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SUPPLEMENT ISSUED TO GUIDE ON "AUDITS OF BANKS"

The AICPA committee on bank accounting and auditing has issued a supplement to the industry audit guide, Audits of Banks (ARA Newsletter, July 17, 1969). The supplement incorporates the substance of the agreements reached with the Federal regulatory authorities and the banking industry on revised reporting requirements for commercial banks.

Following is the text of the supplement, which discusses three substantive reporting areas:

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

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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 continued 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.

(End of Text)

Illustrative Forms Included

The supplement includes illustrative forms of financial statements which reflect the practices described and are suitable for inclusion in annual reports to stockholders.

The supplement is 75 cents if ordered separately. Audits of Banks, which will include the supplement, is priced at $2.00 to AICPA members.

The complete Audits of Banks; Supplement will also be published in the January, 1970, issue of The Journal of Accountancy.