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STATEMENT OF

FREDERICK D. WOLF, DIRECTOR

ACCOUNTING AND FINANCIAL MANAGEMENT DIVISION

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS SUPERVISION, REGULATION AND INSURANCE

OF THE

HOUSE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

ON GAO'S

1984 FINANCIAL AUDITS OF THE FEDERAL DEPOSIT INSURANCE CORPORATION AND FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss our most recent financial audits of the federal depository institution regulators. Recently, much public concern has been expressed regarding the stability of the nation's financial institutions. The number of federally insured banks and savings and loans which was closed in 1984 was a post depression high, and the failure rate in 1985 has exceeded that pace. Perhaps more importantly, the number of so called problem institutions grows each time it is reported.

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This morning, I will discuss the results of GAO's 1984 financial statement audits of the Federal Deposit Insurance Corporation (FDIC) and Federal Savings and Loan Insurance Corporation (FSLIC). The Board of the National Credit Union Administration (NCUA) manages a Share Insurance Fund which is audited by a public accounting firm. GAO audits the Fund by reviewing the firm's financial statement audit. I will briefly discuss our work at NCUA later in my testimony.

GAO's financial audits did not assess the adequacy of the deposit insurance funds and, therefore, I will not address that topic in my testimony. I will, however, discuss how assistance provided to troubled or failed institutions affects the financial statements, and the audit issues that arise from such assistance. I will also mention one of GAO's major projects to improve financial management in the federal government, and, finally, I will leave you with my observations on some of the broader issues raised by my testimony on the deposit insurance funds.

Before discussing our most recent audits of FDIC and FSLIC, I would like to talk briefly about the accounting and auditing profession in this country and GAO's responsibilities for conducting financial statement audits of the deposit insurance funds.

THE ROLE OF ACCOUNTING AND AUDITING

The United States has a vigorous system of public security markets, capital markets and private enterprise which is one of

the backbones of our economy and is second to none in the world. These capital markets are based, to a very large degree, on the concept of full and fair disclosure as the best mechanism for investor protection.

Full and fair disclosure has three primary components:

--a set of generally accepted accounting and disclosure principles which, if properly applied, should result in a full and fair view of an organization's financial position and the results of its operations,

--a responsibility by management to prepare financial statements that provide for full and fair disclosure, and

--annual independent audits that ensure the financial statements and disclosures by management do, in fact, provide a fair picture of the organization.

A comprehensive set of accounting and disclosure standards is necessary to ensure that entities follow the same rules and concepts in preparing financial reports and disclosures. Standards need to be consistently applied so that similar transactions or events will be reported the same way over time and among similar organizations.

Generally accepted accounting principles (GAAP) prescribe the principles and standards necessary to define acceptable accounting practices. GAAP and standards include not only broad guidelines of general application, but also detailed practices and procedures.

Several different organizations have been involved in establishing these principles. Prior to 1973, the Accounting Principles Board of the American Institute of Certified Public Accountants provided much of the leadership in developing standards for financial accounting and reporting. In 1973, that board was replaced by the seven member Financial Accounting Standards Board to give a new impetus to the further development of GAAP. Its members include representatives from the accounting profession, an accounting educator, a corporate financial executive and an official from the federal government. In July 1984, another body, the Governmental Accounting Standards Board, began operations. It was created to establish nationwide standards for financial accounting and reporting by state, county, and municipal governments.

Independent audits of financial statements and disclosures are vitally important to assure for the public the credibility of those statements and disclosures. Such audits must follow a generally accepted set of auditing standards and must be properly performed by competent professionals applying their professional judgment to the circumstances of the specific audit. The independent auditor is responsible for expressing an opinion, in the form of an audit report, on the fairness of the financial statements. Without the independent auditor's report, financial statements would have little meaning because the entity would be representing its financial condition and results of operations without an independent assessment for the user's protection.

GAO'S AUDITS OF GOVERNMENT CORPORATIONS

The Government Corporation Control Act (GCCA), 31 U.S.C. 9105, requires GAO to audit the financial transactions of government corporations in accordance with principles and procedures applicable to commercial corporate transactions. GAO issues reports on the financial statement's fair presentation and conformity with GAAP, and the adequacy of the entity's internal accounting controls and compliance with laws and regulations. GAO staff either directly perform financial statement audits of the entities or audit by reviewing the audit work of other independent auditors.

GAO is presently responsible for conducting audits of 49 government corporations and similar entities. The GCCA lists 22 entities as wholly owned or mixed ownership government corporations. GAO audits the other 27 entities under laws which essentially provide that GAO shall audit in accordance with principles and procedures similar to those contained in the GCCA. FDIC and FSLIC are government corporations. GAO is required to audit FDIC triennially and FSLIC annually under 31 U.S.C. 9105(a)(2). The NCUA is an independent agency and its Share Insurance Fund is not classified as a government corporation. Thus, the Fund is audited by GAO under the Fund's authorizing legislation, the Federal Credit Union Act, although the terms of the audit are like those for government corporations. GAO has been auditing these entities on an annual basis.

Some government corporations and similar entities have determined that they have statutory authority in their authorizing legislation to contract for the independent audits. At present, about 30 of the entities are audited annually by independent CPAs. In such cases, GAO discharges its statutory responsibility by reviewing the corporations' financial statements and the work of the independent auditor. GAO includes the CPA's report and the entity's financial statements, along with the results of GAO's review, in an audit report to the Congress. This avoids a duplication of effort and enables GAO to spread its limited resources among a greater number of entities.

On each of our financial audits, we determine if the financial statements are in conformance with GAAP. To the extent that the statements do not conform to GAAP, we recommend that the entity make appropriate adjustments to bring the statements into conformance. If such adjustments are not made and the amounts involved are material, our opinions are qualified due to the departures from GAAP.

PURPOSE OF THE FDIC AND FSLIC INSURANCE FUNDS

Now let me return to FDIC and FSLIC. As of December 31, 1984, FDIC insured an estimated $1,390 billion in deposits in 14,785 commercial and mutual banks, and FSLIC insured an estimated $724 billion in deposits in 3,167 savings and loan institutions. These deposit insurance funds were created primarily to restore depositors' confidence and reduce the

likelihood and consequences of widespread depository institution failures. To accomplish these objectives the FDIC and FSLIC have a variety of options at their disposal to assist troubled institutions. And if an institution does fail, the FDIC or FSLIC pays off the insured depositors and then seeks recovery through liquidation (sale) of the institution's assets.

Both FDIC and FSLIC are authorized to act to prevent the failure of an insured institution. FDIC may make loans, secured in whole or part, by the assets of an insured bank; purchase any assets or guarantee any insured bank against loss by assuming the liabilities and purchasing the assets of an open bank; or arrange a merger of a failed or failing insured bank with another insured bank. FSLIC may loan or give contributions to an institution to prevent its default or it may facilitate the merger, consolidation, or acquisition of the assets of the institution.

Liquidating an insured institution

When federal or state chartering officials close an insured institution, the appropriate federal insurance authority is normally designated as the receiver. The federal insurance authority, in its corporate capacity, settles the insurance claims either by a cash payout of insured accounts or by transferring the insured accounts to another insured institution. In either situation, the insurance authority in its corporate capacity acquires the account holders' claim against the assets of the defaulted institution. In its

receivership capacity, the insurance authority is then responsible for liquidating the failed institution's assets, recovering the proceeds, and making periodic cash distributions to the failed institution's creditors.

Assets being liquidated by the receiver do not appear on the depository insurers' financial statements. However, FDIC's and FSLIC's financial statements do contain line items which represent the total outstanding claims against the assets of failed institutions. To achieve a fair valuation of this amount, the financial statements should contain an allowance for possible losses on outstanding claims. The allowance represents the estimated loss to the depository insurer based on a calculation of the ultimate collectibility (net realizable value) of the assets of the failed institution being liquidated.

OVERVIEW OF GAO'S 1984
AUDITS OF FDIC AND FSLIC

GAO audited the FDIC and FSLIC as of December 31, 1984, and issued its opinions in reports to the Congress dated May 29, 1985 (GAO/AFMD-85-58), and July 16, 1985 (GAO/AFMD-85-60), respectively. We gave "qualified" opinions to FDIC and FSLIC on their 1984 financial statements indicating our concern about the value of certain assets acquired during default prevention or liquidation activities. Estimating the net realizable value, which includes an allowance for loss, is not easy, as such an estimate is likely based on less than complete information. GAO's opinion on FDIC's 1984 financial statements was qualified because FDIC management did not establish an allowance for loss

related to the loans acquired from Continental Illinois National Bank and Trust Company of Chicago (Continental Bank). Our opinion on FSLIC's 1984 financial statements was qualified due to the uncertain collectibility on claims against assets acquired from three large savings and loan institutions which had failed during the year.

FDIC's 1984 FINANCIAL STATEMENTS SIGNIFICANTLY OVERSTATE THE VALUE OF ASSETS ACQUIRED FROM CONTINENTAL BANK

In GAO's opinion, FDIC's financial statements presented fairly the financial position of FDIC as of December 31, 1984, except for the lack of an allowance for loss on the $2.1 billion of poor quality loans and other assets acquired from Continental Bank as part of an assistance program. We believe the value of those assets was significantly overstated. FDIC should have recognized the probable loss in its accounts as of December 31, 1984.

Before discussing the details of FDIC's accounting for the assistance provided to Continental Bank, I will briefly discuss the financial condition of Continental Bank which led to FDIC's assistance program. It is not my intention to evaluate the merits of the decision to assist rather than liquidate Continental Bank. My purpose today is to discuss FDIC's accounting for the assistance program and whether that assistance is presented fairly in FDIC's 1984 financial statements.

Overview of problems at Continental Bank before the assistance program

The problems of Continental Bank are well known to this Subcommittee. Your September 1984 and July 1985 reports[1] detail those problems including the bank's imprudent strategies and policies of rapid growth that depended upon a strong economy in general, and the energy industry in particular, at the expense of quality loans and investments.

According to the Subcommittee's reports, during the late 1970s Continental Bank outperformed its peers in growth, earnings and market acceptance. For the 5 years ending in 1981, Continental Bank had become one of the largest corporate lenders, increasing total assets by $22.5 billion from $18.6 to $41.1 billion. Material weaknesses occurred in the bank's system of internal controls for loans (written policies and procedures to monitor and control loan activities). Significant problems with asset quality in the bank's oil and gas lending department were highlighted by the Penn Square Bank failure in July 1982. Continental Bank held about $1.1 billion of Penn Square's loans. In 1983 and 1984, significant credit worthiness and loan documentation deficiencies were revealed by bank

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[1]"The Financial Performance of Continental Illinois National Bank: A Chronology and Peer Group Comparison" dated September 1984, and "Continental Illinois National Bank: Report of an Inquiry Into its Federal Supervision and Assistance" dated July 1985. Staff reports to the Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the House of Representatives Committee on Banking, Finance, and Urban Affairs.

examiners and others in Continental Bank's loan operations. As a result, more and more loans were labeled as nonperforming (at least 90 days in arrears). By June 30, 1984, nonperforming loans amounted to $2.8 billion as compared to $444 million as of January 1981.

The Subcommittee's reports discuss the crisis of confidence in Continental Bank that occurred in May 1984 when rumors began circulating that the bank was near insolvency. The bank experienced a serious liquidity problem resulting from the loss of a major portion of both its domestic and foreign funding base. Major providers of overnight and term funds did not renew their holdings and the bank was forced to prepay time deposits and to arrange for the replacement of certificates of deposit. Because no other adequate funding sources were available, the bank resorted to Federal Reserve Bank borrowings which rose to an average daily level of $2.6 billion.

On May 17, 1984, the FDIC, Federal Reserve, and Comptroller of the Currency announced a temporary assistance plan that also included loan participations (partial ownership in a loan or group of loans) by a number of major U.S. banks. The purpose of the plan was to stabilize the bank and provide the regulators additional time to find a permanent solution. The plan provided a $2 billion loan ($1.5 billion was provided by the FDIC with the balance provided by a group of major commercial banks) through the Federal Reserve Bank of Chicago. In addition to Federal Reserve borrowings, a consortium of 28 banks made available a $5.5 billion standby line of credit.

The permanent assistance program for Continental Bank

After FDIC attempted unsuccessfully to find a merger partner, federal regulators concluded that the only practical resolution to the problem was to have Continental Bank continue as an independent institution. To achieve this, a permanent assistance program was announced on July 26, 1984. The major components of that program included the

--installation of a new management team,

--infusion of $1 billion in new capital,

--removal of $4.5 billion in problem loans, and

--continuation of the lines of credit from the Federal Reserve and commercial banks.

The temporary assistance plan's $2 billion loan was repaid by Continental Bank.

Under the terms of the permanent assistance program, the $1 billion capital infusion was from FDIC's purchase of two new issues of Continental Illinois Corporation (the bank's holding company) preferred stock. The first issue, 32 million shares of nonvoting Junior Perpetual Convertible Preference Stock acquired for $720 million, is convertible, upon sale by FDIC to a third party, into five shares of common stock of Continental Illinois Corporation. The second issue, 11.2 million shares of nonvoting Adjustable-Rate Preferred Stock, was purchased for $280 million. This Adjustable-Rate Preferred Stock is callable at Continental Illinois Corporation's option and pays a dividend

tied to the U.S. Treasury rate. During the first three years, the dividend is payable in cash or additional adjustable-rate preferred stock.

The removal of $4.5 billion in problem loans from the bank is being accomplished in several steps. In 1984, $1 billion was written off as a loss by the bank. At that time, FDIC assumed $2.0 billion of the troubled loan portfolio and accepted a promissory note from the bank for $1.5 billion payable within 3 years in cash or with additional troubled loans. As of December 31, 1984, FDIC had acquired a total of $2.1 billion in troubled loans from the bank, and as of June 30, 1985, the bank had transferred a total of $387 million in troubled loans toward the $1.5 billion promissory note. In return for the troubled assets acquired or to be acquired, FDIC assumed the bank's indebtedness to the Federal Reserve Bank of Chicago. Under the assistance agreement, FDIC will pay $3.5 billion plus interest to the Federal Reserve Bank within 5 years (by September 26, 1989) from collections, less expenses, of the troubled loans. If there is a shortfall at that time, FDIC will make up the deficiency with its own funds.

In conjunction with the loan assumption, FDIC was also granted an option to purchase up to 40 million shares of the common stock of Continental Bank's holding company, Continental Illinois Corporation. The purpose of the option is to compensate FDIC for any losses incurred from the collections on the troubled loan portfolio, including administrative costs and

interest expense. If the troubled loan portfolio is not sufficient to repay the $3.5 billion Federal Reserve Bank indebtedness, then FDIC can exercise its stock option to acquire one share of common stock for every $20.00 of loss at the exercise price of $0.00001 per share. If FDIC does not suffer any loss under the permanent assistance program all remaining loans and other assets acquired will be returned to Continental Bank and the option would not be exercised.

FDIC's accounting for the permanent assistance program

In accounting for the permanent assistance program in 1984, FDIC followed generally accepted accounting principles, except for not establishing an allowance for loss on the troubled loans acquired from Continental Bank. FDIC recorded the assumed $3.5 billion indebtedness to the Federal Reserve Bank; the $1 billion investment in Continental Illinois Corporation preferred stock; the $1.5 billion promissory note received from Continental Bank; and the $2.1 billion of troubled loans received from Continental Bank as assets. FDIC did not establish an allowance for loss necessary to achieve an estimated net realizable value of the troubled loans. FDIC included a detailed footnote to the financial statements describing the substance of the permanent assistance program. Regarding the troubled loans, FDIC stated that ultimate collection was subject to significant uncertainties because of the financially troubled nature of the borrowers and the effects of general economic conditions on their industries. FDIC added that because of the complexity and

the number of loans transferred, an estimate of the ultimate collectibility was not completed and, therefore, a determination had not been made as to whether any allowance for loss was necessary.

Preferred accounting treatment for the troubled loans acquired as of December 31, 1984

Generally accepted accounting principles provide that two conditions must be met for a loss contingency[2] to be charged to income as of the date of the financial statements: (1) it is probable that the asset value has been impaired and (2) the amount of the loss can be reasonably estimated. We believe those two conditions existed.

Value of the acquired troubled loans was impaired

GAO believes that FDIC will experience substantial losses from the loan portfolio acquired from Continental Bank. FDIC did not provide us access to the acquired loan portfolio. It only allowed us a limited review of the listing of borrowers. However, all of the loans were classified by bank examiners indicating that some, if not all, of the loan amounts will not be recovered. Some of the acquired loans had previously been written off by Continental Bank as partially or totally worthless. The majority of the loans transferred to FDIC are

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[2]For accounting purposes, a contingency is an existing condition, situation, or set of circumstances involving varying degrees of uncertainty that may, through one or more related future events, result in the gain or loss of an asset or the incurrence or avoidance of a liability.

in troubled segments of the economy, such as oil and gas and commercial real estate. As of June 30, 1985, 52 percent of the unpaid face value of the transferred loans were oil and gas industry related loans, and 10 percent were mortgage and real estate loans.

The probable loss could have been reasonably estimated

GAO believes that FDIC could have determined a reasonable range of probable losses associated with the troubled loan portfolio. During the federal regulator's review of Continental Bank, the loan portfolio was scrutinized by professional bank examiners and loans were categorized as "substandard," "doubtful," or "loss,"[3] each with an increasing percentage as to the estimated loss on that loan. This information was available to FDIC. In May 1985, before FDIC published its financial statements, a range of estimated loss was determined by Continental Bank. The estimated loss ranged from $551 to $774 million and was based on estimated cash collections, assumed interest rates, economic conditions,

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[3]A "Substandard" classification is assigned to those assets inadequately protected by the current sound worth and paying capacity of the obligor, or pledged collateral, if any.

A "Doubtful" classification is assigned to those assets that have all the weaknesses inherent in an asset classified substandard and their collection or liquidation in full is highly questionable.

A "Loss" classification is assigned to those assets considered uncollectible and of such little value that their continuance as an active asset of the bank is not warranted. Loss classification does not mean that an asset has absolutely no recovery or salvage value.

collection expenses, and collateral value. If FDIC had reported the lower amount of the range of estimated loss in its 1984 financial statements, its 1984 stated income would have been reduced by 30 percent, from $1.7 to $1.2 billion.

We understand that FDIC is evaluating the troubled loan portfolio to determine an estimated loss. We will be assessing the adequacy of the estimated loss as part of our audit of FDIC's 1985 financial statements.

FDIC'S PUBLISHED FINANCIAL STATEMENTS EXCLUDE GAO'S AUDIT OPINION

FDIC's 1984 annual report of its operations, which included its financial statements, did not include our opinion on its financial statements. We were surprised that our audit opinion was excluded, as we had worked closely with FDIC's staff to have our opinion ready for publishing in the annual report. Although we are not aware of any legal requirement for FDIC to publish GAO's opinion in its annual report, we believe FDIC should have included our opinion to fulfill its disclosure responsibility to the Congress and other users of its annual report and financial statements. Without the independent auditor's report, the financial statements have less credibility.

Government entities, like private corporations, should include the independent auditor's opinion in their annual reports because of its value to users of their statements. In the case of FDIC, users and interested parties include commercial banks, the Congress, and the citizenry. Having an annual financial audit and reporting the results to the public

is an important discharge of management's fiduciary responsibility. Including the auditor's opinion on the financial statements in FDIC's annual report provides readers and users with an independent assessment of whether the financial information is complete and reliable.

We have worked with FDIC for many years and have found the organization to be very dedicated and professional. While we have not always been in complete agreement on whether FDIC's transactions are fairly presented in its financial statements, FDIC should not withhold these differences from public disclosure.

FDIC's annual report provides the opportunity for management to comment on our audit opinion and, thereby, provide its readers with management's perspective. The Comptroller General has communicated these views to Mr. Isaac, and we hope that FDIC will include our audit opinions in its future annual reports.

FSLIC'S 1984 FINANCIAL STATEMENTS INCLUDE ASSETS OF UNCERTAIN VALUE

In GAO's opinion, FSLIC's 1984 financial statements are fairly presented subject to the uncertain net realizable value of claims against assets acquired from three large institutions--Empire Savings and Loan, Mesquite, Texas; Knox Federal Savings and Loan, Knoxville, Tennessee; and San Marino Savings and Loan, San Marino, California--that were closed in 1984. As of December 31, 1984, FSLIC held $1.3 billion in claims against the assets of the three institutions, and had

established a $468 million allowance for loss based on a preliminary estimate that did not include all possible costs. The recency of the San Marino and Knox Federal failures in late 1984, along with inadequate loan records and pending and possible litigation affecting the three institutions, precluded determining a better estimate of the ultimate collectibility of the claims. Given these uncertainties, we were not able to satisfy ourselves that FSLIC's allowance for loss estimate was reasonable.

<u>Determining the allowance for loss</u>

As previously discussed for the troubled assets FDIC acquired (page 15), GAAP provides that an allowance for loss should be established when it is probable that an asset's value has been impaired, and the amount of the loss can be reasonably estimated. FSLIC followed that guidance in establishing the allowance for loss on the claims against the assets of Empire, Knox Federal, and San Marino.

Also, in accordance with GAAP, to establish the allowance for loss, an impaired asset should be valued on a net realizable basis. To determine net realizable value, management should consider, to the extent possible, the estimated sales price of the asset, disposition costs, direct holding costs (estimated future income and expenses), cost of funds, holding periods, and discounted cash flows.

FSLIC has a two-step process to determine an allowance for loss on claims against assets acquired from failed institutions (where FSLIC has been appointed receiver).

The first step is to calculate an estimate using a cost-to-liquidate analysis. This calculation is a preliminary estimate of the total cost FSLIC would incur should it liquidate the failing institution. It is used to determine the least costly method of dealing with the failing institution's problems. Information available for the analysis may not always be sufficient to compute the ultimate collectibility of the assets. For example, for the three failed institutions, the computation used unaudited financial data that was also several months old, and data stated on a regulatory accounting basis, which included items such as appraised equity capital not recognized by GAAP. Based on the cost-to-liquidate analysis calculation, FSLIC established a $468 million allowance for loss on the failure of Empire, Knox Federal, and San Marino. FSLIC used the allowance in its December 31, 1984, financial statements to value its claims against the assets of the three institutions.

The second step in FSLIC's process is to adjust the allowance figure based on the completion of an inventory audit of the assets being liquidated. FSLIC, as receiver, contracts with a public accounting firm for the audit. Under the terms of the contract, the firm prepares a detailed inventory schedule of all assets and liabilities, and performs an examination of the balance sheet for the receivership at the date of liquidation. The initial balance sheet audit is to be based on a net

realizable value basis. The net realizable value calculation produces a more realistic amount of FSLIC's ultimate collectibility on the assets acquired than the cost-to-liquidate analysis.

As the assets are liquidated and actual experience gained on recoveries, the estimated losses are adjusted annually to reflect this experience. These revised estimates of loss are based on judgments made by the managing officer responsible for liquidating the assets of the receivership. In addition, FSLIC contracts with a public accounting firm to perform a yearly audit of the receivership's balance sheet, which includes an evaluation of the procedures followed in determining the reasonableness for the annual adjusted net realizable value.

The value of acquired assets is uncertain

As of the date of our report, FSLIC had not received a report from the public accounting firms on two of the inventory audits. In the report received (Empire), the auditors had not expressed an opinion on the net realizable value of the assets. As a result, FSLIC initially relied on a March 12, 1984, estimate arrived at by the cost-to-liquidate analysis to determine the value of the assets. The allowance for Empire was revised downward from the cost-to-liquidate amount based on the judgment of the receivership's managing officer.

According to the contracts with the public accounting firms, the inventory audits were to be completed for Empire in August 1984, Knox Federal in March 1985, and San Marino in April 1985. These dates were not met and the firms asked for and were granted extensions. To understand the problems encountered by the public accounting firms in evaluating the net realizable value of the assets, we will present an overview of the conditions that existed at each institution prior to its failure.

We obtained the following information on the three institutions from sources such as reports of examination by the Federal Home Loan Bank Board's[4] Office of Examination and Supervision, various filings by the institutions with the Securities and Exchange Commission, the financial statement and inventory audits performed by public accounting firms, and other evidence from various Federal Home Loan Bank Board divisions. The information revealed a scenario of rapid growth, primarily resulting from the use of brokered deposits (jumbo savings obtained through brokers) to fund highly speculative loans and real estate investments, and material deficiencies regarding management practices, lending policies, recordkeeping and compliance with Bank Board regulations. Several examples follow.

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[4]The Federal Home Loan Bank Board is responsible for supervision and regulation of all federally insured savings and loan institutions.

Empire's assets increased from $20 million in March 1982 to $320 million in March 1984, a 1,500 percent increase over the 2-year period. The rapid growth was based on a lending policy that created large excessive amounts of loans to purchase undeveloped land based on artificially inflated land prices. When the loans matured, construction loans were being granted that included the previous principal, loan origination fees, interest closing costs, and construction and promotional costs of the condominiums. Empire was closed on March 14, 1984.

Knox Federal was closed on November 16, 1984. The net realizable value of many assets at Knox Federal have not been obtained because of the deficient conditions that existed prior to the failure. For example,

--highly speculative and alleged fraudulent loans were extended to related parties and insider entities,

--loan underwriting was often based on appraisals that were inflated and not supported by adequate documentation and in many cases failed to meet the regulators' guidelines,

--loan files often lacked adequate documentation, and

--loans were made in excess of the value of the underlying collateral.

San Marino was closed on December 6, 1984. San Marino's total assets increased from $2 million, at the beginning of its operations in October 1979, to $840 million at its failure in late 1984. Such growth was fostered primarily by the acceptance of brokered deposits to fund aggressive real estate lending

activities. For example, San Marino's financial statements at December 31, 1983, showed that 43 percent of its total assets were real estate which included construction loans and joint venture projects in various geographic locations. Also, San Marino often had an investment rather than a secured position in these projects, which complicated the net realizable value determination. Other significant uncertainties existed related to the assets pledged as collateral for the secured advances. For example, in a letter dated April 11, 1984, the Federal Home Loan Bank of San Francisco advised FSLIC that San Marino had delivered only $150.6 million worth of collateral to secure $360 million of FSLIC-guaranteed advances. Of this amount of collateral, $24.8 million constituted construction loans not normally eligible under the Bank's credit program.

Current status of the inventory audits of Empire, Knox Federal, and San Marino

Since our audit opinion was issued on May 3, 1985, information has not yet been finalized that is needed to resolve the uncertainties we addressed in our qualified opinion.

On February 22, 1985, the public accounting firm of Touche Ross & Company issued its opinion on the March 14, 1984, inventory audit of Empire. Touche Ross & Company stated that deficiencies in recordkeeping practices in Empire's accounting system plus the fact that the institution's operating management personnel were no longer employed by the receivership precluded obtaining sufficient and competent evidential matter to

determine the extent to which adjustments were necessary to state the accounts in accordance with GAAP. As a result of these conditions, Touche Ross & Company did not express an opinion on the inventory audit of the assets in liquidation.

The final inventory audit reports for both San Marino and Knox Federal have not yet been issued. Price Waterhouse believes that a draft of the inventory audit of San Marino may be completed by the end of September. Deloitte, Haskins + Sells believes that its inventory audit report on Knox Federal may be finalized by mid-September. The public accounting firm stated that it will not be able to determine the net realizable value of all the assets due to substantial unresolved litigation and alleged excessive amounts of fraud and misappropriation. As a result, it will not express an opinion on the November 16, 1984, inventory audit of Knox Federal.

ERNST AND WHINNEY'S OPINIONS ON THE SEPTEMBER 30, 1984 AND 1983, FINANCIAL STATEMENTS OF THE NATIONAL CREDIT UNION SHARE INSURANCE FUND

The Share Insurance Fund, governed by the National Credit Union Administration Board insures members accounts in federal credit unions and qualifying state credit unions. The NCUA Board contracts for annual audits of the Share Insurance Fund. The public accounting firm of Ernst and Whinney conducted the 1984 and 1983 examinations. The Federal Credit Union Act (12 U.S.C. 1789(b)(2)), provides that NCUA maintain the Share Insurance Fund's accounts which shall be audited by GAO in

accordance with principles and procedures applicable to commercial corporate transactions as provided in the GCCA. To avoid unnecessary expense and make the most efficient use of our available resources, we audited the Fund by reviewing Ernst and Whinney's audit and relying on it to a considerable extent, rather than duplicating the work of the firm. We have completed our review of Ernst and Whinney's examination of the 1983 Share Insurance Fund financial statements, and we are in the process of reviewing the 1984 audit.

In the opinion of Ernst and Whinney, except for (1) a departure from generally accepted accounting principles in accounting for the cumulative effect of a change in providing for estimated losses from supervised credit unions and (2) the lack of sufficient data in support of the provisions for losses from supervised credit unions, and asset and merger guarantees, the Share Insurance Fund's financial statements present fairly its financial position as of September 30, 1983, and the results of its operations for the year ended September 30, 1983, in conformity with generally accepted accounting principles applied on a consistent basis.

Except for not mentioning the absence of a statement of changes in financial position for the Share Insurance Fund, we found nothing to indicate Ernst and Whinney's opinion on the 1983 financial statements of the Share Insurance Fund are inappropriate or that they cannot be relied on.

Ernst and Whinney did not prepare the reports on internal accounting controls and compliance with laws and regulations required by generally accepted government auditing standards because its contract did not require such reports. However, Ernst and Whinney did study and evaluate internal accounting controls and test transactions for compliance with key laws and regulations. Its work did not disclose any material internal control weaknesses or noncompliance with laws and regulations.

Ernst and Whinney has reported that the 1984 financial statements of the Share Insurance Fund are fairly stated. According to the audit report, Ernst and Whinney satisfied itself that the estimated losses and the related provision for insurance losses were reasonable based on its review of the Share Insurance Fund's actual loss in 1984. The auditor's 1984 report also removed that qualification from the 1983 financial statements. The other qualification in the 1983 report, accounting for the cumulative effect of the 1983 change in providing for estimated losses from supervised credit unions, remained as a qualification on the 1983 financial statements but had no effect on the 1984 statements. GAO has not completed its review of the 1984 audit.

IMPROVING FINANCIAL MANAGEMENT IN THE FEDERAL GOVERNMENT

Before wrapping up with some observations on broader issues related to my testimony, I want to mention one of GAO's major projects--building an effective financial management structure to manage the cost of government. Government corporations are

ahead of most federal departments and agencies in producing business-like financial statements to report the results of their operations and in having an audit conducted by independent auditors to attest to the reliability of the financial statements. It is GAO's long-term goal to bring about regular financial audits of the federal departments, agencies, government corporations, and the consolidated financial statements of the U.S. government. Although there are some problems with the financial statements of FDIC, FSLIC and NCUA, the financial disclosure of these entities is more useful than that for most federal agencies which do not have business-like financial statements.

GAO is trying to move the federal government toward putting its financial management systems in order, so that reliable and useful financial management information is produced and reported, and that annual independent audits are conducted to provide assurance that the financial statements are reliable. We have put together a two-volume educational document entitled "Managing the Cost of Government: Building an Effective Financial Management Structure" (GAO/AFMD-85-35) and (GAO/AFMD-85-35a), dated February 1985. Volume I outlines the major issues and problems, while the second volume provides a conceptual framework for a new system. Under this framework agencies would prepare financial statements that would be subject to an annual audit. Improved financial management is not a panacea that will solve the government's budget problems,

but the benefits will provide federal policymakers with relevant and reliable information needed to manage the federal government and to inform the public on the financial condition of the government.

OBSERVATIONS

I would now like to mention what I think are some of the broader issues which my testimony has touched upon. These are (1) the financial problems facing financial institutions--thrifts in particular, (2) the riskier activities now engaged in by some financial institutions, (3) the need for full and fair public disclosure, and (4) the increasing responsibility of the auditors of financial institutions.

In today's world, prudently managing a bank or thrift institution is not an easy job. Beginning with the problems related to real estate investment trusts in the mid-1970s, financial institutions entered a decade of turmoil. The environment in which they operate has been increasingly deregulated and become far more competitive, while promising areas of growth have presented significant new risks. At the same time, the economy has shifted from growth and inflation, to one with significant business cycles, and for the past few years, relatively stable prices. The roller coaster ride of interest rates has only recently ended and there is mixed opinion on whether it will renew itself.

Large banks poured money into foreign loans and the energy sector and today they are counting their current experience with many of these loans as nonperforming assets. Smaller banks have been troubled by agricultural loans. But more so than the banks, savings and loans and mutual savings banks have encountered the most severe financial difficulties. Until the mid-1970s, thrifts operated in a relatively simple environment, obtaining deposits at artificially low rates under Regulation Q and investing in fixed rate, long-term mortgages at several percentage points higher. But when short-term interest rates skyrocketed in the early 1980s and thrifts were forced to compete for deposits in a deregulated environment, the fixed-rate mortgage became the villain as institutions were now financing these long-term investments with 15 percent certificates of deposit. As a result, 511 thrifts failed from 1980 to 1984, according to Bank Board figures.

Now a new problem has emerged--poor quality loans and investments. In order to earn a higher rate of return, some thrifts made questionable loans and direct investments which offered greater profits, but presented far greater risks. The growth of direct investment activity, in lieu of traditional debt investment, can be traced to the recent deregulation of interest rates, which increased the pressure on savings institutions to turn away from traditional low-yielding home mortgages. Recent federal and state laws triggered much of this growth by granting thrifts the authority to invest in equity

securities and real estate development, among other investments. Although direct investments particularly in commercial real estate and development can be more profitable than normal investments, they also are more risky and have contributed to some of the more spectacular and potentially costly failures in recent years, including San Marino, Empire, and Beverly Hills Savings and Loan Association.

While the Bank Board has discontinued reporting the number of problem thrifts, Chairman Grey has been quite candid in his concern for the industry. In a recent report prepared by FDIC in anticipation of a merger of the deposit insurance funds, FDIC noted that institutions insured by FSLIC have tangible capital of just $6.2 billion on assets of $956 billion. Recently, the thrift industry, overall, has become more profitable due to the general decline in interest rates. However, it remains to be seen if interest rates will remain stable long enough to allow the thrift industry to absorb losses related to poor quality loans and investments and rebuild its weakened net worth position. The concern we have over asset quality remains as many of these problems are slow to be identified.

Recent work we have performed at the request of the House Subcommittee on Oversight and Investigations demonstrated that Beverly Hills' assets grew from $402 million in 1979 to nearly $2 billion by the end of 1983. The growth was largely attributable to Beverly Hills' involvement (often as an investment rather than a lender) in apartment projects, major office buildings, and hotel construction.

The Bank Board has recently observed that "The exercise of these nontraditional investment powers can expose institutions and the FSLIC to a degree of risk inconsistent with the purposes of" the laws establishing federal deposit insurance. We certainly agree and would suggest that the Subcommittee, in the course of these hearings on deposit insurance, reevaluate the insurance program--why it was set up and the type of financial institutions and product offerings it was intended to cover; and determine if certain activities of insured institutions should no longer qualify, or if some adjustment should be made to the insurance premiums these firms pay.

Finally, the need for full disclosure of nonperforming assets and the responsibilities of the independent auditor are related issues I want to briefly mention.

We are working with government corporations to improve the usefulness of their financial statements for their constituents --the Congress and the general public. There is a need for an equal focus on agency financial statements. For example, our experience with FDIC and FSLIC raises the question of what may be uncovered when the combined statements of the federal government are audited. As of September 30, 1984, total outstanding direct loans by the federal government amounted to about $225 billion, and another $400 billion in loan guarantees existed. We believe federal agencies should be preparing financial statements which are audited to increase reliability.

In similar fashion, I have concern that banks and thrifts have been far too slow to recognize the uncollectible portion of their assets. Failures of financial institutions have all too often appeared to leap upon us from nowhere. In retrospect, the failed institutions have been remiss--to be kind--in not establishing a reasonable reserve which recognizes the inherent potential loss in their loan portfolio and investment position. This is where the role of the independent auditor becomes critical.

The auditor accepts a great deal of responsibility in auditing a bank or thrift, and some recent failures have called the auditors' performance into question. I'm not sure I have the answer today, but it may involve a number of things: a closer study of the entity's internal controls in the loan function, a more conservative assessment of the methodology used to estimate losses, a closer questioning of the reserves themselves, greater sharing of information with federal and state regulators, and more disclosure about the entity's activities and risk management strategies in the notes to financial statements. Whatever the answer, auditors of financial institutions must recognize that they are auditing institutions of public trust, and conduct their audits in the most professional and responsible manner possible.

Mr. Chairman, this concludes my statement. I would be happy to address any questions the Subcommittee may have.