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AUDITS OF BANKS

Including

SUPPLEMENT

AN AICPA INDUSTRY AUDIT GUIDE

Prepared by the Committee on Bank Accounting and Auditing of the American Institute of CPAs

NOTICE TO READERS

This volume includes both the industry audit guide, *Audits of Banks,* as it was originally published in 1968 and *Audits of Banks: Supplement,* which was published in 1969. In using the Guide, readers should refer to the additional material in the Supplement with respect to the designation of net income, securities gains and losses, loan losses, and the form of financial statements.

This audit guide and supplement are published for the guidance of members of the Institute in examining and reporting on financial statements of banks. They represent the considered opinion of the Committee on Bank Accounting and Auditing (*Audits of Banks,* 1967-68 Committee; *Audits of Banks: Supplement,* 1969-70 Committee) and as such contain the best thought of the profession as to the best practices in this area of financial reporting. Members should be aware that they may be called upon to justify departures from the Committee's recommendations.

JOE R. FRITZEMEYER
Director, Technical Services

AUDITS OF BANKS: SUPPLEMENT

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Preface

The AICPA industry audit guide, *Audits of Banks,* published in early 1968, included certain reporting recommendations which differed from the requirements of the Federal bank regulatory authorities; the most important of these recommendations concerned the designation of net income, securities gains and losses, and loan losses.

Since the publication of *Audits of Banks,* a series of discussions have been held in which representatives of the banking industry, the Federal regulatory authorities, the Securities and Exchange Commission, and the AICPA have participated in an effort to eliminate the aforementioned differences. As a result of these discussions, the regulatory authorities have recently revised their requirements as to the structure of the financial statements to be included in stockholder reports. This supplement has been prepared to present the Committee's views with respect to the issues underlying these revisions.

November 1969

Committee on Bank Accounting and Auditing 1969-70

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James A. Gallagher
J. W. Gould
Gerald F. Hartley
Eugene H. Kirkman
Alexander S. Loy
Joseph J. Rigney
Leonard Rynski
Dwight C. Swanson

Edmund S. Boe, *Manager Special Projects*
Thomas R. Hanley, *Manager Special Projects*

Audits of Banks: Supplement

Designation of Net Income

The revised regulations require the determination and designation in the income statement of the amount of net income. The Committee approves of this requirement, which conforms the presentation of bank income statements with the practices prescribed in Opinions No. 9 and 13 of the Accounting Principles Board.

Securities Gains and Losses

The revised regulations require that the completed-transaction method of accounting for securities gains and losses be used in the presentation of financial position and results of operations. The Committee, on pages 36-41 of *Audits of Banks,* recognizes the acceptability, as therein described, of both the completed-transaction and the deferral-and-amortization methods.

Loan Losses

The revised regulations require that a provision for loan losses be included in the operating expenses of banks. The Committee agrees with this requirement.

The revised regulations require a minimum charge to operating expenses computed by using a prescribed formula, such as a five-year average ratio of net charge-offs to total loans; a larger charge to operating expenses, based on management's judgment, will be permitted provided that adequate disclosure thereof is made in a note to the financial statements.

The Committee, on page 47 of *Audits of Banks,* recommends that each bank management determine a method (based on past loss experience, adjusted for such factors as known changes in the character of the loan portfolio, in management credit policies, and in economic conditions) which will result in systematic loan-loss charges to operations on a consistent basis. This recommended approach is designed to serve the objective of presenting fairly the results of operations in conformity with generally accepted accounting principles. In most cases, the revised regulations are expected to produce a result consistent with this approach; however, the Committee notes that loan-loss provisions computed under the revised regulations could in some instances be either larger or smaller than the amounts that would be appropriate to present fairly the results of operations in conformity with generally accepted accounting principles.

Under the revised regulations, any addition to the loan-loss reserve in excess of the amount charged to operating expenses is to be charged to undivided profits. The Committee's view is that any such addition is, in effect, an appropriation for contingencies. Under generally accepted accounting principles, the contingency portion of the reserve, whenever created, may not be used to absorb losses.

The reserve for loan losses under the revised regulations will generally consist of the following elements: (a) a valuation portion available for charging loan losses, (b) a contingency portion not available for absorbing losses, and (c) a deferred-tax portion. So that future adjustments to the reserve may be appropriately classified, the reserve should be analyzed to determine the amounts of the several elements; this analysis should be made of the reserve existing at December 31, 1968, and con-

tinued for amounts added thereafter. Loan losses charged to the reserve after December 31, 1968, should not exceed the sum of the valuation portion at December 31, 1968, and the additional valuation portion arising thereafter through charges to operating expenses.

The revised regulations provide for the presentation of the reserve for loan losses in a separate section on the credit side of the balance sheet, below total liabilities and above capital funds.

The conventional form of presentation under generally accepted accounting principles would be one in which (a) the amounts charged to operating expenses constitute a valuation reserve deducted from total loans [APB Opinion No. 12], (b) the additional amounts charged to undivided profits are shown as part of capital funds [ARB No. 43, Chapter 6, paragraph 8], and (c) the related amounts of deferred taxes are presented with all other deferred taxes [APB Opinion No. 11]. However, the presentation of the contingency portion of the reserve outside of capital funds is permissible under ARB No. 43, Chapter 6, paragraph 8, and the Committee believes that the effect of including the valuation and deferred-tax portions in the single reserve section will be immaterial in most cases. In the rare instances where the effect of such classification on the presentation of financial position is material, the relevant facts should be disclosed in a note to the financial statements and referred to in an exception in the auditor's opinion.

Illustrative Forms of Bank Financial Statements

The illustrative forms of financial statements presented herein reflect the practices described in the foregoing discussion and would be suitable for inclusion in annual reports to stockholders.

Balance Sheet

December 31, 19— and 19—

Assets	*December 31* *Current Year*	*Preceding Year*
Cash and due from banks	$ 9,000,000	$ 8,000,000
Investment securities (Note 1):		
U.S. Government obligations	4,000,000	3,900,000
Obligations of states and political subdivisions	2,000,000	2,000,000
Other securities	150,000	100,000
Loans	18,442,000	17,418,000
Stock of Federal Reserve Bank	67,500	67,500
Bank premises and equipment (Note 3)	360,000	970,000
Accrued interest receivable and other assets	152,500	142,500
Total	$34,172,000	$32,598,000

Liabilities	*Current Year*	*Preceding Year*
Demand deposits	$22,300,000	$21,560,000
Savings deposits	4,260,000	3,500,000
Other time deposits	4,000,000	4,000,000
Total deposits	30,560,000	29,060,000
Borrowed funds	100,000	80,000
Accrued taxes and other expenses	220,000	220,000
Other liabilities	60,000	63,000
Total liabilities	30,940,000	29,423,000
Reserve for loan losses (Note 2)	442,000	418,000
Capital funds:		
Capital stock (100,000 shares of $10 par value)	1,000,000	1,000,000
Surplus (Note 7)	1,250,000	1,250,000
Undivided profits	540,000	507,000
Total capital funds	2,790,000	2,757,000
Total	$34,172,000	$32,598,000

See accompanying Notes to Financial Statements.

Statement of Income

For the Years Ended December 31, 19— and 19—

	Current Year	*Preceding Year*
Operating income:		
Interest on loans	$1,000,000	$ 900,000
Interest on U.S. Government obligations	180,000	200,000
Interest on obligations of states and political subdivisions	60,000	60,000
Interest and dividends on other securities	10,000	8,000
Trust department income	100,000	90,000
Service charges on deposit accounts	50,000	45,000
Other operating income	60,000	55,000
Total	1,460,000	1,358,000
Operating expenses:		
Salaries	220,000	200,000
Other employee benefits	15,000	15,000
Interest	480,000	460,000
Net occupancy expense of bank premises	55,000	52,000
Loan-loss provisions (Note 2)	15,000	15,000
Other operating expenses	56,000	65,000
Total	841,000	807,000
Income before income taxes and securities gains (losses)	619,000	551,000
Less applicable income taxes:		
Current	262,000	236,000
Deferred	7,000	—
	269,000	236,000
Income before securities gains (losses)	350,000	315,000
Securities gains (losses), less related income tax effect of $50,000 in 19— and $100,000 in 19—	150,000	(100,000)
Income before extraordinary item	500,000	215,000
(Loss) on sale of branch bank building, less related reduction in income tax of $240,000	(260,000)	—
Net income	$ 240,000	$ 215,000
Earnings data per share:*		
Income before extraordinary item	$5.00	$2.15
Extraordinary item, less related reduction in income tax	(2.60)	—
Net income	2.40	2.15

See accompanying Notes to Financial Statements.

*Earnings data per share conform with the requirements of Opinion No. 15 of the Accounting Principles Board of the AICPA. The bank may elect to present in this section an additional per-share amount for income before securities gains (losses).

Statement of Changes in Capital Funds

For the Years Ended December 31, 19— and 19—

	Capital Stock	*Surplus*	*Undivided Profits*
Balance, January 1, preceding year.	$1,000,000	$1,250,000	$467,000
Net income for the year	–	–	215,000
Total	1,000,000	1,250,000	682,000
Less: Cash dividends declared–$1.75 a share	–	–	175,000
Balance, December 31, preceding year	1,000,000	1,250,000	507,000
Net income for the current year ...	–	–	240,000
Total	1,000,000	1,250,000	747,000
Less:			
Transferred to reserve for loan losses (Note 2)	–	–	7,000
Cash dividends declared–$2.00 a share	–	–	200,000
Total	–	–	207,000
Balance, December 31, current year	$1,000,000	$1,250,000	$540,000

See accompanying Notes to Financial Statements.

Notes to Financial Statements

For the Year Ended December 31, 19—

1. *Investment Securities*

Securities are stated at cost, adjusted for amortization of premiums and discounts.

2. *Loan Losses*

Transactions in the reserve for loan losses for the year were as follows:

	Current Year	*Preceding Year*
Balance, January 1	$418,000	$404,000
Provision charged to operating expenses	15,000	15,000
Transferred from undivided profits	7,000	–
Deferred tax charged against income	7,000	–
	447,000	419,000
Less loans charged off, net of recoveries of $2,000 and $4,000	5,000	1,000
Balance, December 31	$442,000	$418,000

The loan-loss provision charged to operating expenses is based on the Bank's past loan-loss experience and such other factors which, in management's judgment, deserve current recognition in estimating possible loan losses. The amount so provided during the current year exceeds by $2,000 the minimum provision required by the regulatory authorities. The amount transferred from undivided profits represents a provision for loan losses in addition to the amount charged to operating expenses, less the related tax effect.

The balance in the reserve at year end approximates the maximum allowable for tax purposes.

3. *Bank Premises and Equipment*

Bank premises and equipment are stated at cost, less accumulated depreciation which amounted to $320,000 at December 31, 19__ and $600,000 at December 31, 19__. Depreciation, computed on the straight-line method and included in operating expenses, amounted to $23,000 for 19__ and $32,000 for 19__.

4. *Pledged Assets*

At December 31, 19__ assets carried at $1,200,000 were pledged to qualify for fiduciary powers, to secure public monies as required by law, and for other purposes.

5. *Trust Assets*

Property (other than cash deposits) held by the Bank in fiduciary or agency capacities for its customers is not included in the accompanying balance sheet, since such items are not assets of the Bank.

6. *Commitments and Contingent Liabilities*

In the normal course of business there are outstanding various commitments and contingent liabilities, such as guarantees, commitments to extend credit, etc., which are not reflected in the accompanying financial statements. The Bank does not anticipate losses as a result of these transactions.

7. *Surplus Restriction*

The State Banking Law restricts the availability of surplus for the payment of dividends. At December 31, 19__, $650,000 of surplus was so restricted.

[**Comment.** *In addition to the illustrative notes presented above, most of which are more or less specific to banks, the notes to the financial statements of a bank should include any other appropriate disclosures, such as principles of consolidation, accumulated deferred income taxes, and information concerning pension plans.*]

Audits of Banks: Supplement *was adopted by the assenting votes of all twelve members of the Committee, of whom four, Messrs. Beck, Gallagher, Loy, and Rigney assented with qualification.*

Messrs. Beck and Gallagher assent to the publication of the Supplement but disagree with the deferred-income-tax treatment relating to the loan-loss provision on the grounds that this is not a timing difference but is a case of intra-period allocation. They believe that this portion of the tax is a charge equivalent to a reduction in income taxes as called for by paragraph 52 of APB Opinion No. 11 instead of deferred income taxes.

Mr. Loy assents to the publication of the Supplement but disagrees with its acceptance of deferral-and-amortization as an alternative method of accounting for securities gains and losses. He believes that alternative methods of accounting should be sanctioned only when they are adequately supported by generally accepted accounting principles and that the deferral-and-amortization method does not meet that criterion.

Mr. Rigney assents to the publication of the Supplement, but he qualifies his assent because he believes that the Committee should express its views on two questions not covered therein: (a) whether disclosure in a note to the financial statements should be required for the analysis of the reserve for loan losses into three elements at December 31, 1968 and at subsequent dates so the reader will be aware of the portion of the reserve that is not available to absorb loan losses, and (b) whether prior years' income statements should be restated to give effect to the requirement that additions to the loan-loss reserve be divided between charges to operating expenses and appropriations of undivided profits.

AUDITS OF BANKS

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Preface

This booklet has been prepared to assist the independent auditor in serving his clients in the banking industry by describing those aspects of the banking business of which he should be aware. Three separate sections are provided: Section I—The Banking Industry and the Independent Auditor's Role; Section II—Accounting Principles and Financial Statement Presentation; and Section III—Bank Auditing.

Section I provides background information regarding commercial banking, including the role of the regulatory authorities as it relates to bank examinations and financial reporting. It also discusses various types of audit engagements and the reports that may be issued by CPAs in connection with audits of banks.

Section II deals with those accounting and financial reporting practices, which, because of the special nature of the banking business, are peculiar to the banking industry. Considerable attention is devoted to the accounting for investment securities and loans, as well as other subjects. This section also includes a description of the unique features of a bank's balance sheet and statements of income and capital accounts. In addition, illustrative forms of a bank's financial statements are shown as a practical example of the principles set forth in the Guide.

The last part of the booklet, Section III, indicates the factors to be considered in performing an audit of a bank. These factors, among others, include planning, implications in automated operations, treatment of specific accounts, implications in trust

operations, governmental restrictions and directors' requirements. This section also includes suggested auditing procedures designed to provide a pattern of the work to be done; they are, therefore, very general in nature and will apply in varying degrees in particular situations, depending on the size and structure of the institution and the adequacy of its system of internal control.

January 1968

Committee on Bank Accounting and Auditing 1967-68

EUGENE L. LARKIN, JR., *Chairman*
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EDWIN K. WALKER

RICHARD A. NEST, *Director Technical Services*
BRUCE N. WILLIS, *Manager Auditing Procedure*

SECTION I

The Banking Industry and the Independent Auditor's Role

Chapter I

Historical Background of the Banking System

Introduction

In recent years, there has been increasing interest on the part of the banking industry in utilizing the services of CPAs to render opinion audits and to perform other accounting and auditing services. The information and procedures contained in this Audit Guide are primarily intended to be helpful in leading the CPA to an expression of an informed opinion on the financial statements of a commercial bank. It will also assist the CPA in the performance of special accounting and auditing services. Further, the Guide should provide officers and directors of banks and other interested persons with a better understanding of the nature and scope of bank audits by CPAs.

The Guide emphasizes those aspects of bank accounting and auditing unique to the industry, and presumes knowledge on the part of the CPA in those areas similar to those of commercial and industrial enterprises. The portions of the Guide relating to auditing have been designed to present typical situations in a commercial bank offering full banking services but with limited departmentalization and staff. Certain situations prevalent only in larger banks are not discussed.

Regulations and certain other writings referred to in the Guide have not been reproduced in the Appendices because of their previously wide distribution and ready accessibility. Independent auditors who serve commercial banks will find it helpful to

acquaint themselves with the items in the selected bibliography which is available from the American Institute of Certified Public Accountants upon written request.

Description of the U.S. Commercial Banking System

Commercial banking in the United States operates under a dual system—a bank obtains either a Federal or state charter. National banks operate under Federal charters and are supervised by the Office of the Comptroller of the Currency. They are required to be member banks of the Federal Reserve System and to have their deposits insured by the Federal Deposit Insurance Corporation.

State banks are supervised by banking departments of the chartering states. Substantially all are also subject to some form of Federal control. A state bank is not required to join the Federal Reserve System. However, if it chooses to join it must also subscribe to the FDIC; if it does not join, it still has the option of FDIC coverage. Also, to qualify for membership in the Federal Reserve System, a state bank, among other things, must meet national bank capital requirements and maintain the prescribed legal reserve balances on deposit with the Federal Reserve Bank of its district.

The Federal Deposit Insurance Corporation insures each deposit in a subscribing bank up to a specified amount; in return for this protection each such bank pays an assessment based on its total deposits. Approximately 97% of all commercial banks, accounting for approximately 99% of total commercial bank assets, are insured by the FDIC.

Approximately two-thirds of all commercial banks are state banks; the remainder are national banks. The latter, however, hold more than half of the total deposits. About 50% of commercial banks are members of the Federal Reserve System. Approximately 75% of all commercial banks have deposits of $10 million or less.

Banks may also be classified as unit banks, branch banks, chain banks or group banks. A unit bank operates in only one location. A branch bank operates a head office and one or more branch offices controlled by the head office. Branch offices may be located within a city, county, or throughout an entire state,

depending upon applicable state laws. A chain bank is one of a group of banks owned and controlled by one 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. A group bank is an affiliate of a holding company which controls a substantial part of the stock of one or more other banks.

Governmental Supervision of Banks

The role played by commercial banks is essential to the economic life of the community. Acceptance and custody of a depositor's funds impose a public trust and responsibility not generally associated with other business activities. Because of this public interest in depositor protection, commercial banks are subjected to governmental supervision and regulation, including periodic surprise examinations by supervisory agency examiners. The following summary indicates the general pattern of these examinations:

	Supervisory Agency			
Bank Classification	Comptroller of the Currency	State Banking Department	Federal Reserve Bank	Federal Deposit Insurance Corporation
National banks	x			
State banks and trust companies:				
Federal Reserve members (usually joint examination)		x	x	
Non-members:				
FDIC insured (frequently joint or concurrent examination)		x		x
Non-insured		x		

Note: Supervisory examinations are usually scheduled annually, except with respect to national banks where three examinations are scheduled in each two-year period.

As already indicated, the primary responsibility of bank supervisory authorities is to protect the interests of depositors. The examinations conducted by them, therefore, are directed to a

determination of the bank's solvency, the degree of competence of its management, and its compliance with the laws under which it operates.

While banking laws provide broad examination powers, it is only in unusual circumstances that the supervisory examiners would extend the scope of their examinations to what might even approach that of an audit made in accordance with generally accepted auditing standards. This is of course appropriate in view of the purposes of these examinations. Nevertheless, they would rarely, if ever, include all of the audit procedures that have long been accepted by the CPA as a necessary part of an audit made in accordance with generally accepted auditing standards.

Although the scope of supervisory examinations varies depending on the approach of the different agencies, the attitude of the local supervisory authorities, and the circumstances of the banks being examined, it would not be usual, for example, for the supervisory examiner to confirm by direct communication with borrowers the existence and amount of loans and related collateral; to confirm deposits by direct communication with depositors; to make detailed tests of transactions affecting assets and liabilities between examination dates; or to perform auditing tests of income and expense transactions. The differences noted between supervisory examinations and audits are not intended as criticisms of the supervisory examinations, but are mentioned merely to call attention to the different procedures followed to achieve different objectives.

Governmental Influence on Financial Reporting Practices of Banks

The three Federal bank regulatory agencies exert considerable influence on the financial reporting practices of banks. Banks have always been required to submit reports in response to "calls" to the applicable agency (national banks, to the Comptroller of the Currency; state-chartered members of the Federal Reserve System, to the Federal Reserve Board; and insured state-chartered banks, not members of the Federal Reserve System, to the Federal Deposit Insurance Corporation). The instructions for the preparation of the "call reports" contain re-

quirements regarding the form of the financial statements to be submitted and accounting practices to be followed. These requirements have been expanded and modified by the developments mentioned in the following two paragraphs.

Passage of the Securities Acts Amendments of 1964 and issuance of regulations in implementation thereof by the Board of Governors of the Federal Reserve System (FRB) and the Federal Deposit Insurance Corporation (FDIC) provided a stimulus to the adoption by banks of improved, more uniform accounting and reporting practices. Before issuing these regulations, the FRB and the FDIC invited comments from interested groups and received them from various accounting committees within the industry, from the AICPA, and from a committee of securities analysts. It is encouraging to note that the Federal supervisory authorities have expressed their willingness to amend their regulations should it appear necessary to conform them more closely to generally accepted accounting principles.

In 1967, the Comptroller of the Currency issued regulations regarding uniform financial statements and reports to stockholders. In most major respects, the Comptroller's requirements are consistent with those of the FRB and FDIC.

These developments point up the need for CPAs to become more familiar with the commercial banking industry and its problems. Accordingly, this publication has been prepared to assist in this objective.

Chapter 2

The Independent Auditor's Report

General

When reporting on the financial statements of banks, the independent certified public accountant is governed by the same generally accepted auditing standards (including the standards of reporting) which apply in the case of financial statements of companies in other industries. These standards are described in *Statement on Auditing Procedure No.* 33 issued by the Committee on Auditing Procedure of the American Institute of Certified Public Accountants. Inasmuch as banking is considered to be a regulated industry, special attention is directed to Chapter 10, paragraphs 38-40 of Statement No. 33, which deals with reporting on regulated companies.

The Committee on Bank Accounting and Auditing believes that, where the financial statements of a bank do not conform in a material respect with the recommended accounting principles set forth in Section II of this Guide, the CPA should appropriately qualify his opinion or express an adverse opinion, depending upon the materiality of the departure.

The reporting problems faced by the CPA when he is unable to make his audit in accordance with generally accepted auditing standards, because of limitations on the scope of his engagement, are discussed in Section III, Chapter 17.

Opinion on Financial Statements

Most banks prefer, and the supervisory authorities frequently request, the long-form type of report because independent audits of banks are most often performed in fulfillment of Directors'

Examination requirements. However, the short-form report is normally used in reporting to stockholders and in reporting under the Securities Exchange Act of 1934.

The CPA's standard short-form report on the financial statements is presented in the same manner as commercial and industrial company reports. The basic financial statements are the statements of condition, income, and changes in capital. Recently there has been an increase in the use of the CPA's report on these statements in connection with annual reports to stockholders.

Where the CPA is engaged to perform an audit of and express an opinion on the annual financial statements, a substantial portion of his audit procedures may be performed on a surprise basis as of an interim date during the year (frequently in connection with a Directors' Examination, discussed below). The circumstances under which it would be appropriate for a CPA to express an opinion on the annual financial statements, relying in part on auditing procedures carried out as of an interim date, supplemented by additional procedures performed as of the year-end, are discussed in Section III of this Guide. Obviously, in the absence of an adequate system of internal control, it would be necessary for the CPA to perform most of his auditing procedures as of the year-end in order to permit him to express an opinion on the annual financial statements.

Reports on Directors' Examination

The by-laws of national banks (as described in Appendix B) and the laws of most states (applicable to state-chartered banks) require periodic examinations of banks by their directors or a committee thereof. Reports on such examinations are filed with the minutes of the banks' boards of directors. Usually copies of these reports must be furnished to the appropriate regulatory authorities. Where the directors have engaged a CPA to make all or a part of the required examination, the report of the directors or of a committee thereof (as distinguished from the CPA's report to the directors) may take any one of several forms. Among the more common are the following:

1. A report prepared on prescribed forms (required in certain states). Usually when the CPA has made the entire examina-

tion and often when he has participated in only certain phases of it, his report is attached as an appendix to the statutory report. (Further comments on reports prepared on prescribed forms appear below.)

2. A brief report by the directors stating that the required examination was made by a CPA at their request and referring to his supporting report. In their report, the directors may summarize the more important observations included in the CPA's report or may suggest the manner of implementing recommendations contained in the CPA's report.

3. A report containing comments and observations of the directors regarding those aspects of the examination not included in the scope of the CPA's audit and referring to the supporting report of the CPA as to those portions of the examination carried out by him.

4. The use of the CPA's report as the formal report on the directors' examination.

The nature of his engagement to participate in the directors' examination will determine the type of report which the CPA will render. If, for example, he has been engaged to perform only certain phases of the examination, his report will be a special purpose report and he should accordingly be guided by *Statement on Auditing Procedure No. 33,* Chapter 13. If, on the other hand, his engagement comprehends an examination of financial statements in accordance with generally accepted auditing standards, he will render a long form report pursuant to the requirements of *Statement on Auditing Procedure No. 33,* Chapter 12. Rarely would his report in connection with a directors' examination consist of a short form report.

As indicated above, in some states, state-chartered banks are required to submit to their respective State Banking Departments a special type of report on Directors' Examinations. Often, printed forms are furnished by the State for this purpose. Although the report is signed by the Directors, it may be prepared either by the bank or on its behalf by the CPA.

Generally, the form of the state report to be submitted with respect to the Directors' Examination includes a statement of condition, statistical data and comments on matters such as

analyses of capital accounts and investment securities, schedules of assets subject to classification for which reserves would be required, questionnaires designed to disclose noncompliance with the applicable bank statutes or weakness in accounting, operating and internal control procedures, and an affidavit by the Examining Committee that the examination has been carried out in accordance with the statutory provisions. In dealing with the state report, it is incumbent on the CPA to clearly identify those parts of such form for which he is taking responsibility and to word his report accordingly. See paragraph 11, Chapter 13 of *Statement on Auditing Procedure No.* 33 for appropriate reporting where prescribed forms are required.

If the directors prefer to prepare the regulatory report themselves, they still may rely to a great extent on the information supplied by the CPA in his long-form report. Not all the information that would be submitted with the report to the state would necessarily be set forth in the CPA's long-form report, however.

In any event, the CPA should familiarize himself with the applicable forms and regulations and satisfy himself that the requirements of the State Banking Department have been met.

Financial information which may be included in the report (either in schedules, constituting bank representations as to which the CPA is expressing an opinion, or in the CPA's comments regarding his audit, or in interpretation of the bank's financial data) is outlined below (although rarely would all of this information be given):

1. Comments or schedules on financial position:
   (a) Condensed comparative statement of condition showing increases or decreases.
   (b) Condensed statement of the distribution, by percentages, of the assets of the bank compared with the average for banks in the same areas and in the same size group (such statistics are or should be available through the regulatory authorities and the various banking associations, e.g., the Federal Reserve District Banks).
   (c) Comments on the relationship of capital funds to deposits and risk assets and the cash reserve and liquidity position.

2. Comments or schedules on significant assets and liabilities:
   (a) Investment securities:
      1) Comparative summary, by major classifications, of the book value showing increases or decreases.
      2) Summary, by major classifications, of the par, book, and estimated market value at the date of audit.
      3) Recapitulation of the bond investments, by major classifications, by maturity (par and/or book values).
      4) Comments on accounting treatment, appreciation or depreciation, defaulted or non-income producing securities, etc. A summary of the transactions in the valuation reserve, if any, may be given here or may be shown in a schedule setting forth the transactions in all valuation reserves.

   (b) Loans and discounts:
      1) Comparative summary, by major classifications, of the book value showing increases or decreases.
      2) Comments on accounting treatment, evaluation of loans, past-due loan accounts, liabilities of officers, directors, or employees, etc. A summary of the transactions in the valuation reserve may be given here or may be shown in a schedule setting forth the transactions in all valuation reserves.

   (c) Mortgage loans on real estate:
      1) Comparative summary, by major classifications, of the book value showing increases or decreases.
      2) Summary, by major types, of the book value of mortgage loans classified as to bank-serviced, and outside-serviced loans.
      3) Comments on accounting treatment, foreclosures and past-due accounts, and evaluation of loans. A summary of the transactions in the valuation reserve, if any, may be given here or may be shown in a schedule setting forth the transactions in all valuation reserves.

   (d) Other assets—Comments with respect to any other assets which are material and in which significant changes

have taken place during the period under audit.

(e) Due to depositors:

1) Comparative summary, by major classifications, of the number and amount, showing increases or decreases.

2) Comments on interest rates and accruals of interest.

(f) Taxes—Comments with respect to the provisions for income and other taxes.

(g) Other liabilities—Comments with respect to any other liabilities which are material and in which significant changes have taken place during the period under audit.

Scope of examination:

(a) Banking department:

For the information of the bank's directors and the applicable supervisory authorities (who either require, or express a strong wish for, such comments), it is important to include in the long-form report comments with respect to the scope of the audit. The comments should set forth generally the extent of the auditor's review and tests including the inspection, observation, inquiry and confirmation work relating to the various asset and liability accounts, income and expense accounts, memorandum accounts, and other phases of the audit not directly related to the accounting records. The comments should also include any exceptions noted during the audit.

(b) Trust department:

Generally, the scope of the audit of the bank's trust department should meet the requirements of the supervisory authorities. The report should include a description of the scope and any exceptions noted as a result of the investigation of the administration of the accountability for the trust accounts. Usually, this section of the report includes the following:

1) Scope of audit and findings with respect to accountability, setting forth the review and tests made, in-

cluding inspection, observation, inquiry and confirmation work, of the various trust accounts.

2) Scope of audit and findings with respect to the review of administration of the trust accounts selected, setting forth the review and tests of compliance with the terms of the governing instruments.

4. Schedules:

The number and content of the schedules included in the report may vary considerably among banks. There should be included those which contribute useful information and those required by supervisory authorities and bank management. Examples of schedules which may be included are those with respect to past-due paper, under-margined loans or loans secured by not readily marketable collateral, loans subject to classification as a result of the credit review, a summary of confirmation results, and insurance in force.

5. Comments on internal control and internal audit:

Because of the nature of its operations and the highly liquid and negotiable form of its assets, a bank is particularly vulnerable to serious loss through perpetrated irregularities. Consequently, adequate systems of control are essential. The various state and national bank supervisory authorities and the directors of most banks are extremely interested in being informed of any weaknesses in controls and of the CPA's recommendations for strengthening internal control and improving the internal audit program and procedures. In view of the foregoing, the CPA, based on his knowledge developed during the course of the audit, should comment on these matters, as this is one of the most important aspects of his total services rendered. These comments ordinarily are included in the audit report, unless deemed more appropriate to be included in a special report to the Board of Directors.

Special Purpose Reports

Those banks which have their year-end financial statements reported on by a CPA and who also have him perform a Directors' Examination during the year may receive various spe-

cial purpose reports in addition to an opinion on the annual financial statements and a report on the Directors' Examination.

Special purpose reports should be prepared in accordance with pronouncements of the American Institute of Certified Public Accountants. (See Chapter 13 of *Statement on Auditing Procedure No. 33.*) This guide has not attempted to give examples of such reports, since each such report must be specially designed to serve its intended purposes. The report may be addressed to the directors or management of the bank and could include the CPA's comments resulting from departmental audits, internal control reviews, special investigations, etc. If the CPA's comments are based solely on an examination of financial statements rather than on a detailed study of the controls, this fact should be stated in the report.

SECTION II

Accounting Principles and Financial Statement Presentation

Chapter 3

General

Constant awareness by bank managements and supervisory authorities of the importance of protecting and reassuring depositors has in the past been a dominant influence in the development of accounting and reporting practices in the banking industry. Banks have traditionally attempted to present to the public a profile of conservatism, stability, and steady growth. As a consequence of this objective, many of the practices which developed, and which were widely followed in the past and are still relatively prevalent today, particularly in the smaller banks, have the effect of tending to understate assets and to eliminate extreme fluctuations in operating results.

Present indications are that managements of banks of all sizes with public ownership are becoming increasingly aware of the interests of stockholders and the investing public and are re-evaluating the traditional concept that financial presentations should be designed primarily for the benefit of depositors because of their relatively larger financial interest in the bank. They are coming to recognize that depositors' interests are normally adequately served if the bank's financial soundness can be demonstrated. Stockholders and prospective investors, on the other hand, require information regarding financial position and results of operations which will permit them to make informed investment decisions. Informative financial reporting in accordance with generally accepted accounting principles serves the interests of both investors and depositors.

The Committee on Bank Accounting and Auditing has set forth in the following Chapters of this Section its views and

recommendations as to the accounting practices which banks should follow to present fairly financial position and results of operations in conformity with generally accepted accounting principles.

In common with the financial statements of companies in other industries, financial statements of banks prepared on a basis other than the accrual basis normally do not result in a fair presentation of financial position and results of operations, in conformity with generally accepted accounting principles. An exception to this generalization, but one which would not apply in the case of most banks (except as to certain accounts), would be where financial statements prepared on such other basis (such as the cash basis) would result in a presentation not materially different from that resulting from the use of the accrual basis.

Chapter 4

Balance Sheet or Statement of Condition

The most distinctive characteristic of a bank's balance sheet (or statement of condition as it is frequently termed), as compared with those of companies in other industries, is the absence of a segregation of assets and liabilities as between current and non-current. The Committee believes this lack of segregation is entirely appropriate in view of the nature of a bank's assets and liabilities. Except for bank premises and equipment and any long-term debt, the assets and liabilities are generally not susceptible to classification as current or non-current. A bank's investments for the most part are marketable and can readily be converted to cash; however, sound bank management dictates that a certain portion of a bank's assets for liquidity purposes be permanently invested in securities. Similarly, many of a bank's loans are either due within a year or due on demand, but many of them will be renewed or extended and, in addition, it is reasonable to assume that repayments will generally be invested in new loans. Most deposit balances can be withdrawn on demand or else mature in less than a year; nevertheless, it is normally reasonable to expect that for the most part the deposits will merely revolve.

The accounting for and reporting of specific classes of assets, liabilities, and capital accounts are discussed in this section.

Chapter 5

Statements of Income and Changes in Capital Accounts

Until recent years, the vast majority of banks have employed a statement of operating earnings, rather than an income statement, in reporting their results of operations. The final amount shown on the statement of operating earnings is the amount of net operating earnings. Excluded from the determination of this amount are such items as securities gains and losses and provisions for loan losses, together with their related income tax effects. The loan loss provisions, less the related reduction of income taxes, are charged to undivided profits. Securities gains and losses, reduced by their income tax effect, are carried either directly to undivided profits or to a securities reserve. In some instances, they are charged or credited to undivided profits with a corresponding amount being transferred from or to a securities reserve. No amount in either the statement of operating earnings or the statement of changes in capital accounts is designated as net income. Advocates of this form of reporting argue that it reflects the results of the bank's normal operations and avoids distortions which the inclusion of such items as securities gains and losses and loan loss provisions would cause.

More recently, however, many of the larger banks are employing an income statement, rather than a statement of operating earnings, in reporting results of operations. This income statement includes securities gains and losses and loan loss provisions.

Those advocating this form of presentation maintain that loan loss provisions and securities gains and losses directly relate to the operations of the period and accordingly should be included in the income statement. Few of them, however, include these items in the determination of net operating earnings nor do they designate any item on the income statement as net income. Rather they follow the form of presentation prescribed by the Federal bank supervisory authorities, which is discussed below.

The regulations and related forms issued in late 1964 by the Federal Reserve Board and the Federal Deposit Insurance Corporation for use in filings by affected state-chartered banks under the Securities Exchange Act of 1934 require the inclusion in the income statement of securities gains and losses and loan loss provisions. So also do the regulations subsequently issued by the Comptroller of the Currency in 1967, which affect national banks. The income statement form prescribed by the Federal supervisory authorities excludes loan loss provisions and securities gains and losses from the determination of net operating earnings and requires their inclusion, together with the related income tax effect, in a "non-operating additions and deductions" section of the income statement following the amount designated as net operating earnings. The final figure on the income statement is captioned "transferred to undivided profits." No amount is designated as net income.

Accounting and reporting practices relating to securities gains and losses and loan loss provisions are discussed in further detail in Chapters 6 and 7, but have been mentioned here because they are the principal items which have caused difficulties in designating an amount in the income statement as net income.

The aforementioned presentation prescribed by the supervisory authorities appears to be based on the theory that loan loss provisions and securities gains and losses are properly includable in the determination of net income over the entire history of a bank, but that the amounts thereof recognized in the accounts in any given fiscal period may not necessarily be the amounts applicable to such period. The reader of the financial statements is compelled to form his own judgment regarding the amount that represents the net result of the period's activities. Some readers may equate "net operating earnings" with "net income"; others may conclude that the final amount on the in-

come statement is the net income. Authoritative accounting literature supports the premise that this is not a judgment which the reader should be required to make; it is a judgment that informed management, possessing more facts than the reader, is obligated to make.

The Committee believes that banks should include an appropriate provision for loan losses in the determination of net operating earnings in accordance with the recommendations presented hereinafter commencing on page 45 and that securities gains and losses should be included in the income statement in accordance with the recommendations presented hereinafter commencing on page 36. The final figure on the income statement should be designated as the net income for the period. At the same time, the amount shown as net operating earnings should also be prominently presented. Securities gains and losses recognized in income should be presented, together with their income tax effect, in the income statement below net operating earnings and above net income. Separate per share amounts should also be reported for net operating earnings, securities gains and losses, and net income. The separate presentation of securities gains and losses should not be interpreted as indicating that they are extraordinary items as defined in Opinion No. 9 of the Accounting Principles Board of the American Institute of Certified Public Accountants. Where extraordinary items exist, securities gains and losses should be presented above income before extraordinary items.

The statement of changes in capital funds as presented by most banks is similar to a statement of retained earnings in a commercial organization, except that (a) where a "statement of operating earnings" is presented, the capital funds statement includes items which otherwise would be included in the determination of net income and (b) whether an income statement or a statement of operating earnings is presented, the capital funds statement usually presents only transactions affecting total capital funds (and accordingly excludes transactions wholly effected within the capital funds accounts). This latter form of presentation conforms with the aforementioned regulations of the Comptroller of the Currency issued in 1967. The regulations and forms of the FRB and FDIC under the Securities Exchange Act of 1934, on the other hand, require the presentation of

transactions in the various individual capital funds accounts. The Committee recommends that either the reporting practice prescribed by the FRB and FDIC be followed generally or a statement of undivided profits be presented, with any changes in other capital funds accounts appropriately disclosed in a separate financial statement, in footnotes to the financial statements, or in some other manner.

Chapter 6

Investment Securities

Premiums and Discounts

Since premiums and discounts on bonds eligible for purchase by banks represent modifications of coupon rates caused by prevailing conditions in the money market at the dates of purchase, such premiums and discounts should be amortized, in order that operating earnings will reflect, not coupon rates, but yields based on purchase cost, and that the carrying values of the investments will be adjusted systematically during the periods of their holding toward the probable amounts realizable at maturity or earlier disposal. The period of amortization should extend from the date of purchase to the maturity date or to an earlier call date, whichever results in the more conservative presentation of interest income.

Premium amortization has long been recognized in banking circles as essential for the fairest presentation of income from securities purchased above par. Similar acceptance of the practice of discount amortization, however, has not been so widespread. Three factors have probably been most responsible for this. They are (a) the banker's traditional advocacy of conservatism (reflected here as a reluctance to "write up" assets), (b) the tax treatment of bond discounts (whereas for tax purposes premium amortization on other than tax-exempt securities is allowable as a deduction from ordinary income, bond discounts are disregarded until date of disposal of the securities, when

taxable gain or loss is recognized in the amount of the difference between original cost and sales proceeds) and (c) the attitude of many representatives of the supervisory authorities who have viewed discount amortization as resulting in stating investments at amounts in excess of cost. The Committee believes that these factors should not be permitted, however, to determine the method of accounting to be followed. (Under the aforementioned regulations of the three Federal bank supervisory authorities, discount amortization is optional.)

As noted previously, income taxes are not currently payable on amounts credited to income as a result of discount amortization. Nevertheless, in accordance with the principle of recognizing income and the related expense in the fiscal period to which they relate, regardless of when the income is received and the expenditure made, a provision for the applicable deferred income taxes should be made as discount is amortized. The decision whether the ordinary tax rate or the capital gains tax rate is to be used in making this provision should reflect bank management's best estimate of the more appropriate rate. The applicable rate will be either the ordinary tax rate (if, in the year of sale or redemption, there is a net loss for the year on securities transactions) or the capital gains tax rate (if, in the year of sale or redemption, there is a net gain for the year on securities transactions). Since, in the majority of situations, discount securities are purchased with the expectation of their disposal in a year in which a net capital gain will be realized, provision for deferred taxes is usually made at the capital gain rate, rather than at the ordinary tax rate.

Premium and discount amortization not only results in the fairest accounting presentation of investment income but more closely conforms the accounting treatment with the yield concept which is of prime importance in portfolio management. Without amortization, securities purchased at a premium produce an overstatement of operating revenues and those purchased at a discount produce an understatement, offset in each case (although not necessarily in the same fiscal period) by amounts included in securities gains and losses.

When a bank first adopts the practice of amortizing discount, the discount amortization applicable to prior years, if material, should be accounted for as a "prior year adjustment" in accord-

ance with the requirements of Accounting Principles Board Opinion No. 9, "Reporting the Results of Operations."

Securities Gains and Losses

As previously mentioned, until recent years most banks followed the practice of carrying directly to undivided profits or to a general security reserve gains and losses on securities transactions, together with the applicable income tax effect. The principal arguments advanced in support of this practice of excluding securities gains and losses from the income statement are that, in the first place, they are not the result of the normal operations of the period and, secondly, their inclusion would have a distortive effect on the results reported for a period and, perhaps more importantly, would make comparisons from year to year almost meaningless. Those advocating continuation of this practice point out that even if securities gains and losses were considered to be related to the normal operations of the period they should be excluded from the income statement because of the influence of the income tax law on the timing of their realization. (The tax law provides that if securities transactions of a year result in a net gain, it is taxed at capital gain rates; a net securities loss is deductible from ordinary income. Accordingly, banks attempt to realize their gains in "net bond gain years," and to realize their losses in "net bond loss years," in order to maximize the income tax benefits.)

As indicated previously, the regulations of the Federal regulatory authorities presently require the recognition of securities gains and losses at the time of their realization and the inclusion of such gains and losses, together with the related income tax effect, in the nonoperating income additions and deductions section of the income statement following the amount shown as net operating earnings. As also indicated previously, the form of presentation prescribed by the Federal regulatory authorities makes no provision for the designation of any amount as net income for the period. Rather, the final amount on the income statement (being the combined total of net operating earnings and nonoperating additions and deductions) is captioned "transferred to undivided profits."

Except as described hereinafter, all national banks and those

state-chartered banks subject to the provisions of the Securities Acts are required to follow the aforementioned regulations regarding the reporting of securities gains and losses. There is also a growing trend among banks not affected by these regulations to adopt similar reporting practices.

The recognition of securities gains and losses at the time of their realization conforms with practices generally followed in other industries. In addition, such immediate recognition, as well as the reporting practice of including the gains and losses as non-operating items, is strongly supported by a substantial segment of the banking industry. The practice is based on the theory that the sale of a security constitutes the completion of the transactions relating to the holding of that security and that the gain or loss represents an adjustment of the earnings on the investment recognized in the accounts during the period it was held. Since this holding period may have extended over more than one reporting period, the gain or loss is included in the nonoperating, rather than the operating, section of the income statement.

The Committee believes that the recognition of gains and losses at the time of their realization and their exclusion from the determination of net operating earnings conform with generally accepted accounting principles. The Committee also believes, however, that the present practice of not including such items in the determination of an amount designated as net income constitutes a failure to adhere to the requirements of Accounting Principles Board Opinion No. 9 and, accordingly, in that respect is not in conformity with generally accepted accounting principles.

Proposals for Amortization of Securities Gains and Losses

Other methods of accounting for securities gains and losses have been proposed in recent years. Most of these methods would include such gains and losses in net operating earnings over more than one fiscal period. Some of the methods would establish an arbitrary period (five years, for example) over which all gains and losses would be amortized. Such a method would eliminate extreme year-to-year fluctuations in the amounts of gains and losses recognized in the accounts, but, in the opinion of the Committee, cannot be supported logically. One proposed

method, however, can be supported by a philosophy concerning the nature of a bank's investment portfolio. This philosophy views a sale and subsequent reinvestment as constituting no fundamental change in the investment portfolio, provided the sale and subsequent purchase both involve investment grade securities traded in the same or similar securities markets, that is, in markets with the same prevailing market interest rates. Under this method, securities gains and losses would be deferred and amortized over the period from the date of sale to the maturity date of the security sold. This method is discussed in the following paragraphs.

Securities gains and losses represent adjustments of yields on investments. Over an extended period of years, they are as much a part of over-all investment results as are interest earnings. As indicated above, the accounting and reporting problems arise because of the need to report the results of operations for a single year or a part of a year. A gain or loss on the sale of a security (assuming premium and discount amortization) represents the immediate realization of the total discounted difference to maturity between the effective rate of earnings on the security (that is, the coupon rate adjusted for premium or discount amortization) and the prevailing market interest rate.

Prevailing market interest rates determine the market prices of investment grade securities. Such prices tend to settle at levels which will provide the purchaser with a yield on his investment (if held to maturity or call date) equivalent to the prevailing market interest rate at the date of purchase.

Proponents of the practice of deferring securities gains and losses and amortizing them to the maturity date of the security sold, where the proceeds are reinvested, argue that this method of accounting results in the inclusion of the gains and losses in the fiscal periods to which they relate. They point out that the same decline or rise in prevailing interest rates which results in a gain or loss also results in commensurately lower or higher interest earnings (that is, coupon rate adjusted for premium or discount amortization) on the security purchased with the proceeds of sale during the period from the date of the sale to the maturity date of the security sold. Accordingly, they maintain that the deferral and amortization of gains and losses to the

maturity dates of the securities sold result in the fairest presentation of investment earnings.

Those opposing the deferral and amortization method maintain that a sale constitutes a completed transaction. They point out further the lack of precedent for such treatment, either in practice in other industries or in authoritative literature. They also question the desirability of adopting a practice that tends to delay the reflection in interest earnings of changes in prevailing interest rates when, at the same time, such changes are reflected relatively currently in the interest rates banks pay for interest bearing deposits and borrowed funds.

The Federal bank regulatory authorities are generally opposed to the deferral and amortization method. As mentioned above, their regulations require immediate recognition of securities gains and losses and their inclusion as nonoperating items in the income statement. There have been a few instances, however, where the authorities have permitted banks to amortize gains and losses. In these instances, the banks had adopted the practice prior to the time that the authorities had expressed themselves as generally opposed to it. In these few instances, however, the authorities have recently stated that they do not approve the carrying forward of unamortized balances; rather, they are requiring the writing off of the balances as charges or credits to undivided profits, with amounts equal to the annual amortization included in operating earnings being transferred to or from undivided profits.

The Committee believes that there is considerable logic in the arguments advanced in support of the practice of deferring and amortizing securities gains and losses, but only if certain conditions are met. When these conditions are met, as described later, and this practice is followed, amortized amounts would not be considered as gains and losses but as adjustments of interest earnings.

Inasmuch as the deferral and amortization practice derives from the theory that the gain or loss is offset by decreased or increased future earnings resulting from the sale of the security and the reinvestment of the proceeds, there could be no justification for deferral where the proceeds of sale are used to meet depositor withdrawals. In addition, although the logic of the

theory would appear to justify deferral in all instances where the proceeds are reinvested in interest-earning assets, if factors other than prevailing market interest rates could have a significant influence on the rate of earnings on the assets acquired with the proceeds of sale, deferral would be undesirable. Examples of such influencing factors would be the element of risk inherent in loans and the convertible features of certain investments. Accordingly, the practice would ordinarily be confined to transactions in which the proceeds of sale of investment grade securities are reinvested in investment grade securities. In all other instances, securities gains and losses would be recognized when realized and would be reported, together with their income tax effect, in the income statement after net operating earnings and above net income (or above "income before extraordinary items" in the event that there are extraordinary items as defined in Opinion No. 9 of the Accounting Principles Board). Separate per share amounts would also be reported for net operating earnings, securities gains and losses, and net income (and, if applicable, for income before extraordinary items, as well as for extraordinary items).

Where securities gains and losses are deferred, the unamortized balance would be applied as an adjustment to the carrying value of securities in the balance sheet. Inasmuch as the sale would result in immediate gain or loss for tax purposes, the tax effect of the transaction would be similarly deferred and amortized over the period to the maturity of the security sold.

Under the deferral and amortization method, where an amount has been deferred and the security purchased with the sales proceeds is subsequently sold in a transaction requiring immediate recognition of gain or loss, the unamortized balance of the amount deferred would be written off at that time as an adjustment of the gain or loss. The related unamortized balance of the deferred income tax effect would similarly be applied as an adjustment of the income tax effect applicable to the recognized gains and losses. Some banks, particularly large banks with a high volume of securities transactions, may encounter practical difficulties in identifying deferred balances with the subsequent investments with which they are associated, particularly where the portfolio is constantly revolving. In these situations, there would

be no objection to the establishment of reasonable groupings of deferred balances by period to approximate maturity, and considering each of these groupings to be applicable pro rata to the total of holdings of investment grade securities.

The predominant use of the completed transaction method coupled with the various arguments in its favor, as previously set forth, indicate to the Committee that this method is acceptable under generally accepted accounting principles, provided these amounts enter into the determination of net income. At the same time, the Committee believes that the various arguments in support of the deferral and amortization method of accounting for certain securities gains and losses, as previously described, have considerable merit and are supportable in logic when related to the substance of the transactions involved. Therefore, the Committee considers both methods to be acceptable, at this time, in accounting for the results of securities transactions, pending continued AICPA research in accounting for securities and securities gains and losses. Those banks choosing to defer and amortize securities gains and losses should indicate by footnote what the results would have been under the completed transaction method.

Securities Gains and Losses on Dealer Transactions

Some large banks are dealers in government and municipal securities. Profits and losses on the dealer transactions, unlike those in the investment portfolio, are included in operating earnings as trading account income. In view of the nature of these transactions this treatment appears appropriate. There is some difference of opinion, however, regarding the preferable method of presenting interest earned on trading account securities. Some banks include it in interest on securities while others include it in trading account income. Both methods have considerable merit, provided the amount and classification of such interest earnings are disclosed parenthetically or in a footnote. In the interest of uniformity, however, it is suggested that the method prescribed by the Federal regulatory authorities (that is, including such earnings in trading account income) be followed, but with the additional disclosure of the amount and classification of such earnings.

Balance Sheet Presentation

The major categories of investments should be stated separately in the balance sheet. Ordinarily it is sufficient to show three classifications, namely, U. S. Government obligations, obligations of states and political subdivisions, and other securities. Any deferred securities gain or loss should be included in the classification of the securities purchased with the proceeds of the sale giving rise to the gain or loss. For those banks that are dealers in securities, a fourth classification, trading account securities, should be used.

With relatively few exceptions, securities held by banks are of investment grade. If they are held to maturity, they will be redeemed at an amount equal to their amortized cost. Accordingly, it is not customary practice for banks to provide specifically in their accounts for unrealized depreciation in the investment portfolio. This practice appears to be sound. Banks which are dealers in securities, however, should carry their trading account securities, which are in effect inventories, at the lower of cost or market.

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Mr. Barna believes that for those banks which are dealers in securities, this guide should have given consideration to an alternative accounting method whereby trading account securities are carried at market value.

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Although banks do not normally make provisions specifically related to portfolio depreciation, many banks carry general reserves against securities. These reserves are created in various ways. They may include realized securities gains, appropriations of undivided profits, or provisions charged to earnings. Usually they are deducted in arriving at the amount shown as investments in the balance sheet. When in the opinion of bank management, a general security reserve is desirable, it should be established as an appropriation of undivided profits, should be included in the capital accounts section of the balance sheet, appropriately captioned, should not be used to absorb losses, and should be returned to undivided profits when no longer considered necessary.

For the same reasons that provisions and reserves for unrealized losses are not normally required, disclosure of the market

values of a bank's investments is not usually considered essential to a fair presentation of financial position. In certain circumstances, such disclosure might actually contribute to a misinterpretation of the bank's financial soundness. Such might be the case where, solely as a result of rising interest rates, substantial market depreciation in the bank's investment portfolio had occurred. Disclosure of this depreciation might unjustifiably undermine public confidence in the bank's soundness. Even in the absence of possible misinterpretation of the significance of market values, there is some question regarding the value of such disclosure in view of the impracticability of disclosing the fair value of the loan portfolio, which in most banks is considerably larger than the investment portfolio. On the other hand, an advantage of disclosing market values is that it helps a reader of a bank's financial statements to evaluate the potential earning power of the bank's investments, since such potential earning power is governed by prevailing market interest rates applied to the market, and not the book, value of its invested assets. The Committee believes that such disclosure should be made where essential for a fair presentation of financial position.

Banks that are dealers in securities frequently have short positions in particular issues of securities. The usual practice is to show only the net long position of all trading account securities in the balance sheet and to include in equal amounts in other assets and in other liabilities the par or market value of securities borrowed (or due bills issued) to effect 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 compensate for the offsetting of long and short positions in the trading account on the balance sheet. Although this may result in stating total assets and total liabilities properly, it does not present the details of assets and liabilities as fairly as is possible. The Committee recommends that no cognizance be taken in the balance sheet of securities borrowed (other than possibly disclosing the related commitment by footnote) and that short position be classified as liabilities at the higher of selling price or market. The aggregate of the long positions would therefore properly be included as an asset and the bank's obligation to purchase securities to eliminate its short positions would be shown as a liability.

Chapter 7

Loans

Unearned Discount

Loans are frequently made on a discount basis, that is, the interest is deducted from the face amount of the loan at the time the loan is made, with the reduced amount being the proceeds to the borrower. Banks ordinarily record discount loans at their face amount, crediting the discount to a liability account. The discount is subsequently transferred to income over the period of the related loans under some reasonable and systematic method. The balance of unearned discount is included among the liabilities in the balance sheet.

The accounting practices for loan discount described in the preceding paragraph appear proper, except for the method of presentation in the balance sheet of the loan balances and the unearned discount. The Committee believes that it would be more in accordance with the actual facts to deduct unearned discount in arriving at the amount shown as loans, since, in the case of discount loans, the only funds put at risk and made available to borrowers are the net amounts after deducting the discount. Accounting Principles Board Opinion No. 6, in paragraph 14, requires that "Unearned discounts (other than cash or quantity discounts and the like), finance charges and interest included in the face amount of receivable should be shown as a deduction from the related receivables."

Loan Losses

Loan losses suffered by banks can be broadly classified into two groups, the recurring type of losses and those which occur at infrequent, irregular, and unpredictable intervals. Losses of the latter type historically have been larger and have been realized with less advance warning than those of the first type. Typical of the latter group were the severe losses during the economic depression of the 1930's and the losses occasioned by the communist seizures in Cuba in the early 1960's.

Responsible bank managements attempt to accumulate loan loss reserves adequate to absorb both types of losses. The Federal taxing authorities also recognize the need for banks to provide reserves for all such losses. The Treasury tax formula, by which the maximum amounts allowable as deductions for U.S. income tax purposes are customarily determined, permits the accumulation of reserves for loan losses that are greater, in the case of some banks, than the reserves that would be required to absorb only the recurring types of losses.

Since the loan loss provisions allowed under the Treasury tax formula are intended to provide for both types of losses, many banks make accounting provisions in amounts approximating the maximum amounts allowable for income tax purposes. Also contributing to the practice of using the Treasury tax formula for accounting purposes is the requirement that the provision, to be deductible for income tax purposes, must be recorded in the general books.

Prior to 1964, most banks carried their provisions for loan losses, together with the resulting reduction in income taxes, directly to undivided profits. In the balance sheet, the loan loss reserves in most instances were deducted from the amounts shown for loans, although some banks carried the reserve on the liability side as a reserve outside the capital accounts section, others carried it as a reserve among the capital accounts, and a small number of banks segregated the reserve, deducting from loans the portion of the reserve considered required to absorb loan losses in the current loan portfolio and carrying the remaining portion of the reserve on the liability side of the balance sheet, either within or outside the capital accounts section. Beginning in 1964 many banks adopted the presentation required

by the Federal Reserve Board and the FDIC for state chartered banks subject to the Securities Exchange Act of 1934. As mentioned above, this presentation consists of including the provision, together with the related tax reduction, in the income statement as a non-operating deduction, excluded from the determination of net operating earnings, and deducting the reserve in the balance sheet from the aggregate amount of the loans.

The presentation prescribed by the Federal regulatory authorities is gaining in favor and today probably ranks as the most generally followed method. Its proponents argue that, since the provision is intended to establish a reserve solely to absorb loan losses, the entire amount thereof should be included in the income statement with the resulting reserve treated as a valuation reserve deductible from the loan balances. They point out further that over the entire history of a bank the provisions computed in accordance with the Treasury tax formula are probably as reasonable in amount as those which might be determined under some other formula. Although acknowledging the propriety of including the provision in the income statement, these proponents argue that the provision should be excluded from the determination of net operating earnings, because of the inclusion in the total provision of some amount intended to absorb nonrecurring types of losses when they occur. This latter portion of the provision, they maintain, is not related to the current period's operations and accordingly should not be treated as an operating expense. Rather than classifying a portion of the provision as an operating expense and the remainder as a nonoperating item, they prefer to present the total provision, as a single amount in the nonoperating section. Another argument advanced for excluding the loan loss provision from operating expenses is that the provisions allowable for tax purposes may vary widely from year to year and that their inclusion in operating expenses could distort the amounts reported as net operating earnings in a given year.

The presentation of loan losses in the manner described in the preceding paragraph, although generally followed today, in the opinion of the Committee, does not appear to be the most realistic form of presentation. Loan losses are a natural incident of the basic banking function of extending credit and accordingly

should be reflected in operating earnings. At the same time, it is recognized that, because of the need to provide for all types of losses, relatively precise determinations of the amount of such losses applicable to any given fiscal period are impracticable (except possibly in retrospect).

Accordingly, the Committee recommends that each bank management determine a method (based on past loss experience, adjusted for such factors as known changes in the character of the loan portfolio, in management credit policies, and in economic conditions) which will result in systematic loan loss charges to operating earnings on a consistent basis. The method adopted should also take cognizance of the total economic cycle concept, which recognizes that during the depressed periods of such a cycle a reserve based wholly on evaluation of the collectibility of individual balances in the loan portfolio at one particular point of time would generally prove inadequate. The reserve established through charges to operating earnings should be deducted in the balance sheet from the loan balances, with the amount thereof shown as a deduction or indicated parenthetically in the loans caption. Losses on loans, to the extent practicable, should be provided for during the period that earnings are being recognized on the loans but under no circumstances should losses already incurred be deferred into the future when an inadequate reserve for current probable losses would result. To the extent that prior provision for loan losses charged against operating earnings and accumulated into a valuation reserve are inadequate to meet charge-offs, the amount necessary to restore the reserve to a level considered necessary to provide for losses inherent in the portfolio must be recognized as a current period charge. In those instances where the losses are extraordinary in nature, as set forth in paragraphs 21 and 22 of APB Opinion 9, extraordinary treatment may be afforded.

The maximum deductions allowable under the Treasury tax formula may represent reasonable provisions for accounting purposes for many banks. For other banks, the amounts allowable under the Treasury tax formula may be inadequate for accounting purposes. In these instances, operating earnings should be charged for the provision calculated under management's method; to the extent that this provision exceeds the tax deductible amount, the estimated future tax benefit should be recorded as

a deferred charge. In later years, if the provision charged to operations under management's method is less than the tax deductible amount, an appropriate reduction in the deferred charge account should be made.

It is also possible that for some banks the amounts allowable under the Treasury tax formula may be in excess of the provisions required for accounting purposes. In such instances, operating earnings should be charged for the provision computed under the management's method; to the extent that this provision is less than the tax deductible amount, operating earnings should include a provision for deferred income taxes. Any provision for loan losses in addition to the amount charged to operating expense, less the related tax effect, should be treated as an appropriation of undivided profits and should be included in the capital funds section of the balance sheet. If, in later years, the provision for loan losses charged to operations is more than the tax deductible amount, an appropriate portion of the reserve classified in capital funds should be restored to undivided profits.

As indicated previously, most banks have treated their loan loss reserves as valuation reserves, deducted in full from loans. Under the criteria presented above by the Committee, these reserves for many banks would continue to be considered as valuation reserves. In those instances, however, where some part of the reserve is considered to be precautionary, such portion, less the income tax reduction realized when it was established, should be transferred to the capital funds section of the balance sheet with the related tax effect being transferred to the deferred income tax account. Where such transfers are made, net income for affected prior years should be correspondingly restated in any subsequent publication of results for those years.

* * * * * *

Mr. Walker dissents to the requirement, at this time, for tax allocation related to portions of provisions for loan losses allowable under the Treasury tax formula that are appropriated from undivided profits. The Accounting Principles Board in Opinion No. 11 deferred a conclusion as to whether tax allocation should be required in several special areas, including "general reserves" of stock savings and loan associations, until further study and consideration had been completed. Mr. Walker believes that there are many similarities between this type of provision for loan losses of banks, and "general reserves" of stock savings and loan associations; consequently, he believes that no conclusion should be expressed prior to completion of the Board's study.

The Committee believes the above dissent refers to APB Opinion 11 in a manner that may require clarification. The APB Chairman has said that tax allocation accounting for bank loan loss reserves is consistent with Opinion 11 and that, during its deliberations, the Board considered commercial banks specifically and concluded that tax allocation should be applied to them in the same manner as to other profit-making businesses. He also said, contrariwise, the Board believed that for certain other industries unique circumstances may call for a different conclusion and, consequently, the Board deferred a decision pending completion of appropriate research and study.

Chapter 8

Bank Premises and Equipment

Consonant with the traditional concept of conservatism prevalent within the banking industry, many banks have arbitrarily written down their properties to nominal values. In addition, there has been widespread adherence to the practice of charging equipment, furniture, and fixtures to expense at the time of purchase. The arbitrary write-downs have usually been made by direct charges to undivided profits. In most instances where purchases of equipment, furniture, and fixtures have not been capitalized, their immediate charge-off has usually been reflected in operating earnings. Neither of these practices conform to generally accepted accounting principles and do not appear justified, in the light of present accounting standards, by any conditions peculiar to the banking industry. The fairest presentation of financial position and results of operations is obtained by capitalizing fixed assets and prorating the cost of depreciable assets (through realistic periodic depreciation provisions) over the fiscal periods benefited by their use.

The arbitrary write-down of property accounts not only results in understatement of property and capital funds in the balance sheet but, more importantly, relieves subsequent fiscal periods of appropriate charges for depreciation. In most cases, the resultant overstatement of operating earnings is aggravated by the income tax treatment of the transactions. For tax purposes, the write-downs are ignored and depreciation is claimed on the basis of cost. Accordingly, in addition to being relieved of depreciation charges, future fiscal periods benefit from the reduction in

taxes resulting from depreciation deductions not reflected in the financial statements.

The charging to expense of equipment, furniture, and fixtures at the time of their purchase also results in understatement of property and capital funds in the balance sheet. The effect of this practice on the fairness of presentation of operating results in the income statement varies. In years in which purchases exceed the amounts which would have been charged to operating expenses under a policy of capitalization and depreciation, operating earnings are understated. Conversely, if depreciation charges would have been greater than the amount of the purchases, operating earnings are overstated. The effects on net operating earnings of these understatements and overstatements are not mitigated by any related income tax effect, since the depreciation deductible for tax purposes is unaffected by the book treatment.

In those instances where properties have been arbitrarily written down or have been expensed at time of purchase and are still being used for the purpose for which acquired, the Committee believes that they should be reinstated in the accounts at cost, less accumulated depreciation to date of reinstatement, with an offsetting credit to the undivided profits account. If supervisory authorities require that the credit be made to a reserve account, then subsequent transfers to undivided profits from the reserve account (which, for financial statement purposes, should be classified as a capital funds account) should be made in amounts equal to the depreciation on the reinstated properties being charged to operating expenses.

The regulations of the Federal Reserve Board and the FDIC under the Securities Acts require the capitalization and depreciation of bank premises and equipment. An exception is made with respect to acquisitions prior to January 1, 1960. If such assets have not been accounted for on the basis of cost less depreciation, they may, under the regulations, be stated at book value, but with appropriate footnote disclosure of the pertinent facts. Since properties, other than buildings, acquired prior to 1960 would, in normal circumstances, have been substantially depreciated during subsequent years, the prescription of the FRB and the FDIC is probably reasonable in most cases with respect to equipment, furniture, and fixtures but not necessarily with

respect to land and buildings. The regulations of the Comptroller of the Currency issued in 1967 require capitalization and depreciation of fixed assets acquired subsequent to June 30, 1967.

Where an accelerated method for computing depreciation is followed for income tax purposes and another acceptable method is used for financial reporting purposes, appropriate provisions should be made for deferred income taxes.

Where bank properties are owned by an entity not includable in the consolidated financial statements and are occupied by the bank under a lease arrangement substantially equivalent to an installment purchase, as described in Opinion No. 5 of the Accounting Principles Board of the American Institute of Certified Public Accountants, the properties and related obligations under the lease should be included as assets and liabilities in the balance sheet in accordance with the recommendations in that Opinion.

Chapter 9

Reserves

Reference has been made previously to various reserves of a general nature not specifically identified with anticipated future losses, such as general security reserves, loan loss reserves (exclusive of the portions thereof treated as valuation reserves), and general contingency reserves. Banks have provided these types of reserves in various ways, such as, by charges to earnings, by charges to undivided profits, and by crediting security gains directly to the reserves. Frequently these reserves have been used to absorb charges which properly should have been made against income. These practices have resulted in misstatements of income and, in many cases, in completely avoiding any disclosure in the financial statements of substantial losses and expenses.

In those instances where management believes it prudent to provide a reserve against a future contingency, it should be established as an appropriation of undivided profits and should be classified in the balance sheet within the capital funds section. If the eventuality for which the reserve was created materializes, the resultant loss should be charged to income and the reserve restored to undivided profits. Similarly, if it becomes evident that the contingency will not materialize, the reserve should be restored to undivided profits. Under no circumstances should the reserve be used to absorb losses or other charges.

Chapter 10

Capital Notes

Traditionally, banks have obtained necessary capital by means of equity financing. In recent years, however, there has been a growing tendency among banks, particularly large banks with excellent credit ratings, to obtain additional capital through the issuance of debt securities, generally described as capital notes.

Capital notes, as distinguished from current borrowings, are long-term, with final maturity usually at least 20 to 30 years after issuance. They may be convertible into common stock. They are almost always subordinated in right of payment to the claims of depositors. According to the terms of the instrument under which they are issued, they usually mature in installments.

Most banks with outstanding capital notes classify them in the capital funds section of the balance sheet. This practice also conforms with the treatment prescribed in the regulations of the Federal regulatory authorities. The interest on the notes is included in the operating expense section of the income statement.

It is the Committee's opinion that in general, the accounting treatment described in the preceding paragraph is appropriate for banks. Although capital notes are debt obligations, they possess, in comparison with the other liabilities of a bank, more of the characteristics of equity capital than of debt capital. Of prime significance in this distinction is the subordinated feature of the notes. (In those instances where the notes are not subordinated, they should be excluded from the capital funds section and should be included among the liabilities in the balance sheet.)

The Committee believes that, where capital funds include capital notes, the capital funds section should contain a subsection for stockholders' equity with a sub-total shown for the amount recognized as the total stockholders' equity.

Chapter 11

Surplus and Undivided Profits

Balance Sheet Classifications

Banks do not customarily distinguish in their financial statements between capital surplus and retained earnings. In most banks, the surplus account is a combination of both and the undivided profits account represents the portion of retained earnings that have not been transferred to the surplus account. Bank capital stock is ordinarily issued at a premium, thus creating capital surplus. In addition, periodic transfers, at least in part in compliance with statutory requirements, are made to the surplus account either directly from income or from undivided profits. Banks view the surplus balance, regardless of its source, together with the capital stock account, as representing the bank's total permanent capitalization.

Since the entire surplus balance is considered to constitute a part of a bank's permanent capitalization, there appears to be no compelling reason for segregating it in the financial statements into its capital and earned components. Such segregation, however, might constitute an informative, though not essential, disclosure. In any event, the balance in the undivided profits account should be stated separately from that in the surplus account.

Newly organized banks frequently, in accordance with the wishes of the appropriate supervisory agency, transfer to the undivided profits account a portion of the initial paid-in surplus. The purpose of the transfer is to permit the bank to avoid creating a deficit in the undivided profits account during the early, usually unprofitable, periods of its existence. This practice is not often found in other industries and would ordinarily constitute

a departure from generally accepted accounting principles. Where such a transfer has been made, the Committee believes the undivided profits section of the balance sheet be presented in a manner which clearly shows the amount of paid-in capital included therein and its reduction by accumulated losses. The Committee also believes that the amount of paid-in capital included in the undivided profits account should be restored to the surplus account as rapidly as profitable operations permit.

Stock Dividends

As stated in Accounting Research Bulletin No. 43 of the American Institute of Certified Public Accountants, stock dividends (as distinguished from stock split-ups) ordinarily should be accounted for on the basis of the fair value of the shares issued in connection with such dividend. Normally this involves transferring from retained earnings to the category of permanent capitalization (that is, capital stock and capital surplus) an amount equal to the fair value of the additional shares issued. The reasoning underlying the use of fair value, rather than par value or book value, is that the recipient of a stock dividend views it as a distribution of corporate earnings in an amount equal to the fair value of the additional shares received and that stock dividends, as contrasted with stock split-ups, are sufficiently small, in relation to the shares previously outstanding, as to have no apparent effect upon the share market prices.

Banks have customarily accounted for stock dividends by transferring from surplus to capital stock an amount equal to the par value of the additional shares being issued. The transfer is often accompanied by a transfer from undivided profits to surplus of an equal or greater amount, though rarely in an amount as great as the fair value of the additional shares issued.

In evaluating the propriety of the practice commonly followed by banks in relation to generally accepted accounting principles, certain distinctions between banks and industrial companies in general must be recognized. As mentioned previously, the surplus account of a bank usually includes retained earnings, which have been transferred to surplus either to comply with statutory regulations or to benefit the bank by increasing its lending limits, etc. Nevertheless, regardless of its source, the entire balance of

the surplus account, together with the capital stock accounts, constitutes the permanent capitalization of the bank.

Because of the above-described practice of transferring accumulated earnings to the surplus account, a bank's undivided profits account is not the equivalent of the retained earnings (earned surplus) account of companies in other industries, nor is its surplus account the equivalent of other companies' capital surplus. Accordingly, it would be inappropriate to require that undivided profits be charged with the fair value of a stock dividend in view of the prior transfers which most banks have regularly made from undivided profits to surplus. Furthermore, such a requirement could effectively prevent many profitable, well-managed banks from ever declaring stock dividends. Sound bank management dictates that accumulated earnings in excess of anticipated cash dividend requirements be transferred to surplus as rapidly as possible in order to obtain the benefits of a larger permanent capitalization. Adherence to this policy could result in an insufficient balance ever remaining in undivided profits to absorb the fair value of a stock dividend.

The Committee believes that, inasmuch as it is entirely proper under banking law and regulation for banks to declare stock dividends out of the surplus account, regardless of its source (provided surplus is not thereby reduced below a prescribed level), the transaction should be accounted for wholly within the accounts representing the bank's permanent capitalization. (In this connection, it should be recognized that banking regulations require that the surplus balance must equal or exceed a specified percentage of the capital stock account.) Any transfer from undivided profits to the surplus account made concurrently with the recording of the stock dividend would be considered as unrelated to the dividend and merely the result of the exercise of a bank's right to make such transfers. In the light of existing authoritative pronouncements regarding stock dividends, the use of par value, rather than fair value, in accounting for stock dividends would appear not to be in accordance with generally accepted accounting principles. However, because of the peculiarities of banks' capital accounts and the fact that a study of stockholders' equity is in process by AICPA, the Committee believes the use of par value by banks in accounting for stock dividends, is at least for the present, an acceptable practice.

Chapter 12

Subsidiary Companies

Prior to 1964, virtually no banks prepared consolidated financial statements. In a bank's financial statements, investments in subsidiaries were usually stated at cost (or less). Where a subsidiary was utilized to hold title to all or a part of the bank's premises, the investment in the subsidiary was frequently included in the amount captioned as bank premises in the bank's balance sheet. Any outstanding mortgages on the properties accordingly did not appear on the bank's balance sheet.

The previously mentioned Securities Acts regulations of the Federal Reserve Board and the FDIC, issued in December 1964, require that in filings with those agencies consolidated statements of the bank and its majority-owned significant subsidiaries be filed and that, furthermore, every majority-owned bank premises subsidiary and every majority-owned subsidiary operating under the provisions of section 25 or section 25(a) of the Federal Reserve Act ("Agreement Corporations" and "Edge Act Corporations") be consolidated irrespective of whether such subsidiary is a significant subsidiary. The regulations of the Comptroller of the Currency issued in 1967 generally conform to those of the FRB and the FDIC in this respect. As a consequence of these regulations, many banks publish their financial statements on a consolidated basis, whether or not they are subject to the regulations.

Generally, consolidated financial statements are more meaningful than unconsolidated statements and in some instances are essential to a fair presentation of financial position and results

of operations. The principles for consolidation and those for the accounting for unconsolidated subsidiaries described in Accounting Research Bulletin No. 51 and Opinion No. 10 of the Accounting Principles Board of the American Institute of Certified Public Accountants are wholly applicable to the financial statements of banks.

Chapter 13

Operating Revenue

In recent years, interest earnings on obligations of states and political subdivisions have become a relatively more important component of banks' operating income than heretofore. Interest on these obligations is exempt from Federal income taxes and accordingly is at a lower rate than that on securities of comparable quality not enjoying the favorable tax treatment. For such purposes as comparing earnings on tax-exempt obligations with earnings on other invested funds and measuring average rates of return, most bank managements calculate the fully taxable equivalent of the tax-exempt interest. A few bank managements have adopted this concept for purposes of income statement presentation, stating the income on a fully taxable equivalent basis and correspondingly increasing the amount shown as income taxes.

While the use of the fully taxable equivalent concept may be useful for internal comparisons, it should not be reflected in the income statement. The purpose of the income statement is to disclose factually the period's transactions as they occurred; it should not be used to present results which might have been realized if conditions had been different from those which actually existed.

Although tax-exempt interest should not be included in the income statement on a fully taxable equivalent basis, the Committee believes it should be presented separately from other interest for informative reasons. While it should be included on an actual basis in the income statement, there is no objection to including it on a fully taxable equivalent basis in any interpretive charts or analyses contained in the financial report.

Chapter 14

Building Operations

The net occupancy expenses of bank premises should be so classified as an operating expense in the statement of income. All costs and expenses identifiable with or properly allocable to the maintenance and operation of the bank premises (such as salaries and wages applicable thereto, related payroll taxes and insurance, depreciation, rent expense, and real estate taxes), less rentals from tenants and other income related to the premises, should be included as net occupancy expenses. Where rental income from tenants is a material amount, it should be shown parenthetically in the income statement caption of net occupancy expenses.

Where the bank building is owned by an entity not includable in the consolidated financial statements and is occupied by the bank under a lease arrangement substantially equivalent to an installment purchase, as described in Opinion No. 5 of the Accounting Principles Board, the rental expense should be eliminated for financial statement purposes and a charge for depreciation and interest substituted therefor in accordance with the recommendations in that Opinion. The accounting for the building asset and related obligation under the lease in such circumstances is discussed above under Bank Premises and Equipment.

Also as provided in the aforementioned Opinion, material gains and losses under "sale and leaseback" arrangements should be capitalized, net of related tax effect, and should be amortized over the life of the lease, except that, in case of a loss, where the fair value of the property is less than the undepreciated cost, the loss should be recognized immediately.

Chapter 15

Trust Fees and Commissions

The great majority of banks report trust department income (fees and commissions from trust and agency activities) on the cash basis. Although the Securities Acts regulations of the Federal Reserve Board and the FDIC and the regulations of the Comptroller of the Currency (except as they apply to small banks) require that financial statements generally be prepared on the basis of accrual accounting, they permit the use of the cash basis for reporting trust department income in those instances where the presentation of such income on the cash basis would not materially affect the fairness of the financial statement presentation. The regulations of the FRB and the FDIC require that, where trust income is reported on the cash basis, footnote disclosure thereof be made.

In many banks calculation of trust income on an accrual basis would be most difficult and, more importantly, at best might be only approximately accurate. To compute the accrual, analysis of each trust account might be necessary and certain estimates regarding the probable duration of the individual trust accounts would be required.

Rarely would the use of the cash basis for trust income result in a distortion in either the balance sheet or the income statement. The accrued income omitted from the balance sheet would, only in very unusual circumstances, be material in relation to the capital accounts. Similarly, under either the cash basis or the accrual basis, the income statement for a year would include a year's trust income. Accordingly, only rarely would trust

income reported on a cash basis differ materially from that which would have been reported on an accrual basis.

Although the Committee believes that reporting trust income on the accrual basis results in the fairest presentation of financial position and results of operations, it considers other methods, such as the cash basis, to be acceptable if the fairness of presentation of financial position and result of operations is not materially affected thereby.

Chapter 16

Illustrative Forms of Bank Financial Statements

The illustrative forms of financial statements presented on pages 64-67 would be suitable for inclusion in annual reports to stockholders. The caption titles and sequence of presentation conform generally with those prescribed by the FRB and the FDIC for filings with those agencies under the Securities Acts, except that the following illustrative forms are somewhat more condensed than required in such filings and, where the Committee's recommendations as described in this Guide are at variance with the present requirements of the supervisory agencies, the following forms reflect the Committee's recommendations.

Balance Sheet, December 31, 19— and 19—

	December 31	
	Current Year	Preceding Year
Assets		
Cash and due from banks	$ 9,000,000	$ 8,000,000
Investment securities (Note 1):		
U.S. Government obligations	4,000,000	3,900,000
Obligations of states and political subdivisions	2,000,000	2,000,000
Other securities	150,000	100,000
Loans, less reserve of $442,000 in 19— and $418,000 in 19— (Note 2)	18,000,000	17,000,000
Stock of Federal Reserve Bank	67,500	67,500
Bank premises and equipment (Note 3)	360,000	970,000
Accrued interest receivable and other assets	152,500	142,500
Total	$33,730,000	$32,180,000
Liabilities		
Demand deposits	$22,300,000	$21,560,000
Savings deposits	4,260,000	3,500,000
Other time deposits	4,000,000	4,000,000
Total deposits	$30,560,000	$29,060,000
Borrowed funds	100,000	80,000
Accrued taxes and other expenses	220,000	220,000
Other liabilities	60,000	63,000
Total liabilities	$30,940,000	$29,423,000
Capital funds:		
Capital stock (100,000 shares of $10 par value)	1,000,000	1,000,000
Surplus (Note 7)	1,250,000	1,250,000
Undivided profits	540,000	507,000
Total capital funds	2,790,000	2,757,000
Total	$33,730,000	$32,180,000

See accompanying Notes to Financial Statements

Statement of Income
For the Years Ended December 31, 19– and 19–

	Current Year	Preceding Year
Operating Income:		
Interest on loans	$1,000,000	$ 900,000
Interest on U. S. Government obligations	180,000	200,000
Interest on obligations of states and political subdivisions	60,000	60,000
Interest and dividends on other securities	10,000	8,000
Trust department income	100,000	90,000
Service charges on deposit accounts	50,000	45,000
Other operating income	60,000	55,000
Total	1,460,000	1,358,000
Operating Expenses:		
Salaries	220,000	200,000
Other employee benefits	15,000	15,000
Interest	480,000	460,000
Net occupancy expense of bank premises	55,000	52,000
Loan loss provisions (Note 2)	29,000	15,000
Other operating expenses	56,000	65,000
Total	855,000	807,000
Operating Earnings	605,000	551,000
Less income taxes applicable to operating earnings	262,000	236,000
Net operating earnings	343,000	315,000
Securities gains (losses), less related income tax effect of $50,000 in 19– and $100,000 in 19–	150,000	(100,000)
Income before extraordinary item	493,000	215,000
Loss on sale of branch bank building, less related reduction in income tax of $240,000	260,000	–
Net Income	$ 233,000	$ 215,000
Earnings Data Per Share:		
Net operating earnings	$3.43	$3.15
Securities gains (losses), less income tax effect	1.50	(1.00)
Income before extraordinary items	4.93	2.15
Extraordinary item, less related reduction in income tax	(2.60)	–
Net income	2.33	2.15
Cash Dividends Per Share	2.00	2.00

See accompanying Notes to Financial Statements

Statement of Changes in Capital Funds
For the Year Ended December 31, 19–

	Capital Stock	Surplus	Undivided Profits
Balance, January 1	$1,000,000	$1,250,000	$507,000
Net income for the year			233,000
Total	1,000,000	1,250,000	740,000
Less cash dividends declared— $2.00 a share			200,000
Balance, December 31	$1,000,000	$1,250,000	$540,000

See accompanying Notes to Financial Statements

Notes to Financial Statements

For the Year Ended December 31, 19–

1. Investment Securities:

   Securities are stated at cost, adjusted for amortization of premiums and discounts.

2. Loan Losses:

   The Bank provides for loan losses in amounts equal to those allowable for income tax purposes, which amounts are considered appropriate in view of the Bank's past loan loss experience and its estimates of possible future losses. Transactions in the reserve for loan losses for the year were as follows:

Balance, January 1	$418,000
Provision charged to operating expense	29,000
Total	447,000
Less loans charged off, net of recoveries of $2,000	5,000
Balance, December 31	$442,000

3. Bank Premises and Equipment:

   Bank premises and equipment are stated at cost, less accumulated depreciation which amounted to $320,000 at December 31, 19– and $600,000 at December 31, 19–. Depreciation, computed on the straight-line method and included in operating expenses, amounted to $23,000 for 19– and $32,000 for 19–.

4. Pledged Assets:
   At December 31, 19– assets carried at $1,200,000 were pledged to qualify for fiduciary powers, to secure public monies as required by law, and for other purposes.

5. Trust Assets:
   Property (other than cash deposits) held by the Bank in fiduciary or agency capacities for its customers are not included in the accompanying balance sheet, since such items are not assets of the Bank.

6. Commitments and Contingent Liabilities:
   In the normal course of business there are outstanding various commitments and contingent liabilities, such as guarantees, commitments to extend credit, etc., which are not reflected in the accompanying financial statements. The Bank does not anticipate losses as a result of these transactions.

7. Surplus Restriction:
   The State Banking Law restricts the availability of surplus for the payment of dividends. At December 31, 19–, $650,000 of surplus was so restricted.

Comment

In addition to the illustrative notes presented above, most of which are more or less peculiar to banks, the notes to the financial statements of a bank should include any other appropriate disclosures, such as principles of consolidation followed and information concerning pension plans.

SECTION III

Bank Auditing Procedures

Chapter 17

General

Introduction

This Section emphasizes those aspects of bank auditing unique to the industry and presumes knowledge on the part of the CPA in those areas similar to those of commercial and industrial enterprises. This Section has been designed to present typical situations in a commercial bank offering full banking services but with limited departmentalization and staff. Certain situations prevalent only in larger banks are not discussed.

In order to avoid confusion in terminology, the term "audit" as used in this Section, refers to an examination made by a CPA (unless the context clearly indicates that the reference is to an internal audit) whereas the term "examination" refers to examinations made by Supervisory authorities.

The importance of internal control is repeatedly stressed in this Section. Some significant questions relating to internal control are presented for guidance purposes and are not intended to be all-inclusive. Also, other significant points are reiterated in certain chapters of this Section where emphasis is considered desirable. In most bank audits, the CPA not only reports on the fairness of the presentation of financial statements, but also comments on, and submits recommendations for improvement in, the system of internal control and the program of internal audit.

Most large banks and many of the smaller banks employ electronic equipment for processing much of their repetitive data. Throughout this Section, however, the discussion of operations, accounting, internal control, and auditing procedures is generally

based on a consideration of such activities as conducted in a bank not utilizing electronic data processing (EDP). This approach has been deliberately adopted to facilitate presentation of the concepts embodied in the Guide, without unnecessarily expanding its size by describing the alternative operational, accounting, control, and auditing procedures which might be followed in an EDP system. It is assumed that the CPA undertaking an audit of a bank whose operations are computerized will be sufficiently familiar with EDP to recognize appropriate deviations from the operational, accounting, and control procedures described in this Section and to modify the recommended auditing procedures to existing conditions.

Application of Generally Accepted Auditing Standards

Generally accepted auditing standards are applicable in the audit of bank financial statements to the same extent that they are applicable in the audit of industrial and commercial company financial statements. The reporting problems which result when the bank's financial statement presentation is not in conformity with generally accepted accounting principles is discussed under the "General" section of Chapter 2.

Under ordinary circumstances, the CPA's report will state that the 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 he considered necessary in the circumstances. In accordance with the provisions of *Statement on Auditing Procedure No. 33,* if a significant auditing procedure is omitted, a qualified opinion or a disclaimer of opinion will normally be required, depending upon the materiality of the amounts to which the omitted procedure relates.

Two such significant auditing procedures that the CPA may be requested by the client to omit are (1) loan evaluation and (2) test confirmation of accounts by direct correspondence with borrowers and depositors. While cost might be a factor in these decisions, a bank may insist on omission of loan evaluation from the audit scope on the grounds that it is unnecessary in light of the close and continuous supervision of the loan portfolio by the

bank's directors, and confirmation procedures may not be permitted by the bank because of anxiety over possible customer reaction. (For further discussion of this matter, see page 87.)

Sometimes the CPA's client will request that the trust department be excluded from the audit. (A description of the services performed by this department is furnished in Chapter 31.) The trust assets held by a bank (other than uninvested trust funds), and the related accountability therefor, do not appear in the bank's balance sheet. A clear segregation of duties and responsibilities between the trust department and other departments of the bank is an important feature of internal control which should be considered by the CPA in establishing the scope of his tests. However, irrespective of the segregation of activities, if the trust department has improperly handled or disposed of material amounts of trust assets, significant liabilities could exist which would seriously affect the bank's financial condition. Where the trust activities of a bank are significant, either a disclaimer of opinion or qualified opinion will be required on the bank's financial statements unless the CPA has satisfied himself, by appropriate review and testing procedures that effective internal controls are functioning to protect against commingling of bank assets and trust assets and to establish proper accountability over trust activities. The CPA's tests of accountability over trust activities may, in these circumstances, be less extensive than would be required to permit him to express an unqualified opinion on the statements of the trust department.

The CPA's Responsibility for Fraud Detection

In addition to asking the CPA to express an opinion on the financial statements, bank directors and management usually have, as an additional purpose, the objective of fraud prevention. Adequate fidelity coverage, internal control, internal auditing, and independent audits are essential elements in minimizing fraud losses and discouraging irregularities. However, as mentioned in Chapter 1 of *Statement on Auditing Procedure No. 33,* audits of financial statements cannot be expected to detect fraud although its discovery frequently results. If, during the course of the engagement, the independent auditor discovers any de-

falcation or other violation of criminal laws, he should request the client to notify the proper Federal and state authorities.

Bank Directors' Responsibilities for Examinations

The responsibilities for the management of banks are placed on their directors by both statutory and common law. Among these responsibilities is the general requirement that the directors periodically examine the bank's affairs by performing, or by causing the performance of, suitable audits. To fulfill this responsibility, the board generally appoints an examining or audit committee of non-officer directors. These committees generally carry out their audit responsibility by any one of three methods or a combination thereof: (1) by making the audit themselves, (2) by directing the bank's internal auditor to carry out the audit, or (3) by employing independent CPAs or other qualified independent auditors to make an audit on their behalf.

Audits performed by the directors themselves are generally relatively ineffective. Most non-officer bank directors are not familiar with the detailed internal operations of their banks and do not possess the special experience, training, and technical knowledge required to make a satisfactory audit. Consequently, in most cases, the directors rely heavily on the officers and employees to carry out the program, with the result that the elements of surprise audit and of professional independence do not exist.

Audits carried out by internal auditors are sometimes limited by the degree of independence and authority which the auditors can exercise. Such situations are particularly prevalent in smaller banks. Under such circumstances, the assistance provided the directors is accordingly limited.

When the CPA is engaged to assist the bank directors in the discharge of their duty to audit the bank's affairs, it logically follows that he is primarily responsible to the directors or their examining or audit committee. (From the CPA's viewpoint, this is highly desirable inasmuch as it provides him with ready access to the governing board.) The scope of his audit is, of course, determined by discussions with the directors or their committee. The directors, however, are not relieved of their over-all responsibility by the delegation of this function to the CPA, since they

must answer for any significant limitations or omissions in the scope of audit coverage. For example, if they instruct the CPA to omit loan evaluation from his audit program, they must either accomplish it by other means or justify its complete omission.

Special Auditing Problems

In common with auditing problems in all industries, problems in bank auditing generally fall into three categories: (1) accountability, (2) valuation, and (3) reporting.

The first of these, accountability, can be particularly troublesome to the CPA. A high percentage of a bank's own assets consist of cash and negotiable items; in addition, it has custody of the property of others (usually accounted for on memorandum records), such as collateral and safekeeping securities, trust assets, items held for collection, etc. In recognition of these conditions, bank audits are ordinarily begun on an unannounced basis. Until negotiable items have been accounted for and records appropriately tested (which may require several days), it is essential that a high degree of control be exercised, thus requiring a sufficient number of audit staff to maintain control until discharge of accountability has been established.

While the CPA's audit of financial statements cannot be expected to detect all possible irregularities in the bank's accounts, he must recognize that a serious irregularity could affect the fairness of the financial statements on which he is expected to express an opinion and accordingly his audit procedures should be designed with appropriate cognizance taken of the highly volatile nature of bank assets. Unless the CPA establishes at the outset of his audit and maintains control of assets and records until the bank's accountability for cash and negotiable items has been determined, he may be unable to have an informed opinion on the financial statements. If control is lost before such accountability is established, no alternative or additional audit procedures can therefore recapture it as of that audit date.

As indicated above, a major irregularity could have a sufficiently adverse effect on the bank's financial statements as to nullify their fair presentation of financial position and operating results. The CPA should recognize that such a major irregularity would likewise affect his opinion on the financial statements.

In the absence of extensive collusion, however, irregularities of this magnitude should not ordinarily occur where there exists an effectively functioning system of internal control. Hence, a review and evaluation of the adequacy of the bank's system of internal control by the CPA is essential as an audit procedure in itself, as well as providing a basis for determining the required scope of the audit, in order to permit the CPA to express an opinion on the bank's financial statements. In addition, this review provides the basis for the CPA's recommendations for strengthening the system. He should not only discuss his findings and recommendations with bank management, but should submit them in writing so that he will be on record concerning these matters.

There will be situations—particularly in first audit engagements—when the CPA will be faced with the practical reality of a system of internal control that is not adequate. In such situations, it will of course be necessary for the CPA to either (a) expand the scope of his examination and the extent of his testing beyond that which would be required in the presence of an adequate system of internal control or (b) disclaim or qualify his opinion. What then are some of the danger areas? The following seem worthy of comment.

The operations of banks, more than those of other types of business units, are sensitive to the outside affiliations of officers and employees. This suggests that, in the smaller bank, the CPA should consider compiling such affiliations in his review of internal control. In the large bank where such a procedure may not be feasible, he should ascertain that the internal audit program takes this factor into consideration. The deposit or loan accounts for organizations with which officers or employees are affiliated may require the same special consideration as the direct deposit and loan accounts of officers and employees discussed in later sections of this Guide.

There is the possible misstatement of deposit liability through a scheme perpetrated for personal gain by either not posting depositors' checks as they are presented and paid, or by posting to an inactive or other account that should not have been charged. A number of major shortages have involved variations of this scheme. In another situation, a dishonest bookkeeper forges a check on a depositor's account and negotiates it off

premises, possibly by opening a fictitious account with another bank. When the check is presented for payment, the bookkeeper intercepts and destroys it rather than posting it as a charge to the depositor's account, thus resulting in the aggregate of the subsidiary ledger exceeding the control balance. As this procedure is repeated, the difference increases; the bookkeeper secretly removes a group of ledger sheets approximately equal to the difference before trial balances are prepared by other employees, and thus is able to conceal the shortage in the accounts. Another variation would be where the bookkeeper withholds posting checks as an accommodation to a depositor, this might start on a modest scale but quickly develops into a large amount when the bookkeeper is threatened by the depositor with exposure and loss of employment unless the depositor's checks are continued to be held in this manner.

Another situation would be where the bank might be the victim in a check-kiting scheme. Through frequent and recurring transfers of funds between two or more accounts maintained in different banks, a depositor may be able to induce a bank to pay checks against uncollected funds. Unless the client bank is the first to discover this condition, there is the possibility of loss when checks are dishonored and returned by the other banks involved.

Another device utilized to conceal irregularities is the creation of fictitious loans or the misstatement of bona fide loans. In addition, tellers may withhold and subsequently "lap" personal loan payments.

Some consideration needs to be given to holdover items and unprocessed work involved in the reconcilement of subsidiary records with the general ledger controls. Shortages have been concealed by continuously carrying fraudulent items in a holdover classification. In effect, the items are in "orbit" and never reach any final accounting destination.

Another area susceptible to irregularities (although normally on a lesser monetary scale than the situations described above) is the collection function. There is the technique of lapping collection item proceeds. The possibilities of a shortage depend on two general conditions, namely, a constant flow of items and the absence of bank employee rotation in collection item handling. As the dishonest employee will "borrow" collection item pro-

ceeds and continuously replace these amounts by subsequent borrowings as the shortage grows, a scheme of misappropriation will require his uninterrupted attention to avoid detection. Also, he must have a constant source of funds to assure replacement of previously misappropriated amounts. Thus, the extent of auditing must be directly related to the CPA's findings in respect to these general conditions.

The foregoing are mentioned in this section of the Guide to illustrate some of the problem aspects of the accountability phase in a bank audit, and to stress the importance of developing and executing a program of auditing procedures to cope with them.

The second problem area is valuation of bank assets. Principally this relates to investments and loans. To a large extent investments are susceptible to valuation through published market quotations or other recognized sources. The main problems of valuation relate to obligations of local municipalities and the loan portfolio.

As a minimum, the scope of the audit should include review of the loans by reference to the bank's credit files and a test evaluation of loan collateral. In addition, some reliance can be placed on the credit review made by the supervisory authorities. An important consideration to keep in mind is that the CPA is concerned with the over-all fair presentation of the loans. This becomes a matter of determining the general adequacy of the valuation reserve for loan losses and the bank's internal control procedures relating to lending activities, rather than an exacting review which would consider the merits of each individual extension of credit. Nonetheless, problems can arise in banks where credit files yield only meager information and collateral is not subject to objective evaluation. It is not possible to provide answers in this Guide for specific problems of this type but they are basically similar to problems constantly encountered by the CPA in his accountancy practice. Some of the problem areas are:

1. Loans in arrears as to interest or principal.

2. Criticized loans in supervisory examiner reports.

3. Loans with collateral not readily marketable or not susceptible to determination of realizable value.

4. Loans showing a long history of renewals without principal reduction.
5. Loans applicable to industries having a record of economic instability.
6. Loans lacking proper documentation.
7. Loans not supported by adequate and current financial data.

As an over-all conclusion, it would seem that the CPA must apply his general business prudence to these questionable loan situations and extend his procedures through discussion with loaning officers, and such other methods that may be necessary to satisfy himself on the question of fair presentation.

Some Peculiarities of Bank Accounting

The CPA must have a working knowledge of his bank client's accounting system. While bank accounting is not difficult to understand, it is quite different from conventional double entry bookkeeping. Moreover, the banking industry, notwithstanding its extent of regulation, does not use a uniform accounting system. Thus the CPA must have some advance familiarity with a bank's accounting procedures and bookkeeping methods (which may include either on or off-premises EDP applications) as a prerequisite to the performance of an effective audit.

Although the banking industry does not use a prescribed accounting system, there is a certain degree of similarity of accounting methods. Accordingly, the subject can be discussed generally from the standpoint of differences between it and conventional accounting. Some of the more significant differences can be classified as follows:

1. Daily posting and trial balancing of the general ledger.
2. High transaction volume, principally affecting balance sheet accounts.
3. Use of entry tickets in lieu of conventional columnar journals.
4. Inter-department accountability over custody and movement of negotiable items.
5. The central proof and check collections system.
6. The use of memorandum accounts.

One of the more significant differences is the method of posting and trial balancing the general ledger. Banks prepare a daily statement of condition or balance sheet. This need for a daily statement of condition naturally influences the whole accounting system. Income and expense account balances since the last regular closing date are carried in the statement of condition—often in a profit and loss section under the net worth caption. This eliminates closing these accounts to undivided profits at the end of each day. There is no uniform procedure for closing; many banks do this on a semiannual basis.

In bank accounting the majority of daily transactions affect only balance sheet accounts. It is not uncommon for a small bank to handle 4,000 to 5,000 items a day—each being an accounting entry in its own right. Accordingly, special methods must be devised to expedite the sorting and summarization of these accounting entries. Because of the large number of individual transactions involved, banks do not use detailed journals to record individual entries; however, in some EDP systems, transaction journals are frequently developed.

One of the devices used to help speed the flow of accounting information is the use of single entry tickets as the contra to cash transactions. A deposit ticket, for example, becomes the source of entry to the customer's ledger account, with no corresponding written debit entry to cash. To make sure that cash on hand corresponds to other accounting entries generated during the day, tellers prove their cash balances daily. At the end of the day, the net change in the cash balance for the day is posted to the general ledger account.

Tellers' "blotters" or proof sheets are frequently maintained which summarize entries for an entire day's transactions, usually by departments, from which postings are then made to the general and subsidiary ledgers. The use of data processing equipment by banks to speed up accounting and provide for a growing volume of business is constantly increasing and has resulted in some modifications in the more traditional methods of handling transaction data.

Because of the negotiability of the cash, checks, notes, etc., passing through the hands of bank personnel, the accounting system must be set up in such a way that items can be traced

and individual accountability established. Furthermore, since accounting entries continuously move between departments throughout the day, individual accountability and constant "proofing" of transactions are necessary to detect and locate rapidly any errors which may arise.

The focal point of the bank accounting system, under the conventional systems approach, is the proof department. This department receives "batches" of checks, deposit tickets, etc., from other departments in the bank and from outside sources (such as clearing houses and correspondent banks), proves the accuracy of batch totals, and resorts the items for delivery to other departments for further processing. In effect, the department functions as a traffic controller for the multitude of transaction data that flow through the bank each day. It is here that many entries are developed for posting to the applicable general ledger control accounts. The sorted media are then forwarded to the applicable departments for posting to the subsidiary records. The department has only temporary custody of the items as everything it receives is delivered to other areas by the end of the day, subject to any holdover items or unprocessed work carried over to the next business day.

Most business transactions are settled by check and the banking system has the responsibility of check collection. "On-us" checks are those drawn on accounts of the bank receiving them and will be charged against these accounts when presented. Clearinghouse items are drawn on other local banks and are assembled and presented daily to the drawee banks; settlement is one of offset between banks—the net difference, debit or credit, is settled by clearinghouse rules. Checks drawn on out-of-town banks are called "transit items." These are collected (a) through the Federal Reserve System, (b) by "direct sending" to drawee banks, or (c) 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 upon the assumed time necessary to collect the item. While the bank gives the customer provisional credit for the check when it is deposited, the availability of funds determines when the depositor may withdraw the deposit.

The general ledger in many banks is machine-posted and quite

frequently individual entries are consolidated and posted in total to the respective accounts. Certain accounts require detailed posting, however, such as bank premises and net worth accounts.

One of the principal subsidiary records is the demand deposit ledger. This ledger is subdivided into unit controls and each unit contains the individual checking accounts of a group of customers. There are many posting variations, including the practice of "deferred posting." Banks are required either to pay "on-us" items when received or to return them promptly to the senders.

Separate depositor ledgers are maintained for savings accounts. These are often machine-posted and are subdivided in the same manner as the checking accounts. Posting procedures for savings accounts may be either the "unit plan" or the "dual plan." The unit plan involves simultaneous posting of the customer's passbook and ledger card by the teller when the transaction takes place. The dual plan separates the teller and bookkeeping functions.

As already indicated, there is a continuing need for speed in classifying and summarizing accounting transactions. This dictates a certain degree of expediency in the accounting processes, and as a result, accounting information is often abbreviated. The customary offset to debit and credit entry tickets is the payment or receipt of cash; however, some do not involve cash and therefore offsetting debit and credit tickets are required to reflect the whole transaction. This may present a problem to the CPA in attempting to ascertain the offsetting elements as no conventional journal will show this information. He may be required to review all general ledger entry tickets for the day in order to determine the offsetting debits or credits to account postings.

Memorandum accounts are widely used by banks. Such accounts are used to reflect many of a bank's commitments and contingent liabilities, such as its obligations under letters of credit issued, irrevocable loan commitments granted, and unissued savings bonds and travelers checks held on consignment.

In summary, the CPA must become familiar with the accounting processes of his bank client if he is to perform an effective audit—as much as possible should be learned about the system *before* the audit is begun.

Recent Trends in Bank Services

Competitive factors tend to expand the range of services offered by banking institutions. Many of these services represent significant departures from traditional banking concepts. The CPA may encounter unusual innovations provided for the convenience of customers. Among these are such services as lock box accounts receivable collection, computer services, freight bill payment, "in plant" banking, and revolving personal credit plans. The Guide does not consider these services in detail, inasmuch as they are highly individualized services and, more important as regards the Guide, services which do not normally affect the bank's accounting for its own transactions.

Substantial Interim Auditing Procedures Supplemented at Year-End

When the CPA is expressing his opinion on the financial statements at year-end, he may perform substantial interim work (audit procedures carried out as of a date prior to the year-end and for a period then ending) in order to render his report on a timely basis for inclusion by the bank in its annual report to stockholders. If a surprise audit is made during the year for purposes of meeting the requirements of a Directors' Examination or for other purposes, the audit procedures carried out at that time might constitute all or a significant portion of the interim audit procedures. Obviously, in the absence of an adequate system of internal control, it would be necessary for the CPA to perform most of his auditing procedures as of the year-end in order to express an opinion on the annual financial statements. Where an adequate system of internal control exists and interim procedures are performed, many of them (such as counts of cash and inspection of securities) should be performed on a surprise basis and, except for branches and departments whose operations are relatively isolated from the over-all operations of the bank, should be performed as of the same date. Subject to the exception regarding depositors' balances discussed in Chapter 25, confirmations should be requested as of the date that the various balances are examined as of interim dates.

During the interim testing of the records of the bank, the CPA

can determine whether his original evaluation of the effectiveness of the accounting procedures and the system of internal control was accurate. He should also determine the scope of the audit procedures which will have to be followed at year-end in the completion of the audit.

Assuming satisfactory internal controls, at the year-end the CPA would normally include the following among his procedures:

1. Determine, through inquiry and observation, changes in the system of internal control, and, giving appropriate recognition to his conclusions based on the surprise examination, or examinations, made by him earlier in the year, re-assess its effectiveness in the light of such changes.
2. Evaluate the work performed and read the reports submitted by the bank's internal auditors since the last visit of the CPA.
3. Confirm and reconcile balances due from major correspondent banks and the Federal Reserve Bank.
4. On a test basis, analyze the activity in securities accounts since last visit, inspect or obtain confirmation of securities owned and test market prices.
5. Scrutinize year-end personal credit, installment, commercial, and mortgage loans for reasonableness in the light of such balances at the interim audit date. On a test basis, inspect collateral and request confirmation of loan balances. Evaluate unearned discount, delinquent loans and probably loan losses.
6. Test clearinghouse exchanges and similar balances resulting from forwarding cash collection items.
7. Examine support for major changes in fixed assets and test computation of depreciation.
8. Analyze and substantiate unusual or large items included in other assets and other liabilities accounts.
9. Analyze all changes in capital accounts since last visit.
10. Read all minutes.
11. Scrutinize general ledger accounts for unusual items.

12. Make a comparative analysis of branch operating statements and statements of condition.
13. Obtain representations from senior officers regarding loans, mortgages, investments, and liabilities.
14. Interrogate senior officers with respect to overall operations.
15. Review cut-off procedures (including unrecorded liabilities) principally at main office.
16. Determine adequacy of tax accruals and status of tax examinations.
17. Read most recent report of supervisory authorities.
18. Evaluate bank's accounting policies in light of generally accepted accounting principles.
19. Obtain information from legal counsel relative to status of litigation and significant contractual arrangements.

Chapter 18

Planning the Audit

It is absolutely essential that the audit be carefully planned and programmed prior to its commencement, since procedural errors cannot be corrected easily, if at all. The considerations for proper planning and programming are set forth in this chapter.

For initial engagements, it is suggested that the CPA follow the sequence of the topics in this chapter. Naturally, for recurring work, the CPA should be guided by his particular knowledge of the client and should make his arrangements accordingly.

Meeting with the Bank's Representatives on the Scope of the Audit and Other Important Matters

On initial engagements undertaken to assist the directors in their required examination (which is the most usual type of engagement) the CPA should meet as early as practicable with the examining or audit committee or, if a committee has not been appointed, with the board of directors to discuss the proposed audit in detail. Since the directors are legally responsible for the audit, the CPA should point out that the directors' responsibility is more extensive than merely ascertaining the correctness of recorded assets and liabilities. He should empha-

size that the directors' examination should include the determination of (1) the collectibility of loans, (2) the reasonableness of carrying values of other assets, and (3) the adequacy of the reserves for all direct and contingent liabilities; the directors (or the examining committee thereof) cannot delegate responsibility for these functions although they may, in their discretion, rely upon information furnished by the CPA or others.

When agreeing on the scope of the audit, the CPA should stress the importance of obtaining independent confirmations from borrowers, depositors, and other customers. Some bank directors are reluctant to have the standard procedure of confirmation followed because of concern over customer reaction. In this connection, the CPA should point out the present widespread use and acceptance of confirmation procedures by both the business community and the general public and that, in its absence, there is no independent substantiation of the correctness of the individual balances shown by the bank's records for deposits, loans, collateral and safekeeping assets held, etc. He should explain that failure to obtain adequate independent confirmations will result in his audit not being made in accordance with generally accepted auditing standards and therefore requiring him to disclaim an opinion on the financial statements or, as a minimum, to express a qualified opinion on them.

Submitting the Proposal Letter

After the initial meeting, the CPA should address a letter to the directors or a committee thereof requesting confirmation as to the agreed scope, report requirements (including any disclaimer or qualifications in opinion that may be required as a result of limitations in scope, etc.) and other important matters. In order to do this effectively, the CPA should have previously visited the bank to make a general review of internal controls and accounting procedures. The following is a summary which suggests the information needed to complete such a preliminary review (although, if time and other circumstances permit, the obtaining of answers to the other questions relating to internal control which appear in this Guide in Chapters 20 through 22, Chapter 25 and Chapters 28 through 31 would prove helpful in planning the audit):

Checklist of Information to be Obtained in Preliminary Preparation for Bank Audit

Demand Deposit Accounts

1. Number of deposit accounts (regular and low-cost).
2. Number of ledgers (controls) kept.
3. Are statements mailed on all accounts at month-end or on cycle basis?
4. Are dormant accounts segregated?
5. Single or dual posting?
6. How current are addresses?

Time and Savings Accounts

1. Number of accounts.
2. Number of ledgers (controls) kept.
3. Method of posting (window, backroom, etc.)
4. Are dormant accounts segregated?
5. How current are addresses?

Loan Accounts

1. Number of accounts.
2. Principal kind of loan (commercial, installment, real estate, etc.)
3. Method of interest accrual.
4. Liability ledger–where kept and method of posting and controls.
5. Form of collateral records.
6. Quantity, type, and location of collateral.

Cash

1. Number of tellers and average total cash.
2. Does each teller balance separately?
3. Is excess cash turned over to the head teller at the end of the day?
4. Record kept by teller in balancing.

Correspondent banks

1. Number of accounts (active and inactive).

Securities

1. Location of securities.
2. Type of records kept.
3. Number of issues and type (Government, municipal, etc.)

Vaults

1. Location and for what purpose are they used?

Trust Department

1. Number and type of trust accounts.
2. Location of securities.
3. Quantity and types of securities.
4. Method of keeping accounts.
5. When, if at all, are statements mailed to parties at interest?

General

1. Number and locations of branches.
2. Banking hours—weekdays—Saturdays.
3. Type and location of other negotiable items, such as safe-keeping items, unissued Series E bonds, travelers' checks, and official checks.
4. Number of officers and employees.
5. Facilities for addressographing.
6. Typing assistance.
7. Stationery requirements.
8. Any off-premise accounting?
9. Names of officers and key employees who will be concerned with audit.
10. Procedure manuals and organization charts.

The material included in the letter pertaining to scope should enumerate in detail what the CPA has agreed to do; likewise it should specify any generally accepted auditing procedure which is to be omitted, such as confirmation of loans and deposits, particularly when the CPA has been requested by the committee to omit a procedure which is considered essential. Frequently CPAs mention in this letter that the audit cannot be relied upon to disclose irregularities. Whether this is done or not, the CPA should make the committee aware of the limitations of his audit in this regard. In some cases, the CPA may request a letter from the committee authorizing him to conduct the

audit in accordance with the proposed scope outlined in his letter; in other instances, oral authorization is considered sufficient.

Preparations for Commencement of Audit

In the case of a first audit (and to a lesser extent in connection with subsequent audits), the CPA should arrange to survey the bank and its branches with an officer, who is familiar with operations, to determine the bank's accounting procedures and evaluate its internal controls. He should also arrange to be kept abreast of changes thereafter. As in other business enterprises, the internal controls are the first line of defense against irregularities. In banks they are particularly important because of the liquidity of the "commodities" processed.

In this connection the CPA should review the reports, workpapers, and audit programs of the bank's internal auditors to determine the scope of their work, its effectiveness, and the frequency with which such audits are performed. Reports of supervisory examinations should also be reviewed.

Preparation of an audit program cannot begin until the matter of audit scope has been settled and a survey made of the internal controls, accounting procedures and the physical layout. The importance of the audit program cannot be over-emphasized. The CPA should prepare a complete program for each section of the work which specifies the auditing procedures to be followed. In preparing the program, the CPA should not overlook the experience of the internal auditor, who generally will be able to offer some constructive suggestions as to the timing and sequence of the various procedures to be followed. Consideration should also be given to the scope and frequency of the internal audit work performed. The degree of effectiveness and comprehensiveness of this work will have a direct bearing on the extent to which the CPA will be able to limit the application of certain audit procedures.

There is no substitute for adequate planning; it is a prerequisite to a smooth, efficient, and professional audit. Planning of a bank audit is unusual in many respects by comparison with other audits. Noted below are some of the more important aspects in preparing for the audit.

A. *Selection of date and time*

Of particular concern in the preparation for the audit (which is ordinarily made on an unannounced basis in order to maximize its effectiveness) is the selection of the date. In addition, the timing of the work in relation to the bank's business hours, posting schedule, and general operations is extremely important. It generally is prudent to discuss beforehand the timing of the work with the bank so that the unannounced visit is not made at a time which would be awkward to the bank and impede the audit work. The overall control requirements peculiar to a bank audit and other practical operating considerations are vital in the selection of a date and the timing for commencement of a bank audit.

The audit may be commenced in the morning when the vaults are opened at which time all negotiable assets are placed under control until they have been examined; this arrangement requires that the CPA have his staff at the bank prior to the opening of the vaults. An immediate concern of the CPA in a morning start is the counting and releasing of at least certain of the tellers' cash prior to the bank's opening for business. The principal advantage of a morning start is that bank personnel have less opportunity of covering a shortage temporarily, should any exist.

The audit may also be begun in the afternoon, in which case the problem of control may be a little more difficult because the balancing and proving operations may not have been completed by bank personnel, thus providing them with the opportunity of creating fictitious transactions to cover a shortage. An advantage of an afternoon start is that a large part of the physical counting and inspection of loan notes and loan collateral, investments, trust assets, and other negotiable items may be performed after banking hours thereby minimizing the upsetting of daily routine. In addition, the balancing and proving of detailed records can also be performed before the re-opening of the bank for business.

Some of the specific points to bear in mind concerning the selection of the time and date of audit are set forth below:

1. Prior to arriving at the bank the CPA should consider:
   - (a) The confidential nature of the work.
   - (b) The daily closing hours, special occasions and holidays that are recognized by the client.

(c) The problem of getting a large number of auditors in one spot without being obvious.

2. If possible, the CPA should start the work on a day when the bank closes early or when the overall work load of the bank is light. In making these arrangements however, it is important that no pattern be established.

3. He should give recognition to the bank's posting schedule with respect to:
   (a) Demand deposits
      (1) End of month statement mailing.
      (2) Cycle mailing of low cost accounts.
      (3) Full day delayed posting basis.
   (b) Time deposits
      (1) Window posting or other procedure.
      (2) Interest date just prior to circularization date can create unnecessary work.
   (c) Loans
   (d) Trust department

4. Other areas concerning timing:
   (a) Different departments or branches observe different hours.
      (1) Drive-in or sidewalk teller.
      (2) Trust department.
      (3) Personal loan department.
   (b) Overall balancing where branches are operated.
   (c) Processing of clearings and return items.
   (d) EDP department work schedule.
   (e) In order to avoid the possibility of both the CPA and one or more of the supervisory authorities selecting audit and examination dates which might conflict and also to permit the supervisory authorities, when scheduling their examinations, to consider the recentness of the CPA's audit, it is frequently desirable for the CPA to inform the appropriate supervisory authority of the confidential starting date of the audit. These authorities are shown on page 13.
   (f) Assistance from the bank—Arrangements should be

made for the preparation of confirmations and other clerical assistance by the bank's personnel. Arrangements for such assistance should not include advance notification to the participants. Such assistance is particularly effective because of the bank employees' knowledge of operations and familiarity with bank records. This type of work can be done under the control and supervision of the CPA thereby reducing the cost of the audit. The CPA should not overlook the possibility of availing himself of the assistance of the internal audit staff which in many banks is assigned to the outside accountants for the first few days of the audit to expedite the work.

B. Control

Immediately upon arrival at the bank, control must be established by the CPA over all negotiable items and certain records and underlying documents. This is essential to permit the CPA to account satisfactorily for all assets owned or held for customers and to examine records adequately. As a practical matter, control instituted in this manner on a surprise basis is also an effective means of evaluating internal control relating to such assets and records. Such control is also essential to permit the CPA to satisfy himself that he does not inspect the same items twice, that there has been no substitution of either assets or records, and that he does not fail to inspect items which should be inspected. It should be emphasized that control does not involve taking physical possession.

Without control, the probability that the CPA's audit procedures would disclose differences and irregularities, should any exist, would be lessened considerably. For example, if all cash is not simultaneously controlled until it is accounted for, there are opportunities for substitution and recount of funds already checked, or fictitious checks or other items could be introduced in the funds or otherwise used to reduce the amount for which tellers are accountable.

Conversion, as well as substitution, of highly negotiable assets is also a possibility that must be considered. For example, all securities held by a bank must be controlled to prevent trans-

ferring securities or other negotiables from one vault storage area to another as a means of concealing missing items during the CPA's inspection. Also, securities readily convertible into cash or which can be used as a basis for borrowing cash must be controlled in such a manner that they cannot be converted and used to temporarily cover a shortage in another area.

Control must also extend to records which establish accountability for negotiable bank assets and to depositors' ledgers which disclose liability for funds deposited by customers. This requirement for control applies also to trust, safekeeping, loan collateral records, Series "E" bonds, travelers' checks and similar items.

Control is usually accomplished through systematic and simultaneous sealing of files, compartments and other media containing the items and records. In order that day-to-day operations can continue during the period while controls are being maintained, the CPA must keep a working paper record of items released to bank employees which are required for the account of certain customers. No particular problem is involved, but the CPA or a member of his staff must be available at all times during banking hours to attend to these situations.

Particularly important is control of negotiable items. The CPA must be prepared when he enters the bank to establish control in all areas where negotiable items may be located. Such items are:

1. Cash and cash items
   (a) Tellers—The number, type, and location of tellers should be noted.
   (b) Reserve cash—The reserve cash is usually found in one vault and the total included on the head teller's cash blotter.
   (c) Clearings and remittances.

2. Securities—The location of the securities and the type of records maintained should be noted for the following:
   (a) Bank owned—Many of these securities may be held in safekeeping outside the bank.
   (b) Trust—These securities are generally found on the premises.
   (c) Loan collateral—These securities may be in several

locations: teller's cage, vault, safe deposit, etc.

(d) Safekeeping—These are securities held for customers. They may have been used previously for collateral purposes.

3. Unissued savings bonds and unissued travelers' checks—these items are on consignment. Proceeds from sales are remitted in accordance with an established schedule.
4. Negotiable assets recorded in memorandum accounts.
5. Unissued official, treasurer's and officers' checks and other official items—obtain number of lowest numbered unissued check, etc.

C. Confirmation letters

Due to the importance of independent verification of account balances by direct correspondence with customers, the preparation of confirmation letters (positive or negative) and follow-up of exceptions is extremely important. Since a large proportion of the confirmations will be addressed to non-business customers, care must be exercised in wording the request to facilitate the customer's confirming. For example, in the case of installment and mortgage loans, the borrower is often requested to confirm the number of unpaid installments and the amount of each installment. Confirmation of demand deposits should be requested as of a date that the customers receive statements in order to permit them to reconcile the balances. Where internal control is relatively ineffective, arrangements should be made to have statements as of the examination date, together with related paid checks, etc., sent to those depositors whose accounts have been selected for confirmation. The confirmation requests can either be sent with the statements or separately. In those instances where internal controls are adequate, confirmations of demand deposits can usually be requested as of the statement dates immediately preceding or immediately following the examination date, provided sufficient tests are made as of such dates of the agreement of the detailed ledgers with the controls. As interest credits will not have been posted currently to all savings passbooks, confirmation requests covering time deposits will result in a considerable number of exceptions being reported to the CPA; disposition of these differences is facilitated if the con-

firmation letter includes a request for the date of the last posting in the passbook. Other types of differences which may be reported are outlined on p. 135. Examples of typical confirmation request letters are presented in Appendix C. Arrangements should be made to obtain the assistance of internal auditors or other bank personnel in the follow-up and disposition of differences disclosed by confirmation replies. The CPA should of course keep a record of the differences turned over to others for follow-up and must be furnished with adequate evidence supporting the explanations of the differences and the propriety of the disposition made of them.

The CPA should review the general format of the confirmation letters with the bank to make certain that they meet with its approval. For example, some banks may wish to insert a "public relations" paragraph in certain of the letters. Confirmation forms should be prepared prior to the commencement of the audit so that only the specific information, such as customer's name, address and balance need be inserted at the bank.

D. Control techniques

It has been stated that the CPA should establish appropriate controls. This is accomplished by the use of various types of sealing devices, observation, supervision, and other similar means.

E. Initial work phase

Completion of the initial work phase (first 2 or 3 days) must be thoroughly planned. The bank must be in a position to serve the needs of its customers and this means the CPA will necessarily have to be in a position to release control of certain items. Any unnecessary delay in the completion of the designated audit work during the initial phase increases the problem of control by requiring more accounting by the CPA for released items.

At a minimum, the CPA should have a scheduling sheet covering usually the first two days of the audit which identifies the delegation of responsibilities and the assignment of duties for all his personnel. Adequate advance instructions to the audit staff are important to carry out the audit effectively. Many of the so-called "First Day" problems can be avoided by proper instructions. Instructions in most cases must be in detail, such as

the percentage of the various denominations of currency to be counted, the extent of tests, the method of examining loans, the preparation of confirmations, the types of things to observe in the inspection of collateral such as "powers attached," etc. The importance of delegation of responsibilities for key functions, such as the count of tellers' cash, the control of the vaults, the inspection of securities held as investments, as loan collateral, in safekeeping, and in trust, to designated members of the CPA's staff cannot be over-emphasized. The persons designated as supervisors should give adequate instructions to those assigned to assist them. The person responsible for the overall supervision should arrange to coordinate the meal times of his staff with those of bank personnel in order to obtain maximum utilization of time and continuity in the progress of the audit. This is particularly important during the first few days when control is being maintained. Shortly after the beginning of the audit, the supervising CPA should make arrangements with an appropriate bank official concerning the matter of inspection of loan collateral, investments, and trust and safekeeping assets, its time and place and the assignment of bank personnel to work with the staff of the CPA.

It is important that the staff be instructed that they are not to handle items of value except in the presence of client personnel.

Chapter 19

Automation and Bank Auditing

Automated data processing is on the rise in the banking industry at a rate exceeding that in most other industries. Although the term automation encompasses many types of systems, the systems generally employed by banks may be classified into three groups:

Manually Operated Systems

These are systems which involve the use of bookkeeping machines, desk calculators and similar devices. These machines contain automated elements and therefore should be included as a class of automated systems.

Punched-Card Systems

These are probably the best known of the automated systems. Individual system functions such as sorting, calculating, etc., are performed by separate machines.

Electronic Data Processing Systems

Included in this group are computers which use combinations of magnetic tapes, random access devices, cards, etc. These machines may have multiple input and output facilities and can perform essentially all data processing functions. The presence of these more sophisticated devices does not change the CPA's basic audit objectives and standards.

In the case of EDP systems, the CPA should have a basic knowledge of the functions of the equipment, but he certainly

need not be a programmer or a machine technician. He may, however, be faced with the necessity to develop new techniques for satisfying himself in the absence of visible records. As a prerequisite to performing an effective audit, a thorough review of the system must be made and then the CPA must address his audit procedures to the existing controls.

Some of the controls that the CPA should be familiar with in an EDP system include physical controls, programmed controls, computer personnel controls and record retention. The critical problem in the area of control is to detect deviations from an established program or routine. For the purpose of illustration some of the controls within the categories previously discussed are briefly noted below:

1. *Physical controls*
   a. Changes to existing programs should be made in accordance with procedures established to provide effective control over changes.
   b. Provision should be made for protection of tapes against deterioration and accidental destruction.
   c. External labeling of tapes is required in order to facilitate the identification of the tapes that are produced in a computer operation.

2. *Programmed controls*
   a. Validity checks should be made to be certain insofar as possible that all data entering the system is completely valid.
   b. Transaction totals should be accumulated before the documents are transcribed to the processing media.
   c. The number of records or blocks of information which have been written should be accumulated and recorded at the end of each tape as it is written.
   d. Internal labels to identify each reel recorded magnetically at the beginning of each tape are used to prevent the processing of incorrect tapes.

3. *Computer personnel controls*
   a. A computer log should be used to control the computer operator. Control is obtained through the subsequent eval-

uation of the computer log by data processing management.

b. Separation of duties is very important in a computer department. The programmers should not have the responsibility for the daily operation of the system. Only the designated operator should be the person allowed to operate the equipment.

4. *Record retention*—To prevent the accumulation of paper reports and to retain appropriate tapes, a records retention policy should be established. This policy should be executed through a records retention schedule.

One audit technique designed to permit the CPA to check the programming and operation of an EDP system involves the use of test data for which the results have been predetermined. The CPA's test data would include types of transactions which deliberately violate controls programmed into the system.

Another technique is for the CPA to use the equipment to test the records produced by the system, rather than to test the system itself. This is, of course, the traditional audit approach. It has the advantage of permitting the CPA to test the results of operations at a particular time. In contrast, the tests of the system itself will require the presence of the CPA during each operation to be tested. Using the equipment to test the records requires the preparation of a separate program for the CPA's exclusive use.

Still another audit technique, but one which requires considerable familiarity on the part of the CPA with programming, is for the CPA to review the individual program steps and the underlying flow charts and, having satisfied himself as to the logic of the program, to maintain control while the program is used to process the data file.

Another technique (but one which is usually not practicable because of changes which are made in the program, as explained below) involves possession by the CPA of a duplicate copy of the instruction program tape which he has previously reviewed and checked. Thus, on a surprise basis, the CPA can have his copy of the program compared with the program used during the actual processing of the data. This tends to establish that

the program as originally authorized, is, in fact, being used. As an alternative, the CPA may request that data previously processed be reprocessed with his copy of the program so that the end results can be compared. This latter alternative has the added advantage of the possible disclosure of any intervention by the operator. This technique of maintaining a duplicate copy of the program tape is usually impracticable. During the early stages of a system, changes in the program are usually voluminous and frequent and even after the system has been established, some further changes can be expected. The CPA must satisfy himself as to the logic of these changes and must then conform his copy of the program tape to reflect the changes.

For more comprehensive coverage of the problems to be considered in auditing EDP installations, reference should be made to the literature of the AICPA.

Chapter 20

Cash and Due From Banks

In this and the following chapters of the Guide typical accounts of a commercial bank are considered from three points of view; first, a brief description of the nature or function of the accounts; second, significant questions relating to the system of internal control applicable to such accounts; and third, a general discussion of auditing procedures and objectives related to the accounts. The lists of internal control questions and the auditing procedures and objectives discussed are not intended to be all-inclusive; additional questions, procedures, and objectives may frequently be appropriate. Certain accounts common to most business organizations, and therefore not peculiar to the banking industry alone, are treated in general terms only.

Accounts included in this chapter include cash on hand, cash items, clearings and exchanges and due from banks. A discussion of each of these follows:

Cash on Hand

Cash on hand is divided into two parts, funds in the possession of tellers and a reserve fund kept in the vault. The tellers are individually responsible for the funds in their possession, whereas the reserve fund, because of the large amount involved, is often under dual control. Fund balances fluctuate daily as a result of cash transactions.

Fund accountability is established daily by tellers' proof sheets. When summarized, these prove the net change in the cash balance resulting from daily transactions and the new total cash on hand figure for the general ledger account. A typical

system of accounting for cash is through "cash in" and "cash out" tickets. Tellers account for the cash portion of transactions passing through their hands by using these tickets. This procedure permits the remaining transaction data to be forwarded, balanced, and processed in the proof department by interdepartment debit or credit for the cash received or paid by the tellers. This ticket system similarly accounts for cash transactions between tellers and other departments. The daily totals of interdepartment debits and credits offset and are eliminated from general ledger posting. Tellers' cash differences are recognized by entry tickets for posting to the appropriate cash over or short account in the general ledger.

In certain cases, primarily where certain tellers remain open for business after regular banking hours or where evening hours are observed, certain tellers' funds will be balanced or closed out at either the bank's regular closing hour or at some other hour prior to the cessation of activity for the day by those tellers. Subsequent activity is accounted for in the following day's business.

In addition to the foregoing, petty cash funds are held by custodians in various departments as, for instance, trust, safe deposit, etc. Unlike tellers' funds, these are generally maintained on an imprest basis.

Some significant questions relating to internal control of cash on hand are:

1. Do tellers have exclusive access to and custody of their respective cash funds?
2. Is cash always under lock when teller is absent from cage area?
3. Are physical storage facilities for currency and coin adequate to safeguard against loss due to theft, mysterious disappearance, etc.?
4. Is there a systematic plan for surprise counts of tellers' funds?
5. Are appropriate measures taken to reduce loss exposure by limiting amounts of teller funds?
6. Are tellers prohibited from performing checking account bookkeeping duties?

7. Is access to the night depository safe under dual control of two employees who both must be present when the safe contents are removed, listed, and processed?

The CPA must keep in mind the audit objective in developing his audit program for cash on hand, which is to determine that cash on hand as shown in the general ledger is actually represented by currency and coin on hand. He should give consideration to the following procedures, which essentially consist of controlling and accounting for all currency and coin at the audit date.

The CPA should account for cash on hand and maintain control until cash is balanced to control accounts. Tellers' funds should be counted first; the reserve fund can be kept under seal and counted last. The extent of testing of funds is a matter of judgment to be exercised by the CPA. The tellers' funds should be counted either before business in the morning or after close of business depending on whether the examination is begun in the morning or afternoon. In the case of an afternoon start, tellers' cash should be counted after all transactions have been cleared and balances have been established. Tellers' funds which have not been balanced and closed out at the close of business should be balanced under the CPA's control and all transactions sent to the proof department. Cash items held by tellers as a part of their funds should be scheduled and subsequently checked to ultimate collection or other disposition. An officer should be requested to review and approve all such cash items.

It is essential that at the time cash is counted, items such as unissued drafts, travelers' checks, and U.S. Series E Savings Bonds, be inventoried and last issued items accounted for. Confirmation of such items should be obtained from the consignors. The CPA also should obtain information and explanations with respect to deposits and other items held over to the next business day.

The extent to which testing may be employed in lieu of complete detailed counts must be left to the judgment of the CPA. 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

these amounts may be confirmed with correspondent banks or depositors in lieu of physical count.

Cash Items

Cash items may be reflected in a separate general ledger account and/or in the individual teller funds in which latter event they are "buried" in the cash on hand total. Items might include checks cashed after the close of business, maturing coupons and bonds, petty cash vouchers, returned checks, due bills and other items temporarily held pending their liquidation. Technically, they are not in process of collection and each item requires special handling.

These items are usually accumulated and balanced daily by adding machine tape and held by a designated teller for appropriate disposition. Where items are numerous, they may be listed in a register which provides for recording the date items are cleared. Some internal control safeguards relating to cash items:

1. Cash items should be held by only one teller and other tellers should be prohibited from carrying cash items (items other than currency or coin) in their cash funds.

2. Cash items should be reviewed daily for propriety by an officer or supervisory employee, other than their custodian.

Auditing procedures applicable to cash items which are under separate general ledger account control are similar to those used when items are included in tellers' cash. Generally, the audit objectives are to determine that the items are proper and will clear in the normal course of business. When items are numerous, it is usually appropriate to consider only the larger amount items.

Clearings and Exchanges

These are checks drawn on other local banks, sorted, batched, and totaled by drawee bank for delivery and clearinghouse or direct settlement. In communities where there are only two or three local banks, exchange of items and settlement may be done directly between the individual banks, rather than through

an intermediary clearinghouse association. References in the following paragraphs to transactions with clearinghouses apply equally to direct settlement transactions.

Sources of items presented include those received with deposits and other customer transactions. Also banks clear local area checks for certain out-of-town correspondents; these items are received by mail and are 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 its officers and subsidize its operating expenses. In some cities the association staff performs surprise examinations of its members. The scope of these examinations is quite similar to supervisory examinations. The association also establishes rules for check collection, return items, and other matters pertaining to interbank relationships.

Local clearings and exchange items are a byproduct of the proof department (along with "on-us" checks, transit items, etc.). The function of the proof department is discussed on pages 80-81.

Auditing procedures applicable to clearings and exchanges basically are confirmation of total checks forwarded to drawee banks and subsequent follow up of disposition of larger return items. In order to determine that the total checks forwarded are correct and that returned items, if any, are proper, the CPA will establish control of clearings and exchange items on hand upon commencing his audit. However, in some cases, as for example on a morning start, the item may have been already delivered so that none is on hand and no control procedures are necessary. In this event the CPA will send letters to the drawee banks requesting confirmation of the totals of the respective checks already delivered. On the other hand, if the CPA encounters items on hand at the start of the audit, control is established over the items and the confirmation requests are inserted in the respective envelopes, which are then sealed and control maintained until they are forwarded for exchange. The confirmed totals by drawee banks of clearings and exchanges

should be listed and the total thereof reconciled with the general ledger account balance.

The confirmation letters should also request itemization of items being returned in excess of a specified minimum, but this procedure is not always conclusive as all return items are not always listed by the drawee bank. As added assurance, the CPA should ascertain how return items are handled and on the basis of this information should arrange to intercept and inspect (on a test basis if numerous) all such items for the first several business days following the start of the audit. Larger items should be listed by the CPA and traced to their ultimate disposition. The principal objective of this 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 into the processing by employees.

Due from Banks

Balances due from correspondent banks represent deposits placed with such banks to facilitate check collection and other banking services. "Due from" accounts reflect transactions initiated by the bank placing such deposits and are not customarily used to record transactions originating in the depository institutions. The latter is achieved through "due to" accounts included under demand deposit liabilities. It is not uncommon to find reciprocal balances representing accounts with the same bank. (Incidentally, such reciprocal balances should be offset for balance sheet presentation.) Federal Reserve member banks include among their due from banks balances the required balance with the district Federal Reserve Bank which represents funds on deposit 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 actually represent deposits with such "due from" banks. The mechanics of the operation may vary among banks but it usually is 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 upon receipt of the checks; the bank's account is credited after a specific period of time necessary to collect the items; a bank

draft remittance 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 are initiated and documented by debit and credit advices. In addition, the bank draws drafts on these accounts. Statements for active accounts are received daily, others weekly, semi-monthly or monthly. Reconciliation of accounts is usually performed as statements are received. The standard reconciliation format used by the majority of banks recognizes open items from either the sending or receiving bank. While transactions generally are originated by the depositing bank, they result in contra entries by the correspondent on occasions. For example, returned checks, differences in cash letters, items entered for collection, etc., are frequently outstanding in the account reconciliation because of time in transit of advices on such items.

A few major points covering internal controls over the due from bank accounts are emphasized by the following questions:

1. Are the functions of draft issuance, register maintenance and reconciliation divided among different employees?
2. Are records of account reconcilements safeguarded against alteration?
3. Are details of account reconcilements carefully reviewed and approved by an officer or supervisory employee?
4. Are confirmation requests of depository banks, supervisory examiners, etc., handled by an employee other than the account reconciler?

The audit objective for due from bank accounts is to establish that the account balances represent bona fide balances withdrawable upon demand by the bank. The audit procedures for due from bank accounts principally involve ledger and statement balance reconcilement and confirmation with depository institutions. The CPA should prepare reconcilements (or should examine reconcilements prepared by bank personnel) of balances on deposit with other banks, including the Federal Reserve Bank, with statements received directly from such institutions.

Confirmation of balances shown by such statements should also be obtained. The CPA's standard form for requesting confirmation of bank balances can usually be used for this purpose. Statements of account for five or more business days subsequent to and beginning with the audit date should be obtained directly from the depository banks. These statements will facilitate checking out the open items in the reconcilement. Canceled checks and drafts for a selected period of time should be compared with the records of instruments issued, and test checks should be made of footings of the records of issuances. At the start of the audit the CPA should determine the last issued serial numbers of drafts, by inspection of the working supply and tracing such numbers to applicable outstanding lists of drafts.

Chapter 21

Investment Securities

Reference is made to the opening paragraph of Chapter 20 for an explanation of the applicability of, and limitations in, the comments in this Chapter.

Bank-owned securities are recorded in a securities ledger. The ledger generally shows segregation of U.S. Government obligations, obligations of states, counties and municipalities, and other securities owned by the bank, including Federal Reserve Bank stock and investments in subsidiary companies. A further segregation is required if the bank maintains a trading portfolio. Ordinarily, each issue held is reflected on an individual ledger sheet to facilitate accounting control and counting. The ledger sheets are columnarized to provide pertinent data as to cost, premiums and discounts and the periodic amortization thereof, and the proceeds of sales, exchanges or redemptions.

Normally, a bank's securities will be partly on hand and partly on deposit elsewhere. Those on hand will be physically segregated in the vault from those held as collateral, in trust accounts, and in safekeeping under the dual control of the vault custodian and an investment officer. Investments not on hand fall into the categories of (1) securities pledged with or held in safekeeping by the Federal Reserve Bank, (2) securities held in safekeeping by correspondent banks, (3) securities pledged with other banks or the state (or political subdivisions thereof) to secure public deposits, trust functions, etc., and (4) securities loaned to others. Generally, transactions in the investment portfolio require the approval of the bank's investment officer or investment committee; in most cases, ratification of the purchase and sale of

investment securities is reflected in the minutes of the Board of Directors or its committees.

The internal control considerations with respect to investment securities include the following:

1. Are security purchases, exchanges and sales ratified by Board of Directors or investment committee action and made a matter of record in the minutes?
2. Does the Board of Directors receive regular reports on investment securities showing such data as valuations, maturity distributions, average yield, etc.?
3. Are accounting entry tickets prepared by an employee who does not execute or authorize security transactions?
4. Are accounting entry tickets compared with supporting data and initialed as approved by an officer or supervisory employee before posting?
5. Is the investment security subsidiary ledger balanced with reasonable frequency by an employee independent of this accounting function?
6. Are securities on hand kept under dual control?
7. Are securities held in the bank's own vault physically inspected and checked to the records at regular intervals?
8. Are investment securities on hand physically segregated from collateral, safekeeping, and trust securities and are they under physical control of individuals other than those controlling collateral, safekeeping and trust securities?
9. Is there independent check to assure that (a) cash or credit from agency bank is received for securities delivered and (b) securities are received for cash disbursed or credit given to agency bank?

The audit objectives with respect to a bank's investments are to establish the existence of the investments and to substantiate their valuation. As with any highly negotiable asset, the audit procedures must provide for adequate control of the securities until all securities have been accounted for by inspection or otherwise. The audit also includes procedures for balancing, con-

firmation and miscellaneous other procedures. Noted below is a brief summary of suggested audit procedures:

Upon commencement of the audit, control should be established over the securities and should be continued until the individual securities have been examined and reconciled to the securities ledgers.

The securities ledgers should be recapped and totals traced to the general ledger.

Confirmations should be obtained from custodians of securities which are held elsewhere.

In addition, the entries recorded in the investment ledgers should be checked on a test basis by reference to the underlying documentary evidence. The accounting followed in recording premium and discount, interest, and profits and losses on securities should be determined and tested to the extent deemed necessary. A review should be made to ascertain that recognition has been made by the bank of the Federal income tax aspects of security transactions, especially as they relate to gains and losses on securities, Government bond exchanges and bond discount amortization. Market values of the individual security issues should be obtained from published sources or other independent sources (such as municipal bond dealers); it is desirable, but not mandatory, that the total market value of the portfolio be shown parenthetically or by footnote in the statement of condition.

Chapter 22

Loans and Discounts

Reference is made to the opening paragraph of Chapter 20 for an explanation of the applicability of, and limitations in, the comments in this Chapter.

Loans and discounts can be separated into four general classifications, namely, real estate mortgage, time and demand (commercial), installment credit, and Federal funds sold (that is, overnight loans to other banks of a portion of the bank's reserve account with the Federal Reserve Bank). Time and demand loans and installment credit loans can be further classified as secured (that is, collateralized) or unsecured. In addition to direct loans to customers, a bank may have loan participations, that is, loans or portions of loans which it has purchased from other banks. Conversely, of course, it may have sold to (or participated to) another bank all or portions of its own direct loans. The auditing procedures relating to participations are similar to those relating to direct loans, except that where the bank participates in loans of other banks, the requests for confirmation of balances and collateral, if any, are sent to such other banks and where other banks are participating, they are requested to confirm the amounts of such participations. The account description, internal control, and auditing procedures applicable to each of the aforementioned classifications of loans are discussed below. (Also classified as loans in accordance with instructions of the regulatory authorities are securities purchased by banks under agreements to resell, at the banks' option, at specified prices and dates. However, since the internal controls and audit procedures applicable to such assets are substantially the same as

those applicable to investment securities, this type of loan is not discussed separately below.)

Real Estate Mortgage Loans

Real estate mortgage loans are usually subdivided into three groups, conventional, F.H.A. insured, and V.A. ("G.I.") loans. Loans are secured by first mortgage liens on commercial and residential improved property. Repayment terms are customarily based on level semi-annual, quarterly, or monthly payment amortization schedules of principal and interest. Frequently the periodic payments will include deposits for payment of insurance and real estate taxes. Such amounts are termed "escrow deposits" and are ordinarily required in the case of F.H.A. and V.A. loans.

In addition, banks may grant loans to finance the construction of property. Such loans are also secured by first mortgage liens and are usually subject to refinancing upon completion of construction.

Mortgage loans may originate on a direct basis with bank customers or by purchase from others (often these are mortgage banking companies). Similarly, mortgage payments may be made directly to the bank by mortgagors, or may be collected for the account of the bank by a servicing agent who usually is the original seller of the mortgage to the bank.

Generally, an individual mortgage loan record is maintained for each mortgagor. In addition to the unpaid mortgage principal balance, other pertinent information is recorded, including escrow fund balances. Many banks do not record principal payments on the mortgage notes so that the ledger cards are the principal records showing the mortgage balances. Some banks maintain the amortization schedules on a current basis to facilitate principal and interest allocations on loan payments.

If mortgage loan ledger cards are utilized, they usually are maintained in a separate real estate loan department, although if the volume is small, the commercial loan department may assume this function. Mortgage loans are supported by certain documentation, the extent of which largely depends upon the the requirements of local law.

Customarily a mortgage document folder is maintained for each loan. These folders are filed in a vault or fire-proof storage

file. The basic documents may include but are not necessarily limited to:

1. Note, representing evidence of debt.
2. Mortgage, representing the collateral security for the loan. Evidence of recording is shown on the mortgage as indication of its priority as a lien against the property.
3. Assignment, where the bank has purchased the mortgage loan from a prior mortgagee; these assignments generally must be recorded.
4. Title policy or certificate of title, in support of the bank's lien against the property.
5. Appraisal, made either by the bank's own appraisers or by independent appraisers, engaged by the bank, or, in the case of purchased mortgages, by appraisers employed or engaged by former owners of the mortgages.
6. Fire insurance policies, including extended coverage and mortgagee clauses. The bank will usually maintain a separate tickler file of insurance policies, arranged in expiration date order.
7. Federal Housing Administration and Veterans Administration guarantees. The former is usually endorsed on the bond while the latter is a separate document.
8. Documents required under state statutes.
9. Property tax receipts.

The processing of mortgage loan payments is usually performed by employees who are not involved in posting loan records. Sometimes a particular teller is designated for this purpose or all tellers may accept mortgage payments and evidence of these transactions is summarized in the proof department for subsequent posting to the mortgage ledger records.

Some basic points of internal control relating to real estate mortgage loans are summarized in the following questions:

1. Are approvals of new loans recorded in the minutes of the Board of Directors or applicable committee thereof and, in

the case of F.H.A. and V.A. mortgages, are the requirements of those agencies being observed?

2. Are prescribed procedures being followed in the appraisal of mortgaged property?
3. Are appraisals made by individuals not responsible for approving loans?
4. If outside appraisers are engaged, are they compensated on a basis not predicated on appraised value of property?
5. Are the functions of receiving and processing loan payments and of posting mortgage records performed by different employees?
6. Are adequate controls maintained over accrued interest and escrow accounts?
7. Are reasonably frequent trial balances prepared and reconciled with controlling accounts by employees who do not process or record mortgage loan transactions?
8. Are adequate safeguards in effect for physical protection of notes and supporting documents?
9. Are statements and delinquent notices mailed independently?
10. Where loans are serviced by others, are periodic tests made by bank representatives of the records and controls of the servicing agents?
11. Are real estate taxes being currently paid?

In developing an audit program for real estate mortgage loans, the audit objectives are to establish the validity of the loan and to determine that the balance is correct as of the audit date, that the procedures in effect are adequate and are being properly followed and that the loans are collectible and properly secured.

The major audit procedures would include examination of notes, balancing of subsidiary records, confirming of loan balances with mortgagors (for examples of confirmation request forms, see Appendix C), ascertaining the presence of the nec-

essary mortgage documents to insure protection of the bank's lien, and reviewing mortgage lending policies to determine the adequacy of the underlying security for the loans. Frequently the examination of mortgage documents is limited to new mortgages since the date of the last examination, supplemented by limited tests of documents relating to old mortgages. Where mortgage loans are serviced by others, it is usually impracticable to request the mortgagors to confirm their balances; in such instances, confirmations should be obtained from the servicing agents. In addition, where the amount of serviced loans is relatively material, the CPA may wish to make a survey of the records and procedures of the servicing agents or alternatively to review the results of similar surveys made at periodic intervals by representatives of the bank. In this connection the CPA should determine whether the servicer participates in a "single audit" program and, if so, he should review the report received by the bank in connection therewith. In the event that any mortgage documents selected for examination are held by servicing agents or others, the holders should be requested to confirm that fact and the pertinent provisions of the documents. Under certain circumstances, the CPA may wish to examine these documents held by others, in lieu of, or in addition to, obtaining confirmations.

In addition to the foregoing, a review should be made of the bank's procedures followed in determining that adequate insurance coverage is carried against fire and other hazards, that real estate taxes are currently paid, and that the properties are in reasonably good repair.

It is also desirable at the time mortgage loans are being examined to list unexpended balances of escrow deposits for real estate taxes and insurance premiums. It is desirable to confirm these deposits and undisbursed construction fund balances along with mortgage loan balances. When the bank does not furnish the mortgagors with regular statements of escrow balances, confirmation of the specific balances thereof will not be feasible; however, confirmation of the last reported balance and number of payments thereafter can be obtained. In addition, a test review of the activity of the accounts and vouching of selected disbursements may be desirable.

Installment Loans

Installment loans (also called personal loans or consumer loans) originate from two sources—individual bank customers (direct paper) and dealer customers (indirect paper). Some banks follow the practice of including other business term loans payable in installments in this classification.

Where the credit advance originates with an appliance or automobile dealer, the transaction customarily gives rise to a conditional sales contract discounted with the bank and usually without recourse. The bank generally achieves some protection through a dealer "hold-back" account or "dealer reserve" account established by retaining a portion of the purchase price of the paper. Dealer reserves may be charged with the balance of delinquent contracts depending upon the agreement entered into with the dealer. Banks purchasing dealer paper customarily extend their operations to floor plan financing of dealers' inventories. These loans have a single date maturity with or without renewal option and agreed principal reduction. As items are sold from inventory, curtailments are required.

Installment loans are normally made on a discounted basis. 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 in equal monthly amounts with maturities depending on the nature of the loan.

Each installment loan is recorded on a separate subsidiary record. In addition to borrower information, the card usually shows the amount of the original loan, total discount and other charges, monthly payment due, and the current unpaid balance. If collateral security has been supplied, its description is also recorded. The collateral, the majority of which is non-negotiable, is placed in the vault with conditional sales contracts and notes. Ledger cards are serially numbered to correspond with the notes and contracts purchased. Separate files are also maintained of borrower applications for personal loans and of credit information concerning individuals or dealers from whom the bank has purchased paper, and a cross-reference index file is usually maintained by name of borrower indicating the serial numbers of loans advanced which may be outstanding.

Various methods of posting ledger cards are used, the majority

of which involve mechanized accounting equipment. It is not the general practice to post payments on the notes or conditional sales contracts. Many banks use coupon payment books which permit all tellers to accept installment loan payments in the form of coupons; these are assembled in the proof department for posting to the ledger cards, frequently on the day following the transactions.

Discount on installment loans is normally credited to a deferred income account, unearned discount. Transfers to realized earnings are made in accordance with the method of accounting followed. Many banks take up such income in the "rule of 78ths" method (sum of the months digits). Rebates are charged to the deferred income account when loans are repaid ahead of schedule, often resulting from refinancing the loan.

Some important questions in the evaluation of the system of internal control relating to installment credit loans are:

1. Are reports of all new loans (individually or appropriately summarized) regularly reviewed by the Board of Directors or a committee thereof?

2. Are the three functions–loan approval, disbursement and collection, and ledger posting performed by different employees?

3. Are disbursements of loan proceeds by check only?

4. Are new payment books, when utilized, mailed to borrowers by employees who perform none of the functions referred to above?

5. Are reasonably frequent ledger trial balances prepared and reconciled with controlling accounts by employees who do not process or record installment loan transactions?

6. Are amounts of discount, credit life insurance, dealer reserves on new loans and of rebates on prepaid loans recomputed by a second employee?

7. Are collection procedures effective; is the charge-off policy realistic; and is there control over loans written off?

8. Are late charges, extension fees, and the proceeds of repossessed chattels properly accounted for?

9. Is an adequate chattel inspection program in effect for floor plan financing?
10. Are adequate safeguards in effect for physical protection of notes and supporting documents?
11. Are statements and delinquent notices mailed independently?
12. Are loan limitation levels appropriate?
13. Are statements of dealer reserve accounts sent regularly?

Generally, the auditing objectives for installment credit loans are similar to those applicable to real estate mortgage loans. (See page 116.) Listings of the various subclassifications should be prepared and totals compared with control accounts. Notes on hand should be examined on a test basis. A representative number of loans should be selected for confirmation by direct communication with borrowers. (Since the borrower frequently does not know the amount of his unpaid principal balance, it is frequently preferable to request the borrower to confirm the amount of each monthly payment and the number of payments remaining. An illustrative form of positive confirmation request appears as Example 3 in Appendix C, page 166 which also mentions negative forms of requests.) Negotiable collateral should be examined. Non-negotiable collateral should be test examined to ascertain its overall condition. Due to their tendency to be uniform in amount, installment loans can be evaluated on an overall basis. Lending policies, delinquency, loss experience, financial strength of dealers are some of the important factors to be considered in evaluating the adequacy of the related reserve account balance.

Time and Demand Loans (Commercial)

The chief characteristics of these advances are that they are loans made in relatively large amounts to commercial borrowers or to individual customers of recognized credit standing. Most are single payment obligations although some are term loans repayable in monthly or periodic principal installments plus interest. Loans are made on the basis of the financial responsibility of the maker or endorser of the instruments. Loans may be

on an unsecured basis or fully or partially secured by pledging of collateral. Such collateral may consist of securities of various types, warehouse receipts, accounts receivable, etc. Each loan is directly, or indirectly approved by the Board of Directors; directly, by formal resolution in the minutes; indirectly, by periodic inspection and ratification of lists of new loans submitted for Board review.

The general ledger loan account balances are supported by notes, which may or may not have partial payments endorsed thereon, and by loan cards which reflect the loan balance and the status of pledged collateral. When the collateral loan has been paid or where withdrawals or substitutions of collateral are permitted, the borrower acknowledges the release of the securities or other collateral by initialing the collateral card or by signing a separate receipt. In addition, a ledger sheet is prepared for each borrower, on which are shown the daily transactions and the cumulative totals with respect to all types of liabilities the borrower has incurred, including direct and indirect liability as maker, endorser, or guarantor; hence, the name, "liability ledger." The individual columnar totals for a particular type of loan agree with the general ledger control amount. Each individual liability ledger sheet shows the borrower's total liability (except for mortgage and installment credit loans) analyzed by type of indebtedness.

Where loan cards are not used, partial payments are endorsed directly on the notes; conversely, where loan cards are used, such payments may be reflected only on the loan card so that the notes themselves merely evidence the original debt and cannot be tied in to the general ledger balance.

Demand notes are usually filed alphabetically, while time notes are ordinarily arranged in maturity date order. In either case, a further breakdown is often made between types of secured and unsecured indebtedness.

In order to provide the bank officials with sufficient information to extend credit initially and to review such extension periodically, a credit file is maintained for each borrower. This file, at least for borrowers to whom credit is extended on an unsecured basis, usually contains financial statements of the borrower, memoranda regarding the borrower's financial or personal status; financial statements of guarantors (individual or cor-

porate), copies of supplementary agreements between the bank and the borrower, and other correspondence and memoranda applicable to the particular borrower. In the case of borrowers whose loans are secured, the credit file information may be quite meager.

Some general questions relating to the internal controls over time and demand loans include the following:

1. Are the three functions of loan approval, disbursements and collection, and liability ledger posting performed respectively by different employees?
2. Does the function of note processing (disbursement and collection) include:
   a) Recheck of interest, discount, and maturity date computations?
   b) Re-examination of notes for proper execution, and for follow-up on receipt of all required supporting papers (such as, corporate resolutions)?
   c) Re-examination of collateral items for negotiability, proper assignment, completeness, etc.?
3. Is a daily record maintained summarizing note transaction details, i.e., loans made, loans paid, interest collections, etc., to support applicable general ledger account entries?
4. Are the functions of receiving and releasing collateral to borrowers and of making entries in the collateral register performed respectively by different employees?
5. Are notes, negotiable collateral, and valuable papers adequately safeguarded at all times?
6. Are reasonably frequent note and liability ledger trial balances prepared and reconciled with controlling accounts by employees who do not process or record loan transactions?
7. Are loan limitation levels appropriate as to both (a) the loan approval authority of officers in relation to their position in the bank and (b) the character of the lines of credit granted to borrowers in relation to their demonstrated credit-worthiness?

The auditing objectives in the examination of time and de-

mand loans are quite similar to those for other loan classifications. The auditing procedures, accordingly, include inspection of loan notes, collateral, and other documents; proving agreement of the detail with the controls; obtaining confirmation of loan balances and related collateral, if any; and evaluation of collectibility. (See Appendix C for examples of loan confirmation request forms.) In examining time and demand loans, in comparison with other types of loans, more attention is required in the evaluation of the loans.

The condition of the unsecured loans and adequacy of collateral to the secured loans should be reviewed and an estimate made of the amount of collection losses that may be sustained.

In connection with the review of unsecured loans and irrevocable loan commitments, the credit files should be reviewed with particular attention directed to the adequacy of required documentation.

All loans to officers, directors, and employees (and loans to organizations with which such individuals are affiliated) should be reviewed. The liability ledger should be reviewed to determine that no loans to any one borrower are in excess of either the legal or management's limit. Stocks, bonds, insurance policies and other forms of collateral should be examined to determine proper registration, negotiability, etc., and should be priced at current values to determine their adequacy in relation to the loans secured.

As loans and discounts frequently constitute the largest single asset of a bank's statement of condition, some additional comment on loan evaluation is appropriate. As indicated in the preceding paragraphs, evaluation is a matter of determining loan collectibility—will the loan be repaid in the normal course of business? The answer depends on the borrower's financial ability and credit history, the realizable value of loan collateral pledged as security, and the financial responsibility of endorsers or guarantors. Sometimes a combination of these factors determines the soundness of a particular loan. Often one factor alone will permit a conclusion.

From a practical standpoint the CPA, except in very unusual circumstances, would not be required to ascertain the collectibility of each individual loan. His procedures are concerned with determining the overall collectibility of the entire loan port-

folio. Thus, loans would be selected for evaluation on a test basis with due consideration given to larger amounts and considerable weight assigned to lending policies and procedures. In the case of real estate mortgage and installment loans, certain common characteristics such as type of collateral, customary lending terms, range of amounts, etc., would warrant limitation in testing. Here the CPA would be more concerned with procedures rather than with an appraisal of a large number of individual loans. His testing should permit him to draw some overall conclusions on adherence to prescribed lending policies and procedures, and assuming satisfaction with the soundness of these practices, he can arrive at a determination on fair presentation of these loan classifications.

However, evaluation of time and demand (commercial) loans normally requires a more detailed review as amounts may be large and a relatively few marginal risks might have a significant effect on the fair presentation of loans and discounts as well as the statement of condition taken as a whole. The CPA might select for review all loans in excess of a certain amount and a limited number of those of smaller amounts. However, the total dollar amount of loans reviewed, expressed as a percentage of the loan portfolio, cannot be specified with any degree of uniformity. A number of factors must be considered in each individual situation, such as, the extent of delinquent loans, local and general business conditions, past loss experience, bank lending policies, etc.

The principal objective of the detailed review is to identify loans that have more than normal elements of risk. Some of the characteristics indicative of these conditions, of which some have already been mentioned in Chapter 17 are:

1. Excessive loan renewals and extensions.
2. Absence of current financial data.
3. Loans criticized by supervisory examiners.
4. Borrowers having record of operating losses, marginal working capital, inadequate cash flow, etc.
5. Borrowers experiencing business interruption or other difficulties, such as, labor problems, income tax controversies, stockholder dissension, legal actions, casualty losses, etc.

6. Lack of diversification in loan collateral, collateral not susceptible to a determination of realizable value, or collateral not readily marketable.

Through identification of unusual risk loans and their individual evaluation, the CPA can determine within reasonable limits what amount is required as a loan valuation reserve. That is, he can consider the more recent loss experience in relation to outstanding loans and establish a normal reserve requirement to which must be added the amount necessary to provide for possible losses on unusual risk loans. A determination of the adequacy of the valuation reserve in effect establishes the fair presentation of the loans and discounts. The CPA is not required to evaluate loans in the manner of a loan officer who might be asked to extend credit to an applicant for a loan; rather he is considering the loans in total and whether the statement of condition fairly presents their realizable value. Although, for purposes of expressing an opinion on the financial statements, the CPA is concerned only with the fairness of the amount at which the loans are stated in the aggregate, he may be required, under the regulations of some states relating to directors' examinations, to prepare a list of those loans in which more than a normal credit risk appears to exist. Where such requirements exist, his procedures regarding evaluation of credit risks may have to be extended.

Federal Funds Sold

A bank that is a member of the Federal Reserve System is required to maintain a legal reserve in a minimum amount computed by applying prescribed percentages to its various types of deposits. This legal reserve consists of funds on deposit in the bank's "reserve" account with a Federal Reserve Bank, together with currency and coin on hand. A non-member bank located outside a reserve city may, with appropriate permission, place its legal reserve funds on deposit with a member bank located in a reserve city.

When the balance in a member bank's reserve account with the Federal Reserve Bank is in excess of that required for legal reserve purposes, the bank may lend all or a portion of the

excess to another bank temporarily requiring additional funds in its legal reserve. These loans are generally repayable the following business day, although replacement loans are frequently made on such following day. The lending bank authorizes the Federal Reserve Bank to transfer the amount of the loan from its account with the Federal Reserve Bank to the borrowing bank's reserve account. On the following day the borrowing bank furnishes the Federal Reserve Bank with authorization to re-transfer the funds. The amount loaned is recorded as Federal Funds Sold by the lending bank, offsetting the credit in its accounts to its reserve account with the Federal Reserve Bank. In the borrowing bank's accounts, the transaction is classified as "Federal Funds Purchased" or "Federal Funds Borrowed."

As of any date, there are normally few, if any, individual loans included in Federal Funds Sold. The CPA's evaluation of the system of internal control should include consideration of the approvals required to effect transactions in Federal funds and the procedures followed to ascertain that balances are promptly settled.

The CPA's audit of Federal Funds Sold should consist of obtaining confirmations from the borrowing banks, ascertaining agreement of the aggregate of the individual loans with the general ledger control, and examining evidence of subsequent settlement.

Chapter 23

Bank Premises and Equipment

Reference is made to the opening paragraph of Chapter 20 for an explanation of the applicability of, and limitations in, the comments in this Chapter.

In the past, banks frequently have written off, written down or rapidly amortized buildings and equipment without regard to useful life. This practice was generally accepted within the banking industry and stemmed from the desire to remove items from the statement of condition which could not be readily converted into cash. Regulatory authorities also encouraged the practice. However, the practice has been dying out and, except for the remaining effect of past practice, most banks follow practices conforming for the most part with normal practices of other industries.

Subsidiary building and equipment records may provide detailed historical data as to acquisitions, individually and summarized by years. These records may indicate the periodic and cumulative depreciation and amortization charges taken for book purposes and, where such assets are stated on a basis other than that used for Federal income tax purposes, supplementary records may show the same data on a tax basis. Where the volume of transactions is limited, all this information may be recorded on informal working papers.

Depreciation and amortization are credited either to applicable reserve accounts or directly to the respective assets.

The internal control considerations, audit objectives and audit procedures are similar to those followed in other industries. Possible differences between banking practice and generally

accepted accounting principles for fixed assets require that particular attention be given to the propriety of asset bases as reflected by the books. This will require some additional work in investigation of prior years' accounting for additions, dispositions, depreciation and any other adjustments to carrying value. Review of tax returns, Revenue Agent adjustments and reports of supervisory examiners will be of assistance in this area, especially where the bank's fixed asset records are incomplete. On a recurring audit, tests normally are limited to the period since the date of the last audit, but consideration must be given to the current effects of prior years' accounting practices.

Chapter 24

Other Assets

Reference is made to the opening paragraph of Chapter 20 for an explanation of the applicability of, and limitations in, the comments in this Chapter.

The following accounts are among those frequently grouped together under the classification of other assets:

1. Accrued interest receivable
2. Accrued income receivable
3. Accounts receivable (deposits for special purposes, advances to trusts, etc.)
4. Prepaid expenses and deferred charges (insurance, taxes, F.D.I.C. assessments)
5. Suspense accounts (items recorded and held subject to clarification and transfer to proper account)
6. Other real estate owned (foreclosed property held pending disposition)

Generally, records kept for these accounts are similar to those of other business enterprises.

The principal internal control consideration is whether subsidiary accounting records and segregation of functional duties are adequate to permit proper accounting for these amounts.

The CPA in developing his audit program should consider a review of procedures followed, and test checks and other auditing procedures considered appropriate in the circumstances.

Chapter 25

Deposits

Reference is made to the opening paragraph of Chapter 20 for an explanation of the applicability of, and limitations in, the comments in this Chapter.

The two major classifications of deposits, demand and time, are sufficiently unique within themselves to be discussed separately.

Demand Deposits

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

Checking Accounts. Deposits subject to withdrawal on demand by check provide the greatest volume of activity and include a number of classifications, usually by type of depositor served, for control purposes. The primary control groupings are between individual deposits and all others. In the former category are deposits of individuals, partnerships, and corporations. In the case of individuals, there may be a subclassification between regular and special checking accounts. Where deposits are applicable to these three groups but are inactive, unidentifiable, or subject to withdrawal restrictions (such as a court order), they are usually under separate control.

In the "all other" category are public deposits, including states and political subdivisions thereof, deposits of the U.S. Government (Treasury tax and loan account), trust deposits, repre-

senting funds deposited by the bank's trust department, and deposits due to other banks, both domestic and foreign.

Periodic statements for the above accounts, together with canceled checks and credit and debit memos, are sent to depositors.

The account of each depositor is maintained by the bookkeeping department on a separate ledger card or on other recordkeeping media (as, for example, on magnetic tape where automatic data processing equipment is utilized).

The functions of the bookkeeping department are to receive from the proof department, sort and post to the ledgers the checks, deposit slips, and debit and credit advices applicable to each depositor's account.

In addition, the bookkeeping department ascertains on a limited basis that the posting media received are proper by signature verification, observation of endorsements, etc.

The posting to the accounts is performed either on the same day the items are received or on the following day on a delayed posting basis.

Any items determined to be improper, such as checks which are drawn on other banks, missorted, lacking endorsement, or subject to "stop payment" orders and items which, if charged, would create an unauthorized overdraft are rejected and disposed of in the following day's business (these items are sometimes called "holdovers" or "throw-outs").

The individual ledger sheet generally serves as the statement that is sent (usually monthly) to the depositor. If the single posting system is in effect, only one sheet is posted. Because it is mailed to the depositor together with paid checks and other items, the bank must either retain a carbon duplicate for its records or microfilm the statement before mailing it.

Under the dual posting system, transactions are posted on two different ledger sheets, usually by different bookkeepers. This system facilitates discovery of posting errors. One statement is sent to the depositor and the other is filed for reference. Under the single posting system the two statements are identical, one being a carbon copy of the other or a reproduction thereof.

Banks using automatic data processing equipment may either print-out a detailed statement of the transactions since the last statement date or print a stub statement. The stub statement

usually shows the previous balance, the total of transactions for the period, and the account balance as of the date of the statement.

Some significant questions relating to internal control over checking accounts are:

1. Are unposted "holdover" items, overdrafts and return items reviewed and approved daily by an officer or a supervisory employee?
2. Are ledger controls reconciled daily with applicable general ledger accounts and is a permanent record made of these reconcilements?
3. Are trial balances of ledgers taken at reasonable intervals by employees other than the regular bookkeepers?
4. Are adequate safeguards taken against loss, destruction, alteration, etc., of ledger cards, canceled checks, deposit tickets, and signature cards?
5. Are checking account statements regularly mailed or otherwise distributed to depositors?
6. Is statement mailing organized so that no employee can anticipate his assignment to a particular group of accounts?
7. Are "will call" statement files safeguarded against unauthorized access?
8. Does the bank employ any special safeguards in situations where officers or employees render outside services for depositors, e.g., church or school district treasurerships, accounting and bookkeeping services, etc.?
9. Are debit ticket charges to depositors' accounts reviewed and initial-approved by an officer prior to posting to the accounts?
10. Are dormant accounts defined as to period of inactivity, segregated from active ledgers, and placed under dual control?
11. Are signature cards with respect to dormant accounts also segregated and placed under dual control?
12. Are dormant account transactions reviewed and approved for regularity by an officer?

13. If the bank uses off-premises facilities (that is, computer or similar facilities of a service bureau, correspondent bank, or other organization) for its accounting, are there adequate internal controls exercised by the bank?

14. Do the procedures for handling closed accounts and employees' accounts appear to include appropriate safeguards?

In developing his audit procedures for checking accounts, the CPA should keep in mind that the primary objective is to determine the bank's liability for demand deposits. The principal procedures should include control over the ledgers, trial balancing of the ledgers and confirmation of individual account balances. (See Appendix C for a discussion of positive and negative confirmation request forms and for an example of a positive confirmation request form for a demand checking account.) The CPA should also give consideration to the controls and procedures applicable to service-bureau accounting in developing his program. In this respect, he should ascertain from the contract with the service bureau the responsibilities of the respective parties. He should also consider visiting the service-bureau to satisfy himself as to appropriate controls and should satisfy himself regarding the adequacy of the procedures followed by the bank to determine the financial responsibility of the service-bureau.

Immediately upon starting the audit, all ledgers should be placed under the CPA's audit control, and should remain under such control until the CPA has completed his tests of proving agreement of the detail with the related controls and has made his selection of accounts for confirmation. This will require some ingenuity in those audits which begin in the morning, to avoid interference with the normal bank operations. Loss of control can negate much of the surprise element of the audit.

Agreement of deposit ledgers with the general ledger balances should be proved. Assistance of bank employees under the CPA's supervision and control should be utilized for this function when available. Obviously when bank employees are so used they should be assigned to assist in areas other than those in which they are regularly assigned. For example, a deposit ledger bookkeeper should not be used to prove depositors' ledgers. If this approach is used, the CPA must test the accuracy

of the listings, footings, and reconcilement to the general ledger.

Investigation of differences between detail and control balances may be performed by bank employees provided adequate explanations, properly documented, are furnished to the CPA. Some of the items of particular concern are return items, hold-overs in department, overdrafts and service charges. These items should be traced to subsequent disposition or proper approvals.

Regarding confirmation requests, customers obviously must be furnished with a statement and cancelled checks as of the date as of which confirmations are requested. In this connection, reference should be made to the discussion on page 95 and to Appendix C.

Sometimes it is practicable to request confirmations as of a nearby cycle date or month-end. In such cases, tests should be made of the agreement of detail balances with the general ledger control as of such confirmation date; some comparisons should also be made of balances as of the confirmation date with balances as of the audit date.

The extent and type (positive or negative) of confirmations and method of selection are usually left to the CPA's discretion, although under certain circumstances he may be bound by regulatory requirements.

Confirmations should include a sample of dormant accounts and zero balance accounts (those closed during the period under review). Confirmations may be prepared by bank personnel if proper control and supervision are exercised by the CPA.

The CPA should ascertain whether the bank wishes to review the confirmation requests before they are mailed. The CPA should maintain control over the confirmation requests during the review process. The bank should provide adequate reasons in the event there are requests which it does not want the CPA to mail. Such accounts should receive the same attention by the CPA as accounts for which requests are returned undelivered by the postal authorities.

Careful attention should be given to confirmation replies. In addition to properly executed confirmatory replies received directly by the CPA, the following types of replies will also generally be encountered and should be provided for in the audit program:

1. Bearing signature of someone other than addressee.	Should be remailed with request for authorized signature.
2. Bearing no signature.	Should be remailed with request for authorized signature.
3. Wherein the customer indicates that he is unable to confirm.	Ascertain reason, where appropriate.
4. Returned as undelivered by post office.	Find new address if possible.
5. Returned through bank personnel (either directly or by mail).	Request competent bank employee not involved in the receipt of the confirmation to examine signature to determine its validity.

In the case of non-replies to requests for positive confirmations, it is customary to send second requests after an appropriate period. Naturally, the requests should be mailed in the CPA's envelopes so that undelivered confirmations will be returned to him.

Many internal auditors of banks, in connection with their own audits, compare the signatures on the confirmations received with the authorized signatures in the bank's files to determine that the individual signing the confirmation is authorized to sign on the account. The CPA should not include similar procedures for "signature verification" in his audit. Not only are his usual procedures (mailing confirmation requests in his own envelopes, having replies mailed directly to him, etc.) considered adequate for his purposes, but he should not assume responsibility for competence in "verifying signatures." Should the client wish "signature verification" to be a part of the audit, arrangements should be made to have responsible bank personnel perform this function, with the client fully aware that the CPA is taking no responsibility for this operation.

In circumstances where the CPA can place little reliance on internal controls, a suppression test may be performed to determine that all accounts are available for examination. A trial balance dated prior to the audit would be obtained. On a test

basis the CPA would determine that certain accounts are still in the active file at audit date or have been properly closed.

A review for uncollected funds and kiting should be made to determine that the bank has adequate procedures (including production and appropriate review of listings where EDP equipment is used) to safeguard against payment of uncollected funds and subsequent loss therefrom, and that these procedures are being followed.

Closed accounts should be reviewed to determine that they were closed by bona fide transactions and were reported to bank officers.

Accounts of officers and employees (and those of organizations with which such individuals are affiliated) should be reviewed for unusual transactions and entries which are large in relationship to salary levels. Such transactions should be traced to supporting documents. Any unusual findings should be reported to management or the Board of Directors as appropriate.

The CPA may wish to test service charges arising within the demand deposit department in conjunction with his other tests of the deposit accounts.

Official (or treasurer's or officers') Checks, Demand Certificates of Deposits and Escrow Deposits. The accounting for outstanding official checks is usually done by the general ledger bookkeeper. Banks may issue checks drawn upon themselves for a variety of purposes, such as expense disbursements, loan disbursements, dividend payments, withdrawal of account balances, and exchange for cash with customers. Some of the names used for bank checks include official, cashiers, treasurers, expense and loan disbursement checks, and money orders. Certified checks (i.e., depositor's checks presented for certification), after the depositor's account has been charged and the bank's liability set up, are handled in a similar manner. A separate series of checks and general ledger control account may be maintained for each type of disbursement.

When a bank draws a check on itself or certifies a customer's check it reflects a liability for outstanding checks upon its books but does not reduce cash until such time as the check has been actually paid. As checks are issued or certified for customers they are recorded in a check register which may take the form

of a numerical file of duplicate check copies. As the items are paid they are checked off in the register (or the duplicate copy is pulled). The total of all open items in the register should at all times agree with the general ledger balances for the bank's liability for outstanding checks.

Demand certificates of deposit, which may be negotiable or non-negotiable, are non-interest-bearing, and must be surrendered at time of demand for payment. Registers or prenumbered certificate books are maintained, showing the depositor, the identifying number, amount of each certificate held by depositors, and date of payment. Separate listings may also be maintained wherein the certificates are listed in numerical sequence for control purposes.

Deposits securing loans or deposits which are subject to escrow or other withdrawal restrictions, such as deposits representing funds withdrawable only upon presentation of drafts drawn under commercial or travelers' letters of credit, etc., may be separately grouped.

The principal questions relating to internal control over these items are:

1. Are checks prenumbered and controlled?

2. Are checks issued for exchange centered in one cage?

3. Is there appropriate centralization of the check issuance function?

4. Are two signatures required on checks issued and are persons receiving cash not permitted to sign?

5. Are reconciliations prepared by persons independent of issuer?

The audit objective is to determine the extent of the bank's liability for these items.

Lists should be prepared of outstanding items. Canceled certificates and checks for a selected period should be compared with records of items issued as to all details for apparent propriety. Particular attention should be given to items drawn to employees, cash, etc. Items paid during the first several days following the date of audit should be intercepted by the CPA to

ascertain their propriety and to determine that those dated prior to audit date appear as outstanding.

Outstanding non-negotiable certificates of deposit and escrow deposits susceptible of confirmation (as described in Chapter 22) should be confirmed on a test basis.

Time Deposits

Time deposits, which may bear interest, generally consist of savings accounts, time certificates of deposit, commercial and public fund time deposits—open accounts and Christmas and other club accounts. (Time deposits may also include escrow deposits, which have been discussed above in connection with demand escrow deposits.)

Savings Accounts. The tellers of the savings department generally follow the same procedures in accounting for cash as do the commercial tellers; however, the mechanics of the transactions and the scope of their duties usually differ.

When a savings account is opened, most banks provide the depositor with a passbook which becomes his record of deposits, withdrawals, interest and account balance. (There has been a growing tendency, however, probably stimulated by the greater use of computers, for banks to dispense with passbooks and provide savings account depositors with periodic statements.) Usually the bank's rules and regulations affecting the conduct, use and privileges of savings accounts are also shown in the passbook. The passbook usually is presented each time a deposit or withdrawal is made.

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, automatic data processing (including on-line-real-time-OLRT Systems) is being utilized more and more for savings accounts systems. When accepting a deposit, the teller usually compares the name on the deposit slip with the name on the accompanying passbook, verifies the cash, and sees that all items (cash and checks) are listed and totaled. If the system in use provides for simultaneous posting of passbook and ledgers, the teller next selects the proper ledger card, compares the passbook

to the ledger card to determine if there are any transactions or interest credits on the ledger card which have not been entered in the passbook. If the passbook and ledger card agree, the teller places both in the machine and makes the entry for the deposit. When the passbook is not up to date, the teller supplies the missing entries before posting the deposit. The machine prints the deposit and resulting balance on both the ledger card and book simultaneously, and, in addition, records the transaction on a locked tape which is frequently under the internal auditor's control.

In case of a withdrawal, usually both the ledger card and passbook are posted to record the withdrawal, the procedure being the same as that for recording a deposit, except that, in addition, the signature on the withdrawal slip is compared with the signature card. Further consideration should be given to control features in the system where withdrawals are made without presentation of the passbook.

The transactions for the day are usually summarized on a proof sheet or teller's blotter. Checks received are forwarded to the proof department where they are processed for collection.

Methods of computing interest and periods used for compounding vary from bank to bank. The methods currently in use vary from a policy which requires that amounts must 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.

Regulations of state and Federal authorities define the various categories of time deposits and from whom they may be accepted, govern interest rates that may be paid, and specify the reserve requirements which must be maintained against deposit balances. One of the most important regulations in this respect is Regulation Q of the Board of Governors of the Federal Reserve System. While this regulation sets maximum interest rates, it also recognizes the rate limitation set by each individual state for its local banks if lower, and applies the state limitation to all banks within its jurisdiction in the state.

The classification of dormant accounts also varies. Many banks classify accounts as dormant when they have been inactive for three years. If a bank's policy is to permit accounts to remain inactive substantially longer than such period without classifying them as dormant, particular attention should be given by the

CPA to the internal controls over the relatively inactive accounts included among the active accounts. The ledger cards and signature cards for dormant accounts are preferably kept under the control of an individual disassociated from the teller and bookkeeping functions relating to savings accounts in order to prevent unauthorized withdrawals by tellers or other individuals familiar with account activity. Frequently a dual control over such ledger cards is maintained by the internal auditor

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, the passbook is perforated in a canceling machine and returned to the customer, although it is common practice in some banks to hold the passbook pending scrutiny of closed accounts by the internal auditor.

Some of the internal control questions related to the time deposit system for savings accounts are as follows:

1. Are customary control procedures followed in the use of window-posting equipment under the unit-posting plan?
2. If dual-posting plan is used, are bookkeeping duties performed by an employee who does not also act as a teller?
3. Is an independent proof made daily of total deposits, total withdrawals, and net changes in balances of activated ledger accounts?
4. Is accountability exercised over unissued passbooks and other means taken to safeguard against suppression of new accounts, i.e., accepting a new account deposit without making a ledger entry?
5. Are adequate safeguards taken against loss, destruction, alteration, etc., of ledger accounts, withdrawal and deposit tickets, and signature cards?
6. Are large cash withdrawals and withdrawals without passbook referred to an officer for prior approval before disbursement?
7. Are trial balances of ledger units taken at reasonable intervals by employees other than savings tellers?

8. Are dormant accounts defined as to period of inactivity and segregated from active ledgers?
9. Are dormant account transactions reviewed and approved for regularity by an officer?
10. Are ledger cards appropriately noted when accounts are pledged as collateral to loans?

The audit objective for savings accounts is similar to that of demand deposits, as are the principal audit procedures of controlling the ledgers, trial balancing of ledgers and confirmation of individual accounts. (Reference is made to Appendix C for further comments on confirmation procedures and an example of a positive request for confirmation.) In addition to the procedures which were discussed in detail in the section on demand deposits, the following audit procedures are appropriate.

As a further means of confirming balances, and possibly more importantly, of testing the completeness of the bank's records (that is, of ascertaining that all open accounts are included in the bank's records), the CPA can inspect and compare with the records, on a test basis, passbooks presented at tellers' windows during the period that the CPA is in the bank making his audit.

The bank's policy for segregating and controlling dormant accounts should be reviewed and evaluated. Consideration should be given to checking compliance with State escheat laws. Active ledger cards can be reviewed to determine that the bank's policy is reasonable and that segregation of dormant accounts is being performed on a current basis. As with checking accounts discussed above, where little reliance can be placed on internal controls, a suppression test can be performed to determine that all accounts are available for examination.

Time Certificates of Deposit, Commercial and Public-fund Time Deposits and Club Accounts. Time certificates of deposit are similar to demand certificates of deposit, except that maturity is fixed and they usually are interest-bearing.

Interest-bearing savings accounts which are freely withdrawable are generally limited to individuals or non-profit organiza-

tions. Corporate or other business-type depositors may usually hold interest-bearing deposits only where a definite maturity or other limitations on free withdrawal are in effect, such as time certificates of deposit, noted above, or commercial time deposits-open account. Generally, a detailed ledger card is the accounting record, supported by an agreement with the depositor.

Club accounts are savings plans whereby the depositor makes periodic, usually weekly, payments. Coupon books are frequently issued to the depositor and a coupon accompanies each payment. These coupons may be accumulated by the bank to provide, in effect, a detail control over amounts due depositors. Otherwise, detail ledger cards are used.

Some internal control questions relating to time certificates of deposit would be:

1. Are certificates prenumbered, and the issuing function separated from the receipt of cash?
2. If tellers initiate certificates, are they signed by an officer?
3. Is there a procedure with respect to defacing and checking upon payment?

Internal control questions relating to club accounts would be:

4. Are checks disbursed by someone other than tellers?
5. Who prepares reconciliation of such checks, and does it include comparison with the original source?
6. What disposition is made of checks long outstanding or returned as undeliverable?
7. Are club coupons pre-numbered and is the sequence of numbers checked.

The audit objective is to determine the extent of the bank's liability for these items. Audit procedures may include the following steps:

Lists should be prepared of outstanding items. Canceled certificates for a selected period should be compared with records of items issued, noting carefully number, dates of issuance and payment, and payees. The canceled items should include those

received by the bank during the several days following the date of audit.

Outstanding certificates of deposit and time deposits-open accounts should be tested by circularization.

Chapter 26

Other Liabilities

Reference is made to the opening paragraph of Chapter 20 for an explanation of the applicability of, and limitations in, the comments in this Chapter.

The principal items usually encountered in this classification are:

1. Accounts payable
2. Accrued expenses
3. Accrued interest
4. Unearned income (discount)
5. Dividends payable
6. Federal funds purchased (that is, overnight borrowings from other banks of a portion of their reserve accounts with the Federal Reserve Bank. For further explanation, see discussion of Federal Funds Sold in Chapter 22.)
7. Federal income taxes

Internal control considerations, audit objectives, and appropriate auditing procedures relating to the miscellaneous liabilities of banks are similar to those of business organizations in general. Therefore, in accordance with the stated objectives of this Guide, they are not discussed herein.

Chapter 27

Capital Accounts

Reference is made to the opening paragraph of Chapter 20 for an explanation of the applicability of, and limitations in, the comments in this Chapter.

Capital Stock

In addition to common stock, banks may have preferred stock and capital notes and debentures outstanding. Smaller banks often act as transfer agents for their own stock. In larger institutions this service is usually performed by the bank's corporate trust department.

Surplus and Undivided Profits

There are specific statutory requirements pertaining to the bank's surplus, whether a state or national bank, and the CPA should familiarize himself with the applicable laws and regulations. The balance includes amounts paid in in excess of the par value of the capital stock, issued originally or in connection with subsequent sales of stock, amounts capitalized as stock dividends, etc., and statutorily required and other transfers from undivided profits.

At the end of each accounting period net earnings or losses are credited or charged to undivided profits. Transfers to and from reserve accounts, extraordinary charges or credits of substan-

tial amount, dividends declared, and transfers to surplus, are also charged or credited to undivided profits. Such entries should be approved by an official.

Internal control considerations, audit objectives and appropriate auditing procedures relating to the capital accounts of banks are similar to those of business organizations in general. Therefore, in accordance with the stated objectives of this Guide, they are not discussed herein.

Chapter 28

Income and Expense

Reference is made to the opening paragraph of Chapter 20 for an explanation of the applicability of, and limitations in, the comments in this Chapter.

These accounts accumulate income and expense for the current accounting period until such time as they are transferred to undivided profits.

The recording of income depends on the bank's accounting system and whether it operates on a cash, accrual, or semi-accrual basis. The investment security ledger, the daily loan journal sheet, and the mortgage register provide the basis for recording the majority of the bank's income.

The expense register, payroll and pension records, etc., used by a bank do not differ essentially from similar records maintained by other business organizations.

Income and expenses of special functions of the banks, such as trust and safe deposit activities, are usually accumulated on a departmental basis for daily or monthly posting.

Some pertinent questions relating to internal control are:

1. Does the bank have an income and expense budget? If so, do monthly operating statements show a comparison between budgeted and actual results and an explanation of the larger variances?

2. Are expenditures controlled through use of official expense checks with an appropriate system of expenditure authorizations and approvals?

3. Are subsidiary accounting records relating to major sources of income adequate to permit an audit of transactions as assurance of proper accounting for these amounts?

The audit objective is to determine that income earned and expenses incurred are recorded in the proper amounts.

The CPA should examine the income accounts in sufficient detail to satisfy himself that the income has been fairly presented in relation to the amount of loans and investments held for the period under review. In addition to overall tests applied to income accounts, such accounts should be reviewed by reference to bank policy for service charges, etc., and tests made by the CPA to support this information.

Expenses should be reviewed by reference to paid invoices, authorizations, etc. Payrolls should be tested by references to supporting documents for a period selected by the CPA. He should be satisfied that interest expense and depreciation are fairly stated in relation to, respectively, deposits and bank premises.

The provisions for Federal and state income taxes should be reviewed to determine not only their overall propriety, but also that the proper allocation has been made as to the amount applicable to operating earnings and the amount applicable to other transactions.

Chapter 29

Memorandum Accounts

Reference is made to the opening paragraph of Chapter 20 for an explanation of the applicability of, and limitations in, the comments in this Chapter.

In addition to the accounts previously discussed, which are reflected in the bank's statement of financial condition or in its statement of income, many banks carry memorandum accounts necessary to record other services rendered to customers. The more important of these accounts and the services to which they relate are discussed in the following paragraphs.

Most banks provide a service for their customers by collecting sight drafts, letters of credit, notes and similar items on their behalf. Few, if any, of such items are recorded in the bank's general records until ultimate collection.

Some banks render a special service to their customers by accepting from them securities and other valuables for safekeeping. Safekeeping should be distinguished from safe deposit activities, where only the customer has physical access to the items held in the bank's vault. (With respect to safe deposit activities, the CPA should review and evaluate the internal control procedures relating thereto.) In safekeeping, the bank is the only party with access to items held. A receipt for the items deposited is prepared in multiple form. The customer is given the original and a duplicate serves as a permanent record of the bank.

Other banks may use a safekeeping record which usually provides for the signature of the customer when the safekeeping

items are released to him. Safekeeping items are customarily kept in the vault of the bank under dual control. Normally, no general ledger account is maintained.

U. S. Savings Bonds, travelers' checks and letters of credit are often sold by banks. These items are consigned to the bank by the issuers. A record is usually kept of the respective denomination and serial numbers. Certain bank employees may have in their custody a small supply of these items for sale to customers. The reserve supply, however, should be held under dual control in the vault. The consigned amounts held are frequently set up in the general ledger in equal contra accounts which are eliminated in financial statement preparation.

Periodically, settlement is made for U.S. Savings Bonds sold and redeemed and for travelers' checks issued. Travelers' letters of credit are often collateralized by cash or by marketable securities.

Some questions relating to internal control over items coming within the memorandum account classification would be:

1. Are appropriate safeguards exercised over the custody and release of safekeeping items?

2. Are appropriate safeguards exercised for custody and issuance of U.S. Savings Bonds, travelers' checks and commercial and travelers' letters of credit?

3. Are unissued U.S. Savings Bonds, travelers' checks and travelers' letters of credit periodically confirmed with the issuer by someone not responsible for their custody, issuance and accounting?

Generally, the audit objective in connection with memorandum account items is to assure proper accountability at the audit date and consists of determining the adequacy of controls, and the non-existence of unrecorded liabilities. The auditing procedures involve principally (a) an inventory of consigned items and related confirmation with issuers, and (b) a review of details of transactions to provide assurance as to the absence of lapping collection items, etc.

Chapter 30

Minutes and Reports of Supervisory Authorities

Reference is made to the opening paragraph of Chapter 20 for an explanation of the applicability of, and limitations in, the comments in this Chapter.

Review of Minutes

Reference should be made to the minutes of meetings of the stockholders, the Board of Directors and the principal committees thereof, and to the bylaws, for authorizations of investment purchases and sales, loans approvals, transfers to surplus, dividend payments and for other resolutions which may affect the financial statements. The CPA should ascertain (a) that policies enunciated in the minutes have been followed and (b) that transactions which have been consummated which require authorization or approval have been so authorized or approved by the appropriate body.

Review of Reports of Supervisory Authorities

The most recent reports of supervisory authorities on their examinations should be requested and reviewed by the CPA. The purposes of such review are to ascertain:

1. Whether recommended adjustments in values, write-offs, etc., have been made;

2. Whether there are any operating procedures which have been criticized;

3. Whether there are any aspects of internal control and internal auditing which have been commented upon.

The CPA should then ascertain whether the reports have been presented to the Board of Directors and whether appropriate corrective action has been taken. If not, these matters should be discussed with management and, if appropriate, be included in one or more of the CPA's reports.

The reports of some of the supervisory authorities may not be released by the bank without the specific permission of such authorities; the CPA, however, as a representative of the Board of Directors, is ordinarily considered entitled to access to these reports for purposes of his audit.

Chapter 31

Trust Department

Reference is made to the opening paragraph of Chapter 20 for an explanation of the applicability of, and limitations in, the comments in this Chapter.

Trust activities, if provided, are normally performed (in accordance with regulatory intent) by a separate department of the bank, having only minimum contact with the commercial banking departments. Responsibility for holdings, accounting and administration are usually vested in individuals having no responsibility in the general banking area. Only at the very top executive level, such as in the persons of the president and the members of the board of directors, is the responsibility for both banking and trust activities vested in the same individuals. Trust services fall into two general categories—personal and corporate. However, as a practical matter, smaller banks generally limit their activities to personal trust services. Also frequently treated as trust services are a bank's services as custodian, where the bank holds a customer's investment portfolio, buys and sells investments on the customer's instructions, collects interest and dividends on the holdings, remits accumulated earnings periodically and possibly performs other investment services.

The more common personal trust services consist of acting as executor or administrator of an estate, as trustee under will or agreement, as guardian or committee under court appointment, and as custodian under agency agreement.

The corporate trust functions, when rendered, are usually to act as (a) trustee under corporate indenture, (b) transfer agent or registrar for corporate stock, (c) escrow agent, (d) dividend and coupon-paying agent, and (e) trustee for profit-sharing and

pension plans (this last-named function may also be found in a personal trust department.)

In most states, a bank must obtain special permission to exercise trust powers, for only in a few states is a bank, simply by virtue of its original charter, authorized to perform trust services. If it is a national bank, it must obtain this permission from the Office of Comptroller of the Currency. Trust departments are regularly examined by the appropriate supervisory authorities. In many cases this examination is performed separately from that of the commercial banking departments.

In many states, a bank desiring to offer trust services must pledge securities with the state to guarantee faithful performance of its duties and to secure the deposits of uninvested funds.

Regulation 9 of the Code of Federal Regulations, under which national banks carry on their trust business, provides, that, before undertaking to act in a fiduciary capacity (that is, to render any of the trust services previously mentioned), a national bank must open a trust department which must be separate and apart from every other department of the bank. The laws of several states contain substantially the same requirement for state banks.

Regulation 9 further requires that a committee of directors, exclusive of any active officers of the bank, shall, at least once during each period of fifteen months, make suitable audits (as defined therein) of the trust department or cause suitable audits of such department to be made by auditors responsible only to the Board. Such an audit can be made by the bank's own internal auditors.

Except that uninvested trust funds appear in a bank's statement of condition as deposits, trust department accounting, for the most part, is handled as if the department were a separate entity. Its financial transactions are reflected in a separate statement which, in effect, is a composite of all the assets and liabilities of the individual trust accounts coming within the scope of department administration. The assets of the trust funds, consisting for the most part of investments in securities and real estate, are often recorded at so-called par values or unit values, solely for control purposes. For example, shares of stock might be recorded at one dollar per share, bonds at face amount, real estate at one dollar per parcel, etc. The accounts and trust assets of each account are usually kept separately from those of all

other accounts and also must be kept separate from those of the bank itself. There is a practice in many trust departments to file securities by issue rather than by account. In addition to a control ledger maintained for control purposes, the usual records for each trust account consist of the following:

1. Abstract—also referred to as a "synopsis sheet" and used as a convenient digest of duties and responsibilities of the bank in its fiduciary capacity.
2. Docket—containing historical information, a record of accounts accepted and closed, documents received (wills, deed of trust, court orders, etc.)
3. Cash account ledger—showing by account the uninvested principal and undistributed income.
4. Individual subcontrols for each trust account—showing invested principal, uninvested principal, invested income (if any), and undistributed income.
5. Asset record—classified as to stocks, bonds, real estate bonds and mortgages, real estate, etc.
6. Memorandum or supplemental records pertaining to custodies and agencies.

Internal control applicable to trust operations must consider not only accountability, but also the proper discharge of fiduciary responsibility. Some pertinent questions are:

1. Are trust assets properly segregated by account and filed in the vault under dual control?
2. Are accounting entries for acquisition or retirement of trust assets coordinated with vault deposits and withdrawals, so that accounts promptly reflect the movement of trust assets?
3. Is an adequate system of accounts maintained to provide:
   (a) Classification of trust assets, both by account title and by asset?
   (b) Daily journals containing detailed descriptions of principal and income transactions?
   (c) Controlling accounts for various asset classifications, including principal and income cash?

4. Are reconciliations of general trust funds deposited with the banking department or other institutions made by an employee who does not have access to the related records and unissued checks?

5. Are agency bank accounts (dividend, coupon, bond redemption, etc.) reconciled by an employee who does not have access to related records and unissued checks?

6. Are adequate measures taken to safeguard unissued supplies of stocks and bonds?

7. Are uninvested cash balances (or, conversely, overdrafts therein) called to management's attention?

As in the case of internal control evaluation, the audit of trust accounts also embraces the same two major areas, namely, accountability for assets and review of administration of accounts. The audit objective is to establish that no liability exists as a result of failure to maintain the trust assets or to fulfill otherwise the fiduciary responsibilities under the law or the respective trust instruments.

Insofar as the accountability of assets is concerned, the process of examination is generally the same as that for the banking department, in that a statement of trust assets and liabilities is prepared from the departmental control ledger and the items shown thereon are examined by inspection, confirmation, etc. An important factor in establishing accountability is the need to confirm the location of open items. For example, at any given point of time certain trust securities will be out for transfer, entered for collection, etc. Others will be purchased and paid for but not yet received. Accordingly, the CPA should control the pending files of tickets evidencing these open items and use this data to clear exceptions as the trust security inspection is performed. He will also want to confirm these items by direct correspondence with the holders.

Unless impracticable (as where there is no party in a position to confirm), co-trustees or other parties at interest should be requested to confirm the assets held in trust. In the event that such parties cannot be expected to be able to confirm the assets held, it might still be practicable to request them to confirm certain of the transactions, such as their cash withdrawals, or to

request them to confirm that they take no exception to the recorded balances. In this connection, reference is made to Example 8 in Appendix C.

The review of administration of trust accounts is made to determine if the composition of assets and transactions therein are in accordance with the governing instruments, and whether the fiduciary is discharging its responsibility thereunder. The principal areas of investigation following a reading of trust instruments and applicable sections of law relative to trusts are as follows:

1. Are assets legal and/or in conformity with the governing instruments?
2. Are committee procedures for review of the trusts and supervision and approval of the transactions therein adequate and being complied with?
3. In the case of co-fiduciary appointments, is proper approval obtained from the co-fiduciary of investment changes, disbursements, etc.?
4. Have trust funds awaiting investment or distribution been held uninvested or undistributed any longer than was reasonably necessary?
5. Are fees being properly computed?
6. Is income being properly collected and/or distributed?
7. Are disbursements in order and properly supported?
8. Are proper and adequate procedures being followed in respect of other matters appearing to warrant attention, such as ineligible investments, self-dealing mortgage participations, holding of stock of closed corporations, etc.?

Generally, the review is a sampling process of selecting a representative group of accounts sufficient in number to permit the CPA to form some general conclusions on the soundness of administration of the department. As to the accounts selected for test of administration, the CPA may examine transactions from inception of the trust, from the date of the most recent formal accounting submitted to the appropriate court of juris-

diction, or for a recent period, such as the most recent year. Except in a first audit, where the CPA would not normally have prior satisfaction regarding the trust department's past activities, the CPA would not normally examine transactions from the inception of the trust but would confine his examination to transactions since the date of his last audit.

Appendix A

Governmental Restrictions on Bank Operations

A list of loan and investment restrictions applicable to national banks and in part to state member banks of the Federal Reserve System is contained in "Manual of Laws Relating to Loans and Investments by National Banks," published by the National Bank Division of the ABA. Pamphlets on banking laws and applicable regulations of the various states should be consulted for restrictions pertaining to state nonmember banks. Limitations contained therein should be carefully considered by the CPA in connection with his audit.

As a general principle, the breach of any limitation in loaning, investing or other banking functions that might affect the financial position of the bank or the personal liability of its directors must be considered. For example, among the matters to be taken into account in connection with loans are:

Loans to one borrower (U.S.R.S., sec. 5200)

Loans to one borrower on stock or bond collateral (Fed. Res. Act, sec. 11(m))

Loans to executive officers (Fed. Res. Act, sec. 22 (g))

Real estate and building construction loans (Fed. Res. Act, sec. 24)

Loans secured by bank's own stock. (U.S.R.S. sec. 5201)

Loans to purchase or carry securities (Regulation U Board of Governors of the Federal Reserve System)

Loans to bank examiners (Fed. Res. Act, sec. 22 (a))

Statutory bad debts (U.S.R.S. 5204)

Any exceptions that appear to be possible violations should be discussed with the principal executive officer of the bank; in matters of doubt consideration should be given to securing an opinion from the bank's counsel.

Appendix B

Requirements for Directors' Examinations

National Banks

The National Banking Act does not stipulate a requirement for directors' examinations of national banks, and further, there are no regulations governing directors' examinations.

As a practical matter, all national banks have directors' examinations as a result of a provision in their bylaws. The Comptroller of the Currency will not approve a national bank charter unless the bylaws of a bank provide for a directors' examination. The following paragraph appears in the general form of bylaws (prepared by Comptroller) recommended for consideration by the directors.

> EXAMINING COMMITTEE. There shall be an Examining Committee composed of not less than .... Directors appointed by the Board annually or more often, whose duty shall be to make an examination every six months into the affairs of the Association, and to report the result of such examination in writing to the Board at the next regular meeting thereafter. Such report shall state whether the Association is in a sound condition, whether adequate internal audit controls and procedures are being maintained and shall recommend to the Board such changes in the manner of doing business or conducting the affairs of the Association as shall be deemed advisable.

As a guide to directors in performing their examining duties under the bylaws, the Comptroller has issued instructions relat-

ing to scope and procedure which comprise paragraphs 41 and 42 of Treasury Department Circular (Form 1417), Duties and Liabilities of Directors of National Banks.

State Banks

Varying statutes by states cause differences among states in the number of directors' examinations required per year and the delegation of authority expressly permitted. Since these statutory rules may change and regulations differ quite substantially among states, it is incumbent upon every independent auditor to know the requirements of every state in which he conducts a bank audit. Details of current state requirements can be obtained by contacting the department of banking of the state in question.

Appendix C

Illustrative Forms of Confirmation Requests

As indicated in the text of the Guide, confirmation requests may be either positive or negative. As in his commercial audit practice, the CPA will invariably employ the positive form when requesting confirmation of certain types of balances, such as securities held by others and cash on deposit with other institutions (due from banks). In connection with other types of balances, however, such as loans and deposits, he may use either the positive form or the negative form or a combination of both.

Where the negative form is used, it must be accompanied or preceded by some type of statement of the customer's account. The negative request may either be printed on the statement form, be applied to the statement form by ink stamp, or be included on a separate form. In any event, it might contain language somewhat as follows:

> The above (or the accompanying) statement shows the balance in your account at the close of business on _____Date_____. In connection with a regular audit of our accounts by our auditors, A, B & Co., Certified Public Accountants, 25 First Avenue, Typical City, we should appreciate your comparing this balance with your records to determine its correctness. In the event that you believe this balance to be incorrect, please inform A, B & Co., furnishing them with the details of the discrepancy. No reply is required if the balance is correct.

Where positive forms of confirmation requests are used, they should be designed to fit the particular circumstances. Several examples of positive confirmation requests are presented below. They do not represent all the types that the CPA would normally employ in a bank audit but are illustrative of the format and language which might characterize all types. The examples are as follows:

Example 1—Unsecured Loans

XYZ Bank
100 Main Street
Typical City

(Name and Address)

Our records indicate that at the close of business on ___Date___ you were liable to us for unsecured loans made to you in the amount of $__________, the details of which are as follows:

Date of Loan	Interest Rate	Due Date	Interest Paid To	Amount

In connection with a regular audit of our accounts now being made by our auditors, A, B & Co., Certified Public Accountants, 25 First Avenue, Typical City, we shall appreciate your indicating the correctness of the above by signing below and returning this statement to A, B & Co. in the enclosed stamped envelope. If there are any discrepancies, please furnish details in your reply.

Yours very truly,

John Smith
Vice President and Controller

The above statement is correct:

____
(Authorized Signature)

Example 2—Secured Loans

XYZ Bank
100 Main Street
Typical City

(Name and Address)

Our records indicate that at the close of business on __Date__ the following securities were held by us as collateral to your loan of $__________.

Number of Shares or Face Amount	Description

In connection with a regular audit of our accounts now being made by our auditors, A, B & Co., Certified Public Accountants, 25 First Avenue, Typical City, we shall appreciate your indicating the correctness of the above loan balance and collateral by signing below and returning this statement to A, B & Co. in the enclosed stamped envelope. If there are any discrepancies, please furnish details in your reply.

Yours very truly,

John Smith
Vice President and Controller

The above statement is correct:

____
(Authorized Signature)

Example 3—Installment Loans

XYZ Bank
100 Main Street
Typical City

(Name and Address)

Our records indicate that at the close of business on __Date__ the status of your personal loan was as follows:

Loan number __________

Number of unpaid installments __________

Amount of each installment $__________

In connection with a regular audit of our accounts now being made by our auditors, A, B & Co., Certified Public Accountants, 25 First Avenue, Typical City, we shall appreciate your indicating the correctness of the above by signing below and returning this statement to A, B & Co. in the enclosed stamped envelope. If there are any discrepancies, please furnish details in your reply.

Yours very truly,

John Smith
Vice President and Controller

The above statement is correct:

____
(Borrower's Signature)

Example 4—Real Estate Mortgage Loans

XYZ Bank
100 Main Street
Typical City

(Name and Address)

Our records indicate that at the close of business on __Date__ the status of your mortgage was as follows:

Mortgaged property	__________
	__________
Principal amount of outstanding mortgage	$__________
Interest rate	__________
Amount of monthly payment for principal, interest, etc.	$__________

In connection with a regular audit of our accounts now being made by our auditors, A, B & Co., Certified Public Accountants, 25 First Avenue, Typical City, we shall appreciate your indicating the correctness of the above by signing below and returning this statement to A, B & Co. in the enclosed stamped envelope. If there are any discrepancies, please furnish details in your reply.

Yours very truly,

John Smith
Vice President and Controller

The above statement is correct:

____
(Authorized Signature)

Example 5—Depositors' Checking Accounts

XYZ Bank
100 Main Street
Typical City

(Name and Address)

A statement of your checking account has recently been sent to you, showing the following information:

Account number	________
Statement date	________
Balance	$________

In connection with a regular audit of our accounts now being made by our auditors, A, B & Co., Certified Public Accountants, 25 First Avenue, Typical City, we shall appreciate your reconciling the statement balance shown above with your records. If the balance shown above is correct, please sign in the space provided below and return this statement to A, B & Co. in the enclosed stamped envelope. If there are any discrepancies, please furnish details in your reply.

Yours very truly,

John Smith
Vice President and Controller

The above statement is correct:

____
(Authorized Signature)

Example 6—Savings Accounts

XYZ Bank
100 Main Street
Typical City

(Name and Address)

Our records indicate that at the close of business on —Date— the balance in your savings account was as follows:

Account number ____________

Balance $____________

In connection with a regular audit of our accounts now being made by our auditors, A, B & Co., Certified Public Accountants, 25 First Avenue, Typical City, we shall appreciate your indicating the correctness of the balance shown above by signing below and returning this statement to A, B & Co. in the enclosed stamped envelope. Also please indicate below the date of the last entry in your passbook. If there are any discrepancies, please furnish details in your reply.

Yours very truly,

John Smith
Vice President and Controller

The above is correct:

____
(Depositor's Signature)

Date of Last Entry in Passbook:

____

Example 7—Clearings and Exchanges

XYZ Bank
100 Main Street
Typical City

(Drawee Bank)

Please confirm to our auditors, A, B & Co., Certified Public Accountants, 25 First Avenue, Typical City, that the enclosed items* total $________, by signing below and returning this form to them in the enclosed envelope. Also, please furnish them with details of any returned items of $500 or more.

Yours very truly,

John Smith
Vice President and Controller

The above total is correct:

____
(Signature)

Returned items of $500 or more are as follows:

*In the event that the items had been forwarded before the CPA began his examination, this language would require modification. It might read "that the items forwarded to you in connection with the 10 a.m. clearing on ______ Date ______ totaled $ __________."

Example 8—Trust Accounts

XYZ Bank
100 Main Street
Typical City

(Name and address of
party at interest)

Trust account number ______________________

Name of trust ______________________

____

The enclosed statement shows the assets and uninvested cash held by us in the above-captioned trust account as of the close of business on ____Date ____. In connection with a regular audit of our accounts now being made by our auditors, A, B & Co., Certified Public Accountants, 25 First Avenue, Typical City, we shall appreciate your acknowledging to them that you have received the enclosed statement by signing below and returning this form to them in the enclosed stamped envelope. In the event that you maintain records which indicate that the enclosed statement is incorrect in any respect, please furnish details thereof to A, B & Co.

Yours very truly,

John Smith
Vice President and Controller

I acknowledge receipt of the
statement referred to above:

____
(Signature)