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Building and Loan Associations*

BY L. U. CRAWFORD

Building and loan associations have become a material factor in the financial structure of the United States. The importance of these institutions to the welfare of our people cannot be overestimated. They are creating home owners and home builders and bringing to millions of people the teachings of thrift and of systematic savings. More than that, they are building citizens. The ownership of a home or of a sound investment means a happier and a more worth-while man.

The building and loan idea was evolved from societies formed among English working men for the purpose of accumulating funds to acquire homes. A number of men joined together pledging themselves to make periodical payments into the society, and as funds accumulated lots were drawn to determine who should be entitled to priority of loan. The member securing a loan continued his payments, usually without interest, until every member had acquired a home or had received the return of his money. The securing of a loan was the prime object in joining such societies, so that the savings feature did not appeal to prospective members. The lack of earning power did not permit the offering of inducements to investors.

In order to meet the various requirements which developed during the operation of these societies, there was a gradual evolution in methods and forms of organization. Borrowing members were charged rates of interest sufficient to enable associations to offer attractive earnings to investors, the borrower and the investor sharing alike in the increased earnings. The serial and the Dayton plans came into being, and different classes of stock were issued, prepaid and fully paid, as well as instalment. In return for certain privileges, such as the right of full withdrawal after a short period and the right to receive dividends in cash, a member might accept a fixed rate of dividend, waiving his right to participate fully in the profits earned.

The various states have recognized the importance of building and loan associations by providing for regulation and by the enactment of laws enlarging their powers and providing safeguards

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for their business. Thus we find that associations are empowered to borrow money for the purpose of meeting demands for loans in excess of regularly accumulating funds. In case there is a surplus of funds for which no demand exists, shares upon which no loan is made may be retired. There cannot be a run upon a building and loan association because the laws provide that withdrawing members must be paid in the order in which their stock has been filed for withdrawal. It is further provided in some states that only a limited portion of an association's funds may be applied to withdrawals, provision being made for the application of the balance of such funds to the making of loans and to the payment of matured shares. And, not least in the protection of associations, there is the refusal by states to permit guaranteed issues of stock.

The variations in plan are almost without limit. During the past, little thought has been given to the relation between earning and maturity rates, since no fixed time of maturity was ever considered. But there is a growing tendency to fix maturities, or to hold out a definite time of maturity, even though no guaranty can be made. In addition to a lack of data upon which to base the necessary calculations, there has been a lack of knowledge with regard to the principles involved in calculating maturities of building and loan stock. The desirability of a definite maturity, especially in the case of loan shares, is so great that the time is near when all will try to hold out such a maturity. There are two sources of danger involved in this, viz: ignorance as to the principles involved and disregard of those principles under stress of competition. No matter how guarded the statements may be with regard to estimated maturities, the failure of associations to meet their estimates may prove distinctly hurtful to the business.

BUILDING AND LOAN ACCOUNTING

Because of the rapid growth that is being made by these institutions, both in numbers and importance, the demand for accounting services is increasing rapidly. This demand does not stop at auditing or accounting, as commonly accepted, but extends to formulation of financial policies, the preparation of forms, contracts and by-laws and the construction of actuarial formulæ.

It would be a waste of time to go into details with regard to the work necessary in an audit of a building and loan association,

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since the technique is not materially different from that usual in other audits. There are some things, however, which should be stressed. The accountant should observe the following "fourteen points" as a minimum and add such other procedure as may be required in individual cases:

1. As a preliminary, familiarize yourself with the laws governing building and loan associations. Having done this, read the by-laws and note carefully any variation from the provisions of law; also make note of any suggestions which occur to you for making clear the meaning of the by-laws. Remember that the by-laws, subject only to the laws of the state, are the laws and the authority under which the business of an association is transacted. During the course of the audit, note all departures in practice from the by-laws, whether of omission or commission.

2. Secure copies of all certificates of stock, notes, mortgages, contracts and printed matter. Study these carefully and note any departure from the by-laws as well as any failure clearly to express the intent.

As a corporation acts through its board of directors, which speaks through its minutes, it is essential that these minutes be read. See that minutes are properly signed, note particularly the authorization of salaries, the approval of expenditures, the approval of loans, the authorization to borrow money, the declaration of dividends, the auditing of the accounts by the finance committee and the filing and approval of reports by the secretary and by the treasurer.

4. Examine bonds of officers and note approval thereof by the board of directors.

5. Loan papers are usually kept in numbered packages and include the following:

- Note and mortgage or deed of trust.
- Application for loan.
- Abstract of title and attorney's opinion.
- Insurance policies bearing proper loss clauses.
- Certificates of stock assigned as collateral security.

Notes and mortgages should be examined as to form, execution and recording.

6. See that all payments on principal have been entered on the notes.

7. Applications should be approved by the loan committee and should show the committee's valuation of the property offered as security.

8. See that abstracts of title show the loan to the association.

9. The attorney's opinion should state that the borrower has fee-simple title subject to the loan of the association which is a first lien upon the property. It is an added precaution to check the records in the office of the register of deeds.

10. The usual practice is to call in pass-books of members for examination. The better practice is to send a statement to each shareholder, asking him to verify and return it. Enclose for that purpose a stamped envelope addressed to the office of the accountant making the audit. This is especially valuable as a verification of loans and of fully paid and prepaid stock. A strong bid for the cooperation and hearty support of the shareholders can accompany the statement. Such a letter can be made a real booster for the association.

11. See that all certificates have been numbered by the printer and that there is account of all numbers. Check all cancelled certificates. Use special care in accounting for fully paid and prepaid certificates, as they may involve large sums of money. Where partial withdrawals are permitted, as under the Dayton plan, see that a proper form of withdrawal certificate is signed by the withdrawing shareholder.

12. It is suggested that a register containing the numbers of all certificates of fully paid and prepaid stock received from the printer be placed in

the hands of the president who should record the date, name and amount of each certificate signed by him. This record should be available for use in auditing the accounts and is a valuable safeguard. By all means, see that such certificates are kept in a safe place.

13. Where money has been borrowed, secure verifications from the holders of the association's notes, and see that all notes which have been paid are cancelled and on file.

14. Investigate the value of and the income from real estate owned by the association. A building and loan association is not authorized to acquire real estate except for use as an office building or for the purpose of protecting its interests in case of foreclosure.

REPORT OF AUDIT

The audit should be conducted conscientiously of course, but that of itself is not sufficient. The report should be clear and illuminating to the ordinary shareholder or borrower who may be quite incapable of reading a technical financial statement. For example the auditor may offer such comment as the following:

This association was incorporated on May 20, 1916, under the laws of the state of Missouri, as a mutual savings fund and building association. Its authorized capital is \$3,000,000, divided into shares of the par value of \$100 each. The total membership is 2,000, holding 15,000 shares, and includes 850 borrowers who hold 6,500 shares. The net earning of the association from the date of its organization is \$150,000 of which \$90,000 has been paid to members, leaving \$60,000 to the credit of shares now in force. Prior to 1920 the growth of the business was slow, but since that time it has been increasingly rapid.

Instead of stereotyped comment on the balance-sheet, its report should be a human sort of document. There are very few items in a balance-sheet about which nothing of interest can be said. Let us take the item "real-estate loans" for illustration: Shareholders would probably be interested in comment such as this:

Loans made to members upon real-estate security aggregate \$650,000 shown in detail by schedule I of this report. The properties pledged as security have been appraised by your loan committee. Their total valuation of properties held as security for your loans is \$900,000. All loans have been approved by your board of directors. A careful examination of all loan papers has been made, and, except as noted hereinafter, such papers are in order. Notes and mortgages are on file and are of record in the office of the register of deeds. Abstracts of title are on file showing your deeds of trust to be liens upon the properties described therein, and opinions signed by your attorney are to the effect that fee-simple title rests in the borrower subject to the first lien of your loan. Insurance policies on file appear to be ample to protect your interests against loss by fire or storm. All loans upon which payments are delinquent are listed in schedule I, and your attention is called specifically to the following which are badly delinquent and should receive special attention: . . . We have secured from your borrowers signed statements verifying their loan accounts.

When preparing a profit-and-loss statement, the accountant should remember that gross profits, less expense and losses, disclose the net earnings of the association. Dividends or profits

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paid or credited to members are not a reduction of net earnings but are a distribution of earnings to shareholders. In many reports no distinction of this kind is made; and it is surprising what a difference is disclosed when the accounts are properly prepared—especially when the statement covers the period from beginning of the association to date of audit. A table showing the distribution of profits on a percentage basis is always informative.

We are all interested more or less in knowing our state of affairs—therefore a statement showing potential earning power will be interesting. If it is assumed that the business will continue for one year on the basis disclosed at the date of audit, a summing up of the earnings to be made from the various assets and of the expenses and contingencies to be met will disclose the net earnings to shareholders. Such a statement may be presented in the following form:

Classifications	Amounts	Rate	Yearly income	Totals
<i>Factors production of income:</i>				
Loans	\$324,000	9%	\$29,160	
Fees and fines			500	
Interest on bank balances			90	
			\$29,750	
<i>Factors of definite cost:</i>				
Borrowed money	\$18,000	6%	\$1,080	
Loan stock	64,000	9%	5,760	
Full-paid stock	91,000	6%	5,460	
Rural-credit stock	77,000	6%	4,620	
			\$16,920	
Total				
Expenses 1.45% on total assets	\$4,750			
Contingent fund requirements	245		4,995	21,915
			7,835	

Inasmuch as the total to the credit of fully participating stock is \$78,500, this demonstrates an earning power of approximately ten per cent per annum.

In the matter of exceptions, it might be interesting to note some of the things which have been found. For instance, the auditor may find it necessary to report to the shareholders one or more of the following conditions, some accompanied by suggestions:

- Mortgages not on file with loan papers.
- Mortgages not recorded.
- Notes not credited with partial payments on principal.
- Notes and mortgages belonging to loans which have been repaid, in the files and remaining uncanceled.
- Abstracts not completed to show loan.
- Attorney does not certify as to fee-simple title being in borrower, nor as to the loan being a first lien.

Loan was made on lots 27, 28 and 29, block 6, while the mortgage covers only lots 28 and 29.

Title is vested in John Doe, a married man, who signs as John Doe, trustee, his wife not joining.

The by-laws were revised in 1915, and since that time numerous changes have been made in the method of doing business. We believe it to be essential that you amend your by-laws to agree with your present practices.

Chapter 96, laws of Kansas 1915, section 1, provides that associations may issue rural-credit shares on which a "definite or agreed rate of interest or dividends may be paid." Your present practice of declaring semi-annual dividends, based upon earnings and varying in rates, does not appear to comply with this provision of law.

Section 2, article 2, of your by-laws should be repealed, since it provides for the issue of a class of stock which is to profit from the accumulation of a surplus from earnings in excess of limited dividends paid to other classes of stock. No class A stock is now in force and none can be issued under state laws.

At the present time the association is lending money in Kansas at 9 per cent and in Oklahoma at 10.2 per cent per annum. This is objectionable in that it tends to destroy the mutuality of the association by discriminating between members of the same class. A further objection is that the legal rate in Oklahoma is fixed by constitutional provision at 10 per cent per annum. We suggest that thorough consideration be given to fixing a rate to apply in both states alike.

FORMULATING PLANS OF BUSINESS

With the growing volume of investment funds, competition for loans is developing, resulting in decreasing rates of interest. The trend seems to be toward increasingly liberal terms of repayment and to lower margins of security. Some insurance companies are adopting so-called amortization loans, thereby offering a contract approximating the building and loan plan. They are offering the further inducement of an absolute guaranty as to terms of maturity or repayment. This means that building and loan contracts must be changed to meet conditions, and it is of interest to accountants, who should be able to chart the lines of safety.

The associations have been at fault in that they have failed to prepare and preserve statistical data from which to compute tables comparable with the mortality tables of life-insurance companies. What is the expectancy of life with regard to investment shares or to borrowed shares? With information on this question available, an actuary could calculate results at different rates with a fair degree of accuracy. Without such knowledge one must draw upon his fund of experience and exercise his prophetic vision; yet there are certain fundamentals which may help one to escape Scylla and avoid Charybdis.

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The effective lending rate is quite different from the lending rate, since only that portion of the earnings which remains after expenses and losses have been met is available for maturing stock. Set up a statement of resources and extend into columns the yearly earnings at present rates and at proposed rates. From the totals thus obtained deduct the total of expenses and estimated average losses, less the income from fees and fines as determined from past experience, thus determining the effective earnings under the two plans. The effective rate is then determined by dividing effective earnings by total assets.

Prepare a table showing the estimated maturity in months of each class of stock, the monthly payments of dues and of interest, total dues to be paid and earnings required to mature. Then calculate rates required at simple and at compound interest. Also find the actual lending rate. Prepare a like table using the figures involved in the proposed issues of stock. The *Robinsonian Building-Loan Interest Tables* are a great help in making these calculations.

Extend the requirements of all obligations or contracts bearing fixed rates, making allowance for any changes expected under the new conditions. Deduct the totals thus obtained from the totals of effective earnings, and the results will be the amounts available for the maturing of fully participating shares. Dividing these amounts by the book value of fully participating shares in force will give the rates of earning available under each plan. Compare these rates with the rates in the maturity tables and restate the payments of dues and the time of maturity in respect of proposed issues.

Since associations may not be able to keep their funds on loan at all times, it is best to use quarterly compound tables in these calculations.

In associations where the first payments are taken as membership fees, to be returned at maturity, it is obvious that the rates required for maturity will be increased, since both the amount invested and the time for which it is invested have been decreased. As a partial offset to this we shall have fees which are not returned on stock withdrawn before maturity. A comparatively small percentage of stock goes to maturity, especially in long-time issues. Where an association does not pay full earnings upon withdrawals, there is a hidden reserve measured by the aggregate of dividends which will be forfeited by withdrawal.

One should take into consideration the fact that loans will reach the level of lower rates much sooner than will investment shares. Therefore, allowance must be made for more or less of a spread, depending upon surrounding conditions. Further, conditions with regard to present issues must be considered, i. e. : whether there is a reserve earning power over present maturity requirements or not.

INCOME TAXES

And last, but not least, do not overlook the federal income-tax laws. To be exempt a building and loan association must meet the following requirements:

Be organized under state laws;

Its purpose must be the accumulation of funds to be lent to its members;

It must be mutual;

It must be operated so that substantially all of its business is confined to the making of loans to its members;

It must not be operated for profit.

The purposes of a business are judged in the light of the history and of the operations of that business. Wherefore, it is useless to expect exemption where the doing of business, except that of lending money to members for the purpose of building or acquiring homes, is other than incidental.

It is believed that a building and loan association is organized and operated "without profit" within the meaning of the law when the total benefits or profits, aside from a reasonable rate of profit or reasonable dividends upon prepaid shares, accrue to the shareholders still making payments upon their shares.

Borrowing members must not be discriminated against, otherwise mutuality will be brought into serious question.