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American Institute of Certified Public Accountants. Banking Committee

AICPA Industry Audit Guide

AUDITS OF BANKS

As of December 31, 1990

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NOTICE TO READERS

This industry audit guide presents recommendations of the AICPA Banking Committee on the application of generally accepted auditing standards to audits of financial statements of banks. This guide also presents the committee's recommendations on and descriptions of financial accounting and reporting principles and practices for banks. The AICPA Accounting Standards Executive Committee and members of the AICPA Auditing Standards Board have found this guide to be consistent with existing standards and principles covered by Rules 202 and 203 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from this guide.

This edition includes *Audit Risk Alert—Banking Industry Developments—1990.*

Preface

This audit guide has been prepared to assist the independent CPA in auditing 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 audits 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 Committee 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.

* [FASB Statement No. 95, *Statement of Cash Flows,* as amended, supersedes APB Opinion No. 19, *Reporting Changes in Financial Position,* and requires a statement of cash flows as part of a full set of financial statements for all business enterprises in place of a statement of changes in financial position.

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.

Recommended Changes	*Chapter*	*Recommended Treatment for Initial Adoption*
Investment securities		
● Trade date accounting	5	Prospective
● Completed transaction basis	5	Prospective
● Allowance for estimated losses	5	Prospective
● Wash sale—no gain or loss recognized if proceeds are reinvested in same or substantially the same securities	5	Prospective
● 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	Prospective
Trading securities		
● Trade date accounting	6	Prospective
● Securities to be presented at market	6	Cumulative adjustment in current period or restatement
● Presentation of short securities position as liability	6	Restatement
● Short positions to be presented at market	6	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	Prospective
Loans		
● Interest method—amortization of unearned discount	7	Cumulative adjustment in current period
● Application of payments on nonaccrual loans	7	Prospective

Recommended Changes	Chapter	Recommended Treatment for Initial Adoption
● Income recognition of origination and commitment fees	7	Cumulative adjustment in current period; but if not practicable, apply prospecitvely
Capital accounts		
● Presentation of stock dividends at fair value	15	Prospective
● Bank holding company assumption of subsidiary bank debt—capital contribution	15	Restatement
● Subordinated debt reclassified as liability	13	Restatement
Consolidation		
● Goodwill—regulatory writeoff reinstated in consolidation	20	Restatement
● Diversity of accounting policies among affiliates need not be conformed	20	Restatement
● Transfers by a subsidiary from retained earnings to surplus and disclosure requirements	20	Restatement
● Inclusion of trusteed affiliates	20	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*.

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Chapter 1

Introduction to the Banking System

The U.S. Banking System

1.01 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.

1.02 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.

1.03 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.

1.04 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.

1.05 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.

1.06 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.

1.07 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.

1.08 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

1.09 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

	Supervisory Agency			
Bank Classification	*Comptroller of the Currency*	*Federal Deposit Insurance Corporation*	*Federal Reserve System*	*State Banking Department*
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

1.10 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.

1.11 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.

1.12 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).

1.13 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

1.14 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

1.15 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.

1.16 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.

1.17 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

2.01 As used in this guide, the term *audit* refers to an audit 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

2.02 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

2.03 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

2.04 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.

2.05 An auditor may be involved with information other than the financial statements. SAS No. 52, *Omnibus Statement on Auditing Standards—1987,* "Required Supplementary Information", states

> The objective of an audit 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 audit information outside the basic financial statements in accordance with

* [Note: This chapter has been amended by SOP 90-5, *Inquiries of Representatives of Financial Institution Regulatory Agencies.*]

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 financial statements.

The auditor's responsibility for other information not required by the FASB or GASB 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* (AICPA, *Professional Standards,* vol. 1, AU sec. 550). 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* (AICPA, *Professional Standards,* vol. 1, AU sec. 551). The auditor's responsibility for supplementary information required by the FASB or GASB (called *required supplementary information*) is discussed in [SAS No. 52, *Omnibus Statement on Auditing Standards—1987*].

2.06 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.

2.07 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.

2.08 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.

2.09 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.

2.10 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

2.11 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

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

2.13 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.

2.14 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.

2.15 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.

2.16 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

* [Note: Superseded by SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit.* This paragraph will be revised in future editions.]

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. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern.*

2.17 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.

2.18 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

2.19 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.

2.20 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.

2.21 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

2.22 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.

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

Initial Audit Procedures

2.24 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.

2.25 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.

2.26 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

2.27 Several bank audit procedures may entail audit sampling. Such procedures may include tests of transactions to determine compliance with specified internal accounting control procedures and substantive tests of balances, such as validation of deposit and loan accounts.

2.28 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

2.29 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. 48, *The Effects of Computer Processing on the Audit of Financial Statements*
- SAS No. 44, *Special-Purpose Reports on Internal Accounting Control at Service Organizations*
- Federal Financial Institutions Examination Council's *EDP Examination Handbook,* which includes a section on "Internal and External EDP Audit"

Client Representations

2.30 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.

Communications Between Independent Auditors and Examiners

2.31 The independent auditor should review reports of significant examinations and related communications between examiners and the financial institution and, when appropriate, make inquiries of the examiners. The independent auditor should—

- Request that management provide access to all reports of examinations and related correspondence.[1]
- Review reports of significant examinations and related correspondence between examiners and the financial institution during the period under audit through the date of the independent auditor's report.
- Communicate with the examiners, with the prior approval of the financial institution, when their examination of the financial institution is in process or a report on an examination has not been received by the financial institution.

2.32 A refusal by management to allow the independent auditor to review communications from, or to communicate with, the examiner would ordinarily be a limitation on the scope of the audit sufficient to preclude an opinion (see AICPA *Professional Standards,* vol. 1, AU secs. 508.40 through 508.44). A refusal by the examiner to communicate with the auditor may be a limitation on the scope of the audit sufficient to preclude an unqualified opinion, depending on the auditor's assessment of other relevant facts and circumstances.

2.33 In addition, the independent auditor should consider attending, as an observer, with the prior approval of the financial institution, the exit conference between the examiner and the financial institution's board of directors (or an appropriate board committee) or its executive officers or both. Also, if the examiners request permission to attend the meeting between the independent auditor and management or the financial institution's board of directors (or an appropriate board committee) or both to review the report on the audit of the financial statements, and management concurs, the independent auditor should endeavor to be responsive to that request.

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[1] Examinations of financial institutions either can be general in nature and comprehend capital adequacy, quality of loans, investments and other assets, and the financial institution's ability to manage liquidity and funding, or they can be targeted to a specific area of the financial institution's operations, such as real-estate lending or trust operations. In addition, examinations may be limited to compliance with laws and regulations applicable to the financial institution—for example, the Bank Secrecy Act, Consumer Protection, Insider Transactions, Municipal Securities Rule Making Board Requirements, or Regulatory Reporting.

Chapter 3

Internal Accounting Control *

Bank Procedures and Systems

3.01 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

3.02 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

3.03 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.

3.04 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.

3.05 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.

3.06 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.

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* This chapter was originally drafted on the basis of concepts described in SAS No. 1, section 320, *The Auditor's Study and Evaluation of Internal Control.* That section has been superseded by SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit.* Changes to conform this chapter to SAS No. 55, will be made in future editions.

Interdepartmental Accountability

3.07 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

3.08 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 departments 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.

3.09 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.

3.10 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

3.11 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.

3.12 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

3.13 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

3.14 The second standard of field work states, "A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed." 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.

3.15 Section 320 of SAS No. 1,* *The Auditor's Study and Evaluation of Internal Control,* 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 Audit.*

3.16 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:

Class of Transactions	*Transaction Type*
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

* [Note: Superseded by SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit.* This section will be revised in future editions.]

	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

3.17 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

3.18 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.

3.19 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.

3.20 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.

3.21 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 audit.

3.22 Several pronouncements may prove helpful in certain situations. SAS No. 45, *Omnibus Statement on Auditing Standards—1983,* "Related Parties," 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. 45 and FASB Statement No. 57. SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities,* and SAS No. 54, *Illegal Acts by Clients,* relate to the auditor's concern with errors, irregularities, and illegal acts.

3.23 The auditor's evaluation of internal accounting control may reveal material weaknesses in the system. SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit,* requires that such matters as well as other reportable conditions be communicated to the audit committee or to individuals with a level of authority and responsibility equivalent to an audit committee in organizations that do not have one, such as the board of directors, the board of trustees, an owner in an owner-managed enterprise, or others who may have engaged the auditor.

3.24 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"

4.01 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

4.02 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

4.03 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

4.04 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.

4.05 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.

4.06 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.

4.07 Within the bank, local clearings and exchange items are byproducts of the proof department, discussed in chapter 3.

"Due from Banks"

4.08 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.

4.09 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.

4.10 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

4.11 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.

4.12 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

4.13 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

4.14 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

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

4.16 *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.

4.17 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.

4.18 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.

4.19 *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.

4.20 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.

4.21 *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.

4.22 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.

4.23 *"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

5.01 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.

5.02 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.

5.03 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.

5.04 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

5.05 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.

5.06 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, *Accounting for Certain Marketable Securities.*

5.07 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.

5.08 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.

5.09 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

5.10 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.

5.11 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.

5.12 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.*

5.13 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.

5.14 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.

5.15 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

5.16 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.

5.17 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.

5.18 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.

5.19 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

5.20 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.

5.21 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

5.22 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

5.23 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.

5.24 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.

5.25 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.

5.26 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.

5.27 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

5.28 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.

5.29 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 commit-

tee concerning management's intentions on disposing of the securities.

5.30 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.

5.31 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

5.32 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.

5.33 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

5.34 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.

5.35 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.

5.36 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

5.37 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.

5.38 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

6.01 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

6.02 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.

6.03 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.

6.04 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 Audit and Accounting 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

6.05 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.

6.06 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.

6.07 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

6.08 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.

6.09 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.

6.10 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.

6.11 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

6.12 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.

6.13 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

6.14 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

7.01 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.

7.02 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

7.03 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.

7.04 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.

7.05 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.

7.06 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.

7.07 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.

7.08 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.

7.09 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

7.10 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.

7.11 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.

7.12 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).

7.13 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

7.14 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).

7.15 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.

7.16 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.

7.17 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.

7.18 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.

7.19 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.

7.20 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.

7.21 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.

7.22 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

7.23 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.

7.24 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.

7.25 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. FASB Statement No. 96, *Accounting for Income Taxes,* as amended, is effective for fiscal years beginning after December 15, 1991. It will supersede APB Opinion No. 11.

7.26 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

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

7.28 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.

7.29 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.

7.30 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.

7.31 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.

7.32 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

7.33 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.

7.34 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.

7.35 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.

7.36 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.

7.37 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.

7.38 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.

7.39 The accounting and reporting requirements for loans involved in troubled debt restructurings are set forth in FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings.* 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.)

7.40 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.

7.41 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.

7.42 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.

7.43 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.

7.44 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.

7.45 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.

7.46 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. See FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated With Originating or Acquiring Loans and Initial Direct Costs of Leases.*

7.47 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

7.48 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 Statement of Financial Accounting Standards No. 77, *Reporting by Transferors for Transfers of Receivables With Recourse*, that addresses the reporting of such transactions.

7.49 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.

7.50 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.

7.51 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, *Related Party Disclosures,* establishes requirements for related-party disclosures.

7.52 Overdrafts are classified as loans.

7.53 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.

7.54 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.

7.55 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

7.56 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 audit.
- 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

7.57 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

7.58 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.

7.59 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, section 331, *Receivables and Inventories,* paragraphs .03 through .08, provides guidelines for the use of confirmations.) Forms of confirmation requests are illustrated in Appendix D.

7.60 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.

7.61 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).

7.62 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.

7.63 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.

7.64 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. 54, *Illegal Acts by Clients.*

Procedures for Specific Types of Loans

7.65 *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.

7.66 *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.

7.67 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, *Special-Purpose Reports on Internal Accounting Control at Service Organizations,* 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.

7.68 *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.

7.69 *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.

7.70 *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

8.01 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

8.02 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

8.03 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.

8.04 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

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

Auditing

Audit Objective

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

Audit Procedures

8.07 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.

8.08 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.

8.09 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.

8.10 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.

8.11 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.

8.12 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.

8.13 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.

8.14 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.

8.15 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.

8.16 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, individual 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.

8.17 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.

8.18 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

9.01 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.

9.02 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.

9.03 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.

9.04 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

9.05 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.

9.06 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

9.07 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.

9.08 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

9.09 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

9.10 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

9.11 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

9.12 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

10.01 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.

10.02 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.

10.03 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

10.04 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."

10.05 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.

10.06 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, *Accounting for Leases*, provides guidance for accounting for properties subject to leases (either operating or capital).

10.07 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, *Accounting for Income Taxes.* FASB Statement No. 96, *Accounting for Income Taxes,* as amended, is effective for fiscal years beginning after December 15, 1991. It will supersede APB Opinion No. 11.

Financial Statement Presentation

10.08 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.

10.09 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.

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

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

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

10.13 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, *Consolidated Financial Statements,* APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock,* and FASB Statement No. 13.

Auditing

10.14 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

11.01 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.

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

11.03 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.

11.04 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.

11.05 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.

11.06 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.

11.07 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, *Capitalization of Interest Cost,* sets forth criteria for capitalization of interest.

11.08 Guidance on accounting for gains on sales of other real estate is provided in FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings,* and Statement No. 66, *Accounting for Sales of Real Estate.*

Auditing

11.09 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.

11.10 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.

11.11 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.

11.12 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

12.01 The major liabilities of banks are demand and time deposits.

Demand Deposits

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

12.03 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.

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

12.05 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.

12.06 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 maintained, 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.

12.07 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

12.08 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.

12.09 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.

12.10 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.

12.11 Methods of computing interest and periods used for compounding 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

12.12 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

12.13 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

12.14 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.

12.15 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

12.16 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

12.17 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.

12.18 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

12.19 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

12.20 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

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

12.22 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.

12.23 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.

12.24 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.

12.25 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.

12.26 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.

12.27 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.

12.28 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.

12.29 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

13.01 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

13.02 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

13.03 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

13.04 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

13.05 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

13.06 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

13.07 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.

13.08 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.

13.09 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

13.10 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

13.11 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

13.12 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

14.01 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)

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

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

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

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

14.06 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.

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

Chapter 15

Equity

15.01 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

15.02 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, *Consolidated Financial Statements.*)

15.03 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.

15.04 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.

15.05 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.[2] 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, *Restatement and Revision of Accounting Research Bulletins.*)

15.06 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

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

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[2] 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.

15.08 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.

15.09 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.

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

Auditing

15.11 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

16.01 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

16.02 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

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

16.04 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.

16.05 SAS No. 56, *Analytical Procedures*, provides guidance for consideration by the auditor for application of analytical procedures.

Chapter 17

Income Taxes *

17.01 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

17.02 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

17.03 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

17.04 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.

17.05 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

* [Note: FASB Statement No. 96, *Accounting for Income Taxes,* as amended, is effective for fiscal years beginning after December 15, 1991. It will supersede APB Opinion No. 11. This chapter will be revised in future editions.]

- 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

17.06 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.

17.07 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

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

17.09 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

17.10 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.

17.11 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.

17.12 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.

17.13 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*.

17.14 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

17.15 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

18.01 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.

18.02 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

18.03 Trusts can be broadly categorized as either personal or corporate.

Personal Trusts

18.04 *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.

18.05 *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.

18.06 *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.

18.07 *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.

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

18.09 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.

18.10 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.

18.11 *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.

18.12 *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.

18.13 *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

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

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

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

18.17 *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.

18.18 *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.

18.19 *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

18.20 Accounting systems within trust departments range from handposted 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

18.21 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.

18.22 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.

18.23 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.

18.24 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

18.25 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.

18.26 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, *Special-Purpose Reports on Internal Accounting Control at Service Organizations,* 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.

18.27 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.

18.28 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

18.29 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)

18.30 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 co-fiduciaries 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.

18.31 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

18.32 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

18.33 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.

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

18.35 *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

18.36 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.

18.37 *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.

18.38 *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.

18.39 Violations or improprieties in department activity detected by the CPA should be discussed with management and, if necessary, legal counsel. SAS No. 54, *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

18.40 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 Audit and Accounting Guide, *Audits of Investment Companies*, provide guidance for such valuations and the effect of such valuations on the CPA's report.

18.41 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.

18.42 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

19.01 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.

19.02 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.

19.03 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

19.04 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.

19.05 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.

19.06 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.

19.07 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.

19.08 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

19.09 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.

19.10 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.

19.11 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.

19.12 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.

19.13 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

19.14 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.

19.15 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.

19.16 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.

19.17 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.

19.18 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.

19.19 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.

19.20 The principles and guidelines set forth in APB Opinion No. 21, *Interest on Receivables and Payables,* 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

19.21 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

19.22 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.

19.23 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.

19.24 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.

19.25 A receipt or acknowledgment 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.

19.26 If a collection item is received from an out-of-town bank, an acknowledgment 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 acknowledgment 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.

19.27 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.

19.28 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.

19.29 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.

19.30 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

19.31 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.

19.32 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.

19.33 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.

19.34 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

19.35 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

19.36 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

19.37 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, *Accounting for Contingencies,* and (3) income and expenses of each activity are properly reported in conformity with generally accepted accounting principles.

Collections

19.38 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 acknowledgment 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.

19.39 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

19.40 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.

19.41 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

19.42 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

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

19.44 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, *Special-Purpose Reports on Internal Accounting Control at Service Organizations,* 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

19.45 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

20.01 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.

20.02 Accounting Research Bulletin (ARB) 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

20.03 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.

20.04 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

20.05 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.

20.06 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

20.07 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

20.08 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

20.09 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, *Financial Reporting for Segments of a Business Enterprise,* require separation of income and expenses between domestic and foreign operations.

Trusteed Affiliates

20.10 Banks have used trusteed 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 trusteed 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.

20.11 These are the general characteristics of trusteed affiliates:

- The stock of the trusteed 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 trusteed affiliate are endorsed as evidence of ownership of the trusteed affiliate (commonly referred to as endorsed shares).
- The holder of an endorsed share has a proportionate equity interest in the trusteed affiliate, whose shares are held in trust. Each holder's interest in the trusteed affiliate is in the same proportion as his ownership in the bank forming the trusteed 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.

20.12 In some instances, there may be a minority interest in the trusteed corporation; for example, when the trusteed 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.

20.13 The guidelines for consolidation of subsidiaries set forth in ARB No. 51, as amended, and FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries,* apply equally to trusteed affiliates. The limitations on consolidation described in paragraph 2 of ARB No. 51, as amended, and FASB Statement No. 94, Paragraph 4, footnote 1, should be applied in determining whether to consolidate or use the equity method. If the trusteed 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, see FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidi-*

aries, paragraph 10, for the exceptions for when consolidation is inappropriate, the trusteed affiliate should be accounted for by the equity method, following APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock.* If trusteed 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.

20.14 The Board of Governors of the Federal Reserve System and the Comptroller of the Currency require a trusteed affiliate to be consolidated if (1) the amount of the stockholders' equity in the trusteed 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.

20.15 If a separate report must be issued on financial statements of the parent or the trusteed affiliate for legal or other requirements (for example, debt agreements), the relationship of the trusteed 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 trusteed affiliate. In a separate report on the financial statements of the trusteed affiliate, the financial statement headings may refer to the parent—for example, XYZ Corporation (a trusteed 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

21.01 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.

21.02 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.

21.03 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.

21.04 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.

21.05 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.

21.06 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.

21.07 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.

21.08 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.

21.09 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."

21.10 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.

21.11 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.

21.12 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

21.13 Paragraph 6 of SAS No. 58, *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 cash flows. In annual reports to stockholders, bank holding companies generally prepare those basic financial statements on a consolidated basis in accordance with ARB No. 51, *Consolidated Financial Statements,* and FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries,* and include the consolidated results of operations and cash flows of the holding company and its subsidiaries.

21.14 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.

21.15 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.)

21.16 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 Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Federal Reserve System."

21.17 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.

21.18 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.

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

21.20 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

22.01 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.

22.02 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.

22.03 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

22.04 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

22.05 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.

22.06 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.

22.07 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.

22.08 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.

22.09 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

22.10 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.

22.11 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.

22.12 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.

22.13 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

22.14 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.

22.15 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.

22.16 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

22.17 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).

22.18 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.

22.19 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).

22.20 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 eflected on the books when they are settled, with entries made directly to the appropriate "due from foreign banks" account.

22.21 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.

22.22 FASB Statement No. 52, *Foreign Currency Translation,* 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

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

22.24 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.

22.25 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, *Accounting for Contingencies.*

Foreign Exchange

22.26 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.

22.27 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.

22.28 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

22.29 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

22.30 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

22.31 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

22.32 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.

22.33 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

22.34 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.

22.35 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

Introduction

The consolidated financial statements which follow have been designed to portray one example of compliance with the minimum disclosure requirements for a banking organization under generally accepted accounting principles. These consolidated financial statements are not intended to cover all possible disclosures that generally accepted accounting principles might require in regard to any specific banking organization or specific situation. Issuers of financial statements and practitioners should refer to the appropriate professional literature for guidance regarding disclosures required for specific transactions, balances, events and/or conditions.

Banking organizations whose securities are publicly traded will also be required to comply with the disclosure regulations of the banking and/or securities regulatory authorities to which they are subject. Such disclosure regulations often require that financial statements be presented for more periods and contain greater detail disclosure than is required by generally accepted accounting principles. Issuers of financial statements whose securities are publicly traded and practitioners should refer to the financial disclosure regulations of the appropriate securities regulatory authority (or authorities) to which the issuer is subject. Other financial statement issuers may also find such disclosure regulations to be of assistance when considering specific disclosures.

The example financial statements that follow have included disclosures required by accounting standards issued up to and including FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions.*

Independent Auditor's Report

The Board of Directors and Shareholders
Sample National Bank

We have audited the accompanying consolidated statements of condition of Sample National Bank and Subsidiary as of December 31, 19X2 and 19X1, and the related consolidated statements of income, changes in shareholders' equity, and cash flows for each of the years then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Sample National Bank and Subsidiary at December 31, 19X2 and 19X1, and the consolidated results of their operations and their cash flows for each of the years then ended, in conformity with generally accepted accounting principles.

[Auditor's Signature]

Anytown, Anystate
January XX, 19X3

Sample National Bank and Subsidiary
Consolidated Statements of Condition
December 31, 19X2 and 19X1

Assets	*19X2*	*19X1*
Cash and due from banks	$ 3,815,158	$ 2,496,836
Interest bearing deposits with banks	4,558,992	4,443,446
Federal funds sold	1,066,170	152,930
Trading account securities	30,374	30,118
Investment securities (market value of $8,360,340 in 19X2 and $6,626,990 in 19X1)	8,198,266	6,727,274
Loans	30,063,281	29,670,820
Less allowance for credit losses	(597,769)	(582,438)
Net loans	29,465,512	29,088,382
Properties and equipment	750,859	693,141
Customers' liability on acceptances	85,569	55,725
Accrued income and other assets	1,691,592	1,198,395
Total assets	$49,662,492	$44,886,247

Liabilities and Shareholders' Equity		
Liabilities		
Demand deposits	$ 9,073,765	$ 8,068,695
Savings and NOW deposits	8,266,877	8,416,705
Other time deposits	24,173,312	21,908,521
Total deposits	41,513,954	38,393,921
Federal funds purchased and securities sold under agreements to repurchase	2,846,105	1,946,451
Other borrowed funds	648,207	490,183
Acceptances outstanding	85,569	55,725
Accrued expenses and other liabilities	1,129,842	920,086
Long-term debt	330,740	343,461
Total liabilities	46,554,417	42,149,827
Shareholders' equity		
Common stock—$1 par value Authorized—1,000,000 shares; Outstanding—734,480 and 727,200 shares	734,480	727,200
Capital surplus	316,204	280,649
Retained earnings	2,061,771	1,733,284
Unrealized depreciation on equity securities	(4,380)	(4,713)
Total shareholders' equity	3,108,075	2,736,420
Total liabilities and shareholders' equity	$49,662,492	$44,886,247

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

Sample National Bank and Subsidiary
Consolidated Statements of Income
Years Ended December 31, 19X2 and 19X1

	19X2	*19X1*
Interest Income		
Interest and fees on loans	$3,303,613	$2,784,548
Interest on investment securities:		
Taxable	518,945	362,730
Exempt from Federal income tax	153,837	162,815
	672,782	525,545
Interest on trading account securities	4,641	15,819
Interest on federal funds sold	231,007	135,027
Interest on deposits with banks	367,380	336,644
Total interest income	4,579,423	3,797,583
Interest Expense		
Interest on deposits	2,500,222	1,912,015
Interest on federal funds purchased and securities sold under agreements to repurchase	351,175	324,356
Interest on other borrowed funds	39,434	30,567
Interest on long-term debt	32,873	30,012
Total interest expense	2,923,704	2,296,950
Net interest income	1,655,719	1,500,633
Provision for credit losses	(174,871)	(139,345)
Net interest income after provision for credit losses	1,480,848	1,361,288
Other Income		
Income from fiduciary activities	241,799	212,843
Service charges on deposit accounts	162,270	152,901
Other service charges and fees	145,371	118,958
Net trading account profits or losses	2,181	3,107
Net investment securities gains	2,938	806
Other income	168,512	173,323
	723,071	661,938
Other Expenses		
Salaries and employee benefits	877,535	806,995
Occupancy expense	146,741	138,385
Equipment expense	97,769	96,336
Other expense	438,785	407,779
	1,560,830	1,449,495
Income before income taxes	643,089	573,731
Income tax expense	125,538	109,367
Net income	$ 517,551	$ 464,364
Net income per share of common stock	$ 0.71	$ 0.64
Average shares outstanding	730,840	723,601

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

Sample National Bank and Subsidiary
Consolidated Statement of Changes in Shareholders' Equity
Years Ended December 31, 19X2 and 19X1

	Common Stock	*Capital Surplus*	*Retained Earnings*	*Unrealized Depreciation on Equity Securities*	*Total Shareholders' Equity*
Balance at December 31, 19X0	$ 720,002	$ 255,698	$ 1,423,202	$ (2,353)	$ 2,396,549
Net income for 19X1			464,364		464,364
Cash dividends paid—$0.170 per share			(122,133)		(122,133)
1% Stock dividend—7198 shares of common stock	7,198	24,951	(32,149)		
Net change in unrealized depreciation on equity securities				(2,360)	(2,360)
Balance at December 31, 19X1	727,200	280,649	1,733,284	(4,713)	2,736,420
Net income for 19X2			517,551		517,551
Cash dividends paid—$0.201 per share			(146,229)		(146,229)
1% Stock dividend—7280 shares of common stock	7,280	35,555	(42,835)		
Net change in unrealized depreciation on equity securities				333	333
Balance at December 31, 19X2	$ 734,480	$ 316,204	$ 2,061,771	$ (4,380)	$ 3,108,075

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

Sample National Bank and Subsidiary
Consolidated Statements of Cash Flows
Years Ended December 31, 19X2 and 19X1

	19X2	*19X1*
Cash flows from operating activities:		
Net income	$ 517,551	$ 464,364
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	87,633	82,857
Provision for credit losses	174,871	139,345
Deferred income taxes	(4,366)	(15,211)
Net investment securities gains	(2,938)	(806)
Net (increase) decrease in trading account securities	(256)	(23,321)
Increase in accrued income and other assets	(493,198)	(51,374)
Increase in accrued expenses and other liabilities	209,755	137,927
Other, Net	(97,732)	(74,848)
Total adjustments	(126,231)	194,569
Net cash provided by operating activities	391,320	658,933
Cash flows from investing activities:		
Net (increase) decrease in interest bearing deposits with banks	(115,542)	14,386
Net (increase) decrease in federal funds sold	(913,240)	1,039,487
Proceeds from sales of investment securities	261,752	308,528
Proceeds from maturities of investment securities	2,575,689	1,190,063
Purchases of investment securities	(4,681,518)	(3,905,005)
Net increase in loans	(73,549)	(639,842)
Purchases of properties and equipment	(145,351)	(144,010)
Net (increase) decrease in customers' liability on acceptances outstanding	(29,844)	25,820
Net cash used in investing activities	(3,121,603)	(2,110,573)
Cash flows from financing activities:		
Net increase in non-interest bearing demand, savings and NOW deposit accounts	855,242	92,482
Net increase in time deposits	2,264,792	3,326,016
Net increase (decrease) in borrowed funds	1,057,678	(2,686,223)
Net increase (decrease) in acceptances outstanding	29,844	(25,820)
Repayment of long-term debt	(12,722)	(16,465)
Dividends paid	(146,229)	(122,133)
Net cash provided by financing activities	4,048,605	567,857
Net increase (decrease) in cash and due from banks	1,318,322	(883,783)
Cash and due from banks at January 1	2,496,836	3,380,619
Cash and due from banks at December 31	$ 3,815,158	$ 2,496,836
Interest paid	$ 2,801,929	$ 2,159,024
Income taxes paid	$ 111,909	$ 32,506

The accompanying notes are an integral part of these Consolidated Financial Statements.

Sample National Bank and Subsidiary
Notes to Consolidated Financial Statements
Years Ended December 31, 19X2 and 19X1

Note A: Summary of Significant Accounting Policies

Consolidation. The consolidated financial statements of Sample National Bank (the Bank) include the accounts of the Bank and its wholly owned subsidiary which owns all of the Bank's premises. Significant intercompany transactions and amounts have been eliminated.

Investment Securities. Investment debt securities are those securities which the Bank has the ability and intent to hold to maturity. These securities are stated at cost adjusted for amortization of premium and accretion of discount, computed by the interest method. Generally, such securities are sold only to meet liquidity needs. Gains and losses on the sale of investment securities are computed on the basis of specific identification of the adjusted cost of each security. The investment marketable equity security is carried at the lower of cost or market value.

Trading Account Securities. Trading account securities are valued at estimated market value. Trading account gains and losses and fee income are included in other income.

Allowance for Credit Losses. The allowance is maintained at a level adequate to absorb probable losses. Management determines the adequacy of the allowance based upon reviews of individual credits, recent loss experience, current economic conditions, the risk characteristics of the various categories of loans and other pertinent factors. Credits deemed uncollectible are charged to the allowance. Provisions for credit losses and recoveries on loans previously charged off are added to the allowance.

Properties and Equipment. Properties and equipment are stated at cost, less accumulated depreciation. The provision for depreciation is computed principally by the straight-line method.

Interest Income on Loans. Interest on loans is accrued and credited to income based on the principal amount outstanding. The accrual of interest on loans is discontinued when, in the opinion of management, there is an indication that the borrower may be unable to meet payments as they become due. Upon such discontinuance, all unpaid accrued interest is reversed.

Loan Origination Fees and Costs. Loan origination fees and certain direct origination costs are capitalized and recognized as an adjustment of the yield on the related loan.

Pension Costs. Pension costs are charged to salaries and employee benefits expense and are funded as accrued.

Postretirement Benefits. Postretirement health care and life insurance benefits are charged to salaries and employee benefits expense when paid. In December, 1990, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions.* Under SFAS No. 106, beginning in 1993, postretirement benefits other than pensions must be accounted for in a manner similar to current standards for accounting for pensions. SFAS No. 106, will require that the accumulated postretirement benefit obligation be either charged in the income statement as a cumulative effect of a change in accounting in the period of adoption or delayed and amortized over future periods as part of future postretirement benefit costs. The Bank has not yet determined the impact on net income in the year of adoption. The amount paid for such benefits in 19X2 was $23,542.

Income Taxes. Provisions for income taxes are based on amounts reported in the statements of income (after exclusion of non-taxable income such as interest on state and municipal securities) and include deferred taxes on temporary differences in the recognition of income and expense for tax and financial statement purposes. Deferred taxes are computed on the liability method as prescribed in SFAS No. 96, *Accounting for Income Taxes.*

Net Income Per Share of Common Stock. Net income per share of common stock is computed by dividing net income by the weighted average number of shares of common stock outstanding during the period, after giving retroactive effect to stock dividends.

Trust Fees. Trust fees are recorded on the accrual basis.

Off Balance Sheet Financial Instruments. In the ordinary course of business the Bank has entered into off balance sheet financial instruments consisting of commitments to extend credit, commitments under credit card arrangements, commercial letters of credit and standby letters of credit. Such financial instruments are recorded in the financial statements when they become payable.

Cash and Cash Equivalents. For the purpose of presentation in the Statements of Cash Flows, cash and cash equivalents are defined as those amounts included in the balance sheet caption "Cash and Due from Banks."

Note B: Investment Securities

The carrying amounts of investment securities as shown in the consolidated balance sheets of the Bank and their approximate market values at December 31 were as follows:

	Carrying Amount	*Unrealized Gains*	*Unrealized Losses*	*Market Value*
December 31, 19X2:				
U.S. Government and agency securities	$5,584,802	$165,862	$ 43,834	$5,706,830
State and municipal securities	2,251,945	4,258	43,735	2,291,422
Other securities	361,519	569	0	362,088
	$8,198,266	$170,689	$ 87,569	$8,360,340
December 31, 19X1:				
U.S. Government and agency securities	$4,083,389	$ 14,586	$ 97,063	$4,000,912
State and municipal securities	2,279,983	14,775	33,194	2,261,564
Other securities	363,902	612	0	364,514
	$6,727,274	$ 29,973	$130,257	$6,626,990

Assets, principally securities, carried at approximately $5,466,000 at December 31, 19X2 and $2,895,000 at December 31, 19X1 were pledged to secure public deposits and for other purposes required or permitted by law. Included in other securities is one marketable equity security with an original cost of $98,560 and market values of $94,180 at December 31, 19X2 and $93,847 at December 31, 19X1.

Gross realized gains and gross realized losses on sales of securities were:

	19X2	19X1
Gross realized gains:		
U.S. Government and agency securities	$5,648	$2,230
State and municipal securities	1,813	1,261
Other securities	0	0

	19X2	19X1
Gross realized losses:		
U.S. Government and agency securities	$3,919	$1,399
State and municipal securities	604	1,286
Other securities	0	0

The maturities of investment securities at December 31, 19X2 were as follows:

	Carrying Amount	*Market Value*
Due in one year or less	$2,435,358	$2,519,666
Due from one to five years	2,291,509	2,438,578
Due from five to ten years	1,987,676	1,975,466
Due after ten years	1,389,543	1,332,450
Marketable equity security	94,180	94,180

Note C: Loans

The components of loans in the consolidated balance sheets were as follows:

	19X2	*19X1*
Commercial	$17,348,688	$17,552,801
Real estate construction	991,181	1,093,953
Commercial real estate	2,720,650	2,476,617
Residential real estate	3,975,595	3,820,523
Consumer	5,027,167	4,726,926
	$30,063,281	$29,670,820

Note D: Allowance for Credit Losses

An analysis of the change in the allowance for credit losses follows:

	19X2	*19X1*
Balance at January 1	$ 582,438	$ 542,232
Credits charged off	(190,618)	(126,324)
Recoveries	31,078	27,185
Net credits charged off	(159,540)	(99,139)
Provision for credit losses	174,871	139,345
Balance at December 31	$ 597,769	$ 582,438

Note E: Properties and Equipment

Components of properties and equipment included in the consolidated balance sheets at December 31, 19X2 and 19X1 were as follows:

	19X2	19X1
Cost:		
Land	$ 78,188	$ 72,895
Bank premises	520,817	503,179
Furniture and equipment	666,684	560,724
Leasehold improvements	125,046	115,301
Total cost	1,390,735	1,252,099
Less accumulated depreciation	(639,876)	(558,958)
Net book value	$ 750,859	$ 693,141

The Bank's main office building, which has a net book value of $186,981, is pledged to collateralize the 9.25% mortgage payable.

Certain Bank facilities and equipment are leased under various operating leases. Rental expense was $55,811 in 19X2 and $56,610 in 19X1. Future minimum rental commitments under noncancelable leases are:

19X3	$ 28,931
19X4	27,016
19X5	15,968
19X6	14,029
19X7	11,603
Thereafter	78,154
	$175,701

Note F: Short-Term Borrowings

Federal funds purchased and securities sold under agreements to repurchase generally mature within one to four days from the transaction date. Other borrowed funds consist of term federal funds purchased and treasury tax and loan deposits and generally mature within one to 120 days from the transaction date.

Note G: Long-Term Debt

Long-term debt consisted of the following at year-end:

	19X2	19X1
Floating rate notes due 19X6	$290,000	$290,000
9.25% mortgage	15,444	19,746
9% subordinated term loan 20X4	15,000	15,000
Total Bank	320,444	324,746
Notes of subsidiary	10,296	18,715
	$330,740	$343,461

In 19X9, the Bank issued $290,000 of floating rate notes due in 19X6 in a private placement with an insurance company. Interest is calculated semiannually at the rate of 3/4% over the six-month Eurodollar deposit rate (9 3/4% at December 31, 19X2). In September, 19X4, the notes may be redeemed without premium, in whole or in part at the option of the Bank. A portion of the notes qualifies as capital for bank regulatory purposes, which may limit the Bank's ability to repay the notes prior to maturity. At December 31, 19X2, $174,000 qualified as capital.

The 9.25% mortgage is payable in equal annual installments of $6,128 on December 15 each year through 19X5. The Bank may prepay between $2,400 and $6,128 annually without penalty and, in addition, may redeem the remaining notes at declining premiums (2.92% at December 31, 19X2).

The 9% subordinated term loan due May 31, 20X4, is from a non-affiliated bank and may not be repaid prior to June 30, 19X6.

The notes of the Bank's subsidiary represent amounts due to prior owners of certain of the Bank's premises. Such notes mature at various dates through 19X5. These notes are unsecured and have interest rates from 9.5% to 11%.

Except for the Floating rate notes due in 19X6, there are no significant amounts of long-term debt due in any one year.

Note H: Employee Benefits

The Bank has a defined contribution pension plan in effect for substantially all full-time employees. Salaries and employee benefits expense includes $26,493 in 19X2, and $24,053 in 19X1, for such plans. Contributions under the defined contribution plan are made at the discretion of the Board of Directors, but have amounted to 4% of gross salaries for the past five years.

Note I: Income Taxes

The consolidated provision for income taxes consisted of the following:

	19X2	*19X1*
Currently payable		
Federal	$119,392	$ 90,967
State	1,780	3,189
	121,172	94,156
Deferred Federal	4,366	15,211
	$125,538	$109,367

The provision for federal income taxes is less than that computed by applying the federal statutory rate of 34% in 19X2, and 19X1, as indicated in the following analysis:

	19X2	*19X1*
Tax based on statutory rate	$218,652	$195,071
Effect of tax-exempt income	(73,701)	(67,053)
Recognition of previously unrecognized tax benefits on loan loss provisions	(17,373)	(20,518)
Dividends received deduction	(3,049)	(2,769)
Interest and other nondeductible expenses	4,733	4,882
Other (net)	(3,724)	(246)
	$125,538	$109,367

The components of deferred income taxes were principally related to the allowance for credit losses, to depreciation, to loan origination fees and costs and to employee benefits.

Note J: Related Parties

The Bank has entered into transactions with its directors, significant shareholders and their affiliates (Related Parties). Such transactions were made in the ordinary course of business on substantially the same terms and conditions, including interest rates and collateral, as those prevailing at the same time for comparable transactions with other customers, and did not, in the opinion of management, involve more than normal credit risk or present other unfavorable features. The aggregate amount of loans to such related parties at December 31, 19X2, was $443,850. During 19X2, new loans to such related parties amounted to $127,400 and repayments amounted to $122,100.

Note K: Contingent Liabilities and Commitments

The Bank's consolidated financial statements do not reflect various commitments and contingent liabilities which arise in the normal course of business and which involve elements of credit risk, interest rate risk and liquidity risk. These commitments and contingent liabilities are commitments to extend credit, commercial letters of credit and standby letters of credit. A summary of the Bank's commitments and contingent liabilities at December 31, 19X2, is as follows:

	Notional Amount
Commitments to extend credit	$560,000
Credit card arrangements	12,000
Commercial letters of credit	25,000
Standby letters of credit	50,000

Commitments to extend credit, credit card arrangements, commercial letters of credit and standby letters of credit all include exposure to some credit loss in the event of nonperformance of the customer. The Bank's credit policies and procedures for credit commitments and financial guarantees are the same as those for extension of credit that are recorded on the consolidated statements of condition. Because these instruments have fixed maturity dates, and because many of them expire without being drawn upon, they do not generally present any significant liquidity risk to the Bank. The Bank's experience has been that approximately 60% of loan commitments are drawn upon by customers. While approximately 90% of commercial letters of credit are utilized, a significant portion of such utilization is on an immediate payment basis. The remainder are secured by the goods acquired by the customer with the letter of credit. The Bank has not been required to perform on any financial guarantees during the past two years. The Bank has not incurred any losses on its commitments in either 19X2 or 19X1.

The Bank and its subsidiaries are parties to litigation and claims arising in the normal course of business. Management, after consultation with legal counsel, believes that the liabilities, if any, arising from such litigation and claims will not be material to the consolidated financial position.

Note L: Concentrations of Credit

All of the Bank's loans, commitments, and commercial and standby letters of credit have been granted to customers in the Bank's market area. All such customers are depositors of the Bank. Investments in state and municipal securities also involve governmental entities within the Bank's market area. The concentrations of credit by type of loan are set forth in Note C. The distribution of commitments to extend credit approximates the distribution of loans outstanding. Commercial and standby letters of credit were granted primarily to commercial borrowers. The Bank, as a matter of policy, does not extend credit to any single borrower or group of related borrowers in excess of $500,000.

Note M: Regulatory Matters

The Bank, as a National Bank is subject to the dividend restrictions set forth by the Comptroller of the Currency. Under such restrictions, the Bank may not, without the prior approval of the Comptroller of the Currency, declare dividends in excess of the sum of the current year's earnings (as defined) plus the retained earnings (as defined) from the prior two years. The dividends, as of December 31, 19X2, that the Bank could declare, without the approval of the Comptroller of the Currency, amounted to approximately $635,000. The Bank is also required to maintain minimum amounts of capital to total "risk weighted" assets, as defined by the banking regulators. At December 31, 19X2, the Bank is required to have minimum Tier 1 and Total capital ratios of 4.00% and 8.00%, respectively. The Bank's actual ratios at that date were 7.85% and 9.20%, respectively. The Bank's leverage ratio at December 31, 19X2, was 7.00%.

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 audited the accompanying 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 for the year then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets of Common Trust Fund A of Commercial Bank as of [at] December 31, 19X2, and the results of its operations and the changes in its net assets for the year then ended in conformity with generally accepted accounting principles.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplementary information on pages X through XX is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

City, State
Date

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

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

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

* 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

Number of Shares or Principal Amount	*Bonds*—22.32%	Cost*	Fair Value
$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	1,680,000	1,700,000
	Convertible preferred stocks—3.94%		
4,000	XYZ Corporation, $6.00, Series B	320,000	300,000
	Common stocks—73.74%		
	Banks and finance—27.67%		
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
		2,041,200	2,107,300
	Insurance — 15.89%		
5,000	U.S. Casualty Corporation	1,318,700	1,209,800
	Office equipment—15.00%		
2,000	Universal Business Machines, Inc.	505,500	493,500
3,000	U.S. Business Corporation	878,400	648,800
		1,383,900	1,142,300
	Public utilities — 15.18%		
6,000	General Gas Company	1,216,200	1,155,700
	Total common stocks	5,960,000	5,615,100
	Total investments	$7,960,000	$7,615,100

Percentages shown are based on value.

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

* 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	26,300	
Total investment income		$ 126,000
Audit and miscellaneous expenses *		(16,600)
Net investment income		$ 109,400
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 **	3,308,700	
Net realized gains (losses)		$ (330,200)
Unrealized appreciation (depreciation) of investments		
Beginning of year	$1,037,500	
End of year	(344,900)	
Unrealized depreciation during the year		(1,382,400)
Net realized and unrealized gains (losses) on investments		$(1,712,600)

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	(1,382,400)
Increase (decrease) in net assets derived from investment activities	(1,712,600)
From unit transactions	
Net proceeds from issue of units (131,500 units)	1,493,700
Cost of units redeemed (20,000 units)	(228,600)
Increase in net assets derived from unit transactions	1,265,100
Net increase (decrease) in net assets	(447,500)
Net assets	
Beginning of year	7,871,100
End of year	$7,423,600

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.)

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

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

Number of Shares or Principal Amount		*Cost*
	Bonds	
	U.S. government agencies	
$1,000,000	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	3,668,100
	Convertible preferred stocks	
4,000	XYZ Corporation, $6.00, Series B	320,000
	Common stocks	
	Insurance	
4,000	U.S. Casualty Corporation	1,005,000
	Office equipment	
750	Universal Business Machines, Inc.	288,200
1,000	U.S. Business Corporation	295,000
	Public utilities	
3,000	General Gas Company	700,800
	Total common stocks	2,289,000
	Total purchases	$6,277,100

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

Number of Shares or Principal Amount	*Bonds*	*Cost*	*Proceeds*	*Gain (Loss)*
	U.S. government agencies			
$1,000,000	Federal Intermediate Credit Banks Consolidated Collateral Trust, 5.65%, due 8/1/X5	$ 998,400	$1,000,000	$ 1,600
$1,000,000	Twelve Federal Intermediate Credit Banks Consolidated Bond, 6.15%, due 12/3/X5	989,700	999,600	9,900
	Total bonds	1,988,100	1,999,600	11,500
	Convertible preferred stocks			
3,000	International Television Corporation, $4.50, Series 1	320,300	199,600	(120,700)
	Common stocks			
	Banks and finance			
6,000	American Bank Corp.	566,900	504,100	(62,800)
	Public utilities			
6,000	Southern U.S. Electric Company	433,400	275,200	(158,200)
	Total common stocks	1,000,300	779,300	(221,000)
	Total sales or redemptions	$3,308,700	$2,978,500	$(330,200)

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. Exhibits 1 and 2 have been integrated in this appendix from SOP 90-6, *Directors' Examinations of Banks.*

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 director's examination and the standards of the accounting profession.

In some instances, the scope of the independent auditor's services may not be clear when the auditor is engaged to conduct a directors' examination. Contributing reasons for this lack of understanding include the following:

- The majority of directors' examinations are performed for community banks with bank directors and officers who may have a limited knowledge of the differences between an audit in accordance with GAAS and a directors' examination.
- Engagements may actually be initiated by management acting for the board of directors, and the agreed-upon procedures defined without the directors' input. Therefore, the board of directors may not be aware of the existence of the engagement letter.
- Generally, directors' examination reports do not incorporate the financial statements of the bank.
- Although certain states specify minimum scope requirements for directors' examinations, the requirements of other states are undefined.
- Examinations of banks are conducted regularly by bank regulatory authorities who are principally concerned with the soundness of the loan and investment portfolios. As a result of the regulatory emphasis of loans and investments, the procedures agreed upon by boards of directors and independent auditors may exclude testing of loans and the evaluation of the reasonableness of the allowance for credit losses that has been determined by management, or they may provide for limited procedures [for example, reviewing the adequacy of loan documentation but not the collectibility of loans].

[Paragraph added by Statement of Position 90-6, *Directors' Examinations of Banks.*]

The scope of an independent auditor's services regarding a directors' examination, especially as it relates to areas of higher risk, is also subject to misinterpretation by others, including regulatory authorities. This is of particular concern because regulators increasingly rely on the results of directors' examinations or audits of the bank's financial statements in accordance with GAAS to determine the frequency and scope of their examinations.

[Paragraph added by Statement of Position 90-6, *Directors' Examinations of Banks.*]

The principal modifications made by Statement of Position 90-6 include—

a. Incorporation of a statement in the illustrative engagement letter and illustrative report that identifies the omission of certain procedures relating to accounts with higher risk [for example, reviewing the collectibility of loans, the adequacy of collateral thereon, or the reasonableness of the allowance for credit losses] that are normally performed during an audit of the financial statements in accordance with GAAS.

b. Expansion of the accounts identified in the supplement to the engagement letter to include those accounts with higher risk, such as loans and the allowance for credit losses.

c. Substitution of a description of the procedures relating to "Loans" for the procedures relating to "Cash and Due From Banks."

[Paragraph added by Statement of Position 90-6, *Directors' Examinations of Banks.*]

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 audit 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 performing audits 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.[1] 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. 58 gives guidance on reports on audited financial statements, and paragraph 42 of the SAS states that "When restrictions that significantly limit the scope of the audit are imposed by the client, ordinarily the auditor should disclaim an opinion on the financial statements."

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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.

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 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 performed an audit 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 other 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.

Exhibit 1

Illustrative Engagement Letter

Services Other Than Financial Statement Audits

[*Date*]

Audit Committee

XYZ Bank

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.

The procedures to be performed are summarized in the supplement to this letter. Because those procedures will not constitute an audit 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. The scope of this examination as outlined in the supplement does not include an evaluation of all areas which generally are of higher risk in the banking industry, such as securities held or the collectibility of loans, the adequacy of collateral thereon, or the reasonableness of the allowance for credit losses.

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 accounting records and for preparation of financial statements in conformity with generally accepted accounting principles.

Certain of the procedures described in the supplement to this letter will be applied on a surprise basis during the year after we consult with the appropriate supervisory agencies to ensure that the date selected will not conflict with their examinations.[1]

Our report will include a summary of the accounts and elements subject to our examination and the procedures performed.[2]

This report will be issued solely for the information of the bank's board of directors and 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 audit 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.

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[1] Some directors' examinations may not be conducted on a surprise basis or include consultation with supervisory agencies.

[2] In certain instances, the independent auditor 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, the auditor should satisfy the requirements of paragraph 2 in SAS No. 35, *Special Reports—Applying Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement* by applying alternate procedures in order that the parties involved be made aware of the procedures applied before the report is issued.

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. 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.

Sincerely yours,

____

[*Signature of independent auditor*]

Acknowledged:

____

[*Name of bank*]

____

[*Signature of bank director*][3, 4]

____

[*Date*]

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[3] Preferably, the chairman of the bank's audit committee or an outside director should acknowledge the procedures to be performed.

[4] The independent auditor should consider reviewing the engagement letter with the board [or with its committee] in order to allow the directors' participation in defining the scope of the examination.

Supplement to Illustrative Engagement Letter

Procedures to Be Performed in Connection With a Director's 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 reports of examination by, and correspondence with, supervisory agencies.[5]
   c. Review minutes of meetings of the board of directors and of committees reporting to the board.
   d. Review entries to selected general ledger accounts in excess of $______.
   e. Review accounting procedures for handling nonledger assets, such as loan charge-offs and recoveries, loan commitments, loans, "participated" to and services for others, standby letters of credit, collection items, travelers' checks, and U.S. savings bonds.
   f. Obtain letters concerning litigation, claims, and assessments from legal counsel.
   g. Obtain a management representation letter.

Procedures to be performed with respect to individual accounts or elements should be listed in detail, including number and types of confirmations, extent of tests of revenue and expense, and types of sampling methods to be used. Individual accounts and elements to which other procedures are applied generally include:

1. Cash, cash items, and clearings and exchanges
2. Due from banks
3. Securities
4. Federal funds sold [*purchased*]
5. Loans and leases
6. Real estate owned

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[5] Independent auditors should refer to the policies of regulatory agencies on the use of supervisory information.

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 performed. The illustrative procedures listed may or may not be relevant to a particular engagement. The independent auditor should describe those accounts examined and procedures relevant to the specific engagement.

Exhibit 2

Illustrative Report Services
(in Connection With Directors' Examinations)

Audit Committee

XYZ Bank

We have applied certain agreed-upon procedures, as discussed in the attached supplement, to selected accounting records and transactions of the [*name of bank*] as of [*examination date*]. These procedures were performed in accordance with the arrangements set forth in our letter to you dated [*date*].

The procedures we performed, the accounts we examined, and the findings we obtained are summarized in the attached supplement, which is an integral part of this report. Because our procedures do not constitute an audit made in accordance with generally accepted auditing standards, we do not express an opinion on any of the accounts or items referred to in the supplement.

In connection with the procedures referred to in the attached supplement, no [*the following*] matters came to our attention that caused us to believe that the specified [*the following*] account[*s*] should be adjusted. Had we performed additional procedures or had we conducted an audit of the financial statements in accordance with generally accepted auditing standards, matters might have come to our attention that would have been reported to you. The scope of the engagement also does not include an evaluation of areas which generally are of higher risk to the bank, such as an evaluation of securities held or of the collectibility of loans, the adequacy of collateral thereon, or the reasonableness of the allowance for credit losses.

This report relates only to the accounts and items specified in the attached supplement and does not extend to any financial statements of [*name of bank*] taken as a whole.

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.

[*Signature of independent auditor*]

[*City, State*]
[*Date*]

Supplement to Illustrative Report

Loans

We obtained trial balances or subsidiary ledgers of the notes or both from the service center and reconciled the totals to the general ledger in the following amounts:

Account	*Amount Outstanding at May 12, 19X0*
Commercial loans	$
Consumer loans	
Real estate loans	
Participation purchased	
	$

Certain [*specify number*] loans, including lines of credit that had not been fully funded, were selected for confirmation directly with borrowers. The results of our confirmation efforts are summarized in Schedule A. Borrowers with lines of credit of $_____ or more as of May 12, 19X0, who did not respond to confirmation requests by June 13, 19X0, are listed in Schedule B.

We examined selected loans and loan agreements on hand. Also, readily marketable securities and other collateral recorded as held in respect of certain selected secured loans were inspected.

We obtained the Bank's listing of commercial loans, real estate loans, and participations purchased five days or more past due as of May 12, 19X0, and compared it to a similar listing as of June 13, 19X0. The following loans were listed in both reports:

[*List loans.*]

Similarly, we obtained the Bank's listing of consumer loans ten days or more past due as of May 12, 19X0, and compared it to a like listing as of June 13, 19X0. The following loans were listed in both reports:

Name	*Due Date*	*Amount Outstanding at May 12, 19X0*	*Amount Outstanding at June 13, 19X0*

Loan participants "sold" and serviced by the Bank were confirmed with the purchasers, without exception.

We obtained the Bank's listing of overdrafts as of May 12, 19X0, and compared it to a similar listing as of June 13, 19X0. The following overdrafts were listed in both reports:

Name	*Date of Overdraft*	*Amount at May 12, 19X0*	*Amount at June 13, 19X0*

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 performed. The illustrative procedures listed may or may not be relevant to a particular engagement. The independent auditor should describe those accounts examined and procedures relevant to the specific engagement. The accounts and procedures described in the report should generally conform to those described in the engagement letter.

The interest rates and repayment terms of five judgmentally selected loans granted to directors, officers, and other related parties during April 19X0 were compared to the interest rates and repayment terms of similar loans granted to outsiders during the same month. No instances of favorable interest rates or repayment terms being granted to directors, officers, and other related parties were found.

The maturity date and amount of standby letters of credit and loan commitments in excess of $50,000 were confirmed as of April 19X0 by the customers for whose benefit they were issued, without exception. We judgmentally selected five standby letters of credit and five loan commitments, and tested the computation of deferred fee income with satisfactory results.

Requests for confirmation of loan balances could not be mailed to the following borrowers due to lack of sufficient addresses:

Name	*Account Number*	*Balance as of May 12, 19X0*

Lack of Evaluation Collectibility and Adequacy of Collateral

As noted in our engagement letter and report, we did not evaluate the collectibility of loans or the adequacy of collateral thereon.

Lack of Evaluation of the Allowance for Credit Losses

As noted in our engagement letter and report, we did not evaluate the reasonableness of the allowance for credit losses determined by management.

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 listed may or may not be relevant to a particular engagement. The independent auditor should describe those accounts examined and procedures relevant to the specific engagement. Procedures for other accounts should be specified in detail, and differences and subsequent disposition should be reported.

Confirmation Statistics [6]

[Examination Date]

	Loans [7]	*Checking Accounts*	*Savings Accounts*	*Certificates of Deposit*
Dollar amounts				
Total				
Circularized				
Percent circularized to total				
Replies received to total circularized				
Selected but not circularized				
Not delivered by post office				
Number of accounts				
Total				
Circularized				
Percent circularized to total				
Replies received				
Percent replies received to total circularized				
Selected but not circularized				
Not delivered by post office				

Confirmation Requests Not Mailed

	Name and Address	*Reason for Not Mailing*	*Balance as of [Examination Date]*
Loans:			
Checking accounts:			
Savings accounts:			
Certificates of deposit:			

[6] An indication of how the samples were selected—i.e., on a random, statistical, or judgmental basis—as well as an indication of the type of confirmation—i.e., positive or negative requests—should be included.

[7] If the loans are categorized by type in the report, similar categories would normally be used in this schedule.

Appendix D

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, Any City, 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)* for

(We were indebted to you)*

(You held for our account)*

(We held for your account)*

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)* for

(We were indebted to you)*

(You held for our account)*

(We held for your account)*

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.

Appendix E

Statement of Position 83-1

Reporting by Banks Of Investment Securities Gains or Losses

December 31, 1983

Amendment to
AICPA Industry Audit Guide
Audits of Banks

Issued by
Accounting Standards Division
American Institute of
Certified Public Accountants

AICPA

NOTE

This statement of position significantly amends the recommendations on accounting principles in the AICPA Industry Audit Guide, *Audits of Banks* (1983), for bank income statements for periods ending on or after December 31, 1983.

Statements of position of the accounting standards division present the conclusions of at least a majority of the accounting standards executive committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statements of position do not establish standards enforceable under rule 203 of the Institute's Code of Professional Ethics. However, Statement on Auditing Standards 5, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report,* as amended by Statement on Auditing Standards 43, *Omnibus Statement on Auditing Standards,* and Statement on Auditing Standards No. 52, *Omnibus Statement on Auditing Standards—1987,* identifies AICPA statements of position as another source of established accounting principles the auditor should consider. Accordingly, members should be prepared to justify departures from the recommendations in this statement of position.

Reporting by Banks Of Investment Securities Gains or Losses

Background

1. The format of banks' income statements has been periodically reviewed, discussed, and revised by bank regulators, the Securities and Exchange Commission, and the accounting profession during the last sixteen years. Although general agreement has evolved on most issues, the method of reporting realized investment securities gains or losses remains controversial.

2. The issue was first addressed by the AICPA Committee on Bank Accounting and Auditing in the 1968 audit guide, *Audits of Banks*, which was amended by a supplement in December 1969. The amended guide recommended the following:

- Securities gains or losses less related income tax effects should be reported below "income before securities gains (losses)"; such gains or losses are to be included in the determination of net income.
- Earnings per share may be reported for income before securities gains or losses as well as for net income.

Since 1969, this two-step format has been followed for both regulatory and stockholder reporting purposes.

3. In April 1977 the SEC proposed, in a revision of Article 9 of Regulation S-X, that the two-step format be eliminated. The AICPA Banking Committee responded positively to this SEC proposal in a letter dated July 1, 1977. However, as a result of a significant number of negative responses from the banking industry, the SEC decided not to adopt the proposal at that time.

4. For the past several years the AICPA Banking Committee has been preparing a revised *Audits of Banks*. This revised audit guide, issued in February 1983, includes an illustrative income statement using the two-step format for reporting investment securities gains or losses.

5. In a July 1982 revision of Article 9 of Regulation S-X, the SEC again proposed the elimination of the two-step format. On October 13, 1982, the AICPA Banking Committee responded to the proposal, stating in part:

> Although there are substantive arguments for including securities gains or losses as another item of income and not in a separate section of a two-step income statement, we believe this issue should be resolved by the FASB. . . . To assist the FASB in this process, the committee established a special task force to draft a statement of position addressing this issue. . . .

On March 7, 1983, the SEC adopted final rules amending Article 9 of Regulation S-X requiring the use of the one-step format for all bank holding company filings effective for fiscal years ending on or after December 31, 1983, with earlier application permitted.

Rationale for the Two-Step Format

6. The impetus for the two-step format can be traced back to the income tax law in effect before July 12, 1969. This law provided that if securities transactions in a particular year resulted in a net gain, the gain would be taxed at capital gain rates; a net securities loss would be deductible from ordinary income. Accordingly, banks attempted to realize their gains in "net bond gain years" and their losses in "net bond loss years." Banks argued that including such gains and losses in "operating" earnings would cause reported

earnings to fluctuate in an arbitrary, tax-driven manner. The income tax law was amended effective July 12, 1969, resulting in the inclusion of both gains and losses in ordinary income, thus eliminating the potential for such fluctuations.

7. Proponents of the two-step format argue that including investment gains and losses in operating earnings provides an opportunity to manage earnings, because the securities sold and the timing of the sales are at the discretion of management. Proponents also fear that banks may be reluctant to absorb losses as a charge against current earnings, although reinvestment of the proceeds at higher yields is in their long-term economic interest.

8. In connection with the second concern, some proponents believe that changing the reporting format may affect the way funds are invested. For example, bankers might be reluctant to invest in securities with fixed rates of return for extended time periods. Irreparable damage might be done to the market for long-term state and municipal obligations if banks shift funds to shorter term U.S. Treasury bills and other U.S. government obligations.

9. It is also argued that since the gain or loss generally represents an adjustment of the yield to maturity of the related security, it should be spread over some future period rather than be charged or credited entirely to the current period. This view supports deferral and amortization, which are not acceptable under generally accepted accounting principles. As an alternative, the two-step income statement is considered a more meaningful presentation of short-term operating results (income before securities gains or losses) and longer term results (net income) than the one-step format.

10. Finally, it is argued that there is no compelling reason to change because the current format has been in use for many years and is well understood by readers of bank financial statements.

Rationale for the One-Step Format

11. Although investment securities are generally purchased as long-term investments, they may be sold for tax planning, liquidity, or portfolio restructuring purposes. Accordingly, proponents of the one-step format believe that securities gains or losses should be included in operating earnings because they are an integral part of a bank's operations. Proponents also note that the current two-step format presents securities gains or losses in effect as extraordinary items; such gains or losses generally do not meet the extraordinary item classification criteria in Accounting Principles Board Opinion No. 30, *Reporting the Results of Operations.*

12. Banks report income before securities gains or losses and net income with equal prominence in their income statements. However, the thrust of other reporting—press releases, the chairman's letter to stockholders, management's discussion and analysis of earnings included in financial reports, and newspaper articles—generally emphasizes income before securities gains or losses. As a result, there is concern that banks presently are in a position to manage earnings by realizing losses, reporting them "below the line," and investing the proceeds at higher yields, thereby reporting improved future earnings "above the line."

13. Proponents of the one-step format point out that other nonrecurring gains or losses from the sale of bank assets are included in operating earnings. In recent years these assets have included equity securities and real estate acquired in satisfaction of loans, main office and branch bank buildings, the residual value of leased assets, and portions of the loan portfolio. The timing of the transactions is somewhat discretionary, similar to that of investment

securities transactions. Accordingly, there appears to be little justification for classifying and reporting investment securities transactions separately.

14. Proponents of the one-step format discount the concern that irreparable damage will be done to the market for long-term state and municipal obligations. They contend that investment decisions are more likely to be based on economic concerns than on accounting results. For example, they believe that the current period of volatile high interest rates has already adversely affected the market for all long-term fixed-rate securities.

15. Finally, proponents of the one-step format point out that most other types of business enterprises use the one-step approach in reporting their operating results, and they see no continuing theoretical reason to make an exception for banks.

Recommendations of the Banking Committee

16. The AICPA Banking Committee recommends the following:

- Net investment securities gains or losses should be presented on a separate line, on a pretax basis, in the "other income" section of a bank's income statement. If not material, they may be included in "other income."
- Prior periods' interim and annual financial statements should conform with the one-step format.[1]

Rationale for the Recommendations

17. The committee acknowledges arguments supporting both the two-step and the one-step formats. However, the committee concludes the following:

- Investment securities transactions are an integral part of a bank's operations.
- Potential presently exists for realizing losses and reporting them below the line in order to report improved future earnings above the line.
- Nonrecurring gains or losses on the sale of other bank assets are currently reported above the line.
- Some of the original reasons for reporting securities gains or losses below the line are no longer valid. There is little remaining justification for continuing to make an exception for banks in reporting earnings using the two-step income statement format.

Effective Date and Transition

18. The committee recommends that the provisions of this statement of position should apply to bank income statements issued for periods ending on or after December 31, 1983. Comparative income statements of prior periods should conform with the provisions of this statement of position.

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[1] As reported in the June 27, 1983, issue of the *CPA Letter,* the AICPA Auditing Standards Division has considered the provisions of this statement and concluded that this change would not affect consistency in the application of generally accepted accounting principles because it has no effect on financial position or net income. Accordingly, the auditor need not modify his opinion regarding consistency of application of accounting principles as a result of this change, assuming disclosure and retroactive application of the change.

Appendix F

Statement of Position 90-3

Definition of the Term *Substantially the Same* for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position

February 13, 1990

Amendment to AICPA Industry Audit Guide *Audits of Banks* and AICPA Audit and Accounting Guide *Audits of Brokers and Dealers in Securities*

Issued by
Accounting Standards Division

American Institute of
Certified Public Accountants

AICPA

NOTE

Statements of position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statements of position do not establish standards enforceable under Rule 203 of the AICPA Code of Professional Conduct. However, paragraph 7 of Statement on Auditing Standards (SAS) 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*, and SAS No. 52, *Omnibus Statement on Auditing Standards*—1987, includes AICPA statements of position among the sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203. If an established accounting principle from one or more of these sources is relevant to the circumstances, the AICPA member should be prepared to justify a conclusion that another treatment is generally accepted.

SUMMARY

This statement of position provides guidance for determining whether two debt instruments are substantially the same for the purpose of determining whether a transaction involving a sale and purchase or an exchange of debt instruments should be accounted for as a sale or as a financing. This statement of position establishes six criteria, all of which must be met for two debt instruments to be considered substantially the same. It amends AICPA Industry Audit Guide *Audits of Banks* and Audit and Accounting Guide *Audits of Brokers and Dealers in Securities.* This statement of position applies to transactions entered into after March 31, 1990.

Definition of the Term *Substantially the Same* for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position

Scope

1. This statement of position provides guidance for determining whether two debt instruments are *substantially the same*. The recommendations herein are limited to transactions involving a sale and purchase or exchange of debt instruments between entities who hold the debt instruments as an asset. The term *debt instruments* is used in this statement of position to include instruments usually considered to be securities such as notes, bonds, and debentures, as well as other evidence of indebtedness such as money market instruments, certificates of deposit, mortgage loans, commercial loans, and commercial paper, that often are not referred to as securities. Debt instruments also include evidence of indebtedness that represents aggregations of debt instruments, such as mortgage-backed certificates.

2. The conclusions in this statement of position are not intended to modify, in any way, Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*. Paragraph 42 of SFAS No. 15 discusses certain situations in which troubled debt restructurings may involve substituting debt of other business enterprises, individuals, or governmental units for that of the troubled debtors. The accounting principles in paragraph 42 of SFAS No. 15 are not affected by this statement of position. Also, this statement of position is not intended to apply to situations in which financial institutions originate or buy whole loan mortgages and exchange those loans for a participation certificate issued by government-sponsored enterprises or agencies (FHLMC, FNMA, or GNMA) representing direct ownership of the same mortgages. However, the statement of position does apply to exchanges of participation certificates.

3. The recommendations in this statement of position amend AICPA Industry Audit Guide *Audits of Banks* (Bank Audit Guide) and Audit and Accounting Guide *Audits of Brokers and Dealers in Securities* (Broker-Dealer Guide).

Background

4. The preface of the Bank Audit Guide states that certain issues affecting the banking industry are not included in the guide or are under study by the AICPA or the FASB. One of those issues relates to the definition of the term *substantially the same* as used in the guide.

5. In paragraphs 5.20 through 5.21 of the Bank Audit Guide, the term *substantially the same* is used in describing wash sales as follows:

> 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. [*Emphasis added.*]

6. The terms *substantially the same, substantially similar,* and *substantially identical* are also used to describe a factor that is considered in determining whether a sale of a debt instrument under an agreement to repurchase should be accounted for as a sale and a purchase or as a financing transaction. Dollar repurchase—dollar reverse repurchase agreements involve similar but not identical securities. The terms of the agreements often provide data to determine whether the securities are similar enough to make the transaction in substance a borrowing and lending of funds or whether the securities are so dissimilar that the transaction is a sale and purchase of securities.

7. A dollar repurchase—dollar reverse repurchase agreement is an agreement (contract) to sell and repurchase or to purchase and sell back securities of the same issuer but not the original securities. Fixed coupon and yield maintenance dollar agreements comprise the most common agreement variations. In a fixed coupon agreement, the seller and buyer agree that delivery will be made with securities having the same stated interest rate as the interest rate stated on the securities sold. In a yield maintenance agreement, the parties agree that delivery will be made with securities that will provide the seller a yield that is specified in the agreement.

[8.] [Paragraph deleted, August 1991, by the Audit and Accounting Guide *Audits of Savings Institutions.*]

9. The term *substantially identical* is also used by brokers and dealers in discussing repurchase transactions. The AICPA Audit and Accounting Guide, *Audits of Brokers and Dealers in Securities* states the following in paragraph 1.40:

A repurchase transaction, commonly known as a repo transaction, is a sale of security coupled with an agreement by the seller to repurchase the same or substantially identical security at a stated price. . . . A reverse repurchase agreement, known as a reverse repo, is the purchase of a security at a specified price with an agreement to resell the same or *substantially identical* security at a definite price at a specific future date. [*Emphasis added.*]

The Broker/Dealer Guide does not provide any guidance for determining whether the securities are *substantially identical.*

10. Because of the lack of an authoritative definition of *substantially the same,* alternative accounting practices have developed or may develop for the exchange of *substantially the same* assets.

Current Accounting Practices

11. The issue of whether two debt instruments are *substantially the same* is generally encountered in connection with determining whether a transaction involving debt instruments results in a sale or a financing, for example, the sale of a debt instrument under an agreement to repurchase another debt instrument. If the debt instrument to be repurchased is *substantially the same* as a debt instrument sold, it may be viewed as a financing transaction. However, if the debt instrument to be repurchased is viewed as not being *substantially the same,* that transaction is generally recorded as a sale with a commitment to buy another debt instrument.

12. Two debt instruments can differ in a variety of ways, such as the obligor, maturity, interest rate, and yield. If two debt instruments are exchanged and many of the characteristics of the instruments differ, for example, exchange of a U.S. Treasury bill for a mortgage-backed security, virtually all would agree that a transaction has taken place that requires accounting recognition as a sale, not a financing. In contrast, if two debt instruments are exchanged and most of the characteristics of the instruments are the same, many would view the exchange as involving *substantially the same* securities prohibiting accounting recognition, for example, the exchange of two GNMA securities bearing the identical contractual interest rate that are collateralized by similar pools of mortgages resulting in approximately the same yield. Thus, the issue to resolve is how similar the characteristics of two debt instruments have to be viewed as *substantially the same.*

Conclusions

13. To minimize diversity in practice, the AICPA Banking Committee, Savings and Loan Associations Committee, and Stockbrokerage and Investment Banking Committee believe the definition of *substantially the same* should be narrow. Therefore, the committees have concluded that for debt instruments, including mortgage-backed securities, to be *substantially the same, all* the following criteria must be met:

a. The debt instruments must have the same primary obligor, except for debt instruments guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and terms of the guarantee must be the same.[1]

b. The debt instruments must be identical in form and type so as to give the same risks and rights to the holder.[2]

c. The debt instruments must bear the identical contractual interest rate.

d. The debt instruments must have the same maturity except for mortgage-backed pass-through and pay-through securities for which the mortgages collateralizing the securities must have similar

[1] The exchange of pools of single-family loans would not meet this criterion because the mortgages comprising the pool do not have the same primary obligor, and would therefore not be considered *substantially the same.*

[2] For example, the following exchanges would not meet this criterion: GNMA I securities for GNMA II securities; loans to foreign debtors that are otherwise the same except for different U.S. foreign tax credit benefits (because such differences in the tax receipts associated with the loans result in instruments that vary "in form and type"); commercial paper for redeemable preferred stock.

remaining weighted average maturities (WAMs) that result in approximately the same market yield.[3]

e. Mortgage-backed pass-through and pay-through securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages.

f. The debt instruments must have the same aggregate unpaid principal amounts, except for mortgage-backed pass-through and pay-through securities, where the aggregate principal amounts of the mortgage-backed securities given up and the mortgage-backed securities reacquired must be within the accepted "good delivery" standard for the type of mortgage-backed security involved.[4]

Effective Date and Transition

14. The conclusions of this statement of position should be applied prospectively to transactions entered into after March 31, 1990. Earlier application to transactions occurring in periods for which financial statements have not been issued is encouraged. However, previously issued annual or interim financial statements should not be restated.

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[3] For example, the exchange of a "fast-pay" GNMA certificate (that is, a certificate with underlying mortgage loans that have a high prepayment record) for a "slow-pay" GNMA certificate would not meet this criterion because differences in the expected remaining lives of the certificates result in different market yields.

[4] Participants in the mortgage-backed securities market have established parameters for what is considered acceptable delivery. These specific standards are defined by the Public Securities Association (PSA) and can be found in *Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities,* which is published by PSA.

Appendix G

Statement of Position 90-11

Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets

November 30, 1990

Amendment to
AICPA Audit and Accounting Guides
Audits of Banks,
Audits of Credit Unions,
Audits of Finance Companies (Including Independent and Captive Financing Activities of Other Companies),
Audits of Property and Liability Insurance Companies, and
Audits of Stock Life Insurance Companies

Issued by the
Accounting Standards Executive Committee

American Institute of
Certified Public Accountants

AICPA

NOTE

Statements of position of the Accounting Standards Division present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statements of position do not establish standards enforceable under Rule 203 of the AICPA Code of Professional Conduct. However, paragraph 7 of Statement on Auditing Standards (SAS) 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,* and SAS No. 52, *Omnibus Statement on Auditing Standards—1987,* includes AICPA statements of position among the sources of established accounting principles that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203. If an established accounting principle from one or more of these sources is relevant to the circumstances, the AICPA member should be prepared to jusitfy a conclusion that another treatment is generally accepted.

Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets

Scope

1. This statement of position provides guidance for disclosure by financial institutions of certain information about debt securities held as assets. It applies to financial institutions whose policy is to carry such securities either at historical cost or at the lower of cost or market value. Such financial institutions include banks, savings and loan associations, savings banks, credit unions, finance companies, and insurance companies. Entities other than financial institutions that include financial institution subsidiaries in their consolidated financial statements should provide the disclosures required by this statement for debt securities held as assets by such subsidiaries.

2. As used in this statement, *debt securities* include—

- Bills, notes, and bonds issued by—
  - *a.* The federal, state, and local governments in the United States and agencies and authorities of those governments.
  - *b.* Foreign governments and agencies of those foreign governments.
- Bonds and commercial paper issued by business enterprises and not-for-profit organizations, including collateralized bond obligations and interest-only and principal-only strips of such bonds and commercial paper.
- Mortgage-backed and other securitized debt instruments, including collateralized mortgage obligations[1] and principal-only and interest-only strips of such instruments.

Debt securities also include preferred stock that, by its terms, either must be redeemed by the issuing enterprise or is redeemable at the option of the investor because, for the purposes of this statement, such preferred stock has the essential characteristics of debt. Other unsecuritized commercial and personal loans; notes and bonds of foreign governments classified as loans; and unsecuritized leases, credit card receivables, real estate loans, construction loans, and automobile loans are not included in the scope of this statement.

3. This statement amends the following AICPA industry Audit and Accounting Guides:

- *Audits of Banks*
- *Audits of Credit Unions*
- *Audits of Finance Companies (Including Independent and Captive Financing Activities of Other Companies)*
- *Audits of Property and Liability Insurance Companies*
- *Audits of Stock Life Insurance Companies*

[1] For purposes of this statement, collateralized mortgage obligations also include instruments issued in equity form that are required to be accounted for as nonequity instruments under the consensus on Emerging Issues Task Force Issue 89-4.

Background

4. On May 25, 1990, the Accounting Standards Executive Committee (AcSEC) issued an exposure draft of a proposed statement of position, *Reporting by Financial Institutions of Debt Securities Held as Assets.* That exposure draft was issued in response to concerns that the guidance on reporting debt securities held as assets in the AICPA audit and accounting guides for the various financial industries is uniform for particular industries but is inconsistent from industry to industry. Further, changes in the economic environment, deregulation of interest rates, the increased sophistication of interest rate and other risk management techniques, and the availability of new financial instruments used to reduce or hedge interest rate risk have resulted in increased purchases and sales of debt securities classified as investments, which have contributed to diversity in the application of that guidance.

5. Regulators of financial institutions have expressed concern about certain activities concerning securities classified as investments. Such activities are described in the April 14, 1988, Banking Circular, *Selection of Securities Dealers and Unsuitable Investment Practices,* which is reproduced in Appendix B.

6. The exposure draft recommended guidance on reporting debt securities held as investment assets that attempted to make more workable the assessment of the ability and intent to hold such securities that is required under current literature. However, comment letters on the exposure draft raised significant questions about the subjectivity of the guidance, and AcSEC concluded that the proposal needed to be studied further.

7. The exposure draft proposed disclosures about debt securities held as assets, and many commentators recommended expanded disclosures as an interim solution. This statement is intended to be such an interim solution.

Conclusions

8. Financial institutions should include in the notes to their financial statements an explanation of their accounting policies for debt securities held, including the basis for classification into balance sheet captions, such as investment or trading.

9. Financial institutions should also disclose in the notes to their financial statements the following information concerning debt securities carried at either historical cost or the lower of cost or market value[2]

- For each balance sheet presented, the amortized cost [3], estimated market values, gross unrealized gains, and gross unrealized losses for each pertinent category. Examples of such categories are the following:
  - — Debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies
  - — Debt securities issued by states of the U.S. and political subdivisions of the states

[2] If a financial institution carries some debt securities at amortized cost and others at the lower of cost or market value and it reports them in separate balance sheet captions, these disclosures should be presented for each caption.

[3] Amortized cost is the face amount of the debt security increased or decreased by unamortized premium, discount, finance charges, or acquisition fees and costs and may also reflect a previous direct write-down of the debt security. Total amortized cost presented in this disclosure should be reconciled to the amounts presented in the balance sheet, if different.

- Debt securities issued by foreign governments and not classified as loans
- Corporate securities
- Mortgage-backed securities
- Other debt securities

- For the most recent balance sheet, the amortized cost and estimated market values of debt securities due—
  a. In one year or less
  b. After one year through five years
  c. After five years through ten years
  d. After ten years[4]
- For each period for which results of operations are presented, the proceeds from sales[5] of such debt securities and gross realized gains and gross realized losses on such sales

Effective Date and Transition

10. This statement is effective for financial statements for fiscal years ending after December 15, 1990. This statement need not be applied to financial statements for fiscal years ending before its effective date that, for comparative purposes, are being provided with financial statements for fiscal years ending after its effective date.

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[4] Securities not due at a single maturity date, such as mortgage-backed securities, may be included in a separate category. If such securities are not included in a separate category, the method used for inclusion in the maturity table should be disclosed.

[5] As debt securities approach maturity, their market prices tend to approach their maturity amounts less interest and a factor for credit risk, and market risk diminishes as a factor in their pricing. For purposes of this statement, securities that are sold at maturity or near enough to maturity that market risk is substantially eliminated as a pricing factor may be excluded from this disclosure.

APPENDIX A

Illustrative Financial Statement Disclosure

Investment Securities

The amortized cost and estimated market values of investments in debt securities are as follows: [a]

	Amortized Cost [b]	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Market Value
U.S. Treasury securities and obligations of U.S. government corporations and agencies	$XXXXX	$XXX	$(XXX)	$ XXXXX
Obligations of states and political subdivisions	XXXXX	XXX	(XXX)	XXXXX
Debt securities issued by foreign governments	XXXXX	XXX	(XXX)	XXXXX
Corporate securities	XXXXX	XXX	(XXX)	XXXXX
Mortgage-backed securities	XXXXX	XXX	(XXX)	XXXXX
Other debt securities	XXXXX	XXX	(XXX)	XXXXX
Totals	$XXXXX	$XXX	$(XXX)	$ XXXXX

The amortized cost and estimated market value of debt securities at December 31, 19XX, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

[a] This information should be provided for each balance sheet presented that is dated after December 15, 1990.

[b] See footnote 3.

	Amortized Cost	*Estimated Market Value*
Due in one year or less	$ XXX	$ XXX
Due after one year through five years	XXX	XXX
Due after five years through ten years	XXX	XXX
Due after ten years	XXX	XXX
	XXXX	XXXX
Mortgage-backed securities	XXX	XXX
	$XXXXX	$XXXXX

Proceeds from sales of investments in debt securities during 19XX were $______. Gross gains of $______ and gross losses of $______ were realized on those sales.[c]

[c] This information should be provided for each period for which results of operations are presented for periods ending after December 15, 1990.

APPENDIX B

BANKING CIRCULAR—SELECTION OF SECURITIES DEALERS AND UNSUITABLE INVESTMENT PRACTICES *

PURPOSE

This issuance is to provide you with recommended procedures to be employed by all national banks when selecting securities dealers and to advise you of certain securities activities that the depository institution regulators view as unsuitable in an investment portfolio. The Federal Financial Institution Examination Council (FFIEC) recently endorsed the same policy statement. Adoption of the FFIEC policy is intended to achieve uniform and effective supervision by depository institution investment portfolio managers. The following is the text of the policy statement.

BACKGROUND

The depository institution regulators have become aware of speculative activity which has taken place in a number of depository institutions' investment portfolios. Certain of these institutions have failed because of the speculative activities, and other institutions have been weakened significantly as their earnings and capital have been impaired and the liquidity of their securities has been eroded by the depreciation in their market value.

Speculative activity often occurs when a depository institution's investment portfolio manager follows the advice of securities dealers who, in order to generate commission income, encourage speculative practices that are unsuitable for the investment portfolio.

RECOMMENDATIONS CONCERNING THE SELECTION OF A SECURITIES DEALER

It is common for the investment portfolio managers of many depository institutions to rely on the expertise and advice of a securities sales representative for: recommendations of proposed investments; investment strategies; and the timing and pricing of securities transactions. Accordingly, it is important for the management of depository institutions to know the securities firms and the personnel with whom they deal. An investment portfolio manager should not engage in securities transactions with any securities dealer that is unwilling to provide complete and timely disclosure of its financial condition. Management must review the dealer's financial statements and make a judgment about the ability of the dealer to honor its commitments. An inquiry into the general reputation of the dealer also is necessary.

The board of directors and/or an appropriate board committee should review and approve a list of securities firms with whom the depository's management is authorized to do business. The following securities dealer selection standards are recommended, but are not all inclusive. The dealer selection process should include:

- a consideration of the ability of the securities dealer and its subsidiaries or affiliates to fulfill commitments as evidenced by capital strength and operating results disclosed in current financial data, annual reports, credit reports, etc.;

* This banking circular was distributed by the comptroller of the currency on April 14, 1988, to chief executive officers of all national banks, deputy comptrollers, and all examining personnel.

- an inquiry into the dealer's general reputation for financial stability and fair and honest dealings with customers, including an inquiry of past or current financial institution customers of the securities dealer;
- an inquiry of appropriate State or Federal securities regulators and securities industry self-regulatory organizations, such as the National Association of Securities Dealers, concerning any formal enforcement actions against the dealer or its affiliates or associated personnel;
- an inquiry, as appropriate, into the background of the sales representative to determine his or her experience and expertise;
- a determination whether the depository institution has appropriate procedures to establish possession or control of securities purchased. Purchased securities and repurchase agreement collateral should only be kept in safekeeping with selling dealers when (1) the board is completely satisfied as to the creditworthiness of the securities dealer and (2) the aggregate value of securities held in safekeeping in this manner is within credit limitations that have been approved by the board of directors, or a committee of the board, for unsecured transactions (see FFIEC Policy Statement adopted October 1985). Federal credit unions, when entering into a repurchase agreement with a broker/dealer, are not permitted to maintain the collateral with the broker/dealer, reference part 703 of the National Credit Union Administration rules and regulations.

As part of the process of managing a depository institution's relationships with securities dealers the board of directors may wish to consider including in the financial institution's code of ethics or code of conduct a prohibition by those employees, who are directly involved in purchasing and selling securities for the depository institution, from engaging in personal securities transactions with the same securities firm that the depository institution uses for its transactions without specific board approval and periodic review. The board also may wish to adopt a policy applicable to directors, officers or employees concerning the receipt of gifts, gratuities or travel expenses from approved dealer firms and their personnel (also see in this connection the Bank Bribery Law, 18 USC 215 and interpretive releases).

OBJECTIONABLE INVESTMENT PRACTICES

Depository institution directors are responsible for prudent administration of investments in securities. An investment portfolio traditionally has been maintained by a depository institution to provide earnings, liquidity and a means of diversifying risks. When investment transactions are entered into in anticipation of taking gains on short-term price movements, the transactions are no longer characteristic of investment activities and should be conducted in a securities trading account. Securities trading of the types described in section I of the attached appendix will be viewed as unsuitable activities when they are conducted in a depository institution's investment account. Securities trading should take place only in a closely supervised trading account and be undertaken only by institutions that have strong capital and current earnings positions. Acquisitions of the various forms of zero coupon, stripped obligations and asset-backed securities residuals discussed in section II of the attached appendix will receive increased regulatory attention and, depending upon the circumstances, may be considered unsuitable for a depository institution.

State chartered financial institutions are cautioned that certain of the investment practices listed in the appendix may violate state law. If any such practices are contemplated, the appropriate state supervisor should be consulted regarding permissibility under state law.

Appendix to FFIEC Supervisory Policy Statement on the Selection of Securities Dealers and Unsuitable Investment Practices

I. TRADING IN THE INVESTMENT PORTFOLIO

Trading in the investment portfolio is characterized by a high volume of purchase and sale activity, which when considered in light of a short holding period for securities, clearly demonstrates management's intent to profit from short-term price movements. In this situation, a failure to follow accounting and reporting standards applicable to trading accounts may result in a misstatement of the depository institution's income and a filing of false regulatory reports and other published financial data. It is an unsafe and unsound practice to record and report holdings of securities that result from trading transactions using accounting standards which are intended for investment portfolio transactions; therefore, the discipline associated with accounting standards applicable to trading accounts is necessary. Securities held in trading accounts should be marked to market, or the lower of cost or market, periodically with unrealized gains or losses recognized in current income. Prices used in periodic revaluations should be obtained from sources that are independent of the securities dealer doing business with the depository.

The following practices are considered to be unsuitable when they occur in a depository institution's investment portfolio.

A. "Gains Trading". "Gains trading" is a securities trading activity conducted in an investment portfolio, often termed "active portfolio management." "Gains trading" is characterized by the purchase of a security as an investment and the subsequent sale of that same security at a profit within several days or weeks. Those securities initially purchased with the intent to resell are retained as investment portfolio assets if they cannot be sold at a profit. These "losers" are retained in the investment portfolio because investment portfolio holdings are accounted for at cost, and losses are not recognized unless the security is sold. "Gains trading" often results in a portfolio of securities with extended maturities, lower credit quality, high market depreciation and limited practical liquidity.

In many cases, "gains trading" has involved the trading of "when-issued" securities and "pair-offs" or "corporate settlements" because the extended settlement period associated with these practices allows speculators the opportunity for substantial price changes to occur before payment for the securities is due.

B. "When-Issued" Securities Trading. "When-issued" securities trading is the buying and selling of securities in the interim between the announcement of an offering and the issuance and payment date of these securities. A purchaser of a "when-issued" security acquires all the risks and rewards of owning a security and may sell the "when-issued" security at a profit before taking delivery and paying for it. Frequent purchases and sales of securities during the "when-issued" period generally are indications of trading activity and should not be conducted in a bank's investment portfolio.

C. "Pair-Offs". A "pair-off" is a security purchase transaction which is closed out or sold at, or prior to, settlement date. As an example, an investment portfolio manager will commit to purchase a security; then, prior to the predetermined settlement date, the portfolio manager will "pair-off" the purchase with a sale of the same security prior to, or on, the original settlement date. Profits or losses on the transaction are settled by one party to the transaction remitting to the counter party the difference between the purchase and sale price. Like "when-issued" trading, "pair-offs" permit speculation on securities price movements without paying for the securities.

D. Corporate Settlement on U.S. Government and Federal Agency Securities Purchases. Regular-way settlement for transactions in U.S. Government and Federal agency securities is one business day after the trade date. Regular-way settlement for corporate securities is five business days after the trade date. The use of a corporate settlement method (5 business days) for U.S. Government securities purchases appears to be offered by dealers in order to facilitate speculation on the part of the purchaser.

E. Repositioning Repurchase Agreements. Dealers who encourage speculation through the use of "pair-off," "when-issued" and "corporate settlement" transactions often provide the financing at settlement of purchased securities which cannot be sold at a profit. The buyer purchasing the security pays the dealer a small "margin" that is equivalent roughly to the actual loss in the security. The dealer then agrees to fund the purchase by buying the security back from the purchaser under a resale agreement. Apart from imprudently funding a longer-term, fixed-rate asset with short-term, variable-rate source funds, the purchaser acquires all the risks of ownership of a large amount of depreciated securities for a very small margin payment. Purchasing securities in these circumstances is inherently speculative and is a wholly unsuitable investment practice for depository institutions.

F. Short Sales. A short sale is the sale of a security that is not owned. The purpose of a short sale generally is to speculate on the fall in the price of the security. Short sales are speculative transactions that should be conducted in a trading account, and when conducted in the investment portfolio, they are considered to be unsuitable.

Short sales are not permissible activities for Federal credit unions.

II. STRIPPED MORTGAGE-BACKED SECURITIES, RESIDUALS, AND ZERO COUPON BONDS

There are advantages and disadvantages in owning these products. A depository institution must consider the liquidity, marketability, pledgeability, and price volatility of each of these products prior to investing in them. It may be unsuitable for a depository institution to commit significant amounts of funds to long-term stripped mortgage-backed securities, residuals and zero coupon bonds which fluctuate greatly in price.

A. Stripped Mortgage-Backed Securities (SMBS) consist of two classes of securities with each class receiving a different portion of the monthly interest and principal cash flows from the underlying mortgage-backed securities. In its purest form, an SMBS is converted into an interest-only (IO) strip, where the investor receives 100% of the interest cash flows, and a principal-only (PO) strip, where the investor receives 100% of the principal cash flows.

All IOs and POs have highly volatile price characteristics based, in part, on the prepayment of the underlying mortgages and consequently on the maturity of the stripped security. Generally, POs will increase in value when interest rates decline while IOs increase in value when interest rates rise. Accordingly, the purchase of an IO strip may serve, theoretically, to offset the interest rate risk associated with mortgages and similar instruments held by a depository institution. Similarly, a PO may be useful as an offset to the effect of interest rate movements on the value of mortgage servicing. However, when purchasing an IO or PO the investor is speculating on the movements of future interest rates and how these movements will affect the prepayment of the underlying collateral. Furthermore, those SMBS that do not have the guarantee of a government agency or a government-sponsored agency as to the payment of principal and interest have an added element of credit risk.

As a general rule, SMBS cannot be considered as suitable investments for the vast majority of depository institutions. SMBS, however, may be appropriate holdings for depository institutions that have highly sophisticated and well-managed securities portfolios, mortgage portfolios or mortgage banking functions. In such depository institutions, however, the acquisition of SMBS should be undertaken only in conformance with carefully developed and documented plans prescribing specific positioning limits and control arrangements for enforcing these limits. These plans should be approved by the institution's board of directors and vigorously enforced.

In those depository institutions that prepare their published financial statements in accordance with Generally Accepted Accounting Principles, SMBS holdings must be accounted for in accordance with Financial Accounting Standards Board Statement #91 (FAS #91) which requires that the carrying amount be adjusted when actual prepayment experience differs from prepayment estimates. Other institutions may account for their SMBS holdings under FAS #91 or alternatively at market value or the lower of cost or market value.

Several states have adopted, or are considering, regulations that prohibit state chartered banks from purchasing IO strips. Accordingly, state chartered institutions should consult with their state regulator concerning the permissibility of purchasing SMBS.

B. Asset-Backed Securities (ABS) Residuals. Residuals are the excess cashflows from an ABS transaction after the payments due to the bondholders and the trust administrative expenses have been satisfied. This cashflow is extremely sensitive to prepayments, and thus has a high degree of interest rate risk.

Generally, the value of residual interests in ABS rises when interest rates rise. Theoretically a residual can be used as a risk management tool to offset declines in the value of fixed-rate mortgage or ABS portfolios. However, it should be understood by all residual interest purchasers that the "yield" on these instruments is inversely related to their effectiveness as a risk management vehicle. In other words, the highest yielding ABS residuals have limited risk management value usually due to a complicated ABS structure and/or unusual collateral characteristics that make modeling and understanding the economic cashflows very difficult.

Alternatively, those residuals priced for modest yields generally have positive risk management characteristics.

In conclusion, it is important to understand that a residual cashflow is highly dependent upon the prepayments received. Caution should be exercised when purchasing a residual interest, especially higher "yielding" interests, because the risk associated over the life of the ABS may warrant an even higher return in order to adequately compensate the investor for the interest rate risk assumed. Purchases of these equity interests should be supported by in-house evaluations of possible rate of return ranges in combination with varying prepayment assumptions.

Residual interests in ABS are not permissible acquisitions for Federal credit unions. Holdings of ABS residuals by other institutions should be accounted for in the manner discussed under stripped mortgage-backed securities and should be reported as "Other Assets" on regulatory reports.

C. Other Zero Coupon or Stripped Products. The interest and/or principal portions of U.S. Government obligations are sometimes sold to depository institutions in the form of stripped coupons, stripped bonds (principal), STRIPS, or propriety products, such as CATs or TIGRs. Also, Original Issue Discount Bonds (OIDs) have been issued by a number of municipal entities. Longer maturities of these instruments can exhibit extreme price volatility and, accordingly, disproportionately large long-maturity holdings (in relation to the total portfolio) of zero coupon securities appear to be unsuitable for investment holdings for depository institutions.

Appendix H

Schedule of Changes Made to Audits of Banks

Reference	Change	Date
General	The term "examination" has been changed to "audit" to conform to the terminology used in SAS No. 58.	October, 1990
Preface	Note reference to FASB Statement No. 95 added.	October, 1990
Chapter 2	Note reference to SOP 90-5 added.	October, 1990
Paragraph 2.05	Reference to and quote from SAS No. 27 changed to reference to and quote from SAS No. 52.	October, 1990
Paragraph 2.11	Notation of supersession of SAS No. 1, section 320 added.	October, 1990
Paragraph 2.16	Reference to SAS No. 34 changed to SAS No. 59.	October, 1990
Paragraph 2.29	Reference to SAS No. 3 changed to SAS No. 48; reference to Audit and Accounting Guides, *The Auditor's Study and Evaluation of Internal Control in EDP Systems* and *Audits of Service-Center-Produced Records* deleted.	October, 1990
Paragraphs 2.31-2.33	Added from SOP 90-5.	October, 1990
Paragraph 3.14	Second standard of field work conformed to current *Codification of Statements on Auditing Standards.*	October, 1990
Paragraph 3.15	Notation of supersession of SAS No. 1, section 320 added.	October, 1990
Paragraph 3.22	Reference to SAS No. 6 changed to SAS No. 45; reference to SAS No. 16 changed to SAS No. 53; reference to SAS No. 17 changed to SAS No. 54.	October, 1990
Paragraph 3.23	Reference to SAS No. 20 changed to SAS No. 60 and language conformed to SAS No. 60.	October, 1990
Paragraph 7.25	Reference to FASB Statement No. 96 added.	October, 1990
Paragraph 7.46	Reference to AICPA Task Force studying loan origination fees replaced by reference to FASB Statement No. 91.	October, 1990
Paragraph 7.48	Reference to FASB exposure draft replaced by reference to FASB Statement No. 77.	October, 1990
Paragraph 7.64	Reference to SAS No. 17 changed to SAS No. 54.	October, 1990

Reference	Change	Date
Paragraph 9.07	Reference to AICPA study of accounting repo and reverse repo transactions deleted.	October, 1990
Paragraph 10.07	Reference to FASB Statement No. 96 added.	October, 1990
Paragraph 16.05	Reference to SAS No. 23 changed to SAS No. 56.	October, 1990
Chapter 17	Reference to FASB Statement No. 96 added.	October, 1990
Paragraph 18.39	Reference to SAS No. 17 changed to SAS No. 54.	October, 1990
Paragraph 20.13	Reference to ARB No. 43 replaced by reference to FASB Statement No. 94.	October, 1990
Paragraph 21.13	Reference to SAS No. 2 changed to SAS No. 58; reference to FASB Statement No. 94 added; references to statement of changes in financial position changed to statement of cash flows.	October, 1990
Appendix A	Illustrative auditor's reports conformed to SAS No. 58.	October, 1990
Appendix A	Illustrative financial statements updated through FASB Statement No. 106.	July, 1991
Appendix B	Illustrative auditor's reports conformed to SAS No. 58.	October, 1990
Appendix C	Reference to SOP 90-6 added to headnote; paragraphs from SOP 90-6 added, as noted in appendix; Exhibits 1 and 2 replaced by exhibits from 90-6.	October, 1990
Appendix F	SOP 90-3 added.	October, 1990
Appendix F	References to Audit and Accounting Guide *Savings and Loan Associations* and SOP 85-2 deleted.	August, 1991
Appendix G	SOP 90-11 added.	March, 1991
Appendix G	References to Audit and Accounting Guide *Savings and Loan Associations* deleted.	August, 1991

In addition to the above, notes have been added to highlight areas that will be updated in future editions. These areas include:

Paragraph 2.11, *Timing of Audit,* will be conformed to SAS No. 55.

Chapter 3, *Internal Accounting Control,* will be conformed to SAS No. 55.

Chapter 17, *Income Taxes,* will be conformed to FASB Statement No. 96.

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 clearing-house 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."

Audit Risk Alert

BANKING INDUSTRY DEVELOPMENTS— 1990

UPDATE TO AICPA INDUSTRY AUDIT GUIDE, *AUDITS OF BANKS*

ISSUED BY THE AUDITING STANDARDS DIVISION

NOTICE TO READERS

This document is intended to provide auditors of financial statements of banks with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

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Industry and Economic Developments

.01 The problems of the thrift industry inevitably invite comparison to the banking industry. This comparison is not surprising—over the past several years, federal bank regulators have closed or provided assistance to many commercial banks as a result of their deteriorating financial condition. During the first half of 1990, ninety-nine commercial banks failed or required assistance compared to 101 in the first half of 1989. The rate of failures is not expected to change in the second half of 1990. Although the banking industry has not experienced the depth of problems faced by the thrift industry, certain problems do exist that are relevant to audits of bank financial statements.

.02 Deteriorating credit quality, particularly of real estate loans, has been a problem for many banks. Softening real estate markets in certain parts of the country have caused the amounts of loan loss provisions and nonperforming loans to rise. The real estate problems have been most prevalent in the Northeast but have appeared in other areas as well. Also, as the economy softens, such sectors as consumer loans, loans for highly leveraged transactions, and other commercial loans may experience credit quality problems. As a result, asset quality should be a prime focus of audit attention.

.03 Other business activities of commercial banks that may require consideration by auditors include—

- Investments in mortgage-backed securities and their derivatives, including interest-only (IO) and principal-only (PO) strips.
- Frequent sales of investment securities.
- Asset acquisitions, including mortgage servicing rights of failed thrift institutions.
- Significant off-balance-sheet transactions.

.04 Also, the following should be considered by auditors:

- Noncompliance or expected noncompliance with regulatory capital requirements
- Adverse regulatory reports or required regulatory actions
- Inadequate loan documentation
- Out-of-market lending
- Significant concentrations of loans
- Significant lending or investment activity inconsistent with management's policy
- Brokered transactions, including loans, investment products, and deposits
- Valuation of derivative financial instruments
- Valuation of intangibles, including servicing rights
- Restructurings and dispositions of business activities.

Regulatory and Legislative Developments

Condition of BIF

.05 In September 1990, the U.S. General Accounting Office (GAO) issued its audit report on the Bank Insurance Fund (BIF) and reported that BIF faces a "period of danger." The GAO concluded, however, that BIF has sufficient resources to handle failures anticipated in 1990. Nonetheless, the

GAO believes that under certain circumstances, the combination of BIF's low levels of reserves and a recession could lead to a level of bank failures that would deplete BIF and require taxpayer assistance. Accordingly, the Federal Deposit Insurance Corporation (FDIC) agreed to raise bank assessments for FDIC insurance to 19.5 cents for every $100 of insured bank deposits in 1991. The rate for 1990 is 12 cents per $100. In addition, as a result of reports from the GAO as well as the Congressional Budget Office regarding the condition of BIF, Congress has passed legislation that would lift restrictions on the FDIC's ability to raise premiums.

Regulatory Examinations

.06 Beginning in 1989 and continuing into 1990, examiners from the Office of the Comptroller of the Currency (OCC) conducted a series of examinations that resulted in significant increases in loan losses and loan loss reserves at a number of banks. As a result, a number of criticisms were directed at the regulatory examination process for banks, particularly as that process relates to the real estate lending practices of national banks. In response to those criticisms, the OCC examining staff noted that OCC policies and procedures regarding the examination of real estate loans had not changed and cited a weakening in underwriting standards at certain banks and a softening real estate market in certain parts of the country as the factors responsible for the increase in loan losses.

.07 As a result of concerns expressed by banks and others regarding the OCC's actions, the OCC staff held a series of meetings with accountants, analysts, and others to discuss the examination process in the spring of 1990. These meetings revealed that some areas of disagreement exist between the OCC and the accounting profession regarding accounting for loan loss reserves. In this regard, the Financial Accounting Standards Board (FASB) Emerging Issues Task Force (EITF) has addressed the issue of whether institutions can record different allowances under generally accepted accounting principles (GAAP) and regulatory accounting principles (RAP) (Issue No. 85-44). The EITF reached a consensus that institutions could record different loan loss allowances under GAAP and RAP because the amounts computed by preparers of financial statements and regulators may differ due to the subjectivity involved in estimating the amount of loss or the use of arbitrary factors by regulators. However, auditors should be particularly skeptical in the case of GAAP-RAP differences and should be prepared to justify them based on the particular facts and circumstances.

.08 For additional information on auditing the allowance for loan losses, auditors should consult the AICPA Auditing Procedure Study, *Auditing the Allowance for Credit Losses of Banks.*

Capital Requirements

.09 In 1989, the three federal bank regulatory agencies (OCC, FDIC, and Federal Reserve Board) issued final rules regarding risk-based capital standards for measuring capital adequacy. Transitional provisions of these rules become effective December 31, 1990, and banks must maintain a ratio of total capital to weighted risk assets of 7.25 percent. In addition, banks must maintain a minimum standard of Tier 1 capital (in general, common shareholders' equity, noncumulative perpetual preferred stock, and minority interests less goodwill) to weighted risk assets of 3.625 percent. The rules become fully effective on December 31, 1992, at which time banks must maintain a total ratio of 8 percent and a Tier 1 ratio of 4 percent.

.10 In addition to these requirements, banks must also maintain a minimum leverage capital ratio of 3 percent of Tier 1 capital (as defined) to total assets for institutions with a rating of one under the regulatory CAMEL rating system. An additional cushion of at least 100 to 200 basis points will be required for all other institutions.

OCC Bank Accounting Advisory Series

.11 In June 1990, the OCC's Bank Accounting Division released Issue No. 1 of the *Bank Accounting Advisory Series* (BAAS). The purpose of the BAAS is to inform the banking community of the division's views on a variety of accounting issues. The advisories contained in the BAAS are not official rules or regulations of the OCC but represent interpretations of GAAP and bank regulatory accounting by the division. Nonetheless, according to the BAAS, national banks that deviate from these stated interpretations may be required to justify such departures to the OCC. Issue No. 1 of the series covers a variety of topics, including purchase accounting, loans, sale of loans, loan origination and servicing, leases, investment securities, other assets, computer costs, income taxes, and capital.

Payment of Dividends

.12 Under current rules, before banks can declare dividends, they must meet a two-part test: First, the payment of the dividend must not impair capital, and second, the dividend must be paid out of recent earnings. If a dividend payment fails the first test, the second test is irrelevant. However, if the dividend payment meets the first test but fails the second, it may still be allowed, with appropriate regulatory approval. These requirements are contained in 12 U.S.C. 56 and 12 U.S.C. 60.

.13 The OCC and the Federal Reserve Board (Fed) have released proposed rules that would amend these requirements regarding the payment of dividends by national banks and state member banks, respectively. The purpose of the proposed rules is to make the calculation of banks' dividend-paying capacity consistent with regulatory reporting standards and GAAP. In particular, the proposed rules would not permit the allowance for loan and lease losses to be included in the calculation of "undivided profits then on hand" in the first test and "net profits" in the second test. In addition, the proposed rules would clarify that preferred stock dividends are not subject to the limitations of the first test but must meet the constraints of the second test.

.14 The agencies are expected to issue final rules shortly with a required prospective effective date. Banks may elect to calculate net profits prior to the effective date if they apply the provisions on a full calendar-year-to-date basis.

SEC Financial Institutions Task Forces

.15 The Securities and Exchange Commission (SEC) has established two task forces to review compliance with federal securities laws by financial institution holding companies reporting to the SEC. In July 1990, the OCC issued Banking Circular 245 to advise national banks of the SEC's activities.

.16 The SEC Disclosure Review Task Force, located within the Division of Corporation Finance, reviews disclosures under the Securities Exchange Act of 1934 and disclosures related to securities offerings under the Securities Act of 1933. According to Banking Circular 245, this task force focuses on the following areas:

- Adequacy of disclosure of administrative actions taken by banking regulators

- Treatment of loan loss reserves in disclosures, including the accuracy, adequacy, and timeliness of charges
- Adequacy of disclosures related to the investment portfolio, including proper accounting for trading
- Accuracy of disclosures related to highly leveraged transaction lending and real estate lending
- Accuracy of disclosures of compensation and insider transactions including loans to insiders
- Adequacy of disclosures related to supervision and regulation of financial institution subsidiaries, including material aspects of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA)

.17 The SEC has asked the federal bank regulatory agencies for assistance in reviewing the adequacy and accuracy of disclosures. In response, the OCC has announced a limited review of those disclosures referred by the SEC as they relate to any subsidiary national bank.

.18 The SEC Enforcement Task Force, located in the Enforcement Division, investigates and prosecutes allegations of noncompliance by financial institution holding companies under the federal securities laws. This task force emphasizes the following matters:

- Any allegations of noncompliance by holding companies with disclosure requirements, including violations of antifraud provisions, failure to disclose insider transactions, and other disclosure problems that may be identified by the Division of Corporation Finance Task Force
- Sales by financial institutions on public premises of institutions' own securities or their affiliates' securities and, in particular, the adequacy of disclosure that the security is not a government insured deposit
- Securities trading by financial institution insiders based on nonpublic information obtained from such institution's customers (particularly in connection with arranging financing in corporate mergers and acquisitions), and also trading in a financial institution's own securities by its insiders prior to the release of material nonpublic information concerning the condition of such institution.

Audit and Accounting Developments

Audit Issues

.19 *Going Concern Issues.* AICPA Statement on Auditing Standards (SAS) No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,* states that "the auditor has a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. . . ." Under the FDIC's proposed rule regarding the leverage capital ratio discussed previously, any FDIC-insured bank with less than 2 percent of Tier 1 capital would be considered in an "unsafe or unsound condition" that could lead to the removal of deposit insurance. Thus, noncompliance or expected noncompliance with regulatory capital requirements is a condition, when considered with other factors, that could indicate that there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. Other factors that should be evaluated are identified in SAS No. 59.

.20 *Regulatory Examination Reports.* Section 931 of FIRREA requires that all federally insured financial institutions provide their independent auditors with copies of their most recent "call" reports and state and federal reports of examination. In addition, according to the FDIC, institutions must provide the following information, if applicable:

- Any supervisory memorandum of understanding or any written agreement between a federal or state banking agency and the institution in effect during the period covered by the audit.
- A final order resulting from any action during the period covered by the audit under section 8 of the Federal Deposit Insurance Act (FDIA) because of unsafe or unsound banking practices, violations of laws and regulations, or noncompliance with monetary transaction recordkeeping and reporting requirements. These actions include the termination of deposit insurance coverage, the suspension or removal of an institution-affiliated party, the assessment of civil money penalties, and the issuance of a cease-and-desist order.
- A final order resulting from any action taken by a state banking agency under state law during the period covered by the audit that is similar to the actions under section 8 of the FDIA.
- A report of any action that has been initiated and is pending during such period. The institution must provide the auditor with either a written report describing the pending action in all material respects or a copy of the notice or proposed order initiating the action.
- Any other civil monetary penalty assessed under any provision of law during the period with respect to the institution or any institution-affiliated party, which generally refers to any officer, director, employee, and controlling stockholder of an institution.

.21 This information must be provided to any independent auditor retained by the institution since August 9, 1987, even if the auditor is no longer engaged by the institution.

.22 In July 1990, the FDIC issued FIL 37-90, which requests depository institutions under its supervision to ask the auditor to acknowledge the following in writing:

- Specified documents have been received.
- The documents are being provided for the limited purpose of complying with FIRREA.
- The report of examination is the property of the FDIC.
- The report of examination will not be copied nor will verbatim notes be taken from it (subsequent clarification of this requirement by the FDIC is provided later).
- The report of examination will be returned to the institution no later than the date on which the auditor's report is submitted to the institution or will be maintained at the institution in a confidential file.

.23 In August 1990, the FDIC issued a memorandum to its regional directors that included a series of questions and answers regarding section 931 of FIRREA. In particular, Question 4 of the memorandum provides that an examination report may be copied or verbatim notes may be taken, provided the auditor agrees in writing to maintain the confidentiality of the copied material.

.24 *Inquiries of Representatives of Financial Institution Regulatory Agencies.* AICPA Statement of Position (SOP) 90-5, *Inquiries of Representatives of Financial Institution Regulatory Agencies,* amends chapter 2 of the AICPA Industry Audit Guide, *Audits of Banks,* with respect to communications between independent auditors and examiners. The SOP states that the independent auditor should—

- Request that management provide access to all reports of examinations and related correspondence.
- Review reports of significant examinations and related correspondence between examiners and the financial institution during the period under audit through the date of the independent auditor's report.
- Communicate with the examiners, with the prior approval of the financial institution, when their examination of the financial institution is in process or a report on an examination has not been received by the financial institution.

.25 A refusal by management or the examiner to allow the independent auditor to review communications from, or to communicate with, the examiner would ordinarily be a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

.26 The SOP also encourages auditors to attend, as observers, with the prior approval of the financial institution, the exit conference between the examiner and the financial institution representatives. Further, if the examiners request permission to attend the meeting between the independent auditor and the financial institution representatives to review the audit report, and if management concurs, the SOP encourages the independent auditor to endeavor to be responsive to that request.

.27 The SOP should apply to audits of financial statements for periods ending on or after September 30, 1990.

.28 *Directors' Examinations of Banks.* SOP 90-6, *Directors' Examinations of Banks,* provides new guidance regarding auditors' participation in bank directors' examinations. In some cases, bank directors may not understand the differences between engagements for the application of agreed-upon procedures to specified elements, accounts, or items of a financial statement in connection with a directors' examination and an audit of a bank's financial statements in accordance with generally accepted auditing standards (GAAS). The SOP amends appendix C in the AICPA Industry Audit Guide, *Audits of Banks,* as follows:

- It incorporates into the illustrative engagement letter and illustrative report a statement that identifies the omission of certain procedures relating to accounts with higher risk—for example, risk relating to the collectibility of loans or the adequacy of collateral thereon or the reasonableness of the allowance for credit losses—that are normally performed during an audit of the financial statements in accordance with GAAS.
- It expands the accounts identified in the supplement to the engagement letter to include those accounts with higher risk, such as risk relating to the collectibility of loans and the allowance for credit losses.

.29 The SOP applies to directors' examinations commenced after December 31, 1990.

Accounting Issues

.30 *Consensus Decisions of the FASB's Emerging Issues Task Force.* Many consensus decisions of the FASB's Emerging Issues Task Force, especially those dealing with financial institutions, financial instruments, and real estate transactions, are relevant to banks. Auditors of bank financial statements should be familiar with these EITF consensus decisions.

.31 *Statement of Cash Flows.* FASB Statement No. 104, *Statement of Cash Flows—Net Reporting of Certain Cash Receipts and Cash Payments and Classification of Cash Flows From Hedging Transactions,* which is effective for fiscal years ending after June 15, 1990, amends FASB Statement No. 95, *Statement of Cash Flows,* to permit financial institutions, including banks, to report in a statement of cash flows certain net cash receipts and cash payments for (a) deposits placed with other financial institutions and withdrawals of deposits, (b) time deposits accepted and repayments of deposits, and (c) loans made to customers and principal collections of loans. The statement also amends FASB Statement No. 95 to permit cash flows resulting from futures contracts, forward contracts, option contracts, or swap contracts that are accounted for as hedges of identifiable transactions or events to be classified in the same category as the cash flows from the items being hedged, provided that accounting policy is disclosed.

.32 *Debt Securities Held as Assets.* An exposure draft of a proposed SOP, *Reporting by Financial Institutions of Debt Securities Held as Assets,* was issued for comment in May 1990 to provide guidance on applying GAAP in reporting debt securities held as assets by financial institutions, including banks. In September 1990, the AICPA Accounting Standards Executive Committee (AcSEC) agreed to issue an SOP recommending expanded disclosures and to study further the recognition and measurement issues.

.33 The "disclosure" SOP, 90-11, *Disclosure of Certain Information by Financial Institutions About Debt Securities Held as Assets,* is effective for financial statements for fiscal years ending after December 15, 1990. SOP 90-11 requires financial institutions to include an explanation of accounting policies for debt securities held, including the basis for classification into balance-sheet captions such as investment or trading, in the notes to the financial statements. In addition, financial institutions must disclose the following in the notes to the financial statements for debt securities carried at either historical cost or the lower of cost or market:

- For each balance sheet presented, the amortized cost, estimated market values, gross unrealized gains, and gross unrealized losses on pertinent categories of securities
- For the most recent balance sheet, the amortized cost and estimated market values of debt securities due:
  - — In one year or less
  - — After one year through five years
  - — After five years through ten years
  - — After ten years
- For each period for which results of operations are presented, the proceeds from sales of such debt securities and gross realized gains and gross realized losses on such sales

.34 With respect to the recognition and measurement issues, AcSEC sent a letter to the FASB on October 31, 1990, recommending that the FASB add a limited-scope project to its agenda on recognition and measurement of debt securities held as assets by financial institutions. On November 14, 1990, the FASB agreed to consider accelerating a portion of its financial instruments project to address this issue. However, the scope of such a project has not yet been defined.

.35 In addition to the above, the SEC staff indicated, in a December 1989 letter, that it will continue the current practice of reviewing the adequacy of disclosures made by SEC registrants in this area. The SEC staff believes the following disclosures are appropriate for SEC registrants:

- The accounting policy note to the financial statements should clearly identify the characteristics that must be present for the institution to carry a security at amortized cost, rather than at market or lower of cost or market.
- Market value of the portfolio should be disclosed on the face of the balance sheet. If the portfolio is underwater, management's discussion and analysis (MD&A) should assess the significance of the unrealized loss relative to net worth and regulatory capital requirements.
- Proceeds from the sales of securities should be distinguished from the proceeds of maturities in the statement of cash flows or in a note thereto.
- Gross unrealized gains and gross unrealized losses in the portfolio should be disclosed separately in MD&A. Disclosure in the notes to the financial statements is recommended.
- Gross realized gains and gross realized losses should be separately disclosed in MD&A. Disclosure in the notes to the financial statements is recommended.
- MD&A should analyze and, to the extent practicable, quantify the likely effects on current and future earnings and investment yields, and on liquidity and capital resources of: material unrealized losses in the portfolio, material sales of securities at gains, and material shifts in average maturity. A similar analysis should be provided if a material portion of fixed-rate mortgages maturing beyond one year carries rates below current market.
- If sales from the portfolio were significant, the MD&A should describe those events unforeseen at earlier balance-sheet dates that caused management to change its investment intent. Restatement of earlier reports may be necessary if material sales occurred at a loss, and ability and intent to hold at earlier dates cannot be demonstrated.
- If a material proportion of the portfolio consists of securities that are not actively traded in a liquid market, MD&A should disclose that proportion, describe the nature of the securities and the source of market value information, and discuss any material risks associated with the investment relative to earnings and liquidity. Similar disclosure should be furnished if the portfolio includes instruments the market values of which are highly volatile relative to small

changes in interest rates, and this volatility may materially affect operating results or liquidity.

- Investments held for sale, categorized by types of investments, should be presented separately from the balance of the investment portfolio in Table II, "Investment Portfolio," of Industry Guide 3 data. Contractual maturities of investments held for sale need not be presented.

.36 *Definition of* Substantially the Same. SOP 90-3, *Definition of the Term* Substantially the Same *for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position,* provides guidance on whether two debt instruments that are exchanged are substantially the same for the purpose of determining whether a transaction involving a sale and a purchase or an exchange of debt instruments should be accounted for as a sale or as a financing. If such securities are substantially the same, the sale and purchase should be accounted for as a financing. It establishes the following six criteria, all of which must be met, for two debt instruments to be considered substantially the same:

1. The debt instruments must have the same primary obligor, except for debt instruments guaranteed by a sovereign government, central bank, government-sponsored enterprise, or agency thereof, in which case the guarantor and terms of the guarantee must be the same.
2. The debt instruments must be identical in form and type so as to give the same risks and rights to the holder.
3. The debt instruments must bear the identical contractual interest rate.
4. The debt instruments must have the same maturity except for mortgage-backed pass-through and pay-through securities, for which the mortgages collateralizing the securities must have similar remaining weighted average maturities (WAMs) that result in approximately the same market yield.
5. Mortgage-backed pass-through and pay-through securities must be collateralized by a similar pool of mortgages, such as single-family residential mortgages.
6. The debt instruments must have the same aggregate unpaid principal amounts, except for mortgage-backed pass-through and pay-through securities, for which the aggregate principal amounts of the mortgage-backed securities given up and the mortgage-backed securities reacquired must be within the accepted "good delivery" standard for the type of mortgage-backed security involved.

.37 SOP 90-3 amends the AICPA Industry Audit Guide, *Audits of Banks,* and applies to transactions entered into after March 31, 1990.

.38 *Accounting for Foreclosed Assets.* In December 1990, AcSEC issued an exposure draft of a proposed SOP, *Accounting for Foreclosed Assets.* Under the proposed SOP, there is a presumption that foreclosed assets are held for sale and not for the production of income. As a result, the proposed SOP would require foreclosed assets to be classified in the balance sheet as assets held for sale and reported at the lower of cost (including the estimated cost of selling the asset) or fair value. In addition, except for cash payments for capital additions and improvements and any related capitalized interest, net cash payments related to a foreclosed asset should be charged to income for each reporting period as a loss on holding the asset. Net cash receipts during each reporting period should reduce the carrying amount of the asset. No depreciation or amortization expense should be recognized.

.39 The exposure period for the proposed SOP ends in March 1991. Shortly thereafter, AcSEC expects to issue a final SOP that would apply to foreclosed assets held by enterprises on or after the date the final SOP is issued.

.40 *In-Substance Foreclosure.* Practice Bulletin No. 7, *Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed,* issued in April 1990, establishes the following criteria for evaluating whether collateral for a loan has been in-substance foreclosed:

- The debtor has little or no equity in the collateral, considering the current fair value of the collateral.
- Proceeds for repayment of the loan can be expected to come only from the operation or sale of the collateral.
- The debtor has either (a) formally or effectively abandoned control of the collateral to the creditor, or (b) retained control of the collateral, but because of the current financial condition of the debtor, or the economic prospects for the debtor, the collateral, or both in the foreseeable future, it is doubtful that the debtor will be able to rebuild equity in the collateral or otherwise repay the loan in the foreseeable future.

.41 These criteria are identical to those promulgated by the SEC for SEC registrants in Financial Reporting Release (FRR) 28, *Accounting for Loan Losses by Registrants Engaged in Lending Activities.* If the criteria are met, paragraph 34 of FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings,* should be followed. That is, the loan should be reclassified to the category or categories of the collateral, and the recorded investment in the loan should be reduced to the fair value of the collateral, which establishes a new cost basis in the same manner as a legal foreclosure. The excess of the recorded investment in the receivable over the fair value of the collateral should be recognized as a loan loss in the current period to the extent that it is not offset against a previously established allowance.

.42 *ADC Arrangements.* A proposed Practice Bulletin, *ADC Arrangements and Similar Arrangements That are Classified as Real Estate Investments or Joint Ventures,* is being developed to provide implementation guidance on accounting for acquisition, development, or construction (ADC) arrangements and similar arrangements classified as investments in real estate or real estate joint ventures under the February 10, 1986 "Notice to Practitioners on ADC Arrangements." In particular, the proposed practice bulletin is expected to address the following issues:

- Reporting by lenders of their proportionate shares of income or losses on ADC projects
- The relationship between a lender's proportionate share of income or losses and its "expected residual profit," as described in the ADC Notice
- Including depreciation in the determination of the income or loss to be recognized
- Reporting by lenders of interest receipts

- Circumstances in which unrealized appreciation of the property can be considered in determining income or loss to be recognized by the lender

.43 *Interest Income on Troubled or Past Due Loans by Financial Institutions.* A proposed Issues Paper, *Financial Reporting of Interest Income on Troubled or Past Due Loans by Financial Institutions,* is being developed by an AcSEC task force regarding the financial reporting of interest income on troubled or past due loans by financial institutions. Among the questions the task force is addressing are the following:

- When should lenders cease accruing interest on troubled loans?
- How should lenders account for accrued but uncollected interest?
- What disclosures are appropriate for cash payments received on nonaccrual loans?

.44 The status of the project is expected to be discussed by the AcSEC Planning Subcommittee in December 1990.

* * * *

.45 Copies of AICPA authoritative guidance may be obtained by calling the AICPA Order Department at (800) 334-6961 (USA) or (800) 248-0445 (NY). Copies of FASB authoritative guidance may be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.

AUDIT RISK ALERT—1990

GENERAL UPDATE ON ECONOMIC, INDUSTRY, REGULATORY, AND ACCOUNTING AND AUDITING MATTERS

ISSUED BY THE AUDITING STANDARDS DIVISION

NOTICE TO READERS

This audit risk alert is intended to provide auditors with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. This document has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

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Audit Risk Alert—1990 *

Introduction

.01 This alert is intended to help auditors in finalizing their planning for 1990 year-end audits. Successful audits are a result of a number of factors, including acceptance of clients with integrity, adequate partner involvement in planning and performing audits, an appropriate level of professional skepticism, and the allocation of sufficient audit resources to high-risk areas. Addressing these factors in each audit engagement requires substantial professional judgment based, in part, on a knowledge of professional standards and current developments in business and government.

.02 It is important to make sure that written audit programs are *adequately tailored* to reflect *each client's circumstances,* including areas of greater *audit risk.* This alert identifies areas that, based on current information and trends, may be relevant to many 1990 year-end audits. Although it does not provide a complete list of risk factors to be considered, and the items discussed do not affect risk in every audit, this alert can be used as a planning tool for considering matters that may be especially significant for 1990 audits.

Economic Developments

The Current Economic Downturn

.03 Dramatic events in the Persian Gulf and around the world have raised many questions and concerns for American companies. Rising oil prices, lower consumer demand, and reduced availability of capital are just *some* of the factors affecting companies in all industries. Auditors should take these economic factors into consideration and be aware of the ways in which clients have been affected by them as well as of the potential, if any, of a going-concern problem.

Business Failures on the Rise

.04 The current illiquidity in the junk-bond market, coupled with the continuing tightening of credit by lenders throughout the country, have made it substantially more difficult for prospective borrowers to obtain financing, particularly for highly leveraged companies. A recent article in the *Wall Street Journal* called attention to increases in bankruptcy filings, particularly in the real estate, apparel, retailing, and construction industries, due in large part to the weakening cash flow of many businesses as well as the more cautious credit environment. Some industries are becoming very risky undertakings. For example, in 1990, the number of restaurant closings exceeded the number of openings; increased competition has made it nearly impossible to raise menu prices, while costs have continued to increase, especially those for energy, insurance, and wages.

.05 The effects of the economic slowdown will vary across geographic regions and industries, and among companies even within the same industry. Therefore, auditors need to focus specifically on the environment of each client and address each client's particular issues accordingly. Nevertheless, many companies will be unable to pass on increased costs (particularly increased oil prices and medical expenses) due, in part, to increasing competition and softening demand for their products. This could make it difficult for companies to report favorable operating results for the year. With this in mind,

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* This Audit Risk Alert was published in the December 1990 issue of the AICPA's *CPA Letter.*

auditors should be even more sensitive this year to ongoing issues that affect operating results, such as the collectibility of receivables and the potential obsolescence and realizability of inventories.

.06 Highly leveraged companies are particularly vulnerable to a downturn in business activity and the other factors discussed above. Auditors should consider these circumstances when evaluating the ability of highly leveraged clients to continue as going concerns.

Economic Considerations Relating to Debt

.07 Adverse developments in the economy in general, or in a particular financial institution, may cause an institution to refuse to renew loans, to exercise demand clauses (such as the due-on-demand clause), or to decline to waive covenant violations. In addition, these developments may make it more difficult for companies to obtain alternate sources of financing than in the past. In these cases, the auditor should consider the borrower's classification of the liability, potential going-concern issues, management's plans (such as those for alternate financing or asset disposition), and the adequacy of disclosures in the borrower's financial statements. Securities and Exchange Commission (SEC) rules contain specific disclosure requirements in Management's Discussion and Analysis (MD&A) about liquidity and material uncertainties.

Regulatory and Legislative Developments

Environmental Liabilities

.08 The Environmental Protection Agency is empowered by law (through the Superfund legislation) to seek recovery from anyone who ever owned or operated a particular contaminated site, or anyone who ever generated or transported hazardous materials to a site (these parties are commonly referred to as potentially responsible parties, or PRPs). Potentially, the liability can extend to subsequent owners or to the parent company of a PRP.

.09 In connection with audit planning, the auditor should consider making inquiries of management about whether a client (or any of its subsidiaries) has been designated as a PRP or otherwise has a high risk of exposure to environmental liabilities. If a client has been designated as a PRP, the auditor should consider whether any amount should be accrued for cleanup costs and assess the need for disclosure and, possibly, for the inclusion of an explanatory fourth paragraph in the audit report citing the uncertainty, if management is unable to make reasonable estimates of the costs. In addition, for public entities, disclosure should be made in MD&A of estimates of cleanup costs or the reasons why the matter will not have a material effect.

.10 Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies,* and Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss,* provide guidance for the accounting and disclosure of loss contingencies, including those related to environmental issues. The FASB's Emerging Issues Task Force (EITF) reached a consensus in Issue 90-8, *Capitalization of Costs to Treat Environmental Contamination,* that, generally, the costs incurred to treat environmental contamination should be expensed and may be capitalized only if specific criteria are met.

Notification of Termination of Auditor-Client Relationship

.11 The SEC staff has observed instances in which CPA firms have not notified the SEC's Chief Accountant when an auditor-client relationship ends. Under a rule effective May 1, 1989, member firms of the SEC Practice Section of the AICPA Division for Firms must notify the SEC directly by letter *within* *five business days* after the auditor resigns, declines to stand for reelection, or is dismissed.

New Auditing Pronouncements

Implementing SAS No. 55 on Internal Control

.12 AICPA Statement on Auditing Standards (SAS) No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit,* is effective for audit periods beginning on or after January 1, 1990. Auditors who did not apply its provisions early are faced with implementation for December 31, 1990, year-end audits.

.13 To help auditors with questions that may arise, the Auditing Standards Board (ASB) issued the Audit Guide, *Consideration of the Internal Control Structure in a Financial Statement Audit.* The guide presents two preliminary audit strategies for assessing control risk and uses three hypothetical companies ranging from a small, owner-managed business to a large public company to illustrate how the strategies affect the nature, timing, and extent of procedures. Particularly helpful is a series of exhibits that includes sample workpapers documenting the hypothetical companies' compliance with SAS No. 55.

New Financial Institutions Confirmation Form

.14 The AICPA will replace the existing 1966 Standard Bank Confirmation Inquiry. The new form will provide only confirmation of *deposit* and *loan* balances. To confirm other transactions and arrangements, auditors will have to send a separate letter, signed by the client, to a financial institution official responsible for the financial institution's relationship with the client or knowledgeable about the transactions or arrangements. Anyone ordering the new standard form from the AICPA Order Department will receive a copy of a notice to practitioners, which describes the revisions to the process of confirming information with financial institutions, and illustrative letters for confirming some of these types of transactions or arrangements. The new form should be used for confirmations mailed on or after March 31, 1991. Practitioners should neither use the new form before March 31, 1991, nor use the old form on or after that date.

New SAS on Internal Auditing

.15 In April 1991, the ASB issued SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements,* that provides practitioners with expanded and revised guidance on considering the work of internal auditors. Many internal audit activities are relevant to an audit of financial statements because they provide evidence about the design and effectiveness of internal control structure policies and procedures or provide direct evidence about misstatements of financial data contained in financial statements. The SAS is effective for audits of financial statements for periods ending after December 15, 1991, and includes guidance to assist auditors in obtaining an understanding of the internal audit function, assessing the competence and objectivity of internal auditors, and determining the extent to which they may consider work performed by internal auditors. The SAS supersedes SAS No. 9, *The Effect of an Internal Audit Function on the Scope of the Independent Audit,* and incorporates the terminology and concepts of more recent SASs, particularly SAS No. 55.

Forthcoming Guidance on Circular A-133

.16 On March 8, 1990, the Office of Management and Budget (OMB) issued Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions.* The purpose of Circular A-133 is to establish audit requirements and to define federal responsibilities for implementing and monitoring audit requirements for institutions of higher education and other nonprofit institutions receiving federal awards. Institutions covered by Circular A-133 generally include colleges and universities (and their affiliated hospitals) and other not-for-profit organizations, such as voluntary health and welfare organizations and other civic organizations.

.17 The circular applies to nonprofit institutions that receive $100,000 or more in federal awards. (Circular A-133's definition of *financial awards* is broader than the term *financial assistance* used in SAS No. 63, *Compliance Auditing Applicable to Governmental Entities and Other Recipients of Governmental Financial Assistance.*) Nonprofit institutions that receive at least $25,000 but less than $100,000 in federal financial assistance have the option of applying either the requirements of Circular A-133 or separate program audit requirements. For institutions receiving less than $25,000, records must be kept and made available for review, if requested, but the provisions of the circular do not apply.

.18 In the first quarter of 1991, the AICPA's Auditing Standards Division plans to expose a statement of position, prepared by a subcommittee of the AICPA Not-for-Profit Organizations Committee, that will provide guidance about compliance-auditing requirements in Circular A-133. Circular A-133 is effective for audits of fiscal years beginning on or after January 1, 1990. Since the circular permits biennial audits, some institutions may not be required to follow its requirements until the audit of their financial statements for the fiscal year ending June 30, 1992.

Audit Reporting and Communication Issues

Reporting on Uncertainties

.19 Some auditors have issued an unqualified report with an additional paragraph about the existence of an uncertainty in situations when a qualified or adverse opinion should have been issued.

.20 SAS No. 58, *Reports on Audited Financial Statements,* requires an auditor to add an explanatory paragraph (after the opinion paragraph) to the standard report when a matter is expected to be resolved at some future date, at which time sufficient evidence about its outcome is likely to be available. Examples of such uncertainties include lawsuits against the entity and tax claims by tax authorities when precedents are not clear. Because its resolution is prospective, sometimes management cannot estimate the effect of the uncertainty on the entity's financial statements. However, those uncertainties have, in some cases, been confused with other situations in which management asserts that it is unable to estimate certain financial statement elements, accounts, or items.

.21 Generally, matters whose outcomes depend on the actions of management and relate to typical business operations are susceptible to reasonable estimation and, therefore, are estimates inherent in the accounting process, not uncertainties. Management's inability to estimate in these situations should raise concerns about the possible use of inappropriate accounting principles or scope limitations. If the auditor believes that financial statements are materially misstated because of the use of inappropriate accounting principles, a qualified or adverse opinion is required due to the GAAP departure. A scope limitation should result in a qualified opinion or a disclaimer of opinion.

Going-Concern Matters

.22 When an auditor concludes that there is substantial doubt about an entity's ability to continue as a going concern, SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,* requires the auditor to include an explanatory paragraph (following the opinion paragraph) in the report to reflect that conclusion. Auditors have issued reports in which it is unclear whether they are expressing a conclusion that there is substantial doubt about an entity's ability to continue as a going concern.

.23 For situations in which the auditor expresses such a conclusion, the ASB recently amended SAS No. 59 to require the use of the phrase "substantial doubt about the entity's ability to continue as a going concern" (or similar wording that includes the terms *substantial doubt* and *going concern*) in the required explanatory paragraph.

Required Communications to Audit Committees and Others Having Oversight Responsibility

.24 Instances have been noted in which auditors have overlooked the communication requirements of SAS No. 61, *Communication With Audit Committees.* This statement requires auditors to ensure that certain matters are communicated to audit committees or other groups with responsibility for oversight of the financial reporting process. SAS No. 61 applies to—

- Entities that have an audit committee or a formally designated group having oversight responsibility for financial reporting (for example, a finance or budget committee).
- All SEC engagements as defined in footnote 1 of the statement.

.25 In considering the communications required by SAS No. 61, the auditor should also not overlook the communications required by the following:

- SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities.*
- SAS No. 54, *Illegal Acts by Clients* (see discussion below).
- SAS No. 60, *Communications of Internal Control Structure Related Matters Noted in an Audit.*

Illegal Acts

.26 SAS No. 54 provides guidance for communications with clients of possible illegal acts. The auditor has a responsibility to detect and report misstatements resulting from illegal acts having a direct and material effect on financial statement line-item amounts. Auditors may also become aware of other illegal acts that have, or are likely to have, occurred and that may not have a direct and material effect on financial statement amounts.

.27 Auditors should assure themselves that all illegal acts that have come to their attention, unless clearly inconsequential, have been communicated to the audit committee or its equivalent (the board of trustees or an owner-manager) in accordance with SAS No. 54.

Recurring Audit Problems

Questionable Accounting Practices

.28 Managements of companies—public or private—might feel pressure to report favorable results—for example, to maintain a trend of growth in earnings, support or improve the price of the company's stock, obtain or maintain essential financing, or comply with debt covenants. This pressure is most likely to affect public companies, but auditors should not underestimate the pressures on nonpublic companies to "stretch" earnings or report a favorable financial condition—particularly in light of the current credit crunch. In most cases, the actions taken are well-intentioned and believed to be appropriate by the company. However, in certain cases, the result is an inappropriate accounting practice.

.29 The downturn in the economy may have an effect on the way a client conducts its business and carries out its revenue recognition policies. Auditors should be alert to facts and circumstances relating to revenue recognition policies that may not be appropriate, such as—

- Changes in standard sales contracts permitting, for example, continuation of cancellation privileges.
- Situations in which the seller has significant continuing involvement or the buyer has not made a sufficient financial commitment to demonstrate an intent or ability to pay.
- Certain sales with a "bill and hold" agreement.

.30 Revenue should not be recorded until it is realized or clearly realizable, the earnings process is complete, and its collection is reasonably assured.

.31 The following are some other accounting practices that distort operating results or financial position:

- Improperly deferring typical period costs and expenses (for example, personnel, training, and moving costs) or costs for which a specific quantifiable future benefit has not been determined.
- Adjusting reserves without adequate support.
- Nonaccrual of losses (for example, environmental liabilities) or inadequate disclosure in accordance with FASB Statement No. 5, *Accounting for Contingencies.*
- Inadequate recognition of uninsured losses (for example, increased deductibles for workers' compensation or medical care).
- Using improper LIFO accounting practices, including inappropriate pools and intercompany transactions.

.32 Competent and sufficient audit evidence continues to be the foundation for the auditor's opinion. Insufficient professional skepticism, illustrated by "auditing by conversation," or failing to obtain solid evidence to back up management's representations, can lead to audit problems. In the final analysis, auditors need to step back and ask one of auditing's most fundamental questions: Does it make sense?

.33 Problems also can occur due to errors in recording relatively straightforward transactions, particularly in those situations where cost-reduction and restructuring programs have reduced the number and quality of accounting personnel. The importance of principal audit procedures (for example, sales and inventory cut-off tests, searches for unrecorded liabilities, and follow-up on errors noted during tests) cannot be overemphasized. These types of procedures are fundamental and critical to the audit process.

.34 Although clients may impose fee pressures or tight deadlines on auditors, these pressures do not change the professional responsibility to understand and audit the facts and situations carefully and to make professional, knowledgeable decisions.

Communications Between Predecessor and Successor Auditors

.35 SAS No. 7, *Communications Between Predecessor and Successor Auditors,* establishes requirements for communications between predecessor and successor auditors when a change of auditors has taken place or is in process. It has been observed that the guidance provided by SAS No. 7 is sometimes not followed. It is essential that both predecessor and successor auditors are aware of, and adhere to, the requirements of SAS No. 7. For example, the predecessor auditor should respond promptly and fully to the successor's reasonable inquiries unless he or she indicates that the response is limited.

Part of Audit Performed by Other Independent Auditors

.36 In accordance with SAS No. 1 (AICPA, *Professional Standards,* vol. 1, AU section 543), in no circumstances should an auditor state or imply that an audit report making reference to another auditor is inferior in professional standing to a report without such a reference. When a principal auditor decides not to make reference to the work of another auditor, the extent of additional procedures to be performed by the principal auditor may be affected by the other auditor's quality-control policies and procedures (see auditing interpretation "Part of Audit Performed by Other Auditors: Auditing Interpretations of AU Section 543" [AICPA, *Professional Standards,* vol. 1, AU section 9543.18]).

Attorney's Responses

.37 A letter of audit inquiry to the client's lawyer is the auditor's primary means of corroborating information furnished by management concerning litigation, claims, and assessments. Auditors should carefully read all letters from attorneys and ensure that all matters discussed are understood. Ambiguous and incomplete responses should be appropriately resolved with client management and attorneys, and conclusions should be properly documented. An auditing interpretation of SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments,* presented in the AICPA's *Professional Standards,* vol. 1, AU section 9337.18, discusses what constitutes an acceptable reply. Additional inquiries may be needed if replies are not dated sufficiently close to the date of the audit report.

Pitfalls for Auditors

.38 Each year-end seems to abound with pitfalls for auditors. The following reminders are intended to alert auditors to some of these pitfalls.

- Watch out for large, unusual, one-time transactions, especially at or near year-end, that may be designed to ease short-term profit and cash flow pressures. Scrutinize each transaction to ensure validity of business purpose, timing of revenue or profit recognition, and adequacy of disclosure.
- In performing analytical procedures (for example, analyzing accounts, changes from period to period, and differences from expectations), maintain an attitude of objectivity and professional skepticism. Do not assume that the accounts or client explanations are

right. Rather, question, challenge, and compare new information with what is already known about the client and of business in general.

- Make sure that receivables that are supported by real estate as collateral reflect the softening of the market. Increases in the allowance for uncollectibles may be needed. Recognize that assets acquired through foreclosure may be overvalued and difficult to sell.
- Pay special attention to the collectibility of significant receivables from debtors that have recently gone through a leveraged buyout (LBO). A company is not the same entity that it was before an LBO.

Accounting Developments

Financial Instruments Disclosure

.39 In March 1990, the FASB issued Statement No. 105, *Disclosure of Information About Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk,* effective for fiscal years ending after June 1, 1990. It applies to all entities, including small businesses (due to its requirement to disclose significant concentrations of credit risk arising from all financial instruments, including trade accounts receivable).

.40 The statement applies to all financial instruments with off-balance-sheet risk of accounting loss and all financial instruments with concentrations of credit risk, with some exceptions that are detailed in paragraphs 14 and 15 of the statement. It requires all entities with financial instruments that have off-balance-sheet risk to disclose the face, contract, or underlying principal involved; the nature and terms of the financial instrument; the accounting loss that could occur; and the entity's policy regarding collateral or other security and a description of the collateral.

Postretirement Benefits Other Than Pensions

.41 The FASB issued Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions,* in December 1990. The statement significantly changes the prevalent current practice of accounting for postretirement benefits on the "pay as you go" (cash) basis by requiring accrual, during the years that employees render services, of the expected cost of providing those benefits to employees and their beneficiaries and covered dependents. This statement is effective for calendar-year 1993 financial statements. An additional two-year delay is provided for plans of non-U.S. companies and certain small employers.

.42 In the SEC Staff Accounting Bulletin (SAB) No. 74, *Disclosure of the Impact That Recently Issued Accounting Standards Will Have on the Financial Statements of the Registrant When Adopted in a Future Period,* the SEC staff expressed its belief that disclosure of *impending* accounting changes is necessary to inform readers about expected effects on financial information to be reported in the future and should be made in accordance with existing MD&A requirements. The SEC staff provided supplemental guidance regarding SAB No. 74 in the November 1990 EITF minutes.

Reporting When in Bankruptcy

.43 Statement of Position (SOP) 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code,* provides guidance for entities that have filed petitions with the Bankruptcy Court and expect to reorganize as going concerns under Chapter 11.

.44 The SOP recommends that all such entities report the same way while reorganizing under Chapter 11, with the objective of reflecting their financial evolution. To do that, their financial statements should distinguish transactions and events that are directly associated with the reorganization from the operations of the ongoing business as it evolves.

.45 The SOP generally becomes effective for financial statements of enterprises that have filed petitions under the Bankruptcy Code after December 31, 1990.

Audit Risk Alerts

.46 The Auditing Standards Division is issuing Audit Risk Alerts to advise auditors of current economic, industry, regulatory, and professional developments that they should be aware of as they perform year-end audits. The following industries are covered:

- Airlines (022071)
- Agribusiness (022073)
- Banking (022063)
- Casinos (022070)
- Construction contractors (022066)
- Credit unions (022061)
- Employee benefit plans (expected to be available in March 1991) (022055)
- Federal government contractors (022068)
- Finance companies (022060)
- Investment companies (022059)
- Life and health insurance companies (022058)
- Nonprofit organizations, including colleges and universities and voluntary health and welfare organizations (expected to be available in March 1991) (022074)
- Oil and gas producers (022069)
- Property and liability insurance companies (022072)
- Providers of health care services (022067)
- Savings institutions (022076)
- Securities (022062)
- State and local governmental units (expected to be available in June 1991) (022056)

.47 Copies of these industry updates may be purchased from the AICPA Order Department. They are also included in this service.

Call toll free: (800) 334-6961 (USA)
(800) 248-0445 (NY)

AICPA Services

Technical Hotline

.48 The AICPA Technical Information Service answers inquiries about specific audit or accounting problems.

Call toll free: (800) 223-4158 (USA)
(800) 522-5430 (NY)

Ethics Division

.49 The AICPA's Ethics Division answers inquiries about the application of the AICPA Code of Professional Conduct. Auditors may call at any of the following numbers:

(212) 575-6217
(212) 575-6299
(212) 575-6736

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