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Willard C. Westover

John P. Carroll

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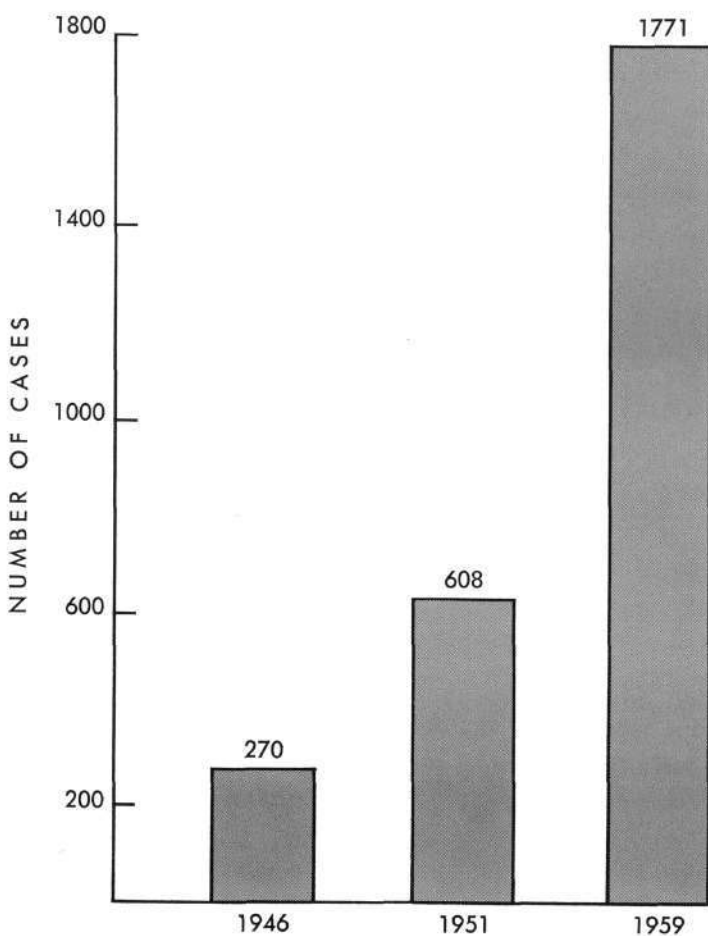
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BANK DEFALCATIONS

Can they be stopped?



by Willard C. Westover

and

John P. Carroll

This article is not intended as a technical article on bank auditing procedures. Its purpose is to show the deficiencies commonly found within a bank's internal control procedures and to clarify the role of bank examinations by regulatory authorities in preventing bank defalcations.

IN NOVEMBER, 1952, THE UNITED STATES INVESTOR MAGAZINE PUBLISHED the complete text of a speech by Lester A. Pratt which he delivered before the Iowa State Banking Association¹. Mr. Pratt both congratulated and cautioned the association when he remarked: "This is a good record, and you might relax with a satisfied smile if some proof could be obtained that no undisclosed embezzlements now exist in your banks. Embezzlements may be likened to icebergs. The potential danger lurks beneath the surface, unseen and undiscovered until the crash comes with its usual fatal consequences."

As you have probably read, in January 1961 the crash came in the little town of Sheldon, Iowa when the assistant cashier of the Sheldon National Bank, who is also the daughter of the president, confessed to the embezzlement of \$2,126,850.10 over a long period of years. This loss is even more astounding when we consider that it is the largest amount embezzled from a commercial bank in the United States. It is noteworthy for one other reason—the amount embezzled exceeded the total assets reported by the bank in its last annual report.

Obviously, this warning several years ago to the Iowa bankers was warranted, for at the moment it was voiced, the irregularities at the Sheldon National Bank undoubtedly had begun. That this warning has application on a national basis is readily seen by the growing number of defalcations shown on the chart. Reported cases increased from 270 in 1946 to 608 in 1951, while in the fiscal year of 1959 alone, a total of 1,771 defalcations was reported to NABAC (National Association of Bank Auditors and Comptrollers).

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1. Lester A. Pratt, "Still Better Audit Control," *United States Investor*, November 1952.

What can be done to stop the upward trend of bank defalcations? The following are the usual lines of defense:

1. Internal control
2. Internal audit
3. Directors' examinations
4. Federal and state bank examinations

These defenses appear adequate and, to the uninformed, negate the requirement for an independent audit by a recognized CPA firm. On closer examination, however, we discover many weaknesses which can be overcome by utilizing the knowledge and skills of the public accounting profession.

Internal Control

As accountants and auditors we are familiar with the objectives of internal control in safeguarding assets and in developing accurate accounting data. Good internal control is a preventative measure in the battle against defalcations. While audit may reveal that securities held as collateral have been misappropriated, adequate internal control (in this instance dual control) should help prevent the opportunity for theft—barring, of course, the possibility of collusion.

There is no doubt that many larger banks have good internal control; neither is there much doubt that many small and medium sized banks have poor internal control. The growth record of defalcations offers tangible evidence that this is the case. The opportunities to have good internal control are greater in a large organization where individual employees perform specialized activities. However, many of the principles of good internal control have application regardless of size. Basic control features such as annual vacations, rotation of duties, control of inactive accounts, and dual control over cash and securities are repeatedly neglected, although these principles are well known to the banking community. Regardless of the size of the bank or the effectiveness of its system of internal control today, the system will deteriorate in time unless positive steps are taken to maintain it.

While defalcations get the headlines, the role of internal control as a means of providing accurate accounting data should not be overlooked. Management frequently looks at internal control as an additional expense without tangible benefits. Experience proves this is not necessarily true, since the procedures used to guard against defalcation frequently reduce errors which cause additional expense or loss of

income. For example, adequate control of record keeping and physical handling of securities held as collateral prevents losses caused by their unauthorized or erroneous release. Similarly, failure to control various income accounts can result in a loss of income regardless of the possibilities for misappropriation.

There are three steps in maintaining good internal control. First, a sound system must be installed; second, the system must be policed to see that it is actually operative; and third, the procedures must be changed as the operations of the institution change. Unless all three steps are taken, a false sense of security may be created. Finally, any control procedures are only as good as the personnel who install and maintain them.

Since the vast majority of commercial banks in this country (about 11,000 out of approximately 13,000) are generally classified as small with total assets under \$10 million, the opportunities for improving internal control within this group are obvious.

Internal Audit

While internal control frequently can be improved in any given organization, it is impractical to provide for any and all eventualities. The Continental Casualty Company, after noting a variety of ingenious ways in which bank defalcations were carried out, stated that "The average dishonest employee usually has advanced to a position of trust by above-average ability, ambition to progress and willingness to accept responsibility, coupled with faithful application to duty over a long period of employment." Since this is the calibre of the foe, we must expect equal or superior attributes (plus honesty) on the part of the internal auditor. Assuming the proper technical and personal qualifications, the internal auditor must have the proper authority to fulfill his very sizable responsibility of protecting the bank's assets.

The internal auditor should report directly to the Board of Directors. In many small banks, the auditor or the person who acts in this capacity may find it necessary to co-ordinate with and report to the President on a day-to-day basis even though he theoretically reports to the Board. There have been many instances where the auditor reported to someone other than the Board and a misappropriation was concealed indefinitely. In a recent New Jersey case the auditor reported directly to the officer who had embezzled \$400,000. It is not enough, therefore, to pay lip service to the freedom of the internal auditor to perform his functions without restrictions from management; it must

be a fact. At a very minimum, written reports should be regularly submitted to the Board covering the scope of the auditor's work, his findings, and his specific recommendations.

Particularly in smaller banks, it is not feasible to employ a full-time auditor. A survey conducted in Iowa some years ago indicated that only 2% of the banks surveyed had full-time auditors. Aside from the fact that the auditor is auditing himself where he functions in a dual capacity, it is difficult to develop and maintain an adequate audit program on a part-time basis.

The best qualified auditor needs a complete, up-to-date written audit program and a schedule to be sure that all procedures are being performed as often as necessary. Also essential is an adequate staff of technically competent personnel to fulfill the requirements of the audit program. Care should be taken not to place too much emphasis on clerical-type procedures which lack over-all effectiveness.

The dangers present are apparent when a part-time auditor is unable to develop technical proficiency or prepare written programs and schedules, and does not report directly to the Board. More insidious is the danger that the internal auditor becomes so familiar with the procedures and personnel in his own organization that he tends to ignore seemingly minor discrepancies which might uncover irregularities. Even under the best circumstances, it is desirable to have the internal auditor's activities and accomplishments subject to the independent challenge of an annual review by a qualified public accounting firm.

Directors' Examinations

Under the National Banking Act directors of national banks are required to appoint annually an examining committee to make—or appoint someone to make on their behalf—suitable examinations every six months. The semiannual requirement is waived by the Comptroller of the Currency if an annual examination is made by a qualified certified public accountant. It should also be noted that directors of a national bank may become liable for losses sustained by the bank due to some breach of statutory requirements participated in or assented to by the directors or because the directors have not exercised that degree of care and prudence required under common law.

There are wide variations in state laws governing directors' examinations, ranging from no requirement to an annual examination by independent qualified accountants in the State of New Jersey. As under

the national banking law, however, the scope of the directors' examination is not clearly defined in state statutes.

The purpose of a directors' examination is to have members of the board satisfy themselves, directly or through the use of public accountants, as to the financial condition of the bank. Many statutes refer to a review of the books, records, accounts, and affairs of the bank. Outside directors seldom have the intimate knowledge of bank operations required to make a thorough examination. Individuals chosen as bank directors are usually prominent in local business enterprises and are selected for their business experience and judgment rather than their knowledge of auditing. Rarely do they have the time to conduct an examination which is reasonably complete in scope. As a result, officers and employees are frequently used to make cash and security counts, to run loan and deposit ledgers, and to perform other audit functions. Examinations are often conducted at a time which will not interfere with regular operations such as at a month end or on a Friday afternoon. Consequently, the element of surprise is missing. Directors' examinations conducted by the directors themselves are often made without the benefit of an audit program and without establishing simultaneous control over liquid assets.

The scope of directors' examinations performed by certified public accountants can be complete enough to render an opinion, but these examinations are frequently restricted in scope to such an extent that the accountant is unable to do so. For example, the accountant may be instructed not to confirm loan and deposit balances and, therefore, may not be in a position to render an opinion. Many banks record their investment, fixed asset, and bad debt reserves and their general reserves in a manner which complicates rendering an opinion in accordance with generally accepted accounting principles. For example, the amounts transferred to reserve accounts may be based on tax or other considerations which are difficult to relate to actual requirements.

In response to a survey of bank auditing practices conducted in Texas, 75% of the banks admitted that a satisfactory directors' examination could not be conducted without qualified assistance. Only a relatively small percentage of the banks reporting used the assistance of an independent auditor, while internal auditors, officers, and clerical employees were used extensively. It appears from this survey that many bank directors either are unaware of—or ignore—their responsibilities and their potential liabilities under national and state banking laws. The apparent reason for this is the reliance of the directors on the effectiveness of federal and state examinations.

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Federal and State Bank Examinations

The objectives of examinations by regulatory authorities are three-fold: first, to determine that banking laws and regulations have not been violated; second, to determine that a given bank is solvent and liquid; and third, to evaluate bank management and bank policies.

Bank examiners have made strenuous efforts to educate the banking community that bank examinations are not audits. In general, the examiner draws his conclusions by reviewing the bank's books and records as shown, but makes little attempt to determine the accuracy of the records. For example, cash can be counted and compared to the balance per books without revealing a cash shortage created by destroying a deposit slip. Confirmation of the particular customer's account would reveal the theft, but this procedure is not followed under ordinary circumstances. Some years ago the former California Superintendent of Banks, M. C. Sparling, stated in *Auditgram*², "Although a bank may be thoroughly examined in one or two days, it could not be completely audited in less than one or two weeks. In all embezzlements it is the concealment feature, primarily through the distortion of records, that generally is discovered only through an adequate audit."

Because regulatory examinations sometimes reveal irregularities, the uninformed believe that this is one of their primary functions. Actually the magnitude of many embezzlements is the real cause of their discovery. This was the case at the Sheldon National Bank where the embezzlement became so huge it collapsed of its own weight after remaining concealed for many years. Speaking from experience as a former bank examiner, an official of NABAC stated that the supervisory authorities cannot find a well-concealed embezzlement unless they trip over it, or unless it has become too large to control. Bank management and bank directors' reliance on regulatory examinations are, therefore, unwarranted since this is not the purpose nor the intent of these examinations.

Up to this point, we have shown that there are widespread deficiencies and misunderstanding in the banking community as to the effectiveness of internal control, internal audit, directors' examinations and regulatory examinations in preventing and discovering bank defalcations. An independent examination by certified public accountants competent in banking can make a significant contribution toward closing the gaps in banks' defenses.

2. Maurice C. Sparling, "The Auditor's Role in Banking," *Auditgram*, June 1951.

Examination by Certified Public Accountants

To serve banking clients, the certified public accountant must have a thorough knowledge of existing procedures and reports regarding internal control, internal audit, directors' examinations, and regulatory examinations. Using this information, he can supplement these internal efforts to eliminate the loss of money and reputation which accompanies each bank defalcation.

From our review, it is evident that banks can use qualified certified public accountants in any or all of the following ways:

1. To review the adequacy of internal control and internal audit programs and to recommend improvements.
2. To perform the annual directors' examination.
3. To supervise the annual directors' examination, the actual work being performed in conjunction with the bank's auditing department or other bank personnel.
4. To perform audits and, when applicable, render an opinion on the bank's financial statements.
5. To provide other specialized services not directly related to the problem of defalcations such as tax advice and management services.

Whether or not a bank can be reasonably sure that engaging independent public accountants will disclose irregularities depends, of course, on the scope of the engagement. For example, a study of 1,000 embezzlements revealed that 65% involved manipulation of either loan accounts or deposit accounts. These discrepancies could have been uncovered by direct confirmation of the accounts involved. Assuming confirmations on a test basis, they would undoubtedly have been uncovered much sooner than they were. This knowledge becomes useless, however, if the scope of the engagement precludes the use of direct confirmations.

A defalcation of the magnitude of the Sheldon National Bank affects the entire banking community and is usually the result of poor internal procedures. Such poor internal procedures are the result of inadequate bank management. Part of the problem is the fact that top bank management frequently has a background in loans, investments, or customer relations. Therefore, they are not always adequately informed as to what constitutes good internal control or sound auditing procedures, and they fail to distinguish the role of the independent certified public accountant from that of the internal auditor or the bank examiner.

They are not aware that the means to substantially reduce bank defalcations are readily available.

The merits of a periodic independent challenge and evaluation by certified public accountants has long been recognized by the management of industrial and commercial enterprises as well as by government regulatory bodies such as the Securities and Exchange Commission. However, a comparable role for certified public accountants in challenging internal accounting and auditing problems has not been recognized by bank management. This situation must be attributed both to the accounting profession for its neglect in identifying its talents and to bank management for its apparent apathy toward utilizing professional services in solving problems. There is, however, an acute awareness in banking of the dangers, both direct and indirect, of the growing number of defalcations. It is up to the accounting profession to communicate the vital role it can play in preventing such defalcations.



Willard C. Westover
Management Services
Central Staff

Mr. Westover has been closely associated with banking for over twenty years. His responsibilities as Director of Services to Financial Institutions include national coordination of audit, tax, and management services engagements to banking clients. He is a graduate of Syracuse University.

John P. Carroll
Management Services
Central Staff

Mr. Carroll is a New York CPA, a magna cum laude graduate of Northeastern University, and has a master's degree in business administration from Pennsylvania State University. Besides being active in several professional societies, he is a member of the faculty of Adelphi College.

