1969

Audits of Banks -- Supplement

American Institute of Certified Public Accountants. Committee on Bank Accounting and Auditing

AUDITS OF BANKS: SUPPLEMENT

AN AICPA INDUSTRY AUDIT GUIDE

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

NOTICE TO READERS

This audit guide supplement is published for the guidance of members of the Institute in examining and reporting on financial statements of banks. It represents the considered opinion of the Committee on Bank Accounting and Auditing and as such contains the best thought of the profession as to the best practices in this area of financial reporting. Members should be aware that they may be called upon to justify departures from the Committee's recommendations.

AUDITS OF BANKS: SUPPLEMENT

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Preface

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

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

Committee on Bank
Accounting and Auditing

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Audits of Banks: Supplement

Designation of Net Income

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

Securities Gains and Losses

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

Loan Losses

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

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

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

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

The reserve for loan losses under the revised regulations will generally consist of the following elements: (a) a valuation portion available for charging loan losses, (b) a contingency portion not available for absorbing losses, and (c) a deferred-tax portion. So that future adjustments to the reserve may be appropriately classified, the reserve should be analyzed to determine the amounts of the several elements; this analysis should be made of the reserve existing at December 31, 1968, and continued for amounts added thereafter. Loan losses charged to the reserve after December 31, 1968, should not exceed the sum of the valuation portion at December 31, 1968, and the additional valuation portion arising thereafter through charges to operating expenses.

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

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

Illustrative Forms of Bank Financial Statements

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

Balance Sheet

December 31, 19— and 19—

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

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

See accompanying Notes to Financial Statements.

Statement of Income

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

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

See accompanying Notes to Financial Statements.

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

Statement of Changes in Capital Funds

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

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

See accompanying Notes to Financial Statements.

Notes to Financial Statements

For the Year Ended December 31, 19—

1. *Investment Securities*

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

2. *Loan Losses*

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

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

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

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

3. *Bank Premises and Equipment*

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

4. *Pledged Assets*

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

5. *Trust Assets*

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

6. *Commitments and Contingent Liabilities*

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

7. *Surplus Restriction*

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

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

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

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

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

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