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# PROPOSED AUDIT GUIDE

# AUDITS OF BANKS

Sixth AICPA
National Conference on Banking
Chicago, Illinois
November 16, 1981

Prepared by the Banking Committee

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## PREFACE

This guide has been prepared to assist the independent CPA in examining and reporting on financial statements of commercial banks, savings banks and bank holding companies. Also, it should help officers and directors of banks and other interested persons 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 reporting by banks. Bank holding companies have become a major factor in the industry, and the range of services offered by banking institutions has expanded. The supervisory authorities have expressed increased interest in reliance on examinations by independent CPAs. Since 1971, the Securities and Exchange Commission (SEC) 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 (AICPA) Committee on 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 guide.

This guide emphasizes aspects of accounting and auditing unique to the banking industry. It reflects the presumption that the CPA understands accounting and auditing common to business enterprises in general. The discussions of auditing present

typical audit situations in banks, including the CPA's review of internal accounting controls of banks. However, the discussions do not necessarily cover all audit situations a CPA might encounter in banks.

Finally, references to the statements on auditing standards of the AICPA and the authoritative accounting pronouncements of the Financial Accounting Standards Board (FASB) and its predecessor organizations, including the Accounting Principles Board (APB) are intended to include the specific pronouncements as well as all subsequent amendments to them effective as of the date of this guide. The CPA should be familiar with any auditing or accounting interpretations issued after the date of this guide.

Chapter 1

# INTRODUCTION TO THE BANKING SYSTEM

## Description of the U. S. Banking System

A United States bank operates either under 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 total deposits.

State banks are supervised by banking departments of the chartering states, but most state banks are also subject to some federal control. Although a state bank is not required to join the Federal Reserve System, if it chooses to join, it must also subscribe to the FDIC. If it does not join, it still has the option of obtaining FDIC coverage. The Depository Institution Deregulation and Monetary Control Act enacted in 1980, significantly changed reserve requirements for financial institutions. It requires all insured depository institutions to maintain reserve balances within the Federal Reserve System.

Banks operate as unit banks, branch banks, chain banks, or group banks. A unit bank operates in one location (but 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 in a city, in a county, or throughout a state, depending on state laws. A chain bank is one of two or more banks owned and controlled by several individuals who, as joint directors, officers, or individual owners, are active in formulating policy and managing the banks in the chain. A group bank is often an affiliate of a holding company that controls a substantial part of the stock of one or more other banks.

Mutual savings banks were the nation's first consumer savings institutions, organized in 1816 to meet the savings needs of individuals and families. Historically, savings banks were chartered by states and 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 under a state insurance fund. Title 12 of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 authorized the Federal Home Loan Bank Board (FHLBB) to grant federal charters to existing state-chartered mutual savings banks, except if such a conversion is in contravention of 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, 1981 only a few mutual savings banks have received permission from the FHLBB to convert to federal charter.

In contrast to banks owned by stockholders, mutual savings banks are owned by its depositors. They are managed by boards of

of trustees who are prohibited from sharing in the profits from the earnings of the bank and who are responsible for setting policies that best serve the interest of the depositors.

Commercial banks and mutual savings banks also differ on the scope of their business activities and 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 shorter term savings and time deposits. Because of the relationship between its assets and liabilities mutual savings banks are more affected by changing interest rates than commercial banks. Recent Federal and state regulatory changes, however, have authorized broadened business powers and activities to 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.

## Government Supervision of Banks

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

of banks.

| Bank Classification | Supervisory Agency | | | |
|---|---|---|---|---|
| | Comptroller of the Currency | Federal Deposit Insurance Corporation | Federal Reserve Banks | State Banking Department |
| National banks | X | | | |
| State banks and trust companies: | | | | |
| Federal Reserve members (frequently joint examination) | | | X | X |
| Non-members: | | | | |
| FDIC-insured (frequently joint examination) | | X | | X |
| Uninsured | | | | X |
| Mutual Savings banks (frequently joint examination) | | X | | X |

Constant awareness by bank management and supervisory authorities of the importance of protecting and reassuring depositors previously was 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 the income generating ability of a bank is important in determining a bank's solvency and the degree of competence of its management.

The three federal bank supervisory agencies influence considerably the financial reporting practices of banks through

the instructions issued principally by the Federal Financial Institutions Examination Council in connection with "call reports" ("Reports of condition and Income by all Insured Commercial Banks that have Only Domestic Offices: National Banks, State Member Banks, Insured State Nonmember Banks"). Those instructions 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 are cash basis accounting followed by many banks with total assets under $25 million and accounting for goodwill which bank supervisory agencies generally prohibit banks (but not bank holding companies) from recording as an asset.

Bank holding companies, defined in Chapter 21 of this guide, 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 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 those holding companies and their affiliates to regulation by the Securities and Exchange Commission (SEC).

Banks subject to the Securities Exchange Act of 1934 (generally those with five hundred or more shareholders) are usually registered with the bank supervisory agencies rather than the SEC. The agencies are required by the Act to substantially conform their securities disclosure regulations with those of the SEC. In 1980, the banking agencies adopted many of the changes from SEC Regulation S-X, Article 9 in Accounting Series Releases through ASR 254. While those changes left the income statement format

optional, they adopted the SEC required disclosures for officers and directors loans, aggregate time certificates of deposit of $100,000 or more, short-term debt and other borrowings, and foreign activities.

## Effect of "Permissible Activities" on Industry Segment Reporting

Pursuant to the requirements of the Bank Holding Company Act of 1956 as amended, the Board of Governors of the Federal Reserve System has defined permissible activities that are a natural incident to banking. Banks believe that all permissible activities consist of services that are closely related 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.

## Effect of the Federal Reserve System on Bank Operations

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

- Act as fiscal agent, legal depository, and custodian of funds for the U.S. Government.
- Regulate the money supply.
- Hold legal reserves of banks and other depository institutions.
- Provide wire transfers of funds.
- Facilitate clearance and collections of checks.
- Examine and supervise state chartered member banks.

- Examine and supervise bank holding companies and nonbanking affiliates.
- Collect and interpret economic data regarding credit.

There are 12 Federal Reserve districts in the United States. Each district has one Federal Reserve bank located in a principal city, and several have branch banks in other cities. The major policies of the Federal Reserve banks are determined by the Board of Governors of the Federal Reserve System in Washington, D.C. Each bank is required by law to maintain a percentage of its deposits in reserve with the Federal Reserve bank in the bank's district.

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

- Increase reserve requirements, thereby requiring banks to increase their reserves by selling investment securities, calling loans, or borrowing funds and transferring them to their accounts at the Federal Reserve bank in its district.
- Sell securities in the open market reducing the supply of money by transferring funds used to pay for the securities from private demand deposit accounts at banks to the bank's FRB accounts.
- Raise the discount rate making it more expensive for banks to borrow and increase loanable funds and, therefore, discouraging borrowing from the FRB.

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

## Chapter 2

## AUDITING CONSIDERATIONS

### Auditing in a Banking Environment

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

### Planning the Audit

Planning is necessary to audit the financial statements of a bank. The information needed for planning is usually developed by a preliminary review of financial data and should include a

review of 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.

## Consulting with Bank Management

The nature, timing, and extent of procedures to be performed and the type of reports to be issued are subject to the CPA's judgment based on the scope of the services required by the bank. The CPA should consult with a prospective bank client to establish the scope of services required. The CPA should send an engagement letter to the bank detailing his understanding of the scope of services required with a request that the bank confirm the understanding. Some of the typical services a CPA may be engaged to perform include

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

Reports issued by the CPA in connection with an audit of financial statements, trust departments, collective investment trusts and systems of internal accounting control are discussed in this guide in Chapter 23, "Auditors' Reports."

The bylaws of national banks and the laws of most states, which apply to banks chartered by 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 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, or a report containing comments and observations of the directors and referring to the CPA's report on the portions of the examination conducted by the CPA.

Timing of the Audit

Based on the evaluation of the bank's internal accounting controls, the CPA may determine that a siginficant amount of the audit can be performed in interim periods and that year end procedures can be limited to such matters as review and investigation of unusual transactions and significant fluctuations for the period from the interim period to the balance sheet date, as well as any additional substantive testing and other audit procedures deemed necessary. However, the CPA should be satisfied that the internal accounting control procedures relied on are still in

effect at year end. Sections 320.60-63 of SAS 1, Codification of Auditing Standards and Procedures, provide guidance as to the timing of tests of compliance with internal accounting control procedures.

## Other Planning Considerations

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

First, there are economic risks. As supply of 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. Some of the risks include the following

- Credit risk. The credit risk is significant in most banks. Loans may develop credit risk problems due to
  - 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, or
  - deterioration in the credit worthiness of the borrowers.

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

- Interest risk. Banks are exposed to interest risk when their assets are subject to legal interest rate ceilings or are invested in intermediate or longer term fixed rate loans or securities and such assets are funded with interest sensitive short term liabilities. If bankers misjudge the movement of interest rates and the rates rise substantially, they must refinance short term borrowing at higher rates, which may result in lower overall profit margins, or an overall loss.
- Liquidity risk. Banks are exposed to the liquidity risk caused by investing disproportionately in long term securities, which generally decrease in market value when interest rates rise. If a bank is forced to sell these investments to generate cash, large losses may be incurred on the transactions. If the bank's liquidity is not sufficient to meet prospective needs and there is evidence that the bank may have to dispose of certain of its assets to obtain liquidity, the propriety of the accounting basis for assets that may be disposed of to meet such needs should be considered. In more serious situations of illiquidity, the independent auditor may also need to refer to SAS No. 34, The Auditor's Consideration When a Question Arises About an Entity's Continued Existance.

Second, the CPA should be aware of the bank's need to maintain an adequate capital base pursuant to regulatory requirements. This adds to the need for a system of internal accounting control that provides reasonable assurance of proper accumulation and disclosure of required financial data.

In addition, there are the usual audit risks inherent in any audit engagement, including the possibility of errors and irregularities, illegal acts by clients, and related party transactions, which are discussed in this guide in Chapter 3, "Internal Accounting Control."

## Audit Objectives

The first step involved in obtaining evidential matter in support of financial statement assertions is to translate the assertions into audit objectives. The audit objectives of a particular engagement should be developed in light of the specific circumstances of a given bank in the context of the nature of banking activity and accounting practices unique to the banking industry. For example, the following audit objectives might be developed for bank assets.

### 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 except for assets not held for such purposes which are properly identified and segregated.

### 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.

## 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.

## Valuation or Allocation

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

## Presentation and Disclosure

- Determine that the assets are properly classified 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.

While the above objectives are generally associated with assets, they also apply, with certain modifications, to liabilities.

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 is needed to be sure that the persons to whom the requests are sent can readily identify the specific items or accounts in question and 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 what checks have been cleared and posted to their demand deposit accounts since the last statement date.

Also important in planning a bank audit engagement is consideration of a bank's organizational structure and mode of operation that include

- Single bank versus diversified holding company,
- One bank versus multibank holding company,
- Unit versus branch banking,
- Centralized versus decentralized accounting and internal auditing,
- EDP capabilities (in-house operations versus use of service bureau),
- International operations.

Each of those considerations could significantly affect the timing, nature, and extent of audit tests. Judgment as to the nature, timing, and extent of the CPA's tests should be exercised for audits of banks, just as it is for other miltidivisional or multinational enterprises. The extent of tests may also be influenced by the client's reporting requirements, such as the need for a separate report on a subsidiary of a bank holding company.

## Initial Audit Procedures

To the extent possible, audit procedures should be performed with a minimum of disruptions in a bank's regular routine. Consequently, before beginning the audit, the audit staff assigned to the engagement should be assembled and briefed as to particular audit requirements. Specific assignments may then be made.

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. The CPA should obtain an overview of internal accounting control before starting detail audit procedures, based on the CPA's understanding of the internal accounting controls inherent in the system and the materiality of items involved. 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. Related confirmation requests may then be prepared. Persons in charge of the various segments of the audit should continue the evaluation of the internal accounting controls and note significant weaknesses that may require modifications of auditing procedures.

## Application of Audit Sampling

A number of auditing procedures in audits of banks may use audit sampling. Such procedures might 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.

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. It includes discussions intended to enhance professional judgment in assessing sampling risk, planning samples, sample selection, and performance and evaluation.

## Auditing and Electronic Data Processing (EDP) Systems

The use of EDP equipment does not affect the objectives of the audits. 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 in auditing records in which EDP processing is significant includes

- SAS No. 3, The Effects of EDP on the Auditor's Study and Evaluation of Internal Control,
- AICPA audit guides, The Auditor's Study and Evaluation of Internal Control in EDP Systems and Audits of Service-Center-Produced Records,

- Federal Financial Institutions Examinations Council publication EDP Examinations Handbook, which includes a section on "Internal and External EDP Audit."

AICPA Auditing Standards Board is currently studying the issues related to special purpose reports for use by other auditors.

## Client Representations

SAS No. 19, Client Representations, requires CPAs to obtain certain written representations from management as part of an audit and provides guidance concerning the representations to be obtained. The specific written representations to be obtained by the CPA depends 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 value of investment securities have been properly reported in the financial statements.
- Commitments to purchase or sell securities under forward placement financial futures contracts and standby commitments have been adequately disclosed to the CPA and in the financial statements as appropriate.

## Chapter 3

## INTERNAL ACCOUNTING CONTROL

### Bank Procedures and Systems

Certain aspects of a bank's accounting and data processing systems are unique. The more important aspects are

- Daily posting and trial balancing of the general ledger to produce a daily balance sheet.
- High transaction volume principally affecting balance sheet accounts.
- Use of single-entry tickets as contrasted to 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).
- Central proof and cash collection system.
- Use of memorandum accounts.

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

Bank supervisory authorities require banks to prepare balance sheets on a periodic basis. That requirement influences the financial reporting system. Income and expense account balances since the last regular closing date are carried in the balance sheet, often in a profit and loss section within the net worth

caption. This precludes the necessity of closing these accounts to retained earnings at the end of each day.

Single Entry Tickets

One of the devices to expedite the sorting and summarization of bank accounting transactions is single entry tickets. The customary offset to debit and credit entry tickets initiated at the teller's cage is cash. To ensure that cash on hand corresponds to other accounting entries generated, tellers prove their cash balances at the end of the day, and the net change in cash is posted to the general ledger account through use of a single entry debit or credit ticket.

Tellers' blotters or proof sheets are frequently maintained. They are used to summarize entries for a day's transactions, often by department, from which postings are made to the general and subsidiary ledgers. The use of data processing equipment by banks to facilitate accounting and to provide for a growing volume of transactions has resulted in modifications in the more traditional methods of handling transaction data.

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

Interdepartmental Accountability

Because of the negotiability of cash, checks, notes, and other items handled by bank personnel, the accounting 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 detect and locate rapidly errors that may arise.

### Central Proof and Cash Collection Systems

The focal point of the bank accounting system is the proof department. That department receives batches of checks, deposit tickets, and so forth from other departments in the bank 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 numerous transaction data that flow 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.

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 presented.

Banks are required either to pay "on us" items when 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. In the case of clearinghouses, settlement is one of offset between banks with the net difference, debit or credit, 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 direct sending to drawee banks, or by forwarding to a correspondent bank in the same area as the drawee bank. When a check is deposited, the availability of the funds depends on the expected time necessary to collect the item. While the bank gives the customer credit for the check when it is deposited, the availability of funds normally determines when the depositor may withdraw the deposit.

Bank Ledgers

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

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

Memorandum Accounts

Memorandum accounts are also 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. Generally accepted accounting principles requirements concerning disclosure of such items are discussed in this guide in Chapter 14.

## Study and Evaluation of Internal Accounting Control

The second standard of field work states that "there is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted." This section is intended to assist the auditor in complying with the second standard as it applies to the study and evaluation of internal controls in banks.

The nature of the audit procedures selected, their timing, and the extent of their application depends 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 of internal accounting control, as a basis for determining 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 considered necessary to evaluate compliance with established internal accounting control procedures, that is, to ascertain that controls are functioning as represented.

To effectively study and evaluate the bank's system of internal accounting control, 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:

| Classes of Transactions | Transaction Types |
|---|---|
| Obtaining deposits | • Demand deposits (checking accounts)<br>• Now accounts<br>• Time deposits (savings accounts)<br>• Other time deposits (certificates of deposit, discount savings certificates)<br>• Time deposits (open account, time certificates of deposit) |
| Maintaining liquidity | • U. S. Government short term securities<br>• Federal agency short term securities<br>• Repurchase agreements<br>• Federal funds<br>• Borrowings from Federal Reserve |
| Granting loans | • Real estate and construction loans<br>• Commercial loans |

- Loans to financial institutions
- Loans for purchasing or carrying securities
- Loans to farmers
- Loans to individuals for household, family, and other personal expenditures
- Acceptance financing
- Lease financing

Investing residual funds

- U. S. Government intermediate and long term securities
- Federal agency intermediate and long term securities
- State and municipal intermediate and long term securities
- Other securities
- Federal funds

Processing payments and transferring funds

- Cash
- Checks
- Drafts

In addition to the classes of transactions outlined above, many banks provide a number of other services to their customers and to their correspondent banks. Some of the more common services are

- Trust (settling estates, administering trusts and guardianships, acting as agent, and so forth)

- Collection
- Safe deposit
- Lock box
- Data processing
- Correspondent bank services
- letters of credit
- Foreign exchange
- Travelers' checks and savings bonds
- Safekeeping arrangements.

In establishing a plan for the review of a class of transactions, the CPA should consider all relevant aspects of the system, including not only asset and liability valuation, but also associated income and expense accounting and management reporting. If the system is to be relied on, 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 is often helpful in reviewing the design of the system of internal accounting control.

Section 320 of SAS No. 1 amplifies and clarifies the application of the basic concepts and rationales included in the study and evaluation of internal accounting control. The existence of an internal audit function may affect the study and evaluation of internal accounting control. SAS No. 9, The Effect of an Internal Audit Function on the Scope of the Independent Auditor's Examination, discusses that matter.

Internal accounting controls over cash, consigned items, loans receivable, securities owned, deposit accounts, and the

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

Bank EDP operations may be maintained solely by the bank, shared with others, or provided by an independent organization supplying specific data processing services for a fee. Auditors should study and evaluate the internal accounting control features of the EDP system as they would other features of internal accounting control over the bank's operations. (The effect of EDP systems on auditing procedures in discussed in Chapter 2.)

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

SAS No. 6, <u>Related Party Transactions</u>, provides guidance on how to identify related party transactions when performing an examination and to satisfy the auditor about the substance of, and

accounting for, such transactions. In addition, the Foreign Corrupt Practices Act (FCPA) of 1977 prescribes records maintenance standards and requires establishment and maintenance of a system of internal accounting control for all companies with securities registered under Section 12 of the Securities Exchange Act of 1934 and companies required to file periodic reports pursuant to Sections 13 and 15(d) of that Act, and revised Article 9 of Regulation S-X of the SEC governing the form and content of financial statements of bank holding companies and certain banks filing with the SEC (Chapter 21 further discusses SEC requirements). Regulation S-X contains disclosure requirements for related-party transactions more detailed than those included in SAS 6. Although the objective of a CPA's examination is to enable the auditor to render an opinion on the financial statements, the examination may also assist in minimizing losses and discouraging irregularities and illegal acts. SAS No. 16, *The Independent Auditor's Responsibility for the Detection of Errors or Irregularities*, and SAS No. 17, *Illegal Acts by Clients*, relate to those concerns.

The independent auditor's evaluation of internal accounting control, made for the purpose of determining the nature, timing, and extent of audit tests, may reveal material weaknesses in the system. SAS No. 20, *Required Communication of Material Weaknesses in Internal Accounting Control*, requires that such weaknesses be reported to the senior management and the board of directors or its audit committee.

An independent auditor may be requested to report on the system of internal accounting control of a bank or its trust or

other departments. SAS No. 30, _Reporting on Internal Accounting Control_, and its interpretations describe the procedures and different forms of reports that may be issued in connection with engagements to report on an entity's system of internal accounting control.

## Chapter 4

## CASH AND DUE FROM BANKS

"Cash and Due from Banks" can be separated into four broad classifications: cash on hand, cash items, clearings and exchanges, and balances due from correspondent banks.

### Cash on Hand

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

### Cash Items

Cash items typically include maturing coupons and bonds, petty cash vouchers, returned checks, due bills, unposted debits, and other items temporarily held pending their liquidation. Technically, those 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 may be included in the cash-on-hand total in teller funds. In the preparation of financial statements, cash items and unposted debits, if material, should be reclassified to the account of ultimate disposition.

Clearings and Exchanges

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

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

The clearinghouse association is a cooperative organization owned and operated by the local banks, who elect the association's officers and subsidize its operations. In some cities, association personnel perform surprise examinations of the members' operations. The scope of those examinations is similar to examinations performed by supervisory agencies. The assocation also establishes rules for check collection, return items, and other matters pertaining to interbank relationships. Within the bank, local clearings and exchange items are a by-product of the proof department, discussed in further detail in Chapter 3.

Due from Banks

Correspondent bank accounts are used to facilitate check collection and other banking services between banks. "Due from" accounts, including interest bearing deposit accounts, may reflect transactions initiated either by the bank placing such 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 required to be deposited with the district Federal Reserve bank for purposes of check collection and legal reserve requirements.

Checks received for collection are normally forwarded to "due from" banks by means of "cash letters," which represent deposits with the "due from" banks. The mechanics of the operation may vary among banks, but it is usually handled by the "due from" bank in one of the following methods:

- the bank's account on the "due from" bank's books is credited immediately on receipt of the checks,
- the bank's account is credited after a specific period of time necessary to collect the items,
- a bank draft remitttance is arranged, or
- another correspondent bank account is credited.

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

The majority of transactions with other banks are initiated and documented by debit and credit advices. In addition, the depositor bank draws drafts on those accounts. Statements for

active accounts are produced and mailed either 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 receiving bank. Returned checks, differences in cash letters, items entered for collection, and so forth, are frequently outstanding in the account reconciliation because of the delay in receiving the advices on such items.

Financial Statement Presentation

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

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

Auditing

Audit Objectives. The audit objectives for cash and due from banks are to consider whether the balances are properly stated, that cash items held will clear in the normal course of business, and that due from accounts are collectible.

Internal Accounting Controls. Because of the negotiability of the items included in the caption cash and due from banks, good internal accounting control is important. Some typical

considerations in evaluating the system of internal accounting control relating to cash and due from banks are:

- 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 from 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?
- Are 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 others processed by an employee other than the one reconciling the account?
- Are the duties of origination, testing, processing, and balancing of wire transfer requests segregated?

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

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

In counting currency and coins, the CPA should consider the following procedures. The CPA should account for cash on hand and maintain control until cash is balanced to control accounts. Tellers' funds should be counted first, while 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 a 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.

Unissued drafts, travelers' checks, and savings bonds may be inventoried and last-issued items accounted for at the time cash is counted. Confirmation of items on consignment is often obtained from the consignors. The CPA also should obtain information and explanations on 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 released to armored car service representatives. Under such circumstances, the amounts may be confirmed with correspondent banks or depositories in place of physical counts.

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

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

Clearings and Exchanges. Auditing procedures applicable to clearings and exchanges include confirmation of total checks forwarded to other banks and subsequent review of the disposition of larger return items. To determine that the total checks forwarded are correct and that returned items, if any, are proper, the CPA may need to establish control of clearing and exchange

items on hand at the start of the audit. However, in some cases, 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 they are forwarded for exchange. The confirmed totals by receiving banks of clearings and exchanges should be reconciled with amounts recorded in the general ledger.

The confirmation letters may also request a listing of items being returned in excess of a specified minimum; alternatively, the CPA should ascertain the procedures for handling return items and consider arrangements to intercept and test 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. The objective of that procedure is to ascertain that the items were received initially by the bank in a bona fide manner and do not represent fictitious items introduced by employees into the processing.

Due from Banks. The CPA should review and test the accuracy of account reconciliations prepared by bank personnel. The tests may 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. Cancelled checks and drafts for a selected period of time may be compared with the records of

instruments used. At the start of the audit, the CPA should normally determine the last-issued serial numbers of drafts by inspecting the working supply and tracing the numbers to applicable outstanding lists of drafts. The CPA should also consider the bank's internal review procedures for ascertaining collectibility of due from accounts, including the financial viability of the depositories and the ability of the bank to withdraw such funds.

## Chapter 5

## INVESTMENT SECURITIES

The investment security portfolio generally represents the second most significant asset of a bank, following loans, which are discussed in Chapter 7. The management of bank funds allows alternatives in the choice of assets, with the objective of an optimum balance between credit quality, liquidity, and income. The investment security portfolio provides a means to accomplish this objective.

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 sub-divisions, 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 stocks. 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.

Certain securities acquired for investment may be required by supervisory agencies to be reported in other categories for regulatory reporting. The reverse has also been required for certain instruments management may consider as arising from the

lending function. The financial statement classification should be determined by the nature of the activity and not solely by the form of instrument.

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

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## Accounting

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

If the debt obligations of others are held to maturity, they will generally be redeemed at face value and therefore are carried at cost. When these securities are expected to be held 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 SFAS No. 12.

It may be necessary to dispose of securities in the foreseeable future to meet the bank's investment objectives or other operational needs. In such cases, an allowance 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 forseeable future or the bank is unable to hold a significant portion of its investment portfolio an allowance for estimated loss should be established.

If the market decline is attributable to specific adverse conditions for a particular security, an allowance should be provided unless persuasive evidence exists to support the carrying amount.

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

Premiums and Discounts. Investment securities are generally acquired at a premium, a price in excess of face value, or at a discount, a price less than face value. A premium paid for a bond at the time of original issuance or at some time thereafter, represents a downward adjustment of the stated rate of interest to reflect the market yield at the time of purchase. Conversely, a bond discount represents an upward adjustment of the stated rate of interest to the market yield at the time of purchase. The carrying amount of the bond during the holding period is systematically adjusted to the amount anticipated to be realized at the maturity date. Amortization of premium and accretion of discount results in a reflection in the income statement of a yield that approximates the market yield at purchase date.

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

The period of amortization or accretion is from the purchase date to the maturity date, except for securities purchased at a premium carrying an early call date at a price higher than par. The premium for those securities may be amortized to the maturity date or to an earlier call date. Premiums or discounts related to securities such 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 APB Opinion 21, Interest on Receivables and Payables.

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

The interest method of amortizing or accreting premium or discount recognizes an amount in earnings each month that produces a constant yield equal to the market yield at 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 decreases each month so that a level yield is reported.

The accretion of discount or the amortization of premium should be recorded in a manner that produces a constant rate of return on the basis of adjusted book value (interest method).

However, straight-line or other methods of amortization or accretion, may be used if the results obtained do not vary materially from those that would be obtained by the interest method.

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

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

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

Security gains and losses should be recognized on the completed transaction basis, that is, those gains and losses should be recognized for financial reporting purposes when realized except for losses arising as a result of adjustment of allowances for losses. Gains and losses on U. S. Treasury bills are often recorded as adjustments of interest income together with accretion of related discount. If such gains or losses are material, they should be included in "Securities gains or losses."

Wash Sales. Bank supervisory agencies currently prescribe that investment security gains and losses be recognized on the completed transaction method. In practice, serious questions develop as to 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.

The risks and opportunities of ownership are transferred in a sale 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 uses the proceeds from sale to reinvest 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 a recognition of a sale. The period of time cannot be defined exactly; rather, the type of securities involved and the circumstances of the particular transaction should enter into the determination of what constitutes a reasonable period of time. For example, a day may be appropriate for a quoted stock or bond that has a history of significant market price fluctuations over short periods of time. Similarly, a bank's liquidity requirements may require that a long term bond be replaced by a short term money market instrument; but, a week later, the bank's liquidity requirements may change, and reacquisition of the bond previously sold may be a reasonable business decision, wholly independent of the previous decision to sell the bond.

Troubled Debt Restructuring

Accounting and reporting requirements for securities that have been involved in troubled debt restructurings (including instances where the substitution of debtors is primarily a matter of form), are set forth in SFAS 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 SFAS No. 15 to account prospectively for the effects of modifications of terms of the debt as an adjustment of interest income for the periods between the restructuring and maturity.

## Financial Statement Presentation

In accordance with SFAS 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 to be instruments representing ownership shares or the right to acquire or dispose of ownership shares in enterprises at fixed or determinable prices and on which market prices are currently available on a national securities exchange or in the over-the-counter market. The amount by which the aggregate cost of the marketable equity securities portfolio exceeds its estimated market value should be accounted for as a valuation allowance. Since banks present unclassified balance sheets, accumulated changes in the valuation allowance should be shown separately in the equity section of the balance sheet.

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

The reporting of municipal interest on a tax equivalent basis in the primary financial statements has been advocated by some banks. Tax equivalent accounting increases the interest income on tax exempt securities to a fully taxable basis with a corresponding increase in tax expense. Proponents of tax

equivalent reporting believe it produces more helpful earnings statistics than those produced by other reporting practices. Others 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 reporting income that will never be received and taxes that will never be paid. Another objection is the difficulty of determining the appropriate income tax rate to use in arriving at the amount of the tax equivalent adjustment. For those reasons, income from tax exempt securities should not be reported on a tax equivalent basis in the primary financial statements.

Some banks present in their annual reports 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 is helpful to a reader of the bank's financial statements in evaluating the bank's investment portfolio.

## Auditing

Audit Objectives. The objective of an audit of a bank's investment securities is 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 been permanently impaired.
- Allowances for losses have been provided, where necessary.
- Securities have been properly identified as investment securities as opposed to trading.
- All required disclosures have been made.

The CPA should be familiar with an auditing interpretation entitled "Evidential Matter for the Carrying Amount of Marketable Securities" (AU9332, January, 1975). This interpretation gives guidance on the evidence the auditor should obtain pertaining to classification and carrying value of marketable securities. It also discusses the effect on the auditor's report when the information available does not support a judgment concerning eventual recovery when there is a decline in market value.

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

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

- Securities pledged with, physically held by, or maintained on the book entry system of the Federal Reserve Bank.
- Securities held in safekeeping by correspondent banks.

- Securities pledged with other banks or the state (or political subdivisions of the state) to secure public deposits, trust functions, and so forth.
- Securities loaned to others.

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

Generally, transactions in the investment portfolio require the approval of the bank's investment officer or investment committee; ratification of the purchase or sale of investment securities is often reflected in the minutes of the board of directors or its investment committee.

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

- Are security purchases, exchanges, and sales ratified by the board of directors or investment committee and recorded in the minutes?
- Does the board of directors receive regular reports on investment securities activity showing data such 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 to the records at regular intervals?
- Are investment securities on hand physically segregated from collateral, safekeeping, and trust securities; 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 assure that (a) cash credit is received from an agency bank for securities delivered and (b) securities are received for cash paid or credit given to an agency bank?

Audit Procedures. Since investment securities are highly negotiable, the audit procedures employed should provide for adequate control of the securities until they have been accounted for by inspection, as follows:

- At the beginning of the audit of securities, control should be established over the securities and should be continued until all other negotiable assets have been properly accounted for.

- The securities ledgers should be recapped and totals traced to the general ledger.
- Confirmation should be obtained from custodians of securities held on account by other institutions.

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

## Chapter 6

## TRADING SECURITIES

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

### Accounting

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

The prevailing practice has been for banks to record on 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 trade date. If reported amounts under settlement date accounting would not be materially different from those under trade date accounting, settlement date accounting is acceptable.

Currently, supervisory agencies permit banks to carry their trading securities at either market or at the lower of cost or

market. The previous AICPA 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 and market.

The AICPA Industry Audit Guide Audits of Brokers and Dealers in Securities indicates that securities held for resale should be accounted for as follows:

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

The market value concept is based on the recognition that trading securities appreciate or depreciate as market or other economic conditions dictate. It reflects the position that decisions to purchase, hold, or sell a particular investment should be accounted for during each accounting period. The market value concept provides the most effective means of measuring the trading decisions of management and trading securities should therefore, be accounted for at market value.

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 recognized in trading

income. The securities should be recorded in the investment account as a new acquisition.

A bank may also transfer securities from its investment securities account to its trading account, although that should also be unusual. The securities should be recorded at market value at the date of transfer and thereafter 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 writeup 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 acquisiton date. Such gains, when recognized, should be reported as investment security gains.

Short Sales. Securities are sold short for a number of reasons: as a hedge against losses, for short term borrowing of funds, in connection with arbitrage transactions, or in anticipation of a market price decline.

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

The obligation incurred in a short sale is recorded as a liability. Since this is a trading activity, the liability is

adjusted to market value at external reporting dates. Interest on the short position is usually accrued and paid to the owner on the due dates. The cost is reported as trading interest. If it is significant, consideration should be given to its separate disclosure.

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

## Financial Statement Presentation

Trading securities should be shown as a separate line item on the balance sheet or be disclosed in a note. Banks that are dealers in securities frequently have short positions in particular issues of securities. Some banks have shown only the net long position of all trading securities in the balance sheet and including as equal amounts in other assets and other liabilities the par or market value of securities borrowed to make delivery in issues with short positions. The reason for including the par or market value of securities borrowed (which are not assets of the bank) as both assets and liabilities is to reflect the value of, and the liability for, borrowed securities. Conversely, loaned

securities to which the bank retains ownership should not be removed from the balance sheet but the liability for any cash received should be reported. Borrowed securities should not be reflected in the balance sheet, except to the extent of any cash given. Trading activity should be reflected as a net position because that presentation best reflects a bank's exposure to interest rate risk. The net presentation is particularly appropriate in arbitrage operations. Consideration should be given to separate disclosure of the aggregate short position if it is significant to the bank's overall financial position. Gains and losses in the trading account, unlike those in the investment portfolio, should be included in operating income.

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

Auditing

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

# Chapter 7

# LOANS

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

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

## Time and Demand Loans

Time and demand loans are made to a variety of borrowers, including individuals, industrial concerns, other financial institutions, brokers/dealers, farmers, and nonprofit organizations. Loans which 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 credit standing of the borrower. Time loans are generally granted for longer periods and contain specific provisions for payment in periodic installments or at maturity.

Time and demand loans may or may not be secured by collateral (referred to as "secured" or "unsecured" in the banking industry). Collateral is frequently 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, 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. They include student loans and loans granted under programs sponsored by the Small Business Administration.

In addition to direct loans to customers, a bank may purchase interests in loans originated by other lenders (loan participations). Conversely, it may sell to other lenders portions of the loans it originates. Also, particularly for large corporate borrowers, groups of banks may agree to participate in a particular loan, with each bank being a direct creditor of the borrower, but with uniform lending terms established for all the banks. One bank is typically appointed as the agent, or lead bank, having primary responsibility for communication and negotiation with the borrower. Loan participations may be negotiated on either a recourse or nonrecourse basis. Also, a participation may be sold on terms that differ from the original loan terms. Accounting for loan participation is discussed in Chapter 19.

In the line of credit arrangement, a common method of commercial financing, 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, or as variations on, the bank's prime lending rate. The extension of a credit line is often informal and represents only an expression of intent, not a binding agreement. Sometimes, however, formal agreements may be signed, providing for, among other things, the payment of fees or maintenance of deposit balances ("compensating balances") as compensation to the bank for holding the line available. One type of formal agreement known as a revolving credit agreement characteristically contains the provision that repayment of amounts previously borrowed under the agreement increases the amount available for subsequent borrowing.

Before granting a loan, a lending officer normally analyzes the financial condition and general credit worthiness 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 element of 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, live-stock, accounts receivable, or inventories.

Changes in business and environmental conditions may result in significant adjustments in the value attributed to collateral.

Deteriorating market and environmental conditions may affect blue chip securities as well as the collectibility of pledged accounts receivable. Thus, the bank frequently evaluates both the collateral and the protection afforded by guarantors and endorsers.

## Real Estate Mortgage Loans

Real estate mortgage loans are usually subdivided into three groups: conventional, F.H.A. (Federal Housing Authority) insured, and V.A. (Veterans Administration—GI) 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 F.H.A. and V.A. loans.

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

Real estate mortgage loans are often made on the basis of a percentage of the appraised value of the mortgaged property at the time the loan is granted. In periods of increasing property

values, an expansion of bank lending activity may occur in the form of junior mortgages (second liens or second trusts).

Mortgage loans may be originated directly with bank customers or by purchase from brokers, such as mortgage banking companies. Mortgage payments may be made directly to the bank by mortgagors or, for purchased loans, may be collected for the account of the bank by a servicing agent, who usually is the originator of the mortgage (Chapter 19, "Other Banking Activities," further discusses mortgage servicing).

Retail Credit and Other Consumer Loans

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

If the loan originates with an appliance or automobile dealer, the transaction customarily results in an installment sales contract discounted with the bank. The bank generally obtains limited protection through the retention of 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 wthout renewal options and scheduled principal repayments. As items are sold from inventory, reduction of the loans are required.

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

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

Another form of personal lending is credit card financing. Currently, several bank sponsored credit card plans are operating nationally, although a number of banks continue to sponsor independent plans. Within geographic areas some banks have formed service companies for the purpose of centralizing card issuance, processing transactions, and maintaining customer accounts. Not all banks that sponsor credit card plans carry the consumer loans that result from use of the cards. The bank may be affiliated with a larger bank in the area that assumes the loan and credit risk; the affiliated bank processes the loan transaction.

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

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

Certain features of credit card operations warrant emphasis. Since the transaction is initiated through the use of an identification card, extreme care and control should be exercised over issued and unissued cards 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 pre-purchase authorization for purchases in excess of a specified amount. Banks monitor accounts with high balances, excessive activity, and delinquencies to lessen the possibility that inappropriate use of credit by the cardholder will result in losses. In an effort to minimize losses resulting from fraudulent use of stolen cards or extension of credit to holders of terminated cards, banks frequently circulate to their merchants listings of card numbers that are not to be honored.

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

to the overdraft or a round amount and concurrently establishes an installment loan balance in the amount of the transfer.

## Lease Financing

In recent years, banks have become more involved in a form of lending referred to 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 owner and lessor of personal property at the specific request of, and for the use of, a customer. Lease financing transactions have many of the characteristics of other forms of installment loans. A typical lease agreement will contain 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. Leases entered into by banks are required to be net full-payout leases (that is, to 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 costs of maintaining the leased property), and they normally possess all of the characteristics of financing transactions. SFAS 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 timing differences should be accounted for in

accordance with the provisions of APB Opinion 11, Accounting for Income Taxes, as amended.

Banks also engage in a specialized form of lease financing, known as leveraged leasing, in which the bank acts as an equity participant. In this type of lease, a substantial portion of the purchase price of the asset is supplied by unaffiliated long-term lenders on a nonrecourse basis. The bank is an equity participant in the lease, and the gross return to the bank is measured by its equity in the sum of investment tax credits, the estimated residual value of the equipment leased, and the excess of rental payments over debt service obligations to the long term lenders. The cash advantage (or cash deficit), which represents the bank's directly recordable income or expense on the transaction, is measured by the difference between the gross return and the bank's equity investment in the lease. That matter is discussed in the section "Investment Tax Credit on Lease Financing" in Chapter 17. 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. In addition, the provisions of SFAS No. 13 apply to leveraged leases.

## Loan and Related Files

Loan files vary in content depending on the type of loan. The principal support for all types of loans is the signed note. For commercial loans, a credit file is commonly maintained. This file usually contains financial statements of the borrower, memoranda 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. However, credit file information is frequently less extensive for borrowers whose loans are considered adequately collateralized.

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

Mortgage loans are supported by documentation the extent of which 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 V.A. guarantee or F.H.A. insurance, if applicable.

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

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

## Accounting

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

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

Interest income on loans is normally credited to operating income based on the outstanding principal amount of the loans. For loans on which interest is separately charged, 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. However, use of the rule of 78ths method (sum of the months' digits) is acceptable provided the results are not materially different from those obtained by using the interest method.

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

Although placing a loan in a nonaccrual status, including loans accruing at a reduced rate, does not necessarily indicate that the principal of the loan is uncollectible in whole or in part, it generally warrants reevaluation of collectibility of principal and previously accrued interest. If amounts are

received on a loan on which the accrual of interest has been suspended, a determination should be made as to whether the payment received should be recorded as a reduction of the principal balance or as interest income.

If the ultimate collectibility of principal, wholly or partially, is in doubt, any payment received on a loan on which the accrual of interest has been suspended should be applied to reduce principal to the extent necessary to eliminate such doubt.

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

To comply with the provisions of SFAS No. 15, it may be necessary 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 amount of the debt satisfied. If cash is received in partial satisfaction of a receivable, the recorded amount of the receivable is reduced by the amount of the cash received. In a restructuring involving modifications of terms, the effect of the restructuring is accounted for prospectively and the recorded amount (as defined in SFAS 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. Therefore, SFAS No. 15 states that "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 amount of the receivable before restructuring, the bank creditor reduces the recorded amount of the receivable to an amount equal to the total future cash receipts specified by the new terms. The amount of the reduction is recognized as a loss.

Banks often receive non-refundable 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 follows:

- A Floating Rate Commitment

  A commitment to provide financing at the market rate at the time the loan is to be drawn down or the purchase transaction settled.

- A Fixed Rate Commitment

  A guarantee to provide financing at or near the market rate at the time the commitment is made.

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

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

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

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

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

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

interest method. If the loan is not funded, unamortized commitment fees should be recognized as income at the end of the commitment period.

Banks also receive fees for originating loans in-house. The normal origination fee (generally referred to as points) is essentially a reimbursement for the expenses of the underwriting process, that is, processing the loan application, reviewing legal title to the collateral, obtaining appraisals, and other procedures. Origination fees, to the extent they are a reimbursement for such costs, should be recognized as income at the time of loan closing. Loan origination fees that are not reimbursements of such costs should be amortized to income over the expected loan period by application of the interest method. The AICPA has formed a task force to study accounting by all financial institutions for loan origination fees and initial direct costs and to prepare an issues paper addressing the diversity in practice.

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

### Financial Statement Presentation

Loans have historically been presented in the balance sheet in an aggregate amount. Note disclosures should include a breakdown of loans by major types of lending activities of the bank. 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 rates of interest and at floating rates of interest. Each bank's share

of a participation loan should be classified using the same classification as for 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 reported as borrowings.

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

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

Loans are frequently made by banks to officers, directors, employees, and principal holders of equity securities (and entities with which they are affiliated) in the normal course of business, subject to compliance with applicable regulations. The bank should disclose such loans if they represent a material portion of the loan portfolio or 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. SAS No. 6 provides guidance for accounting for related party transactions.

Overdrafts are classified as loans.

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

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

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

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

## Auditing

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

- Loan balances are reasonably stated as of the date of the financial statements under examination.
- The allowance for loan losses is adequate to provide for reasonable anticipated losses (discussed in Chapter 8, "Allowance for Loan Losses").

- Income and related accrued interest receivable and deferred discount (unearned discount) are stated in conformity with generally accepted accounting principles.

Internal Accounting Controls. Considerations in evaluating internal accounting controls related to loan transactions include the following:

- 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. Lending policies are generally evaluated and notes and the documents supporting loans are generally inspected by selecting and performing detailed tests of a sample group of loans from all significant loan categories. 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 review 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. It should be noted that appropriate approvals are contained in the loan files and in minutes of the meetings of the board of directors or loan committee.

Tests of the reasonableness of the loan balances include balancing the underlying subsidiary loan records with the general ledger control accounts and requesting confirmations of a representative number of loan balances directly with the bank's customers. Negative confirmations may be used for types of loans that involve a large volume of individually immaterial balances of a homogeneous character. 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 331.03 through .08 provides guidelines for the use of confirmations.) Forms of confirmation requests are illustrated in Appendix D.

In addition to providing evidence as to the effectiveness of the system of internal accounting control, the results of the

detailed inspection of a sample group of loans assists the CPA in evaluating the collectibility of the loan portfolio. However, evaluating the collectibility of loans usually also requires the performance of other separately designed tests and reviews, as discussed in Chapter 8.

The audit program 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 charged off. However, the CPA should avoid communications prohibited by law (for example, bankruptcy law).

Accrued interest receivable, unearned discount, and interest income are often tested for the loans selected for detailed testing. Test procedures should include recalculating accrued interest and unearned discount, balancing subsidiary records to the general ledger control accounts, and testing interest income for a selected period. Interest income should also be tested 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 as of the confirmation date, and collateral.

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

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

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

Procedures for Specific Types of Loans. The following discusses audit procedures for specific types of loans:

- Collateralized Loans. The physical existence and proper assignment to the bank of collateral supporting collateralized loans should be tested. 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 otherwise verifying 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 conditions of cosigners and guarantors. Controls over collateral should

be evaluated, with particular emphasis on controls surrounding negotiable collateral.

- Mortgage Loans. The review of mortgage documents frequently emphasizes loans made since the date of the last audit and 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 mortgage loan principal balances are confirmed. The activity in the escrow accounts should be tested and selected disbursements should be vouched. In addition, 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 reasonably good repair should be reviewed. 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, inquiries should be made as to whether the servicing agent participates in the "single audit" program of the Mortgage Bankers Association and, if so, the CPA should review the report of the servicing agent's CPA relating to the results of his detailed tests. If no such report is received and the amount of serviced loans is material, the CPA should perform alternate 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 as to 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. Additionally, the AICPA Auditing Standards Board is currently studying the issues related to special purpose reports for use by other auditors.

- Credit Card Loans. If the bank is involved in all phases of credit card operations, including credit card issuance and processing of transactions, a thorough knowledge and testing of the credit card operation system is required of the CPA. 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 was processing its own credit card accounts.
- Lease Financing. Lease contracts may contain varying provisions relating to areas such as retention or

pass-through of investment credits, purchase options, and residual values. The CPA should determine whether the bank is aware of, properly accounting for, and has established internal accounting controls for those aspects of such 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 SFAS No. 13. Confirmation of the basic lease terms, including cancellation provisions, if any, should ordinarily be requested from the lessee. For leveraged leases, material aspects of the lease agreement, including information required for income tax purposes, may be requested from the lease trustee.

- Loan Participations. The auditing procedures for participations in loans purchased from other banks are similar to those for direct loans, except that requests for confirmation of balances and collateral, if any, are sent to the managing (lead) bank. Loan files for participations purchased should be available at the bank and should contain pertinent documents, or copies of them, including credit files supporting loans in which it 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. Confirmation between participating banks should be requested of the amount of each bank's participation in the loan. However, care should be exercised in requesting confirmation of

participations sold. Since the borrower normally deals only with the bank originating the loan, the gross balance, including amounts sold to other banks should be confirmed with the borrower.

## Chapter 8

## ALLOWANCE FOR LOAN LOSSES

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

Federal Income Taxes. Under current federal tax regulations for commercial banks, the maximum annual tax basis addition to the allowance for loan losses is based on the greater of a 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 experienced method (Chapter 17 discusses accounting considerations).

Accounting. A bank should mainta 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 based on the adequacy of the allowance determined on a consistent basis, not the provision charged to operating expenses.

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

## Financial Statement Preparation

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

## Auditing

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

Audit Procedures. As previously discussed, the allowance for loan losses represents an amount that, in management's judgment, approximates current amounts of loans that will not be collected. All relevant conditions existing at the balance sheet date should be taken into consideration. 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. Care should be exercised to avoid reliance on, or emphasis of, mechanical formulas that incorporate only collection experience.

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 of guarantors. Most often a combination of those factors determines the soundness of a particular loan.

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

Since loans are generally the largest single class of assets of a bank and generally present the highest potential for loss, the CPA can expect to encounter a number of individuals or groups, in addition to state and federal supervisory agency examiners, who have an interest in evaluating the collectibility of the loan portfolio. Among interested parties are 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 those or similar parties. The audit 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 scope of the examination.

The principal purpose of the audit procedures performed by the CPA is to identify individual loans or conditions within the various classifications of the loan portfolio that require consideration in evaluating the reasonableness of the allowance. Some of the factors to be considered are

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

Except in rare circumstances, the CPA is not required to ascertain the collectibility of each individual loan included in a bank's portfolio. The procedures should be concerned with determining the overall collectibility of the entire portfolio and performed primarily on a test basis. In establishing the scope of the work to be performed, the CPA should consider the composition of the loan portfolio, growth trends being experienced

in specific loan classifications, previous loss and recovery experience, including timeliness of charge-offs, the existence of sound lending policies and procedures, management's procedures for loan review and classification, and subjective factors such as economic and environmental conditions.

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

Loan categories represented by large volumes of relatively smaller 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 rather 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 as to the adequacy of the allowance required for those loan classifications. In evaluating the adequacy of the portion of the allowance attributable to those loans, use of historical average annual charge-off experience should be considered in light of the average remaining lives of loans, consistency of loan policy, and current economic conditions.

Conversely, an evaluation of time and demand (commercial) loans normally requires a more detailed review, since the amounts of individual loans are 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 loans for review from 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. However, 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.

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

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

# Chapter 9

# FEDERAL FUNDS AND REPURCHASE/REVERSE REPURCHASE AGREEMENTS

## Federal Funds

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

Banks hold most of the balances that count toward the fulfillment of their legal reserve requirements as deposits in the Federal Reserve and as cash on hand. A bank with excess reserves may lend such excess, at an agreed rate of interest, to a second bank needing additional funds to meet its reserve requirement. Thus, federal funds transactions are borrowings or loans of balances on deposit in the Federal Re 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.

The following types of transactions involving federal funds are commonly used:

- 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.

- Collateralized transaction, other than by repurchase agreements. A bank purchasing federal funds places U.S. Government securities in a custody account for the seller until the funds are repaid.

In addition to buying and selling funds to meet their own needs, banks with correspondent banking relationships absorb or provide funds as a service or accommodation to their correspondent banks. The banks may operate on both sides of the market on the same day. Transactions between correspondent banks usually clear through the Federal Reserve System.

Repurchase/Reverse Repurchase Agreements

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

Since the sale of securities under a repo agreement is, in substance, a loan to the selling bank collateralized by the securities that are repurchased, it is not unusual for a bank to use this tool for short term financing of its trading portfolio and other earnings assets, depending on prevailing interest rates.

Likewise, banks may enter into reverse repos as a lending accommodation to their corporate customers.

## Accounting

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

When federal funds transactions occur, no physical transfer of funds takes place. The Federal Reserve merely charges the seller's reserve balance and credits the buyer's reserve balance. The respective banks then charge or credit federal funds sold or purchased, offsetting the entry by a charge or credit to their reserve accounts with the Federal Reserve Bank.

## Financial Statement Presentation

Banks may operate on both sides of the federal funds market on the same day. The transactions may be with different entities and there is no right of offset. Therefore, federal funds

transactions should be stated gross rather than net in the balance sheet as are securities sold or purchased subject to repo or reverse repo agreements that qualify as short term loans or borrowings. It is permissible to combine federal funds sold with securities purchased under reverse repo agreements and federal funds purchased with securities sold under repo agreements. Federal funds transactions with maturities exceeding one business day should be classified as loans or other borrowings. The CPA should also be familiar with the financial statement and note disclosure requirements of the relevant supervisory agencies.

## Auditing

Audit Objectives. The audit objective for federal funds and repo or reverse repo agreements is 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 GAAP.

Internal Accounting Controls. Considerations in evaluating internal accounting controls related to federal funds transactions include the following:

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

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

Audit Procedures. The CPA's audit procedures should include:

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

## Chapter 10

## OFFICE BUILDINGS, EQUIPMENT, AND LEASEHOLD IMPROVEMENTS

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

Before the 1960s many banks arbitrarily wrote down their properties to nominal values. Also, the practice of charging equipment, furniture, and fixtures to expense at the time of purchase was widespread. Those practices did not, of course, conform to generally accepted accounting principles. Banks using those practices are now required to reinstate material amounts of property and equipment still in use. The fixed assets should be reinstated at original cost less accumulated depreciation to the beginning of the earliest year's financial statements presented, with a corresponding credit to retained earnings at the beginning of that year. Disclosure of the reinstatement is discussed in APB Opinion 20, Accounting Changes, which specifies requirements for correction of an error.

### Accounting

Bank supervisory authorities require the capitalization and depreciation of bank premises and equipment according to

generally accepted accounting principles. The Comptroller's Handbook for National Bank Examiners (February, 1981) states that "Federal regulations require that all bank fixed assets acquired subsequent to June 30, 1967, be stated at cost less accumulated depreciation or amortization."

Fixed assets, other than buildings acquired prior to the change in the capitalization policy of the bank supervisory authorities, would now be substantially depreciated. Therefore, the difference between GAAP 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 in 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 writeup of assets.

Fixed assets should include all costs related to the acquisition of the property, including transportation costs and all costs connected with installation. If a bank constructs property, cost includes all direct construction costs together with architects' fees, costs of excavations, and supervision of construction. In addition, property taxes, and other carrying charges (excluding interest) incurred during construction may also be, but are not required to be, capitalized. SFAS No. 34, Capitalization of Interest Cost, sets forth criteria for capitalization of interest. SFAS No. 13 provides guidance for

accounting for properties subject to leases (either operating or capital).

Depreciation methods available to banks are similar to those followed in other business enterprises. Using an accelerated method for computing depreciation for income tax purposes and another acceptable method for financial reporting purposes, requires deferred tax accounting, discussed in APB Opinion 11 and its amendments and interpretations.

## Financial Statement Presentation

Fixed assets are normally shown as a single caption on the balance sheet net, of accumulated depreciation and amortization. However, if the individual categories of assets are material, separate captions should be used in the balance sheet or the notes to the financial statements. In either case, the basis of valuation should be indicated in the balance sheet or the notes. Accumulated depreciation and amortization may be shown on the balance sheet as a separate item deducted from the related assets, parenthetically if the assets are reported at a net amount, or in the notes to the financial statements. Property acquired but not used in bank operations, such as repossessed collateral, should be in other assets and not included in office buildings, equipment, and leasehold improvements.

The net occupancy expenses, or in some cases net occupancy income, of bank premises should be classified as an operating item in the statement of income. All costs and expenses identified with or directly allocable to the maintenance and operation of the bank premises should be included as net occupancy expense.

Included would be expenses such as salaries and wages, payroll taxes, insurance, depreciation, rent expense and real estate taxes, less rentals from tenants and other income related to the premises.

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

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

Lease commitments should be disclosed in the financial statements in accordance with SFAS No. 13 and its amendments and interpretations.

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

## Auditing

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

## Chapter 11

## OTHER ASSETS

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

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

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

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

Customers' acceptance liability represents the liability to the bank of its customers on outstanding drafts and bills of exchange that have been accepted by the bank (bankers' acceptances) or by other banks for its account. The bankers' acceptance fills the need of extending credit by guaranteeing payment of the draft or bill of exchange, usually for a period of six months or less. If the drafts or bills of exchange are held by the bank, the customers' acceptances should be reported as loans.

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

The amount at which real estate acquired through foreclosure is recorded should be measured in the same manner as if the asset had been acquired for cash. The fair value of the asset becomes the new cost basis for subsequent accounting. However, in no event should the new carrying value be in excess of the recorded investment. If at a later date it is determined that the total capitalized cost (including completion and holding costs as discussed in the following paragraph) 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 write down of the asset or by a credit to an allowance for losses on real estate owned.

Some supervisory agencies also require that such property be recorded at the lower of recorded investment and "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 an appraiser.

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. SFAS No. 34 discusses legal fees and other direct costs incurred by the bank in a foreclosure to be included in expense when incurred.

Guidance on accounting for gains on sales of other real estate is provided in the AICPA Industry Accounting Guide, Accounting for Profit Recognition on Sales of Real Estate and SFAS No. 15.

Auditing

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

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

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

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

1
2
Chapter 12
3
DEPOSITS
4
5
The major liabilities of banks are demand and time deposits.
6
7
Demand Deposits
8
Demand deposits generally include checking accounts, official
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checks, demand certificates of deposit, and escrow deposits.
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Checking accounts provide the greater volume of activity and
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include a number of classifications, usually by type of depositor
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served, for control purposes. One general category of deposits
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includes accounts of individuals, partnerships, and corporations.
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A second category includes public deposits, including those of
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states and their political subdivisions, deposits of the U.S.
16
Government (Treasury tax and loan remittance option accounts),
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trust deposits, representing funds deposited by the bank's trust
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department, and deposits due to other banks, both domestic and
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foreign.
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Checking accounts that are overdrawn should be included with
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loans. The overdrafts should be evaluated for collectibility as
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part of the loan evaluation process.
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Banks may issue checks drawn on themselves for a variety of
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purposes, such as expense disbursements, loan disbursements,
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dividend payments, withdrawal of account balances, and exchange
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for cash with customers. Some of the names used for bank checks
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include official, cashier's, treasurer's, expense and loan
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disbursement checks, and money orders. A separate series of checks and a separate general ledger control account may be maintained for each type of disbursement.

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

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

Time Deposits

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

When a savings account is opened, many banks provide the depositor with a passbook, providing a record of deposits, withdrawals, interest, and account balance. Normally, the bank's

rules and regulations affecting the conduct, use, and privileges of savings accounts are also shown in the passbook. The passbook is usually presented each time a deposit or withdrawal is made. As a result of increased utilization of EDP equipment there has been a growing tendency to eliminate passbooks and provide periodic statements of savings activity.

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

Methods of computing interest and periods used for 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

The classification of accounts as dormant depends on individual bank policy. The required period of inactivity before savings accounts are classified as dormant is normally longer

than for checking accounts because savings accounts are usually less active. It is preferable that dormant accounts and the related signature cards be kept under the control of individuals independent of the teller and bookkeeping functions. After a specific period of inactivity as determined by the State in which the bank is located, the accounts no longer are deposits of the bank and may escheat to the State.

Closed Accounts

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

Accounting

Demand Deposits. The account of each depositor 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 items rejected 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 "hold-overs" or "throw-outs.") Periodic statements, together with cancelled checks and credit and debit memos, are sent to the depositors.

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

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

## Financial Statement Preparation

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

Deposits (particularly demand deposits) that are received by a bank on terms other than those available in the normal course of business are usually disclosed, particularly if the deposits

represent a significant source of funds for the bank. If material, deposits received from associated companies or other related parties are also disclosed.

## Auditing

Audit Objectives. The audit objective for the bank's liabilities for deposits is 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. Evaluation of the system of internal accounting control 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 "hold-over" 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 periodically reviewed for unusual transactions?

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

Immediately on starting the audit, 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 selections of accounts for confirmation are completed.

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

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

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

For checking and statement savings accounts, customers must be furnished with or 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 such confirmation date; some comparisons may also be made of balances as of the confirmation date with balances as of the audit date.

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

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

Accrued interest payable, interest expense, and service charge income should be tested in connection with the audit of deposit accounts. Test procedures for interest on deposits

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

# Chapter 13

# BORROWED FUNDS

Borrowed funds include (1) debentures and capital notes, (2) borrowings from the Federal Reserve Bank or the Federal Home Loan Bank Board, (3) short term borrowings, and (4) mortgage indebtedness.

## Debentures

Many banks and bank holding companies have turned to the issuance of debt securities to raise funds. Unsecured debt securities, those not collateralized by specific property, are the most common type issued. 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 40 years. Securities that are subordinated to the rights of depositors are usually called capital notes.

## Borrowings from the Federal Reserve Bank

Depository institutions have available to them two methods of short term borrowing from the Federal Reserve bank in their district. These are "discounting" and "advancing." In discounting the Federal Reserve rediscounts, with recourse, the bank's eligible loans. In advancing a member bank executes a promissory note collateralized by government securities. Interest charged in those transactions is referred to as "discount." Loans by Federal Reserve banks are usually of short maturity—up to

15 days—and are advanced at rates set every 14 days by the individual reserve banks. Borrowings from the Federal Reserve bank are made available primarily to cover shortages in the required reserve account.

Treasury Tax and Loan
Note Option Account

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

Short-Term Borrowings

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

Mortgage Indebtedness

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

## Financial Statement Presentation

For supervisory reporting purposes, the provisions of Federal Reserve Regulation F and the regulations of other supervisory agencies govern balance sheet presentation. Instructions to Form F-9A require

- Borrowings from the Federal Reserve bank to be grouped with promissory notes such as commercial paper and reported as other borrowed funds.
- Mortgages payable to be reported separately.

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

Although methods of public reporting vary, the most common presentation is an adaptation of Form F-9A, in which short term borrowings, other than federal funds purchased and securities sold under agreements to repurchase, are classified as other borrowed funds. Long term debt, consisting of mortgage notes, debentures, and capital notes, is often collectively termed "notes payable." Capital notes should be classified as liabilities in financial statements of both banks and bank holding companies. In addition, notes to the financial statements should provide details of significant components and, when appropriate, interest rates, due dates, pledged property and restrictive covenants.

## Auditing

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

Internal Accounting Controls. In the evaluation of the system of internal accounting control 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, made 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 to management made showing all important borrowed funds activity?

Audit Procedures. As in any audit situation, the extent of year end audit procedures for borrowed funds depends on the circumstances surrounding an individual engagement. Several, but not necessarily all, auditing procedures that may be considered by the CPA when examining borrowed funds are

- Request confirmation of terms of borrowing with the lender, including, for example, current balance, interest rate, and pledged property.

- Ascertain and request confirmation of the existence and terms of lines of credit and compensating balance arrangements.
- Read loan agreements, if applicable, and ascertain compliance with restrictive covenants.
- Test interest expense and accrued interest payable.
- Obtain reasonable assurance that required disclosures have been made in the financial statements or the notes.

## Chapter 14

## OTHER LIABILITIES, COMMITMENTS AND CONTINGENCIES

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

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

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

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

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

Records maintained for the types of other liabilities listed above generally are similar to those of other business enterprises.

The principal internal accounting control considerations are the condition of and control over subsidiary records and the extent to which functional duties are segregated.

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

## Chapter 15

## EQUITY

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

### Accounting

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

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

Normally, accounting for stock dividends by entities other than banks involves transferring from retained earnings to a

category of permanent capitalization (capital stock and surplus) 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.

Henceforth, stock dividends (as distinguished from stock split-ups) should be accounted for using the fair value of the shares issued in connection with such a dividend. However, amounts related to stock dividend transfers from retained earnings may be made at an amount less than fair value (not less than par value), to the extent of previous transfers not already used for similar stock dividends accounted for at less than fair value. In this event, the amount of the previous transfers supplementing stock dividend transfers should be disclosed in the notes to the financial statements. Also, consideration should be given to the disclosure of the remaining amount of surplus available for future stock dividends. For closely-held banks there is no need to capitalize stock dividends other than to meet legal requirements (see paragraph 12 of Chapter 7 of ARB No 43).

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

## Financial Statement Presentation

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

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

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

Supervisory agencies may direct newly organized banks to allocate a portion of their initial paid-in capital to retained earnings. The purpose of the transfer is to permit a bank to avoid reporting a deficit in the retained earnings account during the early, usually unprofitable, periods of its existence. If such a transfer has been made, retained earnings should be reported in a manner that clearly describes the amount of paid-in capital included and the amount of accumulated losses. The amount of paid-in capital included in the retained earnings account should be restored to the surplus account as rapidly as profitable operations permit. If those transfers are not adequately disclosed, qualification of the CPA's report may be required.

Auditing

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

## Chapter 16

## OPERATING REVENUE AND EXPENSES

Income and expenses of a bank 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 and reflect 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 categories such as salaries and wages, employee benefits, and occupancy expense.

### Financial Statement Preparation

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 (see Chapter 5, Investment Securities) are stated net of related income tax effects. As with most business enterprises, banks sell securities to (1) obtain greater yield on the investment portfolio through reinvestment of the proceeds of sales in higher yielding securities, (2) realize gains from appreciation of securities, or (3) reduce the size of the portfolio to achieve a required or desired liquidity.

## Auditing

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

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

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

# Chapter 17

# INCOME TAXES

This chapter discusses problems related specifically to accounting for bank income taxes. APB Opinions 11, *Accounting for Income Taxes*; 23, *Accounting for Income Taxes—Special Areas*; 24, *Accounting for Income Taxes—Investments in Common Stock Accounted for by the Equity Method*; and FASB Interpretation 18, *Accounting for Income Taxes in Interim Periods*; provide detailed discussions of the principles involved. The discussions related to federal income taxes are also generally applicable to state and foreign taxes that are based on income.

## Accounting

Banks are required to record income tax expense based on income and expense items reported in the statement of income for the period, including amounts based on interperiod allocation of income taxes.

The aggregate amount of income tax expense should be allocated among the major elements in the statement of income, namely, income before securities gains and losses, securities gains and losses, and extraordinary charges or credits.

*Intraperiod Tax Allocation*. Intraperiod allocation of income taxes is based on the concept that the incremental income tax effect of any income or expense item that receives special treatment in the financial statements should be directly related

to that item. That concept is recognized in the statement of income presentation required by the FRB, the FDIC, and the OCC. Thus, income tax expense should be allocated among the major elements, specified above, in the statement of income with disclosure of the amount allocated to each.

Interperiod Tax Allocation. The tax effects of revenue and expense transactions that enter into the determination of pretax accounting income either earlier or later than 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.

Timing differences typically encountered by CPAs during bank engagements include

- Additions to the allowance for loan losses for tax purposes based on the Internal Revenue Code tax limitations and exceptions that may differ from the provisions for loan losses charged against income for financial accounting purposes.
- Accretion of discount on bonds and U.S. Treasury bills recorded currently for accounting purposes but subject to tax only at maturity or sale.
- Net leasing revenue recorded under the financing method for accounting purposes and the operating method for tax purposes.
- Expenses for deferred compensation recorded on the accrual method for accounting purposes but deducted as paid for tax purposes.

- Valuation of trading securities at market value for accounting purposes but carrying them at cost for tax purposes with gain or loss recognized on sale or at 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.
- Reporting income on a cash basis for tax purposes and on the accrual basis for accounting purposes.
- Provision for losses on writedown of other real estate and other assets for financial statement purposes that are not recognized for tax purposes.

Interperiod tax allocation principles of APB Opinion No. 11 should be considered for differences between the amounts of provisions for loan losses for financial statement purposes and loan loss deductions used in computing income tax liabilities.

Net Operating Losses and Other Tax Benefit Items. For taxable years beginning before January 1, 1976, the Internal Revenue Code permits a net operating loss to be carried back and applied against taxable income of the three preceding years and

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

The CPA should consider the accounting implications of the possible utilization 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 44-50 of APB Opinion No. 11 which provide guidance on the timing of recognition of the tax benefits of net operating losses. As stated in that opinion,

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

Investment Tax Credit on Lease Financing. Paragraphs 42 through 47 of SFAS No. 13, state that the investment tax credit retained by lessors on leveraged lease transactions should be deferred and amortized over the lease term.

Some bank lessors have classified deferred investment credits as part of the net investment in lease financing and reported the

amortization of investment tax credits on both leveraged and financing leases as operating income rather than as a component of the income tax provision because they view the investment tax credit amortization as an integral part of their rate of return on the lease financing. Other lessors have reported the amortization of such investment tax credits as a component of the income tax provision. The method followed should be disclosed.

## Financial Statement Presentation

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

All taxes based on income, including foreign, state and local income taxes, should be classified as income tax expense in the statement of income. The components of income tax expense—amounts currently payable and deferred taxes—should be disclosed. The amounts may be disclosed by separate or parenthetical presentation of the components in the statement of

income, or tax expense can be reported as a combined amount with the components disclosed in the notes to the financial statements. Since banks are required to report at least two income tax amounts (income tax expense on income before security gains and losses and income tax expense on security gains and losses), the current and deferred portions of those items are generally disclosed in the notes to the financial statements rather than in the statement of income.

APB Opinion 11, sets forth certain income tax disclosures in addition to those previously discussed. The disclosures include

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

The method for recognizing investment tax credits in the financial statements is discussed in APB Opinion 4, Accounting for the Investment Credit, SFAS Interpretation 25, Accounting for Unused Investment Tax Credit, and SFAS Interpretation 32, Application of Percentage Limitations in Recognizing Investment Tax Credit.

The income statement and other related disclosures of income tax expense applicable to banks have not changed substantially since the publication of APB Opinion 11 in 1967. However, Regulation S-X of the SEC requires certain income tax disclosures beyond those required by APB Opinion 11. Many banks, though not subject to SEC regulation, have included the additional disclosures in their annual reports. Some of the disclosures typically made include

- The current and deferred components of income tax expense.
- The nature and tax effect of selected timing differences.
- A reconciliation of the reported income tax expense to 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 reconcilation may be presented in percentages or in dollar amounts or both. A recent revision of Regulation S-X also requires disclosure of the domestic and foreign components of income before income taxes.

## Auditing

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

## Chapter 18

## TRUST DEPARTMENT

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

A bank's trust department acts among other things 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. In an audit of a bank's financial statements, the primary objective of the CPA 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 financial statements of the bank.

CPAs are sometimes engaged to issue a report on the system of internal accounting control 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 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. 30 and its related interpretations describe the standards applicable to engagements to report on systems of internal accounting control. Additionally, the AICPA Auditing Standards Board is currently studying the issues related to special purpose reports for use by other auditors.

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

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

Trusts can be broadly categorized as either personal trusts or corporate trusts. Some of the more common types of trust accounts for which a bank may act as trustee are briefly described below.

Personal Trusts

1. Testamentary trust. 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.

2. Voluntary trust (inter vivos). A trust established by an individual during his lifetime. This type of trust is often established with powers of revocation or amendment.

3. Court trust. A trust in which the trustee is accountable to a court. Court trusts generally include estates of a decedent (that is, an adminstrator bank is appointed by a court to settle the estate of a person who died either without leaving a will or who nominated the bank as executor in his will), 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.

4. Collective investment trust. A trust in which the funds of individual trusts are pooled to achieve greater diversification of investment, stability of income, or other investment objectives. Under Federal statute there are two types of collective investment trusts: a common trust fund maintained exclusively for the collective investment of accounts for which the bank serves as trustee, executor, administrator, or guardian; and a commingled pension trust fund, which consists

solely of assets of retirement, pension, profit sharing, stock bonus, or other trusts that are exempt from Federal income taxes. Common trust funds are exempt from Federal income taxes under Section 584 of the Internal Revenue Code. In order to maintain that 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.

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

Under Regulation 9, each collective investment trust must 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 of Regulation 9 include the following:

- Valuation not less frequently than every 3 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 then 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.).

5. Agency agreement. An agreement to care for securities and properties of others. Safekeeping and custodianship agreements are two of the more common types.

6. Property management agreement. An agreement providing 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.

7. Pension or profit sharing trust. A trust providing for the management by a trustee bank of trust funds established for the benefit of eligible company officers or employees or for members of a union, professional organization, or association. Those trusts are established by comprehensive written plans in which the trustees' powers are limited and their duties are well defined.

Corporate Trusts

The following are the more common types of corporate trust and agency accounts. The accounts are discussed in terms of the bank's role as trustee.

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

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

3. Joint registrar—transfer agent. The trust department acts jointly as both registrar and transfer agent for the same company.

4. 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.

5. 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.

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

## Accounting

Accounting systems within trust departments range from handposted records to sophisticated electronic data processing systems. At a minimum, the accounting records of a trust department should generally reflect the department's asset holdings and liabilities to trust customers, the status of each trust account, and all transactions relating to each trust account. Records generally considered necessary to meet those requirements are

- Records relating to the trust department's total asset holdings and total liability:

- General ledger,
- Asset control accounts, and
- Journals and other records of original entry.

- 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, and
  - Investment income.

A trust department usually maintains a separate self-balancing set of accounting records. However, certain activity relating to the trust department is also included in the general ledger and financial statements of the bank. 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 general ledger of the bank.

In response to the urging of bankers, supervisory agencies have permitted banks to continue reporting trust department income on a cash basis on the presumption 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 net income of the bank. Trust department income should be presented on the accrual basis unless such income reported on the cash basis does not differ materially from income that would be reported on the accrual basis.

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

It is current practice to periodically furnish a statement or "accounting" to a customer as a record of the activity within an account. The format or basic information provided in such a statement may vary based 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*. Tests of trust activity in connection with an examination of the financial statements of a bank

should be designed to accomplish the following objectives 1

- to obtain reasonable assurance that the department is conducting activities properly and that no material contingent or unrecorded direct liabilities for errors or omissions have been incurred. 2 3 4 5
- To obtain reasonable assurance that income and expenses of the department have been properly reported in the bank's financial statements. 6 7 8

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Internal Accounting Control. In evaluating the trust department's overall system of internal accounting control, the following should be considered 10 11 12

- The prompt and complete fulfillment of all duties required by the governing trust instruments or agency contracts (legal compliance). 13 14 15
- The physical and administrative security (physical control) of assets for which the trust department has responsibility. 16 17 18
- The complete, accurate, and timely recording of all individual account and departmental transactions (activity control). 19 20 21

The following audit procedures also apply when reviewing legal compliance: 22 23

- 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. 24 25 26
- Determine whether procedures for review of trust activity and for supervision and approval of transactions are adequate and being complied with. 27 28 29

 30

- Determine whether proper approval is obtained from cofiduciaries for investment changes, disbursements, and so forth.
- Determine whether trust funds awaiting investment or distribution have been held uninvested or undistributed longer than was reasonably necessary.
- Determine whether fees are being properly computed.
- Determine whether income is being collected and distributed in a timely fashion.
- Determine whether disbursements or other asset distributions are properly supported.

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

- Approval of the individual purchase and sale of all trust investments by the trust or investment committee or their designees.
- Periodic reconciliations of the trust funds on deposit with the bank, performed by an employee having no check signing authority or access to unissued checks and related records.
- Measures taken to safeguard trust assets by dual control.
- Relationship of vault deposits and withdrawals to accounting records to promptly reflect the purchase and sale of trust assets.

- Procedures to ensure proper classification of trust assets, both by trust title and by nature of asset; daily posting of journals containing detailed descriptions of principal and income transactions; and establishment of control accounts for various asset classifications, including principal and income cash.
- Reconciliation of agency bank accounts (for example, dividends, coupons, and bond redemptions) by an employee having no access to unissued checks or participation in the disbursement function.
- Measures taken to safeguard unissued supplies of stocks and bonds by dual control.
- Periodic physical inspection by an independent person or confirmation of trust assets.
- Frequent reporting and written approval of uninvested cash balances.

In addition to an evaluation of internal accounting control, the following factors should be considered in establishing the scope of audit work 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 arising from trust operations.

Audit Procedures. Examination of a trust department's activity includes tests of systems and procedures that are common to the management of all or the majority of 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.

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 best conducted by department, rather than by individual trust. Functions that may be tested by department include, but are not necessarily limited to, the following

- Opening new accounts.
- Receiving and processing the initial assets that constitute an account.
- Processing purchases, sales, and exchanges of principal assets.
- Receiving and paying cash or other assets.

- Executing specified trust or agency activity.
- Determining fees and charging fees to accounts.
- Processing trust assets in and out of the trust vault.
- Closing accounts.

Overdrafts in trust accounts should be reviewed to obtain reasonable assurance that they are covered by borrowings by the trust department from the commercial department to avoid violation of applicable laws or regulations.

Testing Account Activity. The CPA should perform tests sufficiently detailed to obtain reasonable assurance that transactions and activities within the various types of trust accounts are being properly conducted. The tests should include the following:

- 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. The accounts selected for testing may be coordinated with accounts selected under "Account Administration" below.
- 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 of the trust department.

For the accounts selected, the following procedures should be considered

- 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.

Daily Cash Settlement and Accounting. Daily settlements and supporting details, holdover transactions, rejected transactions, and transactions held in suspense should be reviewed for a selected period.

Testing 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 operations expenses. Those areas may be tested independently or may be integrated, as appropriate, with other tests of trust operations.

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

## Audits of Collective Investment Trusts

The operations of collective investment trusts is normally integrated with other trusts administered by a trust department and 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 many banks voluntarily engage CPAs to perform annual audits in other states. The following factors should be considered 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 valued at market. Dividend income should be recorded on the ex-dividend date. Interest income and expenses should be accrued. Expenses of the fund usually consist of audit expenses and nominal miscellaneous expenses such as postage. Under federal statute, the bank may charge either the collective investment trust or the participating trust, but not both. The bank usually receives no direct fee for administration of collective investment trusts.
- Because additions to and withdrawals from the trust occur periodically, it is important that the related interim financial data on which they are based have been prepared accurately. The CPA should be satisfied with the valuation of investments, the accuracy of income and expense accruals, and the calculation of unit valuations at each interim date at which there are admissions or withdrawals. Interim calculations may be reviewed currently or retroactively depending on the terms of the engagement.
- The trust agreement or state law may require that stock distributions of a certain percentage of outstanding shares of the same class of stock are to be included in

income of the collective investment trust, which is not in conformity with generally accepted accounting principles. The CPA should consider the need for disclosure of that unacceptable policy in the notes to the financial statements and the need for qualification of the auditor's opinion on the financial statements.

- If investments are held for which there is no ready market the trust or investment committee or their designee should determine that all factors relevant to the value of such assets have been considered and that appropriate methods have been used in arriving at their fair values. SEC Accounting Series Release No. 118 and the AICPA industry audit guide, Audits of Investment Companies, provide guidance for such valuations and the effect of such valuations on the report of the CPA.

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

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

## Chapter 19

## OTHER BANKING ACTIVITIES

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

- Collecting sight drafts, notes, and similar items.
- Providing safekeeping, custodial, and safe deposit box services.
- Mortgage servicing.
- Sales of U.S. savings bonds and travelers' checks.
- Issuing letters of credit (See Chapter 22).

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 to the extent of revenues earned and costs incurred on such activities. Memorandum accounts are generally used to maintain accountability for the activities. Memorandum accounts frequently consist of a control and contra-account to designate custody and responsibility, respectively. Although the memorandum accounts may be recorded in the bank's general ledger, they are eliminated when financial statements are prepared. Memorandum accounts may also be maintained in subsidiary ledgers, which identify either assets for which the bank is responsible or commitments issued or contingent liabilities assumed.

While each of those activities usually results in the payment of fees to the bank that 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.

A brief summary of other banking activities is presented in the folowing paragraphs.

Collections

Commercial banks process two types of items for payment—cash items and collections (noncash items). Cash items are payable on demand, have no papers or documents attached, and have simple uniform instructions. Generally, the bank is willing to give immediate, though provisional, credit when deposited.

Collection items, on the other hand, may be payable at some future date, may have documents or papers attached, and may contain special instructions regarding presentation and nonpayment. In accepting items for collection, the bank acts as agent for its customers. Banks generally grant credit for those items when payment or notice of payment has been received. Collection items require special handling and, therefore, should not be mass or batch processed.

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

The principal types of collection items are

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

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

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

### Safekeeping, Custodial, and Safe Deposit Services

While safekeeping functions are often handled by the trust department, a separate safekeeping department may be operated within the commercial department of the bank. It receives valuables from customers for safekeeping, issues a receipt, and

holds and delivers only on the order of the customer. Items held for safekeeping may include jewelry, paintings, silverware, deeds, or other valuables.

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

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

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

Banks customarily provide safe deposit boxes in their public facilities for the use of their customers. Safe deposit boxes are available in varying sizes and are rented generally on an annual basis. This activity differs from safekeeping services in that the bank has no knowledge of the nature of the items placed in safe deposit boxes by customers. 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 assure that security is maintained including the use of code names and restrictive key procedures.

Mortgage Servicing

Many commercial banks service mortgage loans. Servicing arrangements generally provide for the servicing bank to maintain all records related to the servicing agreement, to assume responsibility for billing mortgagors and collecting periodic mortgage payments, and to perform all other activities necessary to the mortgage servicing function. Serviced loans may be originated by the servicing bank itself or by other banks or financial institutions. Loans originated by the servicing bank may be sold, in whole or in part, to investing banks or financial institutions and the servicing activities retained by the seller bank. In any of the foregoing arrangements, the agent receives as compensation a servicing fee, normally expressed as a percentage of the principal balance of the loans outstanding.

Servicing fee rates are ordinarily set at rates currently prevalent in the industry; however, a bank may occasionally sell loans at servicing fee rates significantly different from prevailing rates. AICPA Statement of Position 74-12, Accounting Practices in the Mortgage Banking Industry, sets forth the recommended accounting treatment for loans sold at a servicing fee rate significantly lower than prevailing rates. The AICPA concluded that an adjustment to the sales price would be required whenever the effect on operating results was significant. Such adjustments would result in deferred credits to be written off into servicing fee income over future years.

Gains or losses are usually recognized at the time of sale of loans. However, if at the end of a reporting period it is apparent that a bank intends to sell certain loans and the

anticipated sale will result in a loss, the bank generally establishes an allowance for losses, which is deducted from the related asset in the balance sheet.

In accounting for sales of loans or participations, the objectives are to recognize in the year of sale the economic gain or loss from the transaction and to avoid including in the year of sale income or expense attributable to future periods. Consequently, when loans are sold outright and are not to be serviced by the selling bank, the gain or loss is measured by the difference between the selling price and the carrying amount (less applicable deferred loan fees, if any) of the loans sold. If loans sold are to be serviced by the selling bank, the gain is generally decreased or loss increased by the discounted amount of the excess, if any, of estimated future servicing costs over estimated future servicing revenues.

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 stated rate of interest of such loans. In such cases the premium or discount should be represented by the discounted amount of the difference between the future interest to be collected by the seller and the interest to be paid to the purchaser after considering future servicing revenues and costs.

The principles and guidelines set forth in APB Opinion 21 apply to premiums and discounts. The Opinion sets forth the method of amortization and financial statement presentation and disclosure.

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

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

## Operating Procedures

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

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

Although certain general rules and regulations apply to all collection items, processing for many items varies. Accordingly,

definitive instructions should be furnished with each item presented for collection. In providing this service, the bank is acting as agent for the customer and must comply with instructions accompanying the collection. If, for some reason, instructions are ignored and a loss occurs, the bank could become liable for the loss.

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

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

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

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

bank's account at the sending bank.

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

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

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

Customers using the safekeeping facilities of the bank should be required to sign formal agreements or contracts fully outlining the responsibilities of the parties. Any functions to be performed by the bank, such as collection of principal and interest on securities held and disposition of the proceeds, should be set forth in the contract.

The bank should maintain adequate records of assets held

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

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

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

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

## Financial Statement Presentation

Chapter 14 discusses disclosure of contingent liabilities.

## Auditing

Audit Objectives. The objectives of an audit of the majority of activities described in this chapter are similar to those for an examination of a trust department, namely,

- To obtain assurance that each function is conducting its activities properly and that no material contingent or unrecorded direct liabilities have been incurred.
- To obtain assurance that income and expenses of each activity are properly reported in conformity with generally accepted accounting principles.

Internal Accounting Controls and Audit Procedures. This section discusses internal accounting controls and tests commonly performed in audits of these other banking activities.

Collections. Typical internal accounting controls over collections are as follows

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

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

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

- Signed contracts for safekeeping services.
- Prenumbered receipts containing detailed descriptions of the items received or released by the safekeeping department.
- Detailed inventory records of all items in safekeeping. Copies of prenumbered receipts in an "open account" file often serve this purpose.
- Dual control over assets and periodic inspection and comparison of the assets to the detailed records by employees independent of the safekeeping function.
- Segregation of safekeeping items from bank-owned assets.
- A record of all entries to custodial boxes or vaults.

The following represent a number of audit tests frequently performed in the area of safekeeping

- 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 with customers of assets held.

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. A review of security procedures to evaluate their effectiveness should be considered, since liability claims for breaches in security may be more than revenues derived from such rentals.

Mortgage Servicing. Real estate loan audit considerations are discussed in Chapter 7 and other trust related audit considerations are discussed in Chapter 18.

Banks are frequently required to submit to investors (owners of mortgages serviced) 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. AICPA Auditing Standards Board is currently studying the issues relating to special purpose reports for use by other auditors.

U.S. Savings Bonds and Travelers' Checks. The primary internal accounting controls over U.S. Savings Bonds and travelers' checks include

- Maintenance of adequate control over unissued certificates.
- Prompt remittance or credit of proceeds of sales.
- Periodic count of unissued certificates by someone other

than the custodian.

- Agreement of count to the bank's control record or confirmation with the issuer.

## Chapter 20

## CONSOLIDATION

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

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

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

Accounting Research Bulletin (ARB) No. 51, Consolidated Financial Statements, describes the purpose of and procedures generally used in preparing them. That Bulletin applies to the preparation of consolidated financial statements of banks and bank holding companies. A few consolidation matters that require special consideration are further described in the remainder of

this chapter.

Goodwill

The treatment of goodwill in bank consolidations differs from that in most other companies, including bank holding companies. It has long been the policy of bank supervisory agencies, whose primary emphasis is protecting 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. However, holding companies supervised by the SEC have been required to capitalize purchased goodwill, if material, in accordance with APB Opinion 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 17, the Board of Governors of the Federal Reserve System permitted bank holding companies to capitalize goodwill and subsequently amortize it against income.

The Board of Governors, however, did not extend that policy change to banks and bank subsidiaries, thereby permitting in financial statements filed with regulatory authorities, 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 17, the CPA should consider the necessity of issuing a qualified opinion on financial statements

reported to the public in accordance with the required regulated practice. However, in preparing consolidated bank holding company financial statements, goodwill written off by bank subsidiaries may be reinstated by an adjustment in consolidation.

## Accounting Principles of Subsidiaries that Differ from Those of the Dominant Entity

Banks and bank holding companies have acquired or established "de novo" subsidiaries engaged not only in banking activities but also in bank related activities. In addition, many banks have spun off certain of their banking activities (for example, mortgage servicing and investment advisory) into subsidiaries. In addition to the financial statements of subsidiary banks, the consolidated financial statements of a bank holding company should include the activities of subsidiaries, such as mortgage, leasing, mortgage servicing, computer service, investment advisory, "Edge Act" investment, factoring and venture capital companies.

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

## Transfers by Banks from Retained Earnings to Surplus

On the subject of presentation in consolidated financial statements of a bank holding company 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 (assuming state law permits) may be paid in an amount including such capitalized earnings (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 Allowance in Regulated Bank Situations

When auditing the consolidated financial statements of a bank holding company, generally, the CPA's report relates to the consolidated allowance for loan losses rather than to the indivdiual 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 in effect, transfer an excess allowance for loan losses to another member of the consolidated group.

## Allocation of Income and Expenses

The 1975 Amendments to Regulation S-X by the SEC have significantly increased the occasions on which bank holding companies are required to issue separate audited financial statements of consolidated subsidiaries or groups of subsidiaries. When CPAs were required to report only on consolidated financial statements, questions related to the allocation of items such as administrative overhead, interest, and taxes were not of primary concern because the allocation methods and procedures did not affect the consolidated financial statements. Under the current regulations, however, CPAs have to apply audit procedures to the allocation of income and expenses among members of the consolidated group. In addition, the disclosure provisions of SFAS No. 14 require separation of income and expenses between domestic and foreign operations.

## Trusteed Affiliates

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.

These are the general characteristics of trusteed affiliates

- The stock of the corporation which will be 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 which 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 assuring that the beneficial ownership of the two corporations is and will be identical during the continuance of the trust.
- The voting, dividend, and other stockholder rights attributable to the corporation's stock held in trust are passed through to the owners of the endorsed shares.
- In some instances there may be a minority interest in the 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.

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

The Board of Governors of the Federal Reserve System and the Comptroller of the Currency require a trusteed affiliate to be consolidated if (1) the amount of the stockholders' equity of the trusteed affiliate attributable to the stockholders of the bank exceeds 5% of the equity capital accounts of the bank or (2) the gross operating revenues of the affiliate exceed 5% of the gross operating revenues of the parent.

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

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 domestic governmental body, are subject to the regulations of the FRB which permit bank holding companies to engage only in banking and other activities as authorized by the FRB.

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

Bank holding companies and chain banking organizations provided a vehicle for common ownership of several banks, and each permitted the development of banking systems when branch banking was severely limited by law. In the early stages of development, bank holding companies and chain banking organizations provided the only vehicles that could be used to develop banking systems across state lines. The development of bank holding

companies in the 1920s paralleled 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-1960's when growth surged.

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

While the individual banks owned by bank holding companies have always been regulated by federal and state authorities, the holding companies themselves were not subject to federal or state regulation as banking organizations before 1933. Regulation of bank holding companies was first attempted with the passage of the Federal Banking Act of 1933. The Act 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 for the examination of System-member affiliated banks by the Board.

The BHC Act is the foundation of the present federal regulation for bank holding companies. It originally applied to companies controlling 25% or more of two or more banks, but was amended in 1970, and now applies to companies controlling 25% or more 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 other banking 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% 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. While existing interstate relationships were not disturbed, future interstate banking affiliations were effectively precluded.

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

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

bank holding companies could engage. The amendments to the BHC Act require that permitted activities "be so closely related to banking or managing or controlling banks as to be a proper incident thereto" and that the activities "can reasonably be expected to produce benefits to the public . . . that outweigh possible adverse effects."

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

Consolidated financial reporting practices of bank holding companies have been influenced by the financing reporting practices for banks. Except for its anti-fraud provisions, the Securities Act of 1933 generally exempts banks. The Securities Exchange Act of 1934 did not apply to banks until 1964. Therefore, the SEC influenced the financial reports of bank holding companies only and not of banks in general. The 1964 amendments to the Securities Exchange Act of 1934 imposed shareholder reporting requirements on many banks. However, those amendments vest the administration of shareholder reporting requirements in the OCC, FRB and FDIC, rather than in the

SEC. Those agencies are charged with substantially conforming their securities disclosure regulations with those of the SEC.

On approval by the FRB of its application, a bank holding company may acquire an existing bank related business or may initiate permissable bank related activities without geographic limitation.

## Financial Statement Presentation and Auditing

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

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

In addition to the basic financial statements and the statistical data required by Guides 61 and 3 of the *Guides for Preparation and Filing of Reports and Registration Statements under the Securities Act of 1933 and the Securities Exchange Act of 1934—Statistical Disclosures by Bank Holding Companies*, 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 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 other 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 that responsibility).

Bank holding companies file annual financial reports with the FRB on Form F.R.Y -6, which may require audited financial statements. As noted in the instructions to the Bank Holding Company Financial Supplement to Report F.R.Y-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."

Basic financial statements required to be included in the Form F.R.Y-6 annual report are those of the bank holding company (parent only), the bank holding company consolidated, and the separate financial statements of 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 year.

Beginning in 1974, with certain limited exceptions, information supplemental to Form F.R.Y-6 is required to 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, among other things, consolidating balance sheets and statements of income and changes in financial position for the bank holding company and majority owned bank and bank related subsidiaries and consolidated ex-bank statements (as defined in Form F.R.Y-6) and supplemental schedules for the bank holding company combined with all majority owned, bank related subsidiaries. The information is designed to permit analysis of liquidity and quality of assets and scrutiny of bank related subsidiary activities.

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

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

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

## Chapter 22

## INTERNATIONAL DEPARTMENT AND FOREIGN CURRENCY TRANSACTIONS

The operation of a bank's international department is centered around international trade and related lending. Many customers have only a limited knowledge of the customs, economic conditions, and financial procedures involved in conducting international trade. Accordingly, they may call on the international department of their commercial bank for assistance. The conduct of international trade is complex. Emphasis is placed on the movement of goods and on the various documents required to cover their shipment, delivery and payment. Similarly, the financing of international trade is complex, because most buyers cannot obtain direct credit from the manufacturer and because there are geographical and political limitations that affect the transactions.

The operations of an international department may include the following activities

- Issuing commercial letters of credit to finance the importation of foreign goods and commodities.
- Issuing standby letters of credit.
- Issuing travelers' letters of credit to provide funds for those traveling in foreign countries.
- Buying or selling foreign exchange to meet the needs of exporters or importers who receive or make payment in foreign currencies.

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

In performing those services, the international department operates as a "bank within a bank" — an individual unit forming an integral part of the bank as a whole. Except as further discussed below, the accounting principles, financial statement presentation, and auditing procedures discussed in previous chapters of this guide, for example, cash and due from banks, loans and discounts, deposits, and income and expenses, apply equally to the corresponding operations of an international department. Following is a discussion of the principal operations that are unique to an international department.

## Commercial Letters of Credit

The principal activity of the typical international department is issuing and administering letters of credit. Letters of credit

are instruments by which a bank substitutes its credit for that of individuals, firms, or corporations, so that domestic and foreign trade may be more safely, economically, and expeditiously conducted.

In technical terms, a letter of credit is an instrument drawn by a bank, known as the credit issuing bank (and eventually the drawee bank), on behalf of one of its customers (or on behalf of a customer of one of its domestic correspondents), known as the principal or the account party who guarantees payment to the credit issuing bank. The letter of credit authorizes another bank at home or abroad, known as the credit notifying or negotiating bank (and usually the payer bank), to make payments or accept drafts drawn by a fourth party, known as the beneficiary, when the beneficiary has completed the stipulations contained in the letter.

There are two major types of letters of credit: the commercial letter of credit 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 Regulation H of the Federal Reserve Board, is often used to cover bid and performance obligations to various overseas buyers. In a standby letter of credit transaction, there is generally no security in the event of default by the issuing bank's customer. While the issuing bank's liability is contingent, it could turn into a direct liability if the customer defaults. Accordingly, the element of risk to the issuing bank is usually greater than other letter of credit transactions, which generally enables the issuing bank to take title to the goods in the event of default by

its customer.

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

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

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

- Form of Currency (dollars or foreign currency). A dollar letter of credit is one in which the amount is specified in U.S. dollars (drafts drawn against it must be drawn in U.S. dollars); a foreign currency letter of credit is one in which the draft drawn against it is in foreign currency.
- Privilege of Cancellation. A revocable letter of credit is one in which the credit issuing bank reserves the right to rescind its obligations to honor drafts drawn by the beneficiary by the phrase "good till cancelled" or other 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 irrevocable confirmed (export). But 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 irrevocable 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.

<u>Foreign Exchange</u>

Banks enter into commitments to buy or sell foreign currency or instruments payable in foreign currency. A bank deals in foreign exchange to enable its customers who are involved in international trade to make payments abroad or to obtain payment from abroad either currently or in the future. In addition, some banks trade in foreign exchange for their own accounts. To deal in foreign exchange, banks must maintain balances with banks abroad. The accounts, which are in foreign currencies, are commonly called nostro accounts (our accounts with them). The general ledger control account is due from foreign banks. Those accounts should be distinguished from vostro accounts (their accounts with us), which represent U.S. dollar balances maintained by foreign banks with a U.S. bank and which appear under the general ledger caption due to foreign banks.

A bank may have other accounts that are receivable or payable in foreign currencies. Since the accounts may result in foreign exchange gains or losses, they are also discussed in this section.

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

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

Accounting

Commercial Letters of Credit. The following illustrates accounting for a typical commercial letter of credit. A U.S. dollar sight letter of credit is issued covering an importation. After the credit issuing bank approves the extension of credit to the importer, the 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 liability under letters of credit 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 obtained. The exporter draws a draft on the credit issuing bank in favor of his own bank, to which he presents the draft letter of credit and shipping documents. The payer bank credits the exporter's account and forwards the draft with pertinent documents to the credit issuing bank. If the credit issuing bank accepts the draft after reviewing the documents and ascertaining that the parties have complied with all terms, the account of the payer bank is credited and the importer's account is debited.

The debit advice and documents are forwarded to the importer who

receives the shipped goods on presentation of the bill of lading. The credit issuing bank records the paid draft as a reduction in the memorandum accounts bank's liability under letters of credit and customer's liability under letters of credit.

If a time letter of credit is used, the transaction described above remains unchanged 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 bank's liability under letters of credit and increases the general ledger accounts customer's acceptance liability and bank's acceptance liability. An acceptance tickler is prepared. The importer is given the documents and a copy of the acceptance tickler after signing a trust receipt for the goods received. 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.

<u>Foreign Exchange</u>. 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 posting to general ledger accounts.
- Forward contracts are recorded in contra (memorandum) accounts.
- Foreign currency accounts, including spot and forward contracts, are revalued periodically (usually monthly).

In a typical system, the trader prepares a trading ticket when a foreign exchange trade is accepted and posts the purchase or sale to a position sheet. The position sheet is usually prepared daily and shows the trader the bank's balances in each foreign currency, including amounts for which it is committed on both spot and forward contracts. The position sheet shows the dates, usually biweekly, on which forward contracts in each currency become due. The position sheet is a perpetual inventory record maintained by individual currencies. The foreign exchange contract is posted to one of the following contra accounts.

Purchases

Debit: Foreign exchange purchases (in foreign currency and U.S. dollars)

Credit: Contracts to buy exchange (U.S. dollars only)

Sales

Debit: Contracts to sell exchange (U.S. dollars only)

Credit: Foreign exchange sold (in foreign currency and U.S. dollars)

When the contract is subsequently settled, entries are made to one of the following sets of contra accounts:

<u>Purchases</u>

Debit: Due from foreign banks (nostro)

Credit: Foreign exchange purchased (in foreign currency and U.S. dollars)

Debit: Contracts to buy exchange (U.S. dollars only)

Credit: Official checks, or other appropriate accounts

<u>Sales</u>

Debit: Cash, or other appropriate accounts

Credit: Contracts to sell exchange (U.S. dollars only)

Debit: Foreign exchange sold

Credit: Due from foreign banks (nostro) (in foreign currency and U.S. dollars)

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

In addition to nostro and vostro accounts, there may be certain other foreign currency accounts on the books of the bank, including cash on hand, investments, loans, time bills, customers' deposits, cash collateral, and checks outstanding. Translation to U.S. dollars of such foreign currency accounts and memorandum accounts for foreign exchange contracts bought and sold may result

in gains or losses.

In 1975, the FASB issued SFAS No. 8, *Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements*; in 1977, the FASB amended SFAS No. 8 by issuing SFAS No. 20, *Accounting for Forward Exchange Contracts*. As a result of criticisms leveled against SFAS No. 8, the FASB issued in June, 1981 an Exposure Draft that may supersede SFAS No. 8. At the date of issuance of this guide, the FASB is considering the comments received on the exposure draft. The final statement will likely apply to banks.

In accordance with SFAS No. 8, banks include foreign exchange gains or losses in current operations. Foreign exchange gains and losses associated with monetary asset and liability accounts are calculated by accounting for the foreign currency related to the asset and liability at the spot rate prevailing at the close of business on the day the calculations are made (usually monthly). However, banks often hedge assets and liabilities requiring the receipt or delivery of foreign currency at some fixed future date (for example, time loans receivable in foreign currencies or time deposits or other time borrowings payable in foreign currencies) by the sale or purchase of forward foreign exchange contracts (sometimes referred to as "swaps"). When the interest rates are negotiated on those transactions, the rate is adjusted to compensate for the estimated foreign exchange hedge premium or discount associated with the transaction. For example, a bank that loans Deutsche marks for two years may charge a lower interest rate, since its yield on the loan will be a combination of interest earned and premium (discount) on a forward sale. The premium (discount)

is determined by comparing the U.S. dollar amount on the forward exchange contract maturing in two years with the spot price of Deutsche marks the day the loan is granted. Recognition of the premium (discount) in income is deferred and such amounts are amortized ratably over the two year period as an adjustment of the interest income on the related loan.

Foreign exchange gains or losses associated with unmatured spot and forward foreign exchange contracts are computed by recalculating the contracts at spot and forward rates, respectively, excluding the contracts associated with the asset or liability accounts described above. The foreign exchange gain or loss is computed by applying the closing rates for each position as if it were to be liquidated. The liquidation amount is compared with the book value to determine the profit or loss. If the position in foreign currency is "short" (liabilities and sales exceed assets and purchases), the closing rate to be applied is the buying rate at which the bank can cover its position. If the position is "long," the selling rate is to be applied. Forward contracts should be calculated at the rate prevailing for future deliveries (usually the current buy or sell rate adjusted by a discount or premium that gives effect to market conditions and number of months to deliver).

<u>Financial Statement Presentation</u>

<u>Commercial Letters of Credit</u>. Unused commercial letters of credit are commitments of a bank. They are carried as memorandum accounts and not shown as liabilities in the balance sheet.

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

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

Standby letters of credit, as described previously, may represent a greater risk to the issuing bank and therefore they are required to be disclosed in the notes to financial statements in conformity with the regulations of the supervisory authorities and with the SFAS No. 5.

Foreign Exchange. The following should be considered when reporting on financial statements of banks that deal in foreign currency transactions:

- The principal amounts of spot and forward foreign exchange contracts should not be included in the bank's balance sheet. However, disclosure of the amounts of those commitments in the notes to the financial statement should be considered.
- Since a bank determines profit or loss on foreign exchange by periodically recalculating its positions (including unmatured spot and forward foreign exchange contracts), it includes unrealized profit or loss in its

book income. For income tax purposes, however, profit or loss may be recognized when the contract is completed or otherwise closed. That causes a book-tax timing difference to be accounted for in accordance with the principles discussed in Chapter 17.

- Profit or loss on foreign exchange is included in the statement of income.
- SFAS No. 8 discusses the disclosure in financial statements of the aggregate exchange gain or loss included in determining net income for the period.

## Auditing

Audit Objectives. The audit objectives for commercial letters of credit and foreign exchange activities are

- To obtain reasonable assurance that material commitments and contingent liabilities related to international operations have been disclosed in the bank's financial statements.
- 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.

Internal Accounting Controls and Audit Procedures. The nature, timing, and extent of audit tests of an international department should be determined on the basis of the effect of foreign operations on the bank's financial statements and on the basis of the CPA's evaluation of internal accounting controls.

Commercial Letters of Credit. The principal internal

accounting controls for commercial letters of credit include the following

- Written policies concerning credit review, qualified customers, and documentation are required.
- Duties for posting of accounting records, cash disbursements, preparation of supporting documents initiating the transactions, and reconciliation of detailed records to control accounts are properly segregated.
- Trial balances are prepared and reconciled at least monthly to control accounts.
- Fee and commission computations are checked independently.
- All amendments to letters of credit are approved by an authorized officer of the bank.
- All letters are recorded and sequentially numbered.
- Invoices, shipping documents, delivery receipts, bills of lading, and other documents are agreed to the specific requirements of the letter.
- Delinquencies are promptly reported to management.

Audit procedures for commercial letters of credit may include, but would not necessarily be limited to, 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 account of the bank.
- Collateral is negotiable and adequately supports the acceptances.
- Adequate safeguards exist for the physical protection of drafts, letters of credit folders, collateral, and records.

Foreign Exchange. Several notable examples of the risks inherent in foreign exchange transactions have received national attention because of the significance of losses incurred by certain financial institutions on those transactions. 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, that has been a particularly sensitive audit area.

Important features of an internal accounting control system for foreign exchange transactions are

- 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 to 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 overlimit positions.
- Avoidance of excessive pressure on traders resulting from budget goals or individual compensation plans that might prompt the trader to take undue risks.

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

The auditing procedures for foreign exchange transactions should include, but not necessarily be limited to, 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 overlimit positions.

Finally, assurance should be obtained that there are no gaps in the timing of forward foreign exchange contracts for any one currency (foreign currency transactions that are matched as to amount but have different maturities), unless they have been authorized by designated bank officials.

## Chapter 23

## AUDITORS' REPORTS

As noted in Chapter 2, "Auditing Considerations," the CPA may be engaged to render reports in connection with a variety of accounting and auditing services. The following paragraphs discuss several of the various types of reports and the circumstances under which they might be issued.

### Reports on Financial Statements

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.

### Reports on Internal Accounting Control

An auditor may be required by professional standards or may be requested by a bank to report on a study and evaluation of a bank's system of internal accounting control performed either in conjunction with an audit or based on a special study. SAS 30, *Reporting on Internal Accounting Control*, gives guidance for such a report.

### Reports on Trust Departments

The CPA's report on a trust department may consist only of a summary of significant auditing procedures and findings as a result of those procedures (Chapter 18 discusses auditing a trust

department.). The CPA may also be asked to report on a study and evaluation of the system of internal accounting control of a bank's trust or other department that controls nonbank assets held for others in trust, investment advisory, and custody accounts. SAS No. 30 sets forth procedures for the study and evaluation and related reporting.

## Reports on Collective Investment Trusts

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.

## Special Reports

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 among other things, that distribution of the report be restricted. Alternatively, an engagement might require the auditor to examine the basic financial statements and also certain supplementary data. In that case, the audit report should consist of the standard report supplemented by a report on the supplementary information. The CPA should comply with SAS 29, Reporting on Information Accompanying the Basic Financial Statements in Auditor Submitted Documents. That type of report may include, but not

necessarily be limited to, the following:

- Summary of significant auditing procedures.
- Comments on financial statements and schedules, including significant accounts.
- Asset-liability mix and trends.
- Comments on internal accounting control (See also SAS 30).

## Appendix A

### ILLUSTRATIVE REPORT OF INDEPENDENT CPA AND ILLUSTRATIVE FINANCIAL STATEMENTS

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

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

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

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

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

SAMPLE BANK

BALANCE SHEETS

December 31, 19X2 and 19X1

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

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

SAMPLE BANK

STATEMENTS OF INCOME

for the years ended December 31, 19X2 and 19X1

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

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

SAMPLE BANK

STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

for the years ended December 31, 19X2 and 19X1

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

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

SAMPLE BANK

STATEMENTS OF CHANGES IN FINANCIAL POSITION

for the years ended December 31, 19X2 and 19X1

| | 19X2 | 19X1 |
|---|---|---|
| FINANCIAL RESOURCES PROVIDED | | |
| Operations | | |
| Net income | $ 1,435,000 | $ 1,331,000 |
| Depreciation and amortization, deferred income taxes, and provision for loan losses | 323,000 | 343,000 |
| Total resources provided by operations | 1,758,000 | 1,674,000 |
| Increase in deposits | 852,000 | 2,386,000 |
| Reduction in: | | |
| Investment securities | 5,833,000 | 63,000 |
| Trading securities | 1,275,000 | 128,000 |
| | $ 9,718,000 | $ 4,251,000 |
| FINANCIAL RESOURCES APPLIED | | |
| Increase in: | | |
| Cash and due from banks | $ 73,000 | $ 34,000 |
| Federal funds sold and securities purchased under reverse repurchase agreements | 2,100,000 | --- |
| Loans, net | 4,874,000 | 325,000 |
| Investment in leveraged leases, net | 784,000 | --- |
| Other assets | 614,000 | 101,000 |
| Reduction in: | | |
| Federal funds purchased and securities sold under repurchase agreements | 279,000 | 3,252,000 |
| Other liabilities | 234,000 | 140,000 |
| Purchase of buildings, equipment, and leasehold improvements | 439,000 | 78,000 |
| Dividends paid or declared | 321,000 | 321,000 |
| | $ 9,718,000 | $ 4,251,000 |

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

SAMPLE BANK

NOTES TO FINANCIAL STATEMENTS

## Note 1. Summary of Significant Accounting Policies

- **Investment securities**

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

- **Trading securities**

  Trading securities are carried at market value. Gains and losses on sales and changes in market values are included in OTHER INCOME.

- **Loans and allowance for loan losses**

  Loans are stated at the amount of unpaid principal, reduced by unearned discount and an allowance for loan losses. Unearned discount on installment loans is recognized as income over the terms of the loans by the interest method. Interest on other loans is calculated by using the simple interest method on daily balances of the principal amount outstanding. The allowance for loan losses is established through a provision for loan losses charged to expenses. Loans are charged against the allowance for loan losses when management believes that the collectibility of the principal is unlikely. The allowance is an amount that management believes will be adequate to absorb possible losses on

existing loans that may become uncollectible, based on evaluations of the collectibility of loans and prior loan loss experience. The evaluations take into consideration such factors as changes in the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans, and current economic conditions that may affect the borrowers' ability to pay. Accrual of interest is stopped on a loan when management believes after considering economic and business conditions and collection efforts, that the borrower's financial condition is such that collection of interest is doubtful.

- <u>Leveraged leases</u>

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

- <u>Depreciation</u>

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

- <u>Pension plan</u>

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

- Income taxes

Deferred income taxes are reported for timing differences between items of income or expense reported in the financial statements and those reported for income tax purposes. The differences relate principally to depreciation of office buildings and equipment, accretion of discounts on investment securities, provision for loan losses, and differences in method of recognizing income from leases. Investment tax credits resulting from purchases of equipment for the Bank's use are accounted for under the flow-through method as a reduction of income tax expense in the period the assets are placed in service. Investment tax credits on equipment leased to others are recognized over a period related to the recovery of the lease investment that gives rise to the credits.

- Earnings per share

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

Note 2. Investment Securities

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

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

1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22 23 24 25 26 27 28 29 30

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

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

## Note 3. Loans

Major classifications of loans are as follows:

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

Loans on which the accrual of interest has been discontinued or reduced amounted to $373,000 and $596,000 at December 31, 19X2 and 19X1, respectively. If interest on those loans had been accrued such income would have approximated $37,100 and $59,600

for 19X2 and 19X1, respectively. Interest income on those loans, which is recorded only when received, amounted to $9,300 and $18,700 for 19X2 and 19X1, respectively.

Changes in the allowance for loan losses were as follows:

| | Year ended December 31, | |
|---|---|---|
| | 19X2 | 19X1 |
| Balance, beginning of year | $ 823,000 | $ 819,000 |
| Provision charged to operations | 60,000 | 68,000 |
| Loans charged off | (80,000) | (103,000) |
| Recoveries | 27,000 | 39,000 |
| Balance, end of year | $ 830,000 | $ 823,000 |

Note 4. Investment in Leveraged Leases

Leveraged leases of equipment to customers are comprised of the following:

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

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

Note 5. Office buildings, equipment and leasehold improvements

Major classifications of these assets are summarized as follows:

| | December 31, | |
|---|---|---|
| | 19X2 | 19X1 |
| Land | $ 535,000 | $ 526,000 |
| Buildings | 1,417,000 | 1,144,000 |
| Equipment | 691,000 | 596,000 |
| Leasehold improvements | 112,000 | 125,000 |
| | 2,755,000 | 2,391,000 |
| Accumulated depreciation | (611,000) | (513,000) |
| | $ 2,144,000 | $ 1,878,000 |

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

Note 6. Income Taxes

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

| Year ended December 31, | Currently payable | | Deferred | | |
|---|---|---|---|---|---|
| | Federal | State | Federal | State | Total |
| 19X2 | $ 20,000 | $ 36,000 | $ 85,000 | $ 5,000 | $ 146,000 |
| 19X1 | (105,000) | 25,000 | 100,000 | 13,000 | 33,000 |

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

The items that caused timing differences resulting in deferred income taxes were as follows:

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

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

## Note 7. Subordinated Debentures

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

## Note 8. Pension Plan

The Bank has a noncontributory pension plan covering substantially all of its employees. The total pension expense of 19X2

and 19X1 was $39,000 and $27,000 respectively, which includes, as to certain defined benefit plans, amortization of prior service cost over 30 years. The Bank contributes annually to the plans amounts equal to the accrual for pension expense. A comparison of accumulated plan benefits and plan net assets for the Bank's defined benefit plans is presented below:

| | January 1, | |
|---|---|---|
| | 19X2 | 19X1 |
| Actuarial present value of accumulated plan benefits: | | |
| Vested | $1,500,000 | $1,350,000 |
| Nonvested | 2,800,000 | 2,650,000 |
| | $4,300,000 | $4,000,000 |
| Net assets available for benefits | $2,050,000 | $1,900,000 |

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

Note 9. Commitments, Contingent Liabilities, and Rental Expense

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

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

| | | |
|---|---|---|
| Due in the year ended December 31, | 19X3 | $ 85,000 |
| | 19X4 | 85,000 |
| | 19X5 | 85,000 |
| | 19X6 | 85,000 |
| | 19X7 | 60,000 |
| Due in the remaining terms of the leases | | 98,000 |
| | | $498,000 |

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

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

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

## Note 10. Related Party Transactions

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

## Note 11. Retained Earnings

Banking regulations limit the amount of dividends that may be

paid without prior approval of the Bank's regulatory agency. Retained earnings against which dividends may be charged were $2,000,000 at December 31, 19X2.

## Appendix B

## COMMON TRUST FUND

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.

### Illustrative Report of Independent CPA and Illustrative Financial Statements

Commercial Bank
City, State

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

and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

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

Our examination has been made primarily for the purpose of expressing an opinion on the financial statements taken as a whole. The supplementary information contained on pages 227 through 229 is presented for analysis purposes and is not necessary for a fair presentation of the financial information referred to in the preceding paragraph. It has been subjected to the tests and other auditing procedures applied in the examination of the financial statements mentioned above and, in our opinion, is fairly stated in all material respects in relation to the financial statements taken as a whole.

City, State

Date

COMMERCIAL BANK

COMMON TRUST FUND A

Statement of Assets and Liabilities

December 31, 19X2

| ASSETS | Cost | Value | |
|---|---|---|---|
| Investments in securities, at value:* | | | |
| 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.

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*Short-term securities that represent the temporary use of cash balances may be classified separately from the investment portfolio unless it is the investment policy of the fund 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 | Security | Cost* | Value |
| --- | --- | --- | --- |
| | BONDS—22.32% | | |
| $1,000,000 | ABC Company, 8% subordinated debentures, due 9/15/X3 | $1,050,000 | $1,060,000 |
| 600,000 | Jones Manufacturing Inc. 8-1/4% subordinated debentures, due 6/30/X4 | 630,000 | 640,000 |
| | Total Bonds | 1,680,000 | 1,700,000 |
| | 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 |

*Detailed cost disclosure is optional.

COMMERCIAL BANK

COMMON TRUST FUND A

Portfolio of Investments in Securities—Continued

December 31, 19X2

| Number of Shares or Principal Amount | Security | Cost* | Value |
|---|---|---|---|
| | 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.

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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.

*Detailed cost disclosure is optional.

COMMERCIAL BANK

COMMON TRUST FUND A

Statement of Operations

for the year ended December 31, 19X2

| | | |
|---|---|---|
| Investment Income: | | |
| Dividends | $ 99,700 | |
| Interest | 26,300 | |
| Total Investment Income | | $ 126,000 |
| Audit and miscellaneous expense* | | (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.

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*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 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 and 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

for the 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

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 valuation, 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 income of the common trust fund, 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 and at such 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



1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22 23 24 25 26 27 28 29 30

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*

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 |

* 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—Continued

Investments Purchased*

for the year ended December 31, 19X2

| Number of Shares or Principal Amount | BONDS | Cost |
|---|---|---|
| | 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., 8-1/4% 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 | 1,055,000 |
| | 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 |

* If any securities were acquired through stock dividends or splits, a separate schedule of those transactions should be presented.

1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22 23 24 25 26 27 28 29 30

COMMERCIAL BANK

COMMON TRUST FUND A

Supplementary Information—Continued

Investments Sold or Redeemed
for the year ended December 31, 19X2

| Number of Shares or Principal Amount | BONDS | Cost | Proceeds | Gain or (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

### 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 such 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 authority to perform some or all examination procedures may be assigned by the directors 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 examination report of the directors-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 (OCC) 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 specified forms for reporting the results.

The AICPA Committee on Banking (the Committee) 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 the required services that meet both the objectives of the directors' examination and the standards of the accounting profession.

This document is intended to familiarize CPAs with the general types of services requested by directors in connection with directors' examinations and to provide guidelines for establishing the scope of services and issuing reports.

## SCOPE OF SERVICES RENDERED BY CPAs

The scope of services rendered by CPAs in connection with directors' examinations will vary 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 one of the following three categories: 1 2 3 4 5 6

### Audit of Financial Statements

The purpose of an examination of a bank's financial statements in accordance with generally accepted auditing standards is to enable the CPA to express an opinion on the financial statements. An audit of financial statements is usually acceptable in fulfilling the directors' examination requirements of those supervisory agencies that have specific minimum audit requirements. Also, many supervisory agencies' directors' examination requirements would be met by examining the balance sheet only. Accordingly, an audit may be requested by the directors 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. 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22 23 24

Audit with Scope Limitation

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 testing 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. 1 2 3 4 5 6 7 8 9 10

Procedures Agreed Upon with the Board of Directors

A CPA may be engaged by the directors to perform specified examination procedures. These procedures are generally designed to meet the supervisory agency 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 that is submitted to the agency include certain unaudited financial statements or data. 11 12 13 14 15 16 17 18

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. 19 20 21 22 23 24

GUIDANCE FOR PROCEDURES AGREED UPON WITH THE BOARD OF DIRECTORS

Members of the AICPA making examinations in accordance with generally accepted auditing standards are guided by the AICPA's Statements on Auditing Standards (SAS). These auditing standards are designed for engagements resulting in a CPA's opinion on financial statements; also, these auditing standards are generally applicable to other types of engagements such as a CPA's services performed in connection with bank directors' examinations. Guidance is limited, however, as to the types of procedures to be applied when the CPA's involvement in a directors' examination is 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 with the directors that the types of procedures to be applied may be affected by the specific supervisory agency 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 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 director's examination or the CPA's engagement.

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[1] SAS No. 35, paragraph 2, states that the "parties involved have a clear understanding of the procedures to be performed." In circumstances when the CPA is not able to discuss the procedures directly with all of the parties that 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."

The CPA should consider issuing an engagement letter describing 1
the agreement with the directors on scope and responsibility. 2
The letter would state that the purpose of the CPA's engagement 3
is to assist the directors in performing the directors' 4
examination, and that responsibility for completing the applicable 5
supervisory agency's directors' examination requirements, if any, 6
and for reporting the results to such agency rests with the 7
directors. The engagement letter may include, among other things, 8
details of the major areas to be covered, the extent of procedures 9
to be performed in each area, and any specific supervisory agency 10
requirements to be omitted. An illustrative engagement letter is 11
set forth in Exhibit I of these guidelines. 12

REPORTS ISSUED BY CPAs

Reports prepared by CPAs based on audits of financial statements 13
should comply with the reporting provisions contained in applica- 14
ble SASs. SAS No. 2 gives guidance on "Reports on Audited 15
Financial Statements," and paragraph 12 of the SAS states that 16
"When restrictions that significantly limit the scope of the audit 17
are imposed by the client, the auditor generally should disclaim 18
an opinion on the financial statements." Reports prepared by CPAs 19
based upon the performance 20
of agreed-upon procedures in connection with a bank directors' 21
examination, should be prepared in conformity with SAS No. 35, 22
paragraph 4, and, accordingly, should: 23

"(a) indicate the specified elements, accounts, or items 24
to which the agreed-upon procedures were applied, 25

(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. 4/

4/ 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, further states that "If the accountant has no adjustments to propose to the specified elements, accounts, or items, he may include a comment to that effect in his report. For example, the following language might be included: 'In connection with the procedures referred to above, no matters came to our attention that caused us to believe that the (specified elements, accounts, or items) should be adjusted.' Also, the accountant may wish to indicate that had he performed additional procedures with respect to the specified elements, accounts, or items; or had he made an examination of the financial statements in accordance with generally accepted auditing standards, (other) matters might have come to his attention that would have been reported."

As mentioned earlier, some supervisory agencies require that the report submitted to the agency include financial statements (data). In such instances, the directors will usually include the CPA's special-purpose report and the unaudited financial statements (data), among other reports and statements.2/

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2/ See the footnote from SAS No. 35 that is quoted on the previous page of these guidelines.

An illustrative special report for agreed-upon procedures performed in connection with a directors' examination is set forth in Exhibit II of these guidelines.

A CPA may be requested to perform specific examination procedures while also conducting a "compilation" or "review" of financial statements. The procedures employed in compilation and review engagements and reports issued thereon should comply with the provisions of AICPA Statements on Standards for Accounting and Review Services (SSARS) No. 1, _Compilation and Review of Financial Statements_. In accordance with SSARS No. 1, paragraph 32, any examination procedures "that the accountant might have performed before or during the review engagement, including those performed in connection with a compilation of the financial statements, should not be described in his report." This provision, however, would not preclude a CPA from issuing a separate, special-purpose report on the nature and extent of procedures performed in accordance with SAS No. 35.

EXHIBIT I

ILLUSTRATIVE ENGAGEMENT LETTER -

SERVICES OTHER THAN FINANCIAL STATEMENT EXAMINATIONS

EXAMINING COMMITTEE (Date)
XYX 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 assisting you in completing your directors' examination, and our report to be issued thereon is not intended for any other purpose.

The procedures to be performed are summarized in the Supplement to this letter. Because those procedures will not constitute an examination made in accordance with generally accepted auditing standards, we will not express an opinion on any of those items specified in the aforementioned Supplement or the financial statements of the bank taken as a whole.

Our engagement will not include a detailed examination of all transactions and cannot be relied upon to disclose errors, irregularities, or illegal acts, including fraud or defalcations, that may exist. However, we will inform you of any such matters that come to our attention.

We direct your attention to the fact that management has the responsibility for the proper recording of the transactions in the books of account, for the safeguarding of assets, and for the preparation of financial statements in conformity with generally accepted accounting principles.

The procedures will be applied on a surprise basis* during the year, after consulting with the appropriate supervisory agencies to discuss the procedures to be performed and to ensure that the date selected will not conflict with their examinations.

As mentioned in paragraph 2 above, we will submit a report summarizing the procedures performed, the results of those procedures, and any suggestions we may have for improving the Bank's system of internal accounting control and accounting records and procedures. This report will be issued solely for the information of the Bank's management and appropriate supervisory agencies (or other specified third parties). It is not to be used by any other parties because of the restricted nature of our work. Our report will also contain a paragraph indicating that had we performed additional procedures or had we made an examination of the financial statements in accordance with generally accepted auditing standards, other matters might have come to our attention that would have been reported to you.

Our fees are based on the time required by the individuals assigned to the engagement, plus direct expenses. Individual hourly rates vary according to the degree of responsibility involved and the skill required. 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 CPA)

* Some directors' examinations may not be on a surprise basis.

Acknowledged: 1

_______________________________ 2
(Name of Bank) 3

_______________________________ 4
(Signature of Bank Director) 5

_______________________________ 6
(Date) 7

_______________________________ 8

(A) Some CPAs prefer not to obtain an 9
acknowledgement, in which case their letter would omit the 10
sentence beginning 'If the foregoing...' and the spaces for the 11
acknowledgement. The first paragraph of their letter might begin 12
as follows: 'This letter sets forth our understanding of the 13
terms and objectives of our engagement... 14

(B) In certain instances, the CPA may not be able to discuss the 15
procedures to be performed with all the parties, for example, 16
bonding companies, that will receive a copy of the report. In 17
these circumstances, to satisfy the requirement in SAS No. 35 that 18
these parties have an understanding of the procedures to be 19
performed, the CPA should consider sending a copy of the engagement 20
letter to these parties and asking them to confirm it. 21

SUPPLEMENT TO ILLUSTRATIVE ENGAGEMENT LETTER*

Procedures to be Performed in Connection with Directors' Examination

(Name of Bank)

In connection with our engagement, the procedures to be performed are summarized as follows:

(1) General

(a) Start the engagement on a date selected by us without prior notification of Bank personnel, officers or directors. Obtain immediate control (seal vault, etc.) of assets and records and maintain control until applicable procedures have been completed. The surprise procedures will cover the main office and (the following) branches.

(b) Review the Bank's system of internal accounting control. The review will be limited to describing the system through use of narratives or flow charts, tracing one or more of the significant transaction types through the system, and completing internal control questionnaries.[1/]

(c) Review supervisory agency examination reports.

(d) Review minutes of board of directors.

(e) Review material entries to the general ledger and investigate unusual transactions.

(f) Review accounting procedures for handling nonledger assets, such as loan charge-offs and recoveries, travelers' cheques, and U.S. savings bonds.

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1/ SAS No. 30 gives guidance on "Reporting on Internal Accounting Control."

(g) Obtain letters from legal counsel. 1

(h) Review disposition of our previous comments and 2

recommendations on internal accounting control. 3

(i) Obtain management representation letter. 4

(2) Cash, cash items and clearings ) Procedures to be performed 5
should be listed in detail, 6
and exchanges ) including number and types 7
of confirmations, extent of tests of 8
(3) Due from banks ) revenue and expense, and 9
types of sampling methods 10
(4) Securities ) employed. 11

(5) Federal funds sold (purchased) 12

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* This Supplement is for illustrative purposes only and, therefore, 13
is not considered to be all and only those accounts that may be 14
examined and procedures employed. The CPA should describe those 15
accounts and procedures relevant to the specific engagement. 16

EXHIBIT II

ILLUSTRATIVE REPORT -

SERVICES IN CONNECTION WITH DIRECTORS' EXAMINATIONS

EXAMINING COMMITTEE
XYZ BANK

We have applied certain procedures to selected records and transactions of the (name of bank) as of (examination date). Our examination was made in accordance with the arrangements set forth in our letter to you dated (date).

The procedures we performed are summarized in the Supplement to this report. Also included in the attached Supplement are certain account balances as shown in the bank's records as of the examination date. Because the procedures do not constitute an examination made in accordance with generally accepted auditing standards, we do not express an opinion on any of those items specified in the aforementioned Supplement.

In connection with the procedures mentioned in the attached Supplement, no (the following) matters came to our attention that caused us to believe that any (the following) account(s) might require adjustment. Had we performed additional procedures or had we made an examination of the financial statements in accordance with generally accepted auditing standards, other matters might have come to our attention that would have been reported to you. This report relates only to the accounts specified in the attached Supplement and does not extend to any financial statements of (name of bank) taken as a whole for the (date).

This report is intended solely for the use of management (or specified regulatory agency or other specified third party) and should not be used for any other purpose.

Please contact us if you have any questions regarding this examination.

______________________________
(Signature of CPA)

(Name of CPA)

(Date)

## SUPPLEMENT TO ILLUSTRATIVE REPORT

<u>Cash and Due From Banks</u>

| | |
|---|---|
| Cash on Hand | $ 429,859 |
| Cash items | $ 32,390 |
| Clearings and transit items | $ 324,189 |
| Due from banks | $1,166,980 |

Cash on hand was counted, except that bundled currency in denominations under $50 and rolled coins were test counted. Bundled $20, $10, $5, $2 and $1 bills were counted 25%, 10%, 10%, 5%, and 5%, respectively. Total cash on hand was found to be $1,471.84 less than the general ledger balance. Bank officers have informed us that they are investigating further an unexplained shortage of $1,361.05 in one of the teller's funds.

Cash items were inspected. We ascertained that cash items in excess of $100 clearing the first three days following the examination date were properly disposed.

Clearings and cash letters in transit were totaled and found to be in agreement with the general ledger balance. Clearings were confirmed directly with the banks receiving them. We ascertained that return items in excess of $500 recorded by correspondent banks on (examination date) and the following three days were properly disposed.

Amounts due from banks were confirmed directly with depository institutions. Statements were obtained for five days following (examination date) and no unusual transactions were noted. We ascertained that return items in excess of $500 recorded by correspondent banks on (examination date) and the following five days were properly disposed.

(PROCEDURES FOR OTHER ACCOUNTS SHOULD BE SPECIFIED 1

IN DETAIL AND DIFFERENCES AND SUBSEQUENT 2

DISPOSITION REPORTED.) 3

## CONFIRMATION STATISTICS

(Examination Date)

| | Loans[1] | Checking Accounts | Savings Accounts | Certificates of Deposit |
|---|---|---|---|---|
| **Dollar Amounts:** | | | | |
| Total | | | | |
| Circularized | | | | |
| Percent circularized to total | | | | |
| Replies received[2] | | | | |
| Percent replies received to total circularized[2] | | | | |
| Selected but not circularized | | | | |
| Not delivered by post office | | | | |
| **Number of Accounts:** | | | | |
| Total | | | | |
| Circularized | | | | |
| Percent circularized to total | | | | |
| Replies received[2] | | | | |
| Percent replies received to total circularized[2] | | | | |
| Selected but not circularized | | | | |
| Not delivered by post office | | | | |

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

2 If negative confirmations are used, the following explanation should be included: "Negative confirmations" requesting a reply only when the customer believes that the balances shown on the confirmation are not correct were used to confirm customers' account balances.

CONFIRMATION REQUESTS NOT CIRCULARIZED 1

| | Name and Address | Reason for Non-Circularization | Balance as of (Examination Date) | |
|---|---|---|---|---|
| | | | | 2 3 4 |
| Loans: | | | | 5 |
| Checking accounts: | | | | 6 |
| Savings accounts: | | | | 7 |
| Certificates of deposit: | | | | 8 |

## APPENDIX D

## ILLUSTRATIVE FORMS OF CONFIRMATION REQUESTS

Illustrative forms of confirmation requests are


| Class of Transaction | Type | Page Number |
|---|---|---|
| Loan | Negative | 251 |
| Loan | Positive | 252 |
| Deposit | Negative | 253 |
| Deposit | Positive | 254 |
| General Purpose | Negative | 255 |
| General Purpose | Positive | 256 |

LOAN CONFIRMATION FORM
SAMPLE - NEGATIVE REQUEST

SAMPLE BANK
LETTERHEAD

Date ______________

______________________ (Name
______________________ and
______________________ Address)

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 Interest is Paid to | ______ | ______ | ______ | ______ |
| 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 ______________

* The CPA should exercise judgment in determining whether all of the indicated information is desired.

LOAN CONFIRMATION FORM
SAMPLE - POSITIVE REQUEST

SAMPLE BANK
LETTERHEAD

Date ________________

______________________ (Name
______________________ and
______________________ Address)

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 Interest is Paid to | ______ | ______ | ______ | ______ |
| 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______________________

* The CPA should exercise judgment in determining whether all of the indicated information is desired.

CHECKING ACCOUNTS, NOW ACCOUNTS, SAVINGS ACCOUNTS, AND CERTIFICATES OF DEPOSIT

SAMPLE - NEGATIVE DEPOSIT CONFIRMATION REQUEST

SAMPLE BANK
LETTERHEAD

Date ______________

______________________ (Name

______________________ and

______________________ Address)

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, 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.

CHECKING ACCOUNTS, NOW ACCOUNTS, SAVINGS ACCOUNTS, AND CERTIFICATES OF DEPOSIT

SAMPLE - POSITIVE DEPOSIT CONFIRMATION REQUEST

SAMPLE BANK
LETTERHEAD

Date________________

__________________________ (Name
__________________________ and
__________________________ Address)

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 CONFIRMATION FORM
SAMPLE - NEGATIVE REQUEST

SAMPLE BANK
LETTERHEAD

Date ____________________

______________________ (Name
______________________ and
______________________ Address)

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 | Security Repurchase Agreement |



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GENERAL PURPOSE CONFIRMATION FORM
SAMPLE - POSITIVE REQUEST

SAMPLE BANK
LETTERHEAD

Date_______________

_______________________ (Name
_______________________ and
_______________________ Address)

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 item(s) that are not applicable.

NOTE: This form may be used for transactions such as:

| Safekeeping | Collection Items | Letters of Credit |
|---|---|---|
| Securities | Federal Funds | Security Repurchase Agreement |



1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22 23 24 25 26 27 28 29 30

APPENDIX E

# GLOSSARY

## Terms Common to Banks

ACCOMMODATING BANK. A correspondent bank that receives or provides funds as a service to its correspondent banks.

ACCOUNTING ENTRY TICKET. Ticket used as a posting medium in place of columnar journals as books 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. Also buying a security subject to exchange, conversion, or reorganization and selling the security or securities to be received upon completion of the exchange, conversion, or reorganization.

BANK HOLDING COMPANY. A company controlling one or more banks or bank holding companies. Bank holding companies are subject to Federal Reserve regulations and permitted to engage in activities closely related to banking.

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.

BATCH. A grouping of similar items, for example, deposits or incoming checks, assembled for proofing purposes. The term is also referred to as "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 controlled by 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. 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. Surplus usually created either by issuance of bank capital stock at a premium or by transfers from retained earnings.

CASH ITEM. Maturing coupons and bonds, petty cash vouchers, returned checks, due bills and other similar items 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 a check or other negotiable instrument. CDs may be payable on demand (demand CD) or at some specified date (time CD). 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 30 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.

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.

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, who elect its officers and subsidize its operating expenses.

CLUB ACCOUNT. 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 shall 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 and credit 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, protest, 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. Deposit balance maintained by a customer pursuant to lines of credit, borrowings, or agreements for other services.

COMPLETED TRANSACTION METHOD. Recognition of securities gains and losses when realized.

COMPTROLLER OF THE CURRENCY. An appointed official in the United States 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.

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CREDIT DEPARTMENT. The department responsible for obtaining, 5
assembling, and retaining credit information on a bank's 6
customers. Credit applications for loans generally are 7
presented to this department by a loan officer. The credit 8
department then gathers all available information on the 9
customer and prepares it for the confidential use of the 10
loan officer, who evaluates the creditworthiness of the 11
customer. Also, this department obtains information and 12
answers credit inquiries for correspondent banks. 13
14
CUSTOMERS' ACCEPTANCE LIABILITY. Customer liability on outstanding 15
drafts and bills of exchange that have been accepted by a 16
bank. This acceptance by the bank is referred to as a 17
"banker's acceptance." 18
19
DE NOVO BASIS. Commence a new business rather than acquire an 20
existing one. 21
22
DEALER RESERVE. A portion of the proceeds of the discounted 23
installment sales contract retained by the bank to achieve 24
limited protection against credit losses. Credit losses 25
chargeable against these reserves are covered by the 26
agreement entered into with the dealer. 27
28
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DEFERRED POSTING. A term used to describe a method of posting transactions. The two types of deferred posting methods are (1) Partially deferred posting plan—the previous day's counter checks intersorted with the current day's inclearings and mail items, and posted in one run. (The previous day's counter work is delayed.) (2) Fully deferred posting plan--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. (All checks posted one day after coming into the bank's possession—fully deferred.)

DEMAND DEPOSIT. Deposit funds subject to withdrawal on demand of depositor.

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 per se.

DIRECTORS' EXAMINATION. Periodic examination of banks by their directors, a committee of the directors, or on their behalf by CPAs or other auditors.

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 re-discounts for a member or customer bank the notes, drafts, or acceptances which 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. Issued to cover a short sale when funds are received. A due bill is required to be collaterized three business days after settlement. If not properly collaterized, it is treated as a deposit for reserve requirements.

DUE FROM ACCOUNT. Asset control account used to record a bank's deposits in other banks.

DUE TO ACCOUNT. 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. Also, commonly used to designate accounts credited with the periodic deposits of mortgagors for the payment of real estate taxes and insurance premiums by the bank on behalf of the mortgagor.

EXCHANGE. The settlement of items drawn on other banks through a clearinghouse or by "direct settlement" between banks.

FAIR VALUE. The amount one can reasonably expect to receive in a current but not 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 governmental 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 who 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 Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Board of Governors of Federal Reserve System, Federal Home Loan Bank Board, and National Credit Union Administrations which prescribes uniform principles and standards for the federal examinations of financial institutions, and makes recommendations to promote uniformity in the supervision of the financial institutions.

FEDERAL FUNDS. A loan by a bank (or borrowings by a bank) to decrease (or increase) its reserve account with a Federal Reserve Bank. A bank is required to maintain a legal reserve comprising (a) funds on deposit in the bank's reserve account with a Federal Reserve Bank and (b) 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). The corporation was 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 United States 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 which, if charged, would create an 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 against the account.

INTEREST COLLECTED BUT NOT EARNED (UNEARNED INTEREST). Interest that has been collected in advance of the contract to be performed or 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, second mortgage, subordinate to other mortgages.

LETTER OF CREDIT. A formal document in letter form addressed to and authorizing the beneficiary (for example, 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.

LINE OF CREDIT. A term applied to the maximum amount of credit that a bank will extend to a particular borrower (usually a business concern) over a stated period, subject to the borrower's meeting 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 those 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 their collection or liquidation in full is highly questionable.

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

Other loans especially mentioned (OLEM). Loans that are currently "protected" but that exhibit potentially unwarranted credit risks.

LOSS. See Loan Classifications Used by Supervisory Agencies.

MEMORANDUM ACCOUNT. An account used to control customers' assets or future commitments. This type of account is not reflected in the bank's balance sheet or statement of income. Types of memoranda accounts include unused commitments for letters of credit, collection items, items kept for safekeeping, forward foreign exchange contracts, guarantees, and unused balances under lines of credit.

MORTGAGE PARTICIPATION CERTIFICATE (PC). A certificate representing an undivided interest in specified residential conventional mortgages underwritten and owned by the FHLMC. FHLMC unconditionally guarantees the payment of principal and interest.

NET OCCUPANCY EXPENSE OR 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 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 ACCOUNT. (Negotiable Order of Withdrawal) A transaction account similar to a checking account on which interest is paid.

OLEM. See Loan Classifications Used by Supervisory Agencies.

ON US CHECKS. Those checks drawn on deposit accounts 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 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. Also used to describe 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; it then is said to be in balance.

RESERVES. Reserves include legal reserves and reserves for contingencies. Such reserves are considered appropriated (restricted) retained earnings. The term "reserves" has been used to represent either (a) valuations against asset accounts or (b) liabilities; these reserves should be classified as valuation allowances or liabilities as appropriate.

RESERVE REQUIREMENTS. The percentage of deposits each bank is required by law to maintain on deposit with the Federal Reserve Bank.

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-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.

SIGHT DRAFT. A draft that is payable on presentation to the drawee.

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.

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. Includes 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.

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.

THROWOUTS. See Holdovers.

TRANSIT ITEMS. Items for credit to customers' accounts and payable outside the city of the customers' 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. 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.

UNDIVIDED PROFITS. See retained earnings.

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.

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' deposit 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. An 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.