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Handbook: **Thrift Activities**  
Subject: **Operations Analysis**

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**Section: 430**

## Thrift Activities Regulatory Handbook Update

**Summary:** This bulletin provides an update to Thrift Activities Regulatory Handbook Section 430, Operations Analysis. Please replace the existing handbook section with the enclosed revised section.

**For Further Information Contact:** Your Office of Thrift Supervision (OTS) Regional Office or the Supervision Policy Division of the OTS, Washington, DC. You may access this bulletin at our web site: [www.ots.treas.gov](http://www.ots.treas.gov).

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### SUMMARY OF CHANGES

OTS is issuing an update to Thrift Activities Handbook Section 430. Change bars in the margins of the handbook sections indicate revisions. We provide a summary of substantive changes below.

#### **430 Operations Analysis**

**Off-Site Monitoring:** Updates the discussion.

**Components of Earnings:** Technical changes to delete references to goodwill amortization.

**Earnings Analysis:** Revises the first paragraph to include securitizations and subprime lending to types of business an institution might be engaged in. Adds a new section, Quality of Earnings, to discuss methods of analyzing the quality of reported earnings and specific types of management practices that may overstate or understate income. We discuss the effects on earnings from the accounting for securitization transactions, goodwill, and negatively amortizing loans.

**References:** Adds FASB and AICPA references.

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**Program** Adds three Examination Objectives to include review of the adequacy of policies and procedures, evaluations of the quality and the sources of earnings, and a review of the association's financial performance. Adds new Level I Examination Procedures numbers 3 and 10, and adds 4, 5, and 7. Moves Level I procedures Nos. 8, 9, and 14 to Level II. Moves Level II procedure Nos. 17 and 18 to Level III. Adds new Level II procedure No. 18. Adds new Level III procedures Nos. 23 thru 25 for examining earnings from securitization transactions.



—Scott M. Albinson  
*Managing Director, Supervision*

**INTRODUCTION**

All phases of the regulatory process, from off-site monitoring between examinations to the final Report of Examination (ROE), involve some form of operational analysis. Operational analysis is the interpretation of financial data through careful and questioning study. An analysis of operations should result in a comprehensive review and evaluation of a savings association's past, current, and prospective earnings. To maintain an association's viability and to minimize risks to the Federal deposit insurance funds, it is essential that you recognize and report problems or potential problems, and that the association takes corrective action. This Handbook Section provides guidelines for reviewing and evaluating the financial operations of an association.

**Importance of Earnings**

Earnings are essential to a savings association's continued viability. An association's earnings determine its ability to absorb losses, ensure capital adequacy, and generate a reasonable return. You should evaluate an association's operations for stability, trend, level, and quality of earnings. You should also analyze additional factors, such as capital level, credit risk, and interest rate risk, to thoroughly evaluate an association's operations.

**Importance of Earnings for Mutuals**

Mutuals accumulate capital through earnings. When you determine an Earnings rating for a mutual savings association, you must consider the adequacy of the earnings relative to the need for capital. You should not assume that lower earnings are indicative of a poorly run institution. Mutuals generally have lower earnings than a similarly situated stock association. If management of a well-run mutual with few growth opportunities and an extremely high capital base has low earnings, such earnings, if stable and consistent, may be adequate to maintain capital. Accordingly, mutual thrifts with marginal capital levels or a higher-risk business plan may need to retain more earnings to maintain adequate capital

because generally mutuals cannot raise more capital except from retained earnings.

**Examination Process**

The review of a savings association's operations and financial condition is a continuing process. The preexamination analysis and scoping process identify existing or potential problem areas requiring attention. A comprehensive on-site analysis substantiates and assesses current and prospective earnings. A well-performed analysis not only provides an understanding of an association's operations, but also identifies matters of existing or potential concern. You can use the analysis to facilitate corrective action that will avert problems or prevent existing problems from worsening.

When analyzing financial statements, avoid undue precision or spending excessive time on immaterial amounts. Most importantly, you should constantly maintain a sense of the examination objectives. Since earnings reflect a savings association's overall financial condition, you must be aware when examining an association of the extent of existing or potential problem areas outside the purview of operations analysis. As such, you must maintain a constant flow of communication with individuals working on other examination areas to affect a cohesive and comprehensive review.

Finally, such matters as reporting errors, incomplete information, or deficient accounting procedures may hinder or prevent an accurate evaluation of a savings association's operations. A thorough analysis depends on accurate and reliable information and is an extension of reviews of an association's financial records and reports (Handbook Section 410) and accounting standards.

- Information presented in this Section will enable you to accomplish the following procedures: Establish the scope of the financial analysis aspect of the examination. Section

060, Examination Strategy, Scoping, and Management, provides specific guidance on establishing the scope of the examination.

- Identify practices that are potentially unsafe and unsound and formulate a regulatory response.
- Assess an association's operations and strategies.
- Identify problem areas disclosed by the financial records.
- Obtain satisfactory explanations for all material variances of financial data from prior periods and budgeted amounts.

### INFORMATION SOURCES

The basic sources of information for performing an analysis of a savings association's operations include all the following items:

- Thrift Financial Reports (TFRs) filed quarterly with the Office of Thrift Supervision (OTS).
- Financial pages of the previous and current ROE.
- National Financial Monitoring Reports including the following:
  - Uniform Thrift Performance Report (UTPR).
  - Interest Rate Risk Exposure Report (IRRER).
  - Thrift Monitoring System (TMS).
  - Risk Monitoring System (RMS).
- Additional monitoring reports developed at the regional office, if any.
- Independent and internal audit reports.
- Other internal reports to the board of directors, including budget, business plan, earnings reports such as yield and cost analysis, and investment committee reports.
- For publicly traded stock savings associations, 10Q and 10K reports filed quarterly and annually.
- Board minutes.

### National Financial Monitoring Reports

OTS staff has access to a variety of reports in its data base systems that serve as the basis for its financial monitoring and analysis of savings associations. These reports are available for individual associations or, in some cases, groups of associations, and provide uniformity in the presentation of financial data for monitoring and analytical purposes. The following is a brief summary of the primary national monitoring reports available to OTS staff:

#### *Uniform Thrift Performance Report (UTPR)*

The UTPR is an analytical tool created for monitoring the financial condition of savings associations, both mutual and stock. OTS produces the UTPR every quarter, based on quarterly TFR financial data submitted to it by regulated associations. The report groups associations into seven peer groups based on asset size and peer median data. The UTPR provides an association's percentile ranking within each peer group on virtually all TFR items. The analytical tool that the banking regulators use, the Uniform Bank Performance Report, influenced the format of the UTPR.

The References section at the end of this Handbook Section lists the UTPR sections. This listing provides a comprehensive financial overview of virtually all the major areas of an association's financial condition. This includes an association's relative standing of key financial performance factors measured against peer median levels.

The UTPR presents income information for the current quarter, the prior quarter, the year-to-date, and the two previous years. The UTPR is also available in a format that details the previous five quarters. This provides the opportunity to review the historical condition of one savings association and to analyze the more recent quarterly trends in performance. OTS provides one copy of the report to each regulated association quarterly.

#### *Interest Rate Risk Exposure Report*

The IRRER lists OTS's estimates of an association's Net Portfolio Value (NPV) in nine interest

rate scenarios. It also provides ratios that you may use to assess an association's interest rate risk and compare it to that of other associations. OTS derives NPV from OTS's Interest Rate Risk Model, using information derived from quarterly filings of Schedule CMR of the TFR. The model uses certain assumptions, and generates the present values for a savings association's asset, liabilities, and off-balance-sheet items. See Thrift Activities Handbook Section 410, Financial Records and Reports, and Thrift Activities Handbook Section 650, Interest Rate Risk Management, for additional information.

### *Thrift Monitoring System*

The TMS was developed to provide staff at various levels throughout OTS with the capability of readily viewing selected examination and financial information on savings associations, either on an individual or group basis. A primary attribute of TMS is the flexibility the system provides the user in creating customized analytical reports on groups of associations. The source of the financial information for TMS is the UTPR. TMS presently contains three distinct functions: individual association reports, group query reports and fixed reports.

The TMS individual association report function allows the user to access a summary report on a single association. The summary report contains four quarters of financial information relating to capital adequacy, asset quality, valuation allowances, earnings and interest rate risk, as well as selected examination rating information. Besides such summary information, the report contains a second page that presents a condensed four-quarter balance sheet and operating statement, shown both on a dollar volume and percentage of assets basis. The individual association report is a convenient briefing tool for quickly assessing an association's overall financial condition, as well as for identifying developing financial trends.

The TMS group query report function allows the user to select many examination and financial information items for inclusion in customized reports, and to sort selected information using any selected item as a sort criterion. This function is one of the most powerful aspects of TMS, allow-

ing for a virtually limitless combination of options for creating customized reports to analyze examination and financial information on groups of associations.

The TMS fixed report function allows the user to establish customized threshold tests for analyzing nontraditional asset growth and concentrations in various categories among groups of associations. Users can do this analysis to identify associations that exceed growth or concentration threshold levels in the various categories. This function is particularly useful in providing early identification of associations that are rapidly expanding in high-risk areas. This allows supervisory staff to respond in a timely fashion to potentially adverse trends within a particular association or group of associations.

TMS reports are under the Thrift Monitoring (TM) option, under the Thrift Information Management (TIM) option on OTS's Main Menu. A task force composed of regional and Washington Office representatives reviews existing TMS reports to assess the need for possible updates and works to develop new TMS reports as needed. You should be familiar with how the line items on the aforementioned reports correlate with the line items on the TFR. For additional information and instructions refer to the Thrift Financial Report Instruction Manual, OTS's Net Portfolio Model Manual and TMS online help screens, or contact your regional TMS representative.

### *Risk Monitoring System*

The Financial Monitoring Committee developed RMS to provide regional analysts and examiners with a common, standard tool for identifying worrisome trends and deteriorating financial condition of thrifts. Representatives from all regions and DC comprised the committee.

RMS is an Intranet/HTML based monitoring system that uses 51 ratios to screen for exceptions to established limits and parameters. The system assesses a "hit" when an association's ratio exceeds an established limit. There are a maximum of 51 hits with more hits indicating possible supervisory concern. RMS includes features such as the five-quarter report, links to the thrift's home page,

links to stock price data and publicly available reports.

You can use RMS to rank or prioritize which thrifts in the region or caseload may need more in depth analyses. In contrast, OTS uses the UTPR for case specific analyses.

There are six major categories of ratios:

- Capital
- Asset quality
- Operations
- Interest rate risk
- Nontraditional assets
- Asset growth

To determine hits, RMS uses the following tools:

- Ratio levels (where a hit is assigned if a ratio exceeds a certain fixed level).
- Ratio changes (where the focus is on quarter or annual change in ratios).
- Percentile rankings (where a hit is assigned if a ratio measures in the worst, either 90th or 10th depending on the ratio, percentile among the peer group).

RMS ratios match UTPR ratios and you can access ratio formulas from the RMS.

OTS bases RMS peer groups on asset size and they are identical to those used in the UTPR with two exceptions:

- The \$1-\$5 billion asset size group was added to the over \$5 billion group.
- All RMS peer groups are national rather than regional.

### Off-Site Monitoring

The primary purpose of off-site monitoring is to identify adverse changes in the financial condition and performance of savings associations that may occur between regularly scheduled on-site examinations. OTS has established uniform financial

monitoring guidelines to ensure greater consistency in risk assessment and risk detection. These guidelines define the frequency of monitoring, the scope and content of monitoring reviews, and the format for communicating monitoring results.

OTS may use off-site monitoring to accomplish the following other objectives:

- Identify regulatory trends or problems that warrant immediate attention.
- Identify institutions that need to be examined ahead of schedule.
- Identify specific areas within institutions that should be given close scrutiny during on-site examinations.
- Monitor compliance with supervisory directives to correct problems uncovered in prior examinations.
- Monitor adherence to conditions of approval and business plans.
- Monitor compliance with statutory and regulatory limits.
- Modify an institution's examination rating.
- Assemble data, information, and analysis to support on-site examinations.

Each regional office is responsible for monitoring savings associations on a quarterly basis. The regions have discretion in determining the priority of monitoring reviews. Priorities may be based on various factors, such as the severity of deterioration in the financial condition or performance of the institution as evidenced by the RMS-HR (hits report) or any other available information, the number of hits than an institution receives on the RMS-HR, breach of any regulatory limit or Prompt Corrective Action trigger, high-profile status, CAMELS rating, asset size, or the occurrence of a significant event such as a proposed merger or acquisition.

Monitoring of savings associations with high-risk profiles will be more extensive and more frequent than that of nonhigh-risk associations. High-risk associations include those that fail their minimum capital requirements or have a higher overall risk profile based on such factors as asset quality,

higher risk asset composition, earnings and operations, liquidity, interest rate risk, or capital. For nonhigh-risk associations, it may be sufficient to limit the review to compliance and summary monitoring reports on a quarterly basis.

For a high-profile association, supervisory staff should incorporate in the association's regulatory profile a summary discussion of the monitoring findings and any resultant corrective action recommended or taken. Supervisory staff should document in the regulatory profile any significant actions, including the identification of material concerns and recommendations for action. This documentation should provide an understanding of an association's operations and performance and should identify matters of existing or potential concern. Supervisory staff should, when appropriate, reference all violations of law, regulation, policy or supervisory directives

For any association, you should notify appropriate regional staff of any problems or risks identified through monitoring. The department must maintain written documentation of the results of off-site monitoring. Regional offices must initiate corrective action when appropriate. Such action may range from a telephone call or letter to the association, a meeting with management, recommendation for an examination, or, in the case of serious problems, formal enforcement action.

## COMPONENTS OF EARNINGS

To obtain a complete and accurate understanding of a savings association's operations, it is essential to understand its operating strategy and the components of earnings. OTS identifies the association's strategy in the regulatory profile, or you can identify it by determining revenue and funding sources. Earnings components include such items as interest income and expense, noninterest income and expense, and core income. The paragraphs below describe each of these components in greater detail.

### Interest Income

Interest income consists of interest earned on loans, investment securities, deposits, and mortgage pool securities. Interest income is the most

important income component of core income for nonmortgage bankers. Mortgage loan servicing fees and other fees and charges are the most important income component of core income for associations that emphasize mortgage banking.

### Interest Expense

Interest expense is the interest that the savings association pays on deposits, subordinated debt, collateralized securities, advances from Federal Home Loan Banks, and other borrowed money.

### Net Interest Income

Net interest income (NII) represents the difference between income on interest-earning assets and expense on interest-bearing liabilities. NII is a key component of earnings for most savings associations engaged in traditional activities.

### Net Interest Margin

Net interest margin (NIM) represents net interest income divided by average assets. NIM is a key performance/profitability ratio. Prudent management of NIM includes the following:

- Planning and implementing sound growth strategies that include effective cash flow analysis.
- Maintaining minimum acceptable levels of noninterest-earning and/or nonperforming assets.
- Maintaining adequate and reasonable capital levels.
- Managing interest rate risk to minimize NIM volatility due to changes in market interest rates.
- Maximizing low cost funding sources.
- Balancing investment yield and risk (credit risk, interest rate risk, liquidity risk, etc.).
- Managing the mix of interest-earning assets and interest-bearing liabilities.

### Interest-Earning Assets

Interest-earning assets (IEAs) consist of investment securities, deposits in other institutions,

mortgage-backed securities, mortgage loans, and nonmortgage loans less non-IEA components. Non-IEA components include intangible assets (such as goodwill), nonaccrual loans, real estate owned, and real estate held for investment

### Interest-Costing Liabilities

Interest-costing liabilities (ICLs) consist of deposits, FHLBank advances, subordinated debentures, mortgage collateralized securities, other borrowings, any non-ICL components deducted from these categories, and the combined total. The level of equity capital influences the level of ICL. High capital levels will lower ICL as a percentage of total assets.

### Net Interest Position

A net interest position (NIP) is the same as a net IEA position (IEAs less ICLs). A shrinking NIP indicates a weakening balance sheet, and a greater reliance on products and investment margins for continued profitability. A NIP that is negative may indicate that interest-costing liabilities are financing noninterest-earning assets, which may be a serious weakness.

### Net Interest Spread

Net interest spread is the weighted interest yield on average earning assets less the weighted interest rate paid on average interest paying liabilities.

### Noninterest Income

Noninterest income includes loan origination fees, loan servicing fees, late fees, hedging gains and service corporation profits. This item may also contain nonrecurring sources of income such as gains on the sale of assets, income from REO operations and other income sources of earnings that are generally unpredictable and unstable.

### Noninterest Expense

The major component of noninterest expense is salaries and compensation. This category also includes rent, depreciation, utilities, marketing, assessments, and professional fees. Controlling costs is a critical management function. A reduc-

tion in noninterest expenses will increase core earnings, net income and market value.

### Provision for Loan Losses

Weak or deteriorating credit quality can result in the need for higher provision expenses, which can adversely affect the association's earnings. See Thrift Activities Handbook Section 261, Adequacy of Valuation Allowances, for examination procedures on evaluating the adequacy of the association's valuation allowances.

### Core Income

Core income means only spread income and other sources of recurring and reasonably predictable income. OTS defines core income to be net interest margin plus fees earned from loan servicing and other sources, minus general and administrative expenses. While serving as a useful analytical tool, it is important to realize that even core income can be misleading. For example, if spread income stems from an interest rate risk gamble, or if fee income comes from nonrecurring sources, core income will not be sustainable. It is therefore important to know what percentage of core income consists of interest income. In addition, high-risk loan programs may generate consistently high loan losses. You should consider this when evaluating core income as calculated on the UTPR. See Quality of Earnings Section in this Handbook.

### COMPREHENSIVE INCOME

Besides net income, Statement of Financial Accounting Standard No. 130, Reporting Comprehensive Income (SFAS No. 130), may require savings associations to report comprehensive income. Comprehensive income measures all changes in equity that result from recognized transactions and other economic events not related to transactions with owners in their capacity as owners. Comprehensive income consists of net income and other comprehensive income. Other comprehensive income includes, for example, the following amounts, net of income taxes:

- Unrealized gains and losses on available-for-sale debt and equity securities under SFAS No.

115, Accounting for Certain Investments in Debt and Equity Securities.

- Gains and losses related to qualifying cash flow hedges under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities.
- Minimum pension liability adjustments under SFAS No. 87, Employers' Accounting for Pensions.
- Foreign currency translation adjustments under SFAS No. 52, Foreign Currency Transactions.

SFAS No. 130 does not require a specific format for reporting comprehensive income and its components in the financial statements. However, a savings association should report the total of accumulated other comprehensive income as a separate component of equity capital.

## RETURN ON ASSETS AND EQUITY

### Return on Assets

Return on assets is net income divided by average assets. Traditionally, return on assets is the primary measure of an association's profitability. You should review the level, trend, and peer comparison of this ratio since it is a critical determinant of long-term viability.

### Return on Equity

- Return on equity is net income divided by average equity. Investors and capital markets use the return on equity ratio to determine investment options. Average equity refers to the average of total equity capital: Perpetual preferred stock.
- Common stock.
- Retained earnings.
- Unrealized gains (losses) on available-for-sale securities.
- Other GAAP equity capital defined components.

See Appendix A for the derivation of the return on assets and return on equity ratios.

## EVALUATION OF EARNINGS IN DIFFERENT STRUCTURES

### Mutual and Stock Associations

The factors relating to stability, trend, and level of earnings apply both to mutual and stock savings associations. Since mutual savings associations do not issue stock certificates, they rarely make capital distributions. Therefore, there is no market pressure on mutual savings associations to increase the value of equity securities. Mutual savings associations, like stock savings associations, must, however, generate sufficient earnings to meet expenses, provide for the payment of interest on deposits, and satisfy regulatory capital requirements.

To avoid shareholder dissatisfaction, stock savings associations have a particular need to meet earnings expectations projected by securities analysts. Further, the earnings of stock savings associations must convince shareholders that the return on equity is satisfactory. Failure to satisfy earnings targets may result in shareholder attempts to replace management or insist on a sale of the savings association to enhance shareholder value.

### *Comparisons Between Mutual and Stock Associations*

Mutual savings associations generally have lower earnings, lower net interest income, lower noninterest income, a lower net interest margin, and a lower return on equity relative to stock associations. Given these operating results, and comparing a mutual to a stock association, you might criticize the institution for poor earnings. Such criticism, however, may not be appropriate considering the institution's capital position and operating strategy.

### Subchapter S Corporations

You must modify operations analysis when you review net income and dividends for savings associations electing Subchapter S corporation status. Typically, Subchapter S corporations pay no federal income tax and possibly no state income tax. Unlike most savings associations

(Subchapter C type corporations), Subchapter S savings associations generally report net income that is not reduced by any tax provision. Therefore, certain reported amounts for earnings, income taxes, and dividends are not necessarily comparable to that of a Subchapter C savings association, due to the different tax structures of each type of entity.

Special corporate tax rules treat a Subchapter S corporation as a pass-through entity for federal income tax purposes. The S-Corporation's shareholders normally pay federal income taxes on their proportionate share of the corporation's taxable income, whether the S-Corporation pays a dividend or makes other distributions to the shareholders. OTS and the other federal banking agencies consider S-Corporation distributions that cover the shareholders' personal income tax liabilities to be capital distributions.

A review of a Subchapter S savings association should include an analysis of "reinvested earnings." Reinvested earnings is a term used to describe the amount of earnings reinvested in the company (that is, not distributed). By analyzing reinvested earnings, you should be able to assess the Subchapter S savings association's overall financial health and ability to pay dividends. Otherwise, a strictly traditional evaluation may lead to erroneous conclusions regarding a Subchapter S association's financial strength with regard to its capital growth from earnings.

Without consideration of reinvested earnings, the Subchapter S corporation may appear to pay exorbitant dividends, although it is in the same position as a Subchapter C corporation for its capital growth from earnings. For a Subchapter S corporation, dividends will typically include two components:

- Amounts for its shareholders' taxes that related to all pretax income that passed through to the shareholders on their Subchapter S corporation return.
- Amounts representing a return on investment.

These two components may cause the Subchapter S savings association's dividends to appear inor-

dinately large when compared to those of a Subchapter C savings association.

To review the Subchapter S savings association's financial strength, you should consider the unique aspects of a Subchapter S corporation's taxation and the relevance of reinvested earnings. In analyzing earnings, you may simply analyze reinvested earnings. Another approach is to request that the Subchapter S savings association calculate a pro-forma tax provision as if it had corporate level taxes.

### Internet Operations

OTS has several Internet-only savings associations and other associations that operate their Internet activities separately from their brick and mortar operations. Other associations have added transactional web sites as a customer retention strategy. The U.S. Department of the Justice estimates that the number of households using Internet banking services will increase from 7 million at the end of 1998 to 21 million by 2003.

Internet-only banking operations have several distinguishing characteristics related to operations that merit your special attention. In general, Internet-only banks have higher general and administrative expenses than more traditionally operated associations. Regulators (and association management) expected lower than normal expense ratios for Internet operations. Thus far, however, the cost of providing transactional Internet services is high. While the cost per transaction may be low when compared to a traditional operation, expenditures for marketing, consultants, temporary personnel, and computer software are significantly higher.

Internet-only associations pay higher rates for its deposits and those deposits tend to run off quickly and dramatically to competitors with higher rates. Liabilities are rate sensitive. Core deposits may not exist. There are few online lending operations. Most Internet-only associations still buy loans in the wholesale market to operate, and often pay a premium, to meet CRA requirements. Internet banks that originate loans tend to outsource the servicing and customer support services to reduce overhead expenses.

### *Outsourcing*

Some Internet banks outsource many core banking and Internet functions to service providers. Service providers perform a variety of functions, including, but not limited to, the following:

- Performing the due diligence on purchased loans.
- Conducting internal audits.
- Providing consulting advice on investment decisions.
- Operating information systems such as the general ledger.
- Providing bill payment services for customers.
- Providing Internet banking software.
- Hosting the association's Internet web site.
- Online direct and referral loan origination support.

### *Business Plans*

The Regional Office approves the association's business plan upon the application for charter. You must determine whether the association is operating within the parameters of the business plan. Associations must submit a revised business plan to the Regional Office if its projections change substantially. For example, the need for additional capital during the de novo period may require numerous business plan revisions.

### *Core Operations*

You should consider the core business when you examine an Internet-only association. It can sometimes be difficult to determine the cause of losses. Losses can occur not only from operations, but also because of software development and marketing costs for their product if the association does not outsource these functions.

### *Accounting for Software Costs*

AICPA Statement of Position (SOP) 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use, provides

detailed accounting guidance on the treatment of computer software costs. Its effective date is 1999, unless it was adopted earlier.

According to SOP 98-1, institutions must expense computer software costs if the costs fall under the "preliminary project stage" or the "post-implementation/operation stage." The preliminary project stage includes the following activities:

- Determining the performance requirements of the software.
- Evaluating alternative means of achieving the performance requirements.
- Existence of needed technology.
- Final selection of alternatives to complete the project.

The post-implementation/operation stage includes training and application maintenance activities.

SOP 98-1 allows institutions to capitalize only certain costs incurred during the "application development stage" in connection with activities to obtain computer software. Costs eligible for capitalization include external direct costs of materials and services consumed in developing or obtaining internal-use software (fees paid to third parties), payroll, travel, and related costs for employees directly associated with the project, and interest costs incurred while developing internal-use software.

Although certain exceptions exist, some costs such as maintenance, training, data conversion, or administrative are expensed regardless of when they occur.

Institutions should not make adjustments for remaining internal use software costs either capitalized or expensed prior to the effective date of SOP 98-1.

### *Profitability*

Currently, there are few profitable Internet-only operations. Generally, they have razor thin margins, volatile deposits, too much capital, and sometimes, excessive growth. Gaining market share is key to most business plans and, hoping to

ensure their long-term survival, they pursue market share at the expense of profitability. In theory, once Internet operations get past break-even, profits should begin rising quickly with additional business.

## EARNINGS ANALYSIS

To make a thorough analysis of earnings you should begin with a review of an association's earnings strategies and its strategic business plans. You should evaluate earnings performance relative to measures appropriate for the dominant type of business the association engages in such as traditional thrift activities, mortgage lending, securitizations, subprime lending, or other activity. Your earnings analysis should not only provide an assessment of why earnings are weak or strong, stable or variable, but also give reasons for the earnings performance relative to the association's business strategy and economic environment. For example, if earnings are poor because of lower gain on sale from mortgage banking activities, do not attribute poor earnings to high general and administrative expenses. Most successful mortgage banking operations generally require higher general and administrative expenses.

### Four Key Aspects of Earnings

You should perform an aggregate evaluation of the components of earnings in relation to four key aspects of earnings: stability, trend, level, and quality. We further discuss these four aspects below.

#### *Stability of Earnings*

The stability of earnings relates to the quality, composition, and constancy of income and expense flows relative to internal factors such as credit risks, interest rate risks, or accounting practices, and external factors such as general economic or competitive forces.

A savings association's income stability depends on proper management of its sources of income and expense and the influence of internal and external factors on those sources. Recurring income sources, such as net interest on loans or invest-

ment portfolios, are usually preferable to nonrecurring income sources, such as income derived from the sale of assets. Relying too heavily on nonrecurring sources of income could severely affect an association's future viability. See Quality of Earnings Section in this Handbook.

#### *Trend of Earnings*

Trend is the general direction of the savings association's earnings relative to previous time periods. Evaluating previous time periods should encourage you to identify and investigate both an association's adverse and positive earnings trends.

#### *Level of Earnings*

The level of earnings is the measure of earnings relative to internal factors such as capital position, credit risk, and interest rate risk.

You should perform a comparison to peer groups to determine material variances. In doing so, you may use the standard peer groups based solely on asset size or the more refined peer groups based on charter type (mutual to stock), operational and geographical characteristics, as well as asset size.

You must review additional areas to ensure a comprehensive analysis, since many risks may materially affect earnings. You should therefore review the findings relating to risk analysis that the Asset Quality and Sensitivity to Market Risk Sections of this handbook discuss.

#### *Quality of Earnings*

Your examination of a savings association's earnings should include a review of the quality of earnings. The quality of reported earnings, also referred to as accounting quality, may be defined as how well a company's financial statements accurately depict business activities.

Management is responsible for reporting earnings that are consistent with economic substance. GAAP allows management the flexibility and latitude to effectively communicate the financial position and results of a company's operations. Accordingly, management may implement certain reporting strategies, make certain accrual, defer-

ral, or allocation decisions, or exercise other managerial discretion when reporting earnings.

Management should not manipulate earnings or misuse accruals or underlying assumptions of a transaction such that it misreports income, and thus capital, and causes users of the financial statements to change or alter judgments or decisions about the condition of the company.

Accordingly, it is not only important to look at the components of earnings, but also at the techniques and strategies management may be using to report earnings. The strategies management uses should fall within acceptable limits of GAAP, and not mask the economic condition of the company.

When evaluating the quality of an association's earnings, you should also identify key areas of operating performance that affect profitability. For example, if a key area of operation is in securitization transactions, an association may show impressive profitability by reporting nonrecurring gains and revenues such as gains on sales of securitizations or other asset transfers. It is also possible for thrifts to report impressive profitability ratios and high volumes of income by assuming unacceptable levels of risk. For example, to boost earnings in the short-term, management may seek higher rates on riskier loans and other investments to offset the increased credit risk associated with those assets. However, over the long-term, these assets may not be of a quality to assure either continued debt servicing or principal repayment. Eventually, earnings or capital may suffer when management must recognize the losses in these higher-risk assets.

Aside from any recourse implications that may arise, properly reflecting the quality of earnings is less likely a problem in a generic sale of whole loans than in a securitization or other type of asset sale. For more information on whole loan sales, see Handbook Section 575, "Secondary Markets."

Associations may also have various sources of recurring and nonrecurring fee income including late fees from deposit loan accounts and nonrefundable rate lock fees. You should review fees that you consider significant to the statement of operations. There is a discussion of fee income from servicing loans in Thrift Activities Regula-

tory Handbook (Handbook) Section 572, "Profitability."

You should consult your Regional Accountant with questions concerning earnings management issues.

#### Securitization Transactions

Properly reflecting earnings from securitization transactions or those from mortgage servicing assets may be more difficult because relatively minor changes in the economic environment can significantly affect reporting. In addition to economic influences, financial reporting of securitizations is based on complex accounting standards in SFAS No. 140, Accounting for Transfers and Securitizations of Financial Assets and Extinguishments of Liabilities.

Under SFAS No. 140, an association initially measures and records assets retained in connection with a sale or securitization, based on the relative fair values. That is, the association allocates the previous carrying amount between the sold assets and the retained interests based on their relative fair values. The reported gain is the difference between the net proceeds from the sale and the allocated carrying value of the assets sold. This methodology is often called "gain-on-sale" accounting. While much of the focus on gain-on-sale accounting has been on subprime securitizations, prime securitizations may also take advantage of gain-on-sale accounting.

Because of the subjectivity underlying most assumptions used to determine fair values, management can allocate higher carrying amounts to retained interests. The higher the carrying amount allocated to retained interests, the lower the carrying amount allocated to the sold assets. The lower carrying amount of the assets to be sold results in a higher recorded gain on the assets sold. Thus, reported gains may not be truly reflective of the association's operating performance, or they may be noncash, temporary, or of a nature that the association may never realize them in the future. See CEO Letter No. 156. "Certain Transfers of 'Higher-Risk' Assets," (February 7, 2002).

The following management actions may affect the assigned fair value of the assets, and thus affect the quality of reported earnings:

- Management uses optimistic assumptions to calculate asset values. Since allocating a higher carrying amount to retained interests may result in a larger up front gain on the assets sold, management may use optimistic assumptions that over estimate the value of retained interests. The following factors affect estimates underlying valuations and the ability to measure cash flows reliably:
  - Prepayment rates.
  - Credit loss rates.
  - Discount rates (required rate of return).
  - Lack of a reliable market.
- Management assumes a credit loss rate that is too low or inconsistent with existing market conditions. As a result, credit losses may be high if management fails to timely reassess assumptions. Even if the assumed credit loss rate is consistent with existing market conditions, unanticipated losses may still occur if there is an economic downturn. For example, until the year 2001, growth of the subprime sector occurred during a period of economic prosperity and stability. In the event of a recession or a dramatic economic downturn, losses may increase significantly.
- Management assumes a prepayment speed that is too slow for assets such as mortgage servicing assets or other retained interests. For example, a fall in longer-term interest rates will cause an acceleration of payments. If prepayments are faster than expected, then future cash flows may disappear and the value of the servicing asset or retained interest will decline. Even subprime mortgages, once believed largely insulated from prepayment risk, have become more prepayment sensitive as alternatives for subprime borrowers increase.

### Goodwill

Institutions may find it challenging to keep abreast of new accounting standards that affect reported earnings, as well as to appropriately and

timely implement complex standards into their financial reporting systems. For example, SFAS No. 141, Business Combinations, and SFAS No. 142, Goodwill and Other Intangible Assets, changed how institutions (other than mutuals) account for acquired goodwill and other intangible assets. Institutions no longer amortize goodwill, but must measure the goodwill, if any, for impairment, and make adjustments accordingly. This treatment may create volatility in reported income because impairment losses are likely to occur irregularly and in varying amounts. You should review an association's goodwill, if any, and determine how the association measures and adjusts its goodwill for impairment. You should ensure that the association no longer amortizes goodwill.

### Negatively Amortizing Loans

A significant concentration of loans that are negatively amortizing may affect the quality of earnings. A negatively amortizing loan is one in which the contractual amount due (principal and accrued interest) continues to increase over time because the periodic interest charges exceed the minimum periodic payments required. For single-family loans, the stated purpose of such terms is to reduce the borrower's payments, generally for a temporary period of time, usually two to three years.

For example, if an association makes a \$100,000 loan at a 7% interest rate for 30 years, then the fully amortizing monthly payment would be \$665. If any one of the 360 payments (30 years X 12 months) is less than that fully amortizing amount, then the loan will not be paid-off at the end of the 30 years. The association will recognize interest income based on the 7% interest rate. However if, based on the borrower's ability to pay, the monthly payment is initially set to \$500, then the loan will be negatively amortizing. The \$500 monthly payment equates to an interest-only payment of 6% [ $\$500 / \$100,000 \times 12$ ]. The loan will negatively-amortize at approximately 1% per year (7% less 6%). After three years, the contractual amount due will have grown to \$103,328, including accrued interest of \$3,328 (approximately  $\$100,000 \times 1\% \times 3$  years). Then, if the loan is converted to fully amortizing, the monthly payments will be \$694 for the remaining 27 years,

compared to the original fully amortizing amount of \$665.

Depending on the borrower's circumstances and the loan's characteristics, as well as economic conditions, once the association converts the loan to a fully amortized loan, the borrower may be unable to make the higher payments or to pay any additional balance due on the loan at payoff. Thus, the association has reported these amounts as income, but may not be able to recover the full amount.

### Regulatory Concerns

In summary, incentives to report higher earnings, the nature of assumptions used in certain transactions, like securitizations, and improper reporting in general may affect reported earnings. Examiners should be alert to the regulatory concerns cited throughout this section, and to the following additional regulatory concerns as well:

- Management may use gains to further leverage the balance sheet. You should consider the quality of capital supporting asset growth to the extent that management based gains on optimistic assumptions or that the value of the retained interest is highly sensitive to accelerating prepayments or declining asset quality.
- Management compensation or dividend payouts may be excessive, and dependent on earnings. Associations often tie compensation and dividends to reported profits. To the extent that reported profits are overstated, these payouts can dissipate assets and capital.
- Management may ignore credit quality. The incentive for profits can override attention to quality of earnings. The potentially significant profit that management can generate by gain-on-sale accounting creates a strong incentive to produce originations, often with little attention to credit quality.
- Later impairment assessments may erase reported gains. Management may have to reverse, in later periods, some or all of the up front gains recorded in a securitization or other transfer of assets because of impairment assessments. For income purposes, management should reflect certain adversely classified and

nonperforming assets, especially those where the association does not anticipate future interest payments, on a nonaccrual basis. If management does not place these assets on a nonaccrual status, they may overstate earnings.

- Improper treatment of losses may overstate capital. Management should not create allowances for losses on retained interests. Management should record losses by adjusting the recorded investment in the retained interests. Management should not record such losses in the ALLL. See FASB Emerging Issues Task Force (EITF) Issue No. 99-20, Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets.

### ANALYTICAL TECHNIQUES

Operations analysis involves a review of financial data on a period-to-period basis to substantiate the reasonableness of financial performance without requiring a systematic review of transactions. (This does not preclude a review of transactions, if appropriate.) Through understanding the components of operations analysis you will be able to apply various analytical techniques to assess an association's financial condition. You may use association and peer group ratios to identify discrepancies.

You must be aware of the following weaknesses inherent in the approaches employed in the operations analysis:

- More than one component of the financial data being analyzed cause apparent variances.
- Operations analysis is historical — the financial data that you analyze describes the association at a prior point in time.
- Operations analysis may not answer all questions, but it may raise additional ones.

For example, a common ratio used to evaluate the efficiency of an association's operations is the level of operating expenses expressed as a percentage of operating income. Using this ratio, you may conclude that operating expenses are higher than the peer group and that they have been increasing during the periods under review. The real

concern, however, is not that a variance exists, but why it exists.

### Interrelationships

Operations analysis requires an awareness of the interrelationships of the data used. For example, an increase in the operating expense to operating income ratio may be due to an increase in actual operating expenses. Also, a decline in revenues that was the result of shrinking assets without a corresponding decline in the fixed operating expenses of the company may cause the variance. Examination procedures that investigate operating expenses would not explain why the variance occurred if the ratio increased due to a decline in revenues. By understanding the interrelationships of the data, you will be able to focus your analysis to answer the questions raised by the variance.

### Basic Approaches

All financial analytical techniques are combinations or adaptations of four basic approaches used to evaluate a savings association's operations. We discuss the fundamental considerations of each of the following four approaches below:

- Structural
- Trend
- Ratio
- Comparative.

#### Structural Analysis

Structural analysis is a static analysis, where you view the components of a financial statement in relation to the whole financial statement as of a specific date. This technique can provide insight regarding the relative size of a particular line item in comparison to the other components of the financial statement. You can also use structural analysis to determine whether a particular line item is increasing or decreasing in relation to the other components. For example, total assets on a statement of condition and gross revenues on a statement of operations are base figures representing 100 percent. The financial statement presents each line item as a percentage of these base fig-

ures. An example of a structural analysis of a statement of condition follows:

<b>Statement of Condition</b>		
12/31/XX		
<i>Assets</i>		
Cash	\$ 12,500	0.66%
Marketable Securities	210,000	11.16%
Mortgage Loans	1,275,000	67.75%
Fixed Assets	325,000	17.27%
Prepaid Expenses	50,000	2.66%
Other Assets	<u>9,500</u>	<u>0.50%</u>
Total Assets	\$ 1,882,000	100.00%
<i>Liabilities</i>		
Accounts Payable	25,500	1.35%
Notes Payable	500,000	26.57%
Deposits	1,100,000	58.45%
Other Liabilities	<u>74,500</u>	<u>3.96%</u>
Total Liabilities	1,700,000	90.33%
<i>Stockholders' Equity</i>		
Capital Stock	100,000	5.31%
Retained Earnings	<u>82,000</u>	<u>4.36%</u>
Total Stockholders' Equity	182,000	9.67%
Total Liabilities and Stockholders' Equity	1,882,000	100.00%

As shown, the statement of condition presents each line item as a percentage of total assets.

#### Trend Analysis

Trend analysis is the technique of comparing ratios or a financial statement line items over several periods of time. You should make the comparison by using both the dollar variance and the percentage variance methods. The dollar variance method involves calculating the dollar difference in the line item between the various periods. The percentage change in the line item for the periods is the basis for the percentage variance method.

It is important to use both methods. The percentage variance may not readily disclose large dollar changes in line items if the base is also large. The dollar variance method may not disclose large percentage changes in line items. For example, a line item variance could be under 5 percent but still require investigation if the amount of the change is \$5 million. Conversely, a \$20,000

change in a line item may not seem to be material. If it represents a 35 percent change from a prior period, however, it may also warrant investigation.

### Components of Trend Analysis

We discuss below the three primary components to performing a good trend analysis.

*Number of Accounting Periods:* The use of three or more accounting periods provides an understanding of what will likely be normal changes in the data. By comparing variances in the data over several accounting periods, patterns of change emerge that you can use to identify any unusual changes in current periods. Another benefit is that you can identify a change that may warrant investigation.

The accounting periods reviewed may include annual, quarterly, or monthly data depending on the purpose of the review. Quarterly or annual data in some instances can mask a month-to-month cash flow problem that an association is experiencing. You must use association records to review monthly figures, as OTS no longer requires associations to file monthly reports.

*Sound Judgment:* It is necessary to use sound judgment in assessing the materiality of a variance. You must use professional skepticism when evaluating the change, but must also remember that business is dynamic and change is inevitable. You should pursue only those variances that are not reasonable or are of sufficient magnitude to justify additional examination procedures. You must evaluate such variances in relation to the overall financial position of the association. A number of factors may account for variances including cyclical and seasonal factors, changes in accounting practices, and changes in operating strategies. You should identify and explain positive or adverse trends, so that your findings support the overall evaluation.

*Volume-to-Rate Variance Analysis:* Volume-to-rate variance analysis identifies how much of a change in an income statement line item is due to a change in volume and how much is due to a change in rate. This analysis is especially benefi-

cial in evaluating changes in revenues and expenses associated with interest-bearing assets and interest-costing liabilities. Further, this technique allows you to identify offsetting variances that may otherwise go undetected. For example, although significant changes are occurring, a substantial decline in rate that results in little change in the financial statement line item may offset a large increase in volume. Through this analysis, you can narrow the scope of the examination to focus on the cause of the change in the data. Table 1 illustrates the technique and its benefits.

You can use numerous ratios in a trend analysis. Typical balance sheet ratios include real estate owned to total assets, equity capital to total liabilities, delinquent mortgage loans to net mortgage loans, and subordinate organization investment to total assets. (See Appendix B for a discussion of the latter.) Typical operating ratios include gross income to average assets, operating expense to average assets, net income to average assets, and net interest margin to average earning assets or average costing liabilities.

**Table 1**

<b>Volume-to-Rate Variance Analysis</b>			
	19X1	19X2	Variances
Yield from Mortgage Loans	\$400,000	\$450,000	\$50,000
Average Yield	10.0%	9.0%	
Average Amount of Mortgage Loans Outstanding	\$4,000,000	\$5,000,000	
Volume Variance	= variance in base times the first year rate = (\$5,000,000-4,000,000) x 10% = \$1,000,000 x .10 = \$100,000		
Rate Variance	= variance in rate times second year base = (9.0%-10.0% x \$5,000,000) = -1.0% x \$5,000,000 = .01 x \$5,000,000 = -\$50,000		
Volume	= \$100,000		
Rate Variance	= <u>-\$50,000</u>		
Net Change in Yield	= \$50,000		

*Ratio Analysis*

Ratio analysis is the method of comparing a figure or group of figures in a set of financial statements to another figure or group of figures within the same financial statements. The assumption that there are meaningful relationships between different asset, liability, net worth, income, and expense accounts is the basis for ratio analysis.

Financial analysts have developed numerous standardized ratios for analyzing financial statements. Although it is beyond the scope of this Handbook to provide a listing of all the ratios that you may use to analyze financial statements, the more commonly used ratios include:

- Current assets divided by current liabilities.
- Net income divided by average assets.
- Operating expenses divided by average assets.

You can find these ratios in nearly all intermediate accounting or financial analysis texts. In addition, there are several ratios specific to analysis of financial institutions.

Most traditional lending institutions strive to maintain a relatively stable spread between asset yields and liability costs. Net interest income is a function of interest-earning asset (IEA) yields, interest-costing liability (ICL) costs, and the IEA/ICL relationship.

When IEA/ICL exceeds 100 percent, the excess of earning assets bolsters net interest income and somewhat mitigates the effect of interest rate volatility on earnings. As the IEA/ICL ratio falls below 100 percent, net interest income obviously becomes impaired and becomes less likely to cover operating expenses.

In general, the net interest margin (NIM) will be greater than the spread if IEA exceeds ICL and less than the spread if ICL exceeds IEA. The difference between the yield on earning assets and the cost of funds provides the net interest spread.

You should compare ratios with historical (trend analysis) and peer group standards (comparative analysis) to identify unusual items.

*Comparative or Peer Group Analysis*

Comparative analysis is the method of comparing the components of a financial statement with those of a savings association of a similar size or other similar characteristics. You may also use ratio analysis to compare ratios from one firm with that of industry standards or peer group ratios. You should not rely upon peer group information in isolation, but in conjunction with other pertinent evaluation factors. Peer group or other comparative industry data should not be the sole, or even primary, basis for component ratings.

Whenever possible, compare mutuals associations with other mutuals, not stock associations. Beginning February 2001, fourth quarter UTPR data is available for mutuals only. With mutual-only peer ratios, you are better able to review the various financial ratios in an attempt to spot problem trends and outliers.

When it is not possible to compare a mutual with other mutuals, (such as the case with larger mutuals who have very few peers the same asset size), you should not focus exclusively on net income or other performance ratios without taking into account the institution's capital position and overall strategy.

When comparing mutuals and stocks, it is more appropriate to compare a mutual association's net income with a stock association's net income after dividends. Net income after dividends is the bottom line for both types of institutions.

	<i>Stock</i>	<i>Mutual</i>
Net Income	1,000	800
Dividends	-200	0
Reinvested Earnings	800	800

The Uniform Thrift Performance Report

The UTPR provides a savings association's own ratio, the median value of that ratio for an association's peer group, and the percentile ranking of an association's ratio value within the peer group.

This enables measurement of the relative performance of an association to a peer group of associations, as well as measurement of the relative performance of the association and its peer group over time.

The UTPR constructs seven peer groups for comparative purposes. Asset size is the basis for the first six groups. The seventh group contains associations whose consolidated equity capital is less than zero or are in conservatorship.

Group 1	Assets less than \$50 million.
Group 2	Assets between \$50 million and \$100 million.
Group 3	Assets between \$100 million and \$300 million.
Group 4	Assets between \$300 million and \$1 billion.
Group 5	Assets between \$1 billion and \$5 billion.
Group 6	Assets over \$5 billion.

Except for Group 6, the UTPR includes the peer groups on a regional geographic basis. The UTPR calculates Group 6 (consisting of the largest associations) on a national basis to allow for a larger sample size than would be available in any one region.

Comparative analysis typically uses ratios such as net income to average assets, operating expense to average assets, or cost of funds to average costing liabilities.

### FUTURE OPERATING RESULTS

After you review the stability of operating results and identify historic trends of the primary revenues, you can estimate and evaluate an association's probable future operating results.

A key tool in making this evaluation is the budget prepared by management. You should obtain a copy of the budget including projected revenues, expenses, and underlying assumptions. An evaluation of the budget should include all the following comparisons:

- Projections with prior period results.

- Projections with actual results for the same period.
- Projected return on assets and return on equity with prior period results.
- Projected yields for major earning assets with prior period yields.
- Projected operating expenses as a percentage of assets and revenues with prior period data.
- Projected goals and assumptions with trends in market conditions.

Although comparing the operating budget with prior period data is necessary, the key to evaluating the budget is to understand the validity of the underlying assumptions and the probability of projected goals. Prior data does not provide meaningful information if the entire focus of the association is changing. For example, if a portfolio lender begins mortgage-banking operations, the crucial evaluation of the budget would not come from comparison with prior period data. Instead, the focus would be on the reasonableness of projected loan originations and sales compared with current market conditions.

Controlling business risks is one of the primary responsibilities of management. An association's balance sheet and operating statement reflect the types of risk assumed by the association and how well management controls those risks. By analyzing the balance sheet and operating results, and identifying trends in the financial data, you can make a determination whether management's policies benefit or adversely affect an association.

### PROFITABILITY ASSESSMENT

An association may assess its own profitability in many ways and at different levels. A thrift may evaluate its profitability as a whole or the particular profitability of branches, products, or types of customers. In whatever way an association assesses its profitability, accurate information is the basis for good decisions.

An association's information requirements depend largely on its size and complexity of its operations. While you should encourage management to develop improved systems and information,

associations must be reasonable in their expectations.

### CONSOLIDATED FINANCIAL STATEMENTS

Consolidated financial statements summarize the financial position and results of operations for two or more affiliated companies. Associations prepare and present such statements without regard to the separate legal status of either company. The purpose of consolidated financial statements is to present a parent company and its subsidiaries as if they were a single company. Such statements do not include gain or loss on transactions among the companies in the group. Further, consolidation is usually necessary for a fair presentation when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies.

Savings associations should prepare consolidated financial statements for all GAAP-consolidated subsidiaries in which an association has a controlling financial interest through direct or indirect ownership of a majority voting interest. As a general rule, direct or indirect ownership by one company of over 50 percent of the outstanding voting shares of another company is a condition that suggests consolidation.

In order for the parent and its subsidiaries to be presented as one entity, the institution must consolidate their separate trial balances into one trial balance and eliminate intercompany balances and transactions. The institution must make eliminating entries on consolidating worksheets, but neither the parent nor the subsidiaries are to record them in their general ledgers.

You should review the consolidating entries of intercompany accounts. Typical consolidations include the following eliminating entries:

- Intercompany payables against intercompany receivables.
- Intercompany profit and losses on sales of assets that the parent or subsidiary have not subsequently resold to third parties.
- Investment accounts of first-tier subordinate organizations against the capital accounts of lower-tier subsidiaries.
- Intercompany revenues against intercompany expenses.

See Appendix C, Reconciliation of Intercompany Accounts.

### Materiality

OTS defines materiality as an assessment of relative size and importance. You can analyze the materiality of intercompany transactions by:

- Identifying intercompany transactions that frequently occur. Such transactions include:
  - The parent's investment in capital of the subordinate organization.
  - Long-term loans from the parent to the subordinate organization.
  - Short-term accounts receivable (or payable) between the parent and the subordinate organization pertaining to normal operations.
- Assessing activity in intercompany accounts. This involves reviewing general ledger account histories of selected accounts for following items:
  - Numerous transactions.
  - Correcting entries (original entries posted to the wrong accounts).
  - Large dollar amount entries lacking a clear explanation of their purpose.
- Identifying source documents for review if you deem further analysis of specific transactions necessary. Such documents include:
  - Cash receipts records (cash receipts journals and bank deposit slips).
  - Cash disbursement records (cash disbursement journals and checks issued).
  - Journal vouchers for noncash transactions.

**REFERENCES****Code of Federal Regulations (12 CFR)**

Part 562 Regulatory Reporting Standards

**Office of Thrift Supervision Publications**

Thrift Financial Report Instruction Manual

Thrift Time Series User's Guide

OTS Net Portfolio Value Model Manual

## UTPR Reports:

Section A Summary Statement

Section B Detailed Income Statement

Section C Analysis of Net Interest Income

Section D Detailed Balance Sheet

Section E Asset Quality

Section F Allowances

Section G Capital Accounts and Requirements

Section H Changes in Financial Condition

Section I Lending, Investment, Foreclosure and Restructuring Activity

Section J Questions, Strategies, New Deposit Yields

Section K Composition of CMR Portfolio

Section L Interest Rate Risk Information

Section M Examiner Support Software Ratios

**Financial Accounting Standards Board***Statement of Financial Accounting Standards*

No. 52 Foreign Currency Transactions

No. 87 Employers' Accounting for Pensions

No. 115 Accounting for Certain Investments in Debt and Equity Securities

No. 130 Reporting Comprehensive Income

No. 133 Accounting for Derivative Instruments and Hedging Activities

No. 140 Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities

No. 141 Business Combinations

No. 142 Goodwill and Other Intangible Assets

No. 144 Accounting for Long-Lived Assets

No. 146 Accounting for Costs Associated With Exit or Disposal Activities

**American Institute of Certified Public Accountants (AICPA)***Statement of Position (SOP)*

No. 98-1 Accounting for Costs of Computer Software Developed or Obtained for Internal Use

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# Operations Analysis Program

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## Examination Objectives

To evaluate the appropriateness of the association's operating environment and business strategy.

To evaluate the adequacy of policies and procedures, information systems, internal controls, and budgeting processes relating to operations.

To identify, evaluate, and explain positive and negative income and expense trends.

To evaluate the quality and sources of earnings.

To assess the prospective effect on earnings because of changes in the association's activities or strategies.

To evaluate the association's financial performance and ascertain whether it has sufficient profitability to maintain capital through retained earnings.

## Examination Procedures

### Level I

Wkp. Ref.

1. Review prior examination reports, audit reports, monitoring reports, and any off-site analysis to ascertain strengths and weaknesses in the association's operations.

- 
2. Determine whether management corrected deficiencies mentioned in prior examination and audit reports.

- 
3. Review whether the institution provides periodic earnings and impairment reports with adequate information for management and the board of directors to assess earnings performance.
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**Wkp. Ref.**

4. Review the association's structure and determine if there are any special considerations, for instance, S Corporation structure, comprehensive income, or nontraditional business operations. For Internet operations, see Level II procedures. For securitization transactions, see Level III procedures.

- Determine if sources of earnings are significantly reliant upon nonrecurring gains from the sale of securities, loans, or securitization transactions. If so, see Level III procedures.

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5. Review the findings in examination Program 410, Financial Records and Reports, to ascertain any significant concerns, such as reporting or classification errors, unusual variances, accounting deficiencies or any material inconsistencies in the application of accounting principles that may affect the review of operations.

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6. Review the UTPR financial schedules and the association's financial statements. Identify and explain trends, material variances, and other factors affecting earnings. Note any material reporting errors or items that need further analysis. Include copies in the work papers.

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7. Compare UTPR financial schedules, the association's financial data, and recent earnings trends to the institution's historical results and to standard or customized peer group data and explain material variances.

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8. Review examination findings relating to management assessment and directors' oversight to ascertain whether the association is planning or has initiated any new activities, strategies, or major changes that could materially affect operations.

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9. Review the association's business plan. Compare it to actual operating results and explain any material differences. Determine if the association (rather than an outside consultant) developed the plan and tailored to the association's operating strategies.

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10. Review whether monetary incentives such as bonuses, stock options, or salary increases based on results exist that may create an environment for management to manipulate reported earnings.

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11. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

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### Level II

12. Review the findings of the asset quality review to determine the effect on earnings. For example, consider severity and level of classifications, the need for provisions to ensure the adequacy of allowances for loan and lease losses (ALLL), and loss of interest earnings due to poor quality assets. Consider the cost of carrying nonperforming assets and the effect on earnings stability over the long term. Ensure that the ALLL does not contain any allowances for other types of losses, such as allowances for retained interests. Review write-offs of nonfinancial assets for appropriateness.

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13. Obtain and review the association's current budget. Determine if it is reasonable and supported. Compare the budget to current operations; identify and explain material variances.

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## Operations Analysis Program

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**Wkp. Ref.**

14. Review the findings of the sensitivity to market risk review, particularly the interest rate risk management review. Evaluate the composition of earnings between recurring net interest margin and net noninterest income versus net interest income. Consider the effect on future earnings potential.

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15. Review and evaluate the association's sources and uses of funds since the last examination. This analysis will give insight into the savings association's business operation and the potential risks involved.

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16. Review, if applicable, TFR Schedule CSS, Subordinate Organization Schedule, to determine the extent of the parent association's dependence on a subordinate organization and the adequacy of the parent's return on the investment in the entity. See Appendix B.

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17. Reconcile and determine the materiality of the parent institution and subsidiary inter-company accounts. (For further information, refer to Appendix C, Reconciliation of Intercompany Accounts.)

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18. Examine whether credit losses and suspicious activities reports are high in comparison to peers. If so, discuss concern with asset quality review staff and determine if future earnings will continue to be affected.

- For subprime lending activities, determine if credit losses relate to underwriting practices, appraisal weaknesses, account management activities, or inadequate collection procedures.
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## Operations Analysis Program

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**Wkp. Ref.**

19. For Internet operations determine if the association:
- Periodically (at least quarterly) evaluates its Internet operations and marketing plan.
  - Links its strategic planning process to its Internet operations.
  - Projects the effect of its Internet operations on earnings and capital.
  - Performs cost and benefit analyses of Internet banking activities. Consider start-up, operating costs, required upgrades, customer support, and maintenance costs.
- 

20. Ensure that your review meets the Objectives of this Handbook Section. State your findings and conclusions, and appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.
- 

### Level III

21. Analyze the current cost of interest-costing liabilities and the yield on interest-earning assets and compare with the previous year. Note: The yields on mortgage loans and mortgage-backed securities are dependent on prepayment rates.
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22. Review and evaluate the association's yield spread and compare with the previous year. You should check to ensure that the institution estimates noninterest income and noninterest expense based on normal levels.
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23. Review the statement of operations for nonrecurring gains and losses as well as for nonrecurring revenues and expenses.
- Review accruals and the timing of reversals for appropriateness.
  - Ensure that the ALLL does not contain any allowances for impairment of long-term assets held for disposal, or for the discontinuation of activities.
- 
24. Determine if the association's earnings or payment of dividends relies on asset sales, securitizations, or any other type of nonrecurring transactions.
- Determine if earnings are sufficient to pay dividends after considering the potential overstatements of profits using gain-on-sale accounting.
  - Determine whether earnings are sufficient to maintain adequate capital and reserves after considering asset quality and growth rate.
  - Note the degree of reliance on sales of whole loans for profits. If high, review the credit quality of originations.
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## Operations Analysis Program

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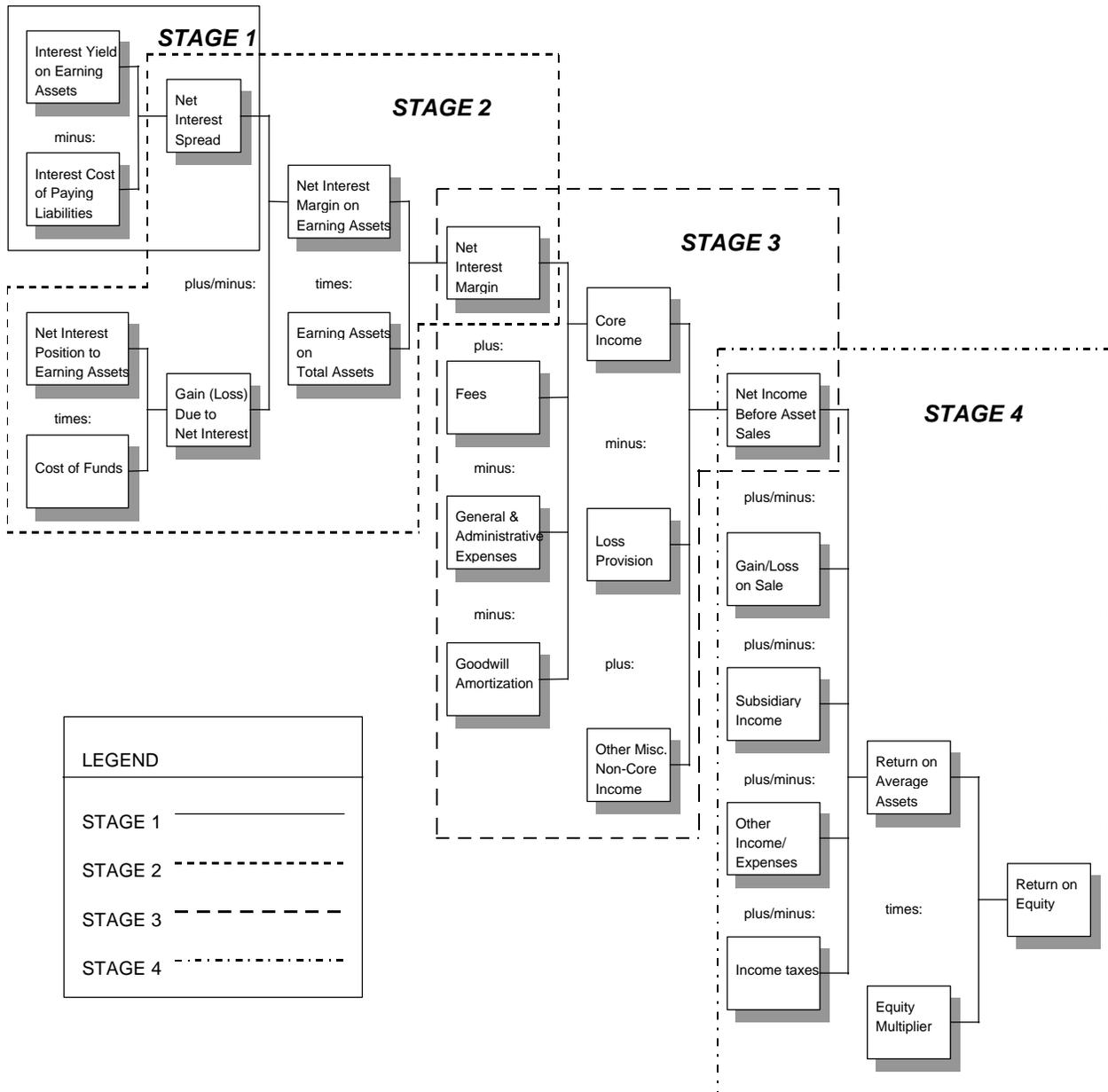
25. Determine whether the association significantly relies on securitization gains for earnings. Note the findings of the asset quality review of securitization transactions and ensure the review focused on the following areas:
- The securitization documents (pooling and service agreements). Does the institution limit its post-sale credit support to that specified in the terms and conditions of the securitization contract?
  - Valuation of retained assets. Does management conservatively value its retained interests, and periodically review its valuation models for soundness?
  - Credit loss assumptions. Are management's credit loss assumptions that support retained interest valuations appropriate?
  - Management's methods for assessing impairment.
    - Are the factors management uses to estimate fair value similar to those used by the institution's peers?
    - Are impairment adjustments comparable to adjustments made for similar types of securitizations, servicing assets, or other types of transactions?
  - Calculate the percentage of retained interests to Tier 1 capital; and consider the reasonableness of the percentage.

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### Examiner's Summary, Recommendations, and Comments

**Exam Date:** \_\_\_\_\_  
**Prepared By:** \_\_\_\_\_  
**Reviewed By:** \_\_\_\_\_  
**Docket #:** \_\_\_\_\_

Derivation of Return on Assets and Return on Equity



## ADEQUACY OF RETURN ON INVESTMENT

One of the primary objectives for investing in subordinate organizations (operating subsidiaries, service corporations, and their lower-tier entities) is to generate earnings. Since parent savings associations operate on a relatively small interest margin, the need to maximize returns on assets is important. The larger the investment in subordinate organizations, the greater is the need for an adequate return on that investment.

Many factors influence investors when choosing alternative investments. The most significant of these factors are the cost of the funds used to make the investment and the desire to maximize yield and minimize risks. In evaluating the adequacy of the return on a parent association's investment in a subordinate organization(s), you must determine whether the:

- Return provides a reasonable margin in excess of the parent association's cost of funds.
- Yield is reasonable for the risks assumed.

### Return versus Cost of Funds

In evaluating the savings association's return on an investment in a subordinate organization, you must determine the amount by which the return differs from the cost of funds. The Uniform Thrift Performance Report (UTPR) provides historical data that you can use to facilitate the analysis.

The following procedures provide a systematic approach for analyzing the margin generated by the investment in the subordinate organizations:

- Determine whether a positive or negative margin is being generated by the investment in the subordinate organization. (See step 1 of the following example.)
- Calculate the dollar effect based on the margin ratio and the investment in the subordinate organization. (See step 2 of following example.)
- Identify or calculate the parent's net income before taxes and nonoperating items as a percentage of average assets. (See step 3 of following example.)
- Calculate earnings of the parent without the contribution or detriment of the subordinate organization investment. (See step 4 of following example.)
- Determine how investment in the subordinate organization affects the parent's net income before taxes and nonoperating items. (See step 5 of following example.)

The materiality of the subordinate organization investment should guide you in applying any or all of these procedures. If the investment in the subordinate organization provides an adequate return with minimal risks, then these procedures would not warrant your use.

For example, Association A has a nominal investment in a subordinate organization. The subordinate organization operates an electronic data processing center that services several clients. The yield on the association's investment averages approximately 15 percent while the average cost of funds is 7 percent. In this example, the above procedures would not warrant your use.

	<b>Association A</b> (000's Omitted)			
	12/31/XX	9/30/XX	6/30/XX	3/31/XX
Total Assets <sup>1</sup>	\$987,535	\$946,916	\$1,019,578	\$937,562
Net Income Before Taxes and Nonoperating Items <sup>1</sup>	3,073	2,475	2,842	4,647
Investment in Subordinate Organization	25,484	25,485	23,359	23,446
Income from Subordinate Organization	1.95%	3.82%	0.26%	47.84%
Cost of Funds <sup>1</sup> (As a % of Average Total Assets Annualized)	7.78%	7.57%	7.57%	8.35%

<sup>1</sup> Obtained from UTPR.

1. Calculate the margin between yield on investment in the subordinate organization and the cost of funds.

Return on Subordinate Organization	1.95%	3.82%	0.26%	47.84%
Cost of Funds	<u>7.78%</u>	<u>7.57%</u>	<u>7.57%</u>	<u>8.35%</u>
Margin	<u>-5.83%</u>	<u>-3.75%</u>	<u>-7.31%</u>	<u>39.49%</u>

2. Calculate the dollar effect of margin.

Beginning Investment Subordinate Organization	\$25,485	\$23,359	\$23,446	\$23,378
Ending Investment Subordinate Organization	<u>+25,484</u>	<u>+25,485</u>	<u>+23,359</u>	<u>+23,446</u>
Total	\$50,969	\$48,844	\$46,805	\$46,824
Average Investment Subordinate Organization	\$25,485	\$24,422	\$23,403	\$23,412
(Average investment equals the sum of beginning and ending investments divided by 2)				
Margin	<u>-5.83%</u>	<u>-3.75%</u>	<u>-7.31%</u>	<u>39.49%</u>
Annual Effect of Margin (Margin times average investment)	-\$1,486	-\$ 916	-\$1,711	\$ 9,245
Quarterly Effect of Margin (Annual margin divided by 4)	<u>\$ -372</u>	<u>\$ -229</u>	<u>\$ -428</u>	<u>\$ 2,311</u>

3. Calculate parent ratio of net income before taxes and nonoperating items (NOI) to average assets.

Beginning Assets	\$ 946,916	\$1,019,578	\$ 937,562	\$928,567
Ending Assets	<u>987,535</u>	<u>946,916</u>	<u>1,019,578</u>	<u>937,562</u>
Total	\$1,934,451	\$1,966,494	\$1,957,140	\$1,866,129
Average Assets	\$ 967,226	\$ 983,247	\$ 978,570	\$ 933,065
(Average assets equal the sum of beginning and ending assets divided by 2)				
NOI	\$ 3,073	\$ 2,475	\$ 2,842	\$ 4,647
NOI/Average Assets	<u>1.27%</u>	<u>1.01%</u>	<u>1.16%</u>	<u>1.99%</u>
(NOI divided by average assets times 4)				

4. Calculate parent ratio of net income before taxes and nonoperating items (NOI) and exclude effect of the subordinate organization margin above or below cost of funds to average assets.

NOI	\$3,073	\$2,475	\$2,842	\$4,647
Quarterly Effect of Investment	<u>(-372)</u>	<u>(-229)</u>	<u>(-428)</u>	<u>(2,311)</u>
NOI Excluding Effect of Investment	\$3,445	\$2,704	\$3,270	\$2,336
Net Income Before Taxes, Nonoperating Items & Effect of Investment/Average Assets	<u>1.42%</u>	<u>1.10%</u>	<u>1.34%</u>	<u>0.93%</u>
(Ratio was annualized by multiplying by 4)				

5. Determine how investment in the subordinate organization affects the parent's net income before taxes and nonoperating items.

Investment's Dollar Effect	-\$1,486	- \$916	- \$1,711	\$9,245
Percent of Average Assets	-0.15%	-0.09%	-0.18%	0.99%
Net Income Before Taxes, Nonoperating Items & Effect of Investment/Average Assets	1.42%	1.10%	1.34%	0.93%
Percentage Effect of Investment on NOI	<u>-10.56%</u>	<u>-8.18%</u>	<u>-13.43%</u>	<u>106.45%</u>
(Dollar effect of subordinate organization investment stated as a percentage of average assets/parent institution's net income before taxes, nonoperating items, and the effect of investment stated as a percentage of average assets, i.e., -0.15%/1.42% = -0.1056 or -10.56%)				

You also should compare data from period to period to identify any trends. You can compare quarterly data for all quarters of the review period, and annual data for the three previous years to identify the cause(s) of any negative trends.

Although historical data provides useful information for evaluating the return on investment, you must also consider management's projected return. Using the preceding example, if you had done an analysis of the return on the investment as of March 31 of that year, your conclusion might have been that the subordinate organization was extremely profitable. Although this may have been true then, a realistic operating budget would have tempered the assessment of profitability based on the return for the remainder of the year. A comprehensive analysis of the adequacy of the return on the investment should include the following determinations and comparisons:

- Determining the projected return on investments in subordinate organizations by reviewing management's operating budget(s).
- Comparing the projected return with historical data and investigating differences from historical patterns by interviewing management and reviewing the budget(s) assumptions for reasonableness.
- Comparing the most recent cost of funds ratio for the parent association with the projected yield on the investment in subordinate organizations.
- Determining the significance of any projected negative margins, by comparing the dollar amount of the negative margin to the capital and projected net income of the parent association.

It is equally important to determine the reasons for changes in the return on investment and whether the changes are a safety and soundness concern. You must determine whether a change is the result of sale of assets, accounting changes, market collapse, etc.

### Risk Versus Return

Once you have determined the margin, you should evaluate the level of risk assumed to generate the

margin. Generally, the higher the return, the higher the risk. Subordinate organizations, like all other businesses, assume certain types of business risk in the process of generating earnings. Determining the types of risk associated with the subordinate organization's activities and comparing the return on investment with the yield on other earning assets establishes a foundation for evaluating the organization's risk and reward position.

A return on investments that is significantly higher than yields on other earning assets may indicate that the subordinate organization(s) has assumed an excessive level of risk. A return that is lower than other earning assets may indicate an inefficient use of investment funds. By understanding the characteristics of all earning assets, you can establish a subjective correlation between yields and risks. You can then use this subjective correlation to evaluate the level of risk assumed or to evaluate the adequacy of the yield earned. For example, investors would expect an investment in a mortgage banking subordinate organization to yield more than the parent's investment in short term investment securities. This higher expected yield is due to the higher level of business risk assumed. On the other hand, if a subordinate organization activity yields more than the parent's investment in commercial loans, that activity is likely to be more risky than commercial lending.

You can compare the yield from a parent's investment in a subordinate organization(s) with the parent's return on the following accounts:

- Mortgage loan portfolio
- Other loan portfolio
- Investment portfolio.

Tax considerations can distort the risk reward correlation. If the parent and the subordinate organization do not file consolidated tax returns, there is an incentive to record income for the parent (which has a lower tax rate) instead of the subordinate organization. For example, the subordinate organization may pay an above market rate on a loan from the parent. To avoid a distorted analysis, you should make comparisons over several periods. As a guide, you should make the comparison for each quarter of the examination

review period. You can further enhance your analysis by comparing returns over the two previous years. In addition to making the comparison with a weighted return for the other assets, you should be alert to current yields on new investments in these assets. You can use this data to evaluate new investments in subordinate organizations. Thrift Activities Handbook Section 650, Interest Rate Risk Management, provides further assistance in identifying and evaluating the risk assumed by subordinate organizations.

You must exercise sound judgment in evaluating the risk and reward position of the subordinate organization(s) since the risk and reward position involves many variables. For instance, ancillary business obtained by the parent as the result of the subordinate organization's activities may be a valuable source of business to the parent. Even though the return on a subordinate organization of this nature may be lower than other assets, the overall benefit to the parent may be significantly greater due to this ancillary business.

## RECONCILIATION OF INTERCOMPANY ACCOUNTS

### Overview

One of the most basic steps in evaluating the propriety of a parent savings association's accounting for its investment in subordinate organizations is to reconcile certain reciprocal accounts. Examples of this are the parent's loans receivable and investment accounts reconciled to loans payable and capital accounts of the subordinate organizations. The reconciliation of reciprocal accounts verifies that the parent association properly reflects on its accounting records adjustments in the investment carrying value. Also, the reconciliation process is an important step in ascertaining if the accounting for the subordinate organizations is in accordance with generally accepted accounting principles (GAAP).

The parent's books should reflect the various tiers of subordinate organizations in accordance with the appropriate GAAP method. The parent's percentage of ownership interest largely determines the method. As discussed in more detail below, a parent may record an investment in a subordinate organization under either the consolidated, equity, or cost methods of accounting, consistent with GAAP.

The term subordinate organization, which 12 CFR § 559.2 defines, includes a federal thrift's operating subsidiaries, service corporations, and their lower-tier entities (that is, entities owned directly or indirectly by a first-tier subordinate organization). A subordinate organization does not include entities in which a savings association invests in as a pass-through investment authorized under § 560.32. (Refer to Handbook Section 730 for a detailed discussion of subordinate organization examinations, or Section 230 for an overview of an association's pass-through investment authority.)

In a multi-tier organizational structure, the entities' intercompany accounts should be reconciled to reflect the operations of all subordinate organizations that have a material effect on the parent association's financial condition. It would be of little benefit to reconcile the accounts of the par-

ent and a first-tier subordinate organization if the subordinate had not recognized a \$1 million loss sustained by its lower-tier business venture. As part of the reconciliation process, a responsible party should first reconcile lower-tier entities' intercompany investments that have a material effect on the accounts of the association up through the subordinate organization corporate structure. Reconciliation of the lower-tier entities should precede reconciliation of the parent's records to the first-tier subordinate organization.

Consequently, the reconciliation process should begin with an identification of all subordinate organizations and their relationship to each other. Data necessary to accomplish this identification is available in the TFR Schedule CSS (Subordinate Organization Schedule) and in the Preliminary Examination Response Kit (PERK).

Before addressing the actual reconciliation process, a responsible party should identify some of the causes of differences between the parent's general ledger accounts and the subordinate organization's accounts. Differences in account balances can result from many circumstances. The more common reasons for differences include the following causes:

- Delays by the parent savings association in recognizing its proportionate share of the subordinate organization's net income or loss.
- Posting errors.
- Inadequate or improper accounting procedures.
- Differences in methods of accounting for payables and receivables.

The example that follows illustrates differences that result from delays in recognizing income or losses.

#### Example:

A common problem encountered in the accounting for investment in subordinate organizations is the timeliness of recording the results of the operations of subordinate organizations in the parent association's investment account. By delaying recognition of a subordinate organization's losses

at year-end, the parent may try to shift the losses into the next accounting period. However, it is important that the results of a subordinate organization's operations be recognized in the appropriate accounting period to allow for a proper evaluation of the financial trends of the parent. In any case, the parent association should record the results of the subordinate's operations at least quarterly to provide complete and accurate reports to the regulatory agencies. (Monthly posting of the subordinate's operations is preferable to quarterly.)

A one-month delay in accounting for the investment in a subordinate organization is a common practice. Generally, financial data for the subordinate organization will not be available until several days past the end of a month. As a result, the parent does not know the necessary financial data at the time the parent makes the posting. If the recognition of the results of the subordinate organization's operations is consistently posted one month late and there are no material changes in the unposted month, you need not take exception. If monthly net income or losses are material to the financial condition of the parent, you should recommend that management make an accrual for month-end financial statement presentation based on an estimate of the most recent month's operations.

You should consider the assessment of the financial condition complete only after verifying that the parent association has properly recognized and timely recorded the financial effect of the subordinate organization. However, you must use judgment in evaluating the importance of a variance in account balances. The key factor to consider is whether the variance misrepresents the financial condition of the parent association. Another factor to consider is the cause of the account variance. Was the cause human error, inappropriate accounting procedures, or intentional misrepresentation? You should bring any account variances to the attention of management for resolution. However, you should pursue for examination purposes only those variances that misrepresent the financial condition of the parent association or appear to result from inappropriate procedures or intentional misrepresentation.

### Overview of Reconciliation Process

Initially, you should determine if the internal accounting staff has already made a reconciliation of accounts. You should test the reconciliation for accuracy. Generally, the reconciliation process involves two basic categories of accounts, namely, investment and reciprocal capital accounts, and intercompany payable and receivable accounts. In many instances, the reconciliation of these accounts is part of the internal or administrative control procedures for the subordinate organization or savings association.

The actual reconciliation process is relatively mechanical. The first step is to identify all capital accounts on the working trial balance for the subsidiary. These generally include the following accounts:

- Common and preferred stock.
- Paid-in-capital.
- Undistributed current earnings.
- Retained earnings or deficit.

You can also identify investment accounts from the parent's working trial balance. Examples include the following accounts:

- Common stock of subsidiary.
- Investment in subsidiary.
- Investment in service corporation.
- Investment in joint venture.
- Investment in operating subsidiary.

Next, total all the investment accounts and the related capital accounts and compare the totals. You should investigate any material differences to determine the reason for the variance.

The following examples illustrate the reconciliation process under the consolidated and equity methods of reporting. The following also provides a discussion of the cost method. The cost method, however, does not involve the reconciliation of intercompany accounts, other than to ensure that

the parent’s books reflect as income dividends received from subordinate organizations.

*Reconciliation of Investments and Capital Accounts*

Consolidation

When a savings association owns more than 50 percent of a subordinate organization’s outstanding common stock, GAAP generally requires the association to consolidate the subordinate’s assets on its financial reports. In a consolidation, the association’s financial reports reflect the financial position, operating results, and cash flows of both the parent and subordinate as if they were a single business entity. Consolidation occurs even though the entities maintain their separate corporate identities. In preparing consolidated reports, the reconciliation process involves the elimination of intercompany accounts. For example, in a consolidated financial statement, the entities eliminate intercompany loans between the parent and subordinate organization. They do this by crediting the parent’s note receivable from the subordinate on the parent’s books and by debiting the note payable to the parent company on the subordinate’s books. From a consolidated entity viewpoint, an intercompany loan transaction simply results in the transfer of cash from one part of the entity to another and does not cause a receivable or payable.

Consolidations are usually complex. Because of this, the parent and subordinate generally prepare worksheets to support the consolidation of assets, liabilities, and income items and certain elimination and adjustment entries. Typical intercompany elimination entries pertain to intercompany stock ownership, intercompany debt, and intercompany revenue and expenses. This includes open account balances, security holdings, sales and purchases, interest, dividends, gain or loss on transactions among companies in the consolidated group, and intercompany profit or loss on assets remaining within the group.

When a subordinate organization is majority (but not wholly) owned by a parent association, the subordinate separately reports the minority interest of shareholders owning less than 50 percent of

outstanding voting common stock. The minority shareholders have an interest in the subordinate’s net assets and in earnings or losses.

You should consult Accounting Principles Board Opinion (APB) No. 16, Business Combinations, when there are complex consolidation matters, such as intercompany profits in assets, goodwill, and income taxes on undistributed earnings.

The following example illustrates the consolidation of a parent company and its subordinate organization, ABC Company. Assume the parent owns 60 percent of ABC Company. By owning more than 50 percent of ABC’s outstanding voting common stock, the parent combines its assets and liabilities with 100 percent of ABC’s assets and liabilities. However, an entry to eliminate the parent’s investment in ABC is necessary to keep from double counting the investment.

Assume that common stock and paid in capital (\$1,500,000) plus retained earnings (\$500,000) total \$2,000,000. The accounting entry will eliminate the parent’s \$1,200,000 investment account in ABC and ABC’s stockholders’ equity accounts on the combined parent company and subsidiary working trial balance sheet. The entry to record the minority interests is as follows:

(000’s omitted)	debit (credit)
Common Stock and Paid-in Capital - ABC Company	\$1,500
Retained Earnings and Undistributed Income - ABC Company	\$500
Investment in ABC Company	(\$1,200)
Minority Interests	(\$ 800)

The \$800,000 represents the remaining 40 percent interest that the parent company does not own. Technically, minority interests are not liabilities since there is no payment obligation to anyone. In practice, however, a parent’s consolidated balance sheet may show minority interests as liabilities, but the usual practice is to show minority interests between liabilities and stockholders’ equity.

The parent company stockholders’ equity accounts do not change. For example, as the following summary format shows, the parent

company stockholders' equity and retained earnings accounts total \$4,400,000 before and immediately after the consolidation. Thus, consolidation does not affect these account balances.

After the parent eliminates the subordinate organization's investment accounts and makes other accounting entries to eliminate the intercompany debt and receivables, the parent combines its remaining assets and liabilities with the subsidiary's remaining assets and liabilities. These entries also combine the parent company stockholders' equity account, including the minority interests, for the consolidated financial statements, as shown below in summary format.

(000's omitted)

	Parent	Subsidiary	Eliminating Entries	Consolidated
Assets	\$ 51,100	15,100	(\$ 1,200)	\$ 65,000
Liabilities	(46,700)	(13,100)	--	(59,800)
Minority Interests	--	--	(800)	(800)
Stockholders' Equity	(4,400)	(2,000)	2,000	(4,400)

Equity Method

When a parent savings association owns between 20 and 50 percent of a subordinate organization's outstanding voting common stock, the parent should generally reflect the investment on its books under the equity method. The parent initially records its investment in the entity at cost. The parent makes subsequent adjustments to the carrying value to reflect its share of the subordinate's earnings or losses in the period that the subordinate reports its operating results. Also, the parent adjusts its investment to reflect dividends received from a subordinate organization. Under the equity method, the parent does not report a subordinate organization's dividends as income, but rather as cash dividends that reduce the subordinate's net assets (and stockholders' equity). Accordingly, the parent should record a proportionate decrease in its investment account for dividends received from the subordinate organization.

The equity method may require other adjustments to the investment account similar to those made in preparing consolidated statements. These include eliminating intercompany gains and losses and to

account for any differences between the parent and the subordinate organization in the measurement of the subordinate's expenses (for example, depreciation).

In the following illustration of the equity method, assume that a review of the subordinate organization's records establishes that the savings association owns 40 percent of ABC. Accordingly, the association's investment should reflect 40 percent of the net book value of ABC. However, after examining the working trial balance for the parent association shown below, the investment account for ABC is \$10,000 short ( $\$2,000,000 \times .40 = \$800,000$  and  $\$800,000 - 790,000 = \$10,000$ ). It is apparent that the investment accounts on the parent's general ledger do not balance with the capital accounts of the subordinate organization.

(000's omitted)

Capital Stock of ABC	\$ 700
Share of ABC Income	<u>90</u>
Total	\$ 790

The working trial balance for ABC Corporation contains the following capital accounts:

(000's omitted)

Common Stock (500 Shares, \$1,000 Par)	\$ 500
Paid-in Capital	1,000
Undistributed Current Earnings	200
Retained Earnings	<u>300</u>
Total	\$ 2,000

You must determine the cause of the difference to complete the reconciliation. One common cause of such a variance is a delay in the posting of the subordinate organization's monthly income to the parent's investment account. By reviewing the previous month's financial statement for ABC, you determine that net undistributed income was \$175,000 for the prior month. This indicates that the net income of ABC for the most recent month was \$25,000 ( $\$175,000 + 25,000 = \$200,000$ , the amount of ABC's undistributed current earnings). The parent savings association's share of the net

income was \$10,000 (\$25,000 x .40). The reconciliation should appear as follows:

(000's omitted)

Parent's Total Investment	\$ 790
Plus: Parent's Share of Current Month Income Recognized After Month's End	10
Parent's Proportionate Share of ABC's Total Capital	\$ 800

You may consult APB No. 18, The Equity Method of Accounting for Investments in Common Stock, for more detail on the equity method.

*Reconciliation of Intercompany Payables and Receivables for Consolidated Financial Statements*

You should identify all intercompany payables and receivables that the parent must reconcile. The parent should reconcile such intercompany transactions prior to eliminating them on the consolidated financial statements. Examples of intercompany payables and receivables include the following accounts:

- Loans and advances
- Income tax payables and receivables
- Accounts payable and receivable.

Generally, the parent association or subordinate organization reconciles only those accounts that are material in relation to their financial position. The parent or subordinate may, however, reconcile routine accounts payable and receivable even though they may not warrant reconciliation due to their small amounts.

You can identify intercompany payables and receivables by reviewing the working trial balances of the subordinate and the parent. In cases where the general ledger account name is inconclusive, you should interview the accounting staff. Also, in some instances it may be necessary to use general ledger subordinate organization records to identify the accounts that you must reconcile. For example, in most instances a parent association will not segregate a mortgage loan to a subordinate or-

ganization on its general ledger. In such cases, you must use the parent's mortgage loan trial balance in the reconciliation process.

After you identify the accounts, you must total each of the intercompany payables and receivables accounts and compare the related totals. You should investigate any material differences to determine the reason for the variance. An example of a common reconciliation of intercompany payables and receivables follows:

ABC Corporation has two loans shown as payable to its parent on its general ledger trial balance as follows:

(000's omitted)

Note Payable Parent	\$ 540
Mortgage Loan Payable	927

A review of the general ledger trial balance for the parent association reveals an account entitled Unsecured Note Receivable ABC for \$540,000. However, the parent does not segregate the mortgage loan on its general ledger trial balance. You must therefore obtain the mortgage loan trial balance to reconcile the mortgage loan payable. After you obtain the loan number from subordinate organization personnel, you can identify the loan on the parent association's mortgage loan trial balance. However, the trial balance lists the loan balance as \$1,200,000.

To reconcile this difference quickly and efficiently, you must be aware of the types of activities conducted by the subordinate organization. If the entity engages in any construction activities, review the loans-in-process balance. Information about loans-in-process may be part of the mortgage loan trial balance or a completely different report. The loans-in-process balance for this particular loan was \$245,000, which gives a net loan balance of \$955,000, or \$28,000 more than reported by ABC. A common cause for this type of variance is a timing difference in recording disbursements between the parent and the subordinate organization. To identify timing differences, you should review the loans-in-process transaction history and the subordinate organization's mortgage loan payable general ledger

account history near the end of the month when the entity usually reconciles accounts.

You should look for disbursements that the mortgage loan payable account does not reflect, or repayments by the subordinate that the loans-in-process account does not reflect, until after the end of the month. In this instance, the subordinate made a disbursement of \$47,000 on the last day of the month but did not post it to the mortgage loan payable account until the first of the next month. Also, the subordinate closed a sale of a developed residential building lot on the last day of the month and issued a check for \$19,000 to the parent to replenish the loans-in-process account. ABC posted this check to its mortgage loan payable account on the last day of the month but the parent did not post it until the second day of the next month. The reconciliation of the mortgage loan payable should be as follows:

(000's omitted)	
Mortgage Loan Receivable Per	
Parent Trial Balance	\$ 1,200
Adjustments:	
Less: Loans-in-Process	(245)
Less: Disbursements Posted After	
Month's End	(47)
Correct Total For Parent Trial Balance	<u>908</u>
Mortgage Loan Payable Per	
ABC's Trial Balance	\$ 927
Adjustments:	
Less: Repayments Posted After	
Month's End	(19)
Correct Total For ABC's Trial Balance	<u>908</u>

### Cost Method of Reporting

Under the cost method, the parent records its investment at cost, and recognizes as income subsequent dividends received that are distributed from net accumulated earnings of the organization. However, OTS considers dividends received in excess of earnings subsequent to the date of investment as a return of investment. Parent associations, consequently, should record dividends that the subordinate pays it in excess of its share of earnings, as a decrease in the cost of the investment. To determine whether a dividend payment is a "liquidating" dividend or an ordinary dividend, you can compare cumulative earnings and dividends.

### **Reporting Examination Findings**

As previously noted, you should investigate only those variances that are material in relation to the parent savings association or the subordinate organization. Compare the variance with the capital and net income of the parent entity to determine the materiality of the variances for the individual subordinate organizations. You should document any material differences in the examination work papers with an explanation for the cause of the discrepancy. You should also identify the appropriate treatment or necessary adjustments within the same work papers. If necessary, initiate refilings of the appropriate regulatory financial reports by the subordinate organization and parent association.