United States General Accounting Office

GAO

Testimony

For Release
on Delivery
Expected at
10:00 a.m.
Tuesday,
April 23, 1991

Accounting and Auditing Reforms are Urgently Needed and Essential to Any Plan for Recapitalizing the Bank Insurance Fund or Deposit Insurance Reform

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Before the
Committee on Banking, Finance and Urban Affairs
House of Representatives

GAO/T-AFMD-91-3

GAO Form 160 (12/87)

Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss accounting and auditing reforms that are essential to any legislation to recapitalize the Bank Insurance Fund or modernize the financial system of this country. My statement summarizes the needed reforms that are detailed in our report, Failed Banks: Accounting and Auditing Reforms Urgently Needed (GAO/AFMD-91-43). Our study focused on 39 banks that failed during 1988 and 1989. These banks accounted for 87 percent of the total assets of banks that failed during those 2 years and $8.9 billion of the $11 billion of losses incurred during 1988 and 1989 by the Fund.

We found that internal control weaknesses continue to be a significant cause of bank failures. Breakdowns in corporate governance by bank management and boards of directors combined with flexible accounting rules have led to both bank failures and a seriously flawed early warning system to identify troubled banks. Without an effective early warning system, bank failures end up being far more costly. In 1989, we reported that internal control breakdowns contributed significantly to banks that failed in 1987 as well as thrifts.[1] We are concerned that this serious problem is continuing to cost the industry and the taxpayer dearly.

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[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).

We have estimated that the cost of resolving troubled thrifts could be $500 billion--much of which will come from the taxpayer. The Bank Insurance Fund balance is dangerously low and needs to be recapitalized. Any plan to recapitalize the Fund without fundamental reforms to correct accounting and internal control problems will only perpetuate the problems that have contributed significantly to the demise of the insurance funds. If the expanded bank powers that the Congress is now considering are enacted without accounting and internal control reforms, losses to the Fund are likely to seriously worsen and could require taxpayer assistance. Accounting and internal control reforms should be part of any plan to recapitalize the Fund and these reforms should be implemented before enacting expanded banking powers.

Our recently issued report on deposit insurance reform contains our proposals to strengthen the regulatory environment and banking industry.[2] Our report on bank supervision[3] along with the report on failed banks that I will discuss today provide the analytical basis for our proposals.

I would now like to explain the details of our findings from reviewing failed banks that demonstrate the breakdowns in (1) the regulatory early warning system, (2) internal controls, and (3) the

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[2]Deposit Insurance: A Strategy for Reform (GAO/GGD-91-26, March 4, 1991).

[3]Bank Supervision: Prompt and Forceful Regulatory Actions Needed (GAO/GGD-91-69, March 16, 1991).

corporate governance system upon which successful regulation depends.

CALL REPORTS FAILED TO PROVIDE EARLY WARNING OF IMPAIRED ASSET VALUES

Bank management submits Quarterly Consolidated Reports of Condition and Income, known as call reports, to the regulators. These reports consist of unaudited financial information that 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 bank examinations. The reports are a principal means that regulators use for off-site monitoring to assess the financial condition of banks and to decide on the timing and extent of examinations.

The early warning system provided by bank call reports of a bank's financial condition and performance is seriously flawed. The call reports submitted to the regulators by the 39 failed banks in our study prior to their failure did not provide regulators with advance warning of the true magnitude of the deterioration in the banks' financial condition and performance. Asset valuations done by the Federal Deposit Insurance Corporation (FDIC) after these banks failed showed that additional loss reserves were needed to cover the deterioration in asset values.

The banks had recorded reserves of only $2.1 billion to reflect the decreased values of their assets, while the regulators found after the banks failed that reserves of $9.4 billion were needed to reflect the fair value of the assets. In other words, $7.3 billion in asset values simply washed away.

We attribute the failure by bank management to accurately report the banks' condition to breakdowns in internal controls and to deficiencies in accounting rules that allowed bank management to unduly delay the recognition of losses and mask the need for early regulatory intervention. Had the regulators known early on that they had more than a $2.1 billion problem, the regulators would have had the opportunity for early intervention and potential savings to the Fund before the losses reached $9.4 billion.

I will first discuss the problems with the accounting rules before getting into the serious breakdown in internal controls.

The primary areas of the banks' balance sheets that accounted for the increase in loss reserves from $2.1 billion to $9.4 billion were deterioration in (1) the quality of the banks' loan portfolio and (2) the value of assets acquired through foreclosure revealed by the FDIC's review after failure. The total estimated loss on loans was $7.3 billion, and the estimated loss on repossessed assets was $0.8 billion--$8.1 billion of the total $9.4 billion loss estimate. These losses are especially significant

when you consider that there was an average of 6 months between bank managements' valuation of the assets for preparing its latest call reports and FDIC's valuation of the institutions' assets after failure. The short time period between bank managements' call reports and FDIC's asset evaluation suggests that substantially the same assets were being evaluated with a materially different result. Further, although market conditions affecting asset values do change, 6 months is not enough time to account for this dramatic decrease in asset values for this large number of banks.

Bank managements' loss reserve estimates were purported to have been made in accordance with generally accepted accounting principles. We believe that the accounting rules for nonperforming assets (loans not paying based on their original contractual terms and assets acquired through foreclosure) need to be tightened up because they allow bank management too much latitude in determining carrying amounts for impaired assets. Bank management has a strong incentive to use this latitude in accounting rules to delay loss recognition as long as possible and avoid recognizing decreases from historical cost to market value because of the adverse effect this has on a bank's reported financial condition. Asset write-downs add to bank expenses and reduce bank capital.

The accounting rules facilitate manipulation of asset values by bank management by requiring that a loss be "probable" to have occurred and "reasonably estimable" before it is required to be

recorded. The definition of probable in this context is vague and can be applied to produce dramatically different results from institution to institution. More often than not, the flexible accounting rules contribute to inaccurate call reports, as demonstrated by the 39 failed banks in our study, and impede early warning of troubled banks that add to insurance losses.

The definition of fair market value in the accounting rules is another area of flexible accounting rules that can result in overstated asset values. Accounting rules permit the use of fair market values based upon assumptions of a normal market and one where the seller is not compelled to sell. These assumptions are frequently not reliable when a bank is experiencing financial difficulties and when regulators are required to dispose of a failed bank's assets. As a rule, regulators dispose of failed bank's assets under existing market conditions, which result in much lower fair market values than those that result from using the hypothetical fair market value definition in accounting rules.

The accounting rules that were used to value the assets of the 39 failed banks in our study are also applied throughout the banking industry. Because FDIC consistently found the carrying values of problem loans and other real estate owned were overstated on the books of the 39 failed banks, it is likely that many open financial institutions have overstated the value of their troubled assets.

An effective early warning system is paramount for regulating financial institutions and for determining an accurate estimate of the Bank Insurance Fund's needs. Without accounting rules, that generate realistic asset values, it is impossible to know the true worth of a financial institution and likewise impossible to have an effective regulatory early warning system for financial institutions. The key to successful bank regulation is knowing what banks are really worth.

As part of the solution for making the early warning system more effective, we believe that the accounting rule setting bodies (the Financial Accounting Standards Board and the American Institute of Certified Public Accountants) should revise accounting principles for identifying and measuring loss contingencies so that the value of banks' problem assets is promptly recognized based on existing market conditions. 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 rules setting community, we recommend that FDIC, the Office of the Comptroller of the Currency (OCC), and the Federal Reserve Board (FRB) promulgate accounting standards for financial institutions along the lines we recommended.

Also, if the Congress allows financial institutions expanded powers to engage in nonbanking activities through subsidiaries of a holding company, transactions between the 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.

There is uncertainty whether accounting rules require that transactions between related parties be accounted for based on their economic substance when it differs from the transaction's legal form. Also, 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. We believe that special accounting rules and audit procedures need to be developed to further clarify that related party transactions are required to be accounted for and reported based on their economic substance. This will protect the insured bank subsidiary's capital from being depleted through fictitious transactions to nonbank subsidiaries.

I would now like to turn to the continuing problem that significantly contributes to bank failures--breakdowns in internal controls and corporate governance.

PERVASIVE INTERNAL CONTROL WEAKNESSES ARE A MAJOR CAUSE OF BANK FAILURES

The strongest, but yet most difficult to ensure, deterrent to unsafe and unsound practices in financial institutions is to have a system of corporate governance through which bank management and directors are effectively fulfilling their responsibilities to operate the bank in a safe and sound manner. Effective corporate governance requires internal controls, including bank directors' supervision of operations and preparation of reliable financial reports. Effective internal controls serve as checks and balances against undesired actions and are essential for banks to operate safely and soundly.

Internal Control Weaknesses Abound in Failed Banks

Our study of 39 failed banks found that the corporate governance system in these banks was seriously inept. Of the 39 banks, 33 had serious internal control weaknesses which the regulators cited as contributing greatly to their failure. Regulators cited the directors for 21 of the 39 failed banks as having acted inadequately or improperly so as to endanger the safety and soundness of the bank. For example, a director was a majority shareholder of a bank and drained $255 million of the bank's capital to a mortgage company he controlled. This director's action ultimately caused the bank to fail. 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 action of this director. Also, the regulators cited directors for authorizing dividend payments in some cases even though the banks were incurring losses and in danger of failing. Paying dividends was clearly imprudent and irresponsible in light of the financial plight of the institutions. Seven of the 39 banks paid dividends in excess of net income. Four of the banks paid dividends while incurring net losses. Directors were the major stockholders and, thus, received a substantial portion of the dividends in some of these cases.

The regulators for the 39 failed banks also cited 30 banks for deficient operating management, such as the lack of competent management and staff; 13 banks for regulatory violations, such as kiting schemes and money laundering; 35 banks for loan portfolio weaknesses, such as liberal lending practices, lack of loan policies, and missing loan file documentation; and 31 banks for inadequate loan loss reserves.

Whenever serious internal control problems exist, bank failure becomes imminent and accurate financial reporting seldom occurs. The regulators reported that in 22 of the 39 failed banks, significant errors and irregularities were reported in their call reports. These misstatements included understating loan loss reserves and the improper recognition of income. If the severity

of these problems had been identified early, and regulatory action taken, these banks may not have failed or their failure could have been significantly less costly to the Bank Insurance Fund.

Failing Banks Often Forgo an Independent Audit

The problem of weak corporate governance and breakdowns in internal controls is compounded by the lack of a mandatory annual financial audit requirement for all banks. Of the 39 failed banks, 4 were never audited--the largest of which had $400 million in assets prior to failure. Also, we found that 23 of the banks that had obtained annual audits were not audited in the year preceding their failure. In addition, 6 of these 23 discontinued audits 2 years prior to their failure. Of the 23 banks that did not issue audited financial statements for 1 or more years preceding their failure, 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 finanical statements during these years. Without an audit, management of a troubled institution can more easily conceal its financial difficulties.

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 presented 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. A financial audit, when it occurs, should provide an important oversight 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 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. If properly executed, audits performed by independent public accountants, 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, the evaluation of internal controls required of the independent auditor is limited in several respects.

Public accountants are required to obtain an understanding of an entity's internal control structure to plan the audit. This involves performing procedures to understand the design of relevant policies and procedures and assessing whether they have been placed in operation. However, the auditor will only test the operation of those internal accounting controls that they rely on based on the assessment of control risk in opining on the annual financial statements. This means that 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, public accountants may not test important management or administrative controls, because they are not directly related to financial statements. 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 by the independent auditor could strengthen financial statement audits and make them more

useful to the bank examination and supervision function of the government.

Improved cooperation between independent public accountants and bank examiners could also result in improved reliability of information in both annual financial statements and call reports. 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 American Institute of Certified Public Accountants has issued a recent position statement intended to encourage auditors to contact examiners, no similar step has been taken to encourage reporting of significant matters noted by auditors to examiners. Auditors have been inhibited by their belief in the confidentiality of information arising from the auditor/client relationship.

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 (1) developing and maintaining a system of internal controls designed to foster sound

practices and (2) complying 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, we recommended that management reporting on internal controls, including those for 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.

Independent Audit Committees Can Enhance the Reliability of Financial Reporting

Although primary responsibility for an institution's financial reporting lies with top management as overseen by the board of directors, a truly 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 a financial institution establish an audit committee.

The National Commission on Fraudulent Financial Reporting[4] noted that the audit committee can play an important role in preventing and detecting fraudulent financial reporting and in enhancing auditor independence. Among other duties, the audit committee should review management's plans for engaging the independent public accountant, review the planned work, and review the audit results and management's evaluation of internal controls. There should be a requirement that financial institutions establish an independent audit committee.

LARGE INSTITUTIONS REPRESENT THE MAJOR EXPOSURE TO THE BANK INSURANCE FUND AND NEED CLOSER MONITORING

The 45 to 50 largest institutions should be subject to additional audit requirements because of the disproportionately larger risk 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 for assisting 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 closings of 20 MCorp subsidiary banks are expected to cost the

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

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 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 is less at risk when it must handle the costs of failure of smaller banks.

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. The independent auditor's review of the quarterly call reports for large institutions and report to the regulators should aid the examination process. 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 should 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, should examine the assumptions underlying management's forecast and report its opinion on the forecast to management and the regulators. This examination would be an adjunct to the auditor's existing responsibilities under auditing standards to evaluate whether there is substantial doubt about the bank's ability to continue as a going concern.

Further, for large banks, 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. Critics have questioned whether private sector auditors are sufficiently independent of their clients in fact and appearance. Criticism includes 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. Expanding independent auditor responsibilities and encouraging increased reliance on auditors by regulatory agencies, as I am recommending, 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.

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 National Commission on Fraudulent Financial Reporting stated in its October 1987 report: "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." 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 that the independent auditor is performing high-quality work in a professional 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.

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 improve the regulators' understanding of the benefits and limitations of independent audits and help the regulators more efficiently and effectively plan their 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 that 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 the Congress.

Our report on the 39 failed banks contains our specific recommendations for the accounting and auditing reforms that I am recommending be enacted through legislation. Attachment I to my testimony includes those recommendations so that they will become a part of the hearing record. As part of my conclusion, I would like to say a few words about the cost of GAO's proposed reforms.

WHAT IS THE COST OF GAO'S PROPOSED REFORMS?

Another way of addressing cost is asking what is the cost if our proposed accounting and auditing reforms are not implemented? We have seen and continue to see the price for the absence of these reforms--the failure of the Federal Savings and Loan Insurance Corporation and a massive taxpayer bailout that followed, the Bank Insurance Fund at a dangerously low level and needing to be recapitalized, deposit insurance rates higher than ever, and an endless stream of financial institution failures. Although precise cost data are not available for our proposed reforms, we believe the long-term benefits to the industry, regulators, and the taxpayers clearly outweigh the costs.

-- Over time, the accounting and auditing reforms should result in lower deposit insurance premiums due to fewer institution failures and a lower cost of failures as a result of earlier intervention. Deposit insurance premiums have increased in the last 2 years from the old historical rate of 8.3 cents per $100 of domestic deposits to the recently proposed 23 cents per $100 of domestic deposits. This increase is a result of the recent flood of bank failures that have placed a tremendous financial burden on the Bank Insurance Fund.

-- The integrated approach we propose places greater reliance on the work of the independent public accountants and can result in significant cost savings. Currently, duplication exists in the work regulators do in evaluating asset quality in an on-site bank examination and the work an independent public accountant does in assessing the adequacy of loss reserves in a financial statement audit.

-- Finally, because regulators can leverage the expertise and manpower resources of public accounting firms, regulators and auditors working together should achieve even more efficiencies in the regulatory process.

CONCLUSIONS

GAO's 1989 reports on banks that failed in 1987 and 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.

Mr. Chairman, this concludes my prepared statement. I would be pleased to answer any questions you or the members of this Committee may have at this time.

GAO RECOMMENDATIONS FOR ACCOUNTING AND AUDITING REFORMS

GAO recommends immediate changes to generally accepted accounting principles. The changes GAO recommends will not prevent the later adoption of a market value accounting model. GAO recommends 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, GAO believes 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, GAO recommends that FDIC, OCC, and FRB promulgate accounting standards for financial institutions along the lines we recommended.

GAO recommends 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 control 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 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, GAO recommends that the Congress enact legislation requiring that the regulators conduct annual on-site, full-scope examinations of all depository institutions.

GAO also recommends 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.

GAO further recommends 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, GAO recommends 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.

GAO also recommends 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, GAO recommends that the AICPA review its professional standards and ethics rules and make appropriate revisions to facilitate the conduct of the additional audit work recommended.