Bank Auditing and Accounting Faces Scrutiny

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Regulators should consider strengthening the ground rules governing bank auditing and accounting, according to FDIC Chairman Don Powell. In a March 5, 2002 speech, Powell noted that bank regulators have had the authority for some time to address auditing conflicts of interest, to mandate the retention of auditing documents, and to enhance sanctions imposed on auditors.

Under Section 36 of the Federal Deposit Insurance Act, every FDIC-insured institution with assets of more than $500 million must be audited annually. Many smaller institutions choose to be audited as well. Bank regulators have the authority to set standards for auditor independence for institutions subject to Section 36. Powell said that regulators should consider banning accounting firms from providing internal auditing and other consulting services to the same financial institution they are auditing externally.

Destruction of audit workpapers, in addition to being widely publicized in connection with the bankruptcy of Enron, has posed problems for the FDIC in connection with its resolution of failing banks. In resolving disputes with auditing firms in the early 1990s, the FDIC was able to obtain agreements from a number of firms regarding the retention of auditing working papers and other documents. Powell suggested that the SEC and other bank regulators may wish to consider a nationwide document retention requirement for the records and working papers used during the audit of any insured depository institution.

Bank regulators can now discipline auditors for "knowing or reckless misconduct" under Section 8 of the Federal Deposit Insurance Act. For ten years, the regulators have had authority to craft regulations for the larger institutions subject to Section 36 that would cast a wider net with respect to auditor discipline, but they have thus far not exercised that authority. Powell said that this may be an appropriate time for bank regulators to implement such regulations.

Powell also emphasized the importance of sound accounting for assets and liabilities arising from securitizations. After praising the new residual capital rule scheduled to take full effect at the end of 2002, Powell said that the current accounting literature may not be sufficient in other areas relating to securitizations. For example, how institutions account for accrued interest receivable arising from securitized assets needs to be considered. This issue directly affects only the small percentage of banks that are engaged in securitization activity, but for those institutions it is important to ensure that the capital reflected on their books is accurate.

While accruing the interest owed by borrowers that has not yet been collected is a common practice, some credit card securitizers have subordinated their right to receive the collected interest payments to the bondholders in their securitizations. Such subordination provides a credit enhancement to those with a senior interest in the securitized assets. This is a form of recourse that requires the securitizing bank to hold capital commensurate with the amount of recourse. The FDIC and the other banking agencies currently are working together to ensure that the capital rules are properly applied in these situations.