under GAAP, a loan that is considered in-substance foreclosed should be accounted for and reported at the fair value of the underlying collateral when this classification is determined. A loan that is classified as in-substance foreclosed is accounted for and reported similar to other real estate owned unless the loan later performs and can be reclassified as a loan.

Under FASB 15, the carrying value of the loan should be based on the fair market value[3] of the collateral for loans in-substance foreclosed. In applying the fair market value definition, the current sale part of this definition is frequently not emphasized in favor of emphasis on a valuation based on a sale with a willing buyer and willing seller other than in forced or liquidation sales. Such emphasis often results in valuations being performed based upon projections of future market conditions which are highly uncertain.

Some, including OCC, have argued that the FASB 15 definition may have conceptual merit for very well capitalized institutions with the ability and intent to hold property until recovery of the market. A recent presentation by David G. Shulman, managing director of real estate research for Solomon Brothers, Inc., disclosed that based on its forecasted annual absorption rate, it would take 10.1 years for demand for office space to use the supply of office space currently available. Based on this and the slow pace of economic recovery occurring in the Southwest, and that may occur in the Northeast and other places experiencing recessionary trends, it seems unreasonable to conclude that current markets are only temporarily impaired and will improve in the near future.

[3]The definition of fair value is the amount that the debtor could reasonably expect to receive in a current sale between a willing buyer and a willing seller other than in a forced or liquidation sale.

These economic conditions and pressures on banks to maintain capital levels can impair bank management's ability to objectively make the judgments necessary to apply the FASB 15 definition of fair value. These factors reinforce our belief that the FASB 15 definition has little merit for banks, especially troubled banks, and interjects a large degree of subjectivity in projecting the extent and duration of temporary market declines. It unnecessarily complicates review of bank financial reports and renders them significantly less useful for banks without a clear ability to hold such assets until market recovery. Assets in troubled banks, and nonperforming assets in any bank, may have to be and often are disposed of in a market when conditions require that the assets be disposed of within a short time frame. As such, accounting information based upon fair values under a current (not forced or liquidation) sale concept is relevant to users of bank financial statements.

Accounting for Other Real Estate Owned Should Be Consistent in Financial Institutions

The application by banks of accounting rules for other real estate owned (including foreclosed property and in-substance foreclosed property) results in more optimistic and often less realistic values than accounting rules applied by savings and loans. This disparity is due to generally accepted accounting principles for banks not requiring that direct holding costs be considered in arriving at other real estate owned carrying values. For savings and loans under GAAP principles adopted in the Audit and Accounting Guide: Savings and Loan Associations, prepared by the American Institute of Certified Public Accountants (AICPA) Committee on Savings and Loan Associations, real estate acquired through foreclosure, and in-substance foreclosure, is recorded at the real estate's fair value at the date of foreclosure. This amount becomes the real estate's new cost basis, and the real estate is subsequently carried at the lower of this new cost basis or net realizable value.

Net realizable value is defined as the estimated selling price in cash or cash equivalents expected to be obtained in the ordinary course of business reduced by the sum of the following estimates:

- direct selling expenses such as sales commissions and other direct closing costs;
- costs of completion or improvement to the stage assumed in determining the selling price; and
- direct holding costs (net of rental or other income), including taxes, maintenance, insurance and cost of all capital (debt and equity), during the period the real estate is assumed to be held.

Savings and loans, under GAAP, are required to include direct holding costs, including cost of capital, in determining the carrying value of other real estate owned; however, banks under GAAP are not. We believe the inclusion of direct holding costs is more representative of the economic substance of what has occurred and more consistent with the primary mission of a financial institution, which is to attract deposits and make loans and not hold repossessed assets. We believe, therefore, that this inconsistency in accounting and reporting should be eliminated and that all financial institutions should be required to take direct holding costs into account. FASB has advised us that they recently added a project to address this inconsistency in the accounting literature.

Other Accounting Rules Needed to Provide More Accurate Financial Reporting

In the recommendations at the end of this chapter, we address modifications to generally accepted accounting principles which will promote more accurate and relevant reporting by banks for asset valuation, particularly loans and other real estate owned. These revisions are important steps needed now to revise the historical cost accounting model for banks. Also, we believe that market value accounting should be adopted now for debt investment securities held by financial institutions. Although further study is needed of a comprehensive market value based accounting model for financial institutions, in the interim, market value disclosures have merit. Further, as deposit insurance is discussed and the issue of expanded powers for financial institutions is considered, rules for proper recording and reporting of related party transactions should be evaluated.

Debt Investment Securities Should Be Accounted for at Market Value

Accounting for debt investment securities under present GAAP is based on management's ability and intent to hold or sell the investments. If the intent is to hold, the investments are typically carried at their historical cost basis. This accounting treatment relies for the most part on management's intent, which may not be consistent with historical experience in the investment portfolio.

While management's intent is the primary basis for the accounting treatment, the accounting guidance also requires an assessment of whether the financial institution has the ability (ability to hold) to carry out management's intent. Our concern is that management's intent and the assessment of ability to hold are very subjective and often cannot be verified until an investment is disposed of or an institution fails. Further, because market values are readily available for most investment securities of financial institutions it seems unnecessary and unreasonable to rely on such subjective measures. In the absence of an intent and ability to hold, investment securities are generally carried at the lower of historical cost or market value.

In the TAPA report for the Dallas subsidiary bank of First RepublicBank discussed earlier, a $72 million loss on debt securities with a book value of $1.9 billion was estimated based on the quoted market values of the securities. The securities held were primarily U.S. Treasury securities, with no credit risk. The losses estimated were due to interest rate fluctuations, with rising interest rates reducing the market value of the securities held (at historical cost) in the investment portfolio. During a period of rising interest rates, the loss on marking to market bank investment securities could be significant.

We believe that recognition of such economic losses on a current basis, rather than through recognition over an extended period as the investments yield below market interest rates, is appropriate. We note that there may be asset/liability management strategies that could be impeded by the application of market value accounting concepts on a piecemeal basis. Similarly, we recognize that piecemeal application may raise policy issues regarding the types of assets banks are encouraged to hold. Nevertheless, the present accounting rules are so flawed that we favor market value accounting for investment securities.

Related Party Transactions Should Be Monitored Closely

If the Congress allows financial institutions expanded powers to engage in nonbank activities through nonbank subsidiaries of a holding company, transactions between the insured institution and the parent or its other affiliates should be closely monitored. Holding company structures permit those in control to arrange transactions among affiliates to meet their own objectives. The true nature and legitimacy of related party transactions are hard to determine. Even the existence of such transactions may be difficult to identify. With a holding company structure, the earnings and capital of insured institutions may be diverted.

The accounting rules for related party transactions should be enhanced to state how the economic substance of such transactions should be determined to guard against the insured institution's resources being used to fund nonbank activities through fictitious transactions. Our limited inquiries regarding the application of these accounting rules show varying views on whether GAAP requires that transactions between related parties be accounted for and reported based on their economic substance, when it differs from its legal form. Further, GAAP does not explain how to discern when the legal form of a transaction is different than its economic substance. FASB needs to clarify how to determine economic substance. Further, regulators will probably need to provide guidance on how to account for various kinds of transactions if the Congress decides to expand banking powers. A precedent exists for this type of regulation in that Section 482 of the Internal Revenue Code gives specific examples of related party transactions and how they are to be reported for income tax purposes.

Full Market Value Implementation Requires Further Study

From the standpoint of estimating reserves for the Bank Insurance Fund, a comprehensive market value based accounting and reporting system for banks has considerable merit in that banks' true financial condition could be reported promptly and information could be available to project Fund losses. However, there are conceptual and implementation issues that need to be addressed by the accounting rule setting and regulatory bodies before a market value accounting model can be formulated and adopted. We believe issues should be resolved as quickly as possible by FASB and the AICPA and a decision should be made on a comprehensive market value based accounting and reporting system. It should be recognized, however, that the complexities of this issue and FASB's due process procedures might preclude FASB and the AICPA from proposing a timely solution; therefore, their progress in this area should be monitored closely by the banking regulators.

In the interim, we support the concepts of market value disclosure recommended by FASB in its exposure draft "Disclosures About Market Value of Financial Instruments." Disclosure of such information and the basis on which it is determined will permit users of bank financial statements to make alternative calculations of bank capital. This should enable better judgments about the true financial condition of banks.

Conclusions

Certain changes to generally accepted accounting principles are needed immediately. When comparing the 39 failed banks' financial position as reported by management prior to failure and after failure as determined by TAPA reviews, the major areas of significant deterioration in asset values were loans and other real estate owned. These dramatic declines were due primarily to the understatement of loss reserves in determining the basis for these assets.

Rather than serving as the critical component in regulatory early warning systems, call reports have been rendered irrelevant by deficiencies in generally accepted accounting principles and bank internal controls. These deficiencies must be corrected as part of a larger effort to restore confidence in the banking system and the soundness of banks. Failure to correct these deficiencies, while moving forward with bank deregulation initiatives, is not prudent. Doing so will increase risks for financial institutions, without correcting flaws in the existing system. These flaws degrade measures of bank capital and financial performance critical to the regulatory process.

A primary cause for the huge loan losses reported by the regulators after a bank failed was that prior to failure, bank management misclassified loans and recorded them at historical cost without specific loss reserves. The lack of specific loss reserves was caused largely by bank management's application of the criteria used under generally accepted accounting principles to determine when a loss has occurred and should be recognized. When bank management did record specific loss reserves for problem assets, including other real estate owned, such amounts reflected optimistic assumptions regarding the recovery of the market value of the assets or their underlying collateral. Management applied the definition used for determining fair market value under generally accepted accounting principles that allows considerable leeway in determining market value. Given that FDIC consistently found in performing TAPA reviews that bank management had overstated the value of loans and other real estate owned, we believe the carrying values of these assets are undoubtedly overstated on the books of other banks.

To the extent that regulators and other financial statement users have, based on present GAAP, adopted threshold ratios against which banks' performance, liquidity, or capital are measured, such measures may need to be modified to accommodate the improvements in financial reporting we recommend.

Recommendations

We recommend immediate changes to generally accepted accounting principles. The changes we recommend will not prevent the later adoption of a market value accounting model. We recommend that (1) the American Institute of Certified Public Accountants and the Financial Accounting Standards Board issue accounting guidance in accordance with the following guidance; and (2) FDIC, OCC, and FRB adopt the revised accounting guidance for all depository institutions.

- Losses for problem loans (loans that are not performing based on their contractual terms) should be taken if considered to be more likely than not, rather than probable. A problem loan should be accounted for as an in-substance foreclosure unless there is clear evidence of the lender's ability to collect the loan based on its contractual terms, as opposed to existing accounting rules that require probable non-payment and clear evidence that the loan will default.
- The definition and determination of fair market value used in existing accounting literature should be changed. The present concept which presumes that the seller is not compelled to sell and can hold this property until market conditions improve is invalid. The value of in-substance foreclosed loans and other real estate owned should be determined based on existing market conditions unless there is clear evidence to support projections of improved financial and economic conditions—for example, signed leases from responsible tenants. The carrying value for other real estate owned should be reduced by estimated carrying costs, including a cost of capital, to the expected date of sale.
- The accounting rules and audit procedures for related party transactions should be enhanced to clarify that related party transactions are required to be accounted for and reported based on their economic substance. Also, to assist in identifying transactions where economic substance differs from the legal form of the related party transactions, guidance should be provided on how to determine economic substance.

The need to improve financial reporting for banks is of critical national importance and prompt action is required. The AICPA and FASB should be offered the opportunity to address these issues within a short period and FDIC, OCC, and FRB should work with them. If the private accounting standards bodies believe that they will be unable to resolve the issue during 1991, we believe that they should notify the appropriate regulatory bodies for depository institutions. In the absence of prompt resolution of the above concerns by the accounting standards setting community, we recommend that FDIC, OCC, and FRB promulgate accounting standards for financial institutions along the lines we recommended.

Internal Control Weaknesses Hinder Early Warning of Problems and Are a Major Cause of Bank Failures

The accounting reforms recommended in chapter 2 should provide better early warning of deteriorating bank financial condition. However, they will not be fully effective unless bank internal control systems ensure that these accounting principles are properly applied in the preparation of bank call reports and financial statements. This is just one aspect of the importance of internal controls to the health of the banking system. Strong internal control systems also can operate to deter unsafe and unsound banking practices and other management abuses. Our review of 39 banks that failed in 1988 and 1989 showed that examiners identified weak internal controls that contributed significantly to the failure of 33 of the 39 banks. These findings are consistent with the results of our review of regulatory and examination documents related to the 184 insured banks which failed in 1987.[1] Serious internal control weaknesses contributed significantly to virtually all of these bank failures.

The myriad of internal control weaknesses noted by regulators in bank examination reports reflect serious breakdowns in the system of corporate governance. Underlying any solution to enhance bank internal control systems must be a cooperative effort between bank management, bank board of directors and audit committee members, independent auditors, and regulators. This chapter discusses reforms needed to strengthen the existing system of management and oversight. In addition, we are presenting special auditing and reporting procedures for large banks to enhance the early warning system for these banks because of their significant potential to affect the solvency of the Bank Insurance Fund.

In a separate assignment, we are reviewing the adequacy of examinations conducted by the banking regulators and the Office of Thrift Supervision, including their reliance on state examinations. Our objective is to determine whether the scope of examinations and their quality is sufficient for regulators to obtain an accurate and timely understanding of an institution's financial condition. Our work will be completed later this year. We note that examiners' guidance materials do not require that a comprehensive study and evaluation of internal controls be conducted as part of the examination. Preliminary observations from our ongoing study confirm that there are gaps in regulators' work on internal controls.

[1] Bank Failures: Independent Audits Needed to Strengthen Internal Control and Bank Management (GAO/AFMD-89-25, May 31, 1989).

Internal Control and Related Problems Cited by Regulators

Regulators emphasize monitoring problem banks and large banks because of their potential effect on the Bank Insurance Fund. Regulators prepare examination reports on an exception basis (that is, they document a bank's weaknesses rather than its strengths). Based on this evaluation, examiners report on bank financial and operating weaknesses in terms of (1) financial soundness, (2) quality of management and policies, and (3) compliance with applicable laws and regulations.

Our review of examination reports for the 39 failed banks showed that in 33 of the banks, pervasive management problems involving a broad array of internal control issues, including violations of laws and regulations, and the competence or integrity of management were frequently cited by the regulators as major factors contributing to the failure of banks. (See table 3.1.)

Table 3.1: Summary of Internal Weaknesses Cited by Regulators for 39 Failed Banks

	Number of banks affected	
Internal weakness	**1988 (19 banks)**	**1989 (20 banks)**
Board of directors inadequacies	12	9
Inadequate operating management	15	15
Serious or continuous legal and regulatory violations	5	8
Weaknesses in loan portfolio management	15	20
Inadequate loan loss reserves	16	15

The weaknesses in management and internal controls were a common occurrence among most of the 39 failed banks. A discussion illustrating these weaknesses follows.

Board of Directors Inadequacies and Inadequate Operating Management

Of the 39 failed banks, regulators cited the directors of 21 (54 percent) as having acted inadequately or improperly so as to endanger the safety and soundness of the bank. Director actions were often cited as a major factor in the failure of the bank, and regulatory efforts to correct the problem were not always successful. For example:

- At one bank, a director, who was also a majority shareholder, drained capital totaling $255 million from the bank to a mortgage company he controlled. His activities continued in violation of a cease and desist order issued by regulators and ultimately resulted in the failure of the bank. Of the total $180 million loss estimated by regulators as a result of the failure of this bank, at least $157 million, or 87 percent, was attributable to the actions of this director.

- At another bank, regulators cited the deception and deliberate distortion of call reports by a bank employee who was director, vice president, and cashier of the bank. The regulators filed a report of apparent criminal activity on the part of this individual and informed the Federal Bureau of Investigation.
- Regulators examining another bank cited serious legal violations occurring with the knowledge of the board, including willful violations of legal lending limits. Many of these weaknesses had originally been identified and a cease and desist order had been issued in 1984. Overall, regulators described board supervision at this bank as "inexcusable." This same bank, without the required regulatory approval, hired a director who had been convicted of a criminal offense involving dishonesty or breach of trust.
- Seven of the 39 banks paid dividends in excess of net income, including all 4 large banks. Four of the 39 banks paid dividends while incurring net losses, including 3 of the 4 large banks. The directors decided the timing and amount of these dividend payments. These 7 banks included the following:

  - Three small banks in which the directors were major stockholders. As such, they received a substantial portion of the dividend proceeds. In these 3 banks, directors owned 11 percent, 36 percent, and 82 percent, respectively, of outstanding stock.
  - Three large banks in which the holding company continued to upstream dividends from subsidiary banks despite the increased strain on their capital positions.
  - One large bank which continued to pay dividends on preferred stock even though the bank's cash sources had not covered cash needs in 2 years, necessitating asset sales. This same bank took out loans totaling $84 million from its subsidiary banks, placing them in violation of the Federal Reserve Act.

We are aware of no federal laws or regulations, except those affecting a limited category of companies registered with the Securities and Exchange Commission (SEC), which expressly establish criteria for service on boards of directors. Bank directors having no employment relationship with the bank are generally selected by bank management and may represent major borrowers from the bank. Sometimes bank directors are selected because of perceived influence with regulators. We are aware of no specific competency requirements for a bank director, but even more importantly, we found no requirements that directors be independent in the sense that they are completely free of prejudice and able to fulfill their fiduciary duty to stockholders, depositors, and other creditors. Further, we found no regulations that identify a duty to FDIC, which we believe should stem from the deposit insurance provided.

In addition to deficiencies among directors, regulators often cited pervasive problems with other levels of management. Operating management has direct daily responsibility for the integrity of the bank's internal control system. An additional nine banks were cited for weaknesses among operating management. These weaknesses included the following:

- At one bank, regulators described the mortgage servicing department as being in a chaotic state. Documentation maintained by the department was often missing, and the adequacy and competence of staff were considered questionable. When another examination was conducted 19 months later, senior management remained unchanged and the lending function still did not have a qualified supervisor.
- At another bank, regulators found that the primary cause of deterioration was the lack of competent management staff. Operating management was cited as inadequate and found to have engaged in inappropriate actions. This bank was cited for internal control weaknesses in numerous areas including loan documentation, reserve requirements, and foreign exchange.

In fulfilling its fiduciary duty, a bank's board of directors should ensure that an adequate internal control structure exists. An effective system of internal controls is an important way directors can discharge their fiduciary duties without undertaking day-to-day monitoring of management. We believe that the internal control requirements applicable to SEC registered companies as contained in the Foreign Corrupt Practices Act of 1977 provide an appropriate model for an effective system of internal controls for banks.

The Foreign Corrupt Practices Act of 1977 amended the Securities Exchange Act of 1934 to require that SEC registered companies shall

- make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect transactions and dispositions of assets, and
- devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that (1) transactions are executed in accordance with management's general or specific authorizations,

(2) transactions are recorded as necessary to permit preparation of financial statements in conformity with GAAP or any other criteria applicable to such statements and to maintain accountability for assets, (3) access to assets is permitted only in accordance with management's general or specific authorization, and (4) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

The Foreign Corrupt Practices Act provides specific criteria for establishing internal controls and basic standards the regulators can use to assess compliance. AICPA has expanded its guidance on internal accounting controls to encompass aspects of administrative and management controls relevant to financial reporting. It also is possible to make standards similar to those in the Foreign Corrupt Practices Act more comprehensive. It is also possible to cover a full array of administrative and management controls as well as internal accounting controls. We believe internal control standards are needed for financial institutions to help ensure their safe and sound operation. In this respect, standards similar to those in the Foreign Corrupt Practices Act would provide basic protection.

Legal and Regulatory Violations Were Common

We also found that serious legal and regulatory violations were a common occurrence. Of the 39 banks we reviewed, regulators cited 13 (33 percent) for serious or continuous legal and regulatory violations. These violations included the following.

- At one bank, regulators attributed the bank's high losses to insider abuses with possible organized crime connections. Fraudulent activity, falsification of records, and a $5 million kiting operation were also cited. During the performance of the TAPA review, the bank's current and former presidents were arrested for money laundering and other illegal acts and were removed from the bank in handcuffs.
- Another bank was cited for over 120 legal and regulatory violations, including loans to insiders, falsification of records, and inadequate appraisals on real estate collateral.
- At one bank, regulators recommended civil money penalties for numerous legal violations, including $8 million in loans identified as violations of the Racketeer Influenced and Corrupt Organizations Act. Regulators determined that this bank was unsatisfactory 4 years before it failed.

We are not aware of any requirement for banks' boards of directors that have audit committees to have lawyers serve on the committees or to seek independent legal advice in discharging their fiduciary responsibilities. Under generally accepted auditing standards (GAAS), bank independent auditors are required to design audits to provide reasonable assurance of detecting illegal acts having a direct and material effect on the financial statements based on an assessment of the risk that such illegal acts may cause the financial statements to contain a material misstatement. However, bank independent auditors are not required to review controls over compliance with laws and regulations, nor are they required to test compliance with specific provisions of safety and soundness laws. Further, in the absence of specific information that comes to the auditor's attention concerning possible illegal acts which may have a material indirect effect on the financial statements, GAAS do not impose an affirmative duty on the auditors to search for such illegal acts. This absence of a requirement for the auditor to review compliance with specific laws and regulations reduces the usefulness of the independent audit for regulators as they review the safety, soundness, and legality of bank operations.

Loan Portfolio Management Was Not Adequate

Weaknesses in the management of the loan portfolio were the most pervasive internal control problems reported by regulators in the 39 failed banks. Regulators found that 35 of the 39 (90 percent) banks in our sample had weaknesses in the management of their loan portfolio. These included liberal lending practices and deficiencies in loan administration, loan documentation, and credit analysis, as well as loan policies that were either nonexistent, inadequate, or not followed. Regulators also cited speculative commercial real estate lending, and significant deficiencies were found in credit and collateral files. For example, appraisals, collateral insurance, and financial disclosures were often missing. Weaknesses of this type are particularly significant because loans comprise such a large component of bank assets. At the time the banks in our sample failed, they were carrying over $41 billion in loans on their books—about 56 percent of total assets.

Effective management controls would inhibit these types of weaknesses. Because the requirements of the Foreign Corrupt Practices Act of 1977 are limited in scope to internal accounting controls, their application to banks would only inhibit some of the practices cited. But, the act does require that there be reasonable assurance that transactions are executed in accordance with management authorizations. This requirement covers some aspects of management controls. It is important to note that internal controls designed to fully meet this objective can aid in ensuring that transactions are executed in accordance with board of directors' and management's objectives. Such controls would help in identifying some of the loan portfolio problems and in bringing them to the attention of the proper level of management and, in serious situations, to the attention of the board of directors.

The following further illustrates how important loan portfolio management controls can be. Management strategies that result in liberal lending and geographic or industry concentrations of loan risk can result in unacceptably high risks to banks and the FDIC. If directors limit management's authority to undertake liberal lending practices, a properly designed internal accounting control system could identify unusual transactions for the directors to review. Independent auditors, if they were responsible for examining internal accounting controls, might identify these transactions and others that were not executed on a sound basis because of inadequate credit analyses and report that condition to the board of directors. Inadequate loan documentation would even more likely be identified by independent auditors, because without such documentation there could be no assurance that transactions were executed in accordance with management's authorization.

Loan Loss Reserves Were Materially Understated

In addition to weaknesses in loan management, regulators also cited deficiencies in the recording of loan loss reserves. Regulators cited 31 of the 39 banks (79 percent) as having recorded inadequate loan loss reserves. Among the banks we reviewed, we found the following.

- One bank had a $51 million loan portfolio but did not record any loss reserve. Regulators estimated actual losses of over $7 million on these loans.
- Another bank recorded a loss reserve of $213,000 on a loan portfolio of $147 million. Regulators estimated actual losses of $42 million on these loans.
- One other bank recorded a loss reserve of $623,000 on a loan portfolio of $190 million. Regulators estimated actual losses of $158 million on these loans.

While we are not in a position to determine the exact causes of these inadequate reserves, weak internal accounting controls as well as accounting principles could have contributed to these problems. For example, the loan review process could have been flawed so that loans were not reviewed thoroughly, or not reviewed on a timely basis.

Banks are not required to report on the adequacy of internal controls, and auditors are not required to examine and report on management's representations on controls. The improvements in internal accounting controls which might be gained by such reports are not being obtained at present.

External Financial Reports Were Distorted by Internal Control Problems

In many cases, the control weaknesses we have discussed in this chapter had an adverse impact upon the external financial reports of bank management. Regulators reported that 22 of the 39 (56 percent) banks we reviewed filed call reports which were misstated due to a variety of errors or irregularities.

- At one bank, regulators cited call reports grossly in error due to information held back or changed by a vice president.
- At another bank, regulators cited call reports for 4 consecutive quarters as materially misstated due to problems including improper recognition of income on foreclosures, omission of securities sold under agreements to repurchase, and a variety of income and expense classification improprieties.
- At one bank, regulators cited material misstatement of call reports for 3 consecutive years. The reason cited for these errors was understatement of loan loss reserves.

In most cases, examiners did not quantify the dollar impact of these problems, and, as a result, their degree of materiality is difficult to measure. However, the examiners often described the effects of these problems on call reports as material or significant. In any event, the pervasive nature of this problem serves to impair the credibility of these important reports and to reduce their usefulness as a regulatory tool.

Independent Audits Can Strengthen Bank Internal Controls

Twenty-three of the 39 failed banks were not audited during their last year prior to failure. In addition, four were never audited. Audits by independent public accountants can improve the reliability of financial reports and, even as presently conducted, can help identify internal control weaknesses. Such audits, therefore, can benefit bank examiners in ensuring the safety and soundness of financial institutions. However, there are several areas, such as internal controls, where the auditing standards applicable to independent public accountants must be strengthened if independent audits are to be an important factor in improving bank examination and regulation.

Banks Were Not Always Audited

Some banks are subject to audit as part of Federal Reserve Board holding company regulations, SEC requirements, or state chartering laws. In addition, FDIC has issued a policy statement requiring applicants for deposit insurance coverage to obtain annual independent audits for each of its first 3 years after FDIC grants deposit insurance coverage. Otherwise, the decision of whether to be audited is at the discretion of bank management and its directors.

The banks we reviewed were not always subject to the oversight of independent audits. Four of the 39 banks we reviewed (10 percent) had never issued audited financial statements. The largest of these had assets totaling $400 million prior to failure. Of the remaining 35 banks, many did not obtain the benefits of an audit when it was needed most. Of these 35 remaining banks, only 12 were audited during their last year prior to failure. Of the 23 not audited in their last year, 6 were not audited in the second year preceding failure either. Of the 23 banks that did not issue audited financial statements for 1 or more years, one had issued unaudited financial statements, and one issued financial statements without an auditor's opinion because the audit was discontinued. The remaining 21 banks did not issue financial statements during these years.

Without the discipline of an audit, troubled institutions are more able to cover up their financial difficulties. One reason for no audits in years prior to failure could be that bank management did not want to deal with an independent auditor's demand to fairly state the bank's financial condition. Another reason could be that bank management did not want to incur the audit cost when it was having financial difficulties. Audit costs in institutions with weak internal controls are likely higher than need be because weak internal controls require the auditors to extend audit procedures. FDIC's position is that the cost of an independent audit should be considered a necessary cost of operations. We agree and believe that an increased fee because of internal control problems should not be allowed to cause a bank to forgo an independent audit.

Because independent audits generally are not required for banks, withdrawal or discharge of the auditor in times of difficulty sends up no red flag to the regulators of impending problems. The regulator is not advised and no intervention is triggered by the discontinuance of an audit by a bank.

Independent Audit Requirements Can Be Strengthened to Detect Internal Control Weaknesses

Thirty-five of the 39 banks in our sample (90 percent) had issued annual audited financial statements which were represented as being prepared in accordance with GAAP. These financial statements are similar to call reports required by the regulators, but include extensive additional narrative disclosures about major facets of bank operations such as significant accounting policies and contingencies. Unlike call reports, financial statements may be subject to a financial audit by an independent public accountant. This oversight, when it occurs, should provide an important mechanism for identifying and correcting errors and irregularities and related internal accounting control weaknesses that impair the reliability and usefulness of the call reports regulators rely upon in fulfilling their supervisory responsibilities.

The present objective of a financial audit conducted by an independent public accountant is to opine on the fairness of the information appearing in the banks' annual financial statements. These audits, therefore, have a different purpose than the examinations of institutions for safety and soundness conducted by the regulatory agencies. Audits by independent public accountants are to be performed in accordance with GAAS. These professional standards are set by the AICPA. The professional standards determine the scope of the audit work done and affect the liability of public accountants to clients and others relying upon the annual financial statements. If properly executed, audits performed by independent public accountants, within the limits mentioned below, can improve the reliability of call reports because the audited financial statements and the call reports are a product of the same financial system. However, if audits by independent public accountants are improperly executed, they can be detrimental by adding credibility to unreliable call reports.

While likely to be more thorough in some respects than regulatory examination procedures, GAAS fall short of requiring all the audit procedures which might benefit bank examinations. For example, the evaluation of internal controls required by GAAS is limited in several respects. Public accountants are required to obtain an understanding of an entity's internal control structure to plan the audit by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation. The auditor will only test the operation of those internal accounting controls that they rely upon based on the assessment of control risk in opining on the annual financial statements. If they rely upon them, then only those controls which are directly related to the financial statements and are material in relation to the financial statements need to be thoroughly tested and evaluated. If they can accomplish the audit by directly testing account balances on the financial statements, they need not thoroughly evaluate nor test internal accounting controls. Further, management or administrative controls, because they are not directly related to financial statements, may not be tested by public accountants. Therefore, such controls which might provide reasonable assurance that the bank is in compliance with applicable laws and regulations may not be tested. Expanding the present narrow focus of internal control work under GAAS could strengthen financial statement audits and make them more useful to the bank examination and supervision function of the government.

When auditing government entities, public accountants are required to follow auditing standards set by the Comptroller General.[2] These standards, although based on GAAS, do provide for public reporting on both internal accounting controls and compliance with laws and regulations. Public reporting on controls and compliance brings public pressure to correct weaknesses, and the prospect of having to report publicly causes management to correct weaknesses promptly before the required reporting time.

Another area that could further improve the reliability of information supplied in both annual financial statements and call reports is improved cooperation between independent public accountants and bank examiners. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) took a step in this direction by requiring insured institutions to provide independent auditors with their most recent examination reports, any supervisory memoranda of understanding, and a report on any enforcement or other supervisory actions initiated or taken. In February 1990, OCC reinforced this position by issuing to national banks an advisory emphasizing the importance of open communication between auditors and examiners. Although the AICPA has issued a recent position statement intended to foster inquiries by auditors of examiners, no similar step has been taken to encourage reporting of significant matters noted by auditors to examiners. They have been inhibited by their belief in the confidentiality of information arising from the auditor/client relationship.

[2]Government Auditing Standards (1988 Revision).

Although annual independent audits can strengthen an institution's internal controls, management has the responsibility to create an environment which encourages safe and sound operations. This responsibility includes developing and maintaining a system of internal controls designed to foster sound practices, and compliance with laws and regulations and to protect the institution against crimes and internal fraud and abuse. In our 1989 reports on bank and thrift failures,[3] we recommended that management reporting on internal controls, including compliance with laws and regulations, could increase management's awareness and help to establish accountability. Such reporting would include management's assessment of the effectiveness of the internal control structure. Also, we recommended an annual audit requirement and that the independent accountant, as part of the annual audit, report on management's assertions concerning the internal control structure. Such reporting would provide additional public disclosure and would benefit federal regulators by providing an independent assessment of assertions contained in management's report.

In the last 2 years, the House of Representatives has considered legislative initiatives to enhance the audit process. In 1989, the House of Representatives passed H.R. 1278, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. The House bill provided for auditing requirements and management reporting on internal controls and compliance with laws and regulations as we recommended. We now believe, with the benefit of insights gained from regulatory proceedings and legal actions brought against failed financial institutions, that the proposed reforms in this bill, although necessary, did not go far enough. Also, in 1990, the House of Representatives passed, but Congress did not enact, H.R. 5269, the Comprehensive Crime Control Act of 1990 which made some modest improvements in auditing procedures, reporting on internal controls, and communications with the SEC for companies subject to its regulation. Additional areas where reforms are needed include audit committees, monitoring of large banks, and concerns about auditor independence and usefulness of their audits for regulators.

[3] Bank Failures: Independent Audits Needed to Strengthen Internal Control and Bank Management (GAO/AFMD-89-25, May 31, 1989) and Thrift Failures: Costly Failures Resulted From Regulatory Violations and Unsafe Practices (GAO/AFMD-89-62, June 16, 1989).

Independent Audit Committees Can Enhance the Reliability of Financial Reporting

Primary responsibility for an institution's financial reporting lies with top management as overseen by the board of directors. A formal, diligent and totally independent audit committee can be an effective influence for minimizing inaccurate financial reporting and overseeing the institution's internal controls. There is no mandatory requirement that financial institutions establish an audit committee.

The Treadway Commission[4] noted that the audit committee can play an important role in preventing and detecting fraudulent financial reporting and in enhancing auditor independence. The Commission also noted that an audit committee can be an effective overseer of an entity's internal controls. It recommended that all public companies be required by SEC rule to establish audit committees composed solely of independent directors. The SEC endorsed the merits of audit committees but decided to encourage the stock exchanges (the self-regulatory organizations) to reexamine their listing requirements relating to audit committees. The SEC believed that the regulatory organizations would be in a better position to consider cases involving smaller companies that may warrant an exemption because of difficulties in establishing independent audit committees.

In addition to calling for truly independent audit committee members, the Treadway Commission set forth a framework for audit committee duties and responsibilities to provide for their effective oversight. These recommendations included the following:

- The institution should develop a written charter setting forth the duties and responsibilities of the audit committee. The board of directors should approve the charter and review it periodically.
- Audit committees should have adequate resources and authority to discharge their responsibilities.
- The audit committee should review management's evaluation of factors related to the independence of the institution's public accountant.
- The audit committee should annually review management's plans for engaging the independent public accountant to perform management advisory services during the coming year, considering both the types of services and fees.

We support these recommendations. With certain enhancements, we believe they should be a requirement for financial institutions.

[4] Report of the National Commission on Fraudulent Financial Reporting, October 1987.

Large Institutions Represent the Major Exposure to the Bank Insurance Fund and Need Closer Monitoring

Additional auditing requirements should be considered for the 45 to 50 largest institutions because of the exposure they pose to the Bank Insurance Fund. Experience has shown that the failure of large banks causes significant impairment to the Fund balance. For example, the total cost to the Bank Insurance Fund of providing assistance to Continental Illinois National Bank and Trust Company of Chicago was over $1.1 billion. Additionally, the cost to the Fund arising from the failure of First RepublicBank Corporation, Dallas, is currently estimated to be $2.9 billion, and the closing of 20 MCorp subsidiary banks is expected to cost the Fund $2.7 billion. Most recently, the failure of the Bank of New England was estimated to cost the Fund $2.3 billion. Of the 39 banks we reviewed that failed in 1988 and 1989, the 4 large banks, which include First RepublicBank Corporation and the 20 MCorp subsidiary banks, are expected to cost the Fund $7.5 billion, or 84 percent of the $8.9 billion total estimated cost for the 39 banks. We believe that failure of just one of the very large money center banks could exhaust the Fund. In contrast, the Fund incurred estimated costs of $2.0 billion in 1989 on failure and assistance transactions for 161 banks with assets of less than $1 billion. The assets of these smaller institutions totaled $7.5 billion. Thus, the Fund appears better able to handle the costs associated with smaller bank failures.

Regulators need timely and accurate financial data on the condition of financial institutions, especially large institutions, to provide effective intervention and minimize losses to the insurance fund. The quarterly call reports provided by bank management are critical to the regulators in off-site monitoring and in planning examinations. We previously reported that unaudited call report data are not always reliable and hinder the timely warning to regulators of the institution's true financial condition.[5] The independent auditor could aid the examination process by reviewing the quarterly call reports for large institutions and reporting the results to the regulators. As a complement to its financial reporting, management's assessment of the institution's ability to continue as a going concern for the next year would also assist the regulators in assessing the need for early intervention. Management's assessment could take the form of a 1-year forecast from the date of the annual financial statements. The independent auditor, as part of the annual audit, could examine the assumptions underlying management's forecast and report its opinion on the forecast to management and the regulators as an adjunct to the auditor's existing responsibilities under

[5]Bank Insurance Fund: Additional Reserves and Reforms Needed to Strengthen the Fund (GAO/AFMD-90-100, September 11, 1990).

GAAS to evaluate whether there is substantial doubt about the bank's ability to continue as a going concern.

For large institutions, quarterly reviews by independent public accountants and specific audit procedures to evaluate going concern status are merited additions to existing regulations designed to improve the examination and regulation of all banks. These special auditing services for large banks could be obtained directly by the bank in arranging for an independent audit. Further, the bank's independent public accountant and the regulator should meet at least annually with the bank's audit committee to review the bank's assessment of internal controls and its financial reports and forecast. More frequent meetings may be necessary if call reports are questioned by the independent public accountants or if significant internal control problems or financial weaknesses need to be dealt with.

Independence Concerns Should Be Addressed to Enhance the Credibility of Independent Audits

Independence is of paramount importance to the effectiveness of the audit function. Representatives of regulatory agencies, as well as critics of the public accounting profession and ineffective corporate governance, have questioned whether private sector auditors are sufficiently independent of their clients in fact and appearance. Criticism has focused on ineffective audit committees, the concept of privity of client information, on long-standing audit relationships spanning several decades, auditor independence being compromised by economic pressures to maintain clients, opinion shopping, hiring by clients of senior audit personnel, and the range of auditors' consulting services apparently inconsistent with an independent relationship. The recent level of legal actions alleging audit failures has highlighted these concerns. Expanding independent auditor responsibilities and encouraging increased reliance on auditors by regulatory agencies, as suggested by the reforms in this chapter, further increase the importance of an arm's length relationship both in appearance and fact between a bank and its outside auditors. Steps must be taken to strengthen confidence in the effectiveness of independent auditors especially for large institutions that represent the major exposure to the Bank Insurance Fund.

In some other countries, the work of the independent public accountant is an integral part of the regulatory process, because regulators rely more heavily on outside accountants to perform audits. However, to ensure independence, the regulators also exert greater control over the accountants' activities. For example, the regulatory process in Canada relies more heavily on public accountants than is the practice in the

United States. Also, in Canada, among other controls, (1) the regulators may review the public accountants' working papers and (2) two outside auditors are required to share responsibility for the audit with one of the two being rotated every 2 years. Regulator access to the auditors' working papers is arranged with the institution by the auditors as part of the audit engagement process.

The creation of truly independent audit committees charged with the selection and retention of independent auditors should dispel some concerns regarding auditor independence. However, as the Treadway Commission reported, "The mere existence of an audit committee is not enough. The audit committee must be vigilant, informed, diligent, and probing in fulfilling its oversight responsibilities." The Treadway Commission's review showed great disparities in the probable effectiveness of audit committees, the functions they perform, and the manner in which they carry out their functions. For large banks, we believe banking or related financial management expertise should be a requirement for audit committee members. Also, the committee should include an attorney or have its own counsel to assist the committee in overseeing internal controls concerning laws and regulations. Finally, large customers of the bank should be prohibited from serving on the audit committee to avoid the appearance of conflict of interest.

In 1977, the AICPA established the accounting profession's self-regulatory program. This program is the cornerstone of the profession's quality assurance mechanism. Its purpose is to help ensure that auditors maintain high quality operations and adhere to professional standards. In 1988, AICPA members voted to make peer review mandatory for those members in public practice as a condition of membership. However, not all accounting firms are members of the AICPA. We believe that all independent public accounting firms auditing financial institutions should be required to undergo periodic peer reviews.

While truly independent audit committees and mandatory peer reviews do address concerns about auditor independence to some degree, the expanded role of the independent auditor we are recommending, requires more regulatory safeguards to ensure the independent auditor is performing in a quality manner.

For all banks, regulators should have the authority to remove auditors under appropriate procedures for cause, such as when generally accepted auditing standards, or special regulatory prescribed standards, are not followed.[6]

For large banks, we believe the regulators should be required to periodically review independent auditor procedures and working papers as a basis for regulatory reliance thereon. Evaluating the quality of the audit work should help ensure that audit work products are meaningful to examiners. Also, it should foster a better understanding on the part of regulators of the benefits and limitations of independent audits and help them more efficiently and effectively plan their own work. As necessary, the regulators should be authorized to require the independent auditors to execute agreed upon procedures in specific audit areas to ensure that regulatory objectives are achieved.

Finally, we believe the regulators as part of their on-site examinations should assess how well the auditing and management reporting reforms at large banks are working and biennially report the results along with any recommendations to the Congress. GAO should be required to review the regulators' evaluation and report its assessment to Congress.

Conclusions

The pervasive and serious internal control and management weaknesses that characterized the banks that failed in 1987 also were evident in failures occurring in 1988 and 1989. These weaknesses contributed significantly to bank failures, resulting in huge losses to the Bank Insurance Fund. Unfortunately, warnings of deficient internal controls and bank management are often delayed because of inadequate accounting rules that delay the recognition of the costs of these deficiencies in financial statements. Intervention by regulators is correspondingly delayed. Internal controls are the responsibility of the banks' board of directors and other management. Weaknesses found in failed banks indicate that during 1987, 1988, and 1989, the system of corporate governance did not result in the safe and sound operation of many banks.

We believe that, because these serious internal control and management weaknesses have continued despite the supervisory efforts of regulators, an urgent need exists to strengthen the regulatory structure and require improvements in the system of corporate governance for banks.

[6]For example, the SEC has established "due process" procedures. Pursuant to Rule 2 (e) of the Rules of Practice of the SEC, accountants can be suspended or barred from appearing before the SEC on findings that they lack qualifications, character, or integrity, or that they have engaged in unethical or improper professional conduct, or willfully violated or aided and abetted a violation of the federal securities laws.

The internal control and auditing reforms discussed in this chapter, along with the accounting rule changes discussed in chapter 2, are critical to improving the regulatory early warning system and the flawed system of corporate governance. These reforms are a vital component of deposit insurance reform. If Congress decides to expand banking powers, the reforms must be in place before expanded powers are implemented. Because large banks present a major exposure to the solvency of the Bank Insurance Fund, their financial condition should be closely monitored by the regulators through special reporting and auditing requirements to assure the reliability of financial data.

The needed internal control and auditing reforms will have an associated cost. Although precise cost data are not available, we believe that the long-term benefits to the industry, regulators, and the taxpayers clearly outweigh the costs. The banking industry is now paying for the inefficiency of the current system through assessments that have risen substantially. Our proposals will cause the regulators and the independent public accountants to work closely together and eliminate overlapping reviews that needlessly increase the costs of audits and examinations. Also, an effective early warning system will benefit the industry through lowering costs of bank failures to the insurance fund and, ultimately, the industry through decreased assessments. Clearly, the consequences of failing to institute the needed reforms are unacceptable. The costs to the savings and loan industry and the taxpayers of resolving that industry's crisis are ample proof—these costs are approaching $400 billion and could reach $500 billion.

Recommendations

We recommend that the Congress enact legislation requiring, that as a condition for federal deposit insurance, depository institutions

- prepare annual financial statements in accordance with generally accepted accounting principles and have them audited by an independent public accountant;
- maintain a system of internal accounting controls which meets requirements like those contained in section 13(b)(2)(B) of the Securities Exchange Act of 1934, as added by the Foreign Corrupt Practices Act;
- maintain controls to ensure compliance with laws and regulations and with special regulatory directives such as memorandums of understanding or cease and desist orders;
- evaluate internal controls in accordance with guidelines issued by the regulators (FDIC, OCC, FRB) to prepare an annual management report to be published along with the audited financial statements and which

(1) describes management's responsibility and actions taken by it for establishing and maintaining an effective internal control structure and for preparing financial statements, (2) contains management's assessment of the effectiveness of the internal control structure and reports material weaknesses that have not been corrected, and (3) is signed by the chief executive officer and the chief accounting or financial officer of the institution; and
- have truly independent audit committees made up solely of outside directors with duties that include reviewing with management and the independent accountant the basis for the reports of management and the independent accountant.

In addition, we recommend that the Congress enact legislation requiring that the regulators conduct annual on-site, full-scope examinations of all depository institutions.

We also recommend that the Congress enact legislation requiring that independent public accountants acting as auditors of federally insured financial institutions be required to

- report on management's assertions described in its report on internal controls by studying and evaluating the institution's internal controls in accordance with generally accepted auditing standards or other procedures prescribed by the regulators and include the auditor's report in management's annual report;
- report to the institution and the regulators the internal control weaknesses that are important but are not defined as material to the financial statements or already included in management's annual report;
- report to the institution and the regulators on the institution's compliance with (1) laws and regulations that are identified by the regulators as relating to safety and soundness where compliance can be objectively determined and (2) special regulatory directives as defined by the regulators to maintain prudent operations or to restore the financial health of the institution;
- immediately pursue indications of illegality by the institution and inform an officer authorized to sign management's annual internal control report and the audit committee of the institution if the accountant determines that an illegality likely occurred and, then, inform the institution's board of directors in a timely manner;
- resign from the audit engagement or report to the regulators on the illegality, or both, if the illegality is substantial and the institution does not take corrective action;

- notify the regulators of the timing and reasons for changes in their status as the auditor of a federally insured financial institution; and
- undergo periodic peer review such as that prescribed by the AICPA's self-regulatory program or such other quality assurance program acceptable to the regulators.

We further recommend that the Congress enact legislation (1) requiring that federal regulators of depository institutions share with the institution's independent public accountant their knowledge of potential illegal acts by the institution, with exceptions for ongoing litigation and investigations, and (2) authorizing the regulators to remove the auditors for cause with appropriate due process.

In addition to the auditing and management reporting reforms recommended for all depository institutions, we recommend that the Congress enact legislation that

- requires large institutions to maintain an audit committee that (1) includes members with banking or related financial management expertise, (2) includes an attorney member or has its own outside counsel, and (3) does not have members that are large customers of the institution;
- requires large institutions to have the independent public accountant that audits their financial statements (1) review and report on the institution's quarterly financial reports employing specific procedures agreed upon with regulators, (2) examine a 1-year financial forecast prepared for the independent public accountant, and (3) meet at least annually with the institution's regulators and audit committee to review the institution's annual financial forecast and assessment of internal controls with more frequent meetings if quarterly or annual reports disclose significant internal control or financial weaknesses;
- requires the regulators to periodically review the independent auditor's procedures and working papers for large institutions as a basis for regulatory reliance thereon; and
- authorizes the appropriate regulator to require the independent public accountant for large institutions to review specific operations of the institution as deemed necessary to ensure regulatory objectives are met.

We also recommend that the Congress enact legislation requiring that the regulators biennially report to the Congress on the effectiveness of the auditing and management reforms at large institutions and that GAO review the regulators' evaluation and report to the Congress.

Finally, we recommend that the AICPA review its professional standards and ethics rules and make appropriate revisions to facilitate the conduct of the additional audit work recommended.

Enforcement Actions and the Cost of Uncorrected Internal Control Problems

When a bank begins to experience internal control and related problems, regulators may initiate administrative enforcement actions in an effort to improve bank operations. These actions include memorandums of understanding, cease and desist orders, civil money penalties, removal of officers, and termination of deposit insurance. If the bank fails, the regulators will investigate the cause. If they find negligence or illegal acts, civil and/or criminal action may be taken against the responsible parties.

In order to gauge the losses directly attributable to the abuses cited in this report and to identify some of the key problems experienced by regulators in their efforts to recover these losses, we reviewed the enforcement process as it was applied to the banks in our sample. Our objective was not to assess the effect of FIRREA or the recently enacted Crime Control Act of 1990[1] on the efficiency or effectiveness of this process, but to illustrate the high cost of the weaknesses cited in this report and to show the difficulties involved in attempting to recover these costs after the weaknesses have led to failure.

Enforcement Actions and Hindrances Incurred

Most of the banks in our sample were subject to enforcement actions during the last few years preceding failure or during the period following failure. For example:

- In 16 of the 39 banks (41 percent) we sampled, including all 4 large banks, regulators referred allegations involving directors and officers to the Department of Justice for criminal prosecution. The allegations included bribery, fraud, forgery, falsification of records, misuse of position, and misapplication of funds. In 2 of the 39 banks, regulators cited alleged criminal acts of directors and officers as the primary reason the banks failed.
- Twenty-seven of the 39 (69 percent) banks were subject to administrative actions when they failed. The basis for these actions included inadequate appraisals on real estate collateral and other real estate owned, excessive dividend payments, and liberal lending practices.
- FDIC is pursuing civil actions against directors, officers, or other affiliated parties for 35 of the 39 banks (89 percent). Its total estimated damages for these cases exceeds $3 billion, and attributes over $2.3 billion to

[1]The Comprehensive Thrift and Bank Fraud Prosecution and Taxpayer Recovery Act of 1990 was enacted as title XXV of the Crime Control Act of 1990, Public Law No. 101-647, 104 Stat. 4789, 4859 (Nov. 29, 1990). Title XXV provides for enhanced penalties, protecting assets from wrongful dispositions, and other reforms.

the negligence of directors and officers and over $470 million to malpractice (audit failure) by independent public accountants.

Attempts to pursue enforcement actions against bank affiliated parties are hampered by numerous obstacles and often take years to conclude. Active criminal actions we reviewed had been in progress for periods ranging from 1 month to 116 months, with an average of 12.5 months. Civil cases can also be lengthy. For a large bank, it can take 18 months or more just to prepare the case for filing. Additionally, administrative actions against bank affiliated parties are not always effective; at least 27 of the banks in our sample failed in spite of them. Finally, legal and investigative obstacles impair the ability of the government to pursue civil and criminal cases or to collect court-awarded restitution. For example:

- Damages in civil actions were often not pursued because defendants lacked the ability to pay or because the cost of identifying concealed assets exceeded the expected recovery. Also, evidence of defendants' net worth can be found in their federal income tax returns, but laws and regulations governing the Internal Revenue Service do not allow FDIC access to these records.
- State law provisions sometimes impede the regulators efforts to recover from guilty parties. For example, Texas, which accounted for 78 percent of the insured deposits in our sample, has a homestead exemption that protects an individual's primary residence from bankruptcy proceedings. Florida has a similar exemption for the wages of a head of household. Section 2522 of the Crime Control Act of 1990 amends the bankruptcy laws to allow regulatory agencies to execute judgments on property covered by a state's homestead exemption for certain kinds of debts owed by an institution-affiliated party. Government attempts to collect other kinds of debts may still be subject to an institution-affiliated party's use of a state's homestead exemption.
- In some cases, several years passed after a civil violation occurred and before the regulators discovered it. As a result, recovery was precluded by the statute of limitations. FIRREA extended the statute of limitations, but there is some question as to whether this law is retroactive to violations occurring before it was enacted.
- Often court awards of restitution are applied against individuals who have been convicted and sent to prison, but since incarcerated individuals are not usually in a position to pay large amounts, collection efforts (excepting nominal monthly payments) often have to be deferred until the defendant is released.

- During the 1980s, approximately 40 states passed legislation the thrust of which was to insulate directors and officers from liability unless misconduct or breach of duty greater than negligence was shown. FDIC told us that a provision in FIRREA was intended to preempt state laws viewed as overly insulating directors and officers from liability, and not to take away any rights FDIC had to enforce a stricter standard such as simple negligence. However, the provision's reference to "gross negligence" has been used to argue that FIRREA institutes a uniform gross negligence standard and therefore directors and officers are not liable for simple negligence even when simple negligence is the standard under applicable state law or other authority.

The primary source of recovery for regulators pursuing civil actions is the coverage provided by insurance companies. In most cases, insurance companies settle out of court for reduced amounts. However, insurance policies covering banks for losses due to director and officer negligence or abuse frequently contain features that impede FDIC collection efforts. These include:

- "Regulatory exclusion" clauses, which purport to preclude coverage of claims by FDIC. FDIC has met with some success in opposing such clauses, but overcoming them increases the cost of litigation.
- "Insured vs insured" clauses in a policy that covers both the bank and its officers and directors. This type of clause purports to preclude payments to FDIC when, as receiver of a failed bank, it attempts to sue the officers and directors on behalf of the bank. As with regulatory exclusion clauses, FDIC's attempts to overcome these clauses have been successful, but expensive.
- "Self-liquidating" insurance policies that protect banks from the abuse of officers and directors and also cover the legal costs of defending them against litigation by FDIC. When litigation is lengthy, the amount of coverage available to pay FDIC may be substantially reduced by the fees of the defense attorneys. These policies can also deter FDIC from attempting to collect the full amount of the damages because the larger the damages claimed, the more vigorous and expensive the legal defense is likely to be.
- Policies that specify that coverage terminates when the bank closes. Abuses discovered by FDIC after the bank fails may not be covered as a result of these policies. According to FDIC officials, FIRREA required that coverage under contracts continue at closure, but included an exemption for bond and directors and officers liability cases.

Conclusions

FIRREA and the Crime Control Act of 1990 significantly increased the penalties that can be levied against all levels of bank management for the type of abuses we found. Regulators may take punitive actions ranging from fines of up to $1 million per day to removal of officers in response to such actions as violations of cease and desist orders or other regulatory restrictions, filing of false financial reports, incomplete or inaccurate recordkeeping, and hiring of convicted individuals. It is clear that FIRREA and the Crime Control Act must be vigorously enforced. But enforcement should not be solely relied upon to recover the costs of internal control and other problems nor to prevent their occurrence. Judging from the magnitude of the problems we found from 1987 through 1989, the new legislation and other actions recommended in this report must be adopted to reduce the huge, unnecessary, and continuing costs of bank failures.

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