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## Audits of Savings and Loan Associations by Independent Certified Public Accountants

American Institute of Accountants

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AUDIT OF SAVINGS AND LOAN ASSOCIATIONS  
BY  
INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

SECTION 1

General

The program of activities issued by the American Institute of Accountants describes the duties of the special committee on savings and loan accounts as follows:

"Continue cooperation with Federal Home Loan Bank Board in an effort to devise program of independent audit of savings and loan associations insured by the Federal Government, and recommend forms of financial statements and auditors' certificates which will satisfy requirements of the Board and eliminate necessity for audits of associations by examiners employed by the Board. Cooperate to whatever extent may be possible with the American Savings and Loan Institute."

In accordance with this program, the special committee has devised the following procedure for the examination of savings and loan associations. In considering what follows, the reader should bear in mind that the accountant must exercise discretion while conducting such audits; procedures must be varied to meet varying conditions due to the size and type of association and the requirements of state or federal authorities.

The program presented should be regarded merely as a guide. It constitutes neither the maximum nor the minimum

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requirement. It is believed, however, that compliance with the program outlined in this pamphlet will enable the accountant to render a report to savings and loan association clients which will be acceptable to the association, to state authorities, and to the Federal Home Loan Bank Board. It is to be hoped that it will make possible more complete understanding between certified public accountants and government examiners.

## SECTION 2

### Recent Developments

Since the organization of the first savings and loan association in this country over one hundred years ago, there have been many changes in financial procedure and management methods. Just as standardization in financial procedure has been impracticable if not impossible, so it was likewise impracticable to attempt to standardize the accounting methods of savings and loan associations until the educational work of the United States Building and Loan League and the American Savings and Loan Institute had made an impression on those interested.

The Federal Home Loan Bank act and the creation of the Federal Home Loan Bank Board gave an immediate stimulus to thought on this subject. Each of the three above mentioned groups has been publishing information on accounting problems, so that today there is available to every association throughout the country some very creditable material designed for its

guidance in proper accounting.

The Federal Home Loan Bank Board has been very helpful by issuing periodical bulletins on the subject of accounting and has developed an excellent examination procedure to aid it in its supervision of member associations. Foremost among the publications on the subject of accounting is the "Standard Accounting Manual for Savings and Loan Associations" prepared by the American Savings and Loan Institute, and the good effect of this manual has been supplemented by a course in accounting, conducted under the auspices of the same organization, in the larger cities of the nation. In addition, there are some very helpful articles on savings and loan accounting in the periodicals published by the several Federal Home Loan Banks, by the United States Building and Loan League and by the several state building and loan societies.

The examination procedures followed by the Federal Home Loan Bank Board were made available for study by the special committee.

### SECTION 3

#### Outline of Examination

In consideration of the scope of the examination which is about to be made, due weight must be given to its purpose and also to the system of internal check in effect. The Federal Home Loan Bank Board examiners examine all associations whose accounts are insured by the Federal Savings and Loan Insurance

Corporation and also members of the Federal Home Loan Bank system located in states in which state supervision is regarded as inadequate. In most commonwealths, the state examiners scrutinize the records of each association incorporated therein in order to determine that the association is solvent and that it is operating in accordance with state laws and regulations. The certified public accountant is not relieved by either of these examinations from carrying out his regular program, although the reports rendered by governmental examiners may be of value to him.

In associations where an adequate system of internal check and control is in operation, the detailed tasks of the auditor may properly be curtailed. It is the duty of the auditor to recommend the installation of such a control if one can be operated without occasioning a great deal of added expense to the client. The extent of test-checking necessary is a matter of judgment to be exercised in view of the conditions peculiar to each particular engagement.

#### TITLES, APPRAISALS

Technical details regarding appraisals, property valuation, and the status of titles are not in the province of the accountant. He should, however, satisfy himself that the considered opinion of qualified experts are on file regarding the value and ownership of the assets and the adequacy of the reserves. Whenever legal and engineering problems arise, it

would be well for the accountant to make reasonable inquiry and upon ascertaining the facts, where appropriate, insist that the Association procure for his satisfaction the opinion in regard thereto of its legal or engineering advisors.

#### FEDERAL AND STATE REQUIREMENTS

It is requisite for the accountant engaged in this kind of work to acquaint himself with the federal or state requirements, as, for example, with the method of setting up reserves against properties or overdue mortgages, as established by certain states; to be well informed on accepted accounting practice for such associations; and to satisfy himself whether these accepted accounting practices have been consistently followed throughout the period covered, and are on a basis consistent with that of the preceding year.

#### BY-LAWS

A review of the association's by-laws should be made at the beginning of the examination.

#### STATEMENT OF CONDITION

If the statement of condition (hereinafter referred to as the balance-sheet) and the statement of operations and reconciliation of undivided profits account and reserves have been prepared by a representative of the association, the accountant should make certain that they are in an accepted form. A form is set forth at the conclusion of this outline.

The association's trial balances should be compared with the accounts in the general ledger and also with the balance-sheet. It is important here to see that no items are offset, one against the other, which would establish a "net" condition in either assets or liabilities unless all assets and all liabilities are fully described. Outstanding changes in the association's condition are reflected by a comparison of the opening and closing statements for the period under audit. Such changes may require more than ordinary attention from the auditor.

#### THE MINUTES

The minutes of the directors' and the shareholders' meetings should be read, and any items appearing therein which affect the financial transactions of the association should be noted. The accountant should satisfy himself that these transactions have been handled in accordance with the minutes and with the law under which the association is operating. Approval for the following should be found in the minutes:

- (a) Loans made, refinanced, transferred, converted foreclosed or released.
- (b) Real estate acquired and disposed of.
- (c) Contract sales made, extended and terminated.
- (d) Funds borrowed and repaid to outside creditors.
- (e) Cash disbursements (Consistent with sound business practice).
- (f) Shares withdrawn (Consistent with sound business practice).
- (g) Shares matured.

- (h) Dividends declared and profits apportioned.
- (i) Additions to and deductions from the contingent reserve, undivided profits and other reserve accounts.
- (j) Fixing rates of interest and premiums on loans.
- (k) Fixing salaries of officers, directors and important employees.
- (l) Approving surety company bonds.
- (m) Approving depository bank and designating signatories on checks.
- (n) Proper signatories on minutes of directors' and shareholders' meetings.

#### CASH AND NEGOTIABLE SECURITIES

Where associations have cash and negotiable securities, these assets should be counted or confirmed concurrently as of the same date, preferably as of the close of business on the date of the statement of condition. If, for any reason, this work cannot be done until a later date, the count or confirmation should be made as of that date and the changes in the intervening period should be checked in detail. The extent of this scrutiny will be governed by the special conditions of each case.

#### VERIFICATION OF RECEIVABLES

The best verification of balances of receivables (accounts, notes, mortgages, etc.) and members' deposit or share accounts, etc., can be obtained by the accountant's requesting confirmation direct from the debtors or members. Wherever practicable and reasonable, and where the aggregate amount of notes and accounts receivable represents a significant

proportion of the current assets or of the total assets of an association, confirming the receivables by direct communication with the debtors should be regarded as generally accepted auditing procedure in the examination of the accounts of an association whose financial statements are accompanied by an independent certified public accountant's report; and the method, extent, and time of obtaining such confirmations in each engagement, whether of all receivables or a part thereof, should be determined by the independent certified public accountant as in other phases of procedure requiring the exercise of his judgment. The Federal Home Loan Bank Board requires a minimum circularization of at least ten per cent of the number and amount of each class of accounts. The requirements of the state under whose law the association is organized must be ascertained by the accountant. Objections to such circularization no longer carry much weight, as the public is now fairly well acquainted with its purpose. As a matter of fact, a careful wording of the request conveying that it was in keeping with up-to-date practice and for the greater protection of the members is an excellent advertisement for the association. It is also suggested that in addition to circularization the auditor might be present at the end of a fiscal period to check those pass books which are submitted for the crediting of dividends.

The confirmation statements used are generally of the affirmative type requiring replies directly to the auditors. In order to facilitate the examination, arrangements may be made to

have these statements prepared by the staff of the association, after which they are checked back and mailed by the auditors. The statements should show the status of shareholders' accounts with respect to dues paid, profits apportioned, mortgage loans, share loans, arrears, and advance payments. Where replies are not received, second requests are generally forwarded.

There follow suggestions as to routine work to be done in respect of the various accounts, grouped in the order the accounts appear in the attached statement of condition, except that cash and securities are considered first, since they usually are the first items taken up in the examination.

In the discussions hereunder as to the scope of the examination of the various assets and liabilities, reference, as a rule, has been made to supporting schedules only in the instances where it was thought desirable to stress the information to be brought out. It should be understood, of course, that the underlying details in all cases, with the possible exceptions of accruals, should be in agreement with the controlling accounts in the general ledger. If the lists have been prepared by the association for the use of the accountant, they should be checked with the underlying records and footed.

Procedure for the examination of income accounts is taken up under the statement of operations, rather than in the discussions of the relative assets. Similarly, accruals have been dealt with under a separate caption.

The sub-classifications used hereinafter are those shown

in the statement of condition and statement of operations recommended by the accounting division of the United States Building and Loan League.

CASH

(1) Cash on hand should be counted and the independent accountant should be satisfied that the association is using a good system of petty-cash control. Any negotiable securities should be inspected or taken under control at the time of the petty-cash count. The independent accountant should guard against the possibility that a cash shortage in such assets is covered up by a temporary conversion of securities.

(2) When counting cash, it is important to observe that all checks produced as part of the cash balance have been entered in the cash book prior to the close of the period. Any checks or advances made from cash but not recorded on the books should be noted. Scrutinize advances to employees and see that personal checks or checks cashed for others as an accommodation are deposited and paid before the completion of the examination.

(3) Bank balances as of the close of business on the balance-sheet date should be confirmed to the accountant by the depositaries, using the standard bank confirmation form devised by the American Institute of Accountants. These balances should be reconciled with the balances shown on the cash book and check-book stubs or check registers, and particulars should be noted of all outstanding items. The checks returned by the banks should be compared with the cash book disbursements. In the case

of small associations, it may be considered advisable to do this for the entire year. In the case of associations having a good system of internal check, this comparison of checks should be made for two or three months taken at random, except that the last month of the period under examination should be covered. Spoiled checks should be accounted for. The list of outstanding checks at the close of the audit period should be compared with the checks returned by the banks in the subsequent month. Any unpaid checks which have been outstanding for a long interval should be especially investigated.

(4) Comparison of recorded cash receipts to bank deposits is required. For small associations, this should be done for the entire period. For associations having a good internal control, the same test may be made as indicated above for the examination of cancelled checks.

(5) Footings of cash book columns must be proved for at least the period during which checks are examined.

(6) All checks outstanding at the beginning of the period which were not returned in a previous examination must be compared to the cash disbursement entry.

(7) If it is the practice of the association to delegate a person to make distribution of mortgage-settlement funds, this person's accounts should be examined so that it may be ascertained, first, that the association's checks have been deposited by the disbursing trustee and, second, that the trustee's disbursements are in order.

(8) All cash transfers between bank accounts of the association and between these and accounts maintained by trustees must be traced.

### SECURITIES

Savings and loan associations frequently own stock in the Federal Home Loan Bank, Federal Home Loan Bank bonds, and United States Government securities, including those of the Home Owners' Loan Corporation. Occasionally there may be other securities on hand.

The procedure for the examination of these securities is as follows:

- (1) Obtain or prepare a list of securities owned showing particulars such as:
  - Description of security,
  - Serial numbers of bonds or other securities,
  - Denomination of bonds or par value of shares,
  - Interest rate of bonds,
  - Face value of bonds; number of shares,
  - Cost of securities and the amount at which carried on the books,
  - Interest and dividends received during period under review,
  - Interest accrued and dividends receivable at the close of the period under review,
  - Market quotations if such are available, location of securities, and if hypothecated, with whom and for what purpose.

- (2) Comparison of securities listed with the corresponding ledger accounts to ascertain the basis on which the securities are carried on the books. Wherever practicable, serial numbers of bonds and other securities should be compared with records of security purchases in order to obtain positive identification and avoid possibility of substitution.
- (3) Examine the securities listed, or obtain confirmation from the holders, if any are held by depositaries or others for safekeeping or as collateral. This examination should be made as close to the date of the balance sheet as possible (see paragraph 1 under "Cash"). It is, of course, more desirable to inspect the actual securities than to account for their disposition subsequent to the date of the balance sheet.
- (4) See that certificates of stock and registered bonds are made out in the name of the association or, if they are in the names of others, that they are so endorsed as to be transferable to the association or are accompanied by powers of attorney.
- (5) Examine coupons on bonds to ascertain that unmatured coupons are intact.
- (6) If certificates are out for transfer, confirm with transfer agents.

- (7) If securities have been bought or sold through brokers, examine brokers' advices in support of purchase sales prices on both.
- (8) Stocks and bonds should be shown separately on the statement of condition and should not be confused with mortgage loans and share loans.
- (9) If securities are stated at prices other than market, the quoted market values should also be shown on the balance sheet. If the total market value of stocks and bonds which might represent temporary investments is less than the total book value by any material amount, it would be well to provide a reserve for the shrinkage.
- (10) If the Association has hypothecated any of its securities, this fact should be stated on the statement of condition.
- (11) Purchase and sale of securities during the period under review should be authorized by the board of directors.

#### MORTGAGE LOANS

Mortgage loans are classified in the statement of condition as follows:

- A. First Mortgage Loans:
  - (a) First mortgage direct reduction loans,
  - (b) First mortgage share account sinking fund loans,
  - (c) First mortgage straight loans,

- (d) Accrued interest receivable on first mortgage loans (unless included in balance of first mortgage loans),
- (e) Advances for taxes, insurance, etc., on first mortgage loans (unless included in balance of first mortgage loans).

B. Second Mortgage Loans:

- (a) Second mortgage loans,
- (b) Accrued interest receivable on second mortgage loans,
- (c) Advances for taxes, insurance, etc., on second mortgage loans.

A suggested procedure for the examination of mortgage loans is as follows:

1. A schedule of the mortgages to show the following is frequently helpful:

- Number,
- Date,
- Name,
- Location,
- Type of Property,
- Original amount,
- Appraisal: date, amount, by whom,
- Shares pledged,
- Balance at examination date,
- Advances (unless included in principal),

Interest in arrears (unless included in principal),  
Taxes in arrears (or date to which paid),  
Contractual delinquencies (number of months and  
amount),  
Amount of prior mortgages, and  
(a) Interest paid to (date),  
(b) Amount of interest in arrears,  
(c) Interest accrued.

In the case of larger associations on account of the volume of work involved, it may be found advisable to check the papers to the records, rather than the schedule, and to draw off a list only of those mortgages requiring special consideration.

2. The following papers supporting mortgage loans should be examined on the first examination of the association:

Mortgage,  
Note or bond and warrant,  
Title insurance policy, guaranteed search, or solicitor's search or abstract,  
Property insurance policy - fire, tornado, etc.  
Loan application properly signed by mortgagor,  
Loan approval signed by proper committee,  
Appraisal reports.

Upon subsequent examinations, the accountant should use his discretion in making a complete check or test check of old loans; in any event papers supporting all new loans should be examined. The accountant should satisfy himself that all documents are on hand or accounted for.

In some cases, a separate assignment of shares signed by the mortgagor is necessary. If the minutes of the property-committee reports the requirement of additional collateral, the assignment of such collateral and the collateral itself should be examined by the accountant.

If the loan is secured by a second mortgage, the amount of the first lien should be listed, and, if it is the practice of the association to acquire sheriff's or marshall's certificates, the accountant should see to it that the certificates are included among the second mortgage papers.

The accountant should also inquire into unusually large mortgages, mortgages having smaller than the prescribed equity, an unusually large number of loans to a single borrower or in any one area, and mortgages of directors, officers, and employees, and those of firms or companies in which such officials are known to be interested.

3. It is preferable to confirm mortgage loans outstanding directly with the mortgagors, and if this cannot be done,

a qualification to that effect should be included in the accountant's report. Arrearages should be scrutinized and confirmed by correspondence at the same time that a mail verification is requested of mortgagors.

4. The accountant should familiarize himself with the requirements of savings and loan association mortgage loans and should see that the required number of shares have been assigned to the association by the mortgagor in conformity with the agreement between mortgagor and association.
5. All loans granted and foreclosures commenced during the period under review should be compared with the authorization in the minutes.
6. The accountant should familiarize himself with state and Federal provisions under which the audited association is operating in order to determine if its loan policy is in compliance therewith.
7. The accountant should also inquire into unpaid taxes and assessments pertaining to mortgaged properties.
8. Loans pledged with the Federal Home Loan Bank or other lender should be confirmed by direct communication. A proper notation should be made on the balance sheet by footnote or otherwise concerning mortgages pledged as collateral on borrowed money.

9. Entries for partial or full repayments of mortgage loans during the period under review should be checked.

#### SHARE LOANS

Share loans are classified in the statement of condition as follows:

- (a) Loans secured by shares of this association,
- (b) Loans on deposit accounts and certificates of investment,
- (c) Accrued interest receivable (unless included above).

For smaller associations, a schedule of share loans should be obtained or prepared, but for larger associations, on account of the volume of work involved, it may be found advisable to check the papers to the records, rather than the schedules, and to draw off a list of only those share loans which may require special consideration.

Examination procedure is suggested as follows:

1. Papers supporting share loans should be examined.
2. It is preferable to confirm share loans outstanding directly with the borrowers, and if this cannot be done, a qualification to that effect should be included in the accountant's report. The authority for the creation of share loans should be found in the minutes if such authority is required by statute. The shareholder's note should be examined, as well as his pledged certificate or passbook.
3. The accountant should make certain that sufficient

payments have been made to warrant the amount loaned; he should also ascertain if the amount borrowed by the shareholder is within the limitation permitted by law.

4. Credits appearing on the loan accounts of shareholders during the year under review should be checked or tested.

#### OTHER LOANS

These loans are classified in the statement of condition as follows:

- (a) Loans on other security,
- (b) Unsecured loans,
- (c) Accrued interest receivable on above.

The same procedure as that set forth under the examination of share loans should be followed in the case of other loans, and written confirmations should be obtained.

#### REAL ESTATE SOLD ON CONTRACT

This is listed and classified in the statement of condition as follows:

- (a) Real estate sold on contract,
- (b) Accrued interest receivable on real estate sold on contract (unless included above),
- (c) Advances for taxes, insurance, etc., on real estate sold on contract (unless included above).

### REAL ESTATE SALES

1. These contracts should be examined and each parcel of property should be listed in the accountant's working papers.
  
2. If the property has been sold at a profit, there are three methods which may be used to take up such profit:
  - (a) The first cash funds received might be considered realized profit.
  - (b) The profits arising from the sale of real estate might be taken into earnings in the proportionate amount consistent with the cash paid by the purchaser.
  - (c) The profit might be deferred until the last payment is received from the purchaser.

The plan described in (b) above is preferable. The association should be consistent in its method of handling the profits on the sale of all parcels of real estate owned.

3. The remarks under mortgage loans as to the desirability of requesting confirmation from the debtors also applies to real estate sold on contract.

### ACCRUED INTEREST RECEIVABLE

Included in the several classes of assets mentioned above there is accrued interest receivable on:

- (1-d) First mortgage loans,

- (2-b) Second mortgage loans,
- (3-c) Share loans,
- (4-c) Other loans,
- (5-b) Real estate sold on contract,
- (10) Investments.

1. The accountant should note the method of computing interest and observe if the details are proved with the controlling accounts.
2. A reasonable test should be made as to the computations on individual cases.
3. It should be borne in mind that the only complete check in respect of delinquents is in the obtaining of confirmations.
4. Interest accrued on mortgages in arrears or interest should be carried to a reserve account rather than credited to income. "A practice required of all Federal Savings and Loan Associations is to reserve for accrued interest on mortgage loans where it is overdue for more than ninety days. It is recommended by the American Savings and Loan Institute that all interest be credited to a reserve until it is actually collected."

REAL ESTATE OWNED

This is classified in the statement of condition as follows:

- Real estate owned (exclusive of office building),
- Real estate equitably owned (in dummy holder).

This account is included merely to insure the fact that an association will not report, as mortgage loans, real estate which is actually owned but which, for purposes of covering up the financial condition, is held in the name of some other individual other than the association.

Real estate in judgment and subject to redemption.

1. The accountant will be well advised to prepare a schedule of real estate owned showing:

Number (of account),

Date acquired,

Location,

Type of property

Balance at previous examination,

Additions during period,

Credits:

Amount received for properties sold

Loss (or profit) on sale

Other credit,

Balance at date of examination,

Appraisal:

Date

Amount

By whom,

Assessed valuation,

Unpaid taxes and assessments,

Papers examined:

Deed

Title papers

Insurance - face and kind,

Income for period,

Expenses for period.

2. Scrutinize carefully the accounts covering all new acquisitions in the real-estate account, checking the cost of each parcel with properly approved vouchers and directors' authorizations. Inquiry should be made as to the basis of establishing the book value of real estate acquired and the accountant's report should contain comment on the basis used.
3. Check the sales prices of all real estate disposed of during year with sales agreements and directors' authorizations.
4. Examine deed, certificate of counsel as to title, guaranteed search, or title-insurance policy, pertinent to each parcel of real estate owned.
5. Check property-insurance policies. Determine that the association is fully protected against the most common hazards, which include fire, tornado, and owners' liability.
6. Check by direct communication accounts of rents in arrears of each tenant and prepare a schedule of such arrearages. In those associations where the task would not be onerous, it would be very informative and helpful to the association if a list of income and expenses on each property were made part of the detailed schedule of real estate owned. Such a schedule might be further augmented by the inclusion of such data as percentages of yield and comparative vacancies during the period under review.

FIXED ASSETS

1. An analysis of the accounts for such assets as the office building and the furniture and fixtures of the association should be prepared. Such an analysis should set forth:
  - (a) Balance of account at beginning of period under review.
  - (b) Cost of new acquisitions or additions.
  - (c) Accumulated depreciation allowance at beginning.
  - (d) Provision and charges to depreciation reserve for year under examination.
  - (e) Encumbrances on each asset.
  - (f) Insurance carried covering each asset.
  - (g) Appraisal value, if any.
  - (h) Assessed value of real estate.
  - (i) Unpaid taxes and assessments.
  - (j) Income from other tenants and operating costs of real estate used to house the association's offices.
2. Sales of fixed assets should be scrutinized, and profits or losses therefrom, when determined, should be recorded separately as extraordinary charges or credits.
3. Any additions or retirements of fixed assets should be supported by properly approved vouchers and (in the case of larger items) by directors' approval.

MISCELLANEOUS ASSETS

Details should be obtained and checked in connection with all miscellaneous assets of any consequence. Pertinent data describing such items should be included in the comments of the accountant's report.

SHARE ACCOUNTS

The accounts of shareholders are classified in the statement of condition as follows:

A. Repurchasable or free shares.

(a) Installment shares dues credited

Deduct - Delinquent dues (if carried)  
Add - Dividends (unless included in dues credited above)

(b) Optional shares (payments and dividends)

(c) Prepaid shares (or income shares)  
Add - Dividends (unless included with shares)

(d) Full - Paid shares

(e) Matured shares

B. Mortgage pledged shares.

Deduct - Delinquent dues (if carried)  
Add - Dividends

1. If the association is operating on a serial plan, the above distinction between free and mortgage-pledged shares may not be readily available, because the value of shares is set forth according to series and the statement which records the progress of shares toward maturity merely indicates the number of free and of pledged shares in each series but does not

compute the value of each class. In the lists of arrearages and of advance payments which are frequently used in such cases, the delinquencies or advances on free shares are scheduled with those on pledged shares. While it has not been customary to segregate these items, it is nevertheless considered to be advisable to do so because it is more informative. Mortgage-pledged shares exist in an association which makes share-account sinking-fund loans.

2. In making an examination of share accounts, the following items should be taken into consideration:

- (a) The general ledger controls must be in agreement with the footings of the balances in the subsidiary ledgers.
- (b) Confirmation of shareholders' accounts by direct communication is desirable. The examination of pass books by the accountant will obviate the need of direct mail confirmation.
- (c) Such confirmation should include the accounts re-purchased or withdrawn and matured during the period under review.
- (d) Serial numbers of pass books and of certificates issued and cancelled should be accounted for.
- (e) Test-check the dividends paid or credited to shareholders during the period under review.
- (f) Ascertain if the association's earnings are sufficient to cover the rate of dividend declared.

DEPOSITS, INVESTMENT CERTIFICATES

Where these exist the same procedure as that set forth under paragraph two of share accounts should be followed. The accountant should examine cancelled certificates in support of withdrawals during the period and should inquire into the control exercised over the issuance of certificates.

ADVANCES FROM FEDERAL HOME LOAN BANK AND OTHER BORROWED MONEY

These should be scheduled and confirmed by direct communication. Interest accrued thereon should be checked. It should be noted in the description of advances from Home Loan Banks that such advances are secured in accordance with the Federal Home Loan Bank act.

All borrowed money must be authorized by the board of directors and should be treated in a manner which conforms to provisions of statute, charter, and by-law.

OTHER LIABILITIES

The following liabilities should be scheduled and checked to the satisfaction of the accountant:

1. Mortgages on real estate owned.
  - (a) Accountant should confirm this item and all pertinent facts with mortgagee.
  - (b) List pertinent information concerning the mortgage, including date made, date due, name of mortgagee, amount, and property covered.

- (c) If such a mortgage is not permitted by the state law under which the association is operating, the accountant should so advise the board of directors.
- (d) Any mortgage against real estate owned which has been assumed or created by the association should be shown as a liability rather than be deducted from the asset account.

2. Dividends declared, unpaid, and uncredited.

- (a) Check authority for such dividends.
- (b) Unless for current period determine why they have neither been paid nor credited.

3. Taxes accrued and unpaid on real estate owned.

- (a) Obtain list of such items and compare with tax bills and the list of properties owned.
- (b) If the accountant is not satisfied with the association's tax records and where property was acquired without foreclosure, a tax search should be recommended.

4. Accounts payable.

Ordinary obligations such as those incurred by any other business may result in accounts payable, particularly for expense bills rendered to the association.

Obtain a list of the recorded accounts payable and make appropriate check with the ledger accounts. Reconcile the total with the controlling account in the general ledger.

It is suggested that the accountant review payments shown by the cashbook subsequent to the date of the balance sheet to ascertain whether any of them are applicable to the period under review. Bills on file which have not been entered should be examined to determine if any of them belong to the period under review.

Investigate any large balances which do not represent specific or recent items. Obtain confirmation from the creditor if any account appears to be irregular.

5. Loans in process.

These include loans which have been approved by the board of directors but for which funds are either entirely or partially withheld. This account should be analyzed to detect dormant accounts and overdrafts. Such loans may be confirmed by direct communication with borrowers. A list of such loans should be prepared and retained by the accountant.

6. Advance payments.

These comprise the following:

- (a) Advance payments by borrowers for taxes and insurance  
(if carried separately)
- (b) Unapplied mortgage credits.

It is preferable to secure confirmations of advance payments directly from the borrowers when requesting confirmation of mortgage loans.

The accountant's report should set forth clearly the provisions of the association's mortgage contracts, that is, whether these credits are applied to the mortgages semiannually or at other stated periods.

7. Accrued interest payable.

Under this heading would be included accrued interest payable on such items as:

Deposits.

Money borrowed and mortgages payable:

- (a) The accountant should review all liability accounts to ascertain whether interest has been accrued on all interest-bearing obligations.
- (b) The accountant should check the method of computing interest and determine that the details prove with the controlling accounts.
- (c) The charge therefor appearing in the statement of operations should at least be test-checked against the liabilities outstanding throughout the year.
- (d) Where the liabilities bearing interest are confirmed, the accrued interest should also be confirmed.

8. Federal or state income tax payable.

If the association is liable for these taxes, the accountant should check their computation.

PERMANENT, RESERVE OR GUARANTY STOCK

Wherever such stock exists, examine the stock records, the authorization for its issue by the board of directors, the propriety of the stock under state law. Confirmation by direct communication with shareholders is desirable and at least fifteen percent of shareholders' accounts should be circularized. The Federal Home Loan Bank Board audit requires check and inspection of at least ten percent of the number of accounts and some states require more circularization than the fifteen percent suggested above. In the latter cases, the accountant must comply with state requirements. Certificates should be accounted for by number and those cancelled during the period should be examined.

DEFERRED CREDITS TO FUTURE OPERATIONS

This may include many different items, the most common of which will be (a) income collected in advance and (b) unrealized profit on real estate sold.

- (1) A check should be made on the mathematical accuracy of the computation of income collected in advance, the extent thereof depending on the volume and on the system of internal check in use.
- (2) The accountant should ascertain the association's policy as to taking into income the earned portion of deferred credits.
- (3) A schedule should be obtained or prepared showing

thereon for each property sold:

Date sold,

Description,

Sale price,

Cost of parcel,

Other expenses,

Gross profit,

Balance of unrealized profit at beginning  
of period

Addition during period,

Realized during period,

Balance of unrealized profit at end of period.

### RESERVES

1. These are placed into two main groups with subordinate classes as follows:

(a) Specific reserves

(1) For uncollected interest

(2) For junior liens

(b) General reserves

(1) Legal reserve

(2) Federal insurance reserve (if insured)

(3) Contingencies

(4) Real estate

2. A schedule should be obtained or prepared summarizing the changes during the period as follows:

Title of reserve  
Balance at beginning of period

Credits:  
Through charges to profit or undivided profit  
Other credits

Charges:  
Through credits to profit and loss undivided profits  
Other charges

Balance at end of period.

3. While uncollected interest is included as an asset under first mortgage loans, a conservative practice in the savings and loan business dictates that it should not be included as part of the association's undivided profits and it is common practice among associations to reserve for the entire amount of uncollected interest. A practice required of all Federal savings and loan associations is to reserve for accrued interest on mortgage loans only in instances where it is overdue for more than ninety days. The accountant should ascertain that the reserve is set up on the basis authorized by the board, should form an opinion of its adequacy, and if necessary, qualify his report.

4. It is common practice to create a reserve in full for all junior liens (such as second mortgages). If this is the desire of the association's board, the accountant should call attention to the existence of any errors or omissions. If, however, another method is used and the reserve is obviously too low and the amount is relatively important, the accountant should include

a proper qualification in his report. The accountant, however, is not an appraiser and is therefore not in a position to assume responsibility for valuations of real estate and properties underlying mortgage loans.

5. Federal and state supervising authorities have legal requirements for creation of reserves. The accountant should ascertain if the association has properly computed such legal reserves.

6. If the association is insured, the accountant should ascertain if it has created the reserves required by Federal Savings and Loan Insurance Corporation.

7. Reserves for contingencies should be scrutinized not only to determine if they appear to be sufficient, but also to ascertain if they are excessive.

8. The accountant should make use of up-to-date reports of competent appraisers in checking the amount of real estate reserves.

9. Expenditures charged to the reserves should be vouched, and it should be ascertained that the minutes contain proper authorizations for assets charged off against reserves. The accountant should insist on the correction of items in the nature of operating expenses improperly charged against reserves, otherwise a qualification relative thereto is necessary in his report.

BONUS ON SHARES AND RESERVE FOR ESTIMATED DIVIDEND REQUIREMENTS

1. The charter for Federal savings and loan associations and some state statutes provide for a bonus on shares as a portion of profits which is available for those shareholders who establish a prompt payment record. Any increase or decrease in such bonus should be carefully examined by the accountant and checked with the association's charter and by-laws, as well as statutory requirements, as applicable.

2. The reserve for estimated dividend requirements is merely the earmarking of an approximate portion of undivided profits which are to be made available to shareholders on the next dividend date upon authorization by the board of directors.

UNDIVIDED PROFITS

1. Analyze undivided profits for the period covered by the examination. Reconcile the opening balance with the undivided profits in the previous balance sheet.

2. Dividends declared, paid, or credited should be checked with the minutes of the board of directors' meetings.

3. The accountant should consider the propriety of all entries in the undivided profits account.

4. Check statutory regulations and limitations, if any, governing this account.

STATEMENT OF OPERATIONS

General

1. The accountant should satisfy himself that income and

expense are properly classified in so far as the facts are known to him or are ascertainable by reasonable inquiry. The extent of the examination of profit and loss operations during the period under examination is dependent upon the factors discussed at the beginning of section 3.

2. This statement should show a breakdown of income and expense into subdivisions similar to those adopted by the accounting division of the United States Building and Loan League.

3. Comparative statements are recommended, and it is suggested that the accountant look into those items which vary materially between the two periods.

Income •

Much of the work on the items of income will in practice be carried out concurrently in connection with the examination of the corresponding asset accounts.

1. The main operating income of savings and loan associations consists of interest on mortgage loans and interest on share loans. These items should be checked by an examination of the loan accounts and a comprehensive test check of income for two or at least one selected month of the period under review, depending upon the size of the association.

2. Rents collected on properties owned may make up a large item of income. The record should be examined in connection with each particular property, checking back the monthly receipts of each tenant as indicated by the leases and the collector's

duplicate receipt books or collector's monthly report. The monthly rent and the arrears of rent, if any, may be confirmed by direct correspondence with the tenant. At least a test circularization of rental accounts should be made.

3. Other income consists of interest on investments, premiums on loans, appraisal fees, fines, membership fees, transfer fees, etc. The policy of each association with respect to these fees should be investigated and test checks made sufficient to satisfy the auditor whether such income has been properly accounted for. It should be noted that bond coupons have been deposited on or about the proper date.

4. Where amounts of premiums on loans are substantial, they may be taken into income over a period of years and current income therefrom will have been checked in connection with the work on deferred credits.

5. The non-operating income consists of dividends or apportioned profits retained on withdrawals, profit on sale of real estate, and profit on sale of investments. These, of course, should be checked in an appropriate manner.

#### Expenses

Much of the work on the items of expense in practice would be carried out concurrently with the examination of the corresponding liability accounts.

1. The expenses consist in part of the cost of operating the real estate, which at the present time would probably be a most important item. Disbursements should be supported by bank

vouchers or other appropriate vouchers, and these should be test checked to invoices rendered to the association. Each invoice should bear the approval of the manager of the real estate or of the members of the special real estate committee, depending upon the practice of the association which is sometimes governed by statutory or supervisory regulation.

2. Other important expenses are compensation to directors, officers, and employees. These should be vouched or checked to see that proper authorization has been given by the board for the amounts paid. If the association owns its own building, there would be, of course, disbursements for its maintenance.

#### SECTION 4

##### Statements

The statement of condition, the statement of operations, reconciliation of undivided profits, and the statement of reserves are set forth below in the form which has been found to be acceptable to the examining division of the Federal Home Loan Bank Board. The statements are rendered in sufficient detail to give all required information to the management and to the shareholders of the association under review. More condensed statements would ordinarily be prepared for dissemination to the general public. In any event, the basis on which real estate, investments, office building, and furniture and fixtures are stated in the balance sheet should be indicated therein.



STATEMENT OF CONDITION (continued)

Exhibit A

CAPITAL AND LIABILITIES

20. Repurchasable or free shares:		
a. Installment share dues credited	\$	_____
Deduct - Delinquent dues (if carried)		_____
Sub-total		_____
Add - Dividends (unless included in 20-a)		_____
Net free installment shares		\$_____
b. Optional shares (payments and dividends)		_____
c. Prepaid shares	\$	_____
Add - dividends (unless included in 20-c)		_____
Net prepaid shares		_____
d. Full-paid shares		_____
e. Matured shares		_____
f.		_____
g.		_____
Total repurchasable or free shares	\$	_____
21. Mortgage pledged shares	\$	_____
Deduct - Delinquent dues (if carried)		_____
Sub-total	\$	_____
Add - Dividends		_____
Net mortgage pledged shares		_____
22. Deposits, investment certificates (by classes):		
a.	\$	_____
b.		_____
c.		_____
d.		_____
23. Interest accrued on item 22		_____
24. Advances from Federal Home Loan Bank		_____
25. Borrowed money:		
a. From banks and other associations	\$	_____
b. From others		_____
26. Mortgages on real estate owned		_____
27. Interest accrued on items 24, 25 and 26		_____
28. Dividends declared, unpaid, and uncredited		_____
29. Taxes accrued and unpaid on real estate owned		_____
30. Accounts payable		_____
31. Loans in process		_____
32. Advance payments:		
a. Advance payments by borrowers for taxes and insurance (if carried separately)	\$	_____
b. Unapplied mortgage credits		_____
33. Other liabilities		_____
34. Permanent, reserve or guaranty stock		_____
35. Deferred credits to future operations:		
a. For unearned profit on real estate sold		_____
b. For income collected in advance		_____
c.		_____
36. Specific reserves:		
a. For uncollected interest	\$	_____
b. For junior liens		_____
c.		_____
37. General reserves:		
a. Legal reserve	\$	_____
b. Federal insurance reserve (if insured)		_____
c. For contingencies		_____
d. Real estate reserve		_____
e.		_____
38. Bonus on shares		_____
39. Undivided profits		_____
40. Reserve for estimated dividend requirements		_____
TOTAL CAPITAL AND LIABILITIES	\$	_____

STATEMENT OF OPERATIONS

Exhibit B

Name of Institution \_\_\_\_\_

From \_\_\_\_\_ For the Year \_\_\_\_\_ 193 \_\_\_\_\_ 193 \_\_\_\_\_ Previous Year Ended \_\_\_\_\_ 1

**I. GROSS OPERATING INCOME:**

1. Interest	_____	_____	_____
a. On mortgage loans - ordinary cash collections	\$ _____	_____	\$ _____
b. On mortgage loans - all other	_____	_____	_____
c. On loans on shares, passbooks and certificates	_____	_____	_____
d. On real estate sold on contract	_____	_____	_____
e. On investments and bank deposits	_____	_____	_____
f. Other	_____	\$ _____	_____
2. Premium or commission on loans (current installment and amortizations only)	_____	_____	_____
3. Appraisal fees, legal fees & initial service charges	_____	_____	_____
4. Other fees and fines	_____	_____	_____
5. Real estate operations	_____	_____	_____
a. Gross income from operation of real estate owned	\$ _____	_____	\$ _____
b. Less - Cost of repairs, taxes and maintenance	_____	_____	_____
Net income or loss from R.E.O. (Black or red)	_____	_____	_____
6. Gross income from office building	_____	_____	_____
7. Dividends	\$ _____	_____	\$ _____
a. On stock in Federal Home Loan Bank	_____	_____	_____
b. Other dividends	_____	_____	_____
8. Miscellaneous operating income	_____	_____	_____
9. Gross operating income	_____	\$ _____	_____
II. LESS OPERATING EXPENSE			
10. Salaries, etc.	\$ _____	_____	\$ _____
a. Compensation to directors, officers, employees, etc.	_____	_____	_____
b. Collection expense (agents, etc.)	_____	\$ _____	_____
11. Legal services - retainer, traveling expenses & special services	_____	_____	_____
12. Expense accounts of directors, officers and employees	_____	_____	_____
13. Rent, light, heat, etc.	_____	_____	_____
14. Office building expense (if owned)	\$ _____	_____	\$ _____
a. Repairs, taxes and maintenance of office building	_____	_____	_____
b. Depreciation of office building	_____	_____	_____
15. Furniture, fixtures and equipment, including depreciation	_____	_____	_____
16. Advertising	_____	_____	_____

STATEMENT OF OPERATIONS

Exhibit B  
(Continued)

	For the Year		Previous Year Ended
	From	to	
	193	193	193
II. Less Operating Expense (continued):			
Brought Forward			
17. Stationery, printing and office supplies	\$ _____		\$ _____
18. Telegraph, telephone, postage and express	_____		_____
19. Insurance and bond premiums	_____		_____
20. Federal insurance premium (if insured)	_____		_____
21. Audit	_____		_____
22. Supervising examinations and assessments	_____		_____
23. Organization dues	_____		_____
24. Other operating expense	_____		_____
25. Total operating expense	_____		_____
III. Net Operating Income Before Interest and Other Charges	\$ _____		\$ _____
IV. LESS INTEREST CHARGES:			
26. On deposits, investments, certificates, etc. _____%	\$ _____		\$ _____
27. On advances from Federal Home Loan Bank	_____		_____
28. On borrowed money	_____		_____
29. Total interest	_____		_____
V. Net Operating Income	\$ _____		\$ _____
VI. ADD NON-OPERATING INCOME:			
30. Dividends retained on repurchases and withdrawals	\$ _____		\$ _____
31. Profit on sale of real estate	_____		_____
32. Profit on sale of investments	_____		_____
33. Other non-operating income	_____		_____
34. Total non-operating income	_____		_____
VII. Net Income After Interest and Before Charges	\$ _____		\$ _____

STATEMENT OF OPERATIONS

EXHIBIT B  
(Continued)

	For the Year	Previous Year Ended
	From <u>193</u> to <u>123</u>	<u>192</u>
VIII. LESS NON-OPERATING CHARGES (do not use lines herein for items charged direct to reserves):		
35. Foreclosure costs and back taxes on real estate acquired (unless capitalized or charged to reserves)	0\$ _____	\$ _____
36. Loss on sale of real estate	_____	_____
37. Loss on sale of investments	_____	_____
38. Other non-operating charges	_____	_____
39. Total non-operating charges	_____	_____
IX. Net Income for Period	\$ _____	\$ _____

RECONCILEMENT OF UNDIVIDED PROFITS ACCOUNTS

Exhibit C

for the year ended \_\_\_\_\_, 193\_\_

1. Balance of undivided profits at beginning of year		\$	_____
2. Net income for the year (item IX of Exhibit B)		\$	_____
Less distribution of net profit:			
3. Transfers to reserves			
a. For bonus on shares	\$	_____	
b. Legal reserve		_____	
c. Federal insurance reserve (if in- sured)		_____	
d. For contingencies		_____	
e. Real estate reserve		_____	
f. _____		_____	
Total transfers to reserves		_____	
4. To dividends			_____
5. Balance to undivided profits (black or red)			_____
6. Balance before adjustments			_____
7. Other additions (itemize)			
a. _____			_____
b. _____			_____
c. _____			_____
8. Sub-total			_____
9. Other deductions (itemize)			
a. _____			_____
b. _____			_____
c. _____			_____
10. Balance of undivided profits at end of year (Item 39 of Exhibit A)		\$	_____



STATEMENT OF RESERVES

Exhibit D  
(Continued)

	Reserve for Contingencies			Previous Year Ended		
	From	To		193	193	193
	193	193		193	193	193
1. Balance at beginning of period	\$	\$		\$	\$	\$
2. Additions during period:						
(a) From net profit	\$	\$		\$	\$	\$
(b)	\$	\$		\$	\$	\$
(c)	\$	\$		\$	\$	\$
(d)	\$	\$		\$	\$	\$
3. Total additions	\$	\$		\$	\$	\$
4. Totals of items 1 and 2	\$	\$		\$	\$	\$
5. Deductions during period:						
(a)	\$	\$		\$	\$	\$
(b)	\$	\$		\$	\$	\$
(c)	\$	\$		\$	\$	\$
(d)	\$	\$		\$	\$	\$
(e)	\$	\$		\$	\$	\$
(f)	\$	\$		\$	\$	\$
(g)	\$	\$		\$	\$	\$
6. Total deductions	\$	\$		\$	\$	\$
7. Balance at end of period	\$	\$		\$	\$	\$
	<u>Real Estate Reserve</u>					
1. Balance at beginning of period	\$	\$		\$	\$	\$
2. Additions during period	\$	\$		\$	\$	\$
3. Totals of items 1 and 2	\$	\$		\$	\$	\$
4. Deductions during period:						
(a)	\$	\$		\$	\$	\$
(b)	\$	\$		\$	\$	\$
(c)	\$	\$		\$	\$	\$
(d)	\$	\$		\$	\$	\$
5. Total deductions	\$	\$		\$	\$	\$
6. Balance at end of period	\$	\$		\$	\$	\$

STATEMENT OF RESERVES

Exhibit D  
(Continued)

	For the Year		Previous Year Ended
	From To	193 193	1
1. Balance at beginning of period		\$ _____	\$ _____
2. Additions during period:			
(a)	\$ _____		\$ _____
(b)	_____		_____
(c)	_____		_____
3. Total additions		\$ _____	\$ _____
4. Totals of items 1 and 2		\$ _____	\$ _____
5. Deductions during period:			
(a)	\$ _____		\$ _____
(b)	_____		_____
(c)	_____		_____
(d)	_____		_____
6. Total deductions		_____	_____
7. Balance at end of period		\$ _____	\$ _____

1

SECTION 5

Accountant's Report

The accountant's report on the examination of a savings and loan association should be along the lines of those recommended in the American Institute of Accountants' bulletin, "Examination of Financial Statements." It should be concise and fully explanatory. Explanations and exceptions, if any, should be stated clearly and concisely, and distinction should be made between comments which are intended to be merely informative and those which indicate dissent from the particular practices of the association.

The accountant should be cautious in making any statements which are not literally true or which might arouse unwarranted implications. A suggested form of accountant's report follows:

Short Form of Independent Certified Public Accountant's Report  
TO THE BOARD OF DIRECTORS OF THE XYZ SAVINGS  
AND LOAN ASSOCIATION:

We have examined the statement of condition of the XYZ Savings and Loan Association as of April 30, 1939, and the statements of operations, undivided profits, and reserves for the fiscal year then ended, have reviewed the system of internal control and the accounting procedures of the association, and, without making a detailed audit of the transactions, have examined or tested accounting records of the association and

other supporting evidence, by methods and to the extent we deemed appropriate.

In our opinion, the accompanying statement of condition and related statements of operations, undivided profits, and reserves present fairly the position of the XYZ Savings and Loan Association at April 30, 1939, and the results of its operations for the fiscal year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

#### NOTES

1. This report would be appropriate only if the accounting for the year is consistent in basis with that for the preceding year; if there has been any material change either in accounting principles or in the manner of their application, the nature of the change should be indicated.

2. The form of report must, of course, be modified when necessary to include any qualifications, reservations or supplementary explanations.

3. This form pre-supposes that the accountant will be satisfied that his examination has been adequate and in conformity with the principles outlined in this bulletin.

4. The accountant's report should be addressed to the directors of the association or to its shareholders if the appointment is made by them.

5. A proper notation should be made on the balance sheet by footnote or otherwise relative to mortgages pledged as collateral or borrowed money.

DETAILED REPORT

It is important that in addition to the certified statements the accountant submit a detailed report disclosing the scope of his work and a discussion of pertinent matters affecting the association's accounts. It should disclose all fiscal policies in use by the association under review.

The following suggestions are submitted as a guide to those matters which might well be covered:

- (a) List of investments, showing market, income and comments on items for which no income was received
- (b) Mortgages:
  - Past due
  - In arrears as to payments
  - In arrears as to taxes
  - Items in process of foreclosure
  - Items for which comparatively recent appraisals are not available
  - Items where loan exceeds per cent of appraisal permitted under the association's policy
  - Accounting practice re: interest in arrears
  - Comments on larger items in arrears and as to sufficiency of the reserve therefor
  - List of mortgages out for filing and other items not examined such as insurance policies, appraisals, certificates of title, etc.
  - Insurance policies without mortgagee clause
- (c) Statistics relative to circularization such as:
  - (1) Number and amount of balances for which confirmations were received and the percent thereof of the totals
  - (2) Similar information as to:
    - Replies received where exceptions were not noted
    - Replies received with exceptions

- (d) Details of loans, showing interest rates and items in arrears
- (e) Schedule of other real estate summarizing changes during year, income and expenses of individual properties, appraised and assessed figures therefor, insurance, etc.
- (f) Comparative statement of income and pertinent percentages in relation thereto
- (g) Statement of application of funds
- (h) Insurance on office building, fidelity, burglary and other insurance in effect
- (i) Salaries of officers and directors' fees
- (j) Instances observed where State Laws, Federal Home Loan Act and regulations are not being observed
- (k) Detailed statements along the lines of those adopted by the Federal Home Loan Board or the recommendation of state supervisors.

Specifically, the accountant should disclose the practice of the association in evaluating property charges taken into the real estate account when a real estate contract is forfeited. When accrued interest is added to the balance of the contract, the report should disclose whether the amount of the accrued interest has been set up in the reserve for uncollected interest or is included as income.

The accountant's comments should state the practice of the association in setting up the account for real estate owned, that is, whether it has been included at the cost or appraised value, whichever is lower, or whether a reserve has been created for the amount by which costs of individual properties exceed the appraised value.

If the reserve for uncollected interest is credited when accrued interest receivable is set up on mortgage loans and such interest taken into income only when cash is received, the accountant's report should disclose this fact.

Generally, there is no provision for depreciation on real estate acquired by an association except on its office building. The reasoning behind this is that real estate is part of the investment account in the case of a savings and loan association and is not considered as fixed capital. If the association does depreciate real estate which has been acquired through foreclosure in the course of its regular lending operations, the accountant should disclose the practice.