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Tentative Draft: Program for Audits or Examinations of Savings and Loan Associations

American Institute of Certified Public Accountants. Special Committee on Savings and Loan Accounts

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Tentative -- Not for Publication

AMERICAN INSTITUTE OF ACCOUNTANTS
SPECIAL COMMITTEE ON SAVINGS AND LOAN ACCOUNTS

Tentative Draft
Program for Audits or Examinations of
Savings and Loan Associations

AUDITS OR EXAMINATIONS OF SAVINGS AND LOAN ASSOCIATIONS

SECTION 1

General

The special committee on savings and loan accounts of the American Institute of Accountants was appointed in the spring of 1936 by the President of the Institute, and the Institute's program of activities for the fiscal year 1936-37 described the duties of such committee 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 the above program, there has been devised the following procedure for the audit of savings and loan associations. In this connection it must be borne in mind that every accountant must exercise discretion while conducting such audits because conditions vary depending upon size and type of associations, and depending also upon state or Federal regulations or requirements.

The program which is presented herein cannot be considered as a definite rule, but merely as a guide, and it constitutes neither the maximum nor the minimum requirement. Neither is this an attempt to instruct the accountant in the fundamentals of auditing.

It is believed 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 coordination between the nation's certified public accountants and government examiners.

Inasmuch as many fundamentals of accounting practice apply to savings and loan associations in the same manner as they would apply to other types of business, it is recommended that those interested in the examinations of Savings and Loan Associations should acquaint themselves with the bulletin prepared and published by the American Institute of Accountants in January 1936 entitled "Examination of Financial Statements by Independent Public Accountants." Accounting principles as discussed in that bulletin are not changed nor altered in this one, and consequently all details discussed therein will be omitted from this text.

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. Insofar as standardization in financial procedure had been impracticable if not impossible, until the educational work of the United States League of Building and Loan Associations and the American Savings and Loan Institute had made an impression on those engaged in this business throughout the country, it was likewise impracticable to attempt to standardize the accounting methods of these institutions.

The Federal Home Loan Bank Act and the creation of the Federal Home Loan Bank Board thereunder, resulted in the rapid crystallization of the best thought on this subject. Each of the three above mentioned groups have 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 this work has been supplemented by that body through the preparation of a course in accounting, conducted under its auspices in the large cities of the nation. In addition, there are some very helpful articles on the same subject of savings and loan accounting to be found in the periodicals published by the several Federal Home Loan Banks, by the United States League of Building and Loan Associations, and by the several State Building and Loan Societies.

In the preparation of this program we wish to acknowledge with appreciation the opportunity to review the examination procedure which has been made available to us by the Federal Home Loan Bank Board.

SECTION 3

Outline of Examination

When considering the scope of the examination which is about to be made, there must be taken into consideration its purpose as well as the system of internal check in effect. It is well known that at least once each year the Federal Home Loan Bank Board examiners examine their member associations, and in the several 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.

"A system of internal check and control" is defined in the "Examination of Financial Statements." In large associations where such a system is in operation, the detailed tasks of the auditor may properly be curtailed. It is also 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. Where such control is had, a detailed audit is not justified, and the accountant may rely on various test-checks. The extent of these test-checks is a matter of judgment which must be exercised by the accountant.

The accountant's work does not include appraisals; property values and the investigation of the status of titles are not within his province. Whenever legal or engineering problems arise, it would be well for the accountant to make reasonable inquiry, and upon ascertaining the facts, suggest to the association that it consult with its legal or engineering advisors. It is requisite for the accountant engaged in this manner of work to acquaint himself with the Federal or State requirements, to be well informed

on accepted accounting practice for such associations, and to satisfy himself that these accepted accounting practices have been consistently followed throughout the period covered. If the statement of condition 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 accepted form. This form is outlined at the conclusion of this outline.

If the accountant prepares these statements, it is recommended that he follow the accepted 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 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.

Where associations have cash and negotiable securities, they 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 latter date, the count or confirmation should be made as of that date and the changes in the intervening period should be investigated. The extent of this scrutiny would be governed by the special conditions surrounding each case.

In regard to balances of receivables (accounts, notes, mortgages, etc.) and members' deposit accounts, etc., the only complete check thereof can be had through the accountant requesting direct from the debtors or members confirmation of balances. Here again a test circularization may suffice, but the accountant should be the sole judge of the accounts selected for that purpose. 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.

There follows the proposed routine examination work to be carried out in respect of the various accounts grouped in the order they 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 thereto 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 should in all cases, with the possible exceptions of accruals, be agreed 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.

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

The subclassifications 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 auditor 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 auditor should guard against the possibility of a shortage in such assets being covered up by a temporary conversion.

(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 no 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 depositories. These balances should be reconciled with the balances shown on the cashbook and checkbook stubs or check registers and particulars should be noted of all outstanding items. The checks returned by the banks should be compared with the cashbook disbursements. In the case of small associations, this should be done for the entire year. In the case of large 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 investigated. 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 specially investigated.

(4) Compare cash receipts with bank deposits. In small associations this should be done for the entire period. In associations having a good internal control, the same test may be made as indicated above in the examination of cancelled checks.

(5) Prove footings of cash book columns for the period during which checks are examined.

(6) Compare all checks outstanding at the beginning of the period which were not returned in a previous examination with the cash disbursement entry.

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

Securities

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

The examination of these securities does not differ materially from that described in the "Examination of Financial Statements" and that portion which is pertinent to the examination of savings and loan associations is set forth below:

- (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 and number of shares

Cost of securities and the amount at which
carried on the books

Interest and dividends received during period
under review

Market quotations if such are available, loca-
tion of securities, and if hypothecated, with
whom and for what purpose.

- (2) Compare securities listed with the corresponding ledger accounts and ascertain the basis on which the securities are carried on the books. Wherever practicable, compare serial numbers of bonds and other securities 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 depositories 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 are bought or sold through brokers examine their advices in support of purchase and/or sales prices.
- (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.

Mortgage Loans

Mortgage loans are the most important assets of a savings and loan association and are classified herein as follows:

A. First Mortgage Loans:

- (a) First Mortgage Direct Reduction Loans
- (b) First Mortgage Share Accounts 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.

The program for the examination of mortgage loans is as follows:

1. For smaller associations, a schedule of the mortgages should be obtained or prepared, showing the following:

Number

Date

Name

Property and location

Original amount

Amount written off

Balance at examination date

Instalments in arrears

Advances

Taxes in arrears (or date to which paid)

Amount of prior mortgages

Interest paid to (date)

Amount of interest in arrears

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 of those mortgages requiring special comment only.

2. The following papers supporting mortgage loans should be examined when a detailed examination of such loans is made:

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.

In some cases, a separate assignment of shares signed by the mortgagor is necessary. If the minutes or the property committee report requires additional collateral, the assignment of such collateral and the collateral itself should be examined by the accountant. If it is 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 mortgages in certain sections and mortgages of directors and officers, as well as those of firms or companies in which such officials are 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.

SHARE LOANS

Share loans are classified 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 on account of the volume of work involved in the case of the larger associations, 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 comment:

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. The shareholder's note should be examined as well as his pledged certificate (or passbook if the association issues no certificate).

3. The accountant should make certain that sufficient payments have been made to warrant the amount loaned and 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 carefully checked.

Other Loans

These loans are classified 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 should be listed and classified 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).
1. These contracts should be examined closely and complete details of each parcel of property should be retained 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 especially 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.

Real Estate Owned

This is classified as follows:

- Real Estate Owned (exclusive of office building)
- Real Estate Equitably Owned (in dummy holder)

Real Estate in Judgment and subject to redemption.

1. Prepare schedule of real estate owned showing:

Number

Date **Acquired**

Description & Location 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

Assessed valuation

Papers examined:

Deed

Title papers

Insurance - face and kind

Income

Expenses

2. Scrutinize carefully all new acquisitions in the real estate account, checking the cost of each parcel with properly approved vouchers and directors' authorizations.

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. Is the association fully protected against the most common hazards which include fire, tornado and owner's liability?
6. Check by direct communication accounts of rents in arrears of each tenant and prepare a schedule of such arrearages. 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) Asset value at beginning of period under review.
- (b) Cost of new acquisitions.
- (c) Accumulated depreciation allowance at beginning.
- (d) Depreciation 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) 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 in the statement of operations.

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.

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

SHARE ACCOUNTS

The accounts of shareholders are classified 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 precautions should be taken:

- (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.
- (c) Such confirmation should include the accounts repurchased or withdrawn and matured during the period under review.
- (d) Test-check the dividends paid or credited to shareholders during the period under review.
- (e) Ascertain if the association has been paying the rate of dividend which most nearly conforms to its earnings.

DEPOSITS, INVESTMENT CERTIFICATES

- 1. Where these exist at least a test circularization of depositors should be carried out.
- 2. The total of these items must be in agreement with the control account.

ADVANCES FROM FEDERAL HOME LOAN BANK & OTHER BORROWED MONEY

These should be scheduled and confirmed by direct communication. Interest accrued thereon should be checked and likewise confirmed. It should be noted in the description of this

item that such advances are secured in accordance with the Federal Home Loan Bank Act.

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 with mortgagee.
 - (b) List all information concerning the mortgage including date made, date due, name of mortgagee and amount.
 - (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.
2. Dividends declared, unpaid and uncredited.
 - (a) Check authenticity of such dividends.
 - (b) 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.
 - (b) In those cases where tax delinquencies existed prior to the Association's acquisition of the

property and where it 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 trade accounts payable, particularly for expense bills rendered to the Association. These should be checked in the manner prescribed by the bulletin, Examination of Financial Statements, published by the American Institute of Accountants.

5. Loans in process.

These include loans which have been approved but for which funds are either entirely or partially withheld. The minutes of the board and the cash advances made prior to the date of examination determine the liability.

6. Advance payments.

These comprise the following:

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

Both loans in process and advance payments may be confirmed by direct communication with borrowers. The source of

each liability, however, can be traced through the cash book. A list of such items should be prepared and retained by the accountant. Details, of course, should be reconciled with general-ledger balances.

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 recommended. Certificates cancelled during the period should be examined.

Included among the liabilities there is found accrued interest payable on:

(23) Deposits

(27) Money borrowed and mortgages.

1. The accountant should check the method of computing interest and see that the details prove with the controlling accounts.

2. The charge therefore appearing in the statement of operations should be checked against the liabilities outstanding throughout the year, either in detail or in total.

3. Where the liabilities bearing interest are confirmed, the accrued interest should also be confirmed.

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) unearned 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 the amortization of all such 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. A practice required of all Federal Savings and Loan Associations is to reserve for accrued interest only in instances where it is overdue for ninety days. The accountant should see that the reserve is set up on the basis authorized by the board, and whatever method is followed 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. 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, the accountant should say so. The accountant, however, is not an appraiser and should not attempt to value real estate or mortgage loans.

5. Federal and state supervising authorities have legal requirements for creation of reserves. These must be adhered to and the accountant should see to it that such legal provisions are properly observed by the association.

6. If the association is insured, the accountant should ascertain if it has created the reserves required by Federal 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. Real estate reserves should be created whenever the appraisal values are lower than book values of real estate owned. The accountant should make use of up-to-date reports of competent appraisers in checking the amount of such reserve.

9. Expenditures charged to the reserves should be vouched and assets written off against the reserves must be approved by the minutes of directors.

BONUS ON SHARES AND RESERVE FOR ESTIMATED DIVIDEND REQUIREMENTS

1. Bonus on shares is a portion of profits which was formerly available (in Federal Home Loan Bank Member Associations) for those shareholders who had established a prompt payment policy

Any increase or decrease in such bonus should be carefully examined by the accountant and checked with the Association's charter and with Federal Home Loan Bank practice.

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.

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. Check dividends declared paid or credited to the minutes of the board of directors' meetings.

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

STATEMENT OF OPERATIONS

GENERAL

1. The accountant should satisfy himself that the income received and the expenditures made are properly classified insofar 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 by the Federal Home Loan Bank Board. This form of statement is considered to be most informative by both management and supervising authority.

3. Comparative statements are recommended.

INCOME

Much of the work on the items of income in practice would be carried out concurrently in connection with the examination of the corresponding asset accounts. Nevertheless the following outline is given here.

1. The main operating income of savings and loan associations consists of interest on mortgage loans. This item should be checked by an examination of each mortgage account and an actual check-up with the cash receipts to see that the payments have been received in accordance with the terms of the mortgage, or if the payments have not been received, that the amount not paid is set up as interest arrears.

2. Another item of interest income consists of interest on loans secured by the shares in the association. This should be treated in a similar manner.

3. Rents collected on properties owned 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 rentals in arrears should be made.

4. 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 it should be noted that bond coupons have been deposited on or about the proper date.

5. 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.

6. 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 the usual manner.

EXPENSES

Much of the work on the items of expense in practice would be carried out concurrently in connection 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. This item should be checked very carefully,

every disbursement should be represented by a bank voucher or other appropriate voucher and should be checked to the invoice rendered to the association, and each invoice should bear the approval of the manager of the real estate or the members of the special real estate committee, depending upon the rules and regulations in the particular state.

2. Other important expenses consist of 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 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. Condensed statements may, of course, 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.

Name of Institution _____

as of close of business on _____, 193_____

ASSETS

- | | | |
|--------------------------------------------------------------------------------------------------|----|-------|
| 1. 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 above) | | _____ |
| e. Advances for taxes, insurance, etc., on first mortgage loans (unless included in above) | \$ | _____ |
| 2. 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 | \$ | _____ |
| 3. Share Loans: | | |
| a. Loans secured by shares of this association | \$ | _____ |
| b. Loans on deposit accounts and certificates of investment | | _____ |
| c. Accrued interest receivable on items 3-a and 3-b (unless included in 3-a and 3-b) | | _____ |
| 4. Other Loans: | | |
| a. Loans on all other security | \$ | _____ |
| b. Unsecured loans | | _____ |
| c. Accrued interest receivable on items 4-a and 4-b. | | _____ |
| 5. Real estate sold on contract: | | |
| a. Real estate sold on contract | \$ | _____ |
| b. Accrued interest receivable on real estate sold on contract (unless included in 5-a) | | _____ |
| c. Advances for taxes, insurance, etc., on real estate sold on contract (unless included in 5-a) | | _____ |
| 6. Real estate owned (exclusive of office bldg.) | | _____ |
| 7. Real estate equitably owned (in dummy holder) | | _____ |
| 8. Real estate in judgment and subject to redemption | | _____ |
| 9. Investments: | | |
| a. Stock in Federal Home Loan Bank | \$ | _____ |
| b. Federal Home Loan Bank Bonds | | _____ |
| c. U. S. Government obligations (including H.O.L.C.) | | _____ |
| d. Other investment securities | | _____ |
| 10. Accrued interest receivable on investments | | _____ |
| 11. Cash on hand and in banks | | _____ |
| 12. Office building (if owned): | | |
| a. Office building | \$ | _____ |
| b. Less allowance for depreciation | | _____ |
| 13. Furniture, etc.: | | |
| a. Furniture, fixtures and equipment | \$ | _____ |
| b. Less allowance for depreciation | | _____ |
| 14. Deferred charges | | _____ |
| 15. Other assets | | _____ |

TOTAL ASSETS

\$ _____

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 _____

For the Year
From 1933 to 1935

Previous Year Ended 1935

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)

From 1935 For the Year to 1935

Previous Year Ended 1934

	Brought Forward	
Operating Expense (Continued):		
7. Stationery, printing and office supplies	\$ _____	\$ _____
8. Telegraph, telephone, postage and express	_____	_____
9. Insurance and bond premiums	_____	_____
0. Federal insurance premium (if insured)	_____	_____
1. Audit	_____	_____
2. Supervising examinations and assessments	_____	_____
3. Organization dues	_____	_____
4. Other operating expense	_____	_____
5. Total operating expense	_____	_____
Operating Income Before Interest and Other Charges	\$ _____	\$ _____
LESS INTEREST CHARGES:		
6. On deposits, investments, certificates, etc.	\$ _____	\$ _____
7. On advances from Federal Home Loan Bank	_____	_____
8. On borrowed money	_____	_____
9. Total Interest	_____	_____
Operating Income	\$ _____	\$ _____
NON-OPERATING INCOME:		
0. Dividends retained on repurchases and withdrawals	\$ _____	\$ _____
1. Profit on sale of real estate	_____	_____
2. Profit on sale of investments	_____	_____
3. Other non-operating income	_____	_____
4. Total non-operating income	_____	_____
Income After Interest and Before Charges	\$ _____	\$ _____

STATEMENT OF OPERATIONS

EXHIBIT B
(Continued)

	<u>For the Year</u>	<u>Previous Year Ended</u>
	<u>From</u>	<u>193</u>
	193	<u>193</u>
	to	<u>193</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)	\$ _____	\$ _____
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	\$ _____	\$ _____

RECONCILIATION OF UNDIVIDED PROFITS

Exhibit C

	For the Year		Previous Year Ended
	From	to	193
	193	193	193
1. Balance at beginning of period	_____	_____	_____
2. Add:			
(a) Net income for period (Item IX, Exhibit B)	_____	_____	_____
(b) _____	_____	_____	_____
(c) _____	_____	_____	_____
(d) _____	_____	_____	_____
(e) _____	_____	_____	_____
(f) _____	_____	_____	_____
(g) _____	_____	_____	_____
3. Total additions	_____	_____	_____
4. Totals of items 1 and 2	_____	_____	_____
5. Deduct:			
(a) Additions to reserves -			
(1) For bonus on shares	_____	_____	_____
(2) Legal reserve	_____	_____	_____
(3) Federal insurance reserve	_____	_____	_____
(4) For contingencies	_____	_____	_____
(5) Real estate reserve	_____	_____	_____
(6) Dividends (%)	_____	_____	_____
(b) _____	_____	_____	_____
(c) _____	_____	_____	_____
(d) _____	_____	_____	_____
(e) _____	_____	_____	_____
(f) _____	_____	_____	_____
(g) _____	_____	_____	_____
6. Total deductions	_____	_____	_____
7. Balance at end of the period (Item 39, Exhibit A)	_____	_____	_____

STATEMENT OF RESERVES

Exhibit D

For the Year

From 193
To 193

Previous Year Ended 193

Legal Reserve

\$ _____ \$ _____

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

1. Balance at beginning of period

2. Additions during period

3. Totals of items 1 and 2

4. Deductions during period:

(a) _____

(b) _____

(c) _____

5. Total deductions

6. Balance at end of period

Federal Insurance Reserve

\$ _____ \$ _____

\$ _____ \$ _____

\$ _____ \$ _____

\$ _____ \$ _____

_____ \$ _____

_____ \$ _____

_____ \$ _____

\$ _____ \$ _____

\$ _____ \$ _____

STATEMENT OF ASSETS

Exhibit D
(Continued)

	For the Year		Previous Year Ended
	From	193	193
	To	193	
<u>Reserve for Contingencies</u>		\$ _____	\$ _____
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 193	To 193	193
	<u>Other Reserves</u>		
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		\$ _____	\$ _____

SECTION 5

Accountant's Report

The accountant's report in the audit or examination of a savings and loan association should embody the same principles as those recommended in the American Institute of Accountants bulletin, "Examination of Financial Statements." It should be concise, it should be fully explanatory and consequently should disclose all fiscal policies in use by the association under review. Qualifications, if any, should be reported 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:

To the Board of Directors of the
A B C Savings and Loan Association:

We have made an examination of the statement of condition of the A B C Savings and Loan Association as at December 31, 1937, and of the operating statement of income and expense for the year 1937. In our opinion, based upon such examination, the accompanying statements and related schedules clearly set forth,

in accordance with accepted principles of accounting consistently maintained by the A B C Savings and Loan Association during the year under review, its position at December 31, 1937, and the results of its operations for the year then ended.

Notes

1. The above certificate would be appropriate only if the accounting for the year is consistent with that for the preceding year; if not, the nature of the change should be indicated.

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

3. 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, is the amount of the accrued interest set up in the reserve for uncollected interest or is such interest included as income?

4. The accountant should disclose 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.

5. The accountant's comments should state the practice of the association in setting up the account for real estate owned, that is, has it been included at the cost or appraised value, whichever is lower at the date of acquisition and has the difference been carried in the reserve for loss on real estate owned?

6. 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.

7. The accountant's report should disclose the amount of mortgages pledged as collateral on advances made to the association.

8. A detailed report should include a discussion of pertinent matters affecting the association's accounts:

- (a) List of investments, showing market, income and comments on items for which no income was received
- (b) Mortgages:
 - Past due
 - Instalment in arrears
 - Interest in arrears
 - Taxes in arrears
 - 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 poli-
cies, 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 on the recommendation of State supervisors.

To the Board of Directors of the
A B C Savings and Loan Association:

We have made an examination of the statement of condition of the A B C Savings and Loan Association as at December 31, 1937, and of the operating statement of income and expense for the year 1937. In our opinion, based upon such examination, the accompanying statements and related schedules clearly set forth, in accordance with accepted principles of accounting consistently maintained by the A B C Savings and Loan Association during the year under review, its position at December 31, 1937, and the results of its operations for the year then ended.

To the Board of Directors of the
X Y Z Savings and Loan Association:

We have made an examination of the statement of condition (or balance sheet) of the X Y Z Savings and Loan Association as at December 31, 1937 and of the statement of operations (or income and expense) for the year 1937. In connection therewith we examined or tested records of the Association including a test circularization of mortgages, borrowers and members in respect of balances of mortgages, loans and members' accounts and other supporting evidence, and obtained information and explanations from officers and employees of the association; we also made a general review of the accounting methods and of the operating and income accounts for the year, but we did not make a detailed audit of the transactions, nor request confirmation of balances of mortgages, loans or members' accounts.

We have not appraised other real estate owned or properties underlying mortgage loans but have relied on reports of the official appraisers of the association in forming an opinion as to the adequacy of reserves in respect therefor.

In our opinion, based upon such examination, and subject to the valuation of real and other properties underlying mortgage loans, the accompanying statement of condition and related statements of operations fairly present, in accordance with accepted accounting principles consistently maintained by the X Y Z Savings and Loan Association during the year under review, its position at December 31, 1937 and the results of its operations for the year.
