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Audit Procedure for the Present-day Building-and-Loan Association

By Robert H. McNair

As a financial institution offering its services to the investing and borrowing public, the building-and-loan association presents to the public accountant a great opportunity for constructive auditing. This idea of constructive auditing—of bringing to light possible dangers and of making recommendations as to future business policies—although not always received enthusiastically by directors, is nevertheless an important phase of public accounting.

In the original type of association only the members of a community participated, and all made payments during the same period of months. This evolved into what is known as the serial plan, under which new series are begun at intervals and each series is treated separately. Of late years there has been a growing tendency toward the optional-payment plan which resembles the savings account in many respects. The older associations are mutuals. The guaranty or permanent stock association is a relatively new form of organization. The many types of organization make it impossible to present an exhaustive study of the audit procedure within the scope of one article. However, the most important features are presented here, with special emphasis on those accounts which are not encountered in the usual audit programme.

Funds are provided by investing members; these funds are lent to other members on first mortgage security. This is the foundation of the building-and-loan association. The auditing of the members' accounts and the examination of the loan files comprise the leading features of the audit programme. A complete audit necessitates also the calculation of reserves to meet maturities on instalment dues accounts.

The following resources will be considered in the order named:

1. Mortgage loans
2. Delinquent interest
3. Advances to borrowers
4. Loans on stock or certificates
5. Other loans

6. Stocks and bonds
7. Miscellaneous receivables
8. Real estate
9. Furniture and fixtures, automobiles, building
10. Organization expense
11. Cash on hand
12. Cash in banks

The mortgage loan account should be verified by an inspection of the legal papers relative to each loan. The loan register, where one is kept accurately, will serve as a guide in this work. All loan files should be taken charge of or sealed until the inspection is completed. Papers may be checked in and out to the office force as required. The column headings for the mortgage-loan schedule are set forth in form 1. It is sometimes informative to prepare this schedule by towns or to make a summary showing the total lent in each town. Under the column for "type of loan," it may be shown whether the property is residential, commercial, apartments, vacant lot, or other.

The column for "paid in" is important since it shows at a glance the net amount still invested in each loan. By listing the dues paid in on each loan the auditor secures a tie-up between the loans and the dues ledger, thereby ascertaining that each loan is being handled regularly. Otherwise there might be a delinquent loan not showing up as delinquent because no ledger sheet had ever been made out for that member.

In the examination of the loan papers the following points should be given attention:

(a) The mortgage or deed of trust should be inspected for the original amount of the loan, the signature of the borrower and the official seal of the county recorder—this last to make sure that the mortgage has been recorded. It is not within the auditor's duties to examine the county records for a proof that the mortgages have not been released and that there are no prior encumbrances. However, this is an excellent means of obtaining important information concerning any large or unusual loan. I have known of loans on property which had so many prior claims against it that the association's loan was practically unsecured. Although the auditor may not be to blame, he may receive criticism for not informing the stockholders of such a situation.

(b) The note or bond should be examined as to original amount, payments on the principal and signature of the maker. Satis-

factory explanation and proof should be demanded for any dummy notes on file.

(c) The abstract of title will, as a rule, be in the loan file. This is an important document and should be on hand, but ordinarily no further inspection of it is necessary.

(d) The stock certificate, assigned to the association, should be in the file.

(e) Information as to the type of loan or the probable value of the property can usually be obtained from the loan application.

(f) Insurance policies, both fire and tornado, should be on hand for the amount of the loan, or more. There should be a mortgage clause in favor of the association.

Different situations will suggest different subsidiary loan schedules such as:

1. Loans in excess of a certain amount
2. Loans to officers and directors
3. Commercial loans.

A schedule of delinquent loans is important. For this schedule form 2 is suggested. By including advances on this schedule all charges against borrowers, other than the original loan, are shown together. These advances are usually made by the association to pay taxes or insurance on the property mortgaged. Loans that have advances made on them are often among the delinquents. Good management requires that losses from foreclosures be minimized by a continual hammering on delinquent loans. Special mention should be made of loans on which the payments are badly in arrears and those which may result in foreclosure suits, as well as those which are in process of foreclosure at the time of the audit. Ample reserves should be created for bad and doubtful loans. A direct verification of all loans in arrears will serve the double purpose of detecting a possible embezzlement of receipts and of promoting collections on slow accounts.

Loans secured by stock or investment certificates should be verified by an inspection of the notes and the certificates pledged. Care should be taken to ascertain that no loan exceeds the cancellation value of the stock securing it. Interest accrued and unpaid, as well as interest collected in advance, should be set up on the books at the end of each accounting period. Some associations lend money on the dues paid in on mortgage-loan stock. This practice violates the principle of a decreasing equity in the

real estate and should be condemned. Form 3 presents the headings for the schedule of certificate loans.

A building-and-loan association of any size will possibly have a part of its funds invested in loans on other collateral or in stocks and bonds. Frequently serial real-estate notes are taken in payment for real estate sold. The notes, mortgages, abstracts and insurance policies should be examined, and interest accrued or prepaid should be calculated. Special comments may be necessary as to notes past due. A close scrutiny of other collateral and securities owned must be made. Evidence of ownership should be examined and the balance-sheet valuation should be conservative.

There may be miscellaneous receivables, such as advances to agents, employees or officers. These are items of a general nature and need not be discussed here. The auditor should, of course, make note of unusual or excessive advances.

In the course of business most associations find it necessary to acquire real estate by foreclosure. One association, with which I am familiar, boasted of years of existence without a foreclosure. It appeared that when a loan reached the foreclosure state one of the directors of the association would arrange to take over the loan and make the payments. This practice of itself is legitimate but might lead to abuses. A careful analysis of directors' loans will reveal anything of this kind. The book value of real estate owned may properly include the original loan plus additional advances and accrued interest less the cancellation value of the dues paid in. Court costs, subsequent improvements and improvement taxes may be added to the asset value. But expenses such as insurance, general taxes and repairs should not be added to the book value of the real estate, nor should rents collected be deducted therefrom. Hence, it is important that the auditor inspect additions to the real-estate account to determine that they are proper.

Since a building-and-loan association is not in the real-estate business, the management is anxious to turn over its real estate as soon as possible. Often losses are suffered in disposing of property. Ample reserves should be created to absorb these losses. A careful appraisal of each piece of property would provide a basis for the creation of this reserve. Deeds, abstracts and insurance policies should be examined. The deeds should bear the county seal as an evidence that they are on record.

If the association owns furniture and fixtures, an office building, automobiles, etc., these should be conservatively valued. Any additions to these accounts during the year should be supported by voucher. It is a conservative practice sometimes followed by financial institutions to charge off all fixed assets entirely, thereby creating a hidden reserve.

The item of organization expense may appear on the books of a new building-and-loan association, but this debit should be charged off against the profits of the first few years. The appearance of an intangible asset of this nature on the statement of a financial institution is not desirable. If it does appear it should include, of course, only actual expenses of organization.

Cash receipts will usually be deposited daily so that the only cash balance will be the petty-cash fund. This should be counted as near the date of the audit as possible. If collections are not deposited intact, it will be necessary to count the cash and audit receipts and disbursements from the audit date to the date of the cash count. Cash items should be given special attention.

Bank balances will be reconciled and verified direct as in commercial audits. Examining vast numbers of cheques issued to investors for interest, cancellation of stock, etc., is not always of sufficient value to justify the time required. It is true that a building-and-loan association is a cash business and all funds must be accounted for, but if there is a good internal check and if the records are well kept, the auditor should exercise his judgment in the use of his time. The same may be said with regard to checking general-ledger postings. No bank reconcilement is complete without a subsequent verification of all outstanding items.

The resources most often encountered in the audit of a building-and-loan association have been discussed. The following items of liabilities and capital should also be considered:

1. Instalment certificates
2. Fully paid certificates
3. Prepaid certificates
4. Optional-payment accounts
5. Other types of certificates
6. Reserves for earnings
7. Notes payable
8. Miscellaneous payables
9. Accrued interest

10. Interest received in advance
11. Due borrowers
12. Guaranty stock
13. Contingency reserve
14. Surplus

The mutual building-and-loan association obtains its funds from the sale of its capital stock. The guaranty association sells a limited amount of stock and obtains the major portion of its funds from the sale of investment certificates. In the following paragraphs the word "certificate" will be used instead of "stock." Several classes of certificates are in general use.

Instalment certificates are paid for by equal monthly payments. The record of these payments may be kept in a register in which the name of each purchaser is listed, a column being provided for each month's payments. A more modern and convenient system provides for a separate ledger sheet or card for each certificate owner. Each payment is posted to this sheet and the total is brought forward each month. As a proof of these accounts the balances should be added and the total should agree with the controlling account in the general ledger.

A direct verification of these accounts may sometimes be obtained by calling in all passbooks. These would then be checked against the ledger-sheet balances with which they must agree. This method was good for the old type of small community association, but for a large organization, with investors in many localities, the calling in of passbooks is not practicable. Certificate stubs should be checked so as to account for all certificates. Cancelled certificates are often pasted to the corresponding stub. This may be omitted in certain circumstances. Some associations issue no certificates for instalment accounts.

Fully paid certificates are usually sold in multiples of $100. Interest is paid periodically, often semi-annually, or, if interest coupons are attached, upon presentation of the coupon. The rate depends upon local economic conditions, but 6% is common. An audit of these accounts may be made by checking all certificate stubs and accounting for all certificates. All cancelled certificates should be on file. An excellent test may be made by applying the rate of interest to the average balance of this account and comparing the result with the total of the account for interest on fully paid certificates. This test might disclose any unrecorded certificates issued, the cash for which was pocketed by a

dishonest employee. Individual interest payments should also be test checked. The total certificates outstanding should agree with the controlling account. A schedule of fully paid certificates may or may not be submitted, according to the circumstances.

The designation "prepaid certificate" as used here refers to that type of building-and-loan investment which is paid for in one sum, interest on which is not paid periodically but is allowed to compound until a specified future date when the original deposit plus the interest accumulation is returned to the investor. Certificates should be accounted for and the total tied in with the control, as recommended for the fully paid certificates.

The optional-payment account is a variation of the instalment certificate. Payments may be made at any time and for any amount, and interest is credited periodically. The nature of this type of certificate makes it peculiarly subject to manipulation for the purpose of covering a shortage. This is partly guarded against in organizations whose size justifies a cashier and a bookkeeper, but when the books are kept and the cash is handled by the same person, the auditor should do all that lies within his power to verify these accounts. The best verification is effected by the calling of passbooks and checking them against the ledger accounts. This procedure may be impracticable. If it is not done, the audit report should be qualified and the recommendation should be made that a continual audit of these accounts be put into effect—the passbooks to be compared with the ledger accounts by some trusted officer or employee who does not handle the cash. This could be done as passbooks are brought in with deposits. However, this is not as effectual a verification as the other plan. In the absence of a direct verification of optional-payment accounts, the auditor should make a thorough test of credits to individual accounts, tracing the cash so received into the bank account. Debits to these accounts should be tested by inspection of the cancelled cheques. The sum of the balances in these accounts must of course be tied in with the controlling account in the general ledger.

There are variations from these general types of building-and-loan investments, each designed to meet the needs of a certain class of investors. Among these variations are:

1. Insured savings, a combination of building-and-loan and life insurance.

2. The sinking-fund certificate, an instalment account which matures and is payable not all in one sum but in part each year for a stated number of years.
3. The special prepaid certificate, on which part of the interest is payable periodically and the rest of the interest accumulates to mature the certificate.
4. The teachers' instalment certificate, on which payments are due for nine months only of each year.

The auditing of these accounts presents no problems other than those previously discussed.

The calculation of reserves for accrued earnings on investment certificates is the most technical phase of a building-and-loan audit. These reserves may or may not be calculated by an employee of the association, but in any case the auditor must determine that they are properly set up. Financial statements in which the surplus and reserves are shown as one item are sometimes published. Unless the association distributes the entire profits to the certificate holders, which is rarely done, a statement of this sort does not throw much light on the true condition of the association. It is especially desirable to show these two accounts separately in the case of a guaranty association because the reserves are set aside for the investment certificates and represent a liability, while the free surplus belongs to the guaranty stock.

Accrued earnings may be set up on each individual ledger sheet or they may be calculated and set up in total only. The latter procedure is, I believe, more generally used, since it is not necessary to know the amount earned on any one certificate until maturity. Earnings allowed on cancellations are based upon rates which differ from the maturity rate.

There is no difficulty in calculating accrued interest on fully paid certificates. If this has been paid up to the close of the fiscal year there is no need for a reserve for this item. Prepaid certificate accounts may be classified according to age in months and maturity period. Compound-interest tables giving the amount of $1.00 for any number of periods at certain rates may be used to calculate the earnings on each group. The age and the rate must be known. If the rate is not known it may be obtained with the use of the table if the number of months required to mature the certificate is known. It may be necessary to interpolate for fractional percentages. The availability of optional-

payment certificates makes it expedient to set up the interest earned on each individual account. The interest is added to the payments on each ledger sheet, and a journal entry is made for the total interest, charging interest expense and crediting optional-payment certificates.

Since fully paid, prepaid and optional-payment certificates as a rule bear definite rates, there is no material difference in the calculations, be it a mutual or a guaranty association. This is not the case, however, with instalment certificates. There are several different methods of calculating reserves for earnings on these. The method to be used depends upon the type of association and upon the policies of the management.

I. METHODS OF CALCULATING RESERVES FOR MUTUAL ASSOCIATIONS

(a) *Dexter plan.*—A distribution is made of each year's earnings, after all expenses and transfers to the contingency reserve, on a dollar-month basis. This distribution is final and the effective rate varies from year to year. The stock matures whenever the annual additions to the payments reach the par value.

(b) *Partnership plan.*—The distributable earnings for the current year are added to the reserve brought forward from prior years and the total is allocated to all instalment stock on a dollar-month basis; thus the earnings over a period of years are equalized. This method is preferred over the Dexter plan because the maturity periods thus become stabilized so that the investor may be reasonably certain as to the maturity date of his certificate. By this method all stock is classified and grouped according to series and certain information is set down as shown in form 5. The rate of earnings per dollar-month is obtained by dividing the total reserve available by the total dollar-months (column 10 of form 5). The rate thus obtained is then applied to the dollar-months of each series, and the result is the earnings of the respective series.

(c) A plan often adopted by the board of directors of a mutual association provides that each class of stock have a definite maturity period. Reserves for earnings are set up on that basis and any excess or deficiency is handled through a surplus or undivided-profits account. This excess, of course, belongs to the instalment stock but is not appropriated. It is used to improve the reserve strength of the association. This arbitrary maturity period should be ample so that the earnings thus distributed will

not exceed the available reserves. Unusual circumstances may necessitate the extension of the maturity period.

Assuming that payments are due the first of the month the formula to be used to obtain the rate per dollar-month under this plan is:

$$\frac{E}{\frac{P+1}{2}\times D}$$

where E represents the earnings, P the maturity period and D the total dues payments.

As an example let us say that a monthly payment of \$10 is required for 78 consecutive months to mature \$1,000. Then the total of dues paid in is \$780 (78×\$10); the earnings are \$220 (\$1,000−\$780), and the period is 78 months. Substituting in the formula above, we have

$$\frac{220}{\frac{78+1}{2}\times 780}=\frac{220}{39.5\times 780}=\frac{220}{30,810}$$

=.0071405, the monthly rate to be used in obtaining column 11, form 5. The annual rate in this case is 12×.0071405 or 8.5686% simple interest. When this plan is adopted the maturity periods of the different classes of stock should be fixed so as to allow very nearly the same rate of earnings on all classes.

II. METHODS OF CALCULATING RESERVES FOR GUARANTY ASSOCIATIONS

(a) Guaranty associations usually pay a definite rate of compound interest to instalment investors. In this case a compound-interest table may be applied either to each account or to each series, according to the instalment plan of the individual association.

(b) In case a membership fee is charged and taken out of the first payments, the true rate will be slightly higher than the stated rate in order to absorb the membership fee during the life of the contract. In some cases fractional rates must be calculated and special tables constructed for use in calculating reserves.

The practice of setting up reserves on a cancellation basis is not conservative and is to be condemned. Reserves set up on a

maturity basis are probably higher than will be required, because many certificates will be cancelled before maturity and thus will receive less interest than has been provided in the reserve. This, however, does not justify the use of a cancellation basis for the reserve. Experience tables of the percentage of persistency for each class of instalment account may some day be available and enable one to reach a closer estimate of required reserves, but until that time the maturity basis should be used.

Other liabilities of a building-and-loan association may include notes payable, which should be verified direct as to amount, due date and accrued interest. Sundry accounts payable for current expenses and accrued items should be set up. Accrued interest payable and interest received in advance should appear on the liability side of the financial statement.

There sometimes appears an account entitled "due borrowers, unfinished loans or construction loans," which represents balances, secured by mortgages, which have not yet been paid out to the borrowers. It is customary to show this on the liability side of the balance-sheet, but it is preferable to show it as a deduction from the mortgage-loan account, the balance representing money actually paid out on mortgages. The unfinished-loans account is sometimes used as a means of inflating the financial statement by crediting to it all loans applied for and pending, whether the loans have been approved and the papers drawn up or not. This practice will be detected during the inspection of loan papers. No loans should be set up as assets on the one side and as due borrowers on the other, unless the mortgage has been signed and recorded and unless the loan is bona fide.

The net-worth section of the balance-sheet of a guaranty building-and-loan association includes guaranty or permanent capital stock, surplus, contingency reserve and other capital reserves.

Guaranty stock may be similar to any of the forms of investment certificate, but differs from them in that it is not withdrawable but serves as a permanent working fund and as a protection to other investors. All stock certificates should be accounted for, a schedule should be built and the total should be balanced with the control account. Special care should be taken to see that none of this stock has been redeemed by the association and that no loans have been made with guaranty stock as security. This would be contrary to the purpose for which it is issued and is in most cases illegal. In some states there is a minimum require-

ment to be paid in on guaranty stock. The auditor must see that this requirement is met. Dividends on guaranty stock may be paid or credited only after all other requirements have been provided.

Any surplus from special sources or appropriated for specific purposes should be so labelled. Contingency reserve is composed of annual increments provided from current profits. Unusual losses on loans, real estate, etc., may be charged against this reserve. The auditor should ascertain that legal requirements have been met as to the yearly addition and the balance maintained in this reserve.

In auditing the income and expense for the year sufficient test checking should be done to satisfy the auditor as to the general accuracy of these accounts. The principal source of income is interest. It is sometimes possible to make an effective proof of the interest by applying the average rate to the average loan balance. Tests should be made by checking the interest credits on the individual ledgers back to the cashbook. Other items of income are membership or withdrawal fees, transfer fees, fines and rents.

Expense items may usually be classified as administrative, selling and collection or general. Under administrative expense there will be executive salaries, office salaries, office supplies, telephone and telegraph, postage, office rent, heat, light and water and the usual other administrative expenses. An analysis of salaries is important.

Salesmen's salaries, commissions, salesmen's travel, automobile, advertising, etc., will be classified as selling and collecting expense. The usual general-expense items are interest, taxes, expense on real estate owned and similar items. Interest in most cases will be the largest expense item. In a mutual association the interest account will be replaced by an account for dividends. The dividend account of course is not an expense but will be deducted direct from surplus. Expense accounts should be audited much as in a commercial audit. The detail work to be done depends upon the size of the association and other conditions.

Little mention has been made of the routine work required in the course of a building-and-loan audit. Specific conditions will call for varying degrees of detailed checking. It may or may not be advisable to check all the general-ledger postings. A fairly thorough test of the addition of the cashbook is considered im-

portant. Building-and-loan shortages have been uncovered by this precaution.

The text of the audit report should set forth the extent of the audit, the auditor's qualifications to his statements and items which deserve special attention. The arrangement of the balance-sheet is optional but the preferred form sets forth mortgage loans first, followed by other types of loans, advances and accrued interest; then real estate and other assets; and finally cash. The liabilities may be arranged in the following order: all certificate accounts, followed by certificate reserves, then due borrowers and other liabilities—and last, permanent stock, surplus, reserve for contingencies and other capital reserves. It is of interest to show the total loans of all kinds, the total liability on certificates and the total permanent stock and capital reserves on the balance-sheet.

The auditor's responsibilities regarding legal requirements must not be overlooked. State laws differ; the auditor must familiarize himself with the statutes governing the building-and-loan association which he is examining. State laws often include the following regulations:

1. Minimum permanent stock required to be paid in for guaranty associations.
2. Permanent stock dividends allowed only after all other interest is provided.
3. Permanent stock, non-withdrawable; no loans may be made on permanent stock as collateral.
4. Part withdrawal or checking against optional payment certificates prohibited.
5. Associations borrowing power limited to a certain percentage of assets; maximum period for which a loan may be made.
6. Second mortgage loans prohibited.
7. Loans to any one person limited to a certain percentage of the assets.
8. Limitations on loans to officers and directors.
9. Regulations on securities owned.
10. Surety bonds on officers required.
11. Maximum rates of withdrawal fees allowed.
12. Requirements as to reserve for contingencies:
    (a) A certain percentage of net earnings each year to be transferred to contingency reserve.
    (b) Reserve must be maintained at a certain percentage of assets.
13. Real estate must not be held for longer than a stated period.

14. Expenses limited to a percentage of loans.
15. Liability of directors for dividends paid in excess of available surplus.

It should be seen that statutes are obeyed. The minutes of directors' meetings should be reviewed for any light they many throw on officers' remuneration, contingent liabilities and general business policies.

FORM 1. MORTGAGE LOAN SCHEDULE

LOAN NO.	DATE OF LOAN	BORROWER	TYPE OF LOAN	AMOUNT OF LOAN	NET DUES PAID IN	ASS'N'S EQUITY	INSURANCE CARRIED	LOAN PAPERS MISSING	REMARKS

FORM 2 DELINQUENT LOAN SCHEDULE

LOAN NO.	BORROWER	NO. MONTHS DELINQUENT	DELINQUENT DUES	DELINQUENT INTEREST	ADVANCES FOR BORROWERS	ACCRUED FINES	TOTAL	REMARKS

FORM 3. CERTIFICATE LOAN SCHEDULE

LOAN NO.	DATE	DATE DUE	BORROWER	AMOUNT OF LOAN	STOCK CASH VALUE	AMOUNT UNSECURED	ACCRUED INTEREST	REMARKS

FORM 4 REAL ESTATE SCHEDULE

FORMER OWNER	DESCRIPTION	DATE ACQUIRED	ORIGINAL COST	ADDITIONAL COSTS	BOOK VALUE	APPRAISED VALUE	RESERVE	MONTHLY RENTAL	REMARKS

FORM 5. AGE AND CONDITION OF SHARES

CLASS and SERIES	DATE OF ISSUE	AGE IN MONTHS	NO. OF SHARES	MONTHLY PAYMENT	* DUES REQUIREMENT	ADVANCE PAYMENT	DELINQUENT PAYMENTS	** NET DUES	*** DOLLAR MONTHS	**** EARNINGS PER SERIES	DUES PER $1000.00	EARNINGS PER $1000.00	VALUE PER $1000.00

* COLUMN (3) X COLUMN (5)
** COLUMN (6) + COLUMN (7) − COLUMN (8)
*** (COLUMN (3) + 1) ÷ 2 X COLUMN (6)
**** COLUMN (10) X RATE PER DOLLAR MONTH