

1983

## Audits of banks (1983); Industry audit guide; Audit and accounting guide

American Institute of Certified Public Accountants. Banking Committee

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**AICPA**

American Institute of Certified Public Accountants

**INDUSTRY AUDIT GUIDE**

**AUDITS OF  
BANKS**

**PREPARED BY THE  
BANKING COMMITTEE**

# **AUDITS OF BANKS**

**PREPARED BY THE  
BANKING COMMITTEE**

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## NOTICE TO READERS

This audit guide presents recommendations of the AICPA Banking Committee regarding the application of generally accepted auditing standards to audits of financial statements of entities in the banking industry. It represents the considered opinion of the committee on the best auditing practice in the industry and has been reviewed by members of the AICPA Auditing Standards Board for consistency with existing auditing standards. AICPA members may have to justify departures from the recommendations contained in this guide if their work is challenged.

This guide also includes descriptions and recommendations regarding specialized accounting and reporting principles and practices for the banking industry. The descriptions and recommendations may refer to an FASB statement or interpretation, an APB opinion, or an accounting research bulletin, all of which are pronouncements enforceable under rule 203 of the AICPA Code of Professional Ethics. Although this guide does not have the authority of those pronouncements, it is intended to be helpful in determining whether financial statements are in conformity with generally accepted accounting principles. Statement on Auditing Standards No. 5, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report*, as amended by SAS No. 43, *Omnibus Statement on Auditing Standards*, identifies AICPA guides as sources of established accounting principles that an AICPA member should consider.

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## Preface

This audit guide has been prepared to assist the independent CPA in examining and reporting on financial statements of commercial banks, savings banks, and bank holding companies. Also, it should help officers and directors of banks, as well as other interested persons, to understand the nature and scope of audits of banks by independent CPAs.

In the last decade, many changes have occurred in the banking industry. Bank supervisory authorities have taken substantial steps to improve financial reporting. Bank holding companies have become a major factor in the industry, and the range of services offered by banking institutions has expanded. The supervisory authorities have expressed increased interest in reliance on examinations by independent CPAs. Since 1971 the Securities and Exchange Commission has required audits of the financial statements of banks included in filings with the SEC.

Because of these changes, the American Institute of Certified Public Accountants Banking Committee has revised the banking industry audit guide, *Audits of Banks*, originally published in 1968 and supplemented in 1969. This guide is a complete revision of that publication.

This guide emphasizes aspects of accounting and auditing that are unique to the banking industry. It reflects the presumption that the CPA understands accounting and auditing matters that are common to business enterprises in general. The guide presents typical audit situations in banks, including the CPA's review of internal accounting controls; however, the discussions do not necessarily cover all audit situations that a CPA might encounter in banks.

References to AICPA Statements on Auditing Standards and the authoritative accounting pronouncements of the Financial Accounting Standards Board (FASB) and its predecessor organizations, the Accounting Principles Board and the Commit-

tee on Accounting Procedure, are intended to include the specific pronouncements as well as all subsequent amendments and interpretations of them through November 1, 1982. The CPA should be familiar with any auditing or accounting interpretations issued after that date.

Finally, users of this audit guide should also be aware that certain issues affecting the banking industry have not been included in this guide or are currently under study by the committee, the AICPA Accounting Standards Executive Committee, or the FASB. The principal issues include allocation of purchase price in a bank acquisition and related amortization of goodwill; regulatory "mark-to-market" accounting; accounting (financing vs. sales) for various transactions involving securities, loans, and other earning assets (for example, coupon and principal stripping of securities and transfers of assets with recourse); guidance in the definition of "substantially the same" as it may apply to securities and other assets exchanged or swapped; loan and other fee recognition; whether interest cost-to-carry should be a factor in determining the net realizable value of restructured real estate loans and other real estate; possible modification of the statement of changes in financial position; accounting for futures and forwards; and accounting and financial statement presentation of bankers' acceptances.

In connection with its proposed revision of Article 9 of Regulation S-X, the SEC has proposed that securities gains and losses be presented in the income statement on a pretax basis as a separately captioned line item along with other items of income and not as presently reflected in a two-step reporting format. This proposal is also being considered by the committee.

As these issues are resolved, amendments to the guide may be issued by the AICPA, or pronouncements may be forthcoming from the FASB.

*Banking Committee*

*November 1982*

# Transition

## Effective Date and Transition

The accounting provisions of this audit guide apply to financial statements prepared for years beginning after December 31, 1983, with earlier application encouraged.

The following schedule outlines the principal accounting and reporting recommendations that have changed since issuance of the previous guide or that provide guidance on issues not dealt with by the previous guide and the recommended treatment for their initial adoption.

<u>Recommended Changes</u>	<u>Chapter</u>	<u>Page</u>	<u>Recommended Treatment for Initial Adoption</u>
Investment securities			
• Trade date accounting	5	30	Prospective
• Completed transaction basis	5	32	Prospective
• Allowance for estimated losses	5	30	Prospective
• Wash sale - no gain or loss recognized if proceeds are reinvested in same or substantially the same securities	5	33	Prospective

<u>Recommended Changes</u>	<u>Chapter</u>	<u>Page</u>	<u>Recommended Treatment for Initial Adoption</u>
Investment securities (continued)			
• Transfers from investment account to the trading account - record at market on the transfer date; gain to be deferred until disposition; loss recognized at transfer date	6	41	Prospective
Trading securities			
• Trade date accounting	6	40	Prospective
• Securities to be presented at market	6	41	Cumulative adjustment in current period or restatement
• Presentation of short securities position as liability	6	42	Restatement
• Short positions to be presented at market	6	42	Cumulative adjustment in current period or restatement
• Transfers from trading account to the investment account - record at market on the transfer date; gain or loss recognized at transfer date	6	41	Prospective
Loans			
• Interest method - amortization of unearned discount	7	51	Cumulative adjustment in current period

<u>Recommended Changes</u>	<u>Chapter</u>	<u>Page</u>	<u>Recommended Treatment for Initial Adoption</u>
Loans ( <i>continued</i> )			
• Application of payments on nonaccrual loans	7	51–52	Prospective
• Income recognition of origination and commitment fees	7	54	Cumulative adjustment in current period; but if not practicable, apply prospectively
Capital accounts			
• Presentation of stock dividends at fair value	15	89	Prospective
• Bank holding company assumption of subsidiary bank debt - capital contribution	15	89	Restatement
• Subordinated debt reclassified as liability	13	84	Restatement
Consolidation			
• Goodwill - regulatory writeoff reinstated in consolidation	20	120	Restatement
• Diversity of accounting policies among affiliates need not be conformed	20	120–121	Restatement
• Transfers by a subsidiary from retained earnings to surplus and disclosure requirements	20	121	Restatement
• Inclusion of trustee affiliates	20	122–124	Restatement



For issues other than those listed above, accounting changes adopted to conform to the provisions of this guide should be reported in accordance with the provisions of APB Opinion No. 20, *Accounting Changes*.

## Chapter 1

# Introduction to the Banking System

### The U.S. Banking System

A U.S. bank operates under either a federal or a state charter. National banks operate under federal charters and are supervised by the Office of the Comptroller of the Currency (OCC). They are required to be members of the Federal Reserve System and to have their deposits insured by the Federal Deposit Insurance Corporation (FDIC). The FDIC insures each deposit up to a specified amount; in return for that protection for its depositors, each bank pays an assessment based on its total deposits.

State banks are supervised by banking departments of the chartering states, but most state banks are also subject to some federal control. A state bank is not required to join the Federal Reserve System, but if it chooses to join it must also subscribe to the FDIC. If it does not join, it still has the option of obtaining FDIC coverage.

The Depository Institution Deregulation and Monetary Control Act of 1980 significantly changed reserve requirements for financial institutions. It requires all insured depository institutions to maintain reserve balances within the Federal Reserve System.

Banks operate as unit banks, branch banks, chain banks, or group banks. A unit bank operates in one location, although it may have satellite terminal locations. A branch bank operates a head office and one or more branch offices at other locations, controlled by the head office. Branch offices may be located within a single city, within a county, or throughout a state, depending on state laws. A chain bank is one of two or more banks owned and controlled by several individuals who, as joint directors, officers, or individual owners, are active in formulating policy and managing

the banks in the chain. A group bank is often an affiliate of a holding company that controls a substantial part of the stock of one or more other banks.

Mutual savings banks were the nation's first consumer savings institutions, having been organized in 1816 to meet the savings needs of individuals and families. Historically, savings banks have been chartered by states, and they operate under the laws of the seventeen states in which they are chartered. Their deposits are generally insured to a specified amount by the FDIC, although in certain states the insurance coverage is provided by a state insurance fund.

Title 12 of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 authorized the Federal Home Loan Bank Board (FHLBB) to grant federal charters to existing state-chartered mutual savings banks unless such a conversion would contravene state law. Under that authority, the FHLBB issued rules and regulations for federal mutual savings banks in June 1979. Those rules and regulations relate to applications for, and issuances of, federal mutual savings bank charters, accompanying bylaws, the organization of such banks, and other general requirements. As of September 30, 1982, only a few mutual savings banks had received permission from the FHLBB to convert to federal charter.

In contrast to banks owned by stockholders, mutual savings banks are owned by their depositors. They are managed by boards of trustees, who are prohibited from sharing in the bank's profits and who are responsible for setting policies that best serve the interest of the depositors.

Commercial banks and mutual savings banks also differ in the scope of their business activities, and the composition of their assets and liabilities differ. The assets of a mutual savings bank are principally long-term, fixed-rate mortgage loans and investment securities, and their liabilities are principally short-term savings and time deposits. Recent federal and state regulatory changes, however, have authorized broadened business powers and activities for mutual savings banks. The independent auditor should be familiar with the current rules and regulations of the applicable supervisory authorities (FDIC, state banking department, FHLBB). Although the majority of their rules and regulations pertain to investment powers, depositor accounts, and operations, some pertain to accounting and financial reporting for regulatory purposes.

## Governmental Supervision of Banks

Banks are essential to the economic life of the community. Acceptance and custody of depositors' funds impose a public trust and responsibility not generally associated with other businesses. Banks are therefore subject to governmental supervision and regulation, including periodic examinations by supervisory agency examiners. Figure 1 summarizes the supervisory agencies having legal responsibility for periodic examinations of banks.

**FIGURE 1**

### Governmental Supervision of Banks

<u>Bank Classification</u>	<u>Supervisory Agency</u>			
	<u>Comptroller of the Currency</u>	<u>Federal Deposit Insurance Corporation</u>	<u>Federal Reserve System</u>	<u>State Banking Department</u>
National banks	X			
State banks and trust companies				
Federal Reserve members (frequently joint examination)			X	X
Nonmembers				
FDIC-insured (frequently joint examination)		X		X
Mutual savings banks (frequently joint examination)		X		X
Uninsured				X

Bank management and supervisory authorities have been well aware of the need to protect and reassure depositors, and this has been the dominant influence in the development of accounting and reporting practices in the banking industry. Banks traditionally attempted in financial reporting to present to the public a profile of conservatism, stability, and steady growth. Consequently, certain practices had the effect of understating assets and reducing fluctuations in reported operating results. The supervisory authorities no longer favor such practices since they recognize that reporting of a bank's income-generating ability is important in determining the bank's solvency and the competence of its management.

The three federal bank supervisory agencies exert considerable influence on banks' financial reporting practices, principally through instructions issued by the Federal Financial Institutions Examination Council in connection with call reports. The instructions for call reports published in *Reports of Condition and Income by All Insured Commercial Banks That Have Only Domestic Offices: National Banks, State Member Banks, Insured State Nonmember Banks* contain requirements regarding the form of the financial statements to be submitted and the accounting practices to be followed, which may vary from generally accepted accounting principles. The most common differences involve cash basis accounting, followed by many banks with total assets under \$25 million, and goodwill, which bank supervisory agencies generally prohibit banks (but not bank holding companies) from recording as an asset.

Bank holding companies are regulated in accordance with the Bank Holding Company Act of 1956, as amended. The act, which applies only to bank holding companies and not to banks, is administered by the Board of Governors of the Federal Reserve System and is implemented in Federal Reserve Regulation Y. The formation of bank holding companies dispersed bank stock ownership and subjected the holding companies and their affiliates to regulation by the Securities and Exchange Commission (SEC).

Banks subject to the Securities Exchange Act of 1934 (generally those with 500 or more shareholders) are usually registered with the bank supervisory agencies rather than the SEC. The act requires the agencies to substantially conform their securities disclosure regulations with those of the SEC. Their securities disclosure regulations permit banks to prepare income statements using either the call report format or the net interest income format prescribed by Article 9 of SEC Regulation S-X.

### **Effect of “Permissible Activities” on Industry Segment Reporting**

Pursuant to the requirements of the Bank Holding Company Act of 1956, as amended, the Board of Governors of the Federal Reserve System has defined permissible activities that are a natural incident to banking. Banks believe that such permissible activities consist of services that are closely related to banking and therefore constitute a single industry segment. Some banks, however, with

significant operations in permissible activities such as mortgage banking, consumer finance, and title insurance, have disclosed separately financial information related to such activities. FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise*, specifies the disclosure of segment information.

## **Effect of the Federal Reserve System on Bank Operations**

The Federal Reserve System serves as a bank for banks. Some of its more important functions are to

- Act as fiscal agent, legal depository, and custodian of funds for the U.S. government.
- Regulate the money supply.
- Hold legal reserves of banks and other depository institutions.
- Provide wire transfers of funds.
- Facilitate clearance and collections of checks.
- Examine and supervise state chartered member banks.
- Examine and supervise bank holding companies and nonbanking affiliates.
- Collect and interpret economic data regarding credit.

There are twelve Federal Reserve districts in the United States. Each district has one Federal Reserve bank located in a principal city, and several have branch banks in other cities. The major policies of the Federal Reserve banks are determined by the Board of Governors of the Federal Reserve System in Washington, D.C. Each bank is required by law to maintain a percentage of its deposits in reserve with the Federal Reserve bank in the bank's district.

The Federal Reserve System exerts a major influence on credit conditions. For example, to decrease the money supply in the United States, the Federal Reserve Board (FRB) can

- Increase reserve requirements, thereby requiring banks to increase their reserves by selling investment securities, calling loans, or borrowing funds and transferring them to their accounts at the Federal Reserve banks in their districts.

- Sell securities in the open market, thereby reducing the money supply by transferring funds used to pay for the securities from private demand deposit accounts at banks to the banks' FRB accounts.
- Raise the discount rate, which makes it more expensive for banks to borrow from the FRB to increase their own loanable funds.

The FRB can take opposite actions to increase the money supply.

## Chapter 2

# Auditing Considerations

As used in this guide, the term *audit* refers to an examination made by a CPA for the purpose of expressing an opinion on a bank's financial statements (unless the context clearly indicates that the reference is to an internal audit), and the term *examination* generally refers to an examination made by a supervisory authority (unless the context clearly indicates that the reference is to an examination by a CPA that does not constitute an audit, for example, a special examination of a bank's system of internal accounting control). An important purpose of a supervisory examination is the protection of depositors and investors, and, accordingly, the supervisory examiner emphasizes quality of assets, liquidity, adequacy of capital, management ability, and future earnings ability. Supervisory examiners also emphasize the review and classification of loans. Although a CPA also covers those areas, the audit scope generally is broader to enable the CPA to state an opinion on the financial statements as a whole.

### Planning the Audit

Planning is necessary to audit the financial statements of a bank. The auditor usually performs a preliminary review of financial data and reviews internal audit reports, reports of examination by supervisory agencies, and related correspondence. Statement on Auditing Standards (SAS) No. 22, *Planning and Supervision*, contains general guidance on audit planning.

### Scope of the Engagement

The nature, timing, and extent of procedures to be performed and the type of reports to be issued are based on the scope of the



services required by the bank. The CPA should establish an understanding with the bank, preferably in writing, regarding the services to be performed. The following are some of the typical services a CPA may be engaged to perform:

- Reporting on the individual or consolidated financial statements of the bank or holding company
- Assisting the board of directors in performing their directors' examination
- Reporting on internal accounting control
- Reporting on the trust department
- Reporting on collective investment trusts managed by the trust department

The CPA's standard report on the financial statements of banks or bank holding companies is the same as that used for other business enterprises.

An auditor may be involved with information other than the financial statements. SAS No. 27, paragraphs 4 and 5, state

The objective of an examination of financial statements in accordance with generally accepted auditing standards is the expression of an opinion on such statements. The auditor has no responsibility to examine information outside the basic financial statements in accordance with generally accepted auditing standards. However, the auditor does have certain responsibilities with respect to information outside the financial statements. The nature of the auditor's responsibility varies with the nature of both the information and the document containing the statements.

The auditor's responsibility for other information not required by the FASB but included in certain annual reports—which are client-prepared documents—is specified in SAS No. 8, *Other Information in Documents Containing Audited Financial Statements*. The auditor's responsibility for information outside the basic financial statements in documents that the auditor submits to the client or to others is specified in [SAS No. 29], *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*. The auditor's responsibility for supplementary information required by the FASB is discussed in [SAS No. 27, *Supplementary Information Required by the Financial Accounting Standards Board*].

A CPA may be engaged to perform only specified procedures, as in the case of a directors' examination (see Appendix C). If so, the

CPA should issue a special report in conformity with SAS No. 35, *Special Reports—Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement*, which requires that distribution of the report be restricted.

A bank may request an auditor to report on a study and evaluation of the bank's system of internal accounting control, either in conjunction with an audit or as a special study. SAS No. 30, *Reporting on Internal Accounting Control*, provides guidance for such a report.

The CPA may report on the application of agreed-upon procedures to specified areas of a trust department in accordance with SAS No. 35. (Chapter 18 discusses the audit of a trust department.) A report on a study and evaluation of the internal accounting control system of a bank's trust or other department that controls nonbank assets held for others in trust, investment advisory, and custody accounts should conform with the requirements of SAS No. 30, which sets forth procedures for the study and evaluation and related reporting. An audit interpretation, *Reports on Internal Accounting Control of Trust Departments of Banks*, issued January 1981, provides guidance for auditors' reports on trust departments of banks.

Until recently, financial statement presentation of collective investment trusts was not uniform. However, there has been a trend toward more uniformity in such reporting. Appendix B illustrates a format of a common trust fund report, which may be used as a guide and modified as appropriate.

The bylaws of national banks and the laws of most states require periodic directors' examinations, that is, examinations of the bank and its trust department conducted under the supervision of the directors or a committee of the directors. Reports on such examinations must be made available to the appropriate supervisory authorities. When a CPA is engaged to perform certain services in connection with a directors' examination (see Appendix C), the report of the directors or committee (as distinguished from the CPA's report to the directors) may take one of several forms. Among the more common forms are a report prepared by the directors on prescribed forms (required in certain states), a brief report by the directors stating that the required examination was made by a CPA at the directors' request and incorporating the CPA's report, and a report containing comments and observations of the directors and referring to the CPA's report on the portions of the examination conducted by the CPA.

## **Timing of the Audit**

Based on several factors, including the evaluation of the bank's internal accounting controls, the CPA may determine that a significant amount of the audit can be performed in interim periods and that year-end procedures can be limited to such matters as analytical review procedures and investigation of unusual transactions and significant fluctuations for the period from the interim date to the balance sheet date, as well as any additional substantive testing and other audit procedures deemed necessary. However, the CPA should satisfy himself that the internal accounting control procedures on which he relied remain in effect at year end. Sections 320.64 through .67 of SAS No. 1, *Codification of Auditing Standards and Procedures*, provide guidance about timing the tests of compliance with internal accounting control procedures.

## **Risks in the Banking Industry**

To determine the scope of audit procedures to be performed, the auditor should be aware of certain factors peculiar to the banking industry.

First, there are economic risks. As supply and demand for credit fluctuate, the effect on interest rates entails risks for banks. As money becomes tighter and interest rates rise, various risks become more pronounced.

The credit risk is significant in most banks. The following factors may cause loans to develop credit risk problems:

- Improper credit extension procedures
- Changes in the economy
- Changes in the status of a particular industry
- The specific geographic area in which a bank operates
- Undue loan concentration
- Insider transactions
- Deterioration in the creditworthiness of the borrowers

Loan quality is the principal factor in consideration of the adequacy of the allowance for loan losses.

Banks are exposed to interest risk when their assets are subject to legal interest rate ceilings or are invested in intermediate- or long-term fixed-rate loans or securities and when these assets are funded through interest-sensitive, short-term liabilities. If bankers misjudge the movement of interest rates and the rates rise

substantially, the bank must refinance short-term borrowing at higher rates, which may result in lower overall profit margins or an overall loss.

Banks are exposed to liquidity risk when they invest disproportionately in long-term securities, which generally decrease in market value when interest rates rise. If a bank is forced to sell these investments to generate cash, large losses may be incurred on the transactions. If the bank's liquidity is not sufficient to meet prospective needs and there is evidence that the bank may have to dispose of certain assets to obtain liquidity, the auditor should consider the propriety of the accounting basis for any assets that the bank may sell. In more serious situations of illiquidity, the independent auditor may also need to refer to SAS No. 34, *The Auditor's Considerations When a Question Arises About an Entity's Continued Existence*.

Aside from economic risks, there may be a need to maintain an adequate capital base pursuant to regulatory requirements. These regulatory requirements amplify the need for a system of internal accounting control that provides reasonable assurance of proper accumulation and disclosure of required capital base financial data.

In addition, there are the usual audit risks inherent in any audit engagement, including the possibility of errors and irregularities or illegal acts by clients.

### **Other Planning Considerations**

The CPA should request confirmation of loan balances and related information and should also consider the need to request confirmation of certain assets (for example, securities held by others) and liabilities (for example, deposits). The considerations for determining the type of requests and the extent of the tests to be performed are the same as those used by the CPA during the audit of other business enterprises. In addition, planning aids in preparing confirmations so that the persons to whom the requests are sent can readily identify the specific items or accounts in question and so that there are sufficient data to reconcile or confirm the items. For example, customers would not normally know of any unposted interest on deposits or of checks that have been cleared and posted to their demand deposit accounts since the last statement date.

Also important in planning a bank audit engagement is consideration of a bank's organizational structure and mode of operation. Is the entity a unit bank, a branch bank, a chain or group bank, or

part of a diversified holding company? Are accounting and internal auditing centralized or decentralized? Does the bank possess in-house electronic data processing (EDP) capabilities, or does it use a service bureau? Does it have international operations? Each of those considerations could significantly affect the timing, nature, and extent of audit tests.

The extent of tests may also be influenced by the client's report requirements, such as a separate report on a subsidiary of a bank holding company.

## **Audit Objectives**

The first step in obtaining evidential matter in support of financial statement assertions is to translate the assertions into audit objectives. Among audit objectives that might be developed for bank assets are the following:

### *1. Existence or occurrence*

- Determine that the assets presented in the balance sheet exist.
- Determine that the assets represent items held for use in the normal course of business unless otherwise identified and segregated.

### *2. Completeness*

- Determine that asset quantities, such as numbers of shares of securities, include all items on hand, held by others for the account of the bank, or in transit.
- Determine that asset listings, such as investment securities runs, are accurately compiled and that the totals agree with the control accounts.

### *3. Rights and obligations*

- Determine that the bank has legal title or similar rights of ownership to the assets.
- Determine that the assets exclude collateral owned by others, pledged on loans, or held in a fiduciary capacity for others, including bank customers and correspondent banks.

### *4. Valuation or allocation*

- Determine that the assets are properly stated at cost, except when market or another valuation basis is appropriate in the circumstances.
- Determine that the assets are reduced, if necessary, to fair value or estimated net realizable value.

### 5. *Presentation and disclosure*

- Determine that the assets are properly categorized in the balance sheet.
- Determine that the major categories of asset groups and their bases of valuation are adequately disclosed in the financial statements.
- Determine that the pledging or assignment of assets is appropriately disclosed.

Although these objectives are generally associated with assets, they also apply, with certain modifications, to liabilities.

## **Initial Audit Procedures**

Auditors should attempt to perform their procedures in a way that minimizes disruptions in the bank's regular routine. Consequently, before beginning the audit, the audit staff assigned to the engagement should be briefed about particular audit requirements.

Letters of accreditation should be obtained from the bank to be sure that the auditor's personnel can gain access to each bank office in which field work will be scheduled. The letters should be presented on entering the bank office. If a surprise examination of selected key areas is conducted, control over the areas should be established immediately.

Several areas that may require immediate control include cash on hand, investment and trading account securities and consigned paper on hand, the trust vault, passbooks and negotiable collateral held for loans, and subsidiary ledgers of loan and deposit accounts. If necessary, securities and reserve (vault) cash may be sealed to be counted later. Audit personnel should determine that the totals of subsidiary ledgers agree with the general ledger control accounts; they may then prepare related confirmation requests. Audit personnel in charge of the various segments of the audit should continue to note weaknesses that may require modifications of auditing procedures.

## **Application of Audit Sampling**

Several bank audit procedures may entail audit sampling. Such procedures may include tests of transactions to determine compli-

ance with specified internal accounting control procedures and substantive tests of balances, such as validation of deposit and loan accounts.

SAS No. 39, *Audit Sampling*, provides guidance for planning, performing, and evaluating audit samples. The guidance in that statement applies equally to nonstatistical and statistical sampling.

## **Auditing and EDP Systems**

The use of EDP equipment does not affect the objectives of an audit; however, organizational and control procedures used in electronic data processing may differ from those used in manual or mechanical data processing, and audit procedures applied to accounting records maintained on EDP equipment may vary from those applied to records maintained manually or on mechanical equipment. This guide does not discuss the effects of EDP on an audit. Guidance for auditing records in which EDP processing is significant may be found in the following publications:

- SAS No. 3, *The Effects of EDP on the Auditor's Study and Evaluation of Internal Control*
- SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at Service Organizations*
- AICPA Audit and Accounting Guide, *The Auditor's Study and Evaluation of Internal Control in EDP Systems*
- AICPA Audit Guide, *Audits of Service-Center-Produced Records*
- Federal Financial Institutions Examination Council's *EDP Examination Handbook*, which includes a section on "Internal and External EDP Audit"

## **Client Representations**

SAS No. 19, *Client Representations*, requires CPAs to obtain certain written representations from management as part of an audit and provides guidance concerning the representations to be obtained. The specific written representations to be obtained depend on the circumstances of the engagement and the nature and basis of presentation of the financial statements. Paragraph 4 of SAS No. 19 lists matters ordinarily included in management's representation letter. Certain other representations related to banking operations are normally obtained from bank clients. Those

other items include, but are not necessarily limited to, representations that

- All contingent assets and liabilities, including loans charged off and outstanding letters of credit, have been adequately disclosed to the CPA and in the financial statements where deemed appropriate.
- Adequate provision has been made for any losses, costs, or expenses that may be incurred on securities, loans, or leases as of the balance sheet date.
- Liabilities are adequate for interest on deposits and other indebtedness, including subordinated capital notes and participation loans.
- Permanent declines in the value of investment securities have been properly reported in the financial statements.
- Commitments to purchase or sell securities under forward-placement financial futures contracts and standby commitments have been adequately disclosed to the CPA and in the financial statements, as appropriate.



## Chapter 3

# Internal Accounting Control

### Bank Procedures and Systems

Banks' accounting and data processing systems have certain unique aspects:

- Daily posting and trial balancing of the general ledger to produce a daily balance sheet
- Use of single-entry tickets for cash transactions and use of general ledger debit and credit tickets instead of conventional columnar journals or double-entry vouchers as sources of original entry
- Interdepartmental accountability for custody and movement of negotiable items (cash, checks, notes, securities)
- A central proof and cash collection system to process the high transaction volume principally affecting balance sheet accounts
- Maintenance of subsidiary ledgers
- Use of memorandum accounts

### Daily Posting and Trial Balancing of the General Ledger

Bank supervisory authorities require banks to prepare balance sheets on a periodic basis. That requirement influences the financial reporting system. Income and expense account balances since the last regular closing date are carried in the balance sheet, often in a profit-and-loss section within the net worth caption. This practice precludes the necessity of closing these accounts to retained earnings at the end of each day.

### Single-Entry Tickets

One device to expedite the sorting and summarization of bank accounting transactions is the single-entry ticket. Customarily,

cash is used to offset debit and credit entry tickets initiated at the teller's cage. To ensure that cash on hand corresponds to other accounting entries, tellers prove their cash balances at the end of the day, and the net change in cash is posted to the general ledger account through use of a single-entry debit or credit ticket.

Tellers' blotters or proof sheets are frequently maintained. They are used to summarize entries for a day's transactions, often by department; postings are made from these records to the general and subsidiary ledgers.

In recent years, the use of data processing equipment to process a growing volume of transactions has modified the traditional methods of handling transaction data.

Some transactions do not involve cash; offsetting debit and credit tickets are required to reflect those transactions. The CPA may find it difficult to determine the offsetting elements, since no conventional journal or voucher will show this information. The CPA may have to review all general ledger entry tickets for the day to determine the offsetting debits or credits to a particular account posting. In many EDP-oriented systems, however, transaction journals are available.

### **Interdepartmental Accountability**

Because of the negotiability of cash, checks, notes, and other items handled by bank personnel, the internal accounting control system should provide reasonable assurance that items can be readily traced and that individual accountability is established. Furthermore, since accounting entries continuously flow between departments throughout the day, individual accountability and constant balancing of transactions are necessary to rapidly detect and locate errors that may arise.

### **Central Proof and Cash Collection System**

The focal point of the bank's accounting system is the proof department. It receives batches of checks, deposit tickets, and so forth from other departments and from outside parties (such as clearinghouses and correspondent banks), proves the accuracy of batch totals, and resorts the items for delivery to other departments for further processing. The department functions as a traffic controller for the high transaction volume that flows through the bank each day. Many entries are developed in the department for posting to the applicable general ledger control accounts. The sorted transactions are then forwarded to the applicable depart-

ments for posting to the subsidiary records. The department's custody of the items is temporary, since everything it receives is delivered to other areas by the end of the day, except for any holdover items or unprocessed work that should normally be processed the next business day.

Most business transactions are settled by check, and the banking system is responsible for check collection. "On us" checks are those drawn on deposit accounts of the bank receiving them; they are charged against those accounts when they are presented. Banks are required either to pay "on us" items when they are received or to return them promptly to the senders. Items drawn on other local banks are assembled and presented daily to the drawee banks or to a clearinghouse. Clearinghouses offset debits and credits between banks, and the net difference is settled by clearinghouse rules. Checks drawn on out-of-town banks are called "transit items." They are collected in one of three ways: through the Federal Reserve System, by sending directly to the drawee bank, or by forwarding to a correspondent bank in the same area as the drawee bank.

When a check is deposited, the availability of the funds depends on the expected time necessary to collect the item. While the bank gives the customer credit for the check when it is deposited, the availability of funds normally determines when the depositor may withdraw the deposit.

### **Bank Ledgers**

Many banks' general ledgers are prepared by machine, and individual entries are consolidated and posted in total to the respective accounts. Certain accounts require detailed posting.

Two of the principal subsidiary records are the demand and time deposit ledgers. Those ledgers may be subdivided into unit controls, with each unit containing the individual accounts of a group of customers. The accounting procedures relating to those ledgers vary with the degree of EDP use.

### **Memorandum Accounts**

Memorandum accounts are widely used by banks to reflect certain commitments and contingent liabilities, such as obligations under letters of credit issued, irrevocable loan commitments granted, and unissued savings bonds and travelers' checks held on consignment. Requirements concerning disclosure of such items are discussed elsewhere in this guide.

## Study and Evaluation of Internal Accounting Control

The second standard of field work states, "There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted." The nature of the audit procedures selected, their timing, and the extent of their application depend to a considerable extent on the degree of reliance the independent auditor intends to place on the system of internal accounting control. The auditor's study and evaluation of the system, as a basis for restricting the scope of audit tests to be performed, involves both the initial inquiry necessary to ascertain the bank's procedures and those additional investigations, tests, and inquiries performed during the audit to evaluate compliance with established internal accounting control procedures, that is, to ascertain that controls are functioning as represented.

Section 320 of SAS No. 1 discusses the study and evaluation of internal accounting control. If the bank has an internal audit function, the auditor should also consult SAS No. 9, *The Effect of an Internal Audit Function on the Scope of the Independent Auditor's Examination*.

The CPA should acquire an understanding of the significant classes of transactions and their related transaction types. Transactions may be grouped in a variety of ways, for example, by cycles of business activity or by business function. Significant classes of transactions customarily include the following:

<i>Class of Transactions</i>	<i>Transaction Type</i>
Obtaining deposits	Demand deposits (checking accounts) NOW accounts Time deposits (savings accounts) Other time deposits (certificates of deposit, discount savings certificates) Time deposits (open account, time certificates of deposit)
Maintaining liquidity	U.S. government short-term securities Federal agency short-term securities Repurchase agreements Federal funds Borrowings from the Federal Reserve
Granting loans	Real estate and construction loans Commercial loans

	Loans to financial institutions
	Loans for purchasing or carrying securities
	Loans to farmers
	Loans to individuals for household, family, and other personal expenditures
	Acceptance financing
	Lease financing
Investing residual funds	U.S. government intermediate- and long-term securities
	Federal agency intermediate- and long-term securities
	State and municipal intermediate- and long-term securities
	Other securities
	Federal funds
Processing payments and transferring funds	Cash
	Checks
	Drafts

In addition, many banks provide a number of other services to their customers and to their correspondent banks. The following are some of the more common services:

- Trust (settling estates, administering trusts and guardianships, acting as agent, and so forth)
- Collection
- Safe deposit
- Lock box
- Data processing
- Correspondent bank
- Letter of credit
- Foreign exchange
- Travelers' check and savings bond
- Safekeeping

In establishing a plan for the study and evaluation of a class of transactions, the CPA should consider all relevant aspects of the system, including the recording of assets, liabilities, and the related income and expenses and their impact on financial reporting. If the system is to be relied on to restrict substantive tests, tests of compliance should be made in each major class of transactions to provide reasonable assurance that the accounting

control procedures are being applied as prescribed. Preparation of flowcharts often helps in reviewing the internal accounting control system.

Internal accounting controls over cash, consigned items, loans receivable, securities owned, deposit accounts, and the handling of transactions related to these items are particularly important in banks. For example, cash handling functions should be segregated, to the extent practicable, from related record keeping responsibilities. Adequate controls should be established for deposit accounts, including inactive accounts, lending procedures, including loan approvals, appraisal reports, document control, and loan disbursements.

Bank EDP operations may be maintained solely by the bank, shared with others, or provided by an independent organization supplying specific data processing services for a fee. Auditors should study and evaluate the internal accounting control features of the EDP system in the same manner that they study and evaluate other internal accounting control features.

Competitive factors have expanded the range of services offered by banking institutions. Many of the new services are significant departures from traditional banking; they include innovations provided for the convenience of customers. Among the services are automatic teller machines, electronic funds transfer, lock box accounts, receivable collection, computer services, freight bill payments, in-plant banking, revolving personal credit plans, and new trust services. The auditor should study internal accounting controls over such activities and evaluate the controls to determine the nature, timing, and extent of audit tests to be performed during the examination.

Several pronouncements may prove helpful in certain situations. SAS No. 6, *Related Party Transactions*, provides guidance on identifying related-party transactions and determining their substance. FASB Statement No. 57, *Related Party Disclosures*, also establishes requirements for related-party disclosures. The Foreign Corrupt Practices Act of 1977 prescribes record maintenance standards and requires establishment and maintenance of a system of internal accounting control for all companies (1) that have securities registered under section 12 of the Securities Exchange Act of 1934 and (2) that are required to file periodic reports pursuant to sections 13 and 15 (d) of that act and Article 9 of SEC Regulation S-X. Regulation S-X contains disclosure requirements for related-party transactions more detailed than those included in

SAS No. 6 and FASB Statement No. 57. SAS No. 16, *The Independent Auditor's Responsibility for the Detection of Errors or Irregularities*, and SAS No. 17, *Illegal Acts by Clients*, relate to the auditor's concern with errors, irregularities, and illegal acts.

The auditor's evaluation of internal accounting control may reveal material weaknesses in the system. SAS No. 20, *Required Communication of Material Weaknesses in Internal Accounting Control*, requires that such weaknesses be communicated to the senior management and the board of directors or its audit committee.

An independent auditor may be requested to report on the internal accounting control system of a bank or one of its departments. SAS No. 30, *Reporting on Internal Accounting Control*, and its interpretations describe the procedures and the different forms of reports that may be issued in connection with engagements to report on an entity's system of internal accounting control.

## Chapter 4

# Cash and “Due From Banks”

Cash and “due from banks” can be separated into four broad classifications: cash on hand, cash items, clearings and exchanges, and due from correspondent banks.

### Cash on Hand

Cash on hand consists primarily of funds in the possession of tellers and a reserve fund kept in the vault. The tellers should be individually responsible for the funds in their possession, whereas the reserve fund, because of the large amount involved, should be under dual control. Teller and reserve fund balances fluctuate daily as a result of cash transactions.

### Cash Items

Cash items typically include maturing coupons and bonds, petty cash vouchers, returned checks, due bills, unposted debits, and other items temporarily held pending their liquidation. Technically, the items are not in process of collection, and each item requires special handling. Cash items should be recorded in a separate general ledger account, but they may be included in the cash-on-hand total in teller funds. In the preparation of financial statements, cash items and unposted debits, if material, should be reclassified to the account of ultimate disposition.

### Clearings and Exchanges

Clearings and exchanges are checks drawn on other banks. They are received with deposits and other customer transactions and



sorted, batched, and totaled by the drawee bank for clearinghouse delivery or for direct settlement. Banks also clear local checks for certain out-of-town correspondents. In communities having only two or three local banks, exchange of items and settlement may be handled directly between the individual banks rather than through an intermediate clearinghouse association. In the paragraphs that follow, references to transactions with clearinghouses also apply to direct settlement transactions.

Clearing and exchange items are received from various external sources and merged with the receiving bank's own items for clearinghouse delivery and settlement. The clearinghouse meeting is customarily held in the morning, although in larger urban areas several meetings each day may be needed to expedite the collection of local items.

The clearinghouse association is a cooperative organization owned and operated by the local banks, which elect the association's officers and subsidize its operations. In some cities, association personnel perform surprise examinations of the members' operations. Those examinations are similar to examinations performed by supervisory agencies. The association also establishes rules for check collection, return items, and other matters pertaining to interbank relationships.

Within the bank, local clearings and exchange items are by-products of the proof department, discussed in chapter 3.

## **“Due from Banks”**

Correspondent bank accounts are used to facilitate check collection and other banking services between banks. “Due from” accounts, including interest-bearing deposit accounts, may reflect transactions initiated either by the bank placing the deposits or by the correspondent institution. It is not uncommon to find reciprocal balances representing “due from” and “due to” accounts with the same bank. Federal Reserve member banks include among their “due from bank” balances the amounts that must be deposited with the district Federal Reserve bank for purposes of check collection and legal reserve requirements.

Checks received for collection are normally forwarded to “due from” banks by means of cash letters, which represent deposits with the “due from banks.” Although the mechanics vary among banks, the “due from” bank usually handles the operation by one of the following methods:

- It may credit the “due to” account immediately on receipt of the checks.
- It may credit the “due to” account after a specific period necessary to collect the items.
- It may arrange a bank draft remittance.
- It may credit another correspondent bank account.

The bank forwarding the cash letter debits the “due from” account in its books to coincide with the credit entry made by its correspondent.

The majority of transactions with other banks are initiated and documented by debit and credit advices. In addition, the depositor bank draws drafts on those accounts. Statements for active accounts are produced and mailed daily, weekly, semimonthly, or monthly. Accounts are usually reconciled as statements are received. The standard reconciliation format used by the majority of banks recognizes open items from either the sending or the receiving bank. Returned checks, differences in cash letters, items entered for collection, and so forth are frequently outstanding in the account reconciliation because of the delay in receiving the advices on such items.

## **Financial Statement Presentation**

All items included in the four broad classifications described above are normally included in the “cash and due from banks” caption in the balance sheet. However, material interest-bearing deposits with banks should be disclosed separately in the balance sheet. “Due to” accounts are included with deposit liabilities.

Reciprocal due to/from balances should be offset for balance sheet presentation if they may legally be offset in the process of collection or payment. After reciprocal balance adjustments are made, “due from” credit balances should be reclassified as short-term borrowings. Similarly, “due to” debit balances should be reclassified as loans.

## **Auditing**

### **Audit Objectives**

The significant audit objectives for “cash and due from banks” are to consider whether the balances are properly stated, whether

cash items held will clear in the normal course of business, and whether “due from” accounts are collectible.

### **Internal Accounting Controls**

Because of the negotiability of the items included in the “cash and due from banks” caption, internal accounting control is important. Some typical considerations are as follows:

- Do tellers have exclusive access to, and custody of, their respective funds?
- Is cash locked up when the teller is not in the cage area?
- Are physical storage facilities adequate to safeguard currency and coins against theft or other misappropriation?
- Is a systematic plan used for surprise counts of teller cash funds?
- Is loss exposure reduced by limiting the amounts of tellers’ funds?
- Is vault cash (reserve fund) under dual control?
- Is access to the night depository under the control of two employees, both of whom must be present when the safe contents are removed, listed, and processed?
- Are cash items (other than currency or coins) held by only one teller, and are other tellers prohibited from carrying cash items in their cash funds?
- Are cash items reviewed daily for propriety by an officer or a supervisory employee other than the custodian of the items?
- Is each of the functions of draft issuance, register maintenance, and reconciliation performed by a different employee?
- Are “due from” accounts reconciled and outstanding items investigated on a timely basis by responsible bank personnel?
- Are details of “due from” account reconciliations reviewed and approved by an officer or supervisory employee?
- Are confirmation requests received from depository banks, supervisory examiners, and other parties processed by an employee other than the one reconciling the account?
- Are the duties of origination, testing, processing, and balancing of wire transfer requests segregated?

### **Audit Procedures**

The following paragraphs discuss audit procedures related to cash on hand, cash items, clearings and exchanges, and “due from banks.”

*Cash on Hand.* In developing the audit program for cash on hand, a CPA should understand the relationship of cash on hand to the financial statements taken as a whole. The CPA should determine the extent to which sampling may be used in place of complete detailed counts to determine that cash on hand as shown in the general ledger is represented by currency and coins on hand.

In counting currency and coins, the CPA should account for cash on hand and maintain control until the cash is balanced with control accounts. Tellers' funds should be counted first; the reserve fund may be kept under seal and counted last. Tellers' cash normally should be counted after all transactions have been processed and balances have been established by individual tellers. Tellers' funds that have not been balanced at the close of business usually are balanced under the CPA's control. All transaction documents held by the tellers are normally sent to the proof department under the CPA's control. Cash items held by tellers as part of their funds usually are scheduled and subsequently checked to collection or other disposition. An officer should be requested to review and approve all such material cash items.

The auditor may inventory unissued drafts, travelers' checks, and savings bonds and account for last-issued items at the time cash is counted. The auditor requests confirmation of items on consignment from the consignors. The CPA also should obtain information and explanations about deposits and other items held over to the next business day. Shipments of currency and large payrolls packaged and ready for delivery may be sealed and controlled until they are released to armored car service representatives. Under such circumstances, the amounts may be confirmed with correspondent banks or depositories rather than physically counted.

*Cash Items.* Cash items are usually accumulated and balanced daily by adding machine tape and held by a designated teller for appropriate disposition. If items are numerous, they may be listed in a register that provides for recording the date on which items are cleared.

Auditing procedures applicable to cash items that are under separate general ledger control are similar to those used when items are included in tellers' cash. If items are numerous, it is usually appropriate to consider principally the larger dollar items.

*Clearings and Exchanges.* Auditing procedures applicable to clearings and exchanges include confirmation of total checks

forwarded to other banks and subsequent review of the disposition of larger return items. To determine that the total checks forwarded are correct and that returned items, if any, are proper, the CPA may need to establish control of clearing and exchange items on hand at the start of the field work. In some cases, however, the items may have been delivered to the clearinghouse, making control procedures unnecessary. If so, the CPA may find it desirable to send letters to the receiving banks requesting confirmation of the totals of the checks already delivered. Where control is established, confirmation requests may be inserted in envelopes used for forwarding the items and then sealed; however, control should be maintained until the items are forwarded for exchange. The confirmed totals should be reconciled with amounts recorded in the general ledger.

The confirmation letters may also request a listing of items being returned in excess of a specified minimum; alternatively, the CPA should ascertain the procedures for handling return items and should consider arrangements to intercept and inspect those items for the first several business days following the start of the audit. Larger items may be listed by the CPA and traced to their disposition. In this way, the auditor can test whether the bank initially received the items in a bona fide manner and that they are not fictitious items introduced by employees into the processing.

*“Due From Banks.”* The CPA should test the accuracy of account reconciliations prepared by bank personnel. The tests normally include direct confirmation of balances with depository banks. Statements of account for several business days following the reconciliation date may be obtained directly from the depository banks; those statements normally facilitate checking the open items in the reconciliation. The CPA may compare cancelled checks and drafts for a selected period with the records of instruments used. At the start of the year-end procedures, the CPA should normally determine the last issued serial numbers of drafts by inspecting the working supply and tracing the numbers to applicable outstanding lists of drafts. The CPA should also consider the bank’s internal review procedures for ascertaining collectibility of “due from” accounts, including the financial viability of the depositories and the ability of the bank to withdraw such funds.

## Chapter 5

# Investment Securities

The management of bank funds allows alternatives in the choice of assets, with the objective being an optimum balance between credit quality, liquidity, and income. This objective is attained through the investment security portfolio, which is the bank's second most significant asset, following loans, which are discussed in chapter 7.

The most common types of securities in which banks invest are (1) U.S. Treasury securities, (2) obligations of federal government agencies, (3) obligations of states, municipalities, and their political subdivisions, and (4) corporate bonds. The types of securities allowable are usually stipulated by law and by bank supervisory agencies. The supervisory agencies' concern with safety causes them generally to prohibit an investment in common stock. There are exceptions to this prohibition, but they generally relate to investments by savings banks and certain state-chartered banks, investments in bank subsidiaries engaged in bank-related activities, repossessed collateral, and investments in certain specified government corporations.

Supervisory agencies may require that certain securities acquired for investment be reported in other categories for regulatory reporting. The reverse has also been required for certain instruments that management may consider to fall under the lending function. The financial statement classification should be determined by the nature of the activity and not solely by the form of instrument.

Liquidity of the securities is another consideration in an investment security portfolio. Liquidity is required to meet normal, anticipated withdrawals of deposits, to provide a margin of safety for unforeseeable withdrawals, and to meet customers' credit needs.

Also, securities are generally required to be pledged to guarantee the collectibility of certain deposits, such as trust funds and public deposits, and they may be required for repurchase agreements.

## **Accounting**

Some banks have traditionally recorded the purchase and sale of investment securities and the effect of transactions and valuation adjustments on the settlement date. Others have recorded such transactions on the trade date. Although trade date accounting is required, settlement date accounting is acceptable if the reported amounts would not be materially different.

If the debt obligations of others are held to maturity, they will generally be redeemed at face value; therefore, they are carried at cost. If they have the ability and intent to hold these securities on a long-term basis, banks do not customarily provide for unrealized declines in their value resulting from interest rate fluctuations. However, adjustments may be required to the carrying amounts of marketable equity securities pursuant to FASB Statement No. 12.

It may be necessary to dispose of securities in the foreseeable future to meet the bank's investment objectives or other operational needs. An allowance for estimated losses should be established to provide for a decline in value of these securities, for example, if bank management intends to dispose of a part of its investment securities portfolio in the foreseeable future or the bank is unable to hold a significant portion of its investment portfolio.

An allowance also should be provided if there is a market decline that is attributable to specific adverse conditions for a particular security unless persuasive evidence exists to support the carrying amount.

The related provisions for these allowances should be charged to earnings and classified in the income statement with securities gains and losses. If subsequent events prove that the conditions precipitating the origination of the allowance were only temporary in nature, the allowance should be reduced or eliminated.

## **Premiums and Discounts**

Investment securities are generally acquired at a premium, a price in excess of face value, or at a discount, a price less than face value. A premium paid for a bond at the time of original issuance or at some time thereafter represents a downward adjustment of the

stated rate of interest to reflect the market yield at the time of purchase. Conversely, a bond discount represents an upward adjustment of the stated rate of interest to the market yield at the time of purchase. The carrying amount of the bond during the holding period is systematically adjusted to the amount anticipated to be realized at the maturity date. Amortization of premium or accretion of discount results in a reflection in the income statement of a yield that approximates the market yield at purchase date.

The entry to record the amortization of premium requires a debit to interest income with a corresponding credit to the investment asset or accumulated amortization account, which is netted against the asset account on the balance sheet. The reverse entry is used to record discount accretion. Accretion of bond discount and amortization of bond premium are based on the assumption that the face amount of the investment will be realized at maturity or at a call date.

The period of amortization or accretion is from the purchase date to the maturity date, except for securities purchased at a premium carrying an early call date at a price higher than par. The premium for those securities may be amortized to the maturity date or to an earlier call date. Premiums or discounts related to such securities as Government National Mortgage Association (GNMA) modified pass-through certificates should be systematically amortized or accreted over the estimated average life of the contract.

The two prevalent methods of amortizing premium or accreting discount are the straight-line method and the interest method, as defined in Accounting Principles Board (APB) Opinion No. 21, *Interest on Receivables and Payables*.

Straight-line accretion of discount or amortization of premium records in earnings equal periodic amounts from the time of purchase to the maturity date or earlier call date. The method has the advantages of being simple to compute and of affecting earnings each month by the same amount. However, since the book value of the security is increased or decreased monthly by the amount of accretion or amortization reflected in monthly earnings, the book yield on the security decreases or increases each month.

The interest method of amortizing or accreting premium or discount recognizes an amount in earnings each month that produces a constant yield equal to the market yield at the date of purchase. Using this method, the total amount of accreted discount added to the book value of the security by the end of each month increases each month; therefore, the amount of accretion credited



to earnings also increases each month so that a level yield is reported. Conversely, the total amount of premium amortization deducted from the book value of the security by the end of each month increases each month; therefore, the amount of amortization charged to earnings increases each month so that a level yield is reported.

The accretion of discount or the amortization of premium should be recorded in a manner that produces a constant rate of return on the basis of adjusted book value (interest method). However, straight-line or other methods of amortization or accretion may be used if the results obtained do not vary materially from those that would be obtained by the interest method.

### **Security Gains and Losses**

Banks frequently realize significant gains and losses as the result of sales, early redemptions, and exchanges of investment securities. The recognition of discount gains and premium losses at maturity is eliminated for financial reporting purposes if bond premiums are amortized and discounts accreted. On securities sold before maturity, the gains and losses, even after adjustment for accreted discount and amortized premium, can be significant.

The amounts invested in bond portfolios in many banks may fluctuate with changes in deposit levels and loan demand. The fluctuation may result in substantial buying and selling of bonds. When funds are in ample supply, bond prices tend to be high and yields comparatively low. At those times, many banks buy bonds in order to make productive use of available cash. Conversely, when funds are scarce, bond prices tend to be low. The demand for funds may cause banks to sell bonds at substantial losses to satisfy loan demand and, on occasion, to meet deposit withdrawals. Furthermore, banks may engage in bond transactions solely for tax or yield considerations. The transactions may produce substantial bond gains and losses.

If there is substantial turnover in the investment portfolio, management's intention and experience determine whether a trading function is occurring and the appropriate classification and valuation method to be used.

Security gains and losses should be recognized on the completed transaction basis; that is, the gains and losses should be recognized for financial reporting purposes when they are realized, except for adjustments of allowances for losses. Gains and losses on U.S.

Treasury bills are often recorded as adjustments of interest income together with accretion of related discount. If such gains or losses are material, they should be included in "securities gains or losses."

### **Wash Sales**

Bank supervisory agencies currently prescribe that investment security gains and losses be recognized according to the completed transaction method. In practice, serious questions develop about the proper definition of "completed transactions" when securities are sold with the intent to reacquire the same or substantially the same securities, most often to obtain income tax or other benefits. In such transactions, known as "wash sales," the period of time between sale and reacquisition varies. It is often very short, especially when readily marketable securities are involved. In some cases, the security or evidence of ownership of the security remains in the possession of the seller or his agent; only brokers' advices provide evidence of the sale and reacquisition.

In a sale, the risks and opportunities of ownership are transferred for a reasonable period of time; such a transfer is necessary to constitute realization and permit recognition of revenue. Therefore, when a bank sells a security and concurrently reinvests the proceeds from the sale in the same or substantially the same security, no sale should be recognized, since the effect of the sale and repurchase transaction leaves the bank in essentially the same position as before, notwithstanding the fact that the bank has incurred brokerage fees and taxes. When the proceeds are not reinvested immediately, but soon thereafter, the test is whether the bank was at risk for a reasonable period of time to warrant recognition of a sale. The period of time cannot be defined exactly; rather, the type of securities involved and the circumstances of the particular transaction should enter into the determination of what constitutes a reasonable period of time. For example, a day may be appropriate for a quoted stock or bond that has a history of significant market price fluctuations over short periods of time. Similarly, a bank's liquidity requirements may require that a long-term bond be replaced by a short-term money market instrument; but, a week later, the bank's liquidity requirements may change, and reacquisition of the bond previously sold may be a reasonable business decision, wholly independent of the previous decision to sell the bond.

## **Troubled Debt Restructuring**

Accounting and reporting requirements for securities that have been involved in troubled debt restructuring (including instances in which the substitution of debtors is primarily a matter of form), are set forth in FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*. In certain circumstances, banks recognize losses resulting from troubled debt restructuring immediately; in addition, they are required by FASB Statement No. 15 to account prospectively for the effects of modifications of debt terms as an adjustment of interest income for the periods between the restructuring and maturity.

## **Financial Statement Presentation**

In accordance with FASB Statement No. 12, marketable equity securities held in a bank's portfolio should be carried at the lower of aggregate cost or estimated market value, determined at the balance sheet date. Marketable equity securities are defined as instruments representing ownership shares or the right to acquire or dispose of ownership shares in enterprises at fixed or determinable prices and on which market prices are currently available on a national securities exchange or in the over-the-counter market. The amount by which the aggregate cost of the marketable equity securities portfolio exceeds its estimated market value should be accounted for as a valuation allowance. Since banks present unclassified balance sheets, accumulated changes in the valuation allowance should be shown separately in the equity section of the balance sheet.

Disclosure of the market value of investment securities, in either the balance sheet or the notes to the financial statements, helps a reader of a bank's financial statements to evaluate the potential earning power of those investments, since the potential earning power is governed by prevailing market interest rates applied to the estimated market value and not the book value of the bank's invested assets. Disclosure of the market value is required.

The reporting of municipal interest on a tax equivalent basis in the primary financial statements has been advocated by some banks. Tax equivalent accounting increases the interest income on tax-exempt securities to a fully taxable basis with a corresponding increase in tax expense. Proponents of tax equivalent reporting believe it produces more helpful earnings statistics than those produced by other reporting practices.

Other people agree that tax equivalent accounting can be a useful tool for internal management reporting in making allocations to various bank functions and in appraising investment and profit performance, but they do not believe that tax equivalent accounting should be used in published financial statements. They object primarily because it results in the reporting of income that will never be received and taxes that will never be paid. Another objection is the difficulty of determining the appropriate income tax rate to use in arriving at the amount of the tax equivalent adjustment. For those reasons, income from tax-exempt securities should not be reported on a tax equivalent basis in the primary financial statements.

Some banks' annual reports present supplemental information about investment securities, such as average maturities, book value, yields on a tax equivalent basis, concentration of investments in securities of a particular issuer, and other facts arranged by major security classification. Such information helps a reader of the bank's financial statements to evaluate the bank's investment portfolio.

## **Auditing**

### **Audit Objectives**

The significant objectives of an audit of a bank's investment securities are to obtain reasonable assurance that

- The physical securities are on hand or held in custody or safekeeping by others for the account of the bank.
- Interest and dividend income and securities gains or losses have been recorded properly.
- Investments and the related income, gains, and losses are properly presented in the financial statements, including disclosure of amounts pledged and market value.
- Investments have not suffered a permanent reduction in recoverable value.
- Allowances for losses have been provided where necessary.
- Securities have been properly identified as investment or trading securities.
- All required disclosures have been made.

The CPA should be familiar with an auditing interpretation entitled *Evidential Matter for the Carrying Amount of Marketable Securities* (AICPA Professional Standards, vol. 1, AU sec. 9332, January 1975). This interpretation provides guidance on the evidence the auditor should obtain pertaining to classification and carrying value of marketable securities, including

- Reasons for and evidence of the market decline when market value is below cost and evidence of whether the market decline is temporary or reflects more persistent conditions.
- Management's estimates of the outcome of future events.
- The bank's financial position, requirements for operating funds, and any contractual obligations, or other requirements that could affect the bank's ability to hold the securities. For investments in bonds and other investments with fixed maturity amounts, market declines may be considered temporary unless the evidence indicates that such investments will be disposed of before they mature or that they may not be realizable.
- Management's representation regarding its intent in the client's representation letter. The CPA should read the minutes of the board of directors meetings and should inquire of the investment committee concerning management's intentions on disposing of the securities.

If securities that will be disposed of in the foreseeable future have a market value lower than their carrying amount, the auditor should obtain persuasive evidence that a recovery in the market value will occur before the securities' maturity or sale date, whichever is earlier, or within a one-year period from the balance sheet date. Generally, such evidence would be limited to substantial recovery subsequent to the year end. If there is no evidence to support the carrying amount, and management has not established an allowance for the amount of the writedown to market value, the auditor should consider the need to modify the audit report for a departure from generally accepted accounting principles.

If securities not to be disposed of in the foreseeable future have a market value below cost, the CPA should consider the bank's ability to recover the carrying value, and should obtain persuasive evidence supporting the carrying amount. An allowance should be provided if there is a market decline that is attributable to specific adverse conditions for a particular security unless persuasive

evidence exists to support the carrying amount. If the decline in market value is attributable to general market conditions, an allowance need not be established by management unless there is evidence that the carrying amount will not be recovered. If any required allowances are not established by management, the auditor should consider the need to modify the audit report for a departure from generally accepted accounting principles. The auditor should consider whether available information does not support a judgment regarding eventual recovery or a contrary judgment that recovery will not occur. In such a situation, the auditor should consider the need to modify the audit report.

### **Records and Controls**

Investment securities are typically recorded in a securities ledger. The ledger generally segregates securities as follows: U.S. government obligations; obligations of states, counties, and municipalities; and other securities owned by the bank, including Federal Reserve Bank stock. The information is often presented in columns to provide pertinent data about cost, premium or discount, periodic amortization or accretion, and the proceeds of sales, exchanges, or redemptions.

A bank's securities may be on hand or on deposit elsewhere. Securities on hand should be under dual control and physically segregated in the vault from those held as collateral, in trust accounts, or as safekeeping items. Investments not on hand fall into one of the following categories:

- Securities pledged with, physically held by, or maintained on the book entry system of the Federal Reserve Bank
- Securities held in safekeeping by correspondent banks
- Securities pledged with other banks, the state, or political subdivisions of the state to secure public deposits, trust functions, and so forth
- Securities loaned to others

Many of the U.S. Treasury securities issued by the Federal Reserve System are currently accounted for in book entry form; under that method, no formal certificate is issued to provide evidence of certain federal debt. Instead, purchases, sales, and redemptions are made by entry on the books of the Federal Reserve Bank and confirmed in writing.

Generally, transactions in the investment portfolio require the

approval of the bank's investment officer or investment committee. Ratification of the purchase or sale of investment securities is often reflected in the minutes of the board of directors or its investment committee.

The following are typical internal accounting control considerations for investment securities:

- Are security purchases, exchanges, and sales ratified by the board of directors or investment committee and recorded in the minutes?
- Does the board of directors receive regular reports on investment securities activity showing such data as valuations, maturity analysis, and average yield?
- Are accounting entry tickets prepared by an employee not executing or authorizing security transactions?
- Are accounting entry tickets compared with supporting data and initialed as approved by an officer or supervisory employee before posting?
- Is the investment security subsidiary ledger balanced with reasonable frequency by an employee independent of the employee responsible for this ledger?
- Are securities on hand kept under dual control?
- Are securities held in the bank's vault physically inspected and checked against the records at regular intervals?
- Are investment securities on hand physically segregated from collateral, safekeeping, and trust securities and are they under physical control of individuals other than those controlling collateral, safekeeping, and trust securities?
- Are securities held by others verified periodically by physical examination, confirmation, or other procedures by persons independent of the employee responsible for control over the securities?
- Is there an independent check to ensure that (a) cash credit is received from an agency bank for securities delivered and (b) securities are received for cash paid or credit given to an agency bank?

### **Audit Procedures**

Since investment securities are highly negotiable, the audit procedures employed should provide for adequate control of the

securities until they have been accounted for by inspection. Control should be established over the securities at the beginning of the security count and should be continued until all other negotiable assets have been properly accounted for. The CPA should recap securities ledgers and trace totals to the general ledger. Confirmation should be obtained from custodians of securities held on account by other institutions.

The entries recorded in the investment ledgers should be tested by reference to the underlying documentary evidence. The accounting followed in recording premium and discount, profits and losses on securities, and interest should be determined and tested to the extent deemed necessary. The CPA should obtain market values and information relating to credit quality of the individual security issues from published sources, rating agencies, or other independent sources (such as municipal bond dealers).



## Chapter 6

# Trading Securities

Commercial banks are permitted to underwrite and deal in certain securities. Banks involved in those activities seek to earn a profit by trading for their own account or selling the securities to customers. A markup in price, known as a *spread*, represents compensation to the bank for distributing and making a market in the securities.

### Accounting

When securities are purchased, a bank should determine whether they are intended for its trading or its investment account. A bank should not record newly purchased securities in a suspense account and later determine the category. Recording of securities in either the trading or investment account should be documented with management approvals.

The prevailing practice has been for banks to record on the settlement date (1) the purchase and sale of trading securities and (2) the income statement effects of transactions and valuation adjustments. The required practice is to report the transactions as of the trade date. If reported amounts under settlement date accounting would not be materially different from those under trade date accounting, settlement date accounting is acceptable.

Currently, supervisory agencies permit banks to carry their trading securities either at market value or at the lower of cost or market. The previous edition of *Audits of Banks* stated that banks acting as dealers in securities should present trading securities, which in effect are inventories, at the lower of cost or market. The AICPA Industry Audit Guide, *Audits of Brokers and Dealers in*

*Securities*, indicates that securities held for resale should be accounted for as follows:

- Marketable securities at current market value
- Securities and other investments with no ready market at fair value as determined by management, with costs disclosed
- The increase or decrease in unrealized appreciation or depreciation resulting from the foregoing treatment included in the income statement
- Deferred taxes provided for the difference in the reporting of these amounts for financial reporting and tax purposes

The market value concept is based on the recognition that trading securities appreciate or depreciate as market or other economic conditions dictate. The market value concept provides the most effective means of measuring management's trading decisions; therefore, trading securities should be accounted for at market value. Therefore the resultant unrealized appreciation or depreciation should be recognized in income in the current accounting period.

Under certain unusual circumstances, a bank may transfer securities from its trading account to its investment account. The securities should be transferred at market value on the date of transfer, and the resulting gain or loss should be recognized in trading income. The securities should be recorded in the investment account as a new acquisition.

A bank may also transfer securities from its investment securities account to its trading account, although that also should be unusual. The securities should be recorded at market value at the date of transfer and thereafter should be treated as trading securities. A writedown from cost to estimated market value should be charged to investment security losses at the time of transfer. Recognition of a gain from write-up of cost to estimated market value should be deferred until final disposition of the securities, since the particular securities were not designated as part of the trading account at the original acquisition date. Such gains, when recognized, should be reported as investment security gains.

### **Short Sales**

Securities are sold short for a number of reasons: as a hedge against losses, for short-term borrowing of funds, in connection

with arbitrage transactions, or in anticipation of a market price decline.

The substance of a short sale is that securities not owned at the time of sale are sold, with the intention that substantially the same securities of the entity will be acquired at a future date to cover the sale. In the interim, the securities sold short are generally delivered to the buyer by borrowing securities from a third party, by the buyer's accepting the bank's secured promise to deliver securities purchased at a future date, or by the delivery of a due bill.

The obligation incurred in a short sale is recorded as a liability. Since this is a trading activity, the liability is adjusted to market value at external reporting dates. Interest on the short position is usually accrued and paid to the owner on the due dates. The cost is reported as trading securities interest expense. If it is significant, consideration should be given to its separate disclosure.

If securities held in a bank's investment portfolio are sold short in its trading portfolio, the question arises of whether a short sale has occurred. The transaction may be considered a short sale if investment and trading are separate functions of the bank, management can support and document its intention to enter into a short sale, and securities are not borrowed from the investment account to make delivery. If the transaction cannot be demonstrated to be a short sale, it is a completed transaction at the time of the initial sale, and the resulting gain or loss should be recognized immediately.

## **Financial Statement Presentation**

Trading securities should be shown as a separate line item on the balance sheet or disclosed in a note. Banks that are dealers in securities frequently have short positions in particular issues of securities. Such short positions should be shown as liabilities, representing the bank's obligation to purchase the related securities. Some banks show trading securities net of short positions in their balance sheets, because, in their opinions, that presentation best reflects a bank's exposure to interest rate risk. Such presentation should not be followed if the short positions are material. Gains and losses in the trading account, unlike those in the investment portfolio, should be included in operating income.

Some banks include interest earned on trading securities in interest income, while others include it in trading income. The

preferable method is to report interest income separately from trading income unless the amount is immaterial. The method of including such earnings in income should be followed consistently, and the amount and classification of such earnings should be disclosed. In addition, disclosure in a note of the major categories of securities in the trading portfolio may be desirable.

## **Auditing**

The internal accounting control considerations and auditing procedures for trading accounts are the same as for investment securities, with the additional considerations of (1) controls to ensure that management's intent in regard to the purpose of security purchases is designated promptly in the bank's records and historical experience involving completed transactions support management's intent and (2) audit procedures to test trading activity.

## **Chapter 7**

# **Loans**

Federal and state bank supervisory agencies impose numerous limitations and requirements concerning the lending activities of banks. They include maximum individual borrower lending limits; limitations on specific types of loans, such as real estate and building construction loans and loans to purchase or carry securities; and conditions surrounding loans to directors, executive officers, and bank examiners. The CPA should become familiar with the supervisory regulations pertaining to bank lending policies and practices.

Loans generally represent the bank's largest asset. Lending activities are generally classified as (1) time and demand loans (commercial or personal), (2) real estate mortgage loans (commercial or personal), (3) retail credit and other consumer loans, and (4) lease financing.

### **Time and Demand Loans**

Time and demand loans are made to a variety of borrowers, including individuals, industrial concerns, other financial institutions, brokers/dealers, farmers, and nonprofit organizations. Loans that are payable on demand generally contain a provision for maturity or renewal, frequently 90 to 180 days from the date of the loan, or provide for a periodic review of the status of the loan. It is not uncommon for demand loans to be continued or renewed for additional periods, assuming no deterioration in the borrower's credit standing. Time loans are generally granted for longer periods and contain specific provisions for payment in periodic installments or at maturity.

Time and demand loans may or may not be secured by collateral

(referred to as “secured” or “unsecured” in the banking industry). Collateral frequently consists of negotiable securities; however, it may also take a variety of other forms, such as cash surrender value of life insurance policies, warehouse receipts, savings accounts, or security interests in such items as automobiles, crops, livestock, accounts receivable, or inventories. Also, loans may be guaranteed or endorsed by third parties and sometimes may be guaranteed by agencies of the federal government, as in the case of student loans and loans granted under programs sponsored by the Small Business Administration.

In addition to direct loans to customers, a bank may purchase interests in loans originated by other lenders (loan participations). Conversely, it may sell to other lenders portions of the loans it originates. Also, particularly for large corporate borrowers, groups of banks may agree to participate in a particular loan, with each bank being a direct creditor of the borrower, but with uniform lending terms established for all the banks. One bank is typically appointed as the agent, or lead bank, having primary responsibility for communication and negotiation with the borrower.

Loan participations may be negotiated on either a recourse or nonrecourse basis. Also, a participation may be sold on terms that differ from the original loan terms. Accounting for loan participation is discussed in chapter 19.

A common method of commercial financing is the line-of-credit arrangement, in which the bank provides the borrower with a maximum borrowing limit for a specified period, say, one year, at a stated interest rate, usually expressed in terms of the bank’s prime lending rate. The extension of a credit line is often informal and represents only an expression of intent, not a binding agreement. Sometimes, however, formal agreements may be signed, providing for, among other things, the payment of fees or maintenance of deposit balances (compensating balances) as compensation to the bank for holding the line available. One type of formal agreement, known as a revolving credit agreement, characteristically contains the provision that repayment of amounts previously borrowed under the agreement increases the amount available for subsequent borrowing.

Before granting a loan, a lending officer normally analyzes the financial condition and general creditworthiness of a borrower, since the financial stability of the borrower, generally expressed in terms of earnings potential and ability to generate cash flow, may represent the bank’s only security. The bank’s risk may be

significantly reduced if adequate collateral has been pledged as security for the loan. However, some collateralized loans have greater risk than others. For example, the risk involved in a loan collateralized by marketable securities may be significantly different from the risk associated with a loan collateralized by such items as automobiles, crops, livestock, accounts receivable, or inventories.

Changes in business and environmental conditions may result in significant adjustments in the value attributed to collateral. Deteriorating market and environmental conditions may affect blue chip securities, as well as the collectibility of pledged accounts receivable. Thus, the bank frequently evaluates both the collateral and the protection afforded by guarantors and endorsers.

## **Real Estate Mortgage Loans**

Real estate mortgage loans are usually subdivided into three groups: conventional, FHA (Federal Housing Administration) insured, and VA (Veterans Administration) guaranteed. Such loans are usually secured by first mortgage liens on improved commercial or residential property. Repayment terms are customarily based on level semiannual, quarterly, or monthly payments of principal and interest. Certain mortgage loans are priced on a variable rate basis. The periodic payments often include deposits or advances for the payment of insurance and real estate taxes; those amounts are escrow deposits and are ordinarily required for FHA and VA loans.

In addition, banks may grant loans to finance construction. Construction loans are generally granted only after the borrower has arranged for long-term financing at the completion of construction (a takeout commitment). Although usually secured by real estate, construction loans generally entail more risk than real estate loans on improved property. Internal controls over construction loans include documentation requirements for advances of funds and periodic on-site inspection of the property.

Real estate mortgage loans are often made on the basis of a percentage of the appraised value of the mortgaged property at the time the loan is granted. In periods of increasing property values, an expansion of bank lending activity may occur in the form of junior mortgages (second liens or second trusts).

Mortgage loans may be originated directly with bank customers or purchased from brokers, such as mortgage banking companies.

Mortgage payments may be made directly to the bank by mortgagors or, for purchased loans, may be collected for the account of the bank by a servicing agent, who usually is the originator of the mortgage. (Chapter 19, "Other Banking Activities," further discusses mortgage servicing.)

## **Retail Credit and Other Consumer Loans**

To an increasing extent, banks have expanded their lending activities to individuals by financing consumer goods, such as automobiles, boats, mobile homes, household goods, and vacations. Historically, the principal form of this type of loan has been the installment loan, which originates from two sources: bank customers (direct paper) and dealer customers (indirect paper).

If the loan originates with an appliance or automobile dealer, the transaction customarily results in an installment sales contract discounted with the bank. The bank generally obtains limited protection by retaining a portion of the proceeds of the discounted note as a "dealer hold-back" or "dealer reserve." Dealer reserves may be charged with the balance of delinquent contracts, depending on the agreement with the dealer. Banks purchasing dealer paper customarily extend their operations to floor plan financing of dealer inventories. These loans have single maturity dates, with or without renewal options, and scheduled principal repayments. As items are sold from inventory, reduction of the loans is required.

Installment loans may be made on either a simple interest or a discounted basis. The discounted basis means that interest (discount), life insurance premiums, and other charges are added to the amount advanced to arrive at the face amount of the note. The note is repayable in installments, usually equal monthly amounts. Maturities generally depend on the nature of the loan and type of collateral.

Unearned interest income on installment loans is normally credited to an unearned income account, frequently referred to as unearned discount. Transfers to operating income should be made using the interest method.

Another form of personal lending is credit card financing. Currently, several bank-sponsored credit card plans are operating nationally, although a number of banks continue to sponsor independent plans. Within geographic areas some banks have formed service companies for the purpose of centralizing card



issuance, processing transactions, and maintaining customer accounts. Not all banks that sponsor credit card plans carry the consumer loans that result from use of the cards. The bank may be affiliated with a larger bank in the area that assumes the loan and credit risk; the affiliated bank processes the loan transaction.

After a customer has been issued a credit card, thereby establishing a line of credit, loan transactions are initiated by the customer's purchase of goods or services from a participating merchant. The merchant submits the charge slips to the bank and receives credit for the amount of the transaction less a negotiated discount. The charge slips are then processed and charged to the cardholder's account.

The cardholder is rendered monthly statements. The entire account balance may be paid without interest, depending on the bank's policy, or the cardholder may pay a specified minimum amount on an installment basis, with interest charged each month on the outstanding balance.

Certain features of credit card operations warrant emphasis. Since the transaction is initiated through the use of an identification card, issued and unissued cards should be controlled to prevent fraudulent use. Theft of cards while in the processing or delivery stage or after receipt by the cardholder represents a significant portion of the losses sustained by banks in connection with credit card operations. Dealers are generally required to obtain prepurchase authorization for purchases in excess of a specified amount. Banks monitor accounts with high balances, excessive activity, and delinquencies to lessen the possibility that inappropriate use of credit by the cardholder will result in losses. In an effort to minimize losses resulting from fraudulent use of stolen cards or extension of credit to holders of terminated cards, banks frequently circulate to their merchants listings of card numbers that are not to be honored.

Banks also offer to their customers other forms of revolving credit loans marketed under a variety of names, such as *ready credit* and *no-bounce checking*. These result in installment receivables similar to credit card loans. In checking account overdraft plans, a loan is initiated when the bank customer's checking account becomes overdrawn. At that time the bank transfers to the customer's checking account an amount equivalent to the overdraft or a round amount and concurrently establishes an installment loan balance in the amount of the transfer.

## Lease Financing

In recent years, banks have become more involved in a form of lending known as direct lease financing. Bank entry into the leasing field began in 1963 when the Comptroller of the Currency issued a ruling permitting national banks to become the owners and lessors of personal property at customers' specific request and for the use of those customers.

Lease financing transactions have many of the characteristics of other forms of installment loans. A typical lease agreement contains an option providing for purchase of the leased property by the lessee at the expiration of the lease at fair value or at a specified price. Banks may enter into only net full-payout leases (leases that provide for the recovery of the total purchase price of the leased equipment and the cost of financing the property over the lease term, with no obligation by the bank to assume the costs of maintaining the leased property), which normally possess all of the characteristics of financing transactions.

FASB Statement No. 13, *Accounting for Leases*, prescribes the accounting for leases, including income recognition methods and considerations related to residual values. If transactions qualify under the Internal Revenue Code, the bank may elect to record lease income under the operating method for tax purposes. Such treatment generally results in book-tax timing differences and, accordingly, requires the recognition of deferred income taxes. The bank should account for timing differences in accordance with the provisions of APB Opinion No. 11, *Accounting for Income Taxes*, as amended.

Banks also engage in a specialized form of lease financing, known as leveraged leasing, in which the bank acts as an equity participant. In this type of lease, a substantial portion of the purchase price of the asset is supplied by unaffiliated long-term lenders on a nonrecourse basis. As owner of the equipment, the bank obtains indirect benefits from the investment of funds generated in the early years of the lease from tax deferrals arising from the use of the operating lease method for federal income tax purposes (see chapter 17). The provisions of FASB Statement No. 13 apply to such leveraged leases.

## Loan Files

Loan files vary in content, depending on the type of loan. The principal support for all types of loans is the signed note.

For commercial loans, a credit file is commonly maintained. This file usually contains the borrower's financial statements, memorandums regarding the borrower's financial or personal status, financial statements of guarantors (individual or corporate), copies of supplemental agreements between the bank and the borrower, and other loan-related correspondence. The timely receipt and review of those documents provides a basis for extending credit, reviewing extensions, and maintaining an awareness of loan status. Credit file information is frequently less extensive for borrowers whose loans are considered adequately collateralized.

Files supporting either direct or indirect installment loans generally include the borrower's application, discount sheet (loan computations), credit information, title or financing statement and evidence of the existence of an in-force insurance policy payable to the bank, and the note. Credit files are also maintained on dealers from whom the bank has purchased loan paper.

The extent of the documentation supporting mortgage loans depends in part on the requirements of local law. The basic documents generally include, but are not necessarily limited to, the note, loan application, appraisal report, deed of trust, mortgage, title insurance or opinion, insurance policy, settlement statement, and VA guarantee or FHA insurance, if applicable.

Loan files should also contain indications of compliance with consumer credit disclosure requirements of Federal Reserve Regulation Z, *Truth in Lending*. This regulation, which provides for mandatory disclosure of effective interest rates being charged the borrower, applies to all lending institutions, both federally and state chartered.

Collateral records typically are maintained, either as part of the detail loan record or in separate files, indicating the current status of pledged collateral. If collateral is deposited with the bank, a multi-copy receipt is generally prepared, one copy of which constitutes the bank's permanent collateral record. When the loan has been paid, or when collateral is withdrawn or substituted, the borrower acknowledges the release of the collateral by signing another collateral receipt, a copy of which is retained by the bank. The open file of properly executed collateral receipts frequently provides the principal control relating to collateral held by the bank.

## **Accounting**

Separate general ledger control accounts are normally maintained by type of loan to facilitate preparation of supervisory

agency and other reports. The control accounts should be supported by subsidiary records. Individual subsidiary records may consist of the note, in which case interest and principal transactions are frequently posted directly on the note, or they may consist of manually or machine-posted ledger cards or computer-processed records. Depending on the type of subsidiary record used, a single record may contain all pertinent information relating to a loan, including escrow balances for real estate loans, total discount and other charges for installment loans, and the amount of monthly payments. Conversely, it may be necessary to refer to a number of separate records to obtain all necessary loan information.

Many banks maintain an ancillary liability ledger in which all borrowers' liability transactions are posted. The ledger presents the cumulative total of all borrower liabilities, including direct and indirect liabilities as maker, endorser, or guarantor. The ledger provides a readily available source to obtain information relating to an individual borrower's total commitments to the bank.

Interest income on loans is normally credited to operating income based on the outstanding principal amount of the loans. For loans on which interest is charged separately, such as time, demand, and real estate loans, interest is usually accrued daily or monthly. For loans on which interest is included in the face amount of the loans (discounted loans), unearned discount should be recognized as income over the life of the loans, using the interest method. Use of the rule-of-78s (sum-of-the-months'-digits) method is acceptable, provided the results are not materially different from those obtained by using the interest method.

Many banks suspend accrual of interest income on loans when the payment of interest has become delinquent or collection of the principal has become doubtful. Such action is prudent and appropriate. Regulatory reporting guidelines for nonaccrual loans have been established by federal supervisory agencies.

Although placing a loan in a nonaccrual status, including loans accruing at a reduced rate, does not necessarily indicate that the principal of the loan is uncollectible in whole or in part, it generally warrants reevaluation of collectibility of principal and previously accrued interest. If amounts are received on a loan on which the accrual of interest has been suspended, a determination should be made about whether the payment received should be recorded as a reduction of the principal balance or as interest income.

If the ultimate collectibility of principal, wholly or partially, is in doubt, any payment received on a loan on which the accrual of

interest has been suspended should be applied to reduce principal to the extent necessary to eliminate such doubt.

The accounting and reporting requirements for loans involved in troubled debt restructurings are set forth in FASB Statement No. 15. That statement discusses transfers of assets from debtors to creditors and modification of the terms of the debt. (Chapter 11 of this guide discusses accounting for other real estate owned by banks.)

To comply with the provisions of FASB Statement No. 15, a bank may have to account for the fair value of assets transferred or equity interests granted. The bank creditor would recognize a loss for the difference between the fair value of the assets received and the recorded investment in the satisfied debt. If cash or other assets are received in partial satisfaction of a receivable, the recorded investment in the receivable is reduced by the fair value of the assets received. In a restructuring involving modifications of terms, the bank accounts prospectively for the effect of the restructuring, and the recorded amount (as defined in FASB Statement No. 15, footnote 17) is not changed at the time of the restructuring unless it exceeds total future cash receipts specified by the new terms. FASB Statement No. 15 states, "The effects of changes in the amounts or timing (or both) of future cash receipts designated either as interest or as face amount shall be reflected in future periods." However, if the total future cash receipts specified by the new terms of the receivable are less than the recorded investment in the receivable before restructuring, the bank creditor reduces the recorded investment in the receivable to an amount equal to the total future cash receipts specified by the new terms. The amount of the reduction is recognized as a loss.

Banks often receive nonrefundable fees that may represent adjustments of the loan interest yield or remuneration for extending binding loan commitments to prospective borrowers or sellers of loans. Binding loan commitments assure the borrower of financing by the bank for a specified period of time or at a specified date. Such commitments may generally be categorized as floating rate commitments, which guarantee financing at the market rate at the time the loan is to be drawn down or the purchase transaction is to be settled, or fixed rate commitments, which guarantee financing at or near the market rate at the time the commitment is made.

Banks have recorded income from commitment fees in a variety of ways, including recognition

- In full when received.
- When the commitment period has expired or the loan has been drawn down.
- Ratably over the commitment period.
- Ratably over the combined commitment and loan period.

The accounting for recognition of income from commitment fees should be based on the nature and substance of the transactions. However, a bank's method of accounting should ensure that any income that represents an adjustment to the interest yield is deferred until the loan is drawn down and then amortized over the expected life of the loan in relation to the outstanding balance. Consideration should thus be given to such factors as

- Reasonableness of income from commitment fees in relation to direct costs (including salaries and fringe benefits of lending officers and other costs directly related to making the commitment).
- Reasonableness of the interest yield on the loan in relation to market conditions.

Fees representing compensation for a binding commitment or for rendering a service in issuing the commitment should be deferred and amortized over the commitment period using the straight-line method.

If it is not practicable to separate a fee into component parts (for example, a binding commitment, services rendered, the assumption of risk of adverse changes in market interest rates, or an adjustment of the yield on the loan), the amount of the fee should be deferred and amortized over the combined commitment and expected loan period. The straight-line method of amortization should be used during the commitment period. At the time the loan is drawn down or the purchase transaction is settled, the remaining unamortized commitment fee should be deferred and amortized over the expected loan period using the interest method. If the loan is not funded, unamortized commitment fees should be recognized as income at the end of the commitment period.

Banks also receive fees for originating loans in-house. The normal origination fee (generally referred to as points) is essentially a reimbursement for the expenses of the underwriting process, that is, processing the loan application, reviewing legal title to the

collateral, obtaining appraisals, and other procedures. Origination fees, to the extent they are a reimbursement for such costs, should be recognized as income at the time of loan closing. Loan origination fees that are not reimbursements of such costs should be amortized to income over the expected loan period by application of the interest method. The AICPA has formed a task force to study accounting by all financial institutions for loan origination and commitment fees and initial direct costs and to prepare an issues paper addressing the diversity in practice.

Some banks charge a periodic fee to credit card holders. Such fees, when material, should be deferred and amortized over the term of the fee.

## **Financial Statement Presentation**

Loans have historically been presented in the balance sheet in an aggregate amount. Note disclosures should include a breakdown of loans by major types of lending activities. Consideration should also be given to the need for disclosure of other information, such as maturities for significant categories of loans and the amounts of loans at fixed and floating rates of interest. Each bank's share of a participation loan should be classified according to the same classifications as its other loans. If the bank that originated the loan retains the risk, the entire loan should be reported as an asset of that bank, and the participation proceeds should be reported as borrowings. The FASB has issued an exposure draft, *Reporting by Transferors for Transfers of Receivables With Recourse*, that addresses the reporting of such transactions.

Related accrued interest receivable is generally included in other assets or stated separately. Unearned discount should be deducted from related loan balances. Similarly, the allowance for loan losses and unamortized loan origination fees, which represent an adjustment of yield, should be deducted from related loan balances. Other unamortized loan fees, if material, should be presented as other liabilities.

In addition, the amount of loans on a nonaccrual basis (including loans accruing at a reduced rate) and the income effect of nonaccrual loans should be disclosed if they are material. Disclosure requirements for loans involved in troubled debt restructurings are presented in FASB Statement No. 15.

Loans are frequently made by banks to officers, directors, employees, and principal holders of equity securities (and entities

with which they are affiliated) in the normal course of business, subject to compliance with applicable regulations. The bank should disclose such loans if they represent a material portion of the loan portfolio or if their amount is material in relation to stockholders' equity. Also, disclosure should be made if evidence indicates that significant amounts of such loans were made at other than ordinary terms. FASB Statement No. 57 establishes requirements for related-party disclosures.

Overdrafts are classified as loans.

Lease financing can be considered another form of lending. The aggregate of lease payments receivable plus estimated residual value, less the amount of unearned income and applicable allowance for losses, may be classified as loans in the balance sheet or set forth in a separate caption. Lease disclosures are discussed in FASB Statement No. 13.

Loan fee income that represents an adjustment of yield should be included with interest and fees on loans; other loan fees should generally be classified as other income.

The summary of significant accounting policies included in the notes to financial statements should include

- Methods of recognizing loan income (including nonaccrual policy) and, if significant, loan fees.
- The method used in providing for loan losses.
- Policies followed for balance sheet presentation and income recognition of lease financing transactions and related investment tax credits, if significant.

## **Auditing**

### **Audit Objectives**

Certain audit objectives are common to all types of loans. They include determination that

- Loan balances are reasonably stated as of the date of the financial statements under examination.
- The allowance for loan losses is adequate to provide for reasonable anticipated losses (discussed in chapter 8, "Allowance for Loan Losses").
- Income and related accrued interest receivable and deferred discount (unearned discount) are stated in conformity with generally accepted accounting principles.



## **Internal Accounting Controls**

In evaluating internal accounting controls related to loan transactions, the auditor considers such questions as these:

- Are loans made only in accordance with policies established by the board of directors?
- Are credit reports obtained for new loans?
- Are loans properly approved by officers and, if required, reviewed by a loan committee?
- Is the performance of the three functions—loan approval, disbursement and collection, and ledger posting—appropriately segregated among different employees?
- Is cash disbursement of loan proceeds to the borrower prohibited?
- Is physical protection of notes, collateral, and supporting documents adequate?
- Are reasonably frequent ledger trial balances prepared and reconciled with control accounts by employees who do not process or record loan transactions?
- Are paid notes cancelled and returned to the borrowers?
- Are supporting documents on new loans inspected for proper form, completeness, and accuracy by someone other than the lending officer?
- Are loans reviewed on a timely basis for collectibility, write-offs recorded where applicable, and allowance for loan losses evaluated properly?

## **Audit Procedures Common to All Types of Loans**

The CPA reviews lending policies and inspects notes and documents supporting loans. Specifically, the auditor selects a sample group of loans from all significant loan categories and performs detailed tests on it. Although larger loans are commonly emphasized, a sample should also represent a cross section of the various types of loans granted by the bank. The tests should include inspection of the executed notes, loan applications, financial statements of borrowers, and other credit information and supporting documentation appropriate to the types of loans being examined. The CPA should check for appropriate approvals contained in the loan files and in minutes of the meetings of the board of directors or loan committee.

After the underlying subsidiary loan records are balanced with the general ledger control accounts, the auditor should request confirmation of a representative sample of loan balances directly with the bank's customers. Negative confirmations are often used if loans involve a large volume of individually immaterial balances and if the auditor considers internal accounting control surrounding such loan accounts to be effective. Positive confirmation procedures should be used for larger loans and for loans that require confirmation of information, such as amount and type of collateral and amount of escrow deposits, in addition to the loan balance. (SAS No. 1, sections 331.03 through .08, provides guidelines for the use of confirmations.) Forms of confirmation requests are illustrated in Appendix D.

In addition to providing evidence of the effectiveness of the internal accounting control system, the results of the detailed inspection of a representative sample group of loans assist the CPA in determining that loans actually exist. To evaluate the collectibility of loans, the auditor should perform other, separately designed tests and reviews, as discussed in chapter 8.

The audit should also include procedures to test compliance with bank policies related to loan charge-offs. In addition, the CPA should consider requesting confirmation of loans that have been charged off. However, the CPA should avoid communications prohibited by law (for example, bankruptcy law).

Accrued interest receivable, unearned discount, and interest income are often tested for a representative sample group of loans. Audit procedures should include recalculation of accrued interest and unearned discount, balancing of subsidiary records to the general ledger control accounts, and testing of interest income for a selected period. The CPA should also test interest income overall by relating income for the period under examination to the average loan balance by type of loan and comparing the resulting yield to interest rates in effect during the period. The confirmation requests should include appropriate information relating to accrued interest receivable, interest rates in effect on the confirmation date, and collateral.

The auditor should review loans to officers, directors, and employees (and loans to organizations with which such individuals are affiliated). The CPA should correlate information developed through other audit tests with reports of federal and state supervisory examiners and with any records maintained by the bank relating to potential conflicts of interest. Such bank records may

include summaries of the business interests of directors and principal officers.

Publications such as the *Comptroller's Manual for National Banks* and the various regulations issued by the Board of Governors of the Federal Reserve System, the FDIC, or state supervisory authorities contain the laws and regulations affecting bank lending activities. Procedures that the CPA performs primarily for the purpose of expressing an opinion on the financial statements may also bring possible violations of those laws and regulations to the CPA's attention. In such circumstances, the CPA should be guided by the provisions of SAS No. 17, *Illegal Acts by Clients*.

### **Procedures for Specific Types of Loans**

*Collateralized Loans.* The auditor should test the physical existence and proper assignment to the bank of collateral supporting collateralized loans. Collateral in the custody of the borrower, such as floor plan merchandise, should be inspected on a test basis or, if considered appropriate, a review should be made of the reports of bank personnel who perform that function. The CPA should also consider examining or requesting confirmation of collateral not on hand. The examination of loan documentation should include tests of the adequacy of both the current value of collateral in relation to the outstanding loan balance and, if needed, insurance coverage on the loan collateral. For guaranteed loans, the CPA should review the financial statements and other evidence of financial condition of cosigners and guarantors. Controls over collateral should be evaluated, with particular emphasis on controls surrounding negotiable collateral.

*Mortgage Loans.* The review of mortgage documents frequently emphasizes loans made since the date of the last audit. The review is supplemented by limited tests of documents relating to mortgage loans originated in prior periods. The unexpended balance of escrow funds should be confirmed with borrowers at the same time that mortgage loan principal balances are confirmed. The activity in the escrow accounts should be tested. In addition, the auditor should review the procedures the bank follows for determining that adequate fire and other hazard insurance coverage is carried, that real estate taxes are currently paid, and that properties are in good condition.

A portion of the mortgage loan portfolio may be serviced by

agents of the bank. It is frequently impractical to request those mortgagors to confirm their balances directly with the bank. Confirmations of those loans should be obtained from the servicing agent. Additionally, the CPA should inquire whether the servicing agent participates in the "single audit" program of the Mortgage Bankers Association; if so, the CPA should review the report of the servicing agent's CPA relating to the results of his detailed tests. SAS No. 44 provides guidance on the use of a special-purpose report on certain aspects of internal accounting control of an organization providing certain services to a client whose financial statements the CPA has been engaged to examine. The statement requires the CPA to consider the division of accounting and control functions between the client organization and the service organization. If no such special-purpose reports are received and the amount of serviced loans is material, the CPA should perform alternative procedures necessary to determine whether adequate independent confirmation and other testing has been performed. In some cases, for example, arrangements may be made to receive a report from the servicing agent's CPA about the nature and scope of work performed on the bank's loans. The CPA may consider it necessary to inspect mortgage documents held by servicing agents.

*Credit Card Loans.* If the bank is involved in all phases of credit card operations, including credit card issuance and processing of transactions, the CPA should study and evaluate the system of internal accounting controls for credit card operations. Procedures for the review of credit card operations depend on the degree of the bank's involvement in such operations. If the bank assumes the customer receivables, a review of lending policies, confirmation of customers' balances, and tests of interest and service charges, delinquencies, and charge-offs may be appropriate. If the bank simply processes merchants' deposits and the resulting receivables are assumed by other banks, a review of the arrangements and a test of service fee income may suffice. However, the processing bank may also be responsible for billing and other recordkeeping; if so, tests should be made as though the bank were processing its own credit card accounts.

*Lease Financing.* Lease contracts may contain varying provisions relating to such areas as retention or pass-through of investment credits, purchase options, and residual values. The CPA should determine whether the bank is aware of, is properly

accounting for, and has established internal accounting controls for those aspects of the lease contracts. Although alternative methods may be used for reporting income for tax purposes, the CPA should determine that income for book purposes is being recorded in conformity with FASB Statement No. 13, as amended. Confirmation of the basic lease terms, including cancellation provisions, if any, should ordinarily be requested from the lessee. For leveraged leases, material aspects of the lease agreement, including information required for income tax purposes, may be requested from the lease trustee.

*Loan Participations.* The auditing procedures for participations in loans purchased from other banks are similar to those for direct loans, except that requests for confirmation of balances and collateral, if any, are sent to the managing (lead) bank. Loan files for purchased participations should be available at the bank and should contain pertinent documents, or copies of them, including credit files supporting loans in which the bank has purchased participations from other banks. Details of participations in the bank's direct loans sold to other banks should be confirmed with the participating banks. The CPA should request each participating bank to confirm the amount of its participation in the loan. However, care should be exercised in requesting confirmation of participations sold. Since the borrower normally deals only with the bank originating the loan, the gross balance, including amounts sold to other banks, should be confirmed with the borrower.

## Chapter 8

# Allowance for Loan Losses

The allowance for loan losses is the estimated amount of losses in a bank's loan portfolio and is maintained by charges against operating expenses. In the event that prior years' provisions for loan losses charged to operating expenses are deemed to be less than losses currently anticipated, the amount necessary to increase the allowance to equal losses currently anticipated should be recognized as a current period charge to operating expenses.

### Federal Income Taxes

Under current federal tax regulations for commercial banks, the maximum annual tax basis addition to the allowance for loan losses is based on the greater of six-year average of loan loss experience or a formula that permits, subject to certain limitations, an addition increasing the aggregate allowance for loan losses to a fixed percentage of eligible loans, as defined in Internal Revenue Service regulations. The fixed percentage factor will be eliminated after 1987. Thereafter, the maximum addition will be based on the six-year-moving-average-loss-experience method. (Chapter 17 discusses accounting considerations.)

### Accounting

A bank should maintain a reasonable allowance for loan losses applicable to all categories of loans through periodic charges to operating expenses. The amount of the provision can be considered reasonable when the allowance for loan losses, including the current provision, is considered by management to be adequate to cover estimated losses inherent in the loan portfolio. In other

words, the propriety of the accounting treatment should be judged according to the adequacy of the allowance determined on a consistent basis, not the provision charged to operating expenses.

Loans should be written off when they are deemed uncollectible, and that practice should be applied consistently in all interim financial reporting periods.

## **Financial Statement Presentation**

The notes to financial statements should include a summary of activity in the allowance for loan losses account for the period.

## **Auditing**

### **Audit Objective**

The significant objective of the audit of the allowance for loan losses is to evaluate the reasonableness of the recorded allowance.

### **Audit Procedures**

As previously discussed, the allowance for loan losses represents an amount that, in management's judgment, approximates the current amount of loans that will not be collected. All relevant conditions existing at the balance sheet date should be considered. The considerations should not be limited to previous collection experience but should also include estimates of the effect of changing business trends and other environmental conditions. Mechanical formulas that incorporate only collection experience should not be overemphasized.

Loan evaluation is a matter of ascertaining loan collectibility, that is, whether the loan will be repaid or the principal otherwise recovered. The answer may depend, among other factors, on the borrowers' financial abilities as indicated in past and projected earnings and cash flow, credit history, net realizable value of the loan collateral, and the financial responsibility of endorsers or guarantors. Most often a combination of those factors determines the soundness of a particular loan.

The CPA is responsible not for calculating the amount of the allowance but for obtaining reasonable assurance that management has recorded a reasonable allowance, based on available information and all relevant factors bearing on loan collectibility.

Since loans are generally a bank's largest single class of assets

and generally present the highest potential for loss, the CPA can expect to encounter numerous individuals or groups, in addition to state and federal supervisory agency examiners, who have an interest in evaluating the collectibility of the loan portfolio. Interested parties include loan committees, executive committees, internal auditors, and directors' examining committees. The groups' specific responsibilities in loan review vary, depending on the size of the bank and the directives of the board of directors and management. Before starting an evaluation of the adequacy of the allowance, the CPA should determine the existence and role of the interested parties. The testing of the loss provision and allowance account should be designed to maximize the use of information available from these sources, and the CPA may consider their efforts when setting the nature, extent, and timing of tests.

The principal purpose of the audit procedures performed by the CPA is to identify individual loans or conditions that require further consideration in evaluating the reasonableness of the allowance. Factors include

- Current trend of delinquencies.
- Loans classified by supervisory agency examiners.
- Excessive loan renewals and extensions.
- Absence of current financial data related to borrowers and guarantors.
- Borrowers experiencing such problems as operating losses, marginal working capital, inadequate cash flow, or business interruptions, such as involuntary conversions due to fire loss or condemnation.
- Loans secured by collateral that is not readily marketable or is susceptible to deterioration in realizable value.
- Loans in industries experiencing economic instability.
- Inadequately documented loans.

The CPA is not required to ascertain the collectibility of each individual loan included in a bank's portfolio. The audit procedures should be designed to determine the overall collectibility of the entire portfolio and should be performed primarily on a test basis. In establishing the scope of the work to be performed, the CPA should consider the composition of the loan portfolio, growth trends being experienced in specific loan classifications, previous loss and recovery experience, including timeliness of charge-offs,



the existence of sound lending policies and procedures, management's procedures for loan review and classification, and subjective factors, such as economic and environmental conditions.

Although the CPA's primary responsibility when reviewing the allowance for loan losses is to evaluate its adequacy as a whole, practical considerations may dictate that the review be directed to the separate categories of loans that constitute the bank's portfolio. Since the risk and other inherent characteristics of primary loan categories vary, the nature and extent of the separate reviews can be expected to vary.

Loan categories represented by large volumes of relatively small loans with similar characteristics, such as real estate mortgages, installment loans, and retail credit loans, are generally evaluated on a "pool" basis. The CPA is generally more concerned with the effectiveness of and adherence to sound procedures related to such loans than with a critical appraisal of each individual loan. Unless unusual circumstances exist, the testing of procedures and review of delinquency status reports should permit a conclusion to be drawn about the adequacy of the allowance required for those loan classifications. In evaluating the adequacy of the portion of the allowance attributable to those loans, use of historical average annual charge-off experience should be considered in light of the average remaining lives of loans, consistency of loan policy, and current economic conditions.

Conversely, an evaluation of time and demand (commercial) loans normally requires a more detailed review, since the amount of individual loans is generally large and the types of borrowers and the purposes of the loans may be dissimilar. A relatively small number of potential losses can often significantly affect the adequacy of the allowance. The CPA in those circumstances may select and review a certain number of loans in excess of a certain amount, with particular attention to problem loans previously identified by the bank's internal review procedures, the auditor's prior experience, and loans commented on by regulatory authorities. Loans selected for review may be further stratified by type of loan, such as construction loans, floor plan loans, working capital loans, or loans to a specific class of business, depending on the CPA's assessment of the relative exposure to loss presented by the various categories.

The total amount, number, and type of loans reviewed, expressed as a percentage of the loan portfolio, cannot be specified with any degree of uniformity. In making such decisions, individu-

al judgment, based on existing facts and circumstances, should prevail. Factors such as trends in the level of delinquent loans, local and general business conditions, specific industry conditions, past loss experience, and bank lending and loan review policies must be considered case by case.

Audit procedures for the allowance for loan losses should also include evaluation of unused loan commitments, overdrafts, leases, accrued interest receivable, and irrevocable and standby letters of credit.

For purposes of expressing an opinion on the financial statements, the CPA must be concerned with the amount at which loans are stated in the aggregate. Therefore, the specific allowances identified with individual loans and pools of loans should be supplemented by an amount provided for inherent loan portfolio losses not specifically provided for. That amount should be based on judgments regarding risk of error in the specific allowance for individual loans and pools of loans, exposures existing in the bank's loan portfolio, and other relevant factors consistently applied. Loss contingencies and loan commitments are discussed in chapter 14.

## Chapter 9

# Federal Funds and Repurchase/ Reverse Repurchase Agreements

### Federal Funds

The federal funds market is a specialized product of the U.S. banking system. It is primarily an interbank market. Technically, the term federal funds refers to deposit balances held at Federal Reserve banks.

Banks hold most of the balances that count toward the fulfillment of their legal reserve requirements as deposits in the Federal Reserve and as cash on hand. A bank with excess reserves may lend the excess, at an agreed rate of interest, to a second bank needing additional funds to meet its reserve requirements. Thus, federal funds transactions are borrowings or loans of balances on deposit in the Federal Reserve or other banks in order to meet reserve requirements or to earn interest on excess funds. In practice, they are described as purchases or sales. The federal funds market does not increase or decrease total bank reserves but merely redistributes them, thus facilitating efficient use of bank reserves and resources. Ordinarily, purchases and sales are for one day only, with the selling bank regaining its funds on the following business day.

Two types of transactions involving federal funds are commonly used. In an unsecured loan, the selling bank sells federal funds on one day and is repaid on the following day or at the maturity of the term, whichever is applicable. In a collateralized transaction, other than by a repurchase agreement, a bank purchasing federal funds places U.S. government securities in a custody account for the seller until the funds are repaid.

In addition to buying and selling funds to meet their own needs,

banks with correspondent banking relationships absorb or provide funds as a service or accommodation to their correspondent banks. The banks may operate on both sides of the market on the same day. Transactions between correspondent banks usually clear through the Federal Reserve System.

## **Repurchase/Reverse Repurchase Agreements**

The bank may invest excess funds by buying U.S. government securities from the borrowing bank or dealer in U.S. securities for immediate delivery. On the agreed date, usually the following day, the borrower repurchases the securities at the same price plus interest at a predetermined rate. Those transactions are referred to as securities sold under agreements to repurchase (repos) by the borrowing bank and as securities purchased under reverse repurchase agreements (reverse repos—also known as resell agreements) by the lending bank.

Since the sale of securities under a repo agreement is, in substance, a loan to the selling bank collateralized by the securities that are repurchased, it is not unusual for a bank to use this tool for short-term financing of its trading portfolio and other earnings assets, depending on prevailing interest rates. Likewise, banks may enter into reverse repos as a lending accommodation to their corporate customers.

## **Accounting**

Separate general ledger control accounts are usually maintained for federal funds sold, federal funds purchased, securities purchased under reverse repo agreements, and securities sold under repo agreements. Depending on the extent of the transactions, the control accounts may be supported by subsidiary records. The subsidiary records normally include written repo or reverse repo agreements, names of the banks involved in the transactions, interest rates, methods of payment, settlement dates, and identification of securities subject to repo/reverse repo agreements. Accounting for certain repo and reverse repo transactions is currently being studied by the AICPA. Any pronouncement issued is expected to be applicable to banks.

When federal funds transactions occur, no physical transfer of funds takes place. The Federal Reserve merely charges the seller's reserve balance and credits the buyer's reserve balance. The

respective banks then charge or credit federal funds sold or purchased, offsetting the entry by a charge or credit to their reserve accounts with the Federal Reserve Bank.

## **Financial Statement Presentation**

Banks may operate on both sides of the federal funds market on the same day. The transactions may be with different entities, and there is no right of offset. Therefore, federal funds transactions should be stated gross rather than net in the balance sheet, as are securities sold or purchased subject to repo or reverse repo agreements that qualify as short-term loans or borrowings. It is permissible to combine federal funds sold with securities purchased under reverse repo agreements and federal funds purchased with securities sold under repo agreements. Federal funds transactions with maturities exceeding one business day should be classified as loans or other borrowings. The CPA should also be familiar with the financial statement and note disclosure requirements of the relevant supervisory agencies.

## **Auditing**

### **Audit Objectives**

The significant audit objectives for federal funds and repo or reverse repo agreements are to obtain reasonable assurance that the asset or liability balances represent valid amounts due from or to others and that the revenue and expense related to federal funds transactions are stated in conformity with generally accepted accounting principles.

### **Internal Accounting Controls**

The evaluation of internal accounting controls related to federal funds transactions includes the following considerations:

- Are there clearly communicated policies that limit the amount due from a single source?
- Are transactions properly approved?
- Are procedures adequate to provide accurate and timely accrual of income and expense?
- Are there adequate procedures to provide prompt settlement of balances?

- For transactions subject to security arrangements, are there procedures to promptly identify securities pledged?

### **Audit Procedures**

The CPA's audit procedures should include

- Obtaining confirmation from the banks and dealers involved.
- Ascertaining agreement of subsidiary ledgers with the general ledger control accounts.
- Reviewing subsequent collection of funds sold.
- Testing income and expenses for the period.
- Testing approvals on a sample of transactions.
- Testing for adherence to administrative and supervisory policies that limit the amount due from a single source.

## Chapter 10

# Office Buildings, Equipment, and Leasehold Improvements

Office buildings, equipment, and leasehold improvements (fixed assets) include land, buildings, furniture, fixtures, equipment, and leasehold improvements used for banking purposes or purchased for potential use in banking operations. The amount of a bank's investment in fixed assets is limited by regulation.

Before the 1960s many banks arbitrarily wrote down their properties to nominal values. Also, the practice of charging equipment, furniture, and fixtures to expense at the time of purchase was widespread. Those practices did not, of course, conform to generally accepted accounting principles.

Banks using those practices are now required to reinstate material amounts of property and equipment still in use. The fixed assets should be reinstated at original cost less accumulated depreciation to the beginning of the earliest year's financial statements presented, with a corresponding credit to retained earnings at the beginning of that year. Disclosure of the reinstatement is discussed in APB Opinion No. 20, *Accounting Changes*, which specifies requirements for correction of an error.

## Accounting

Bank supervisory authorities require the capitalization and depreciation of bank premises and equipment according to generally accepted accounting principles. The *Comptroller's Handbook for National Bank Examiners* (February 1981) states, "Federal regulations require that all bank fixed assets acquired subsequent to June

30, 1967, be stated at cost less accumulated depreciation or amortization.”

Fixed assets, other than buildings acquired prior to the change in the capitalization policy of the bank supervisory authorities, would now be substantially depreciated. Therefore, the difference between generally accepted accounting principles and supervisory agency regulations is probably not material for fixed assets for most banks. Banks that have written down fixed assets or have followed capitalization policies that do not conform with generally accepted accounting principles should reinstate the accounts for the fixed assets still in use, together with the accumulated depreciation, regardless of the date of acquisition. It may be necessary to obtain the approval of supervisory agencies before making the entry since the agencies may view it as a write-up of assets.

Fixed assets should include all costs related to the acquisition of the property, including transportation costs and all costs connected with installation. If a bank constructs property, cost includes all direct construction costs together with architects' fees, costs of excavations, and supervision of construction. FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, addresses the capitalization of property taxes and other carrying charges (excluding interest) incurred during construction. FASB Statement No. 34, *Capitalization of Interest Cost*, sets forth criteria for capitalization of interest. FASB Statement No. 13 provides guidance for accounting for properties subject to leases (either operating or capital).

Depreciation methods available to banks are similar to those followed in other business enterprises. Using an accelerated method for computing depreciation for income tax purposes and another acceptable method for financial reporting purposes requires deferred tax accounting, discussed in APB Opinion No. 11.

## **Financial Statement Presentation**

Fixed assets are normally shown as a single caption on the balance sheet, net of accumulated depreciation and amortization. However, if the individual categories of assets are material, separate captions should be used in the balance sheet or the notes to the financial statements. In either case, the basis of valuation should be indicated in the balance sheet or the notes. Accumulated depreciation and amortization may be shown on the balance sheet



as a separate item deducted from the related assets, parenthetically if the assets are reported at a net amount, or in the notes to the financial statements. Property acquired but not used in bank operations, such as repossessed collateral, should be in other assets and not included in office buildings, equipment, and leasehold improvements.

The net occupancy expenses, or in some cases net occupancy income, of bank premises should be classified as an operating item in the statement of income. All costs and expenses identified with or directly allocable to the maintenance and operation of the bank premises should be included as net occupancy expense, including expenses such as salaries and wages, payroll taxes, insurance, depreciation, rent expense, and real estate taxes, less rentals from tenants and other income related to the premises.

Net occupancy expense should not include expenses of holding other real estate. Those expenses should be included in other operating expenses.

Mortgage interest expense should be included in interest expense rather than occupancy expense.

Lease commitments should be disclosed in the financial statements in accordance with FASB Statement No. 13.

Some bank properties are owned by building subsidiaries and leased to banks. The financial statements of subsidiaries should be consolidated in accordance with the provisions of Accounting Research Bulletin (ARB) No. 51, APB Opinion No. 18, and FASB Statement No. 13.

## **Auditing**

The audit objectives, internal accounting control considerations, and audit procedures for bank fixed assets are similar to those for other business enterprises. Differences between past bank reporting practices and generally accepted accounting principles for fixed assets may require attention to the propriety of asset costs as reflected in the books, such as additional investigation of prior years' accounting for additions, dispositions, depreciation, and other adjustments to carrying value. Review of tax returns, internal revenue agent adjustments, and reports of supervisory examiners will assist the auditor in this area, especially if the bank's fixed asset records are incomplete.

## Chapter 11

# Other Assets

The following accounts are among those frequently grouped under other assets:

- Customers' acceptance liability
- Investments in subsidiaries that have not been consolidated
- Investments in 50 percent-and-less-owned companies
- Other nonmarketable investments
- Other real estate owned by the bank
- Accrued interest receivable
- Accrued income receivable
- Accounts receivable (deposits for special purposes, advances to trusts, and so forth)
- Prepaid expenses and deferred charges (insurance, taxes, FDIC assessments, and so forth)
- Suspense accounts (items recorded and held subject to clarification and transfer to the proper account, such as loan account and branch clearing transactions)

These accounts may be presented in the balance sheet in one or more categories, depending on the materiality of the accounts, and they are usually presented as the last asset item or items.

Generally, accounting for these items is similar to that for other business enterprises. The following is a discussion of matters peculiar to banking.

Customers' acceptance liability represents the liability to the bank of its customers on outstanding drafts and bills of exchange that have been accepted by the bank (bankers' acceptances) or by

other banks for its account. The bankers' acceptance fills credit needs by guaranteeing payment of the draft or bill of exchange, usually for a period of six months or less. If the drafts or bills of exchange are held by the bank, the customers' acceptances should be reported as loans.

Other real estate owned may include both foreclosed property held pending disposition and real estate other than bank premises. Generally, banks are not permitted to purchase real estate for development or sale. Real estate acquired through foreclosure should be valued at the lower of its fair value or the recorded investment in the related loan. Fair value is defined as the amount a seller can reasonably expect to receive in a current but not a forced or liquidation sale between a willing buyer and a willing seller and should be measured by market value if an active market exists. If no active current market exists for the assets but exists for similar assets, the selling price in the market for similar assets may be helpful in estimating the fair value of the assets acquired. If no market price is available, estimation of fair value may involve discounting the expected future cash flows at a rate commensurate with the risk involved. At foreclosure, if the fair value of the real estate acquired is less than the bank's recorded investment in the related loan, a writedown should be recognized through a charge to allowance for loan losses.

The amount at which real estate acquired through foreclosure is recorded should be measured in the same manner as if the asset had been acquired for cash. The fair value of the asset becomes the new cost basis for subsequent accounting. However, in no event should the new carrying value exceed the recorded investment. If at a later date it is determined that the total capitalized cost (including completion and holding costs) of the property cannot be recovered through sale or use, the additional loss should be immediately recognized by a charge to income with a corresponding writedown of the asset or by a credit to an allowance for losses on real estate owned.

Some supervisory agencies also require that such property be recorded at the lower of recorded investment or fair market value (as defined in supervisory agency pronouncements) and that the value be substantiated by an annual appraisal prepared by an independent, qualified appraiser. SAS No. 11, *Using the Work of a Specialist*, discusses using the services of specialists, such as appraisers.

When the property is in a condition for use or sale at the time of

foreclosure, any subsequent holding cost should be included in expense as incurred. When the property is not in a condition for use or sale at the time of foreclosure, completion and holding costs, including such items as real estate taxes, maintenance, and insurance, should be capitalized. Legal fees and other direct costs incurred by the bank in a foreclosure should be included in expenses when they are incurred. FASB Statement No. 34 sets forth criteria for capitalization of interest.

Guidance on accounting for gains on sales of other real estate is provided in FASB Statement No. 15 and Statement No. 66, *Accounting for Sales of Real Estate*.

## **Auditing**

Audit objectives, internal accounting control considerations, and audit procedures for customers' acceptance liability are similar to those for loans. The procedures should include inspection of related documents, proving detail ledgers with control accounts, direct confirmation with customers, and evaluation of collectibility.

Internal accounting control considerations related to the other accounts discussed in this chapter primarily include adequacy of accounting records and segregation of duties. With the exception of other real estate owned and suspense accounts, the records maintained for those accounts generally are similar to those of other business enterprises.

The auditing procedures related to foreclosed property should include a review of legal documents and title papers and an examination of appraisals. Writedowns of recorded amounts to reflect regulatory requirements may necessitate further investigation to obtain reasonable assurance that the writedowns are in conformity with generally accepted accounting principles.

Suspense account transactions should be reviewed to verify propriety of accounting treatment. In addition, entries to clear suspense balances should be reviewed to consider the necessity of reclassification or adjustment.

## Chapter 12

# Deposits

The major liabilities of banks are demand and time deposits.

### Demand Deposits

Demand deposits generally include checking accounts, official checks, demand certificates of deposit, and escrow deposits.

Checking accounts provide the greatest volume of activity and include a number of classifications, usually by type of depositor served, for control purposes. One general category of deposits includes accounts of individuals, partnerships, and corporations. A second category includes public deposits, including those of states and their political subdivisions, deposits of the U.S. government (Treasury tax and loan remittance option accounts), trust deposits, representing funds deposited by the bank's trust department, and deposits due to other banks, both domestic and foreign.

Checking accounts that are overdrawn should be included with loans. The overdrafts should be evaluated for collectibility as part of the loan evaluation process.

Banks may issue checks drawn on themselves for a variety of purposes, such as expense disbursements, loan disbursements, dividend payments, withdrawal of account balances, and exchange for cash with customers. Some of the names used for bank checks include official, cashier's, treasurer's, expense, and loan disbursement checks and money orders. A separate series of checks and a separate general ledger control account may be maintained for each type of disbursement.

Demand certificates of deposit, which may be negotiable or nonnegotiable, must be surrendered at the time of demand for payment. Registers or prenumbered certificate books are main-

tained, showing depositor name, identifying number, amount of each certificate held by depositor, and date of payment. Separate listings may also be maintained with certificates listed in numerical sequence for control purposes.

Deposits collateralizing loans and deposits that are subject to escrow or other withdrawal restrictions (for example, deposits representing funds withdrawable only on presentation or drafts drawn under commercial or travelers' letters of credit) may be separately controlled.

## **Time Deposits**

Time deposits, which usually bear interest, generally consist of savings accounts, negotiable orders of withdrawal (NOW) accounts, time certificates of deposit, commercial and public fund time deposits, and Christmas and other club accounts. Time deposits may also include escrow deposits, which were discussed in connection with demand escrow deposits. Time certificates of deposit are similar to demand certificates of deposit, except that time certificates of deposit generally have fixed maturity dates.

When a savings account is opened, many banks provide the depositor with a passbook, providing a record of deposits, withdrawals, interest, and account balance. Normally, the bank's rules and regulations affecting the conduct, use, and privileges of savings accounts are also shown in the passbook. The passbook is usually presented each time a deposit or withdrawal is made. As a result of increased use of EDP equipment, there has been a growing tendency to eliminate passbooks and provide periodic statements of savings activity.

State and federal regulations define the various categories of deposits, govern interest rates that may be paid, and specify from whom they may be accepted and the reserve requirements that must be maintained against deposit balances. One of the most important regulations is Regulation Q of the Board of Governors of the Federal Reserve System. Although that regulation sets maximum interest rates, it also recognizes the rate limitation set by each individual state for its local banks and applies the state limitation, if lower, to all banks within jurisdiction in the state. The Depository Institution Deregulation Act phases out, over a six-year period beginning March 1, 1980, the interest rate limitations imposed by Regulation Q.

Methods of computing interest and periods used for compound-

ing vary from bank to bank. The methods currently in use vary from a policy that requires amounts to be on deposit for the entire interest period to earn any interest to a policy of allowing interest for the exact number of days on deposit.

## **Dormant Accounts**

The classification of accounts as dormant depends on individual bank policy. The required period of inactivity before savings accounts are classified as dormant normally exceeds that for checking accounts because savings accounts are usually less active. It is preferable that dormant accounts and the related signature cards be kept under the control of individuals independent of the teller and bookkeeping functions. After a specific period of inactivity, as determined by the state in which the bank is located, the accounts no longer are deposits of the bank and may escheat to the state.

## **Closed Accounts**

When an account is closed, the signature card should be removed from the file of active accounts and placed in a closed account section. Generally, if a passbook is used, it is perforated in a cancelling machine and returned to the customer.

## **Accounting**

### **Demand Deposits**

Each depositor's account is maintained by the bookkeeping department on a separate ledger card or in an EDP file. The posting to the accounts is performed either on the day the items are received or on the following day on a delayed posting basis. Any rejected items are disposed of in the following day's business. Rejected items may include checks that are missorted, lacking endorsement, subject to "stop payment" orders, or drawn on other banks and items that, if charged, would create an unauthorized overdraft. (These items are sometimes called "holdovers" or "throw-outs.") Periodic statements, together with cancelled checks and credit and debit memos, are sent to the depositors.

When a bank draws a check on itself or certifies a customer's check, it records a liability for outstanding checks on its books but

does not reduce cash until the check has been paid. When checks are issued or certified for customers, they are recorded in a check register, which may be a numerical file of duplicate check copies or an EDP file. When the items are paid, they are checked off in the register or removed from the file. The total of all open items represents the bank's total liability for outstanding checks and should agree with the general ledger or other appropriate account balance.

### **Time Deposits**

Some systems provide for the simultaneous posting of passbooks and ledger sheets by the teller, while others provide for subsequent posting of the ledgers by savings bookkeepers. In addition, EDP has had a significant effect on the maintenance of savings account files. Ledger cards or customer statements prepared by computer have replaced passbooks as the medium for recording customer activity at many banks.

### **Financial Statement Presentation**

Current practice is to disclose separately the following components of the deposit liability: domestic demand, domestic time, foreign demand, foreign time deposits and certificates of deposit of \$100,000 or more. If material, NOW accounts should be disclosed separately. The Federal Reserve has set forth disclosure guidelines in Regulation F.

Deposits (particularly demand deposits) that are received by a bank on terms other than those available in the normal course of business are usually disclosed, particularly if the deposits represent a significant source of funds for the bank. If material, deposits received from associated companies or other related parties are also disclosed.

### **Auditing**

#### **Audit Objectives**

The significant audit objectives for the bank's liabilities for deposits are to obtain reasonable assurance that the deposit, revenue, and expense accounts are fairly stated in conformity with generally accepted accounting principles and that the accounts are properly classified in the financial statements.



## **Internal Accounting Controls**

The study and evaluation of the internal accounting control system for demand and time deposits should include consideration of the following:

- Are subsidiary ledger control accounts reconciled to the general ledger daily?
- Is approval of an officer or supervisory employee obtained for unposted holdover items, overdrafts, and return items?
- Is adequate protection of files, ledger cards, cancelled checks, deposit tickets, and signature cards maintained?
- Are depositor account statements mailed regularly?
- Is dormant account activity reviewed by an officer or supervisory employee?
- Are prenumbered official checks used and adequately controlled?
- Is segregation of duties adequate?
- Are employees' accounts reviewed for unusual transactions?

## **Audit Procedures**

The principal audit procedures include balancing the underlying subsidiary deposit records with the general ledger control accounts and confirmation of account balances.

In starting the fieldwork on a surprise basis, the CPA should obtain audit control of pertinent records and should retain control until tests for proving agreement of the detail with the related control accounts for non-EDP applications and selection of accounts for confirmation are completed.

Bank employees may assist in proving agreement of machine-posted detail ledgers with the general ledger under the CPA's supervision and control. When bank employees are used in this capacity, they should assist in other than regularly assigned areas. For example, a deposit ledger bookkeeper should not be used to prove totals of depositors' ledgers.

Differences between detail and control balances may be investigated by bank employees, provided that properly documented explanations are furnished to the CPA. Some of the items of particular concern are returned items, adjustment items, holdovers in departments, overdrafts, and service charges. The CPA may decide to test subsequent disposition or proper approvals.

The extent and type (positive or negative) of confirmations and methods of selection (including audit sampling) are usually left to the CPA's discretion, although the selection of tests may be influenced by regulatory requirements. Confirmations may be prepared by bank personnel under the control and supervision of the CPA.

For checking and statement savings accounts, customers should be furnished with or should have previously received a statement that includes the balance as of the date confirmations are requested. Sometimes, depending on the evaluation of internal accounting controls, it is practicable to request confirmation as of a recent cycle date or month end. In such cases, tests may be made of the agreement of detail balances with the general ledger control as of the confirmation date; some comparisons may also be made of balances as of the confirmation date with balances as of the audit date.

Some depositors may have instructed the bank that their accounts are on a "no mail" basis. There should be a written request from the depositor authorizing the "no mail" status. Those accounts and accounts for which confirmation requests are returned undelivered by the postal authorities should be subjected to alternative procedures. If alternative procedures are not practicable, the CPA should consider whether a scope limitation exists.

The bank's policy for segregating and controlling dormant account records should be reviewed for compliance with state escheat laws where applicable. Active accounts may be reviewed to determine whether the bank's policy is reasonable and whether dormant accounts are being segregated currently. Confirmation of a sample of dormant accounts and zero-balance accounts (those closed during the review period) may be desirable.

Accrued interest payable, interest expense, and service charge income should be tested in connection with the audit of deposit accounts. Test procedures for interest on deposits include the balancing of subsidiary records with the general ledger controls, recalculation of interest paid and accrued interest payable, and testing of interest expense for a specified period. Overall tests of interest may be performed by relating interest expense for the period under examination to the average balance of the respective interest-bearing deposit accounts and comparing the resulting yields to interest rates in effect during the period. Service charge income should be tested to determine that the fees were charged in accordance with the bank's policy.

## Chapter 13

# Borrowed Funds

Borrowed funds include (1) debentures, (2) accounts with a Federal Reserve bank or a Federal Home Loan bank, (3) Treasury tax and loan note option accounts, (4) short-term borrowings, and (5) mortgage indebtedness.

### Debentures

Many banks and bank holding companies have turned to the issuance of debt securities to raise funds. Unsecured debt securities, those not collateralized by specific property, are the most commonly issued type. Those instruments, termed debentures, may be subordinated to other types of bonds and may be convertible into shares of common stock. Their maturities generally range from seven to forty years. Securities that are subordinated to the rights of depositors are usually called capital notes.

### Accounts With a Federal Reserve Bank or a Federal Home Loan Bank

Depository institutions have available to them two methods of short-term borrowing from the Federal Reserve bank in their district. These are “discounting” and “advancing.” In discounting, the Federal Reserve rediscounts, with recourse, the bank’s eligible loans. In advancing, a member bank executes a promissory note collateralized by government securities. Interest charged in those transactions is referred to as “discount.” Loans by Federal Reserve banks are usually of short maturity—up to fifteen days—and are advanced at rates set every fourteen days by the individual reserve banks. Borrowings from a Federal Reserve bank are made

available primarily to cover shortages in the required reserve account. If a mutual savings bank is a member of the Federal Home Loan Bank System, it can obtain advances from the Federal Home Loan bank in its district.

## **Treasury Tax and Loan Note Option Account**

Banks may elect to transfer amounts from the Treasury tax and loan remittance option account to the Treasury tax and loan note option account. Those deposits are subject to withdrawals and are evidenced by an open-ended, interest-bearing note maintained at the Federal Reserve bank. They should be included in the financial statements as other borrowed funds.

## **Short-Term Borrowings**

Bank holding companies or their nonbank subsidiaries, like other business enterprises, may issue commercial paper regularly. Commercial paper is generally short-term, negotiable, and not subordinated. Other forms of short-term borrowing include unsecured notes, whose floating interest rates are tied to the U.S. Treasury bill rate, and borrowings under lines of credit.

## **Mortgage Indebtedness**

Banks, and sometimes their subsidiaries, finance expansion programs using traditional real estate mortgages. Maturities are generally longer than for debentures because the value of specific property usually can be projected more accurately than the ability of an enterprise to meet future servicing requirements.

## **Financial Statement Presentation**

For supervisory reporting purposes, the provisions of Federal Reserve Regulation F and the regulations of other supervisory agencies govern balance sheet presentation. Instructions to Form F-9A require borrowings from the Federal Reserve bank to be grouped with promissory notes such as commercial paper and reported as other borrowed funds. The instructions also require that mortgages payable be reported separately. Long-term debt,

subordinated notes, and debentures also comprise a separate liability category.

Although methods of public reporting vary, the most common presentation is an adaptation of Form F-9A, in which short-term borrowings, other than federal funds purchased and securities sold under agreements to repurchase, are classified as other borrowed funds. Long-term debt, consisting of mortgage notes, debentures, and capital notes, is often collectively termed “notes payable.” Capital notes should be classified as liabilities in financial statements of both banks and bank holding companies.

Notes to the financial statements should provide details of significant components and, when appropriate, interest rates, due dates, pledged property, and restrictive covenants.

## **Auditing**

### **Audit Objective**

The significant audit objective for borrowed funds is to obtain reasonable assurance that liabilities and related expense accounts are fairly presented in conformity with generally accepted accounting principles and that required disclosures have been made in the financial statements or the notes.

### **Internal Accounting Controls**

In the study and evaluation of the internal accounting control system procedures for borrowed funds, the CPA should consider the following:

- Is there a clearly communicated policy on limits on amounts of borrowings by type and other liability management guides?
- Is there adequate segregation of duties so that the subsidiary records are not handled by personnel who also process receipts, make disbursements, or prepare all the supporting documents for debt repayment?
- Are subsidiary records reconciled at least monthly with general ledger control accounts?
- Are inventories of unissued notes or debentures maintained under dual control and periodically inventoried?
- Are surrendered notes and debentures properly cancelled?
- Are interest computations independently checked?

- Are periodic reports made to management showing all important borrowed funds activity?

### **Audit Procedures**

As in any audit situation, the extent of year-end audit procedures for borrowed funds depends on the circumstances surrounding an individual engagement. The CPA may consider such procedures as the following when examining borrowed funds:

- Requesting the lender to confirm the terms of borrowing, including, for example, current balance, interest rate, and pledged property
- Ascertaining and requesting confirmation of the existence and terms of lines of credit and compensating balance arrangements
- Reading loan agreements, if applicable, and ascertaining compliance with restrictive covenants
- Testing interest expense and accrued interest payable
- Reading the financial statements to determine if required disclosures have been made

## Chapter 14

# Other Liabilities, Commitments, and Contingencies

The following accounts are among those frequently identified as other liabilities:

- Acceptances outstanding
- Accrued payrolls
- Accrued income taxes currently payable
- Deferred income taxes
- Accrued interest
- Undistributed payroll deductions
- Accounts payable
- Cash dividends declared but unpaid
- Suspense accounts (items recorded and held subject to clarification and transfer to the proper account, such as unapplied deposit account transactions and branch clearing transactions)

If material, each of these accounts should be stated separately in the balance sheet or in the related notes.

Accrued income tax liabilities include income taxes estimated to be payable currently and deferred income taxes.

Amounts representing accrued interest should be audited in conjunction with the examination of the related balance sheet accounts.

Records maintained for these types of liabilities are similar to those of other business enterprises.

The principal internal accounting control considerations are the

condition of subsidiary records, the control over such records, and the extent to which functional duties are segregated.

The auditor should obtain reasonable assurance that the bank has complied with the provisions of FASB Statement No. 5 and related interpretations setting forth the required accrual and disclosures of loss contingencies.



## Chapter 15

# Equity

The equity section of a bank's balance sheet typically includes capital stock, surplus, and retained earnings (often referred to in the banking industry as undivided profits). Transactions in those accounts are subject to the regulations of the appropriate supervisory agencies. However, except for differences noted in this guide, financial statement disclosure and accounting and auditing considerations are the same for banks as for other business enterprises.

### Accounting

In addition to the usual transactions affecting a corporation's capital accounts, the board of directors of a bank, often with the encouragement of supervisory agencies, or as required by law, may transfer amounts to surplus from retained earnings. Such transfers by subsidiaries need not be reflected in consolidations. (See ARB No. 51.)

Although some differences do exist between generally accepted accounting principles and bank supervisory agency accounting for capital transactions, modifications or changes in the regulations of supervisory agencies in recent years have reduced the number of such differences. The most frequently encountered difference is in accounting for stock dividends.

Normally, accounting for stock dividends by entities other than banks involves the transfer from retained earnings to a category of permanent capitalization (capital stock and surplus) of an amount equal to the fair value of the additional shares issued. Banks, as opposed to bank holding companies, frequently account for stock dividends by transferring from retained earnings to capital stock an amount equal to the par value of the additional shares being issued.

That practice is traditional; however, there is no regulatory prohibition against capitalization of the fair value of the shares issued.

Stock dividends (as distinguished from stock splits) should be accounted for using the fair value of the shares issued in connection with such a dividend.<sup>1</sup> For closely held banks there is no need to capitalize stock dividends other than to meet legal requirements. (See chapter 7, paragraph 12, of ARB No. 43.)

Although it does not occur frequently, the assumption of a subsidiary bank's debt by its parent company is generally reported as an addition to surplus (as a capital contribution) in the bank's separate financial statements. Consideration should be given to the need for disclosure of the bank's contingent liability for such debt.

## **Financial Statement Presentation**

Within the equity section, the classes of a bank's authorized stock should be disclosed separately.

The definition of surplus may have special significance to banks' lending limits. Therefore, transactions recorded in surplus are not directly analogous to those of nonbank corporations.

Bank supervisory regulations usually restrict the amount of dividends a bank is allowed to pay and charge to retained earnings without prior approval of the applicable bank supervisory agency. Dividend limitations may exist that are more restrictive than those contained in bank supervisory regulations. The most restrictive limitations should be disclosed in the balance sheet or in the notes to the financial statements.

Supervisory agencies may direct newly organized banks to allocate a portion of their initial paid-in capital to retained earnings. The purpose of the transfer is to permit a bank to avoid reporting a deficit in the retained earnings account during the early, usually unprofitable, periods of its existence. If such a transfer has been made, retained earnings should be reported in a manner that clearly describes the amount of paid-in capital included and the amount of accumulated losses. The amount of paid-in capital included in the retained earnings account should be

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<sup>1</sup>Stock dividends may be recorded at less than fair value, but not less than par value, to the extent that previous transfers unrelated to stock dividends have been made to surplus from retained earnings. The difference between the recorded amount and fair value should be disclosed in the year of the stock dividend. Also, consideration should be given to the disclosure of the remaining amount of surplus available for future stock dividends.

restored to the surplus account as rapidly as profitable operations permit.

## **Auditing**

Audit objectives, internal accounting control considerations, and auditing procedures relating to the equity accounts of banks are similar to those of other business enterprises.

## Chapter 16

# Operating Revenue and Expenses

A bank's income and expenses are accumulated in revenue and expense accounts for the current accounting period until they are closed into retained earnings. Income accounts are generally maintained on a functional basis, reflecting the various operations of the bank, for example, loans, investments, and trusts. Expense accounts generally reflect operating expenses that cross functional areas and are grouped for financial statement purposes into such categories as salaries and wages, employee benefits, and occupancy expense.

### Financial Statement Presentation

The format of a bank's statement of income differs from a conventional commercial format in one significant area: Net gains and losses on investment securities transactions are separately classified below a caption typically described as income before securities gains and losses. Net securities gains and losses represent the result of each period's sales activity. Such gains and losses and provisions for losses on investment securities are stated net of related income tax effects. (See chapter 5, "Investment Securities.") As with most business enterprises, banks sell securities (1) to obtain greater yield on the investment portfolio through reinvestment of the proceeds of sales in higher yielding securities, (2) to realize gains from appreciation of securities, or (3) to reduce the size of the portfolio to achieve a required or desired liquidity.

### Auditing

The procedures used to audit bank revenue and expense accounts are similar to those for other enterprises having a high volume of transactions.

Other chapters of this guide, such as those relating to loans, investment securities, trading securities, deposits, fixed assets, and the trust department, provide information on the accounting, reporting, and auditing of revenues and expenses derived from those areas of operations.

SAS No. 23, *Analytical Review Procedures*, provides guidance for consideration by the auditor for application of analytical review procedures.

## Chapter 17

# Income Taxes

This chapter discusses problems related specifically to accounting for bank income taxes. APB Opinion No. 11, *Accounting for Income Taxes*, APB Opinion No. 23, *Accounting for Income Taxes—Special Areas*, APB Opinion No. 24, *Accounting for Income Taxes—Investments in Common Stock Accounted for by the Equity Method*, and FASB Interpretation No. 18, *Accounting for Income Taxes in Interim Periods*, provide detailed discussions of the principles involved. The discussions related to federal income taxes generally also apply to state and foreign income taxes.

### Accounting

Banks are required to record income tax expense based on income and expense items reported in the statement of income for the period, including amounts based on interperiod allocation of income taxes. The aggregate amount of income tax expense should be allocated among the major elements in the statement of income, namely, income before securities gains and losses, securities gains and losses, and extraordinary charges or credits.

### Intraperiod Tax Allocation

Intraperiod allocation of income taxes is based on the concept that the incremental income tax effect of any income or expense item that receives special treatment in the financial statements should be directly related to that item. That concept is recognized in the statement of income presentation required by the FRB, the FDIC, and the OCC. Thus, income tax expense should be allocated among the major elements in the statement of income, and the amount allocated to each should be disclosed.

## **Interperiod Tax Allocation**

The tax effects of revenue and expense transactions that enter into the determination of pretax accounting income either before or after they become determinants of taxable income should be recognized in the periods in which the differences between pretax accounting income and taxable income arise and in the periods in which the differences reverse. Since permanent differences do not affect other periods, interperiod tax allocation is not appropriate for such differences.

The following timing differences are frequently encountered during bank engagements:

- Additions to the allowance for loan losses for tax purposes based on the Internal Revenue Code tax limitations and exceptions that differ from the provisions for loan losses charged against income for financial accounting purposes
- Accretion of discount on bonds and U.S. Treasury bills recorded currently for accounting purposes but subject to tax only at maturity or sale
- Net leasing revenue recorded under the financing method for accounting purposes and the operating method for tax purposes
- Expenses for deferred compensation recorded under the accrual method for accounting purposes but deducted as paid for tax purposes
- Valuation of trading securities at market value for accounting purposes but at cost for tax purposes, with gain or loss recognized at sale or maturity
- Organization costs written off for book purposes as incurred but amortized in tax returns
- Commitment fees and rental income included in taxable income when collected but deferred to a period when earned for book purposes
- Depreciation deductions for tax purposes that differ from amounts recorded for accounting purposes, for example, use of an accelerated method of depreciation for tax purposes and the straight-line method for accounting purposes
- Income reported on a cash basis for tax purposes and on the accrual basis for accounting purposes
- Provision for losses on the writedown of other real estate and other assets for financial statement purposes that are not recognized for tax purposes

## **Net Operating Losses and Other Tax Benefit Items**

For taxable years beginning before January 1, 1976, the Internal Revenue Code permitted a net operating loss to be carried back and applied against taxable income of the three preceding years and then, to the extent it was unused, carried forward and applied against taxable income of the succeeding five years. For taxable years beginning after December 31, 1975, banks are allowed a ten-year net operating loss carryback in addition to a five-year carryforward. This extended carryback period does not apply to income attributable to nonbank subsidiaries (nor to the bank holding company itself), but to those companies that have a longer carryforward period. The IRS has not yet issued regulations on the application of those rules in a consolidated return.

The CPA should consider the accounting implications of the possible use of net operating loss and other carryforwards. If the current year loss exceeds available carrybacks and reversals of previous deferred taxes, reference should be made to paragraphs 44 to 50 of APB Opinion No. 11, which provide guidance on the timing of recognition of the tax benefits of net operating losses:

The tax benefits of loss carryforwards should not be recognized until they are actually realized, except in unusual circumstances when realization is assured beyond any reasonable doubt at the time the loss carryforwards arise. . . . In those rare cases in which realization of the tax benefits of loss carryforwards is assured beyond any reasonable doubt, the potential benefits should be associated with the periods of loss and should be recognized in the determination of results of operations for those periods.

## **Investment Tax Credit on Lease Financing**

Paragraphs 42 through 47 of FASB Statement No. 13 indicate that the investment tax credit retained by lessors on leveraged lease transactions should be deferred and amortized over the lease term.

Some bank lessors have classified deferred investment credits as part of the net investment in lease financing and reported the amortization of investment tax credits on both leveraged and financing leases as operating income rather than as a component of the income tax provision because they view the investment tax credit amortization as an integral part of their rate of return on the lease financing. Other lessors have reported the amortization of such investment tax credits as a component of the income tax provision. The lessor should disclose which method is followed.



## Financial Statement Presentation

Income tax amounts included in the balance sheet usually include taxes estimated to be currently payable and the net amount of deferred tax charges and credits that relate to timing differences. Those amounts are typically classified in the balance sheet with other accrued expenses or as other liabilities. Deferred taxes arising from loan loss tax deductions in excess of amounts reflected in the statement of income represent timing differences, and they should be included with other net deferred tax credits in other liabilities. Refundable taxes arising from carrybacks and net deferred charges have generally been classified in other assets. More descriptive captions for all tax-related amounts should be used if the amounts involved are material.

All taxes based on income, including foreign, state, and local income taxes, should be classified as income tax expense in the statement of income. The components of income tax expense—amounts currently payable and deferred taxes—should be disclosed. The amounts may be disclosed by separate or parenthetical presentation of the components in the statement of income, or tax expense can be reported as a combined amount with the components disclosed in the notes to the financial statements. Since banks are required to report at least two income tax amounts (income tax expense on income before security gains and losses and income tax expense on security gains and losses), the current and deferred portions of those items are generally disclosed in the notes to the financial statements rather than in the statement of income.

APB Opinion No. 11 sets forth certain additional income tax disclosures:

- Amounts of any operating loss carryforwards not recognized in the loss period, together with expiration dates (indicating separately amounts which, upon recognition, would be credited to deferred tax accounts);
- Significant amounts of any other unused deductions or credits, together with expiration dates; and
- Reasons for significant variations in the customary relationships between income tax expense and pretax accounting income, if they are not otherwise apparent from the financial statements or from the nature of the entity's business.

The method for recognizing investment tax credits in the financial statements is discussed in APB Opinion No. 4, *Accounting*

*for the Investment Credit*, FASB Interpretation No. 25, *Accounting for an Unused Investment Tax Credit*, and FASB Interpretation No. 32, *Application of Percentage Limitations in Recognizing Investment Tax Credit*.

The income statement and related disclosures of income tax expense applicable to banks have not changed substantially since the publication of APB Opinion No. 11 in 1967. However, SEC Regulation S-X requires certain income tax disclosures beyond those required by APB Opinion No. 11. Many banks, though not subject to SEC regulation, have included the additional disclosures in their annual reports. The disclosures include

- The nature and tax effect of selected timing differences.
- A reconciliation of the reported income tax expense with the “computed expected” tax amount. (The “computed expected” tax amount is defined as the amount determined by multiplying the financial statement income before income tax by the applicable statutory federal income tax rate. The reconciliation may be presented in percentages, in dollar amounts, or both.)
- Domestic and foreign components of income taxes.

## **Auditing**

Audit objectives, internal accounting control considerations, and audit procedures for bank income taxes are similar to those for other business enterprises.

## Chapter 18

# Trust Department

Although a trust department is an integral part of a bank, it is required to operate independently of the bank's commercial departments. The organization of the trust department largely depends on the types of services offered, management preference, and the historical growth of the department.

Among other things, a bank's trust department acts as trustee, agent, or fiduciary for customers. While the trust department may have responsibility for the custody of trust assets, they are not assets of the bank and, therefore, should not be included in the bank's financial statements.

### Types of Trusts

Trusts can be broadly categorized as either personal or corporate.

#### Personal Trusts

*Testamentary Trust.* This is a trust created under a will. Administrative responsibility begins when assets are transferred from the estate to the trust. Almost all testamentary trusts are irrevocable.

*Voluntary Trust (Inter Vivos).* Such a trust is established by an individual during his lifetime. This type of trust is often established with powers of revocation or amendment.

*Court Trust.* In a court trust the trustee is accountable to a court. Court trusts generally include decedents' estates (under which the courts appoint administrator banks to settle the estates

of persons who either died without leaving wills or who nominated the banks as executors in their wills), guardianships, and some testamentary trusts. Some banks consider court trusts as a third major division of trust department activity, in addition to personal and corporate trusts.

*Collective Investment Trust.* Under this arrangement the funds of individual trusts are pooled to achieve greater diversification of investment, stability of income, or other investment objectives. Under federal statute there are two types of collective investment trusts: a common trust fund maintained exclusively for the collective investment of accounts for which the bank serves as trustee, executor, administrator, or guardian and a commingled pension trust fund, which consists solely of assets of retirement, pension, profit sharing, stock bonus, or other trusts that are exempt from federal income taxes.

Common trust funds are exempt from federal income taxes under section 584 of the Internal Revenue Code.

Many of the state statutes that authorize bank common trust funds also require conformity with the rules and regulations of the Comptroller of the Currency. Commingled pension trust funds derive their tax-free status from sections 401 and 501 of the Internal Revenue Code and from revenue rulings.

For common trust funds to maintain their tax exemption, a state-chartered and national bank must operate the common trust funds in accordance with the rules and regulations (currently Regulation 9) of the Comptroller of the Currency. Regulation 9 requires each collective investment trust to operate under a written plan or agreement that must include provisions relating to investment powers, participant eligibility, auditing, and method and frequency of valuation. Specific operating restrictions include the following:

- Valuation not less frequently than every three months.
- Annual audit and annual financial statements. Under some states' statutes, the audit must be performed by independent public accountants.
- Limitation on the amount invested in any issuer to 10 percent of the market value of the fund. This limitation does not apply to commingled pension trust funds.
- Limitation on the participation by any single trust to 10 percent of the then market value of the fund. This limitation does not apply to commingled pension trust funds.

*Agency Agreement.* This is an agreement to care for other parties' securities and properties. Safekeeping and custodianship agreements are two of the more common types.

*Property Management Agreement.* Such an agreement provides for the management of property, for example, real estate or securities investments, by the trustee bank. The bank, as agent, has managerial duties and responsibilities appropriate to the kind of property being managed.

*Pension or Profit Sharing Trust.* This trust provides for a trustee bank to manage trust funds established for the benefit of eligible company officers or employees or for members of a union, professional organization, or association. Such trusts are established by comprehensive written plans in which the trustees' powers are limited and their duties are well defined.

## **Corporate Trusts**

*Transfer Agent.* The trust department transfers registered (in contrast to bearer) securities from one owner to another and maintains the records of ownership.

*Registrar.* The trust department maintains control over the number of shares issued and outstanding.

*Joint Registrar-Transfer Agent.* The trust department acts jointly as both registrar and transfer agent for the same issue.

*Paying Agent.* The trust department distributes interest or dividend payments or redeems bonds and bond coupons of corporations and political subdivisions within the terms of an agency agreement.

*Trustee Under Indenture.* The trust department acts as trustee under a trust created by a corporation, typically in connection with the issuance of bond indebtedness.

*Fiscal Agent.* The trust department acts as an agent designated by a municipality or corporation to administer specified cash receipt or payment functions. In the municipal area, a fiscal agent may act for a governmental body or political subdivision to pay bond principal and interest.

## Accounting

Accounting systems within trust departments range from hand-posted records to sophisticated electronic data processing systems. The accounting records of a trust department should generally reflect at least the department's asset holdings and liabilities to trust customers, the status of each trust account, and all transactions relating to each trust account. This requires records relating to the trust department's total asset holdings and total liability: (1) general ledger, (2) asset control accounts, and (3) journals and other records of original entry. It also requires records providing detailed information for each trust account:

- Principal (corpus) control account
- Principal cash account
- Income cash account
- Investment records for each asset owned, such as stocks, bonds, notes and mortgages, savings and time accounts, real property, and sundry assets
- Liability record for each principal trust liability
- Investment income

A trust department usually maintains a separate, self-balancing set of accounting records; however, certain activity relating to the trust department is also included in the bank's general ledger and financial statements. In particular, cash accounts of individual trusts are deposited with the bank in demand and time deposit accounts. Revenues and expenses of the trust department also are recorded in the bank's general ledger.

In response to the urging of bankers, supervisory agencies have permitted banks to continue reporting trust department income on a cash basis on the assumptions that (1) certain elements of trust income, particularly income derived from the administration of estates, were not readily susceptible to reasonable accrual and (2) the difference between cash and accrual accounting in this area would not have a material effect on the bank's net income. Trust department income should be presented on the accrual basis unless such income reported on the cash basis does not differ materially from income that would be reported on the accrual basis.

The trust department is subject to periodic reporting requirements. Several types of internal reports are generated as the basis for management of the trust department as a whole and for

management of individual accounts. Generally, a daily trial balance of assets and liabilities is prepared for the department. The values at which assets of the various trusts are carried in the ledger vary and may include a combination of nominal value, cost, tax basis, and market value. The values are used solely for control purposes. Accordingly, the trial balance does not purport to present financial position in conformity with generally accepted accounting principles but represents an accountability record.

Current practice is to furnish a statement or “accounting” to a customer periodically as a record of the activity within an account. The format or basic information provided in such a statement may vary, depending on court accounting or other requirements imposed on the trust department through the trust agreement. The statement or accounting generally provides a detailed record of the income and principal cash transactions during the accounting period. It is usually a supplement to a statement of the property or assets held in the trust account as of the statement date.

## **Auditing**

### **Audit Objectives**

In an audit of a bank’s financial statements, the CPA’s primary objective concerning trust operations is to evaluate the bank’s liability exposure should the trust department fail to fulfill its fiduciary duties and responsibilities. The exposure to liability may be significant because of the relative significance of the trust assets administered. Thus, the importance of the trust department should not be underestimated. A second objective is to obtain satisfaction that the fee income resulting from trust activities is recognized properly in the bank’s financial statements.

CPAs are sometimes engaged to issue a report on the internal accounting control system in the bank’s trust department. Usually, such an engagement is the result of the need of pension plan auditors or other auditors to obtain evidential matter regarding the system of internal accounting control in the departments of a bank controlling nonbank assets. Since a bank may administer many plans, it may not be economically feasible for each plan’s auditor to carry out audit procedures at the trustee bank. Accordingly, one CPA may perform procedures in the area or department administering all plans at the bank and issue a report to the bank on internal accounting controls related to administration of the plans.

SAS No. 44 provides guidance on the CPA's preparation of a special-purpose report on certain aspects of internal accounting control of organizations such as bank trust departments.

If the pension plan auditors or other auditors do not wish to rely solely on the report on internal accounting controls but, in addition, require substantive testing of a particular plan or account, such testing can be performed either by the bank's independent auditor or by the plan's auditor. The auditor engaged by the bank can usually do that testing more efficiently because of his familiarity with the bank's procedures, controls, records, and personnel.

A CPA should become familiar with the various state, local, and supervisory agency pronouncements governing the conduct of trust activities, particularly OCC Regulation 9 for national banks.

### **Internal Accounting Control**

In evaluating the trust department's overall internal accounting control system, the CPA should consider the following controls:

- The prompt and complete fulfillment of all duties required by the governing trust instruments or agency contracts (legal compliance)
- The physical and administrative security (physical control) of assets for which the trust department has responsibility
- The complete, accurate, and timely recording of all individual account and departmental transactions (activity control)

When reviewing legal compliance, the CPA should determine whether

- Assets acquired in the name of a specific trust are in conformity with the governing trust instrument(s) and applicable laws and regulations.
- Procedures for review of trust activity and for supervision and approval of transactions are adequate and are actually being followed.
- Proper approval is obtained from confiduciaries for investment changes, disbursements, and so forth.
- Trust funds awaiting investment or distribution have been held uninvested or undistributed longer than was reasonably necessary.



- Fees are being properly computed.
- Income is being collected and distributed in a timely fashion.
- Disbursements or other asset distributions are properly supported.

Controls over physical custody of assets and other trust department internal accounting controls are interrelated. Some of the control features that should be considered are as follows:

- Approval of the individual purchase and sale of all trust investments by the trust or investment committee or their designees
- Periodic reconciliations of the trust funds on deposit with the bank, performed by an employee having no check signing authority or access to unissued checks and related records
- Measures taken to safeguard trust assets by dual control
- Relationship of vault deposits and withdrawals to accounting records to promptly reflect the purchase and sale of trust assets
- Procedures to ensure proper classification of trust assets, both by trust title and by nature of asset; daily posting of journals containing detailed descriptions of principal and income transactions; and establishment of control accounts for various asset classifications, including principal and income cash
- Reconciliation of agency bank accounts (for example, dividends, coupons, and bond redemptions) by an employee having no access to unissued checks or participation in the disbursement function
- Measures taken to safeguard unissued supplies of stocks and bonds by dual control
- Periodic physical inspection by an independent person or confirmation of trust assets
- Frequent reporting and written approval of uninvested cash balances

In addition to evaluating internal accounting control, the CPA should consider the following factors in establishing the scope of audit work to be performed:

- The organization of the trust department and the degree of separation from the commercial banking departments (for example, the role of legal counsel in trust account administration and the vulnerability to disclosure of insider information)

- The nature of comments on trust operations indicated in the reports of supervisory agencies
- The extent and nature of insurance coverage
- The type and frequency of lawsuits, if any, brought against the bank and arising from trust operations

### **Audit Procedures**

Examination of a trust department's activity includes tests of systems and procedures that are common to the management of all or most individual trusts or agency accounts, asset counts and tests of the activity in selected representative individual trust accounts in each area of trust department service (for example, personal, corporate, and agency), and tests of income and expenses attributable to trust department operations. As a result of those tests, the CPA should be able to evaluate the propriety of the department's conduct of its activities, the accuracy of the accounting records, and the extent of exposure, if any, to material liability.

In addition, daily settlements and supporting details, holdover transactions, rejected transactions, and transactions held in suspense should be reviewed for a selected period.

*Testing of Trust Activities' Common Procedures.* The procedures followed for the numerous types of trusts and agency activities involve many common or similar functions. Tests of the department's conduct of those activities may be done on the department as a whole rather than on individual trusts. Functions that may be tested by the department include the following:

- Opening of new accounts
- Receipt and processing of the initial assets that constitute an account
- Processing of purchases, sales, and exchanges of principal assets
- Receipt and payment of cash or other assets
- Execution of specified trust or agency activities
- Determination of fees and charging of fees to accounts
- Processing of trust assets in and out of the trust vault
- Closing of accounts

The CPA should review overdrafts in trust accounts to obtain reasonable assurance that they are covered by trust department

borrowings from the commercial department to avoid violation of applicable laws or regulations.

*Testing of Account Activity.* The CPA should perform sufficiently detailed tests to obtain reasonable assurance that transactions and activities within the various types of trust accounts are being conducted properly. The tests should cover asset validation and account administration. For asset validation a sample of accounts should be selected, trial balances of assets should be obtained, and the physical existence of assets for which the trust is responsible should be determined on a test basis. For account administration a sample of trust accounts should be selected for testing of individual transactions. If appropriate, certain of those transactions may be incorporated in testing of common procedures in the trust department. The CPA may coordinate the selection of accounts for testing asset validation and account administration. The CPA should consider performing the following procedures for the selected accounts:

- Read the governing instrument and note the significant provisions.
- Review activity during the year for compliance with the governing trust instrument and applicable laws and regulations.
- Review the assets held for compliance with the provisions of the governing trust instrument.
- Examine brokers' advices or other documentary evidence supporting the purchase and sale of investments.
- Obtain reasonable assurance that income from trust assets has been received and credited to the account.
- Obtain reasonable assurance that required payments have been made.
- Test computation and collection of fees.
- Determine whether the account has been reviewed by the investment committee as required by the supervisory authorities or by local regulations.
- Test the amounts of uninvested cash to determine whether amounts maintained and time held are not unreasonable.
- Determine whether required tax returns have been filed.
- Review the adequacy of trust reporting to cotrustees and beneficiaries.

- Confirm individual trust account assets, liabilities, and activity with cotrustees and beneficiaries.

*Testing of Trust Department Revenues, Expenses, and Bank Liability.* Although a substantial amount of activity may be conducted and reported on within the trust department, items typically reflected in the bank's financial statements are income from trust or agency services and trust operation expenses. Those areas may be tested independently or may be integrated, as appropriate, with other tests of trust operations.

Violations or improprieties in department activity detected by the CPA should be discussed with management and, if necessary, legal counsel. SAS No. 17, *Illegal Acts by Clients*, provides guidance in such instances. Consideration should be given to recording a direct liability or disclosing the occurrence of possible contingent liabilities in the bank's financial statements, if necessary.

### **Audits of Collective Investment Trusts**

The operations of collective investment trusts are normally integrated with those of other trusts administered by a trust department, and they are examined only to the extent necessary for the audit of the trust department. However, certain states require that collective investment trusts be audited annually by an independent public accountant, and in other states many banks voluntarily engage CPAs to perform annual audits. The CPA should consider the following factors in connection with audits of collective investment trusts:

- The assets of a collective investment trust usually consist of readily marketable securities and cash. Income is usually distributed at frequent and specified dates; consequently, a relatively small amount of undistributed income will be reflected in the statement of assets and liabilities.
- The trust usually qualifies for exemption from federal income tax under the Internal Revenue Code.
- Securities transactions should be accounted for on their trade date, and securities should be reported at market value. Dividend income should be recorded on the ex-dividend date. Interest income and expenses should be accrued. Expenses of the fund usually consist of audit expenses and nominal miscellaneous expenses, such as postage. Under federal statute, the bank may

charge either the collective investment trust or the participating trust but not both. The bank usually receives no direct fee for administration of collective investment trusts.

- Because additions to and withdrawals from the trust occur periodically, it is important that the related interim financial data on which they are based have been prepared accurately. The CPA should be satisfied with the valuation of investments, the accuracy of income and expense accruals, and the calculation of unit valuations at each interim date at which there are admissions or withdrawals. Interim calculations may be reviewed currently or retroactively, depending on the terms of the engagement.
- The trust agreement or state law may require that stock distributions of a certain percentage of outstanding shares of the same class of stock are to be included in income of the collective investment trust, which is not in conformity with generally accepted accounting principles. The CPA should consider the need for disclosure of that unacceptable policy in the notes to the financial statements and the need for qualification of the auditor's opinion on the financial statements.
- If investments are held for which there is no ready market, the trust or investment committee or their designee should determine that all factors relevant to the value of such assets have been considered and that appropriate methods have been used in arriving at their fair values. SEC Accounting Series Release No. 118 and the AICPA Industry Audit Guide, *Audits of Investment Companies*, provide guidance for such valuations and the effect of such valuations on the CPA's report.

If market values are not available and securities are valued by management, that fact should be disclosed. This may be particularly applicable to real-estate-related investments. If the trust agreement allows a method that is inconsistent with generally accepted accounting principles, for example historical cost, the auditor may have to take exception in the report.

An illustrative report and illustrative financial statements of a common trust fund, a type of collective investment trust, are provided in Appendix B.

## Chapter 19

# Other Banking Activities

In addition to activities discussed in other chapters of this guide, banks engage in several other activities, including

- Collecting sight drafts, notes, and similar items.
- Providing safekeeping, custodial, and safe deposit services.
- Mortgage servicing.
- Sales of U.S. savings bonds and travelers' checks.

Banks are responsible for maintaining records related to each of those activities; however, since the bank acts as agent or fiduciary, the activities are not included in the bank's financial statements, except for revenues earned and costs incurred through such activities. Memorandum accounts are generally used to maintain accountability for the activities. Memorandum accounts frequently consist of a control and contra-account to designate custody and responsibility, respectively. Although the memorandum accounts may be recorded in the bank's general ledger, they are eliminated when financial statements are prepared. Memorandum accounts may also be maintained in subsidiary ledgers, which identify either assets for which the bank is responsible or commitments issued or contingent liabilities assumed.

While each of those activities usually results in the payment of fees to the bank, which should be measured and recorded, the CPA's primary concern is the possibility of contingent liabilities as a result of the failure of the bank to fulfill its responsibilities as a fiduciary or agent.

### Collections

Commercial banks process two types of items for payment—cash items and collections (noncash items). Cash items are payable on

demand, have no papers or documents attached, and have simple, uniform instructions. Generally, the bank is willing to give immediate, though provisional, credit when the items are deposited. Collection items, on the other hand, may be payable at some future date, may have documents or papers attached, and may contain special instructions regarding presentation and nonpayment. In accepting items for collection, the bank acts as agent for its customers. Banks generally grant credit for those items when payment or notice of payment has been received. Collection items require special handling and, therefore, should not be mass or batch processed.

The collection department at a bank assists customers having no readily available means to collect and transfer funds. Commercial bank customers are offered that service for a fee, through the Federal Reserve Noncash Collection Service and through correspondent banks.

The principal types of collection items are

- Drafts, with or without attached documents, such as bills of lading, warehouse receipts, securities, mortgages, deeds, and savings passbooks.
- Notes.
- Acceptances.
- Bonds and coupons that are to be presented for payment.
- Installment or permanent collections whereby the bank, on behalf of the holder, collects and remits the proceeds from installment notes, land contracts, mortgage notes, or equipment contracts.

Collections are frequently classified by geographical location. City collections are payable locally and can be reached with local messenger service. Country collections require collection outside the local area; they must be serviced by mail or by the Federal Reserve Noncash Collection Service.

Collections within the bank are also classified as incoming or outgoing collections. Incoming collections are items initiated by other banks and received by the bank for collection locally. Outgoing collections are items received by the bank from its customers that must be sent to other banks for collection.

## **Safekeeping, Custodial, and Safe Deposit Services**

While safekeeping functions are often handled by the trust department, a separate safekeeping department may be operated

within the commercial department of the bank. It receives valuables from customers for safekeeping, issues receipts, and holds and delivers only on the order of the customer. Items held for safekeeping may include jewelry, paintings, silverware, deeds, and other valuables.

Through the use of the bank's safekeeping services, a customer may receive assurance that assets are physically protected and may request delivery on written notice, thereby eliminating the need to visit the bank personally to make the transfer.

Banks may also hold valuables in safekeeping under escrow arrangements. Stocks, bonds, coins, currency, deeds, mediums of exchange, or other items are deposited for safekeeping with the bank to be delivered to a third party on the fulfillment of some condition or performance under a contract or agreement.

The department may also perform custodial services that are similar to safekeeping services, except that, in addition to providing vault services, the bank also collects and remits to the customer interest and dividends earned on the assets held.

Banks customarily provide safe deposit boxes in their public facilities for the use of their customers. Safe deposit boxes are available in varying sizes and are rented generally on an annual basis. This activity differs from safekeeping services in that the bank has no knowledge of the nature of the items that customers place in the safe deposit boxes. The bank assumes responsibility only for preserving the privacy of entrance into the box, which is usually limited to the customer who rents the facility. Various methods are employed by banks to ensure that security is maintained, including the use of code names and restrictive key procedures.

## **Mortgage Servicing and Sales of Loans or Participations**

Many commercial banks service mortgage loans. Servicing arrangements generally provide for the servicing bank to maintain all records related to the servicing agreement, to assume responsibility for billing mortgagors and collecting periodic mortgage payments, and to perform all other activities necessary to the mortgage servicing function.

Serviced loans may be originated by the servicing bank itself or by other banks or financial institutions. Loans originated by the servicing bank may be sold, in whole or in part, to investing banks or financial institutions, with the servicing activities retained by



the seller bank. In any of the foregoing arrangements, the servicing agent receives as compensation a servicing fee, normally expressed as a percentage of the principal balance of the outstanding loans.

A bank may occasionally sell loans at servicing fee rates significantly different from current rates. FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities*, sets forth the recommended accounting treatment for loans sold at a servicing fee rate significantly different from current rates. The statement concludes that an adjustment to the sales price is required whenever the effect on operating results is significant. Such adjustments would result in deferred amounts, to be amortized to servicing fee income over future years. In addition, if current servicing fees are expected to be less than estimated servicing costs over the estimated life of the mortgage loans, the expected loss on servicing the loans shall be accrued at that date.

Gains or losses are usually recognized at the time the loans are sold. However, if at the end of a reporting period it is apparent that a bank intends to sell certain loans and the anticipated sale will result in a loss, the bank generally establishes an allowance for losses, which is deducted from the related asset in the balance sheet.

In accounting for sales of loans or participations, the objectives are to recognize in the year of sale the economic gain or loss from the transaction and to avoid including in the year of sale income or expense attributable to future periods. Consequently, when loans are sold outright and are not to be serviced by the selling bank, the gain or loss is measured by the difference between the selling price and the carrying amount of the loans sold (less applicable deferred loan fees, if any). If loans sold are to be serviced by the selling bank, adjustment of the selling price to provide a current servicing fee may be required, as discussed earlier in this section.

Because of the variety of arrangements under which loan participations are sold, it is important to consider the terms of sale, effective yield to the purchaser, and arrangements for servicing in addition to the stated selling price. A premium or a discount may result when a participation is sold at a price equal to the carrying amount of the loans included in the participation sale and the seller agrees to pay the purchaser a rate of interest greater or less than the loans' stated rate of interest. In such cases the premium or discount should be represented by the discounted amount of the difference between the future interest to be collected by the seller and the interest to be paid to the purchaser after considering future servicing revenues and costs.

The principles and guidelines set forth in APB Opinion No. 21 apply to premiums and discounts. The opinion sets forth the method of amortization and financial statement presentation and disclosure.

## **Sales of U.S. Savings Bonds and Travelers' Checks**

U.S. savings bonds and travelers' checks are consigned to a bank by the issuers, with arrangements for periodic settlement for bonds and checks issued. The bank is responsible for unissued items and, accordingly, must maintain adequate records to account for inventories of unused items, as well as the proceeds and revenues from sales.

## **Operating Procedures**

### **Collections**

Standardized transmittal forms known as collection letters are used in collection. Collection letters should be prenumbered, multicopy forms that provide the information or instructions required for collection of an item. Because of the different types of collection items, separate forms are normally used for incoming and outgoing collections.

Complete instructions must be obtained for all collection items. Each item should contain such information as the amount, the due date, the name of the payor, and the place of payment. The customer should provide instructions for the delivery of documents, the collection of interest, the method of payment (whether the customer's account is to be credited or a cashier's check or draft is to be issued), and information about whether the item is subject to protest.

Although certain general rules and regulations apply to all collection items, processing varies. Accordingly, definitive instructions should be furnished with each item presented for collection. In providing this service, the bank is acting as agent for the customer and must comply with instructions accompanying the collection. If, for some reason, instructions are ignored and a loss occurs, the bank could become liable for the loss.

A receipt or acknowledgement is given for each item received for collection. The receipt forms should be prenumbered and accounted for. The receipt may be in the form of a copy of the collection letter.

If a collection item is received from an out-of-town bank, an acknowledgement form (generally produced as a copy of the bank's multicopy incoming collection register form) is normally mailed as a receipt. Some banks enclose an acknowledgement request form with the collection item, particularly for an item that is not collectible immediately. The form is stamped and initialed by a member of the receiving bank's collection department and is mailed to the sending bank. It serves as a receipt and as evidence that the item is in process of collection.

The collection letter, the item, and the attached documents, if any, are mailed to a correspondent bank in the vicinity of the drawee to collect the item. Should collection of an item take longer than normal, a tracer is generally mailed to the collecting bank to determine the cause of the delay. The tracer is returned by the correspondent bank with an appropriate explanation.

In due course, the item is paid or returned. Payment may be made either in the form of a bank draft issued by the collecting bank, an advice of credit to the sending bank's account at the collecting bank, or an authorization to debit the collecting bank's account at the sending bank.

A service charge plus out-of-pocket expenses are usually charged to compensate the collecting and sending banks. The sending bank then turns over the net proceeds to its customer.

Although the bank issues a receipt to the customer for items held for collection, the items are not processed through any other department of the bank. They are sent directly to a correspondent bank or to other collection points. Collection items normally are not credited to the customer's account until they are paid. They do not appear as either liabilities to customers or bank assets during the collection period; they are recorded only in the collection records or in supplementary records maintained for control.

### **Safekeeping, Custodial, and Safe Deposit Services**

Items that are accepted from customers for safekeeping should be received and stored under dual control. They should be described on prenumbered safekeeping receipts. Normally, the receipt is a multicopy form, a copy of which goes to the customer. The receipt should be nonnegotiable. Delivery of assets from safekeeping to the customer should be made only on surrender of the receipt or on the customer's written order.

Customers using the bank's safekeeping facilities should be required to sign formal agreements or contracts fully outlining the

responsibilities of the parties. Any functions to be performed by the bank, such as collection of principal and interest on securities held and disposition of the proceeds, should be set forth in the contract.

The bank should maintain adequate records of assets held and collections of principal and income on behalf of customers. The bank should also maintain adequate records to ensure the collection of fees for safekeeping services.

Revenue derived from safe deposit box rentals is usually recorded when cash is received. The practice is viewed as acceptable because of the immateriality of the amounts involved.

### **Mortgage Servicing**

With few exceptions, the accounting functions, records, and controls maintained in the mortgage servicing area do not vary significantly from those in a typical mortgage loan department. Investors frequently require segregation of cash collected on their behalf, but that represents merely a refinement in accounting. Chapter 7 discusses accounting procedures in mortgage loan departments.

### **Sales of U.S. Savings Bonds and Travelers' Checks**

Banks normally maintain a record of the denominations and serial numbers of U.S. savings bonds and travelers' checks held on consignment from issuers. While certain bank employees may individually maintain custody over a small number of unissued items for convenient sale to customers, the reserve supply should be held under dual control in the vault. Memorandum accounts are usually maintained for those items.

## **Auditing**

### **Audit Objectives**

The significant objectives of an audit of the majority of activities described in this chapter are similar to those for an examination of a trust department to obtain reasonable assurance that (1) each function is conducting its activities properly, (2) all material contingent or unrecorded direct liabilities have been accounted for and reported in accordance with FASB Statement No. 5, and (3) income and expenses of each activity are properly reported in conformity with generally accepted accounting principles.

## **Collections**

Typical internal accounting controls over collections are as follows:

- Collection registers should be maintained, detailing the origin and final disposition of each item received for collection.
- Prenumbered collection letters should be used, a copy of which may serve as an acknowledgement or receipt for the item received for collection.
- All incoming tracers and inquiries should be handled by an officer or employee who does not process collection items.
- Journals should be maintained to record all collection items paid and credited and all collection fees. The related collection numbers and amounts should be recorded, along with the date and the manner in which the customer received credit.
- Procedures should make sure that customers are promptly notified if collection items have not been paid.
- Holdovers, rejected transactions, and similar items should be reviewed and followed up when they occur.

Documentation relating to those transactions may not be available after the day the items are processed. Transactions from the current day's activity should therefore be tested.

## **Safekeeping, Custodial, and Safe Deposit Services**

The significant types of transactions within the safekeeping department include safekeeping agency accounts, custody accounts, and accounts with investment responsibility. The primary internal accounting controls over safekeeping and custodial activities include

- Signed contracts for safekeeping services.
- Prenumbered receipts containing detailed descriptions of the items received or released by the safekeeping department.
- Detailed inventory records of all items in safekeeping. Copies of prenumbered receipts in an "open account" file often serve this purpose.
- Dual control over assets and periodic inspection and comparison of the assets with the detailed records by employees independent of the safekeeping function.

- Segregation of safekeeping items from bank-owned assets.
- A record of all entries to custodial boxes or vaults.

The following audit tests are frequently performed:

- Selection of a representative number of each type of significant safekeeping transaction to verify compliance with safekeeping contracts
- Review and evaluation of safekeeping vault procedures
- Physical inspection of assets selected from inventory records and vice versa
- Direct confirmation of assets with customers

Audit testing of the safe deposit box function is generally limited to the performance of overall tests of revenue received. That form of testing is considered adequate because rental trends can be related to investment in safe deposit boxes. The CPA should consider reviewing security procedures to evaluate their effectiveness, since liability claims for breaches in security may be more than revenues derived from such rentals.

### **Mortgage Servicing**

Real estate loan audit considerations are discussed in chapter 7, and other trust-related audit considerations are discussed in chapter 18.

Banks are frequently required to submit to investors (owners of the serviced mortgages) reports from their CPAs on the banks' servicing activities. The reports vary in scope and complexity. *The Single Audit Program for Mortgage Bankers*, published by the Mortgage Bankers Association, provides further guidance in this area. SAS No. 44 provides guidance on the use of special-purpose reports on internal accounting control at organizations such as bank trust departments or data processing service centers.

### **U.S. Savings Bonds and Travelers' Checks**

The primary internal accounting controls over U.S. savings bonds and travelers' checks include

- Maintenance of adequate control over unissued certificates.
- Prompt remittance or credit of sale proceeds.

- Periodic count of unissued certificates by someone other than the custodian.
- Agreement of the count with the bank's control record or confirmation with the issuer.

## Chapter 20

# Consolidation

Before the mid 1960s, bank financial statements were not consolidated, and investments in subsidiaries were carried at cost or accounted for by the equity method. In December 1964 the FRB and the FDIC issued regulations adopting a majority of the provisions of the Securities Acts Amendments of 1964. The regulations extended to banks, for the first time, reporting requirements similar to those for certain other publicly held companies. The regulations require that

Except where good reason exists consolidated financial statements of the bank and its majority-owned, significant subsidiaries should be filed. Every majority-owned bank-premises subsidiary and every majority-owned subsidiary operating . . . as an “Agreement Corporation” . . . or an . . . “Edge Act Corporation” shall be consolidated with that of the reporting bank irrespective of whether such subsidiary is considered a significant subsidiary.

In 1967 the OCC issued regulations on consolidated financial statements that are generally the same as those of the FRB and the FDIC. As a result, most banks and bank holding companies currently present consolidated financial statements.

Accounting Research Bulletin No. 51, *Consolidated Financial Statements*, describes the purpose of and procedures generally used in preparing such statements. ARB No. 51 applies to the preparation of consolidated financial statements of banks and bank holding companies. FASB Statement No. 52, *Foreign Currency Translation*, provides guidance as to foreign subsidiaries. A few consolidation matters that require special consideration are further described in the remainder of this chapter.



## **Goodwill**

The treatment of goodwill in bank consolidations differs from that in most other companies, including bank holding companies. It has long been the policy of bank supervisory agencies, whose primary emphasis is to protect depositors, that goodwill should not be capitalized in the financial statements of banks or their majority owned subsidiaries (including Edge Act corporations or agreement corporations). That policy was extended to holding companies that were regulated by the supervisory agencies. Holding companies supervised by the SEC, however, have been required to capitalize purchased goodwill, if material, in accordance with APB Opinions No. 16, *Business Combinations*, and No. 17, *Intangible Assets*. Accordingly, on the acquisition of businesses accounted for by the purchase method, banks and their subsidiaries have been required to write off immediately to retained earnings goodwill arising from the acquisitions. That policy was modified somewhat in 1971 when, in response to publication of APB Opinion Nos. 16 and 17, the Board of Governors of the Federal Reserve System permitted bank holding companies to capitalize goodwill and subsequently amortize it against income.

The Board of Governors, however, did not extend that policy change to banks and bank subsidiaries, thereby permitting financial statements filed with regulatory authorities to reflect the immediate write-off of goodwill arising in business combinations of banks and bank subsidiaries. Since this practice conflicts with the provisions of APB Opinion No. 17, the CPA should consider the necessity of issuing a qualified opinion on financial statements reported to the public in accordance with the required regulatory practice. In consolidated bank holding company financial statements, however, goodwill written off by bank subsidiaries may be reinstated by an adjustment in consolidation.

## **Accounting Principles of Subsidiaries That Differ From Those of the Dominant Entity**

Banks and bank holding companies have acquired or established *de novo* subsidiaries engaged in bank-related activities as well as banking activities. In addition, many banks have spun off certain of their banking activities (for example, mortgage servicing and investment advisory activities) into subsidiaries. In addition to the

financial statements of subsidiary banks, the consolidated financial statements of a bank holding company should include other subsidiaries whose activities are mortgage, leasing, mortgage servicing, computer service, investment advisory, Edge Act investment, factoring, and venture capital companies.

Bank-related subsidiaries may apply generally accepted accounting principles that differ from those of the bank subsidiaries included in the consolidated group. For example, a bank may carry its investment securities at cost, an Edge Act investment company may carry its investment securities at either cost or its equity in the investee company's underlying net assets, and a venture capital subsidiary may carry its investment securities at fair value as determined by its board of directors. As in other businesses, a variety of accounting principles applied by the constituent companies generally are also applied in consolidation.

## **Transfers by Banks From Retained Earnings to Surplus**

On the subject of presentation in a bank holding company's consolidated financial statements of discretionary transfers by constituent banks from retained earnings to surplus, ARB No. 51 states

Occasionally, subsidiary companies capitalize earned surplus arising since acquisition, by means of a stock dividend or otherwise. This does not require a transfer to capital surplus on consolidation, inasmuch as the retained earnings in the consolidated financial statements should reflect the accumulated earnings of the consolidated group not distributed to the shareholders of, or capitalized by, the parent company.

There is an implied presumption that the parent company may pay dividends in the amount reported in consolidated retained earnings, unless otherwise stated. If a constituent bank has capitalized a portion of its accumulated earnings, permission of the supervisory agencies is required before dividends may be paid in an amount which includes the capitalized earnings (assuming state law permits). (Chapter 15 discusses disclosure of restrictions on the amount of dividends a bank subsidiary is allowed to pay.)

## **Theoretical Application of Excess Allowances Against Deficient Allowances in Regulated Bank Situations**

In an audit of a bank holding company's consolidated financial statements, the CPA's report generally relates to the consolidated allowance for loan losses rather than to the individual bank and bank-related subsidiaries' allowances. However, banks that are members of a consolidated group are viewed as separate entities for regulatory purposes. Accordingly, the CPA should consider a bank's ability to transfer an excess allowance for loan losses to another member of the consolidated group.

### **Allocation of Income and Expenses**

When CPAs report only on consolidated financial statements, questions related to the allocation of items such as administrative overhead, interest, and taxes are not of primary concern because the allocation methods and procedures do not affect the consolidated financial statements. However, in those instances where separate audited financial statements of consolidated subsidiaries or groups of subsidiaries are required, CPAs should apply audit procedures to the allocation of income and expenses among members of the consolidated group. In addition, the disclosure provisions of FASB Statement No. 14 require separation of income and expenses between domestic and foreign operations.

### **Trusted Affiliates**

Banks have used trusted affiliates to hold certain stock interests that supervisory agencies generally do not permit banks to hold directly. While banks may not own specific investments, incorporation of trusted affiliates to hold such investments is permitted. The benefit of such a mechanism is to provide a maximum return to stockholders afforded by the ownership of the investments.

These are the general characteristics of trusted affiliates:

- The stock of the trusted affiliate is held in a stock trust. The stock may not be withdrawn during the existence of the trust.
- The outstanding common shares of the corporation that forms the trusted affiliate are endorsed as evidence of ownership of the trusted affiliate (commonly referred to as endorsed shares).

- The holder of an endorsed share has a proportionate equity interest in the trustee affiliate, whose shares are held in trust. Each holder's interest in the trustee affiliate is in the same proportion as his ownership in the bank forming the trustee affiliate.
- Ownership of the two equity interests may not be traded separately, thus ensuring that the beneficial ownership of the two corporations will be identical during the continuance of the trust.
- The voting, dividend, and other stockholder rights attributable to the corporation's stock held in trust are passed through to the owners of the endorsed shares.

In some instances, there may be a minority interest in the trustee corporation; for example, when the trustee corporation is a foreign corporation, it may be beneficial to have some ownership interest in the hands of the citizens of that country. The existence of a minority interest does not in itself preclude the accounting treatment presented in the following paragraphs.

The guidelines for consolidation of subsidiaries set forth in ARB No. 51 apply equally to trustee affiliates. The limitations on consolidation described in paragraph 2 of ARB No. 51 and paragraph 8 of ARB No. 43, chapter 12, should be applied in determining whether to consolidate or use the equity method. If the trustee affiliate is material in relation to financial position or results of operations, and the financial statements are prepared for issuance to stockholders as the financial statements of the primary reporting entity, combined financial statements should usually be presented. If combined financial statements are inappropriate because the activities are not homogeneous, the trustee affiliate should be accounted for by the equity method, following APB Opinion No. 18. If trustee affiliates are material in relation to financial position or results of operations, summarized information about assets, liabilities, and results of operations should be presented in the notes, or separate statements should be presented for such affiliates, either individually or in groups.

The Board of Governors of the Federal Reserve System and the Comptroller of the Currency require a trustee affiliate to be consolidated if (1) the amount of the stockholders' equity in the trustee affiliate attributable to the stockholders of the bank exceeds 5 percent of the bank's equity capital accounts or (2) the

gross operating revenues of the affiliate exceed 5 percent of the parent's gross operating revenues.

If a separate report must be issued on financial statements of the parent or the trustee affiliate for legal or other requirements (for example, debt agreements), the relationship of the trustee affiliate to the parent should be disclosed. Because that relationship is different from the relationship between a parent and a subsidiary, a separate report on parent-company-only financial statements may contain a middle paragraph explaining the reasons for presentation of the separate statements and describing the relationship of the parent to the trustee affiliate. In a separate report on the financial statements of the trustee affiliate, the financial statement headings may refer to the parent—for example, XYZ Corporation (a trustee affiliate of ABC, Inc.—note 1). The reference may also be included in the CPA's report.

## Chapter 21

# Bank Holding Companies

### Characteristics of Bank Holding Companies

A bank holding company is a company that controls one or more banks. A bank holding company may also own subsidiaries with operations closely related to banking. All such companies operating in the United States, whether chartered by a foreign or a domestic governmental body, are subject to the regulations of the FRB, which permit bank holding companies to engage only in banking and other activities as authorized by the FRB.

Bank holding companies started in the United States around 1900 and developed rapidly in the 1920s. Before then, a practice called chain banking had developed, in which individuals or partnerships acquired ownership control of more than one bank. Chain banking was popular in rural areas of unit banking states, in which banking operations were restricted to one physical location. A few chain banking organizations still exist, with ownership control held by individuals.

Bank holding companies and chain banking organizations provided a vehicle for common ownership of several banks, and each permitted the development of banking systems when branch banking was severely limited by law. In the early stages of development, bank holding companies and chain banking organizations provided the only vehicles that could be used to develop banking systems across state lines. The development of bank holding companies in the 1920s reflected the financial prosperity of the country and a favorable business climate, which encouraged widespread expansion of general corporate activity through internal growth or acquisition. The depression of the 1930s and the subsequent world war generally dampened bank holding company

development. Activity was renewed after World War II, generally by existing holding companies that began to acquire new bank affiliates. The significance of the bank holding company in the banking community increased moderately until the mid 1960s, when growth surged.

The Bank Holding Company Act of 1956 (BHC Act) and abolition of a tax penalty for filing consolidated federal income tax returns contributed to the renewed expansion of bank holding companies.

While the individual banks owned by bank holding companies have always been regulated by federal and state authorities, the holding companies themselves were not subject to federal or state regulation as banking organizations before 1933. Regulation of bank holding companies was first attempted with the passage of the Federal Banking Act of 1933, which required bank holding companies that controlled member banks of the Federal Reserve System to register with the Federal Reserve Board and to obtain a permit to vote the bank's stock. The act also provided the Federal Reserve banks with authority to examine banks affiliated with Federal Reserve System members.

The BHC Act is the foundation of the present federal regulation of bank holding companies. It originally applied to companies controlling at least 25 percent of two or more banks, but it was amended in 1970, and it now applies to companies controlling at least 25 percent of the stock of a single bank or otherwise controlling a bank. The BHC Act provides standards for the formation of bank holding companies and confines their business to banking and its related activities. FRB approval is required for the establishment of each bank holding company. Also, the BHC Act prohibits the acquisition of more than 5 percent of the stock of a bank domiciled outside the state in which the bank holding company conducts its principal operations unless the law of the state in which the acquisition is to be made specifically allows bank acquisitions by an out-of-state company.

The existence of restrictive federal and state regulations on the type of financial activities that were considered to be banking related, and the desire of some bank managements and shareholders to diversify into other profitable activities, led to the creation of a substantial number of one-bank holding companies in the late 1960s. One-bank holding companies were not then subject to Federal Reserve System supervisory control; accordingly, they provided a vehicle for individual banks to expand into new service areas without regulatory agency supervision or control.

The rapid expansion of unregulated one-bank holding companies in the late 1960s led to amendment of the BHC Act. The 1970 amendments subjected ownership, except ownership by an individual, to the provisions of the BHC Act and to the rules and regulations of the FRB. Under the amendments, restrictions that had existed before 1970 on the types of permissible activities in which multibank holding companies could engage were extended to one-bank holding companies. The statutory tests for determining permissible bank-related activities were amended to give the FRB increased flexibility.

The amendments also re-established the FRB's role in designating the allowable activities in which all bank holding companies could engage. The amendments to the BHC Act require that permitted activities "be so closely related to banking or managing or controlling banks as to be a proper incident thereto" and that the activities "can reasonably be expected to produce benefits to the public . . . that outweigh possible adverse effects."

The FRB is continually interpreting and ruling on the nature of activities it finds to be in accordance with the definition of "closely related to banking." Among the acceptable activities are leasing of real and personal property, bookkeeping or data processing services, underwriting of credit life and credit accident and health insurance related to loans made by a holding company and its affiliates, and management consulting advice to unaffiliated banks. However, operation of an armored car service and underwriting of mortgage guaranty insurance are examples of business activities the FRB has held to be not in accordance with the provisions of the BHC Act. Regulation Y specifies the activities currently permitted.

Consolidated financial reporting practices of bank holding companies have been influenced by the financial reporting practices for banks. The Securities Act of 1933 generally exempts banks from its regulations. The Securities Exchange Act of 1934 did not apply to banks until 1964. Therefore, the SEC influenced the financial reports of bank holding companies only and not of banks in general. The 1964 amendments to the Securities Exchange Act of 1934 imposed shareholder reporting requirements on many banks; however, those amendments vest the administration of shareholder reporting requirements in the OCC, FRB, and FDIC rather than in the SEC. Those agencies are charged with substantially conforming their securities disclosure regulations with those of the SEC.

On approval by the FRB of its application, a bank holding



company may acquire an existing bank-related business or may initiate permissible bank-related activities without geographic limitation.

## **Financial Statement Presentation and Auditing**

Paragraph 6 of SAS No. 2, *Reports on Audited Financial Statements*, notes that the basic financial statements reported on by CPAs include balance sheet(s) and statements of income, changes in stockholders' equity, and changes in financial position. In annual reports to stockholders, bank holding companies generally prepare those basic financial statements on a consolidated basis in accordance with ARB No. 51 and include the consolidated results of operations and changes in financial position of the holding company and its subsidiaries.

Bank holding companies subject to the periodic reporting provisions of the Securities Exchange Act of 1934 are required to file annual report Form 10-K with the SEC. Regulation S-X governs the form and content of financial statements filed with the SEC.

In addition to the basic financial statements and the statistical data required by *Securities Act Industry Guide 3* and *Exchange Act Industry Guide 3*, registrants are required by Regulation S-X to submit supplementary schedules as specified in Article 5 for parent-only statements (except as modified by Article 9) and by Article 9 for bank and consolidated bank holding company statements. The auditor's report on financial statements contained in Form 10-K must cover the basic financial statements and supplementary schedules. Also, the CPA should read sections of the 10-K and annual report to stockholders not covered by the report to determine whether there are material inconsistencies with the audited financial statements. (SAS No. 8, *Other Information in Documents Containing Audited Financial Statements*, discusses this responsibility.)

Bank holding companies file annual financial reports with the FRB on Form FRY-6, which may require audited financial statements. As noted in the instructions to the bank holding company financial supplement to Form FRY-6, "the balance sheet and income statement contained therein are designed to parallel closely the Consolidated Report of Condition and the Consolidated Report of Income submitted by commercial banks to the Comp-

troller of the Currency, the Federal Deposit Insurance Corporation, and the Federal Reserve System.”

Basic financial statements required to be included in the Form FRY-6 annual report are those of the bank holding company (parent only), the bank holding company (consolidated), and each direct and indirect bank-related subsidiary, regardless of whether it is consolidated. The financial statements required are balance sheets, statements of changes in capital accounts, and statements of income for the current and prior years.

Beginning in 1974, with certain limited exceptions, information supplemental to Form FRY-6 must be filed by any bank holding company that has fully consolidated assets in excess of \$500 million and banking assets in excess of \$100 million. The supplemental information includes consolidating balance sheets and statements of income and changes in financial position for the bank holding company and bank and bank-related subsidiaries and consolidated ex-bank statements (as defined in Form FRY-6) and supplemental schedules for the bank holding company combined with all bank-related subsidiaries. The information is designed to permit analysis of liquidity and quality of assets and scrutiny of bank-related subsidiary activities.

CPAs should obtain reasonable assurance that the financial statements, supplemental schedules, analyses, and disclosures filed with supervisory agencies are in accordance with the regulations.

In addition to an examination of financial statements and schedules and disclosures contained in annual reports to stockholders and annual reports filed with regulatory agencies, CPAs may be required to report on financial statements and schedules in filings with the SEC. Such filings may include

- Registration statements in connection with equity or debt security offerings.
- Registration statements in connection with intentions to issue securities in a business acquisition or stock option plan.
- Proxy statements in connection with annual shareholders’ meetings.

## Chapter 22

# International Department and Foreign Currency Transactions

The operation of a bank's international department is centered around international trade and related lending. Many customers have only limited knowledge of the customs, economic conditions, and financial procedures involved in conducting international trade; accordingly, they may call on the international department of their commercial bank for assistance.

The conduct of international trade is complex. Emphasis is placed on the movement of goods and on the various documents required to cover their shipment, delivery, and payment. Similarly, the financing of international trade is complex because most buyers cannot obtain direct credit from the manufacturer and because geographical and political limitations affect the transactions.

The operations of an international department may include the following activities:

- Issuing commercial letters of credit to finance the importation of foreign goods and commodities
- Issuing standby letters of credit
- Issuing travelers' letters of credit to provide funds for travelers in foreign countries
- Buying or selling foreign exchange to meet the needs of exporters or importers who receive or make payment in foreign currencies
- Lending money to importers to enable them to buy goods for inventory

- Collecting foreign drafts drawn by or on customers
- Lending funds on drafts presented for collection drawn against letters of credit
- Trading in foreign exchange for profit
- Processing cable and mail transfers of funds
- Rendering reports on the credit standing and activities of foreign businesses
- Providing customers with letters of introduction to bankers and third parties abroad
- Making loans and accepting deposits from foreign corporations and multinational companies in either U.S. dollars or foreign currencies
- Supervising the operation of foreign branches

In performing those services, the international department operates as a bank within a bank—an individual unit forming an integral part of the bank as a whole. Except as specifically discussed in this chapter, the accounting principles, financial statement presentation, and auditing procedures discussed in previous chapters of this guide apply equally to the corresponding operations of an international department.

## **Commercial Letters of Credit**

The principal activity of the typical international department is issuing and administering letters of credit, which are instruments by which a bank substitutes its credit for that of individuals, firms, or corporations so that domestic and foreign trade may be conducted more safely, economically, and expeditiously. In technical terms, a letter of credit is an instrument drawn by a bank, known as the credit issuing bank (and eventually the drawee bank), on behalf of one of its customers (or on behalf of a customer of one of its domestic correspondents), known as the principal or the account party, who guarantees payment to the credit issuing bank. The letter of credit authorizes another bank at home or abroad, known as the credit notifying or negotiating bank (and usually the payer bank), to make payments or accept drafts drawn by a fourth party, known as the beneficiary, when the beneficiary has completed the stipulations contained in the letter.

There are two major types of letters of credit: the commercial

and the standby letter of credit. The commercial letter of credit is normally used to finance a commercial contract for the shipment of goods from seller to buyer. This type of letter of credit provides for prompt payment to the seller in accordance with its terms. The standby letter of credit, defined in Federal Reserve Board Regulation H, is often used to cover bid and performance obligations to various overseas buyers.

In a standby letter of credit transaction, there is generally no security in the event of default by the issuing bank's customer. While the issuing bank's liability is contingent, it could turn into a direct liability if the customer defaults. Accordingly, the element of risk to the issuing bank is usually greater than in other letter-of-credit transactions, which generally enable the issuing bank to take title to the goods in the event of default by its customer.

The typical format of a commercial letter of credit consists of a heading, an address of the beneficiary, a promise to honor drafts, and information about the tenor of drafts, the amount, the required documents, the nature of shipment, the expiration date, privileges of cancellation, if any, and other supplementary details.

In addition, commercial letters of credit may be classified into one or more of the following categories:

- *Direction of shipment (export or import)*. An export letter of credit is arranged to finance the export of merchandise; an import letter of credit finances the import of merchandise.
- *Security (documentary or clean)*. A documentary letter of credit is supported by a bill of lading and related papers; a clean letter of credit generally is not.
- *Tenor of drafts (sight or time)*. A sight letter of credit is one in which the draft drawn against it is payable on presentation; a time or acceptance credit is one in which the draft is payable a stipulated number of days after the date of acceptance.
- *Form of letter (straight or revolving)*. A straight letter of credit is one issued to finance the shipment of specified merchandise, and thereafter it becomes void. A revolving letter of credit is automatically renewed for the original stipulated amount each time a draft is drawn against it and is not exhausted until the expiration date.
- *Form of currency (dollars or foreign currency)*. A dollar letter of credit is one in which the amount is specified in U.S. dollars; drafts drawn against it must be drawn in U.S. dollars. A foreign

currency letter of credit is one in which the draft drawn against it is in foreign currency.

- *Privilege of cancellation.* A revocable letter of credit is one in which the credit issuing bank reserves the right to rescind its obligations to honor drafts drawn by the beneficiary by the phrase “good till cancelled” or a similar expression. An irrevocable letter of credit is one in which the credit issuing bank waives the right to revoke the credit before the expiration date unless the beneficiary consents. The irrevocable letter of credit may be strengthened by having the notifying bank in the exporter’s country add its own unqualified assurance that the credit issuing bank’s obligation will be performed and that, if the latter refuses to honor the draft drawn against the credit, the notifying bank will pay or accept in any event. Such a letter of credit is known as “irrevocably confirmed” (export). If the notifying bank merely transmits the issuing bank’s obligation to the beneficiary without confirming the latter’s undertaking, thereby not making the issuing bank’s commitment its own, the letter of credit is called “irrevocably unconfirmed.”
- *Payment of principal (paid or guaranteed).* A paid letter of credit is one in which funds are deposited by the principal (buyer) with the credit issuing bank at the time of issue. This form is rarely used. The usual type is the guaranteed letter of credit, in which the principal guarantees payment of the amount of the draft to the credit issuing bank at its maturity.

## Foreign Exchange

Banks enter into commitments to buy or sell foreign currency or instruments payable in foreign currency. A bank deals in foreign exchange to enable its customers who are involved in international trade to make payments abroad or to obtain payment from abroad, either currently or in the future. In addition, some banks trade in foreign exchange for their own accounts.

To deal in foreign exchange, banks must maintain balances with banks abroad. The accounts, which are in foreign currencies, are commonly called *nostro* accounts (our accounts with them). The general ledger control account is due from foreign banks. Those accounts should be distinguished from *vostro* accounts (their accounts with us), which represent U.S. dollar balances maintained by foreign banks with a U.S. bank and which appear under

the general ledger caption “due to foreign banks.” A bank may have other accounts that are receivable or payable in foreign currencies.

Buying and selling of foreign currencies are usually centralized in the trading section of the international department. The trader controls the position of the bank in each foreign currency and establishes the rates at which the bank is prepared to buy or sell foreign exchange within certain guidelines prescribed by the bank.

Contracts for the purchase or sale of foreign exchange currencies are classified as “spot” or “forward.” Spot contracts call for delivery and settlement within a few days, usually up to ten days. Forward contracts usually call for delivery within periods up to six months; however, longer periods are possible. The rate of forwards is fixed at the time the contract is entered into, although settlement is not made until delivery.

## **Accounting**

### **Commercial Letters of Credit**

In discussing accounting for typical commercial letters of credit, it is important to outline the sequence of events generated by their issuance. In a case of importation, after the credit issuing bank approves the extension of credit to the importer, a sight letter of credit is prepared, signed, and mailed to the exporter, with a copy to the importer. Simultaneously, the credit issuing bank makes an entry in the memorandum accounts, increasing bank’s and customer’s liability under letters of credit. If the exporter approves the letter of credit, the goods are loaded for shipment, and the necessary documents are obtained. The exporter draws a draft on the credit issuing bank in favor of his own bank, to which he presents the draft letter of credit and shipping documents. The payer bank credits the exporter’s account and forwards the draft with pertinent documents to the credit issuing bank. If the credit issuing bank accepts the draft after reviewing the documents and ascertaining that the parties have complied with all terms, the account of the payer bank is credited, and the importer’s account is debited.

The debit advice and documents are forwarded to the importer, who receives the shipped goods on presentation of the bill of lading. The credit issuing bank records the paid draft as a reduction in the memorandum accounts of bank’s and customer’s liability under letters of credit.

If a time letter of credit is used, the transaction is the same as for a sight letter of credit through the presentation of the draft by the exporter to the payer bank. Rather than waiting the stipulated number of days, the exporter requests immediate discount of the draft by the payer bank. The payer bank credits the exporter's account and forwards the draft with pertinent documents to the credit issuing bank. If the documents are correct, the credit issuing bank stamps the draft "accepted" and returns the accepted draft to the payer bank. By accepting the draft, the credit issuing bank has agreed to pay the draft on presentation at maturity. The accepting bank reduces the memorandum account of bank's liability under letters of credit and increases the general ledger accounts of customer's and bank's acceptance liability. An acceptance tickler is prepared. The importer signs a trust receipt for the goods received and is given the documents and a copy of the acceptance tickler. When the draft matures, the credit issuing bank decreases customer's acceptance liability by debiting the importer's account and decreases bank's acceptance liability by crediting the account of the payer bank.

### **Foreign Exchange**

A typical system for foreign exchange has the following characteristics:

- The inventory of foreign exchange, in the form of demand deposits held abroad, is accurately accounted for.
- Auxiliary records are maintained in foreign currency and the U.S. dollar equivalent.
- Transactions expressed in foreign currency are translated to U.S. dollars when they are posted to general ledger accounts.
- Forward contracts are recorded in contra (memorandum) accounts.
- Foreign currency accounts, including spot and forward contracts, are revalued periodically (usually monthly).

In a typical system, when a foreign exchange trade is accepted, the trader prepares a trading ticket and posts the purchase or sale to a position sheet. The position sheet, which usually is prepared daily, shows the trader the bank's balances in each foreign currency, including amounts for which it is committed on both spot and forward contracts. The position sheet shows the dates, usually biweekly, on which forward contracts in each currency become



due. The position sheet is a perpetual inventory record maintained by individual currencies.

The foreign exchange contract is posted to one of several contra accounts. For a purchase, a debit is posted to foreign exchange purchases (in foreign currency and U.S. dollars), and a credit is posted to contracts to buy exchange (U.S. dollars only). For a sale, a debit is posted to contracts to sell exchange (U.S. dollars only), and a credit is posted to foreign exchange sold (in foreign currency and U.S. dollars). When the contract is subsequently settled, new entries are made. For a purchase, the bank credits foreign exchange purchased (in foreign currency and U.S. dollars), official checks, or another appropriate account, and the bank debits "due from foreign banks" (nostro) or contracts to buy exchange (U.S. dollars only). For a sale, the bank debits foreign exchange sold, cash, or another appropriate account, and it credits contracts to sell exchange (U.S. dollars only) or "due from foreign banks" (nostro, in foreign currency and U.S. dollars).

Some banks set up only forward contracts in contra accounts; they control spot contracts through a centralized file of open spot contracts. The spot contracts are first reflected on the books when they are settled, with entries made directly to the appropriate "due from foreign banks" account.

In addition to nostro and vostro accounts, certain other foreign currency accounts may appear on the bank's books, including cash on hand, investments, loans, time bills, customers' deposits, cash collateral, and checks outstanding. When these accounts and memorandum accounts for foreign exchange contracts bought and sold are translated into U.S. dollars, gains or losses may result.

FASB Statement No. 52 establishes financial accounting and reporting standards for the effects of translation adjustments and transaction gains and losses. Banks with international activities are required to apply the provisions of this statement.

## **Financial Statement Presentation**

### **Commercial Letters of Credit**

Unused commercial letters of credit are bank commitments. They are carried as memorandum accounts and are not shown as liabilities in the balance sheet.

Two accounts regularly appear in the balance sheet of banks with international departments: customer's acceptance liability and

bank's acceptance liability. Those two contra accounts are used to record in the general ledger the bank's acceptance of drafts drawn on letters of credit. When the drafts are paid, the accounts are reduced. If a customer anticipates a time acceptance by prepaying, the customer's liability account is reduced; the bank's liability account is reduced when it makes payment at maturity. If the beneficiary elects to discount a time acceptance, the bank, on paying, records it in loans as own acceptances discounted. For financial statement purposes, both customer's and bank's acceptance liability are reduced by the amount of own acceptances discounted.

Standby letters of credit may represent a greater risk to the issuing bank; therefore, they must be disclosed in the notes to the financial statements in conformity with the regulations of the supervisory authorities and with FASB Statement No. 5.

## **Foreign Exchange**

The principal amounts of spot and forward foreign exchange contracts should not be included in the bank's balance sheet. However, disclosure of the amounts of those commitments in the notes to the financial statement should be considered.

Since a bank determines profit or loss on foreign exchange by periodically recalculating its positions (including unmatured spot and forward foreign exchange contracts), it includes unrealized profit or loss in its book income. For income tax purposes, however, profit or loss may be recognized when the contract is completed or otherwise closed. That causes a book-tax timing difference, which should be accounted for in accordance with the principles discussed in chapter 17.

Profit or loss on foreign exchange is included in the statement of income. FASB Statement No. 52 discusses the financial statement disclosure of the aggregate exchange gain or loss included in net income for the period.

## **Auditing**

### **Audit Objectives**

The significant audit objectives for commercial letters of credit and foreign exchange activities are (1) to obtain reasonable assurance that material commitments and contingent liabilities related to international operations have been disclosed in the bank's

financial statements and (2) to obtain reasonable assurance that gains and losses from foreign exchange activities and operating expenses of the international department are properly presented in the bank's financial statements.

### **Commercial Letters of Credit**

The principal internal accounting controls for commercial letters of credit include the following:

- Written policies concerning credit review, qualified customers, and documentation
- Segregation of duties for posting of accounting records, cash disbursements, preparation of supporting documents initiating the transactions, and reconciliation of detailed records with control accounts
- Preparation of trial balances and at least monthly reconciliation of the balances with control accounts
- Independent checking of fee and commission computations
- Proper approval by an authorized bank officer of all amendments to letters of credit
- Recording and sequential numbering of all letters
- Comparison of invoices, shipping documents, delivery receipts, bills of lading, and other documents with the letter's specific requirements
- Prompt reporting of delinquencies to management

Audit procedures for commercial letters of credit may include obtaining reasonable assurance that

- Letters of credit and acceptances are properly approved, recorded, and supported by drafts or other necessary documents and are in compliance with supervisory agency requirements for the amount of drafts accepted by the bank.
- Subsidiary records are posted properly and agree with control accounts.
- Acceptances are collectible in full, or anticipated losses, including losses on confirmed letters of credit, are provided for by adequate allowances.
- Collateral as recorded in the collateral records is either on hand or in the possession of custodians for the bank's account.

- Collateral is negotiable and adequately supports the acceptances.
- Adequate safeguards exist for the physical protection of drafts, letters of credit folders, collateral, and records.

### **Foreign Exchange**

Several notable examples of the risks inherent in foreign exchange transactions have received national attention because of the significance of the losses incurred by certain financial institutions. As a result, accounting controls over foreign exchange transactions have received increasing attention in recent years. The nature of trading in an international department, in which traders deal extensively by telephone, can lead to the circumvention of prompt recording of exchange transactions. Therefore, foreign exchange has been a particularly sensitive audit area.

The following are important features of an internal accounting control system for foreign exchange transactions:

- Adequate control over trading tickets by prenumbering or other procedures
- Independent review of currency positions and exchange rates used in computing such positions
- Auxiliary records in support of control accounts and independent agreement with the general ledger
- Prompt confirmation of forward contracts by operations personnel independent of the traders
- Adequate subsidiary records in support of all foreign currency balances, including unmatured spot and forward foreign exchange contracts
- Establishment of trading limits, including overall trading volume, position limits by currency and in the aggregate, maturity gap limits by currency, and individual customer trading limits
- Adequate segregation of duties between trading, accounting, and operations personnel
- Timely management review of reports setting forth maturity gaps, trader's positions, trading volume by trader and by broker, and positions over the limit
- Avoidance of excessive pressure on traders resulting from budget goals or individual compensation plans, which might prompt the trader to take undue risks

The overall management policy for establishing an acceptable level of risk for speculative profit should be clearly enunciated and made known to all responsible personnel within trading operations. The effectiveness with which management monitors the policy is important in determining the extent of testing necessary in an audit of foreign exchange transactions.

The auditing procedures for foreign exchange transactions should include steps to obtain reasonable assurance that proper accounting principles are being applied. The periodic foreign currency revaluations should be tested for accuracy, and the rates used should be tested for propriety. Spot and forward foreign exchange contracts should be substantiated by confirmation and reviewed for approval. Furthermore, audit procedures should include cutoff and full inclusion tests of trading tickets, reconciliation of the traders' position reports to the general ledger, and tests of controls over management reporting of currency, traders, and positions over the limit. Finally, the auditor should be satisfied that there are no gaps in the timing of forward foreign exchange contracts for any one currency (foreign currency transactions with identical amounts but different maturities), unless they have been authorized by designated bank officials.

## APPENDIX A

### Illustrative Bank Financial Statements

(The following report of the independent CPA and financial statements illustrates one form of currently acceptable practice. The CPA should be guided by existing auditing standards concerning the report. Other forms of financial statements are acceptable. More or less detail should appear in the financial statements or in the notes depending on the circumstances.)

#### Independent Auditor's Report

To the Board of Directors and Stockholders  
Sample Bank  
Sampletown, U.S.A.

We have examined the accompanying balance sheets of Sample Bank as of December 31, 19X2 and 19X1, and the related statements of income, changes in stockholders' equity, and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the financial position of Sample Bank at December 31, 19X2 and 19X1, and the results of its operations and changes in its financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Officetown, U.S.A.  
January 24, 19X3

**Sample Bank  
Balance Sheets  
December 31, 19X2 and 19X1**

<u>Assets</u>	<u>19X2</u>	<u>19X1</u>
Cash and due from banks	\$ 5,498,000	\$ 5,425,000
Interest-bearing deposits in banks	1,000,000	1,000,000
Investment securities (Approximate market value of \$32,886,000 and \$41,567,000 respectively) (Note 2)	37,695,000	43,528,000
Trading securities	4,640,000	5,915,000
Federal funds sold and securities purchased under reverse repurchase agreements	2,100,000	—
Loans, less allowance for loan losses of \$830,000 and \$823,000 respectively (Note 3)	48,586,000	43,772,000
Investment in leveraged leases, net (Note 4)	1,897,000	1,113,000
Office buildings, equipment, and leasehold improvements, net (Note 5)	2,144,000	1,878,000
Customers' acceptance liability	237,000	379,000
Other assets	1,408,000	794,000
	<u>\$105,205,000</u>	<u>\$103,804,000</u>
 <u>Liabilities and Stockholders' Equity</u>		
Deposits		
Demand	\$ 19,427,000	\$ 24,061,000
NOW accounts	7,107,000	—
Savings	30,135,000	33,449,000
Time, \$100,000 and over	15,500,000	12,200,000
Other time	17,574,000	19,181,000
	<u>89,743,000</u>	<u>88,891,000</u>
Federal funds purchased and securities sold under repurchase agreements	2,279,000	2,558,000
Acceptances outstanding	237,000	379,000
Accrued interest and other liabilities (Note 6)	1,918,000	2,062,000
Subordinated debentures (Note 7)	1,000,000	1,000,000
Total liabilities	<u>95,177,000</u>	<u>94,890,000</u>
Commitments and contingent liabilities (Note 9)		
Stockholders' equity		
Common stock, par value \$10; 150,000 shares authorized and outstanding	1,500,000	1,500,000
Surplus	4,500,000	4,500,000
Retained earnings (Note 11)	4,028,000	2,914,000
Total stockholders' equity	<u>10,028,000</u>	<u>8,914,000</u>
	<u>\$105,205,000</u>	<u>\$103,804,000</u>

The accompanying notes are an integral part of these financial statements.

**Sample Bank**  
**Statements of Income**  
**Years Ended December 31, 19X2 and 19X1**

	19X2	19X1
Interest income		
Interest and fees on loans (Note 4)	\$6,859,000	\$5,527,000
Interest on investment securities		
U.S. Treasury securities	741,000	836,000
Obligations of other U.S. government agencies and corporations	186,000	268,000
Obligations of states and political subdivisions	1,248,000	1,256,000
Other securities	58,000	42,000
Interest on trading securities	221,000	241,000
Interest on federal funds sold and securities purchased under reverse repurchase agreements	332,000	105,000
Interest on deposits in banks	86,000	72,000
	<u>9,731,000</u>	<u>8,347,000</u>
Interest expense		
Interest on deposits	6,446,000	5,340,000
Interest on federal funds purchased and securities sold under repurchase agreements	253,000	78,000
Interest on subordinated debentures (Note 7)	80,000	80,000
	<u>6,779,000</u>	<u>5,498,000</u>
Net interest income	2,952,000	2,849,000
Provision for loan losses (Note 3)	60,000	68,000
Net interest income after provision for loan losses	<u>2,892,000</u>	<u>2,781,000</u>
Other income		
Trust department income	187,000	166,000
Service fees	106,000	103,000
Trading profits and commissions	174,000	67,000
Other	74,000	77,000
	<u>541,000</u>	<u>413,000</u>
Other expense		
Salaries	727,000	718,000
Pensions and other employee benefits (Note 8)	153,000	130,000
Occupancy expenses, net	356,000	304,000
Other operating expenses	747,000	648,000
	<u>1,983,000</u>	<u>1,800,000</u>
Income before income taxes and net securities gains (losses)	1,450,000	1,394,000
Applicable income taxes (Note 6)	80,000	48,000
Income before securities gains (losses)	<u>1,370,000</u>	<u>1,346,000</u>
Securities gains (losses) net of related taxes (benefits) 19X2, \$66,000; 19X1, \$(15,000)	65,000	(15,000)
Net income	<u>\$1,435,000</u>	<u>\$1,331,000</u>
Per share of common stock		
Income before securities gains (losses)	\$ 9.13	\$ 8.97
Net income	<u>\$ 9.57</u>	<u>\$ 8.87</u>

The accompanying notes are an integral part of these financial statements.



**Sample Bank**  
**Statements of Changes in Stockholders' Equity**  
**Years Ended December 31, 19X2 and 19X1**

	<i>Common Stock</i>			<i>Retained Earnings</i>	<i>Total</i>
	<i>Shares</i>	<i>Par Value</i>	<i>Surplus</i>		
Balance, December 31, 19X0	150,000	\$1,500,000	\$4,500,000	\$1,904,000	\$ 7,904,000
Net income				1,331,000	1,331,000
Cash dividends declared, \$2.14 per share				(321,000)	(321,000)
Balance, December 31, 19X1	150,000	1,500,000	4,500,000	2,914,000	8,914,000
Net income				1,435,000	1,435,000
Cash dividends declared, \$2.14 per share				(321,000)	(321,000)
Balance, December 31, 19X2	150,000	\$1,500,000	\$4,500,000	\$4,028,000	\$10,028,000

**Sample Bank**  
**Statements of Changes in Financial Position**  
**Years Ended December 31, 19X2 and 19X1**

	<i>19X2</i>	<i>19X1</i>
<i>Financial Resources Provided</i>		
<i>Operations</i>		
Net income	\$1,435,000	\$1,331,000
Depreciation and amortization	173,000	162,000
Deferred income taxes	90,000	113,000
Provision for loan losses	60,000	68,000
Total resources provided by operations	1,758,000	1,674,000
Increase in deposits	852,000	2,386,000
Reduction in investment securities	5,833,000	63,000
Reduction in trading securities	1,275,000	128,000
	\$9,718,000	\$4,251,000
<i>Financial Resources Applied</i>		
<i>Increase in</i>		
Cash and due from banks	\$ 73,000	\$ 34,000
Federal funds sold and securities purchased under reverse repurchase agreements	2,100,000	—
Loans, net	4,874,000	325,000
Investment in leveraged leases, net	784,000	—
Other assets	614,000	101,000
<i>Reduction in</i>		
Federal funds purchased and securities sold under repurchase agreements	279,000	3,252,000
Other liabilities	234,000	140,000
Purchase of buildings, equipment, and leasehold improvements	439,000	78,000
Dividends paid or declared	321,000	321,000
	\$9,718,000	\$4,251,000

The accompanying notes are an integral part of these financial statements.

**Sample Bank**  
**Notes to Financial Statements**  
**Years Ended December 31, 19X2 and 19X1**

**I. Summary of Significant Accounting Policies**

*Investment securities.* Investment securities are stated at cost adjusted for amortization of premiums and accretion of discounts, which are recognized as adjustments to interest income. Gains or losses on disposition are based on the net proceeds and the adjusted carrying amount of the securities sold, using the specific identification method.

*Trading securities.* Trading securities are carried at market value. Gains and losses on sales and changes in market values are included in other income.

*Loans and allowance for loan losses.* Loans are stated at the amount of unpaid principal, reduced by unearned discount and an allowance for loan losses. Unearned discount on installment loans is recognized as income over the terms of the loans by the interest method. Interest on other loans is calculated by using the simple interest method on daily balances of the principal amount outstanding. The allowance for loan losses is established through a provision for loan losses charged to expenses. Loans are charged against the allowance for loan losses when management believes that the collectibility of the principal is unlikely. The allowance is an amount that management believes will be adequate to absorb possible losses on existing loans that may become uncollectible, based on evaluations of the collectibility of loans and prior loan loss experience. The evaluations take into consideration such factors as changes in the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans, and current economic conditions that may affect the borrowers' ability to pay. Accrual of interest is discontinued on a loan when management believes, after considering economic and business conditions and collection efforts, that the borrowers' financial condition is such that collection of interest is doubtful.

*Leveraged leases.* Income on leveraged leases is recognized by a method that yields a level rate of return on the lease investment.

*Depreciation.* Office equipment and buildings are stated at cost less accumulated depreciation computed principally on the straight-line method over the estimated useful lives of the assets. Leasehold improvements are amortized on the declining-balance method over the shorter of the estimated useful lives of the improvements or the terms of the related leases.

*Pension plan.* The bank has a noncontributory pension plan covering substantially all employees. The bank's policy is to fund accrued pension costs. Prior service costs are being amortized over thirty years.

*Income taxes.* Deferred income taxes are reported for timing differences between items of income or expense reported in the financial statements and those reported for income tax purposes. The differences relate principally to depreciation of office buildings and equipment, accretion of discounts on investment securities, provision for loan losses,

and differences in method of recognizing income from leases. Investment tax credits resulting from purchases of equipment for the bank's use are accounted for under the flow-through method as a reduction of income tax expense in the period the assets are placed in service. Investment tax credits on equipment leased to others are recognized over a period related to the recovery of the lease investment that gives rise to the credits.

*Earnings per share.* Earnings per share are calculated on the basis of the weighted average number of shares outstanding.

## 2. Investment Securities

Carrying amounts and approximate market values of investment securities are summarized as follows.

	<i>December 31, 19X2</i>	
	<u><i>Carrying Amount</i></u>	<u><i>Approximate Market Value</i></u>
U.S. Treasury securities	\$11,023,000	\$ 9,801,000
Obligations of other U.S. government agencies and corporations	2,493,000	2,192,000
Obligations of states and political subdivisions	23,279,000	20,056,000
Other securities	900,000	837,000
	<u>\$37,695,000</u>	<u>\$32,886,000</u>

	<i>December 31, 19X1</i>	
	<u><i>Carrying Amount</i></u>	<u><i>Approximate Market Value</i></u>
U.S. Treasury securities	\$14,674,000	\$13,858,000
Obligations of other U.S. government agencies and corporations	4,690,000	4,540,000
Obligations of states and political subdivisions	23,364,000	22,442,000
Other securities	800,000	727,000
	<u>\$43,528,000</u>	<u>\$41,567,000</u>

Investment securities with a carrying amount of \$6,892,000 and \$13,524,000 at December 31, 19X2 and 19X1, respectively, were pledged to secure public deposits and securities sold under agreements to repurchase and for other purposes required or permitted by law.

### 3. Loans

Major classifications of loans are as follows.

	<i>December 31,</i>	
	<u>19X2</u>	<u>19X1</u>
Commercial	\$14,634,000	\$11,823,000
Construction	4,200,000	4,223,000
Mortgage	10,346,000	10,482,000
Installment	22,222,000	19,889,000
	<u>51,402,000</u>	<u>46,417,000</u>
Unearned discount	<u>(1,986,000)</u>	<u>(1,822,000)</u>
	49,416,000	44,595,000
Allowance for loan losses	<u>(830,000)</u>	<u>(823,000)</u>
Loans, net	<u>\$48,586,000</u>	<u>\$43,772,000</u>

Loans on which the accrual of interest has been discontinued or reduced amounted to \$373,000 and \$596,000 at December 31, 19X2 and 19X1, respectively. If interest on those loans had been accrued, such income would have approximated \$37,100 and \$59,600 for 19X2 and 19X1, respectively. Interest income on those loans, which is recorded only when received, amounted to \$9,300 and \$18,700 for 19X2 and 19X1, respectively.

Changes in the allowance for loan losses were as follows.

	<i>Year Ended December 31,</i>	
	<u>19X2</u>	<u>19X1</u>
Balance, beginning of year	\$823,000	\$819,000
Provision charged to operations	60,000	68,000
Loans charged off	(80,000)	(103,000)
Recoveries	<u>27,000</u>	<u>39,000</u>
Balance, end of year	<u>\$830,000</u>	<u>\$823,000</u>

### 4. Investment in Leveraged Leases

Leveraged leases of equipment to customers comprise the following.

	<i>December 31,</i>	
	<u>19X2</u>	<u>19X1</u>
Gross rents receivable	\$4,248,000	\$2,760,000
Nonrecourse debt	<u>(1,219,000)</u>	<u>(785,000)</u>
Net rentals receivable	3,029,000	1,975,000
Estimated residual value	222,000	115,000
Unearned income	<u>(1,354,000)</u>	<u>(977,000)</u>
Investment in leveraged leases	<u>\$1,897,000</u>	<u>\$1,113,000</u>

Income on leveraged leases of \$223,000 for 19X2 and \$122,000 for 19X1 is included in interest and fees on loans.

## 5. Office Buildings, Equipment, and Leasehold Improvements

Major classifications of these assets are summarized as follows.

	<i>December 31,</i>	
	<u>19X2</u>	<u>19X1</u>
Land	\$ 535,000	\$ 526,000
Buildings	1,417,000	1,144,000
Equipment	691,000	596,000
Leasehold improvements	112,000	125,000
	<u>2,755,000</u>	<u>2,391,000</u>
Accumulated depreciation and amortization	<u>(611,000)</u>	<u>(513,000)</u>
	<u>\$2,144,000</u>	<u>\$1,878,000</u>

Depreciation and amortization expense amounted to \$173,000 in 19X2 and \$162,000 in 19X1.

## 6. Income Taxes

The total income taxes in the statements of income are as follows.

	<i>Year Ended December 31,</i>	
	<u>19X2</u>	<u>19X1</u>
Currently payable		
Federal	\$ 20,000	\$(105,000)
State	36,000	25,000
Deferred		
Federal	85,000	100,000
State	5,000	13,000
	<u>\$146,000</u>	<u>\$ 33,000</u>

Accumulated deferred income taxes of \$1,102,000 and \$1,012,000 at December 31, 19X2 and 19X1, respectively, are included in accrued interest and other liabilities.

Deferred income taxes according to the timing differences which caused them were as follows.

	<i>Year Ended December 31,</i>	
	<u>19X2</u>	<u>19X1</u>
Income on leases recognized under the finance method for financial statement purposes but recognized under the operating method for income tax purposes (Note 4)	\$73,000	\$ 22,000
Excess of provision for loan losses over deduction for federal income tax purposes	(3,000)	(2,000)
Accretion of discount on investment securities	6,000	78,000
Accelerated depreciation	10,000	10,000
Other	4,000	5,000
	<u>\$90,000</u>	<u>\$113,000</u>

Interest income on loans and securities totaling \$1,258,000 and \$1,266,000 for 19X2 and 19X1, respectively, is exempt from federal income taxes; accordingly, the tax provision is less than that obtained by using the statutory federal corporate income tax rate.

## **7. Subordinated Debentures**

Subordinated debentures consist of 8 percent notes due June 1, 19X5. The notes are subordinated to all other indebtedness of the bank, and they may be prepaid, in whole or in part, at a premium of 1.833 percent to May 1, 19X3, and at reducing premiums thereafter. The terms also restrict incurrence of debt, mergers, and payment of cash dividends. As of December 31, 19X2, none of the restrictions effectively limit the bank's operations.

## **8. Pension Plan**

The bank has a noncontributory pension plan covering substantially all of its employees. The total pension expense of 19X2 and 19X1 was \$39,000 and \$27,000, respectively, which includes amortization of prior service cost over thirty years. The bank contributed annually to the plan amounts equal to the accrual for pension expense. A comparison of accumulated plan benefits and plan net assets for the bank's defined benefit plan is presented below.

	<i>January 1,</i>	
	<u>19X2</u>	<u>19X1</u>
Actuarial present value of accumulated plan benefits		
Vested	\$1,500,000	\$1,350,000
Nonvested	<u>2,800,000</u>	<u>2,650,000</u>
	<u>\$4,300,000</u>	<u>\$4,000,000</u>
Net assets available for benefits	<u>\$2,050,000</u>	<u>\$1,900,000</u>

The weighted average assumed rate of return used in determining the actuarial present value of accumulated plan benefits was 8 percent for both 19X2 and 19X1.

#### **9. Commitments, Contingent Liabilities, and Rental Expense**

The bank leases three branch offices under noncancellable agreements, which expire between December 31, 19X6, and November 30, 19X9, and require various minimum annual rentals. One of the leases requires payment of the property taxes and insurance on the property.

The total minimum rental commitment at December 31, 19X2, under the leases is \$498,000, which is due as follows.

Due in the year ending December 31,	19X3	\$ 85,000
	19X4	85,000
	19X5	85,000
	19X6	85,000
	19X7	60,000
Due in the remaining terms of the leases		<u>98,000</u>
		<u>\$498,000</u>

The total rental expense was \$85,000 and \$55,000 in 19X2 and 19X1, respectively.

In the normal course of business, the bank makes various commitments and incurs certain contingent liabilities that are not presented in the accompanying financial statements. The commitments and contingent liabilities include various guarantees, commitments to extend credit, and standby letters of credit. At December 31, 19X2, commitments under standby letters of credit and guarantees aggregated \$150,000. The bank does not anticipate any material losses as a result of the commitments and contingent liabilities.

The bank is a defendant in legal actions arising from normal business activities. Management believes that those actions are without merit or that the ultimate liability, if any, resulting from them will not materially affect the bank's financial position.

## **10. Related-Party Transactions**

At December 31, 19X2, certain officers and directors, and companies in which they have 10 percent or more beneficial ownership, were indebted to the bank in the aggregate amount of \$600,000.

## **11. Retained Earnings**

Banking regulations limit the amount of dividends that may be paid without prior approval of the bank's regulatory agency. Retained earnings against which dividends may be charged were \$2,000,000 at December 31, 19X2.



## APPENDIX B

### **Illustrative Common Trust Fund Financial Statements**

The following report of independent CPAs and financial statements illustrate one form of currently acceptable practice. The CPA should be guided by existing auditing standards concerning the auditor's report. The CPA may also address conformity of the financial statements with the plan of trust. Other forms of financial statements are acceptable. For example, many banks present comparative statements of operations and changes in net assets and provide several years per unit data as supplementary information. Regulation 9 of the Comptroller of the Currency specifies the minimum annual financial statements of collective investment trusts operated by banks subject to that regulation.

#### Independent Auditor's Report

Commercial Bank  
City, State

We have examined the statement of assets and liabilities of Common Trust Fund A of Commercial Bank, including the portfolio of investments in securities as of December 31, 19X2, and the related statements of operations and changes in net assets and the supplementary information for the year then ended. Our examination was made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the net assets of Common Trust Fund A of Commercial Bank at December 31, 19X2, the results of its operations, and the changes in its net assets for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Our examination has been made primarily for the purpose of expressing an opinion on the financial statements taken as a whole. The supplementary information contained on pages X through XX is presented for analysis purposes and is not necessary for a fair presentation of the financial information referred to in the preceding paragraph. It has been

subjected to the tests and other auditing procedures applied in the examination of the financial statements mentioned above and, in our opinion, is fairly stated in all material respects in relation to the financial statements taken as a whole.

City, State

Date

**Commercial Bank  
Common Trust Fund A  
Statement of Assets and Liabilities  
December 31, 19X2**

<u>Assets</u>	<u>Cost</u>	<u>Fair Value</u>
Investments in securities*		
Bonds	\$1,680,000	\$1,700,000
Preferred stocks	320,000	300,000
Common stocks	<u>5,960,000</u>	<u>5,615,100</u>
	<u>\$7,960,000</u>	7,615,100
Cash		
Principal	\$ 600	
Income	<u>14,300</u>	
		14,900
Accrued income receivable		9,600
Due from brokers for securities sold but not delivered		<u>100,000</u>
		<u>7,739,600</u>
 <u>Liabilities</u>		
Due to brokers for securities purchased but not received	\$ 300,000	
Income distribution payable	14,400	
Accrued expenses	<u>1,600</u>	
		<u>316,000</u>
Net assets (equivalent to \$10.27 per unit based on 722,800 units outstanding)		<u>\$7,423,600</u>

The accompanying note is an integral part of these financial statements.

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\*Short-term securities that represent the temporary use of cash balances may be classified separately from the investment portfolio unless the fund's investment policy is to have some or all of its assets invested in such securities.

**Commercial Bank  
Common Trust Fund A  
Portfolio of Investments in Securities  
December 31, 19X2**

<i>Number of Shares or Principal Amount</i>	<i>Bonds—22.32%</i>	<u>Cost*</u>	<u>Fair Value</u>
\$1,000,000	ABC Company, 8.00% subordinated debentures, due 9/15/X3	\$1,050,000	\$1,060,000
\$ 600,000	Jones Manufacturing, Inc., 8.25% subordinated debentures, due 6/30/X4	630,000	640,000
	Total bonds	<u>1,680,000</u>	<u>1,700,000</u>
	<i>Convertible preferred stocks—3.94%</i>		
4,000	XYZ Corporation, \$6.00, Series B	<u>320,000</u>	<u>300,000</u>
	<i>Common stocks—73.74%</i>		
	<i>Banks and finance—27.67%</i>		
9,000	National Company	1,128,300	947,300
10,000	First National Corporation	249,200	457,500
5,000	First National Bank	663,700	702,500
		<u>2,041,200</u>	<u>2,107,300</u>
	<i>Insurance—15.89%</i>		
5,000	U.S. Casualty Corporation	<u>1,318,700</u>	<u>1,209,800</u>
	<i>Office equipment—15.00%</i>		
2,000	Universal Business Machines, Inc.	505,500	493,500
3,000	U.S. Business Corporation	878,400	648,800
		<u>1,383,900</u>	<u>1,142,300</u>
	<i>Public utilities—15.18%</i>		
6,000	General Gas Company	<u>1,216,200</u>	<u>1,155,700</u>
	Total common stocks	<u>5,960,000</u>	<u>5,615,100</u>
	Total investments	<u>\$7,960,000</u>	<u>\$7,615,100</u>

Percentages shown are based on value.

The accompanying note is an integral part of these financial statements.

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\*Detailed cost disclosure is optional.

*Note:* Securities that are in default or arrears or are non-income-producing should be so identified. Securities in default may have been transferred to a separate liquidating account.

**Commercial Bank  
Common Trust Fund A  
Statement of Operations  
Year Ended December 31, 19X2**

Net investment income		
Dividends	\$ 99,700	
Interest	<u>26,300</u>	
Total investment income		\$ 126,000
Audit and miscellaneous expenses*		<u>(16,600)</u>
Net investment income		<u>\$ 109,400</u>
Realized and unrealized gains (losses) on investments		
Realized gains (losses) from security transactions (excluding short-term securities)		
Proceeds from sales**	\$2,978,500	
Cost of securities sold**	<u>3,308,700</u>	
Net realized gains (losses)		\$ (330,200)
Unrealized appreciation (depreciation) of investments		
Beginning of year	\$1,037,500	
End of year	<u>(344,900)</u>	
Unrealized depreciation during the year		<u>(1,382,400)</u>
Net realized and unrealized gains (losses) on investments		<u>\$ (1,712,600)</u>

The accompanying note is an integral part of these financial statements.

\*The trust agreement may require that such expenses be charged to principal.

\*\*The proceeds and cost of short-term securities sold should be excluded unless regulations require their inclusion or the investment policy of the fund is to have some or all of its assets invested in such securities. A parenthetical reference to the exclusion should be made. Such short-term transactions usually represent the temporary use of cash and should be excluded from transactions in the investment security portfolio. Short-term securities are usually interest bearing and redeemable at par; therefore, no gain or loss on disposition is realized. If a gain or loss is realized, it should be reported separately from investment portfolio gains or losses in realized gains (losses) from security transactions.

**Commercial Bank  
Common Trust Fund A  
Statement of Changes in Net Assets  
Year Ended December 31, 19X2**

From investment activities	
Net investment income for the year	\$ 109,400
Income distributed or distributable to participants	(109,400)
Net realized gains (losses) from securities transactions	(330,200)
Unrealized appreciation (depreciation) during year	<u>(1,382,400)</u>
Increase (decrease) in net assets derived from investment activities	<u>(1,712,600)</u>

From unit transactions	
Net proceeds from issue of units (131,500 units)	1,493,700
Cost of units redeemed (20,000 units)	<u>(228,600)</u>
Increase in net assets derived from unit transactions	1,265,100
Net increase (decrease) in net assets	<u>(447,500)</u>
Net assets	
Beginning of year	7,871,100
End of year	<u><u>\$7,423,600</u></u>

The accompanying note is an integral part of these financial statements.

**Commercial Bank  
Common Trust Fund A  
Note to Financial Statements  
Year Ended December 31, 19X2**

**Significant Accounting Policies and Other Information**

The following is a summary of significant accounting policies, which are in conformity with generally accepted accounting principles and the trust agreement.

*Security valuation.* Investments in securities traded on a national securities exchange are valued at the last reported sales price on the last business day of the year. (Include here the pricing source.) Securities traded in the over-the-counter market and listed securities for which no sale was reported on that date are valued at the mean between the last reported bid and asked prices. Short-term notes are stated at cost adjusted for amortization of discount or premium, which approximates market value. (If market values are not available and securities are valued by management, that fact should be disclosed. That may be particularly applicable to real-estate-related investments. If the trust agreement allows a method that is inconsistent with generally accepted accounting principles, for example, cost, the CPA may have to take exception in the audit report.)

*Federal income taxes.* The fund is exempt from federal income tax.

*Securities transactions.* Purchases and sales are accounted for on the trade date. Dividend income is recorded on the ex-dividend date. Interest income is reported as earned. Cost of securities sold is determined by the identified certificate method. (If the trust agreement or state law requires stock dividends of a certain percentage of outstanding shares of the same class of stock to be included in the common trust fund income, that practice should be disclosed, since it is not in conformity with generally accepted accounting principles.)

**AICPA**  
**INTERNAL**  
**MEMORANDUM**

Date: April 14, 1983

To: Pubs. Distribution      Cost Center: All  
Lists A, B, F

From: Production & Edit.      Cost Center: 449  
Services, Publications Division

Subject: Audits of Banks, #011128

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The new edition of the Industry Audit Guide, Audits of Banks, distributed to you this last month, contains an error on page 157. Four lines were inadvertently dropped at the top of the page in the pre-printing process.

Accompanying this notice is a patch of corrected type to be affixed to the top of that page.

For convenience in mounting the type, the backing has been slit so that it may be peeled off the adhesive. To correct the page, line the patch of correction type up with the first line of type on the page and press it down over the lines presently there.

Copies of the book now in inventory are being corrected. Persons who have already received the book are being provided with correction patches.

If you require more correction patches, please call the production department (#6261).

*K. Koehler*

*Unit issues, redemptions, and distributions.* In accordance with the terms of the plan of trust, the net asset value of the fund is determined as of the end of each month. Units are issued and redeemed only at that time, at the monthly net asset value. Also, in accordance with the plan of trust, net investment income is distributed monthly, but realized and unrealized securities gains are not distributed.

*Expenses.* In accordance with the plan of trust, the trustee may charge the fund for audit and other expenses incurred. Certain trust expenses may be borne by the trustee. (This treatment may vary according to state law or the trust agreement.)

**Commercial Bank  
Common Trust Fund A  
Supplementary Information  
Selected Per Unit Data**

Following are selected data for each participant unit (based on the weighted average number of units outstanding except for net asset values) for the year ended December 31, 19X2.

Net investment income	\$ .16
Income distributed	(.16)
Net realized gains (losses) and increase (decrease) in unrealized appreciation	(2.61)
Net increase (decrease) in net asset value	(2.61)
Net asset value	
Beginning of year	12.88
End of year	\$ 10.27
Units outstanding at end of year	722,800

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*Note:* This schedule may be included in the notes to the financial statements and is usually provided for more than one year. Also, selected ratios may be included, such as portfolio turnover and net investment income to average asset value. If so, a note may be required describing how the ratios were calculated.

trust, net investment income is distributed monthly, but realized and unrealized securities gains are not distributed.

*Expenses.* In accordance with the plan of trust, the trustee may charge the fund for audit and other expenses incurred. Certain trust expenses may be borne by the trustee. (This treatment may vary according to state law or the trust agreement.)

**Commercial Bank  
Common Trust Fund A  
Supplementary Information  
Selected Per Unit Data**

Following are selected data for each participant unit (based on the weighted average number of units outstanding except for net asset values) for the year ended December 31, 19X2.

Net investment income	\$ .16
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Net realized gains (losses) and increase (decrease) in unrealized appreciation	(2.61)
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Net asset value	
Beginning of year	12.88
End of year	\$ 10.27
Units outstanding at end of year	722,800

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*Note:* This schedule may be included in the notes to the financial statements and is usually provided for more than one year. Also, selected ratios may be included, such as portfolio turnover and net investment income to average asset value. If so, a note may be required describing how the ratios were calculated.



**Commercial Bank  
Common Trust Fund A  
Supplementary Information  
Investments Purchased  
Year Ended December 31, 19X2**

<u>Number of Shares or Principal Amount</u>	<u>Bonds</u>	<u>Cost</u>
\$1,000,000	U.S. government agencies Federal Intermediate Credit Banks Consolidated Collateral Trust, 5.65%, due 8/1/X5	\$ 998,400
\$1,000,000	Twelve Federal Intermediate Credit Banks Consolidated Bond, 6.15%, due 12/3/X5	989,700
\$1,000,000	ABC Company, 8% subordinated debentures, due 9/15/X3	1,050,000
\$ 600,000	Jones Manufacturing, Inc., 8.25% subordinated debentures, due 6/30/X4	630,000
	Total bonds	<u>3,668,100</u>
	<u>Convertible preferred stocks</u>	
4,000	XYZ Corporation, \$6.00, Series B	<u>320,000</u>
	<u>Common stocks</u>	
	<u>Insurance</u>	
4,000	U. S. Casualty Corporation	1,005,000
	<u>Office equipment</u>	
750	Universal Business Machines, Inc.	288,200
1,000	U. S. Business Corporation	295,000
	<u>Public utilities</u>	
3,000	General Gas Company	700,800
	Total common stocks	<u>2,289,000</u>
	Total purchases	<u>\$6,277,100</u>

*Note:* If any securities were acquired through stock dividends or splits, a separate schedule of those transactions should be presented.

**Commercial Bank  
Common Trust Fund A  
Supplementary Information  
Investments Sold or Redeemed  
Year Ended December 31, 19X2**

<u>Number of Shares or Principal Amount</u>	<u>Bonds</u>	<u>Cost</u>	<u>Proceeds</u>	<u>Gain (Loss)</u>
	U.S. Government agencies			
\$1,000,000	Federal Intermediate Credit Banks Consolidated Collat- eral Trust, 5.65%, due 8/1/X5	\$ 998,400	\$1,000,000	\$ 1,600
\$1,000,000	Twelve Federal Interme- diate Credit Banks Consolidated Bond, 6.15%, due 12/3/X5	989,700	999,600	9,900
	Total bonds	<u>1,988,100</u>	<u>1,999,600</u>	<u>11,500</u>
	<u>Convertible preferred stocks</u>			
3,000	International Television Corporation, \$4.50, Series 1	<u>320,300</u>	<u>199,600</u>	<u>(120,700)</u>
	<u>Common stocks</u>			
6,000	Banks and finance American Bank Corp.	566,900	504,100	(62,800)
6,000	Public utilities Southern U.S. Electric Company	433,400	275,200	(158,200)
	Total common stocks	<u>1,000,300</u>	<u>779,300</u>	<u>(221,000)</u>
	Total sales or redemptions	<u>\$3,308,700</u>	<u>\$2,978,500</u>	<u>\$(330,200)</u>

## APPENDIX C

### **Suggested Guidelines for CPA Participation in Bank Directors' Examinations**

*Note:* Appendix C has been prepared by the banking committee for the information of AICPA members and other interested parties. However, it does not represent an official position of any of the Institute's senior technical committees.

#### **The Nature of Directors' Examinations**

The bylaws of national banks and many state laws governing state-chartered banks require periodic examinations of banks and their trust departments by the board of directors. The name "directors' examination" is derived from these requirements. In fulfilling their responsibilities, the directors, or a committee of directors, may personally complete the examination procedures or may engage other parties, including internal auditors or CPAs, to assist them. Thus, the directors may assign the authority to perform some or all examination procedures to other parties, but ultimate responsibility for an examination that fulfills the requirements of the bank supervisory agency rests with the directors.

Bank supervisory agencies often require the directors to report on the results of their examination. Some supervisory agencies also specify the form and content of such reports. Usually, the directors' examination report—as distinguished from the report to the directors by a CPA or other third party—is presented in one of the following formats:

- A report prepared in compliance with supervisory agency or statutory requirements and on prescribed forms
- A report containing the directors' comments on the scope and results of the examination and also referring to the report of a CPA or other third party who performed some of the examination procedures on the directors' behalf
- A statement by the directors referring to the report of a CPA or other third party who performed all of the examination procedures on the directors' behalf in accordance with the requirements of the board of directors or the supervisory agency

The Office of the Comptroller of the Currency has published guidelines for directors' examinations for national banks and two handbooks for national bank and trust examiners containing checklists for evaluating the scope of work performed by internal auditors and CPAs. Several state banking departments have also prescribed matters to be covered in directors' examinations and forms for reporting the results.

The AICPA Committee on Banking believes that guidance is necessary for CPAs wishing to assist directors in performing bank directors' examinations. Specifically, the committee believes assistance is necessary to enable CPAs to provide directors with services that meet both the objectives of the directors' examination and the standards of the accounting profession.

### **Scope of Services Rendered by CPAs**

The scope of services rendered by CPAs in connection with directors' examinations varies, depending on the circumstances of the engagement, the needs of the board of directors, and the requirements of the supervisory agency. However, the types of services requested of CPAs generally fall into three categories.

The CPA may be engaged to audit the bank's financial statements. The purpose of an examination of a bank's financial statements in accordance with generally accepted auditing standards is to enable the CPA to express an opinion on the financial statements. An audit of financial statements is usually acceptable in fulfilling directors' examination requirements established by supervisory agencies that have specific minimum audit requirements. Many supervisory agencies' directors' examination requirements can be met by an examination of only the balance sheet. Accordingly, the directors may request an audit either as the sole basis for fulfilling directors' examination requirements or as a supplement to the performance of other directors' examination procedures. In either event, the directors are ultimately responsible for an examination that meets the requirements of supervisory agencies, and some supervisory agencies may require a separate report or statement from the directors indicating their conclusions, even though the examination was based solely on the CPA's report.

A CPA may be engaged to audit financial statements except that certain auditing procedures may be omitted at the request of the directors. Generally, the omitted procedures are tests of the bank's loan portfolio and concurrent evaluation of the adequacy of management's allowance for loan losses. Many bank directors believe that the testing and evaluation process is the most time-consuming and subjective aspect of an audit and that such procedures are adequately covered by the bank's internal loan review system and by supervisory agency examinations.

A CPA may be engaged by the directors to perform specified examination procedures. These procedures are generally designed to meet the supervisory agency's requirements. The CPA's special report describing the nature and results of procedures performed is usually submitted to the directors without financial statements. However, several states

require that the report submitted to the agency include certain unaudited financial statements or data.

The committee believes that, while all three types of services meet the supervisory agency requirements for a directors' examination, an audit of financial statements generally provides the greatest benefit to a bank's management, directors, and shareholders. As noted earlier, an audit generally meets the directors' examination requirements of federal and state supervisory agencies.

## **Guidance for Procedures Agreed Upon With the Board of Directors**

AICPA members making examinations in accordance with generally accepted auditing standards are guided by the AICPA's Statements on Auditing Standards. These auditing standards are designed for engagements resulting in a CPA's opinion on financial statements; also, they are generally applicable to other types of engagements, such as services performed by a CPA in connection with bank directors' examinations. Guidance is limited, however, regarding the procedures to be applied by a CPA when he is engaged by the directors to perform only certain agreed-upon procedures. Thus, CPAs should be aware, when discussing the proposed scope of the engagement or describing procedures frequently followed in similar types of engagements, that the procedures to be applied may be affected by the specific supervisory agency's requirements.

SAS No. 35, *Special Reports—Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement*, should serve as the principal guidance for CPAs engaged to apply agreed-upon procedures in connection with directors' examinations. A CPA's participation in a directors' examination should be structured to meet the individual needs of the bank and its directors and the requirements, if applicable, of the supervisory agency. The CPA and the board of directors should have a clear understanding of the scope of the CPA's procedures and the specific responsibilities of each party. In this regard, SAS No. 35, paragraph 1, states:

An accountant may accept an engagement in which the scope is limited to applying, to one or more specified elements, accounts, or items of a financial statement, agreed-upon procedures that are not sufficient to enable him to express an opinion on the specified elements, accounts, or items, provided (a) the parties involved have a clear understanding of the procedures to be performed and (b) distribution of the report is to be restricted to named parties involved.

Paragraph 3 of the SAS states that the general standards are applicable to these types of engagements; thus, in accordance with the second general standard, the accountant must be independent.

The CPA may be requested to assist the directors in determining the procedures to be performed by the directors or by other third parties. In this regard, the CPA may be asked to meet with the supervisory agencies

to ascertain their specific requirements.<sup>1</sup> As a result, changes may need to be made in the scope of either the entire directors' examination or the CPA's engagement.

The CPA should consider issuing an engagement letter describing the agreement with the directors on scope and responsibility. The letter would state that the purpose of the CPA's engagement is to assist the directors in performing the directors' examination and that responsibility for completing the applicable supervisory agency's directors' examination requirements, if any, and for reporting the results to the agency rests with the directors. The engagement letter may include, among other things, details of the major areas to be covered, the extent of procedures to be performed in each area, and any specific supervisory agency requirements to be omitted. An illustrative engagement letter is set forth in exhibit 1.

## Reports Issued by CPAs

Reports prepared by CPAs, based on audits of financial statements, should comply with the reporting provisions contained in applicable SASs. SAS No. 2 gives guidance on reports on audited financial statements, and paragraph 12 of the SAS states that "When restrictions that significantly limit the scope of the audit are imposed by the client, the auditor generally should disclaim an opinion on the financial statements."

Reports prepared by CPAs, based upon the performance of agreed-upon procedures in connection with a bank directors' examination, should be prepared in conformity with SAS No. 35, paragraph 4, which states that they

should (a) indicate the specified elements, accounts, or items to which the agreed-upon procedures were applied, (b) indicate the intended distribution of the report, (c) enumerate the procedures performed, (d) state the accountant's findings, (e) disclaim an opinion with respect to the specified elements, accounts, or items, and (f) state that the report relates only to the elements, accounts, or items specified, and does not extend to the entity's financial statements taken as a whole.

A footnote to that paragraph adds the following information:

When the accountant consents to the inclusion of his report on the results of applying agreed-upon procedures in a document or written communication containing the entity's financial statements, he should look to SAS No. 26, *Association With Financial Statements*, or to Statement on Standards for

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1. SAS No. 35, paragraph 2, states that the "parties involved [should] have a clear understanding of the procedures to be performed." For circumstances in which the CPA is unable to discuss the procedures directly with all of the parties who will receive the report, paragraph 2 gives examples of procedures the CPA may take, such as comparing the procedures to be applied to written requirements of a supervisory agency or distributing a draft of the report or a copy of the client's engagement letter to the parties involved with a request for their comments before the report is issued.

Accounting and Review Services No. 1, *Compilation and Review of Financial Statements*, as appropriate, for guidance on his responsibility pertaining to the financial statements.

SAS No. 35, paragraph 5, provides the following guidance:

If the accountant has no adjustments to propose to the specified elements, accounts, or items, he may include a comment to that effect in his report. For example, the following language might be included: "In connection with the procedures referred to above, no matters came to our attention that caused us to believe that the (specified elements, accounts, or items) should be adjusted." Also, the accountant may wish to indicate that had he performed additional procedures with respect to the specified elements, accounts, or items or had he made an examination of the financial statements in accordance with generally accepted auditing standards, (other) matters might have come to his attention that would have been reported.

As mentioned earlier, some supervisory agencies require that reports include financial statements or data. In such instances, the directors will usually include the CPA's special-purpose report and the unaudited financial statements or data.

A CPA may be requested to perform specific examination procedures while conducting a compilation or review of financial statements. The procedures employed in compilation and review engagements, and reports thereon, should comply with the provisions of AICPA Statement on Standards for Accounting and Review Services No. 1, *Compilation and Review of Financial Statements*. In accordance with SSARS No. 1, paragraph 32, any examination procedures "that the accountant might have performed before or during the review engagement, including those performed in connection with a compilation of the financial statements, should not be described in his report." This provision, however, would not preclude a CPA from issuing a separate, special-purpose report on the nature and extent of procedures performed in accordance with SAS No. 35.

Exhibit 2 presents an illustrative special report for agreed-upon procedures performed in connection with a directors' examination.

**Illustrative Engagement Letter  
Services Other Than Financial Statement Examinations**

**Examining Committee  
XYZ Bank**

(Date)

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide to (name of bank) for the year ending (date).

We will apply certain procedures to selected records and transactions for the purpose of helping you to complete your directors' examination, and our report is not intended for any other purpose.

The procedures to be performed are summarized in the supplement to this letter. Because those procedures will not constitute an examination made in accordance with generally accepted auditing standards, we will not express an opinion on any of the items specified in the supplement or the financial statements of the bank taken as a whole.

Our engagement will not include a detailed examination of all transactions and cannot be relied upon to disclose errors, irregularities, or illegal acts, including fraud or defalcations, that may exist. However, we will inform you of any such matters that come to our attention.

We direct your attention to the fact that management has the responsibility for the proper recording of the transactions in the books of account, for the safeguarding of assets, and for the preparation of financial statements in conformity with generally accepted accounting principles.

The procedures will be applied on a surprise basis during the year after we consult with the appropriate supervisory agencies to discuss the procedures to be performed and to ensure that the date selected will not conflict with their examinations.<sup>1</sup>

As mentioned in paragraph 2 above, we will submit a report summarizing the procedures performed, the results of those procedures, and any suggestions we may have for improving the bank's system of internal accounting control and accounting records and procedures. This report will be issued solely for the information of the bank's management and appropriate supervisory agencies (or other specified third parties); it is not to be used by any other parties because of the restricted nature of our work. Our report will also contain a paragraph indicating that, had we performed additional procedures or had we made an examination of the financial statements in accordance with generally accepted auditing standards, other matters might have come to our attention that would have been reported to you.

Our fees are based on the time required by the individuals assigned to the engagement, plus direct expenses. Individual hourly rates vary according to the degree of responsibility involved and the skill required.

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1. Some directors' examinations may not be conducted on a surprise basis.



Interim billings will be submitted as services are rendered and as expenses are incurred.

We will be pleased to discuss this letter with you at any time. If the foregoing is in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.<sup>2</sup>

Sincerely yours,

\_\_\_\_\_  
(Signature of CPA)

Acknowledged:

\_\_\_\_\_  
(Name of bank)

\_\_\_\_\_  
(Signature of bank director)

\_\_\_\_\_  
(Date)

2. Some CPAs prefer not to obtain an acknowledgement, in which case their letter would omit the sentence beginning "If the foregoing . . ." and the spaces for the acknowledgement. The first paragraph of their letter might begin as follows: "This letter sets forth our understanding of the terms and objectives of our engagement. . . ."

*Note:* In certain instances, the CPA may not be able to discuss the procedures to be performed with all the parties, for example, bonding companies, that will receive a copy of the report. In these circumstances, to satisfy the requirement in SAS No. 35 that these parties have an understanding of the procedures to be performed, the CPA should consider sending a copy of the engagement letter to these parties and asking them to confirm it.

**Supplement to Illustrative Engagement Letter  
Procedures to Be Performed in Connection With a Directors'  
Examination  
(name of bank)**

In connection with our engagement, the procedures to be performed are summarized as follows.

- 1. General
  - a. Start the engagement on a date selected by us without prior notification of bank personnel, officers, or directors. Obtain immediate control (seal vault, etc.) of assets and records and maintain control until applicable procedures have been completed. The surprise procedures will cover the main office and (the following) branches.

- b. Review the bank's system of internal accounting control. The review will be limited to describing the system through use of narratives or flowcharts, tracing one or more of the significant transaction types through the system, and completing internal control questionnaires.<sup>1</sup>
  - c. Review supervisory agency examination reports.
  - d. Review minutes of board of directors meetings.
  - e. Review material entries to the general ledger and investigate unusual transactions.
  - f. Review accounting procedures for handling nonledger assets, such as loan charge-offs and recoveries, travelers' checks, and U.S. savings bonds.
  - g. Obtain letters from legal counsel.
  - h. Review disposition of our previous comments and recommendations on internal accounting control.
  - i. Obtain a management representation letter.
- 2. Cash, cash items, and clearings and exchanges
  - 3. Due from banks
  - 4. Securities
  - 5. Federal funds sold (purchased)
- {

Procedures to be performed should be listed in detail, including number and types of confirmations, extent of tests of revenue and expense, and types of sampling methods employed.

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1. SAS No. 30 provides guidance on reporting on internal accounting control.

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*Note:* This Supplement is for illustrative purposes only and, therefore, is not considered to be an all-inclusive list of accounts that may be examined and procedures that may be employed. The CPA should describe those accounts examined and procedures relevant to the specific engagement.

**Illustrative Report  
Services in Connection With Directors' Examinations**

**Examining Committee  
XYZ Bank**

We have applied certain procedures to selected records and transactions of the (name of bank) as of (examination date). Our examination was made in accordance with the arrangements set forth in our letter to you dated (date).

The procedures we performed are summarized in the supplement to this report. Also included in the attached supplement are certain account balances as shown in the bank's records as of the examination date. Because the procedures do not constitute an examination made in accordance with generally accepted auditing standards, we do not express an opinion on any of the items specified in the supplement.

In connection with the procedures mentioned in the attached supplement, no (the following) matters came to our attention that caused us to believe that any (the following) account(s) might require adjustment. Had we performed additional procedures or had we made an examination of the financial statements in accordance with generally accepted auditing standards, other matters might have come to our attention that would have been reported to you. This report relates only to the accounts specified in the attached supplement and does not extend to any financial statements of (name of bank) taken as a whole for the period ended (date).

This report is intended solely for the use of management (or specified regulatory agency or other specified third party) and should not be used for any other purpose.

Please contact us if you have any questions regarding this examination.

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(Signature of CPA)

(Name of CPA)

(Date)

**Supplement to Illustrative Report**

***Cash and "Due From Banks"***

Cash and "due from banks" consists of the following:

Cash on hand	\$ 429,859
Cash items	32,390
Clearings and transit items	324,189
Due from banks	1,166,980

Cash on hand was counted, except that bundled currency in denominations under \$50 and rolled coins were test counted. Bundled \$20, \$10, \$5,

\$2, and \$1 bills were counted 25 percent, 10 percent, 10 percent, 5 percent, and 5 percent respectively. Total cash on hand was found to be \$1,471.84 less than the general ledger balance. Bank officers have informed us that they are investigating further an unexplained shortage of \$1,361.05 in one of the teller's funds.

Cash items were inspected. We ascertained that cash items in excess of \$100 clearing the first three days following the examination date were properly disposed.

Clearings and cash letters in transit were totaled and found to agree with the general ledger balances. Clearings were confirmed directly with the banks receiving them. We ascertained that return items in excess of \$500 recorded by correspondent banks on (examination date) and the following three days were properly disposed.

Amounts due from banks were confirmed directly with depository institutions. Statements were obtained for five days following (examination date), and no unusual transactions were noted. We ascertained that return items in excess of \$500 recorded by correspondent banks on (examination date) and the following five days were properly disposed.

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*Note:* Procedures for other accounts should be specified in detail, and differences and subsequent disposition should be reported.

**Confirmation Statistics  
(Examination Date)**

	<u>Loans<sup>1</sup></u>	<u>Checking Accounts</u>	<u>Savings Accounts</u>	<u>Certificates of Deposit</u>
Dollar amounts				
Total				
Circularized				
Percent circularized to total				
Replies received <sup>2</sup>				
Percent replies received to total circularized <sup>2</sup>				
Selected but not circularized				
Not delivered by post office				
Number of accounts				
Total				
Circularized				
Percent circularized to total				
Replies received <sup>2</sup>				
Percent replies received to total circularized <sup>2</sup>				
Selected but not circularized				
Not delivered by post office				

- 
1. If the loans are categorized by type in the report, similar categories would normally be used in this schedule.
  2. If negative confirmation requests are used, the following explanation should be included: Negative confirmations, necessitating a reply only when the customer believes that the balances shown on the confirmation requests are not correct, were used to confirm customers' account balances.

**Confirmation Requests Not Circularized**

	<u>Name and Address</u>	<u>Reason for Non- Circularization</u>	<u>Balance as of (Examination Date)</u>
Loans:			
Checking accounts:			
Savings accounts:			
Certificates of deposit:			

# Illustrative Forms of Confirmation Requests

## Negative Loan Confirmation Request (Sample Bank Letterhead)

(Name and address)

(Date)

In connection with their examination of our records, please confirm the correctness of the following information directly to our auditors, A.B. & Co., Certified Public Accountants, 100 Main Street, Anycity, State, Zip Code.

Our records show that at the close of business on \_\_\_\_\_ (date) you were indebted to us for \$\_\_\_\_\_ as follows:

Loan number(s)	_____	_____	_____	_____
Balance as of _____ (date)	_____	_____	_____	_____
Original loan amount	_____	_____	_____	_____
Date of loan	_____	_____	_____	_____
Due date of loan	_____	_____	_____	_____
Interest rate	_____	_____	_____	_____
Date to which interest is paid	_____	_____	_____	_____
Collateral	_____	_____	_____	_____

IF YOUR RECORDS AGREE WITH THE INFORMATION SHOWN, NO REPLY IS NECESSARY.

IF YOUR RECORDS DO NOT AGREE with the information shown, please indicate what you believe to be the correct information, sign in the space provided, and return this letter to our auditors in the enclosed self-addressed, stamped envelope.

Sincerely,

Sample Bank  
\_\_\_\_\_  
By \_\_\_\_\_

A.B. & Co.:

The above information is not correct. The differences are as follows:

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

Date \_\_\_\_\_ Signature \_\_\_\_\_  
Title \_\_\_\_\_

\_\_\_\_\_  
*Note:* The CPA should exercise judgment in determining whether all of the indicated information is desired.

**Positive Loan Confirmation Request  
(Sample Bank Letterhead)**

(Name and address)

(Date)

In connection with their examination of our records, please confirm the correctness of the following information directly to our auditors, A.B. & Co., Certified Public Accountants, 100 Main Street, Anycity, State, Zip Code.

Our records show that at the close of business on \_\_\_\_\_ (date) \_\_\_\_\_ you were indebted to us for \$ \_\_\_\_\_ as follows:

Loan number(s)	_____	_____	_____	_____
Balance as of _____ (date)	_____	_____	_____	_____
Original loan amount	_____	_____	_____	_____
Date of loan	_____	_____	_____	_____
Due date of loan	_____	_____	_____	_____
Interest rate	_____	_____	_____	_____
Date to which interest is paid	_____	_____	_____	_____
Collateral	_____	_____	_____	_____

IF YOUR RECORDS AGREE with the information shown, please sign in the appropriate space below and return this letter to our auditors in the enclosed self-addressed, stamped envelope.

IF YOUR RECORDS DO NOT AGREE with the information shown, please sign in the appropriate space below, indicate what you believe to be the correct information, and return this letter to our auditors.

Sincerely,

Sample Bank  
By \_\_\_\_\_

A.B. & Co.:

The above information is correct.

Date \_\_\_\_\_ Signature \_\_\_\_\_  
Title \_\_\_\_\_

The above information is not correct. (The exceptions are shown on the reverse side of this letter.)

Date \_\_\_\_\_ Signature \_\_\_\_\_  
Title \_\_\_\_\_

*Note:* The CPA should exercise judgment in determining whether all of the indicated information is desired.



**Negative Deposit Confirmation Request  
(Sample Bank Letterhead)**

(Name and address)

(Date)

In connection with their examination of our records, please confirm the correctness of the following information directly to our auditors, A.B. & Co., Certified Public Accountants, 100 Main Street, Anycity, State, Zip Code.

Our records show that at the close of business on \_\_\_\_\_ (date) the balance in your (type of deposit account) was as follows:

Account number \_\_\_\_\_

Balance \_\_\_\_\_

**IF YOUR RECORDS AGREE WITH THE INFORMATION SHOWN, NO REPLY IS NECESSARY.**

**IF YOUR RECORDS DO NOT AGREE** with the information shown, please indicate what you believe to be the correct information, sign in the space provided, and return this letter to our auditors in the enclosed self-addressed, stamped envelope.

Sincerely,

Sample Bank

By \_\_\_\_\_

A.B. & Co.:

The above information is not correct. The differences are as follows:

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

Date \_\_\_\_\_ Signature \_\_\_\_\_

Title \_\_\_\_\_

*Note:* This confirmation request pertains ONLY to the account described above and not to any other accounts you may have with the bank as of the date shown above.

**Positive Deposit Confirmation Request  
(Sample Bank Letterhead)**

(Name and address)

(Date)

In connection with their examination of our records, please confirm the correctness of the following information directly to our auditors, A.B. & Co., Certified Public Accountants, 100 Main Street, Anycity, State, Zip Code.

Our records show that at the close of business on \_\_\_\_\_ (date) the balance in your (type of deposit account) was as follows:

Account number \_\_\_\_\_

Balance \_\_\_\_\_

IF YOUR RECORDS AGREE with the information shown, please sign in the appropriate space below and return this letter to our auditors in the enclosed self-addressed, stamped envelope.

IF YOUR RECORDS DO NOT AGREE with the information shown, please sign in the appropriate space below, indicate what you believe to be the correct information, and return this letter to our auditors.

Sincerely,

Sample Bank

By \_\_\_\_\_

A.B. & Co.:

The above information is correct.

Date \_\_\_\_\_ Signature \_\_\_\_\_

Title \_\_\_\_\_

The above information is not correct. (The exceptions are shown on the reverse side of this letter.)

Date \_\_\_\_\_ Signature \_\_\_\_\_

Title \_\_\_\_\_

\_\_\_\_\_  
*Note:* This confirmation request pertains ONLY to the account described above and not to any other accounts you may have with the bank as of the date shown above.

**General Purpose Negative Confirmation Request  
(Sample Bank Letterhead)**

(Name and address)

(Date)

In connection with their examination of our records, please confirm the correctness of the following information directly to our auditors, A.B. & Co., Certified Public Accountants, 100 Main Street, Anycity, State, Zip Code.

Our records show that at the close of business on \_\_\_\_\_ (date)

(You were indebted to us)\*

(We were indebted to you)\*

(You held for our account)\*

(We held for your account)\*

for

**IF YOUR RECORDS AGREE WITH THE INFORMATION SHOWN,  
NO REPLY IS NECESSARY.**

**IF YOUR RECORDS DO NOT AGREE** with the information shown, please indicate what you believe to be the correct information, sign in the space provided, and return this letter to our auditors in the enclosed self-addressed, stamped envelope.

Sincerely,

Sample Bank

By \_\_\_\_\_

A.B. & Co.:

The above information is not correct. The differences are as follows:

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

Date \_\_\_\_\_ Signature \_\_\_\_\_

Title \_\_\_\_\_

\*Line out the items that are not applicable.

\_\_\_\_\_

*Note:* This form may be used for transactions such as safekeeping, collection items, letters of credit, securities, federal funds, or security repurchase agreements.

**General Purpose Positive Confirmation Request  
(Sample Bank Letterhead)**

(Name and address)

(Date)

In connection with their examination of our records, please confirm the correctness of the following information directly to our auditors, A.B. & Co., Certified Public Accountants, 100 Main Street, Anycity, State, Zip Code.

Our records show that at the close of business on \_\_\_\_\_ (date)

(You were indebted to us)\*  
(We were indebted to you)\*  
(You held for our account)\*  
(We held for your account)\*

for

IF YOUR RECORDS AGREE with the information shown, please sign in the appropriate space below and return this letter to our auditors in the enclosed self-addressed, stamped envelope.

IF YOUR RECORDS DO NOT AGREE with the information shown, please sign in the appropriate space below, indicate what you believe to be the correct information, and return this letter to our auditors.

Sincerely,

Sample Bank  
By \_\_\_\_\_

A.B. & Co.:

The above information is correct.

Date \_\_\_\_\_ Signature \_\_\_\_\_  
Title \_\_\_\_\_

The above information is not correct. (The exceptions are shown on the reverse side of this letter.)

Date \_\_\_\_\_ Signature \_\_\_\_\_  
Title \_\_\_\_\_

\*Line out the items that are not applicable.

\_\_\_\_\_  
*Note:* This form may be used for transactions such as safekeeping, collection items, letters of credit, securities, federal funds, or security repurchase agreements.

## Glossary

**accommodating bank.** A correspondent bank that receives or provides funds as a service to its correspondent banks.

**accounting entry ticket.** A ticket used as a posting medium in place of a columnar journal as the book of original entry.

**advancing.** A method of borrowing from a Federal Reserve bank requiring execution of a promissory note, with governmental securities as the underlying collateral.

**allowance for loan losses.** A valuation allowance established and maintained by charges against operating income to provide a balance for absorbing possible losses in a bank's loan portfolio.

**arbitrage.** The act of buying a security in one market and selling it in another. The term also refers to the act of buying a security subject to exchange, conversion, or reorganization and selling it upon completion of the exchange, conversion, or reorganization.

**banker's acceptance.** A time draft that the drawee bank has agreed to pay at maturity by stamping "accepted" over the signature of an officer.

**bank holding company.** A company controlling one or more banks or bank holding companies. Bank holding companies are subject to Federal Reserve regulations and are permitted to engage in activities closely related to banking.

**batch.** A grouping of similar items (for example, deposits or incoming checks) assembled for proofing purposes. Such a grouping is also referred to as a "block."

**blotter.** A proof sheet summarizing a day's transactions, usually by department or branch. Postings are made from the blotter to the general and subsidiary ledgers.

**branch bank.** A bank operating one or more branch offices under the control of the main office.

**call.** A demand by bank supervisory agencies requiring submission of a report (“call report”) on the bank’s financial condition.

**capital note.** A debt security issued by a bank that, by its terms, is subordinate in the event of liquidation to all other liabilities of the bank. In liquidation, a capital note is senior to stockholders’ equity.

**capital surplus.** A surplus usually created either by issuance of bank capital stock at a premium or by transfers from retained earnings.

**cash item.** A maturing coupon or bond, petty cash voucher, returned check, due bill, or similar item temporarily held pending liquidation.

**cash letter.** A list of items that are to be credited immediately to the account of a depositor (usually a bank or a large corporation). The items covered by such a letter may be charged back to the depositor’s account if not paid.

**cash on hand.** Funds in the possession of tellers and a reserve fund kept in the vault.

**certificate of deposit (CD).** A receipt to the depositor for funds deposited with a bank. Some CDs are transferable and may be endorsed to other parties and negotiated like checks or other negotiable instruments. CDs may be payable on demand (“demand CDs”) or at some specified date (“time CDs”). Demand CDs generally bear no interest, and time CDs bear interest at a simple interest rate. In addition, time CDs may contain a repayment notification clause (generally not less than thirty days).

**chain bank.** One of a group of banks owned and controlled by a group of individuals who, as joint directors, officers, or individual owners, take an active part in formulating policy and managing the banks in the chain.

**clearinghouse.** A place where representatives of banks in the same locality meet each day at a specified time to exchange checks, drafts, and similar items drawn on each other and to settle the resulting balances.

- clearinghouse association.** A cooperative organization owned and operated by local banks, which elects its officers and subsidizes its operating expenses.
- clearings.** Checks and other items deposited for exchange among member banks of a clearinghouse. The total daily clearings are published in newspapers and other periodicals as an index of business activity.
- club account.** A savings plan whereby the depositor makes periodic, usually weekly, payments. Coupon books frequently are issued to the depositor, and a coupon generally accompanies each payment.
- collateral.** Specific property that a borrower pledges as security for the repayment of a loan. The borrower agrees that the lender will have the right to sell the collateral for the purpose of liquidating the debt if the borrower fails to repay the loan at maturity or otherwise defaults under the terms of the loan agreement.
- collection department.** The department handling checks, drafts, coupons, and other items received from depositors with instructions to credit their accounts after final payment is received.
- collection item.** An item received for collection to be credited to a depositor's account after final payment.
- collection letter.** The letter accompanying items to be handled for collection and credit after payment. Collection letters usually contain instructions for delivery of documents, protests, wire advices, and so forth.
- collective investment.** Commingling of funds of individual trusts into a common pool for greater diversification, stability of earnings, or other investment objectives.
- compensating balance.** A deposit balance maintained by a customer pursuant to lines of credit, borrowings, or agreements for other services.
- completed transaction method.** The recognition of securities gains and losses when they are realized.
- Comptroller of the Currency.** An appointed official in the U.S. Treasury Department who is responsible for the chartering and supervision of national banks.

**corporate trust.** A trust authorizing a bank to act as agent for a corporation. The bank may serve as registrar, transfer agent, and coupon and bond paying agent.

**correspondent bank.** A bank serving as a depository for another bank. The correspondent bank accepts deposits in the form of cash letters and collects items for its bank depositor. The depository bank will generally render banking services to its correspondent in the depository bank's region.

**coupon book.** A book of coded payment forms to be used by club account depositors or by borrowers in remitting payments.

**credit department.** The department responsible for obtaining, assembling, and retaining credit information on a bank's customers. Credit applications for loans generally are presented to this department by a loan officer. The credit department then gathers all necessary information on the customer and prepares it for the confidential use of the loan officer, who evaluates the creditworthiness of the customer. Also, this department obtains information and answers credit inquiries for correspondent banks.

**customers' acceptance liability.** Customers' liability on outstanding drafts and bills of exchange that have been accepted by a bank. This acceptance by the bank is referred to as a "banker's acceptance."

**dealer reserve.** A portion of the proceeds of the discounted installment sales contract retained by the bank to achieve limited protection against credit losses. Credit losses chargeable against these reserves are covered by the agreement entered into with the dealer.

**deferred posting.** A method of posting transactions. The two types of deferred posting methods are (1) the partially deferred posting plan, whereby the previous day's counter checks are intersorted with the current day's inclearings and mail items and posted in one run, the previous day's counter work being delayed, and (2) the fully deferred posting plan, whereby the previous day's inclearings and mail and the previous day's counter work are intersorted and posted in one run on the current day. Under the fully deferred posting plan, all checks are posted one day after coming into the bank's possession.



**demand deposit.** The deposit of funds subject to withdrawal on demand of the depositor.

**de novo basis.** Commencing a new business as contrasted with acquiring an existing one.

**directors' examination.** The periodic examination of banks by their directors, a committee of the directors, or CPAs or other auditors on behalf of the directors.

**direct paper.** Installment loans originating from bank customers.

**direct settlement.** Direct exchange by banks of checks, drafts, and similar items drawn on each bank. This practice generally is used in communities having a limited number of banks and, therefore, no need for a clearinghouse.

**discount.** 1. The amount of interest withheld when a note or draft is purchased. 2. A note on which the interest is paid. 3. The process of making a loan by requiring a note larger by the agreed interest charge than the amount paid to the borrower or credited to his account (sometimes referred to as "add-on interest"). A discount is distinguished from a loan by the fact that interest on a loan is collected at the time the note is paid or at regular intervals during the term of the loan, as in the case of a demand loan. 4. The process by which a Federal Reserve or other bank rediscounts for a member or customer bank the notes, drafts, or acceptances that the member bank already has discounted for its customers.

**doubtful.** See *loan classifications used by supervisory agencies*.

**draft (bill of exchange).** A signed written order addressed by one person (the drawer) to another person (the drawee) directing the latter to pay a specified sum of money to the order of a third person (the payee).

**due bill.** A bill issued to cover a short sale when funds are received. A due bill is required to be collateralized three business days after settlement. If not properly collateralized, it is treated as a deposit for reserve requirements.

**due from account.** An asset control account used to record a bank's deposits in other banks.

**due to account.** A liability control account used to record deposits held for other banks.

**escheat.** The reversion of property, such as the property of a decedent with no heirs and unclaimed or abandoned property, to the state.

**escrow.** Delivery of a deed or other title to a third person, who releases it to the grantee upon the fulfillment of certain specified conditions. The term is also commonly used to designate accounts credited with the periodic deposits of mortgagors for the payment of real estate taxes and insurance premiums by the bank on behalf of the mortgagor.

**exchange.** The settlement of items drawn on other banks through a clearinghouse or by direct settlement between banks.

**fair value.** The amount one can reasonably expect to receive in a current sale, not a forced or liquidation sale, from a willing buyer. It is measured by market value when an active market exists. If no active current market exists for the assets acquired but exists for similar assets, the selling price in the market for similar assets may be helpful in estimating the fair value of the assets acquired. If no market price is available, a forecast of expected cash flows may aid in estimating the fair value of assets transferred, provided the expected cash flows are discounted at a rate commensurate with the risk involved.

**Federal Deposit Insurance Corporation (FDIC).** A U.S. government corporation that insures the deposits of Federal Reserve System member banks and nonmember banks electing to join the FDIC. Deposits are insured up to a specified amount. In return for this protection, each bank pays an assessment based on total deposits. The FDIC is responsible for supervision of state-chartered, FDIC-insured banks that are not members of the Federal Reserve System. The FDIC is also responsible for liquidating failed FDIC-insured banks.

**Federal Financial Institutions Examination Council (FFIEC).** A council composed of representatives from the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, the Federal Home Loan Bank Board, and the National Credit Union Administration, which prescribes uniform principles and standards for the federal examination of financial institutions and makes recommendations to promote uniformity in the supervision of the financial institutions.

**federal funds.** Loans to another bank (or loans from another bank that increase (or decrease)) the other bank's reserve account with a Federal Reserve bank. A bank is required to maintain a legal reserve comprising (1) funds on deposit in the bank's reserve account with a Federal Reserve bank and (2) currency and coin on hand. If a bank's legal reserve is deficient, it may borrow federal funds to increase its reserve position. The loans are generally repayable the following day and are commonly referred to as "federal funds purchased" or "federal funds sold." Banks may loan cash to a member bank of the Federal Reserve System. The loans may be secured by U.S. government or federal agency securities.

**Federal Home Loan Mortgage Corporation (FHLMC).** A corporation chartered by an act of Congress in July 1970 for the purpose of assisting in the development and maintenance of a secondary market in conventional residential mortgages. The corporation purchases mortgages from financial institutions, the accounts of which are insured by an agency of the U.S. government. The corporation is often referred to as Freddie Mac.

**Federal Reserve Board (FRB).** A board of seven members, appointed by the President of the United States and confirmed by the U.S. Senate, responsible for supervising, coordinating, and formulating monetary policy. The FRB has regulatory power over member banks.

**Federal Reserve System.** The central banking system of the United States, created by an act of Congress (Federal Reserve Act) in 1913. The system includes national and state member banks and twelve Federal Reserve banks and their branches.

**foreign exchange.** Commitments to buy or sell foreign currencies or instruments receivable or payable in foreign currencies.

**foreign exchange position.** The aggregate of a bank's assets, liabilities, and commitments receivable or payable in a particular foreign currency.

**forward foreign exchange contract.** A contract for the purchase or sale of foreign exchange to be delivered at a future date (usually six months) at a rate fixed at the time the contract is entered into. Settlement is made at delivery.

**general ledger debit and credit tickets.** Transaction slips used by banks in place of columnar journals as items of original entry.

**Government National Mortgage Association (GNMA).** A wholly owned corporate instrumentality of the U.S. government, which purchases, services, and sells mortgages insured or guaranteed by the Federal Housing Administration (FHA) and the Veterans Administration (VA) and may perform other secondary market functions to support the home mortgage market. The association is often referred to as Ginnie Mae.

**group bank.** An affiliate of a holding company that controls a substantial part of the stock of one or more other banks.

**holdovers.** Items that are unprocessed at the end of the day. These unprocessed transactions include rejected items that are generally disposed of in the following day's business. They include checks drawn on other banks, items lacking endorsement, checks subject to "stop payment" orders, and items that, if charged, would create unauthorized overdrafts in customers' deposit accounts.

**indirect paper.** Installment loans originating from dealer customers.

**installment loan.** A note repayable in installments (usually in level monthly amounts) with maturities depending on the nature of the loan.

**insufficient funds.** A term used to express the fact that a depositor's balance is inadequate for the bank to pay a check drawn on the account.

**interest collected but not earned (unearned interest).** Interest that has been collected in advance of the contract to be performed or the consideration to be met.

**interest earned but not collected (interest receivable).** Interest on loans and investment securities not collected in advance but due and payable at specified future dates.

**junior mortgage.** A mortgage (for example, a second mortgage) that is subordinate to other mortgages.

**letter of credit.** A formal document in letter form addressed to and authorizing the beneficiary (for example, an exporter) to draw a draft to a stated amount of money against the accepting bank.

**level yield method.** The recording of premium amortization and

discount accretion in a manner that produces a constant rate of return on the basis of adjusted book value.

**liability ledger.** A subsidiary ledger containing all obligations of an individual borrower to the bank.

**line of credit.** The maximum amount of credit that a bank will extend to a particular borrower (usually a business concern) over a stated period, provided the borrower meets certain conditions, such as maintaining a specified cash balance on deposit at the bank.

**loan classifications used by supervisory agencies.** *substandard.* A classification assigned to loans inadequately protected by the current sound worth and paying capacity of the obligor or by pledged collateral, if any. *doubtful.* A classification assigned to loans that have all the weaknesses inherent in an asset classified substandard and whose collection or liquidation in full is highly questionable. *loss.* A classification assigned to loans considered uncollectible and of such little value that their continuance as active assets of the bank is not warranted. Loss classification does not mean that an asset has absolutely no recovery or salvage value. *other loans especially mentioned (OLEM).* Loans that are currently protected but that exhibit potentially unwarranted credit risks.

**loss.** See *loan classification used by supervisory agencies.*

**memorandum account.** An account used to control customers' assets, obligations to others, or future commitments. This type of account is not reflected in the bank's balance sheet or statement of income. Types of memorandum accounts include unused commitments for letters of credit, collection items, items kept for safekeeping, travelers' checks, U.S. savings bonds, charged-off loans, forward foreign exchange contracts, guarantees, and unused balances under lines of credit.

**mortgage participation certificate (PC).** A certificate representing an undivided interest in specified conventional residential mortgages underwritten and owned by the FHLMC. The FHLMC unconditionally guarantees the payment of principal and interest.

**net occupancy expense (net occupancy income).** The difference

between gross occupancy expense and rental income. This amount does not include expenses of other real estate owned; these expenses are generally included with other operating expenses.

**nostro account.** An asset account representing foreign currency balances maintained by a U.S. bank with a foreign bank. It is generally included in the financial statement caption “due from foreign banks.”

**NOW (negotiable order of withdrawal) account.** A transaction account similar to a checking account on which interest is paid.

**OLEM.** See *loan classifications used by supervisory agencies.*

**on us checks.** Checks drawn on the accounts of depositors of the bank receiving them.

**overdraft.** The amount by which the sum of checks paid against an account exceeds the balance in the account.

**passbook.** A document containing a complete record of a customer’s savings account, showing deposits and withdrawals as well as the interest credited at regular periods. A bank may require that the passbook be presented for proper entry of transactions.

**pass-through certificate.** A certificate guaranteed by GNMA representing shares in pools of mortgages insured by the FHA, VA, or Farmers Home Administration. The pools include mortgages with the same interest rate and same approximate maturity. The payback to investors includes both interest and principal, both guaranteed by GNMA. There are minimum trading unit amounts.

**proof.** 1. A process for testing the accuracy of a previous operation, such as a relisting of the checks and adding of their amounts to determine the accuracy of the total shown on a deposit slip. 2. Applied to the proof sheet, the record on which the test is made. 3. The method by which a type of transaction is proved, such as proof and transit. Proof generally is effected when a total agrees with another total of the same item arrived at in a different manner; the total then is said to be in balance.

**reserve requirements.** The percentage of deposits each bank is required by law to maintain on deposit with the Federal Reserve System.

- reserves.** Legal reserves and reserves for contingencies. Such reserves are considered appropriated (restricted) retained earnings. The term “reserves” has been used to represent either valuations against asset accounts or liabilities; but, these reserves should be classified as valuation allowances or liabilities, as appropriate.
- retained earnings.** Undistributed earnings less discretionary transfers to surplus.
- return item.** An item (for example, a check) returned unpaid by a designated payor bank.
- rule of 78s.** Use of the sum-of-the-months'-digits method for amortization.
- safekeeping.** The use of a bank's vault facilities by a customer to store valuable assets, such as securities, jewelry, and art, for which the customer pays a fee, usually on an annual basis.
- short sale.** A sale of securities that the seller does not own at the time of sale. The short sale must be covered by the seller through the subsequent acquisition and delivery of the securities sold short.
- sight draft.** A draft that is payable on presentation to the drawee.
- single-entry ticket.** A medium for recording contra entries, usually to cash transactions.
- spot foreign exchange contract.** A contract for the purchase or sale of foreign exchange to be delivered within a few days at a rate fixed at the time the contract is entered into. Settlement is made at delivery.
- standby letter of credit.** Every letter of credit (or similar arrangement, however named or designated) that represents an obligation to the beneficiary on the part of the issuer to (1) repay money borrowed by or advanced to or for the account of the party at interest, (2) make payment on account of any evidence of indebtedness undertaken by the party at interest, or (3) make payment on account of any default by the party at interest in the performance of an obligation.
- substandard.** See *loan classifications used by supervisory agencies*.
- surplus.** Capital surplus and discretionary transfers from retained earnings.

**suspense accounts.** Accounts used to record items that will be held subject to clarification and transfer to the appropriate account.

**tax-equivalent reporting.** A practice of raising interest income on tax-exempt items (often securities) to a fully taxable basis, with a corresponding increase in the provision for income taxes.

**throwouts.** See *holdovers*.

**time deposit.** Savings, time certificates of deposit, commercial and public fund time deposits, and Christmas club and other club accounts. These may bear interest and may include escrow accounts.

**transit items.** Items for credit to customers' accounts that are payable outside the city of the bank receiving them.

**trust.** An arrangement by which an individual or a corporation as trustee holds title to property for the benefit of one or more persons, usually under the terms of a will or other written agreement.

**trusteed affiliate.** An affiliated entity (such as an insurance agency or bank premises owning company) whose stock is held by a trust for the benefit of the bank's stockholders.

**uncollected funds.** The portion of a deposit or deposit account not yet collected or paid because the items deposited are in transit to the drawer bank.

**undivided profits.** See *retained earnings*.

**unit bank.** A bank that operates only in one location, including, in some states, a satellite office.

**unposted debits.** Checks or items not charged against customers' deposits or general ledger accounts until the following business day.

**vault cash.** That portion of the cash on hand that generally is not required for immediate use and is left in the bank vault as an intermediate reserve.

**vostro account.** A liability account representing U.S. dollar balances maintained by foreign banks with a U.S. bank. It is generally included in the financial statement caption "due to foreign banks."



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