

STATEMENT OF PHILIP B. CHENOK
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BEFORE THE
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES

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Mr. Chairman and Members of the Committee, I am Philip B. Chenok, President of the American Institute of Certified Public Accountants (AICPA), the national professional association of certified public accountants (CPAs). Over the years, AICPA has been a principal force in the development of standards, educational programs, and professional guidance to improve the quality of services provided by CPAs. Throughout its 100 years of service to the public and to its membership, the Institute has become widely recognized as the authoritative voice of the profession in the United States. Our present membership consists of more than one quarter of a million CPAs in public practice, in industry, in academia, and in government.

I fully appreciate the considerable burden and responsibility which this Committee must bear. To you falls the task, in principal measure, of determining what factors led to the crisis in the savings and loan industry, how to make good on the pledge to protect depositors' funds, and how to make sure that these circumstances cannot recur in the future. AICPA appreciates the opportunity to contribute to your understanding of these matters and stands ready to assist in fashioning corrective remedies.

INTRODUCTION

The central focus of today's proceedings is a Government Accounting Office (GAO) report^{1/} which conveys the results of

^{1/} CPA Audit Quality: Failures of CPA Audits to Identify and Report Significant Savings and Loan Problems. (GAO/AFMD 89-45)

GAO's review of certain audits performed by CPA firms for 11 failed savings and loan associations (S&Ls) in the Dallas District.^{2/} That the GAO found insufficient evidence of audit work or reporting problems in some S&L audits should be a matter of concern to this Committee. The AICPA shares that concern. But the Congress and the public ought not think, as initial press accounts have suggested, that GAO's findings warrant a broad conclusion that the accounting profession failed its public trust or is in some way responsible for the current S&L crisis. To the contrary, the profession has been one of the few consistent voices urging caution (and even outright objection) to the sometimes desperate attempts by regulators, and even this Congress, to mask the true dimensions of the problem.

Your hearings today begin what I expect will be a long and difficult retrospective examination of the origins of the present crisis. The public has an understandable need to know what went wrong, what part of the system failed, and which participants contributed to failure. Obviously, auditor performance is a proper subject of inquiry. Equally proper and more to the point are inquiries concerning savings institution examiner performance and the contributive influences of the actions or inactions of the Federal Home Loan Bank Board (FHLBB), the District Banks,

^{2/} For the purpose of the GAO review, an S&L was considered to have failed when the Federal Savings and Loan Insurance Corporation (FSLIC) placed it either into receivership or into FSLIC's Management Consignment Program.

FSLIC, state governments, the Office of Management and Budget, and the Congress.

This Committee has already received considerable testimony on several of these matters. The steps to deregulate the thrift industry and the problems encountered as S&Ls sought to acclimate to changing and increasingly competitive markets have been documented and redocumented. I do not intend to offer yet another summary of events or seek to single out any particular initiative or participant for blame. What I do want to point out and emphasize for our purposes here today, however, is that the current crisis did not spring from the shadows suddenly and unexpectedly in the last few months or in the last few years.

The problems of the thrift industry, particularly those in the southwest, were well-known in the early and middle part of the 80's. It simply strains credibility to suggest or believe for a moment that today's crisis has developed because auditing firms failed "to sound early alarms about impending disasters in the industry." In fact, alarm bells were sounded by the accounting profession and others during the 1980's and were largely unattended.

ALARMS SOUNDED BY THE ACCOUNTING PROFESSION

Let me list only a few examples of how the profession responded over the years to warn about activities which the profession felt weakened accounting disciplines applicable to S&Ls.

As far back as 1981, when the FHLBB allowed savings and loan associations to defer losses from the sale of assets with below market yields, the profession warned that such treatment was inconsistent with generally accepted accounting principles.

When the FHLBB permitted certain mutual capital certificates and income capital certificates to be included as net worth, the profession warned against inconsistency with generally accepted accounting principles.

In 1982, when Congress passed the Garn/St. Germain Depositor Institutions Act which allowed qualifying subordinated debentures, appraised equity capital, and net worth certificates to be included in net worth for regulatory purposes, the profession specifically warned that such differences between regulatory accounting principles and the generally accepted accounting principles could lead to confusion and misleading financial reports.

When regulators appeared to be allowing excessive up-front income recognition for loan origination and commitment fees, the profession warned against inconsistency with generally accepted accounting principles.

Again, when proposals to permit the deferral and amortization of loan losses in a manner at odds with sound accounting procedure emerged during considerations of The Competitive Equality Banking Act of 1987, the profession warned against such actions.

And, as recently as last year, when FHLBB sought to have withdrawn AICPA's guidance requiring disclosures of certain loss possibilities in FSLIC-assisted mergers, the profession held firm.

Specific citation to the communications of the profession to the FHLBB and various committees of the Congress with respect to these matters are noted in the appendices to my statement.

PROFESSIONAL COMMITMENT TO AUDIT QUALITY

Before I make specific comment on the GAO report, I would like to present some general background about the AICPA and the financial reporting system so that my next statements might be placed in a proper context.

The AICPA and its members are committed to the goal of assuring that investors and other users of financial information have the highest quality information it is reasonable to provide. Good auditing is a necessary part of the assurance system designed to protect the integrity of financial information. But it is not the only part.

To meet users' needs, it must first be determined that the information being audited is useful for the user's purpose. Usefulness is largely determined by the nature and type of the information required to be disclosed and the accounting principles employed to measure and report it. These matters are the direct responsibility of the Financial Accounting Standards Board (FASB), the Securities and Exchange Commission (SEC) in the

case of publicly-held companies, and the bank regulatory agencies in the case of certain federally insured banking and thrift depositories. To cope with changing economic circumstances, these bodies have the primary and continuing duty to monitor and improve accounting principles.

It is the auditor's responsibility to determine whether the financial statements of the audited company are fairly presented in accordance with generally accepted accounting principles and are free from material misstatement (e.g., fraud or material error). In so doing, the auditor seeks to give reasonable assurance to the user that the financial information reported is reliable and credible. This is a function of auditing standards and procedures, auditing quality controls, and individual auditor performance. Here is where the AICPA enters the assurance system. To satisfy audit objectives, the Institute has established a number of interrelated programs to strengthen standards and auditor performance. In this respect,

- ° the AICPA has adopted and continuously augments auditing standards and other types of auditor guidance;
- ° the Institute has adopted quality control standards that are required to be followed by all members in public practice;
- ° the Institute's Division for CPA Firms monitors compliance by its members with quality control and auditing standards by a comprehensive program of peer review; and,
- ° AICPA administers programs designed to complement the activities of governmental agencies, the courts, and state boards of accountancy to deal with allegations of individual misconduct.

Over the years, the system of public and private sector supervision of the financial reporting process has evolved to produce the world's most comprehensive and reliable financial information. The system also has demonstrated remarkable adaptability to respond to changing circumstances.

Nevertheless, as good as this system has become, the Institute knows full well that the financial reporting process would deteriorate without constant attention and strengthening. This is a dynamic, evolving process in which progress is made incrementally. The job is never complete. The effort must be continuing; the commitment to improvement must be constant. Accordingly, the Institute has developed a considerable capacity for self-criticism. And, we give respectful consideration to the criticisms offered by others.

THE GAO REPORT

With this background in mind, now let us turn to the GAO report and examine it for what it says and what it does not. First, GAO has reported that it found six instances in which CPA firms "did not adequately audit and/or report the S&L's financial or internal control problems in accordance with professional standards." GAO is not asserting that the standards themselves are deficient or that the system itself is flawed. Rather, GAO is alleging performance failures or deficiencies, i.e., an alleged failure in a particular audit engagement to adhere to standards or to follow good audit procedures. Second, GAO is

critical of the speed with which CPA firms responded to the dramatic changes occurring in the financial operations of the particular S&L examined or in the S&L industry as a whole. AICPA is itself cited for not responding "quickly to all the major changes in the S&L industry." Both instances, the noted concern with auditor responsiveness and the asserted deficiencies of the Institute in providing timely audit guidance, bring into question the essential capacity of the system and its participants to respond to rapidly changing conditions. I will comment on each of these matters in turn.

A. GAO Allegations of Poor Auditor Performance

At the outset, let me be very specific: The AICPA takes most seriously any allegation concerning failures in auditor performance.

Perceptions of shortcomings in the effectiveness of independent audits erode public confidence in the integrity of the financial reporting system. In the case of publicly-held companies, a corresponding loss of investor confidence would significantly impair the capital markets and diminish the attractiveness of investment in U.S. business. A related erosion of trust in the integrity of financial reports of financial institutions could weaken depositors' confidence and provide barriers to the acquisition of new capital at the time it is most needed. Therefore, we assure this Committee that we fully understand the profession's public responsibility in these

matters. And we want you to have complete confidence that those instances of reporting and auditing problems referred for our review by GAO will be examined and acted upon expeditiously, as appropriate.

In making this pledge, however, I must note one particular word of caution. At the present moment, we have only GAO's broad statements and a list of seemingly unrelated, itemized deficiencies. These are not matched to particular firms or institutions. Although GAO's cover letter to the Committee lists the six firms whose work it criticizes, GAO has not linked the statements in its report to the firms it has identified. Nor has it provided us with the financial statements or the related audit reports. We are, therefore, operating without benefit of a concise and particularized statement of the facts and circumstances of each case.

We also have not yet received an explanation from the firms involved as to how they might view the matter. GAO informs us that its employees have consulted with each of the firms in advance of the issuance of its report, and I am sure this has occurred. But the report does not tell us whether or to what extent the firms dispute GAO's statement of the case or its conclusions. So AICPA must reserve judgment on these matters until the facts are known. Minimum standards of fair play and due process require us to do so.

Before I leave this point, I call attention to one particular comment which appears in GAO's report. Announcing its intention to refer certain specific cases to regulatory and professional bodies, the GAO offers the opinion that "[r]eview [by these bodies] of CPA's audit work and reporting, and disciplinary action if warranted, would increase the public accounting profession's awareness of the consequences of performing poor quality audits." As I said earlier, the profession treats most seriously any allegation of failed performance on the part of auditors. And we will give GAO's referrals to us serious and respectful attention. However, I hardly believe that anything we might do would significantly "increase the public accounting profession's awareness of the consequences of performing poor quality audits." That awareness is already at its zenith.

In today's litigious environment, auditors are routinely sued in the wake of business failures. Often the auditor is the only one with any remaining assets amidst the financial rubble of a failed entity. The auditor is seen not as the deepest pocket, but as the only pocket left from which to draw. The potential for damages measured in hundreds of millions of dollars and the consequent jeopardy to each partner's personal assets already provides the most compelling inducement imaginable for audit firms to perform careful work.

B. Recommendations to AICPA

Now let me turn to the GAO report's specific recommendations to AICPA and offer some comments on the pace of change in the American business environment and the ability to adapt systems to it.

In defining the conditions which may have contributed to the audit problems which it encountered in its review, GAO suggests, among other factors, that

CPA firms did not always have sufficient knowledge of the risks associated with land and ADC loans, and that the CPA firms did not always respond quickly to the dramatic changes in the financial operations of their individual clients or the S&L industry."^{3/}

Because of its role and influence in S&L auditing, the GAO has recommended that AICPA expeditiously revise the AICPA Audit and Accounting Guide for Savings and Loan Associations to provide more current guidance to auditors of S&Ls and has asked the Institute to take special measures to communicate to all of AICPA's members the results of the GAO review and other noted S&L audit problems.

AICPA is responding affirmatively to both GAO recommendations. We have already taken steps to furnish our membership with the GAO's observations and conclusions. This will be accomplished within the week. Moreover, we will publish

^{3/} GAO report, pg. 9.

the entire GAO report in the March issue of the Journal of Accountancy which goes to each of the Institute's members. In this same issue, I will address an open letter to the membership which will call attention to GAO's specific noted concerns with S&L audits. Those accounting firms identified as having S&L audit clients will receive a separate mailing of the full GAO report and a letter recommending that each firm review the quality of their S&L audits to make sure that:

- ° staff performing the audits have sufficient knowledge in S&L operations;
- ° audit methodologies are specifically tailored to take into account changes in the operations of their individual S&L clients and the S&L industry environment;
- ° evidence of all work is properly documented in the working papers; and,
- ° financial risks, regulatory violations and formal regulatory actions, and internal control weaknesses are disclosed, as required.

In addition, in response to an informal request conveyed to us by the GAO in the last few days, this letter will advise the firms to give special attention to accounting for loan loss reserves in audits currently being performed.

We have also taken steps to expedite auditor guidance in certain critical areas. As the GAO report notes, the AICPA Audit and Accounting Guide was last issued in 1979. The Guide has been in the process of revision.^{4/} Because it addresses both audit

^{4/} I should note for the record that the Guide was less than five-years old at the time the audits subject to GAO's review were conducted.

and accounting issues, a considerable degree of care must be taken in developing authoritative guidance. Also, due process procedures must be observed. Nevertheless, avenues for expediting the process are available to us. To this end, the Chairman of the Institute's Board of Directors has appointed a special committee to work exclusively on updating audit guidance for savings and loan associations with the greatest dispatch possible in keeping with our due process obligations.^{5/}

I would like this Committee to conclude from my remarks today that AICPA is responding affirmatively and with alacrity to GAO's recommendations. I do not want to leave you with the impression, however, that this is all that we believe needs to be done. I must again emphasize that efforts to improve financial reporting and audit quality are part of a continuous process. Nor should you be left to understand that AICPA or other

^{5/} GAO requests detailed discussion and specific recommendations for:

- ° identifying the nature and inherent risks of land and ADC loans;
- ° evaluating the potential effects of increases in restructured and past-due loans;
- ° following up on the work of federal examiners;
- ° ensuring that regulatory violations and formal regulatory actions are disclosed; and,
- ° properly reporting all material weaknesses in internal controls.

participants in the financial reporting system have been dormant during the emerging crisis in the thrift industry. In fact, we have been quite active.

The AICPA issues accounting and audit guidance primarily through the Accounting Standards Executive Committee (ACSEC) and the Auditing Standards Board (ASB). Included in the accounting guidance issued by the Institute in the last five years (listed in Appendix A) were seven statements of position, twelve notices to practitioners^{6/} -- including one on allowance for loan losses, insider loans, loan participants, and ADC loans -- and five practice bulletins. In particular, the Auditing Procedure Study, Auditing the Allowance for Credit Losses of Banks, issued in October 1986, significantly expanded on the available guidance on evaluating loan losses for financial institutions.

In the same five-year period, the ASB developed and issued seventeen new or revised auditing standards. This work constitutes the most comprehensive examination and restatement of auditing standards in the last thirty years. Fundamental issues addressed include matters related to an auditor's responsibilities to identify and assess the risk of material fraud, the study and evaluation of internal controls, procedures to be followed when a question arises about an entity's continued existence, and obligations to communicate with audit committees

^{6/} Of the twelve notices, all but two directly or indirectly relate to financial institutions. Three notices in the five-year period addressed developments in ADC arrangements.

of the board of directors. In addition, ASB issued during the last five years a special report on audits of repurchase securities transactions, three auditing procedure studies -- one on auditing the allowance for credit losses of banks -- and twelve audit guides.

Since 1981, AICPA has issued twelve comment letters on regulatory and legislative proposals affecting accounting and auditing issues for savings and loans and testified on two occasions before Congressional committees on S&L matters (see Appendix B). The Institute's Savings and Loan Associations Committee meets at least six times annually to identify accounting and auditing issues in the savings and loan industry. The Committee, on behalf of AICPA, sponsors an annual national conference to provide the latest update on issues affecting S&Ls. A summary of relevant topics developed in these annual conferences is included in Appendix C together with a listing of the materials covered in continuing professional education programs sponsored over the last several years by the Texas Society of CPAs. A quick perusal will show that the AICPA and the CPA state societies had identified the relevant problem issues in the savings and loan industry and were acting to "get the word out" among practitioners.

From all of this, I hope you recognize that AICPA has been busy, indeed very busy, at the job of adapting existing standards and guidance to changing circumstances. So, too, has been the

FASB. Since January 1983, the FASB has issued a number of Statements of Financial Accounting Standards and technical bulletins having direct and indirect effect on thrift institution accounting (see Appendix D). Moreover, 80 of the 192 issues addressed between the summer of 1984 and November 1988 by the FASB's Emerging Issues Task Force dealt with financial institutions and instruments.

I have brought together in the appendices to my testimony a listing of the considerable work of the FASB, the AICPA, and our continuing professional education programs so that the Committee might gain an appreciation for what is involved in keeping current our system of financial reporting and corporate accountability. It would be a mistake for the Committee or for any other party to conclude that practitioners have been without guidance or professional support since the AICPA Audit and Accounting Guide for Savings and Loan Associations was last revised. As I believe these appendices amply demonstrate, there has been a wealth of material developed and disseminated over the last 8-10 years which relates directly or indirectly to financial institutions.

Also, it is important to keep in mind that the authoritative guidance provided by AICPA, while important, constitutes only the starting point in the development of sound audit procedures. Each CPA firm designs its own audit programs and procedures tailored for each audited entity which build upon and supplement

the profession's official guidance. These programs and procedures are in a constant state of review and revision. You should understand that this is a dynamic, not a static, situation. Once an audit guide is revised, the profession does not simply lock itself into a fixed set of procedures until the guide is next revised. Firms continuously update and adapt their procedures to changing circumstances and market developments.

CONCLUSION

The most significant problem confronting the accounting profession today is the pace of change and the volatility in the American business environment. Increased competitiveness in all facets of commercial activity, wide fluctuations in the price of basic commodities, interest rate volatility and the emergence of new and ever-changing methods of finance are all presenting severe challenges to our system of financial reporting and accountability.

In no sector of our economy is that challenge as severely presented as it is in the economic world created by the deregulation of the thrift industry. Over the last decade, we have been confronted by an ever-changing host of new methods of financing and business arrangements. Little in the manner of marketplace discipline has emerged to replace previously applicable regulatory constraint. Moreover, the application of regulatory accounting principles have too often been applied to mask the savings and loan industry's true financial condition.

In this latter respect, the accounting profession (through the joint efforts of the FASB and AICPA) has been especially steadfast in its defense of generally accepted accounting principles. The integrity and uniform application of these principles remain our best shield against misleading financial information.

The public can be assured that the accounting profession will remain dedicated to protecting the integrity of generally accepted accounting principles. In addition, the AICPA will continue to strive to improve and keep current our institutional controls and technical standards applicable to the audit function to make it as difficult as possible for negligence or other human failings to persist. We must recognize, however, that no system is failsafe. Management fraud may defeat even the most well-constructed procedures. Unfortunately, error and mistakes of judgment do happen.

Equipped with the benefit of hindsight, it is possible to find instances where one may have expected the auditor to have uncovered fraud or misstatements. Nevertheless, the objective record demonstrates that independent audits of public companies continue to be of high quality. We must keep in perspective that the number of cases even alleging audit failure in these highly litigious times involve only four-tenths of one percent (.4%) of the audits performed over the last six years for entities whose securities are registered with the SEC. At the conclusion of

these cases, we are confident that the number of judicially confirmed audit failures of publicly-held companies will be even fewer. At the present moment, notwithstanding GAO's findings about the eleven audits of failed S&Ls which they reviewed, we fully expect that any examination of the entire universe of the independent audits conducted of this nation's 3,000 FHLBB-regulated savings and loan associations would also demonstrate a general high-quality of work.

Despite this expected high-quality, however, it is important to understand the limitations that attend the audit function as currently defined. An audit is based on tests. Following a set of professional standards, authoritative guidance and specific procedures, an audit seeks to permit an independent public accountant to form an opinion as to whether or not a company's financial statements are free from material misstatement and are fairly presented in accordance with generally accepted accounting principles.

The audit is not a guarantee of these things, nor could it be. For one thing, each and every transaction is not examined. A review of documents is conducted only on a test basis. More importantly, an auditor has not designed nor maintained the company's system of accounts or its system of internal controls. Nor has the auditor prepared the financial statements on which it has been asked to form an opinion. These are all responsibilities of the audited company's management. An audit,

no matter how well conducted, cannot assure management integrity or competence. Nor can it substitute for or perform regulatory functions that the Congress has assigned to agencies of the federal government.

Nevertheless, it is entirely appropriate to ask whether more can be done to strengthen the audit function. The AICPA constantly tests its systems and governance procedures with this question in mind. Accordingly, as Chairman May indicated in his introductory remarks to this testimony, the Institute intends to conduct a critical examination of its decisional processes to determine how to accommodate ever-increasing demands being placed upon them. This is a matter of particular importance to the Institute and to the profession as a whole. You may be assured we will tend to it with dispatch.

I thank the Committee for its kind attention, and I will be pleased to take any questions.

Appendices