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Report to Congressional Committees

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# AUDIT COMMITTEES

## Legislation Needed to Strengthen Bank Oversight

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**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

In our report entitled, Failed Banks: Accounting and Auditing Reform Urgently Needed (GAO/AFMD-91-43, April 22, 1991), we noted that banks were failing in record numbers. Major causes of these failures were numerous internal control breakdowns, which contributed to improper extensions of credit; outright fraud; and insider loan dealings. That report contained a number of recommendations to strengthen the corporate governance of banks through, among other things, a strengthened role for bank audit committees. This report examines the extent to which audit committees of large banks have the independence, expertise, and information needed to properly carry out their functions and provides further support for our previous recommendations.

Audit committees play a very important role in the corporate governance of banks. Their responsibilities typically include reviewing financial statements and important accounting policies; supervising the audit activities of the internal and external auditors; and monitoring bank internal controls, including those relating to compliance with laws and regulations. Typically, audit committees are made up of several of a bank's "outside" or nonmanagement directors. The basic reason for this membership criterion is to enable an independent review of management's conduct of the business of the bank.

We studied the audit committees of the largest banks in the United States to assess the extent to which they had the necessary independence, expertise, and information on bank operations to effectively perform their important corporate governance functions. Our study included a questionnaire sent to the audit committee chairpersons of 47 banks with assets of $10 billion or more. We received responses from 40 of the 47 chairpersons.

## Results in Brief

Many of the 40 chairpersons of the audit committees responding to our questionnaire reported that their committees lacked the independence and expertise that we believe are necessary to properly oversee bank operations. Specifically,

- 25 reported that their committees included members who were large customers of the bank, including 3 committees that were comprised solely of large customers of the bank;
- 19 reported that their members had little or no expertise in banking, even though their committees were responsible for approving the bank's response to findings from bank regulatory examinations; and
- 13 reported that their members had no expertise in law and never met independently with the bank's legal counsel, even though they were responsible for assessing management compliance with banking laws and regulations.

Also, audit committee chairpersons indicated that independent evaluations by external auditors of internal controls and compliance with laws and regulations, beyond those which are currently provided, would be of great use to bank audit committees in overseeing bank operations.

Existing statutes do not require banks to have audit committees, and guidance from federal bank regulators and bank audit committee charters inadequately address (1) independence criteria for membership on bank audit committees, (2) expertise that bank audit committees should have to carry out their oversight role, and (3) information the committees should receive and review. The House and Senate banking committees have recently passed H.R. 6 and S. 543, respectively, which contain provisions addressing these matters.

## Background

Audit committees have long been recognized as a key component of the corporate governance system for banks. Bank regulatory agencies strongly encourage the establishment of audit committees consisting entirely, if possible, of independent members of a bank's board of directors. The Office of the Comptroller of the Currency (OCC), the regulator for 33 of the 47 largest banks, stated in its publication, The Director's Book, that an audit committee should be one of the most important committees of a board of directors. Specifically, the guidance states that it should be the "eyes and ears" of the board.

In 1985, the National Commission on Fraudulent Financial Reporting (known as the Treadway Commission),[1] which was formed to look for ways to minimize the incidence of fraudulent and misleading corporate disclosures, also took the view that audit committees were a key component of an institution's corporate governance. The Commission 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."

## Objectives, Scope, and Methodology

Our overall objective was to study key aspects of the audit committees of the largest banks in the United States. Specifically, we gathered information on the extent to which audit committees of the nation's largest banks

- included large customers or parties with an employment relationship with their respective banks, whose independence might be impaired;
- had expertise in the key areas of accounting and auditing, banking, finance, and law; and
- received evaluations of bank management controls from independent public accountants.

We focused our review on the 47 banks with assets of $10 billion or more as of September 30, 1990, because their size presents a potentially large exposure to loss for the bank insurance fund. These banks are located in 18 states and account for more than $1 trillion in total assets.

We used a questionnaire to obtain the views of the audit committee chairpersons of the largest banks. The survey included questions on the number of audit committee members that were large bank customers or employees; the number of committee members with expertise in accounting and auditing, banking, finance, and law; and the extent to

[1]The Treadway Commission was a private sector initiative sponsored by the American Institute of Certified Public Accountants, the American Accounting Association, the National Association of Accountants, the Financial Executives Institute, and the Institute of Internal Auditors.

which audit committees acquired needed analyses from their independent public accountants.

Prior to distribution of the survey, we conducted extensive interviews with 10 chairpersons located in 4 different regions of the country in order to test our survey instrument. We incorporated many of the interview comments into the final version of the questionnaire.

The initial distribution of the survey to the 47 largest banks was followed by telephone calls and meetings with several of the chairpersons. The follow-up contact was done to clarify and expand on answers provided in the questionnaire responses. For example, we contacted several chairpersons to determine how they arrived at their responses regarding the number of their committee members who were large bank customers. The chairpersons told us that they used a variety of sources for those answers, including personal knowledge and information provided by the general auditor or corporate secretary of their bank. Of the 47 chairpersons we initially contacted, 40 (85 percent) responded to our survey.

We also obtained the charters for 39 of the 40 audit committees that responded. One of the 40 committees did not have a charter. We reviewed, summarized, and analyzed each charter to identify the different duties and responsibilities assigned to audit committees. We also made follow-up calls to the banks to obtain additional information when necessary.

In addition, we obtained Office of the Comptroller of the Currency, Federal Reserve System (FRS), and Federal Deposit Insurance Corporation (FDIC) guidance relating to audit committees and internal and external audits. The guidance included sections from regulator bank examination handbooks and OCC instructions to bank boards of directors. We reviewed the regulators' guidance and summarized and analyzed their contents to determine the different requirements for the composition of bank audit committees. We also requested regulator reports of examination relating to the audit function for 46 banks for calendar years 1990 and 1991. We used the available reports of examination to determine the types of problems the regulators may have found or recommendations they may have made relating to audit committees.

We also analyzed reports on audit committees prepared by a number of other regulatory and professional groups. For example, we examined audit committee guides published by several independent public accounting firms. We reviewed each of these reports to identify views on the importance and composition of audit committees.

We conducted our review between March 1991 and October 1991 in accordance with generally accepted government auditing standards. However, because the report essentially summarizes the results of responses of audit committee chairpersons to our questionnaire and no new conclusions or recommendations are being made, we did not obtain comments on this report.

## Many Audit Committees Include Large Customers

Many bank audit committees have members that have customer relationships with their respective banks that could impair independence and result in conflicts of interest. In addition, a few committees also have members with employment relationships with their banks that also could impair independence. Although most bank audit committee charters prohibited employment relationships, none of the charters addressed customer relationships. In addition, regulatory guidance does not adequately address the participation of large customers on audit committees. However, various groups, including bank regulators, have widely recognized that audit committees must be independent in order to be effective.

In our April 1991 report on bank failures, we recommended that all insured depository institutions have independent audit committees and that large customers of large institutions be prohibited from serving on audit committees to avoid any conflict of interest. Other groups, such as the Treadway Commission, have also recognized that audit committee members' employment relationships can impair a member's independence.

Customer, as well as employment relationships between audit committee members and their respective organizations, can impair independence. Customer relationships may entail large borrowings or large deposits by an audit committee member or the member's employer. We believe that the economic interdependence of a bank and its large customers greatly impairs the independence of a director who is such a customer or who is affiliated with such a customer. Conflicts of interest stemming from such a relationship limit the member's abilities to provide independent oversight. Monitoring compliance with credit risk policies, judging related party transactions, or determining compliance with safety and soundness laws can be directly affected by this relationship. Other audit committee responsibilities relating to internal controls, accounting, and auditing can also be affected.

Bank audit committee chairpersons reported that many of their committees included members who were large bank customers. These large customers include members who had employment relationships with companies that were large bank customers. We asked the audit committee chairpersons to indicate the number of members serving on their audit committees as of March 31, 1991, that, in their judgment, were large customers of the bank. Twenty-five chairpersons reported that their audit committees had one or more members that were large customers of the bank, including 11 committees in which half or more of the members were large customers and 3 committees in which all of the members were large customers. In addition, four chairpersons reported that their committees included one or more members who held management positions with the bank.

Although 26 of the 39 audit committee charters we reviewed required that audit committees be made up of outside directors, none of the charters prohibited large bank customers, or parties who had employment relationships with large bank customers, from serving on the audit committee. Further, regulatory guidance on audit committee independence does not adequately address the participation of large bank customers on the audit committee. For example, a number of recent examination reports of large banks contained a determination of whether audit committees were comprised solely of outside directors, but did not discuss whether those directors had any significant customer or other economic relationship with the bank.

## Independence Widely Recognized as Important

All of the 40 chairpersons who responded to our survey indicated that independence was either a great or very great factor in determining the effectiveness of the audit committee. Of the 11 factors we asked the audit committee chairpersons to rate in determining the effectiveness of the audit committee, the chairpersons rated independence of audit committee members as the highest.

Most bank regulatory agencies also recognize the importance of independent audit committees. To achieve this independence, OCC emphasizes that a typical audit committee should be made up only of outside directors, defining an outside director as one that has no management position with the bank. FDIC, the insurer of all 47 banks, strongly encourages banks to establish audit committees consisting entirely of outside directors, if possible.

Both the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASDAQ) have described the type of independence that audit committees of companies listed on their exchanges should have. Each domestic company with common stock listed on NYSE is required to have an audit committee comprised solely of directors independent of management and free from any relationship that, in the opinion of its board of directors, would interfere with the exercise of independent judgment as a committee member. NASDAQ has adopted a set of corporate governance rules that requires each NASDAQ National Market System user to establish and maintain an audit committee, with the majority of its members being independent directors.

NASDAQ's definition of independence is similar to that of NYSE. Both entities define independence to recognize not only employment affiliations but also economic relationships of committee members. For example, the NYSE definition recognizes that economic affiliations can include a banking relationship with the company. However, both NASDAQ and NYSE vest the board of directors with the responsibility of determining whether a director with a banking relationship is independent.

## Many Audit Committees Lack Expertise Related to Their Responsibilities

In our April 1991 report, we recognized the need for audit committees of large banks to have certain areas of expertise represented on their committees. Specifically, we stated that these committees should include members with banking or related financial management expertise. The mix of related financial management expertise needed depends upon the nature of the financial management responsibilities of an individual committee. In addition, we stated that committees of all large banks should have access to legal counsel.

### Audit Committee Activities

Many audit committee chairpersons reported that audit committees should assess an institution's "tone at the top" or management's integrity. For example, 28 chairpersons reported that monitoring management's adherence to established codes of conduct is one of their primary responsibilities. Another important responsibility is the monitoring of high risk activities. Responses from the audit committee chairpersons provided the following examples of the high risk activities monitored by audit committees. Of the 40 committees chairpersons that responded

- 38 reported that their committees were responsible for reviewing the adequacy of bank management's internal control structure, supervising the bank's internal audit function, and assessing the adequacy of the external auditor's performance;
- 32 reported that their committees were responsible for assessing management's compliance with banking laws and regulations;
- 17 reported that their committees were responsible for monitoring management's compliance with established credit risk policies for controlling billion dollar loan portfolios; and
- 17 reported that their committees were responsible for monitoring related party transactions.

## Committee Expertise Did Not Match Oversight Responsibilities

While all but five of the chairpersons reported that their committees had expertise in at least one area of financial management, many reported that their committees lacked expertise in specific areas such as accounting and auditing where they had oversight responsibilities. Specifically, of the 40 chairpersons that responded

- 19 reported that their committees had members with little or no expertise in banking, although they were responsible for approving the bank's responses to findings from regulatory examinations;
- 14 reported that their committees did not have any members with expertise in accounting and auditing, although they were responsible for supervising the internal audit function and approving the scope of the annual external audit; and
- 13 did not have any members with expertise in law and never met independently with the bank's general counsel, although they were responsible for assessing management's compliance with banking laws and regulations.

Nine of the audit committee chairpersons indicated that a formal training program covering banking, law, and/or accounting would be useful for new audit committee members.

Although banking regulatory guidance acknowledges a wide range of audit duties and responsibilities for audit committees, such guidance does not specifically address audit committee member expertise. Further, none of the 39 charters we reviewed specified what areas of expertise should be represented on the audit committee. In addition, only 8 of the 39 charters specifically stated that the audit committee should have independent access to either the institution's general counsel or to outside counsel for advice.

## Independent Assessments of All Key Bank Operations Not Available to Many Audit Committees

In order to carry out their important management oversight responsibilities, audit committees need information that can help them identify internal control weaknesses before significant problems develop. Many audit committee chairpersons reported that they relied heavily on the bank's annual financial statement audit, performed by an independent public accountant, to help them identify problem situations. However, existing statutes and regulations, and auditing standards related to financial statement audits do not require that the independent public accountant provide a full assessment of either the bank's internal control system or the bank's compliance with laws and regulations. Over 65 percent of the audit committee chairpersons reported that these extra assessments would be useful to any bank audit committee.

### Audit Committees Rely on External Auditors for Key Independent Analyses

Most audit committee chairpersons of large banks reported that their banks experienced major internal control related problems within the last 2 years. Such problems included internal control weaknesses in key areas, such as the evaluation of loan quality and compliance with banking laws and regulations. Twenty-seven of the chairpersons reported at least one significant problem area, with 11 of these reporting three or more problem areas.

The audit committee chairpersons responding to our survey indicated that they strongly relied on the work and expertise of their external auditors to help them identify bank problems. Of the 40 committee chairpersons who responded to our survey

- 38 reported that the quality of the evaluations made by their external auditors was a great or very great factor in determining the effectiveness of their bank oversight activities and
- 33 reported that they expected their annual external financial audit to identify all significant weaknesses in internal controls, and 22 expected the audit to identify noncompliance with banking laws and regulations, to a great or very great extent.

Bank management, bank regulators, and internal auditors may also provide information to audit committees. However, as recent bank failures have demonstrated, bank management may not always be a reliable source of objective information. Similarly, internal auditors, who typically report administratively to bank management, are not always sufficiently independent to provide objective information. Banking regulators have also not consistently provided effective early warning to troubled institutions.

## Key Independent Analyses Not Performed for Many Audit Committees

Many audit committee chairpersons reported that their annual external financial audits did not consistently help identify or make recommendations to help resolve problems related to internal controls and compliance with laws and regulations. In particular, 14 of the 25 chairpersons that reported significant asset quality/loan collectability problems and 4 of the 6 chairpersons that reported significant problems with compliance with banking laws and regulations, also reported that their external audits did not help them identify these problems.

For the banks that had significant problems with loan collectability and/or compliance with laws and regulations, the chairpersons reported that in 12 out of 26 cases their external financial audits made no recommendations to help correct the problem.

Audit committee chairpersons reported that additional information and analyses from external auditors, beyond what is currently required in financial statement audits, would be greatly useful to bank audit committees. Of the 40 chairpersons responding to our study

- 28 believed that an annual evaluation of the adequacy of management's internal control structure would be of great use and
- 27 believed that an assessment of the institution's compliance with applicable banking laws and regulations would be of great use.

While many audit committee chairpersons strongly believed that these independent analyses would be useful, 15 reported that they currently did not receive an annual evaluation of the adequacy of management's internal control system and 23 reported that they currently did not receive an assessment of the institution's compliance with applicable banking laws and regulations. For those reporting that they did receive these analyses, most reported that the analyses were of great use to the committee. Specifically, 21 reported that the additional internal control analyses they received were of great use, and 10 reported that the assessments of compliance they received were of great use.

## Audit Standards Do Not Require Adequate Examination and Reporting on Internal Controls and Compliance

Historically, the objective of a financial audit conducted by an independent public accountant has been to express an opinion on the fairness of the information appearing in the bank's financial statements. Audits by independent public accountants are to be performed in accordance with professional standards, which determine the scope of the audit work done and the responsibility of the public accountants to clients.

Although these standards may be more thorough in some respects than regulatory examination procedures, they do not require all the audit procedures and reporting that might benefit bank oversight. Current generally accepted auditing standards require the auditor to examine only those internal accounting controls that the auditor relied upon in opining on the annual financial statements. Currently, standards do not require that auditors examine any management or administrative controls that are not directly related to financial statements. Our previous work has shown that the controls which are the weakest are not examined. For example, controls which might provide reasonable assurance that the bank is in compliance with safety and soundness laws and regulations are generally not examined. Further, current standards do not require auditors to test banks' actual compliance with laws and regulations including those relating to safety and soundness, that are not directly related to financial statements.

## Legislation Needed to Strengthen Bank Audit Committees

Audit committees have received broad-based support for many years as a key component of corporate governance. An independent and diligent audit committee can be an effective influence in minimizing inaccurate financial reporting and overseeing an institution's internal controls and compliance with laws and regulations.

To strengthen bank audit committees and ensure they operate as a key component of the corporate governance system, we recommended in our April 1991 report that the Congress enact legislation that

- requires all federally insured depository institutions to have independent audit committees made up solely of outside directors and
- requires large institutions to maintain an audit committee that (1) does not have members that are large customers of the institution, (2) includes members with banking or related financial management expertise, and (3) has access to legal counsel.

In our April 1991 report, we also recommended that the Congress enact legislation requiring management of federally insured institutions to report on the institution's internal control structure and independent public accountants who audit the institution's financial statements 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

- report to the institution and the regulators on the institution's compliance with laws and regulations that are identified by the regulators as relating to safety and soundness where compliance can be objectively determined.

We also recommended that the independent public accountant for large institutions be required to review and report to the audit committee on the institution's quarterly financial reports. Such specific examination and reporting requirements will help ensure that bank audit committees have sufficient information to carry out their duties.

We continue to strongly support legislation to strengthen bank oversight. Currently, H.R. 6 and S. 543 have passed the House and Senate banking committees, respectively. These bills contain provisions addressing the key issues in this report.

This report was prepared under the direction of David L. Clark, Director, Legislative Reviews and Audit Oversight, who may be reached on (202) 275-9489 if you or your staff have any questions. Other contributors are listed in appendix I.

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