

Regulatory Bulletin  
RB 32-19

RB 32-19 rescinded 8/5/03 and 12/18/03 by RB 32-29 and RB 32-33. Click [HERE](#) to link to RB 32-29 and [HERE](#) to link to RB 32-33



Handbook: Thrift Activities  
Subject: Capital and Earnings

Sections: 110, 430

# RESCINDED

**Summary:** This bulletin provides updates to the following Thrift Activities Regulatory Handbook Sections: 110, Capital Stock and Ownership; and 430, Operations Analysis. Please replace the existing handbook sections with the enclosed revised sections.

**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). If you wish to purchase a handbook and a subscription to the updates, please contact the OTS Order Department at (301) 645-6264.

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## SUMMARY OF CHANGES

OTS is issuing updates to the following Thrift Activities Handbook Sections. Change bars in the margins of the handbook sections indicate revisions. We provide a summary of all substantive changes below. These handbook sections are in plain language as part of OTS's continuing effort to convert all guidance to plain language.

### 110 Capital Stock and Ownership

**Mutual Organization:** Adds a new section on the ownership of mutual associations.

**Capital Stock:** Revises information on mutual holding companies to reflect Gramm-Leach-Bliley Act changes.

**Contributed Capital:** Clarifies that savings associations may accept certain capital contributions without limit.

### 430 Operations Analysis

**Importance of Capital for Mutuels:** Adds a new section.

**Information Sources:** Adds a new section on the Risk Monitoring System.

**Components of Earnings:** Clarifies net interest income and net interest margin.

**Comprehensive Income:** New section that discusses SFAS No. 130.

**Return on Assets and Equity:** Adds information about ROAs for mutual and stock institutions.

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**Evaluation of Earnings in Different Structures:** New section that includes subsections on mutual and stock associations, subchapter S corporations, and Internet Operations.

**Analytical Techniques:** Under Comparative Analysis adds information on the new mutual only ratios in the UTPR and how to appropriately compare mutual and stock associations.

**Program:** Adds new procedure number 2 with a question about special considerations; adds new procedure 20 with a question about Internet operations. Revises procedures numbers 5 and 9 to reflect the ability to use standard or customized peer groups.



—Scott M. Albinson

*Managing Director, Supervision*

**INTRODUCTION**

This Section of the Handbook presents basic information concerning the mutual and stock form of organization. This section assists in identifying controlling interests in a savings association and in determining the appropriate allocation and exercise of control. This section provides information in the following areas:

- Mutual organization.
- Mutual Holding Companies.
- Types of capital stock.
- Conversions from mutual to stock organization.
- Securities and Exchange Commission (SEC) reporting requirements.
- Insider stock trading.
- Change in control.
- Divestiture of control.
- Contributed capital.
- Capital distributions.
- Employee stock ownership plans (ESOPs).

The Section assists in identifying controlling interests in a savings association and in determining the appropriate allocation and exercise of control.

**MUTUAL ORGANIZATION**

Savings associations organized as mutual institutions issue no capital stock and therefore have no stockholders. Mutual savings associations build capital almost exclusively through retained earnings. Mutual savings associations may receive pledged deposits and issue mutual capital certificates and subordinated debentures, however, mutuals rarely use these capital forms. When a new mutual savings association organizes, certain founding members pledge savings for the time required for the new mutual to build-up capital and operate profitably.

**Background**

The first savings associations appeared in the United States in the first half of the nineteenth century. Savings banks first appeared in Boston and Philadelphia in 1816. The first savings association was in 1831 in Frankford, Pennsylvania, now part of the city of Philadelphia. All thrift type institutions were originally mutual institutions. Not until the latter part of the nineteenth century did the first stock savings and loan type thrifts appear. At first, they were only in a few states. Savings banks remained exclusively mutual until the 1980s. All federal savings associations were in mutual form from 1933 to 1974, when Congress amended the Home Owners' Loan Act to permit the conversion of federal mutual savings associations to stock form. The Garn-St. Germain Depository Institutions Act of 1982 first authorized the direct chartering of federal stock savings associations.

Mutual thrift institutions initially were organized by individuals and groups for the common good of working class individuals and families who lacked the financial service facilities necessary for the accumulation of capital through savings plans and access to credit for housing needs. These mutual institutions greatly expanded in number and location throughout the nineteenth and early twentieth centuries. They generally were small institutions, although some eventually grew to substantial size, mostly in the larger cities. Although a substantial number of mutual institutions migrated to stock form savings associations through conversion since the mid-1970s, there remain a substantial core of mutual institutions. There are over 400 mutual savings associations under OTS supervision and several hundred more state chartered savings banks whose federal regulator is the FDIC. These mutual savings associations, while generally smaller than the stock institutions, carry on the basic mission of the founders of the thrift movement. The mutual savings associations remain close to their communities and the immediate needs of their localities for basic banking services for the citizens. In general, mutual savings associations often tend to have

higher capital levels, somewhat lower earnings, and high quality assets.

### Ownership of Mutual Savings Associations

The concept of ownership in mutual savings associations resulted in extensive discussion and subsequent litigation. The courts have determined that mutual account holders have only a contingent interest in the surplus of mutual savings associations in the event of liquidation. In the first case to challenge the newly adopted conversion regulations of the Federal Home Loan Bank Board, *York v. Federal Home Loan Bank Board*, the court concluded that conversion to a federal stock organization did not deprive the mutual depositors of property rights.

### Members Rights of a Federal Mutual Savings Association

The federal mutual charter grants certain rights to mutual members, which give them some control over the affairs of the savings association. All holders of the savings association's savings, demand, and other authorized accounts are members of the savings association. The ability to exercise control over a mutual savings association by its members, however, is not coextensive with the rights of stockholders of ordinary corporations, although there are similarities. The members of a federal mutual savings association have the right to:

- Vote.
- Amend the charter.
- Amend the by-laws.
- Nominate and elect directors.
- Remove directors for cause.
- Request special meetings.
- Communicate with other members.
- Inspect the corporate books and records.
- Share pro rata in the assets of the savings association following liquidation.

In enacting the Home Owners' Loan Act Congress generally left to the OTS (or its predecessor, the

FHLBB) the authority to determine when a mutual savings association's members have voting rights. Except for provisions relating to the conversion of a federal mutual to stock form, there is no statutory requirement that federal mutual savings associations' members have voting rights. Although the charter of a federal mutual savings association does grant such rights, it does not specify a member vote for all significant corporate transactions.

In practice, members delegate voting rights and the operation of federal mutual savings associations through the granting of proxies typically given to the board of directors (trustees) or a committee appointed by a majority of the board.

### CAPITAL STOCK

Capital stock consists of stock certificates issued to investors (stockholders) as evidence of their ownership interest in the savings association. One or more individuals or any business entity such as a partnership, a trust, or a corporation may own the stock.

### Common Stock

Common stock represents all the basic rights of ownership. Common stockholders exercise their basic rights in proportion to the shares owned. These rights include the following:

- The right to vote for the directors.
- The right to share in dividends declared by the board of directors.
- The right to share in the distribution of cash or other assets, after payment of creditors, in the event of liquidation of the savings association.

Savings associations may value capital stock on their books at a stated par value. A savings association will assign a nominal par value if the stock does not have a par value. Savings associations account for amounts paid in excess of the par value as additional paid-in capital.

The market value of shares does not coincide with par values. The market price reflects many factors, including the following:

- Overall economic conditions.
- Financial health of the savings association.
- Liquidity of the stock.
- Competition.
- Dividend policies.
- Growth potential.
- Market saturation in financial institution issues (supply and demand).

A savings association may list its shares on an organized exchange, or trade them over the counter (OTC). A savings association may act as its own registrar and transfer agent. If the savings association has 500 or more stockholders, the savings association must adhere to the SEC regulations when performing transfer agent functions.

Among the records a stock savings association must maintain is a (registrar's) list of stockholders. The list should include the following information:

- Name of holder.
- Address.
- Number of shares owned.
- Date acquired.
- Certificate number(s) held.
- Amount and type of dividend paid each stockholder.

It is important to promptly record transfers of shares to new owners. Savings associations, periodically, should reconcile the stockholder ledger with the general ledger control account and the stock certificate book.

### Preferred Stock

Preferred stock carries certain preferences, such as a prior claim on dividends, over common stock. Often preferred stock conveys no voting rights, or only limited voting rights, to the holders. The articles of incorporation (charter) govern special rights

of a preferred stock issue. The chartering authority may also regulate stockholders' rights.

Whether preferred stock is includable in regulatory or generally accepted accounting principles (GAAP) capital depends on its permanence as a funding source. The status of preferred stock as part of capital also depends on whether a savings association is subject to the Securities Act of 1933 and the Securities Exchange Act of 1934. Like common stockholders, preferred stockholders have basic ownership rights and do not have priority over creditors in the event of liquidation.

Although forms of permanent perpetual preferred stock exist, other preferred stock contains defined redemption terms and consequently it is not as permanent or long-term a funding source as common stock.

OTS regulation §563c.102 states that savings associations subject to the Securities Act of 1933 and the Securities Exchange Act of 1934 may not include subordinated debt securities or mandatorily redeemable preferred stock in equity.

Savings associations not subject to federal securities laws financial report requirements may make financial reports using Thrift Financial Report (TFR) instructions and rely on OTS capital regulations. Under 12 CFR Part 567 (Capital), savings associations include noncumulative perpetual preferred stock in core capital (§567.5(a)(1)(ii)). Savings associations include cumulative perpetual preferred stock in supplemental capital (§567.5(b)(1)(i)). Supplemental capital also may include certain redeemable preferred stock and subordinated debt issued under OTS regulations and memoranda. Eligibility for such instruments to qualify as part of regulatory capital depends on the timing of the redemption and other contractual characteristics. See 12 CFR § 563.81, Issuance of subordinated debt securities and mandatorily redeemable preferred stock.

### Mutual Holding Companies

The Mutual Holding Company regulation implements § 10(o) of the Home Owners' Loan Act (HOLA). Part 575 authorizes a mutual holding company to engage in capital raising activities. A

mutual holding company may pledge or issue up to 49.9 percent of its post-reorganization stock to persons other than the mutual holding company.

A MHC may create a new subsidiary stock holding company (SHC) that would exist between the MHC and its savings association in a three-tier corporate structure. The SHC, like a stock savings association subsidiary, must issue at least a majority of its shares to the MHC and could issue up to 49.9 percent of its shares to the public. The SHC must own 100 percent of the shares of the savings association subsidiary.

On July 12, 2000 OTS issued an Interim Rule based on the Gramm-Leach-Bliley Act. OTS changed the activities limitations for MHC's to mirror those applicable to financial holding companies. These changes enhance the MHC as a more suitable long-term alternative than full conversion from stock form for mutual savings associations considering conversion.

### Subchapter S Corporations

Subchapter S corporations generally receive pass-through tax treatment for federal income tax purposes. The Small Business Job Protection Act of 1996 made changes to the Internal Revenue Code that allows financial institutions, and their parent holding companies to elect Subchapter S Corporation status under the Code. The savings association must meet the following criteria:

- Shareholders may only be individuals, certain estates, and trusts.
- There may be no more than 75 shareholders and they must all consent to the election of S Corporation status.
- There must be only one class of stock.
- Must use (or convert to) the specific charge-off method in accounting for bad debts for tax purposes.
- Must use a calendar year, unless IRS grants permission to use some other year.

A Subchapter S holding company may wholly (but not partially) own a savings association that is a Subchapter S Corporation. Thus, holding compa-

nies and their wholly owned depository institution subsidiaries are both eligible for S Corporation status.

Savings associations may voluntarily or involuntarily lose their S Corporation status. Although there is no penalty or direct tax for a termination, either a voluntary or an involuntary loss may have adverse effects on a savings association's capital. For example, revocations may adversely affect an association, because the association may need to re-establish deferred tax accounts, which may reduce capital.

### *Ability to Raise Capital*

If an S Corporation needs to raise capital, its initial efforts will often focus on selling additional common stock to its existing stockholders to preserve its tax status. If existing stockholders are unable or unwilling to properly capitalize the thrift, the institution will normally offer to sell common stock to Subchapter S eligible investors who consent to the tax election. The institution should seek to limit the increase in the number of its stockholders to stay within the 75-shareholder limit for S Corporation.

S Corporation stockholders customarily sign shareholder agreements that prevent them from selling stock or otherwise transferring their stock to ineligible stockholders. These agreements typically require a shareholder who wishes to sell stock to first offer the shares to the other existing stockholders before offering the shares to any other party. As a prerequisite to purchasing an S Corporation's stock, a new investor must agree to sign the shareholder agreement.

If the institution cannot successfully increase its capital through these means, it may pursue other potential investors who may cause the institution to lose its Subchapter S election. Alternatively, the institution may have to issue a second class of stock that will result in an involuntary termination of its election. In either case, the institution would not incur any tax penalties because of its return to C Corporation status. Therefore, an institution's tax status as an S Corporation does not prevent it from raising additional capital.

**STOCK CONVERSION**

For mutual savings associations, conversion to stock form is the avenue available to raise capital in the equity market.

To facilitate the conversion process, management may contract for the services of attorneys, accountants, appraisers, and conversion managers who have conversion experience. Savings associations record conversion sales proceeds after deduction of conversion expenses. In smaller offerings, conversion expenses may amount to as much as ten percent of the equity raised.

Following is a description of various types of conversions. See Part 563b for additional information.

*Standard Conversion*

A standard conversion offers a funding source for healthy savings associations. In this form, eligible account holders receive nontransferable, pro-rated subscription rights to purchase the stock of the converting savings association before the public offering. Savings associations sell shares of the converting institution not purchased by persons with subscription rights either in a public offering through an underwriter or by the savings association in a direct community offering.

Submission of a conversion plan according to § 563b.3 is the first requirement before effecting a standard conversion. The resulting savings association must comply with the capital standards of Part 567. The accounting used for acquiring assets and liabilities in a standard conversion is generally historical cost of the acquired savings association (pooling-of-interest accounting).

*Supervisory Conversion*

A supervisory conversion permits savings associations that fail to meet specified capital levels to raise additional capital without government assistance. The resulting savings association must be a viable entity under § 563b.26(b).

Any significantly undercapitalized SAIF-insured savings association will qualify for a supervisory conversion unless OTS determines otherwise. OTS

may permit, on a case-by-case basis, an undercapitalized savings association to undertake a supervisory conversion if the savings association can demonstrate that a standard conversion is not feasible. Any BIF-insured mutual savings bank may qualify for voluntary supervisory conversion provided OTS concurs in a certification given by FDIC in accordance with 12 USC 1464(o)(2)(c).

A savings association may accomplish a supervisory conversion through a nonpublic offering (that is, the sale of the savings association's securities issued in the conversion directly to a person or persons).

A majority of the board of directors of the converting savings association must adopt a plan of supervisory conversion that is in accordance with Part 563b. The members of the savings association shall have no rights of approval or participation in the conversion or rights to the continuance of any legal or beneficial ownership interest in the converted savings association.

*Merger Conversions*

A merger conversion occurs when an existing stock institution or holding company acquires a converting mutual savings association. The converting mutual exchanges its stock for stock of the acquirer. OTS limits merger conversions to cases involving financially weak savings associations. OTS will also consider requests for waivers from this general policy for very small institutions, such as those with assets under \$25 million.

**Stock Organization**

Section 552.2-1 outlines the process for organizing a federal stock savings association. Stock organization means that management decisions are subject to shareholder vote and scrutiny. Stock savings associations must hold annual meetings of shareholders subject to regulatory requirements. These requirements appear in § 552.6 or applicable state law and/or § 14 of the Securities Exchange Act of 1934 (Exchange Act). Savings associations that convert to stock form face increased public disclosure requirements in becoming a public reporting company under that act.

## REVIEW OF EXCHANGE ACT AND SECURITIES OFFERING FILINGS

Under § 12(i) of the Exchange Act, OTS has the powers, functions, and duties vested in the SEC to administer and enforce several sections of the Exchange Act for savings associations. The applicable sections are §§ 12, 13, 14(a), 14(c), 14(d), 14(f), and 16. For this purpose, OTS is the securities disclosure oversight regulator for all Home Owners' Loan Act (HOLA) federal charters (both SAIF and BIF members). In addition, OTS is the securities disclosure oversight regulator for state-chartered savings association SAIF members. The FDIC is the comparable regulator for all BIF-insured, state-chartered savings banks.

Approximately 136 savings associations have a class of equity securities registered under the Exchange Act. Therefore, they are subject to Exchange Act periodic reporting requirements and rules governing a wide range of activities. Such activities include proxy solicitations; tender offers; and the acquisition of securities by officers, directors, and significant shareholders. In addition, savings associations that engage in public offerings of securities generally must file an offering circular with OTS. OTS declares the offering circular effective under the requirements of OTS securities offerings regulations for savings associations. These regulations include 12 CFR Parts 563b, 563d, and 563g.

The Business Transactions Division (BTD) of the Office of Chief Counsel and the Accounting Policy Division (APD) of the Office of Supervision review Exchange Act and securities offering filings of savings associations for compliance with the Exchange Act and OTS regulations. The applicable OTS regulations are 12 CFR Parts 563b, 563d, and 563g.

The regional offices are responsible for timely review of filings of savings associations and holding companies for information of supervisory concern. Regional staff should alert Washington to disclosure problems noted during these reviews. For a more detailed discussion of the Washington and Regional Processing of Exchange Act Filings, refer to Appendix B.

## Filing Requirements

Controlling persons, such as savings association directors and officers, are potentially liable in connection with their savings association's reports. Directors and officers should ensure accurate filings. This duty to evaluate the completeness and accuracy of reports applies to directors and responsible management officials whether or not they sign the report.

### *Savings Associations*

Section 563d.1 applies Exchange Act rules, regulations, and forms to securities issued by savings associations. As a result, savings associations with a class of equity securities registered under § 12 of the Exchange Act must file various periodic reports with both Washington and the appropriate regional office.

Failure to file timely and accurate Exchange Act reports is a violation of the federal securities laws and applicable OTS regulations. Violations may subject a savings association and its officers, directors, and other related persons to sanctions. These sanctions include:

- Civil suit.
- Cease-and-desist order.
- Civil money penalties.
- Supervisory agreement.

If you note any apparent violations of the Exchange Act filing requirements, report your findings to Washington and the regional accountant without discussing the apparent violations with the savings association. It is very important that any apparent violations of filing requirements be brought to the attention of Washington to ensure uniform interpretation and enforcement of Exchange Act regulations. BTD or APD will contact the savings association and OTS Enforcement, if necessary.

A savings association may become subject to reporting obligations under the Exchange Act in one of four ways:

- Section 12(b) of the Exchange Act requires the registering of any class of a savings association's securities registered on a national securities exchange.
- Exchange Act rules generally require that each savings association with 500 or more shareholders and \$5 million or more in assets register its equity securities under the Exchange Act. Savings associations may satisfy this requirement by filing Form 10 with OTS. Also, savings associations may register securities not otherwise requiring registration by filing Form 10 with OTS.
- Section 563b.3(c)(19)(i) generally requires savings associations converting from the mutual to the stock to register the class of securities issued in the conversion under the Exchange Act. Savings associations may not deregister such securities for three years.
- Each savings association, not otherwise required to report under the Exchange Act, has special responsibilities relating to offering circulars filed with BTD. If BTD declares an offering circular effective pursuant to Part 563g, savings associations must make filings pursuant to § 563g.18 with OTS. Savings associations must make these filings for at least the first year during which the offering circular becomes effective. These filings consist of periodic and current reports on Forms 10-K, 10-Q, 10 KSB, 10 QSB, and 8-K as Section 13 of the Exchange Act may require. The duty to file reports under § 563g.18 is automatically suspended for any fiscal year under the following condition:
  - If at the beginning of the fiscal year, (other than the fiscal year the offering circular became effective) the securities of each class to which the offering circular relates are held of record by less than 300 persons.

In addition, § 563g.2 provides that no savings association shall offer or sell any security unless the offer or sale includes an effective offering circular. Part 563g provides for the declaration of effectiveness of offering circulars. In certain circumstances, an exemption from filing requirements is available. Savings associations must file offering circulars required under Part 563g with both BTD and the appropriate regional office.

### *Savings and Loan Holding Companies*

OTS regulation, 12 CFR § 584.1, requires savings and loan holding companies to file Form H-(b)11 with the respective regional offices.

Holding companies with securities registered with the SEC under the Exchange Act must attach certain SEC filings to the H-(b)11. For example, the H-(b)11 must include the following information:

- Proxy material filed with the SEC.
- The annual report on Form 10-K.
- Current reports filed on Form 8-K.
- Any prospectus filed in connection with the public offering of securities.
- SEC reports not excluded by request of the OTS regional office.

### **Description of Filings**

#### *The Annual Report (Form 10-K or Form 10-KSB)*

Savings associations must file this report within 90 days of the close of a fiscal year.

#### *The Quarterly Report (Form 10-Q or Form 10-QSB)*

Savings associations must file this report for each fiscal quarter (except the fourth quarter) no later than 45 days after the end of the quarter.

The Annual and Quarterly reports provide specific financial information regarding the savings association as well as management's discussion of the savings association's financial condition. The reports also include a description of matters voted on by securities holders, and other relevant matters as required by the applicable form and regulations.

#### *The Current Report (Form 8-K)*

Savings associations must file this report with OTS because of the occurrence of the following events and within the following time frames:

- Any changes in control of the savings association - 15 days.

- Acquisition or disposition of assets (of a significant amount other than in the ordinary course of business) - 15 days.
- Placing of the savings association in receivership or conservatorship - 15 days.
- Any change in the savings association's certifying accountant - 5 days.
- Occurrence of other events the savings association deems to be materially important to security holders - no time frame, but within a reasonable time.
- Resignation of directors - 5 days.
- A change in fiscal year - 15 days.

### *Beneficial Ownership Reports*

#### The Initial Statement of Beneficial Ownership (Form 3)

Those who fall into any of the categories listed below must file within 10 days, Form 3 with OTS.

- Officers.
- Directors (regardless of whether they own any securities).
- Beneficial owners of ten percent or more of any class of the savings association's equity securities.

#### A Statement of Change in Beneficial Ownership of Equity Securities (Form 4)

Previous filers of Form 3 must file Form 4 when a change occurs in the nature or amount of the person's beneficial ownership of the savings association's equity securities. Filers must file Form 4 within ten days after the end of the month in which a change occurs.

#### Annual Statement of Changes in Beneficial Ownership (Form 5)

Report annually, within 45 days of the end of the fiscal year, any other small changes in ownership.

#### The Shareholder Report of Beneficial Ownership (Schedule 13D)

Shareholders must file Form 13D within ten days of the acquisition of beneficial ownership of more than five percent of any class of equity securities. Any material change in the facts of the statement requires that the shareholder promptly (generally within two business days of the material change) file an amendment.

#### Schedule 13G

Mutual funds and other institutions that invest funds or manage portfolios for beneficial owners must file Schedule G. Filers must file Schedule G within 45 days after the end of the calendar year.

Shareholders must file 13D and 13G reports with the savings association, OTS, each exchange where the savings association's securities trade, or to the National Association of Securities Dealers, Inc. (NASD) if the National Association of Securities Dealers Automated Quotation System (NASDAQ) quotes the stock.

In reviewing Forms 3, 4, and 5 and Schedule 13D, BTB attorneys watch for issues related to Part 574, the potential for hostile takeovers, and possible trading on insider information. You should be alert to these possibilities and alert BTB to relevant information.

Persons own directly any stock held in their own name or held by a bank, broker, or nominee in a street name for their account. Under the convention of holding shares in a street name, a broker executes the trade and holds the stock in the name of the brokerage firm or a nominee. The savings association, through the shareholder (registrar's) ledger, is unaware of the individual initiating the transaction. There are no rules governing the disclosure of ownership held in a street name except for the threshold reporting requirements described above.

Persons are the beneficial owners of any stock that they have the right to acquire through the exercise of presently exercisable options, including options granted through a stock option plan. Indirect beneficial ownership includes stock held in the name of

another person if, because of an agreement or relationship, a person obtains benefits substantially equivalent to those of ownership. Such benefits include the right to receive income and the right to control transfer of the stock. For example, a person generally is the beneficial owner of stock in the following situations:

- Stock held by certain family members, such as a spouse or minor children.
- Stock owned as trustee, where the person or members of the person's immediate family have a vested interest in the income or principal of the trust.
- Stock held in trust for which the person is a beneficiary.
- Stock owned by a partnership of which the person is a member.
- Stock owned by a corporation that the person controls.

#### *Proxy and Information Statements*

Exchange Act Regulations 14A and 14C require the filing of preliminary copies of all Proxy Statements, other soliciting materials, and Information Statements (used where there is no solicitation of proxies). Savings associations file this material with OTS at least ten calendar days prior to the date of first sending or giving such information to shareholders. Savings associations file definitive copies of the above materials with OTS no later than the date of sending or giving such materials to shareholders.

In certain circumstances, savings associations must provide an Information Statement that contains the information specified by Regulation 14C under the Exchange Act. In those instances where a savings association plans corporate action, the Exchange Act requires the filing of an Information Statement. This is a requirement even where there is no solicitation of proxies. The corporate action may occur either at a meeting of the savings association's security holders or by written authorization or consent of such holders. Savings associations must file preliminary copies of either proxy-solicitation material or an Information Statement, as appropriate, with OTS. Savings associations must submit

this material within a specified period prior to any distribution of such information to security holders.

#### *Annual Report to Shareholders*

Savings associations must mail to shareholders copies of the Annual Report to Shareholders. Savings associations mail the Annual Report to Shareholders with, or subsequent to the mailing of, either proxy-solicitation material or an Information Statement. The Information Statement relates to an annual meeting, a special meeting instead of an annual meeting, or a written consent instead of either an annual or special meeting that includes election of directors.

#### **Insider Stock Trading**

There are substantive limitations on the ability of savings association directors, officers, and ten percent shareholders to trade in the savings association's stock. Any profit realized from any purchase and sale or sale and purchase of the savings association's stock within a six-month period (short-swing trade) is subject to recapture. Either the savings association or the savings association's stockholders by filing suit on its behalf (15 USC § 16(b)) may seek recapture. The rule provides a rigorous guard against misuse of confidential information by insiders. Prohibition, however, does not extend to all reportable transactions.

Furthermore, the Exchange Act generally prohibits directors, officers, and ten percent stockholders from making any short sale of their savings association's stock. That is, any sale of stock that the seller does not then own. The Exchange Act also requires that directors, officers, and 10 percent stockholders deliver to buyers within 20 days any stock they sell. Alternatively, the Exchange Act requires the depositing in the mail within 5 days any stock sold by directors, officers, and 10 percent stockholders.

In addition, Rule 10b-5 under the Exchange Act prohibits a person from trading a savings association's stock using material inside information. Inside information refers to information not available to the public in general (17 CFR § 240.10b-5). The rule also prohibits a person in possession

of material nonpublic information from selectively disclosing this information to others (tipping) and generally bars the tippees from trading on such a tip. Information is material for this purpose if a reasonable investor would consider it important in reaching an investment decision or would attach actual significance to the information in making the decision. Thus, savings association officers, directors, and others in possession of material inside information must not trade in the savings association's stock until the information is available to the investing public. Managers must not make any disclosures of material information to selected persons without concurrently releasing the information to the public.

### Change in Control

Regulators have concerns about the control of a savings association's voting rights because a change in control may influence the direction and operating policies of the savings association. No person shall acquire control of a savings association through a purchase, assignment, transfer, pledge, or other disposition of voting rights of such savings association without OTS approval. This includes the individual acting directly or indirectly or through or in concert with one or more other persons. OTS rules on acquisition of control of savings associations are in 12 CFR Part 574.

Section 563.181 contains special notification requirements that apply whenever a change occurs in the outstanding voting rights that will result in control (or a change in control) of any mutual savings association. The president or other chief executive officer must report such facts to the OTS. They should file the report within 15 days of their knowledge of such change.

Section 563.183 requires the savings association to file a report whenever there is a change in control of any savings association or holding company and there is also a change or replacement of the chief executive officer within a specified time.

The president or other chief executive officer must file a report when a change in control of a savings association or holding company occurs concurrently with, or within 60 days after or 12 months before, a change or replacement of the chief execu-

tive officer. (A change in control also mandates filing Form 8-K for a savings association or holding company subject to public reporting requirements of the Exchange Act.)

The president or other chief executive officer shall report to OTS whether a change in ownership or other change in the outstanding voting rights under §§ 563.181 or 563.183 will result in control or a change in control of the savings association or holding company. Section 574.4 outlines the conditions under which an acquirer possesses control. The regulation also includes conclusive control determinations.

Section 563.181(c) states the conditions that will require a report from a mutual savings association president or CEO when there is a solicitation of voting rights of the savings association. If a solicitation is of a continuing nature, it is necessary to file a report only when the solicitation begins. The report should indicate the continuing nature of the solicitation. No further reporting is necessary unless or until there is a change in the solicitor.

The president or CEO of the savings association or the holding company should file the report required under 12 CFR §§ 563.181 and 563.183. Under 12 CFR § 516.1(c), they should send an original and two copies to the regional office.

Savings associations must provide a business plan with each of the following applications:

- Approval of change in control of a stock savings association.
- Change in control of a mutual savings association.
- Change in or replacement of the chief executive officer.

Willful violations of §§ 563.181 and 563.183 may be subject to harsh enforcement action, including civil money penalties. If you discover such activity, you should remind savings associations and savings and loan holding companies of these reporting requirements. Savings associations and savings and loan holding companies are to resolve any doubt regarding the necessity of filing by submission of a report.

Section 574.4(b) requires reports whenever any person, partnership, corporation, trust, or group of associated persons acquires, receives, or in effect, becomes the holder of ten percent or more of the outstanding stock or voting rights of a savings association.

## REGULATORY CONSIDERATIONS

### Divestiture of Control

Section 567.13 requires that any acquiror subject to a capital maintenance obligation give prior written notice to OTS if the acquiror proposes divestiture of the savings association.

After receiving the notice, OTS has 90 days to conduct an examination of the savings association. OTS determines the extent of any capital deficiency and communicates the results to the acquiror. If the examination indicates that no deficiency exists, the acquiror may divest control of the savings association upon receiving written notice of the examination results.

If a capital deficiency does exist, any acquiror subject to a capital maintenance agreement may only divest a savings association if they provide OTS with a capital infusion agreement. Such an agreement must provide that the acquiror will infuse the savings association with the amount necessary to remedy the deficiency. Further, the acquiror must arrange for payment, satisfactory to OTS, or otherwise satisfy the deficiency. If the acquiror provides OTS with a satisfactory agreement before the completion of an examination made to determine the extent of any capital deficiency, it may proceed to divest control. Also, the acquiror must arrange for payment, satisfactory to OTS, to ensure payment of any deficiency. Alternatively, the acquiror may immediately satisfy the deficiency.

### Contributed Capital

Savings associations may accept without limit the following capital contributions:

- Cash
- Cash equivalents

- Other high quality, marketable assets provided they are otherwise permissible for the savings association.

Savings associations may accept assets that meet the following three-part test and contribute them up to 25 percent of core capital if the association receives prior OTS approval.

- The assets must be separable and capable of being sold apart from the savings association or from the bulk of the savings association's assets.
- Savings associations must establish the market value of the assets on an annual basis. In addition, savings associations must establish the market value through an identifiable stream of cash flows. In addition, there must be a high degree of certainty that the assets will hold their market value despite the future prospects of the savings association.
- The savings association must demonstrate and document that a market exists that will provide liquidity for the asset.

Generally, it is not an accepted practice for savings associations to accept noncash capital contributions other than those outlined above. OTS policy requires that savings associations deduct from assets and capital the contribution of noncash assets that do not meet the above standards for purposes of determining core capital.

### Capital Distributions

FDICIA § 38 prohibits an insured institution from taking certain actions if, as a result, the institution would fall within any of the three undercapitalized capital categories. The prohibited actions include the following:

- Declare any dividends.
- Make any other capital distribution.
- Pay a management fee to a controlling person.

See 12 CFR § 565.4(b) and Thrift Activities Handbook Section 120, Capital Adequacy, for guidance regarding the capital categories.

A savings association permitted to make a capital distribution under the prompt corrective action regulations may do so in accordance with 12 CFR Part 563, Subpart E - Capital Distributions. This new rule was effective on April 1, 1999. The revised capital distribution regulation incorporates FDICIA's capital distribution requirements and imposes other limitations comparable to those applicable to national banks.

#### *Subchapter S Distributions*

Distributions by a Subchapter S corporation are dividends for regulatory purposes, including prompt corrective action. This includes distributions intended to cover a shareholder's personal tax liability for the shareholder's proportionate share of the taxable income of the institution

OTS may restrict such distributions to shareholders in amount or prohibit them in some instances. There may be some cases where the amount of dividends that shareholders would need to receive to pay their personal income taxes would exceed the amount of dividends allowable under 12 CFR Part 563, Subpart E - Capital Distributions. It is also possible for an association to be generating taxable income in a period when the association is reporting a loss or nominal income for financial reporting purposes. This situation can arise, for example, when an association takes a large provision for loan losses because of credit quality problems but has not yet charged off specific loans.

#### **EMPLOYEE STOCK OWNERSHIP PLANS**

It is customary for a significant holder of a savings association's shares to be an Employee Stock Ownership Plan (ESOP). An ESOP is an employee benefit plan. The Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code (IRC) of 1986 describe an ESOP as a stock bonus plan, or combination stock bonus and money purchase pension plan. ESOPs invest primarily in an employer's stock, generally by using tax deductible contributions made to the ESOP under the terms of the plan. Other pension plans normally limit the amount of the plan's assets allowable for investment in the employer's securities.

Federal legislation encourages the use of ESOPs to help achieve two major objectives:

- Broadening stock ownership of corporations by employees.
- Providing corporations with an additional source of capital funds.

A plan and trust are the vehicles used to establish an ESOP. The trustee is typically a financial institution. There are over 100 savings associations with trust powers. A savings association with trust powers can be the trustee for its own ESOP and the ESOPs of other employers.

After the establishment of the plan and the trust, the employer periodically contributes to the ESOP. The ESOP uses the contributions to purchase stock of the employer and to pay administrative and other expenses.

A common form of this type of benefit plan is the leveraged ESOP, whereby the sponsoring company forms a tax-qualified ESOP trust. The ESOP then borrows funds from a lending institution to acquire shares of the employer's stock. The stock may consist of outstanding shares, Treasury shares, or newly issued shares.

The debt of the ESOP is usually collateralized by the pledge of the stock to the lender. Also, there is either a guarantee or a commitment from the employer to make future contributions to the ESOP sufficient to cover the debt service requirements. There is a prohibition on the use of guarantees during a stock conversion. In leveraged ESOPs, the employer provides contributions to repay the debt and pay administrative expenses associated with the plan.

A suspense account under the control of the trustee of the plan usually holds the stock shares. Employees receive credit to their individual account when the trustee releases shares from the suspense account. The trustee releases shares from the suspense account as the ESOP repays the loan.

An ESOP must be tax qualified in order for the corporation's contribution to the plan to be tax free. This means the plan must meet certain requirements specified by the Internal Revenue Code

and is, therefore, subject to IRS examination. These requirements pertain to participation, vesting, distribution, and other rules designed to protect the interests of the employees.

Recognition of a deferred tax liability may occur if a savings association contributes more than the maximum percentage allowed for deduction in the current year. This allows for an inter-period tax allocation in a future year. Further, ESOPs allow for an above the line deduction for federal income tax purposes. This consists of a pre-tax deduction for employer contributions to the ESOP. The deduction includes both the principal and interest on the loan. Alternatively, if the ESOP is not leveraged, a deduction is allowable for the contribution up to a certain maximum. The net effect of this transaction is a reduction in operating income for the tax year.

An ESOP also may be a non-tax-qualified plan; the corporation simply receives no tax benefits as a result. Attraction or retention of key, highly compensated individuals often involves the use of non-tax-qualified ESOPs.

An ESOP is subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA) and is consequently subject to the rules and regulations promulgated by the Department of Labor.

ESOPs provide the following benefits:

- Employees can acquire stock ownership in their employer without having to invest their own funds.
- The employer can use the ESOP to generate additional capital with tax-deductible dollars.
- Shareholders of a closely held corporation may benefit from creation of a larger market for their stock.

Federal savings associations have the implied authority to establish ESOPs, as they have the authority to compensate their employees. State-chartered savings associations also appear to possess the implied authority to establish ESOPs. This question, however, is a matter of state law. This also holds true for holding companies.

A savings association must establish and operate an ESOP in a safe and sound manner. Section 563.47 requires savings associations establishing employee pension plans to satisfy requirements. Such requirements concern funding, amendments for cost of living increases, and termination. In addition, there are recordkeeping requirements for plans not subject to the recordkeeping and reporting requirements of ERISA and the Internal Revenue Code. The rule is applicable to ESOPs formed by service corporations as well.

A savings association, another financial institution with trust powers, or a service corporation may administer or act as a trustee for an ESOP. Some savings associations have service corporations that are separate trust companies; when this is the case, ESOPs are typically trusted by those service corporations.

### Regulatory Restrictions and Issues

Creation and structuring of ESOPs as an anti-takeover device frequently occurs during conversions. Discussion of three issues of particular interest relating to ESOPs follows:

- An ESOP may purchase no more than ten percent of the stock offered in a conversion.
- Limitations exist in a conversion as to the amount of stock that an individual may purchase and as to the amount of stock that management as a group may purchase. An individual's stock purchase limitations do not include stock held in an ESOP. There is no aggregation of the individual and ESOP stock holdings. Stock held in an ESOP that is a management recognition or retention plan (MRP) is non-tax-qualified. Include stock held in a non-tax-qualified ESOP in determining the overall limitation for management purchases of conversion stock.
- OTS continues to prohibit a savings association, during a conversion, from extending its own credit to finance the funding of any employee stock benefit plan. OTS also prohibits a converting savings association from guaranteeing the debt incurred by the ESOP when it borrows from another lending institution. The major objective of the conversion process is to

raise new capital. To permit a savings association to extend financing or to guarantee debt of the ESOP would be inconsistent with that objective. OTS requires a savings association to service the debt of the ESOP and reserves the right to disapprove a plan that is unrealistic in view of historical performance. In addition, substantial conversions could involve violations of ERISA if not done properly.

#### Transactions with Affiliates

Savings associations are subject to §§ 563.41 and 563.42. These rules restrict and prohibit certain transactions with affiliates. In many cases, ESOPs are affiliates because the trustees are also directors, partners, or trustees of the savings association or its holding company. In some cases, an ESOP is an affiliate because of other control. For example, the ESOP may own, control, or have the power to vote 25 percent of a class of voting securities of the holding company or savings association. If the ESOP is an affiliate, the savings association may not make a loan, guarantee, or other extension of credit to the ESOP. This is because the collateral requirements of § 563.41(c) would be difficult, if not impossible, to meet. The securities issued by an affiliate of the association are not acceptable as collateral for a loan or extension of credit to, or guarantee, acceptance, or letter of credit issued on behalf of the affiliate.

Despite this limitation, the funding of most ESOPs does not raise concerns. Typically, most ESOPs receive funding by a loan or guarantee from the holding company, as opposed to the savings association itself. A loan by the holding company is not a covered transaction under the affiliate regulations. Refer to Handbook Section 380 for further details on Transactions with Affiliates.

#### Compliance with ERISA

ERISA imposes complex requirements upon savings associations acting as trustee or in other fiduciary capacities for ESOPs, and severe penalties can result from statutory violations. In addition, the savings association, as the employer or plan sponsor of its own employees' retirement plan, is a party in interest pursuant to ERISA. This is the case whether or not the savings association is

the trustee. Almost without exception, all transactions involving the purchase or sale of an asset of the plan to or from the savings association, any affiliate, officer, or employee are subject to the provisions of ERISA. There are only certain narrowly defined exemptions. The plan sponsor or its administrative committee may be subject to reporting, disclosure, and plan design requirements. There are also a number of other responsibilities under ERISA if the savings association is acting as trustee or in a fiduciary or similar capacity.

#### Risk to Savings Association as Employer or When Acting as Trustee

Most of the responsibility for administration lies with the trustee, and there consequently is little risk to the savings association when it uses an outside trustee. However, the plan and trust establishing the ESOP stipulate the respective rights, duties, and obligations of the employer and trustee. For example, the employer normally keeps records on the number of persons employed. The employer may be subject to liability under ERISA if it violates any of its duties or obligations.

#### Acquisition of Control

No company, including an ESOP trust, may acquire control of a savings association or holding company without the prior written approval of OTS.

#### Valuation of Savings Association Stock

Shares of a publicly held savings association where fair market value is recognizable in an actively traded market generally do not raise problems. Difficulties may arise with closely held savings associations; the stock is not marketable and the ESOP creates but a limited market. IRS Ruling 59-60 outlines major principles of stock valuation; one of the principles requires the use of an independent appraiser.

#### Repurchase Liability

At separation or retirement, employees generally want cash for their shares of stock. The law requires an employer to redeem the shares if there is no readily available market for them. The issue of

cash availability can become a critical one for a small, privately held savings association. The ESOP repurchase liability is the savings association's continuing obligation to repurchase its stock from former ESOP participants and their beneficiaries. The savings association should perform a careful analysis of the magnitude of the obligation and include it in the financial planning process if necessary to ensure that enough cash is available.

### Accounting

The present accounting for ESOPs comes from a project undertaken by the Accounting Standards Executive Committee (AcSEC), which resulted in Statement of Position 93-6 (SOP 93-6, Employers' Accounting for Employee Stock Ownership Plans). This SOP provides guidance on employers' accounting for ESOPs. The SOP applies to all employers with ESOPs (both leveraged and nonleveraged). It does not address reporting by ESOPs. There is a discussion of financial reporting by ESOPs in the AICPA Audit and Accounting Guide: Audits of Employee Benefit Plans.

The necessity for SOP 93-6 is due to the great expansion in the number of ESOPs, their increased complexity, plus revised laws by Congress concerning ESOPs. In addition, the Internal Revenue Service (IRS) and the U.S. Department of Labor (DOL) issued many regulations covering the operation of plans. These actions caused changes in the way ESOPs operate and the reasons for their establishment.

SOP 93-6 brought significant changes in the way employers report transactions with leveraged ESOPs. Although SOP 93-6 did not change how employers with nonleveraged ESOPs account for ESOP transactions, it contains guidance for nonleveraged ESOPs.

The following paragraphs summarize significant accounting rules applicable to employer's accounting for ESOPs.

#### *Leveraged ESOPs*

- Employers should report the issuance of new shares or the sale of treasury shares to the ESOP when the issuance or sale occurs. Also,

employers should report a corresponding charge to unearned ESOP shares, a contra-equity account.

- For ESOP shares committed for release in a period to compensate employees directly, employers should recognize compensation cost equal to the fair value of the shares committed for release.
- For ESOP shares committed for release in a period to settle or fund liabilities for other employee benefits, employers should report satisfaction of the liabilities when the employer commits to release the shares to settle the liabilities. Other employee benefits include an employer's match of employees' 401(k) contributions or an employer's obligation under a formula profit-sharing plan. The use of an ESOP has no bearing on the recognition of compensation cost and liabilities associated with providing such benefits to employees.
- For ESOP shares committed for release to replace dividends on allocated shares used for debt service, employers should report satisfaction of the liability to pay dividends when the ESOP commits for the release of shares for that purpose.
- Employers should credit unearned ESOP shares as they commit shares for release based on the cost of the shares to the ESOP. Employers should charge or credit to additional paid-in capital the difference between the fair value of the shares committed for release and the cost of those shares to the ESOP.
- Employers should report dividends on unallocated shares as a reduction of debt or accrued interest payable or as compensation cost. The use of the dividend for either debt service or payment to participants determines the form of accounting entry. Employers should charge dividends on allocated shares to retained earnings. They should make satisfaction of dividends payable by:
  - Contributing cash to the participant accounts.
  - Contributing additional shares to participant accounts.

- Releasing shares from the ESOP's suspense account to participant accounts.
- Employers should report redemptions of ESOP shares as purchases of treasury stock. Employers should also report redemption of shares of leveraged and nonleveraged ESOPs as purchases of treasury stock. Employers must give a put option to participants holding ESOP shares that are not readily tradable. When participants exercise a put option, employers must repurchase the shares at fair value. The put option requirement applies to both leveraged and nonleveraged ESOPs.
- Employers that sponsor an ESOP with a *direct loan* (a loan made by a lender other than the employer to the ESOP) should report the obligations of the ESOP to the outside lender as liabilities. Employers should accrue interest cost on the debt. They should report cash payments made to the ESOP to service debt as reductions of debt and accrued interest payable when the ESOP makes payments to the outside lender. Apply this rule regardless of whether the source of cash is employer contributions or dividends.
- Employers that sponsor an ESOP with an *indirect loan* (loan made by the employer to the ESOP with a related outside loan to the employer) should report the outside loan as a liability. Employers should not report a loan receivable from the ESOP as an asset and should not recognize interest income on such receivable. Employers should accrue interest cost on the outside loan and should report loan payments as reductions of the principal and accrued interest payable. Employers do not recognize in the financial statements contributions to the ESOP or the concurrent payments from the ESOP to the employer for debt service.
- Employers that sponsor an ESOP with an *employer loan* (no related outside loan) should not report the ESOP's note payable and the employer's note receivable in the employer's balance sheet. Accordingly, employers should not recognize interest cost or interest income on an employer loan.
- For earnings per share computations, consider ESOP shares committed for release as out-

standing. ESOP shares are not outstanding if there is no commitment for release.

#### *Nonleveraged ESOPs*

- Employers with nonleveraged ESOPs should report compensation cost equal to the contribution called for in the period under the plan. Measure compensation cost as the fair value of shares contributed to or committed for contribution to the ESOP as appropriate under the terms of the plan.
- Employers with nonleveraged ESOPs should charge dividends on shares held by the ESOPs to retained earnings. An exception is that employers should account for suspense account shares of a pension reversion ESOP in the manner described in SOP 93-6 for leveraged ESOPs.
- Account for the redemption of shares of a nonleveraged ESOP in the same manner as that required for a leveraged ESOP. Employers must give a put option to participants holding ESOP shares that are not readily tradable, which on exercise requires employers to repurchase the shares at fair value. The put option requirement applies to both leveraged and nonleveraged ESOPs. Employers should report the satisfaction of such option exercises as purchases of treasury stock. (See the prior discussion of redemptions in the leveraged ESOPs section.)
- Treat all shares held by a nonleveraged ESOP as outstanding in computing the employer's earnings per share, except suspense shares of a pension reversion ESOP. Treat shares of a pension reversion ESOP as outstanding until making commitment for release for allocation to participant accounts. Different rules also apply if a nonleveraged ESOP holds convertible preferred stock.

Consult SOP 93-6 for a comprehensive discussion of rules applicable to employers' accounting for ESOPs.

**FOREIGN OWNERSHIP**

The Federal Reserve requests that OTS provide information on foreign ownership of savings associations and savings and loan holding companies. You have special responsibilities regarding the foreign ownership of savings associations. These responsibilities include completion of the foreign investment form in Appendix A. Do not include ownership by foreign citizens who have maintained at least five years of permanent U.S. residency. Determine the country of ownership from the highest tier of ownership.

**REFERENCES****United States Code (12 USC)***Federal Reserve System*

§371c(23A) Banking Affiliates  
 §371c-1(23B) Restrictions on Transactions  
 with Affiliates

*Home Owners' Loan Act*

§1464(i) Conversions  
 §1464(o) Conversion of State Savings  
 Banks  
 §1464(p) Conversions  
 §1467a(10) Regulation of Holding Compa-  
 nies  
 §1468(11) Transactions with Affiliates

*Federal Deposit Insurance Act*

§1817(j) Change in Control of Depository  
 Institutions

**United States Code (15 USC)***Securities Exchange Act of 1934*

§12 Registration Requirements  
 §13 Periodical and Other Reports  
 §14 Proxies  
 §16 Insiders

**United States Code (29 USC)**

§1001 Employee Retirement Income  
 Security Act of 1974

**Code of Federal Regulations (12 CFR)***FDIC Rules*

Part 303 Change in Bank Control  
 Subpart E

*Office of Thrift Supervision Rules*

Part 543 Federal Mutual Associations  
 Part 552 Federal Stock Associations  
 §561.4 Affiliate  
 §561.5 Affiliated Person  
 §563.41 Loans and other Transactions  
 with Affiliates and Subsidiaries  
 §563.43 Loans to Executive Officers,  
 Directors and Principal Share-  
 holders  
 §563.47 Pension Plans  
 §563.81 Issuance of Subordinated Debt  
 Securities and Mandatorily Re-  
 deemable Preferred Stock  
 Part 563 Capital Distributions  
 Subpart E  
 §563.181 Reports of Change in Control of  
 Mutual Savings Associations  
 §563.183 Reports of Change in CEO or  
 Director  
 Part 563b Conversions from Mutual to  
 Stock Form  
 Part 563d Securities of Savings Associa-  
 tions  
 Part 563g Securities Offerings  
 §565.4 Capital Measures and Capital  
 Category Definitions  
 §567.5 Components of Capital  
 §567.13 Obligations of Acquirors of Sav-  
 ings Associations to Maintain  
 Capital  
 Part 569 Proxies  
 Part 574 Acquisition of Control of Sav-  
 ings Associations  
 §584.1 Registration, Examination, and  
 Reports

**Code of Federal Regulations (17 CFR)**

*Securities and Exchange Commission Rules*

- §240.10b-5 Insider Trading
- §240.12b Registration under the Exchange Act
- §240.13 Shareholder and Periodic Reporting
- §240.14a Proxies
- §240.14c Distribution of Information
- §240.14e Tender Offer Rules
- §240.16a-1 Reports by Insiders
- §240.17f-2 Fingerprinting of Transfer Agent Personnel
- §240.17Ad-2 Turnaround of Items by Transfer Agents
- §240.17Ad-4 Exempt Transfer Agents
- §240.17Ad-11 Reports of Record Differences

**OTS Applications Processing Handbook**

Section 440 Stock Conversions

**OTS Trust & Asset Management Handbook**

Section 620 Employee Benefit Accounts

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

- No. 47 Disclosure of Long-term Obligations
- No. 89 Financial Reporting and Changing Prices

**Internal Revenue Service**

Revenue Ruling 59-60 Stock Valuation

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

No. 93-6 Employers' Accounting for Employee Stock Ownership Plans

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# Capital Stock and Ownership Program

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## Examination Objectives

- Identify and determine the nature of ownership and control of the savings association.
- Determine whether any individual has exerted a detrimental influence through ownership or control.
- Determine if adequate physical safeguards for stock certificates and ownership records are in place.
- Determine compliance with applicable laws, rulings, regulations, and any expressed agreements with OTS, FDIC, or state regulators.
- Determine the adequacy of the savings association's policies, procedures, and controls related to capital stock.
- Review securities filings for information of a supervisory interest and report results of the review to Business Transactions Division (BTD). Include the OTS number in all correspondence.
- Determine if a savings association prudently administers an Employee Stock Ownership Plan (ESOP).
- Initiate corrective action when deficiencies exist that could affect safety and soundness, or when you note significant violations of laws or regulations other than securities violations.

## Examination Procedures

Wkp.Ref.

### Level I

1. Summarize information from securities offering filings, directors' minutes, audit reports, and other sources pertaining to any new issuance of capital stock (including the payment of stock dividends), notes, subordinated debentures, and other capital instruments. File the information within the continuing examination file (CEF), if applicable.

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2. Either you or the regional office should make a brief review of the Forms 10-K, 10-Q, 10-KSB, 10-QSB and any other Exchange Act reports. (See Appendix B.) Compare the Exchange Act reports to TFRs, other reports, information, and documents relating to the savings association that are available. Immediately report any material discrepancies between the disclosures contained in the Exchange Act reports and information known to the regional office. The regional office should inform BTD and the Accounting Policy Division (APD) by e-mail.

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**Docket #:** \_\_\_\_\_

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## Capital Stock and Ownership Program

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**Wkp.Ref.**

3. Carefully review all transactions involving Treasury stock. Determine whether the board of directors' actions adequately support Treasury stock transactions. Consider whether transactions have a detrimental effect.

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4. Update the CEF, if applicable, with the Schedule of Stockholders (PERK 014). Alternatively, summarize the following information for each director and director's interests, officer, attorney, partner, and all other stockholders who own or control five percent or more of the savings association's stock:

- Number of shares.
  - Percent to total outstanding.
  - Stock certificate number (optional).
  - Issuing price (optional).
  - Date of issue (optional).
  - Confirm the timely reporting of changes in ownership on Forms 3, 4, 5 or Schedules 13D or 13G by companies subject to the Exchange Act.
- 

5. Determine stock concentration by noting the total number of shareholders along with the number of shares outstanding. Report foreign ownership to the Board of Governors of the Federal Reserve System. Use the form for Foreign Ownership in U.S. Savings and Loan Associations and Savings and Loan Holding Companies, Appendix A.

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6. If the savings association elected S Corporation status since the last examination, perform the following procedures:

- Review the association's eligibility for the election.
- Review shareholder agreements regarding stock transfers which management will use to maintain compliance with the eligibility requirements.
- Verify that management has a method for monitoring ongoing compliance with S Corporation eligibility requirements.

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## Capital Stock and Ownership Program

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**Wkp.Ref.**

- Confirm that management periodically test and review the method for monitoring compliance.
- 
7. Review whether the institution has realistic expectations about its ability to increase its capital while maintaining its S Corporation status.
- 
8. Determine whether the association's management and shareholders understand that limitations may exist on the ability of an S Corporation to pay dividends.
- 
9. Determine whether management understands the overall effect of any potential dividend distribution limitations on an S Corporation.
- 
10. Review proxy records from the last election of the directors. Identify anyone who has controlled the election of the board through proxies.
- 
11. On the basis of information obtained in procedure No. 4 and review of shareholder and related information, consider:
- Whether there was a change in control in the association. If yes, determine if BTD received the information, and if not reported, provide details to BTD for a determination of needed disclosures.
  - Whether ownership, or change in control, of the savings association has significantly affected the savings association's operating policies or mode of operations to the detriment of the savings association.
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## Capital Stock and Ownership Program

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**Wkp.Ref.**

12. ERISA and IRS rules and regulations are complex. Accordingly, you should request the ESOP administrator in the savings association to provide evidence that specialist legal counsel assists in helping to maintain the plan in compliance with all applicable rules and regulations. You should request the ESOP administrator to provide evidence that the savings association is able to meet its repurchase liability. The ESOP administrator also should support the stock valuation of closely held savings associations.

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13. From a review of plan documents or other appropriate sources, determine the duties and responsibilities of the savings association regarding its ESOP. Ascertain whether the savings association is satisfactorily performing its duties and responsibilities. If the need for expert advice is apparent, you should recommend that the savings association obtain the advice of an ESOP legal specialist. (Note: Section 620 of the Trust & Asset Management Handbook contains additional examination procedures if the savings association or its service corporation is acting as trustee, or serving in a fiduciary or similar capacity.)

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14. If the savings association established an ESOP in conjunction with a conversion, determine if the ESOP purchased ten percent or more of the stock offered in the conversion.

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15. Determine if the savings association aggregates stock held in the ESOP with an individual's purchase limitations.

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16. Determine if during a conversion the savings association extended its own credit to finance the funding of the ESOP. Also determine if during a conversion the savings association guaranteed the debt incurred by the ESOP when borrowing from another savings association.

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17. Determine if the ESOP is an affiliate or an affiliated person. If so, verify that transactions such as loans and other financing arrangements with the savings association are consistent with OTS and FRB restrictions and prohibitions. (12 CFR §§ 561.5 and 563.43 and Federal Reserve Act §§ 23A and 23B).

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## Capital Stock and Ownership Program

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Wkp.Ref.

18. Determine if an ESOP trust acquired control of the savings association or an S&L holding company. If so, verify OTS approval of the acquisition of control, as required by § 574.3.

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19. Summarize pertinent information relating to stock option plans and ESOPs and file in the CEF, if applicable.

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20. 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

21. Ensure that capital distributions are of the type and in the amount permitted by Part 563, Subpart E—Capital Distributions.

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22. For savings associations subject to the Exchange Act, determine whether the savings association makes timely required filings. If not, contact the regional office or BTB.

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23. If the savings association acts as its own transfer agent or registrar, examine the records pertaining to stock certificates to ensure controls are adequate to prevent over-issuance of stock.

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

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

Foreign Ownership in U.S. Savings and Loan Associations and Holding Companies

Circle one: Announced Applied Approved Consummated

S&L/S&LHC Name & Docket Number: \_\_\_\_\_

Address \_\_\_\_\_

Date of Acquisition: \_\_\_\_\_

Citizenship or Country of Incorporation of Investor: \_\_\_\_\_

Investor Name (company number), Address (City and Country) \_\_\_\_\_

Ownership percent (\*if controlling ownership)/percent of ownership added:

\_\_\_\_\_/\_\_\_\_\_

Source of Information: (circle one)

- Securities filing S&LHC Application Change of Control Notice
Stockholder Register Newspaper (send a copy) Other (identify)

Please attach any additional pertinent information.

This form was prepared by

Name \_\_\_\_\_ Telephone \_\_\_\_\_

OTS Region \_\_\_\_\_ Date Prepared \_\_\_\_\_

Send this form to: Brenda Harris, Stop N-401 Micro Statistics Section Division of Research and Statistics Board of Governors of the Federal Reserve System 20th St. and Constitution Ave., N.W. Washington, D.C. 20551

File a copy in the examination workpapers and send a copy to the OTS Director for Financial Reporting, Research and Analysis.

**WASHINGTON AND REGIONAL PROCESSING OF EXCHANGE ACT FILINGS***Background*

Savings associations must provide full, fair, accurate and complete information regarding their business and financial condition to the investing public to avoid potential liability under the anti-fraud rules of the federal securities laws. It is essential to the supervisory efforts of the regional offices that regulators be aware of critical information disclosed in filings.

The Business Transactions Division (BTD) of the Office of Chief Counsel and the Accounting Policy Division (APD) of the Office of Supervision review Exchange Act and securities offering filings of savings associations for compliance with the Exchange Act and OTS regulations. Also, BTD, upon request, assists the SEC by reviewing filings of savings and loan holding companies referred by the SEC.

Coordination between regional and Washington staff is essential to ensure that savings associations fulfill their obligations to make full, fair, accurate, and complete representations to the public about their financial condition and operations. Reliable public disclosure and market integrity for saving association's securities are key to the savings association industry's capital-raising process.

*General Procedures*

Each quarter BTD furnishes to the regional offices a list of savings associations registered under the Exchange Act, and the BTD attorney assigned to each association. The specific BTD attorney reviews and examines all of that savings association's Exchange Act reports and any offering circulars it may file.

The regional office should contact the appropriate BTD attorney or an APD accountant whenever questions arise with respect to a particular savings association's disclosure obligations. Also, the regional office should contact BTD by telephone or e-mail whenever information comes to their attention that potentially affects such obligations.

The responsibility for reviewing disclosure documents filed by savings associations for compliance with the Exchange Act and the OTS securities offerings regulations rests with BTD. BTD also is responsible for issuing comment letters relating to a particular filing. Further, BTD is responsible for resolving legal, disclosure, and accounting questions that may arise under the Exchange Act and 12 CFR Parts 563b, 563d, and 563g.

APD performs accounting reviews for the non-transactional Exchange Act filings that contain financial statements. APD is primarily responsible for accounting reviews of the following forms: 8-K, 10, 10-SB, 10-K, 10-KSB, 10-Q, 10-QSB, 12b-25, G-12, applications for conversions, applications for conversions with mergers, and applications for mutual holding company conversions. The BTD staff is primarily responsible for accounting reviews for secondary offering circulars, mergers, and subordinated debt.

Both APD and BTD closely review examination reports and other supervisory communications in connection with their review of securities filings to ensure appropriate disclosures in the filings. APD and the appropriate BTD attorney or supervisor coordinate to secure resolution of novel and precedential accounting issues.

The APD generally issues accounting comments in conjunction with comments issued by BTD on the Exchange Act filings for which it has primary responsibility. Otherwise, BTD provides to the savings association or other filing party all comments relating to the accuracy, adequacy, and timeliness of Exchange Act filings made with OTS. APD and the regional office receive copies of all comments and responses to comments BTD issues. BTD and the regional offices receive copies of all comments the APD issues and reviews.

The APD maintains a shared electronic file of all comments on filings that is accessible by BTB and each regional accountant or a designee. The shared file ensures that each office is aware of each other's findings and can determine if there is a need for a supervisory response. BTB, APD, and the regional office must be aware of problems that require disclosure in filings. The latter must also be aware of BTB and APD comments, and responses to those comments.

BTB (and APD as appropriate) will resolve all issues regarding a savings association's compliance with BTB and APD comments. Also, BTB will resolve any necessary enforcement or other actions regarding compliance with filing requirements. In some instances, BTB or APD may seek the assistance of a regional office in obtaining savings association compliance with comments.

BTB and APD must rely on regional regulators to observe and report events that may affect Exchange Act disclosures, particularly events raising significant supervisory concerns. Regional regulators, therefore, must have a general knowledge of the content of a savings association's securities filings.

#### *Time Requirements*

For a report to be timely, OTS must receive a properly filed report by the required date. The mailing or post-marking of a report on the last day on which a report is to be filed does not constitute a timely filing.

A savings association may receive an extension of time to file a report if the savings association follows the procedures described in the regulations and satisfies all of the requirements of an extension. Exchange Act Rule (17 CFR § 240) 12b-25 contains general provisions to follow if a savings association fails to file within a prescribed time frame all or portion of an Exchange Act periodic report. If a savings association fails to submit a complete required Exchange Act periodic report within the prescribed time period it must file a Form 12b-25. The savings association must file Form 12b-25 no later than one business day after the due date of such report. The association must disclose its inability to file the report on a timely basis and the reasons why in reasonable detail, and otherwise comply with all other requirements of Rule 12b-25. Among other things, the savings association must represent in the Form 12b-25 that it cannot eliminate the reasons for the delay without unreasonable effort or expense. The savings association also must represent that it will make the filing within the period of the extension.

Rule 12b-25 provides for a 15-day extension for a Form 10-K or 10-KSB and a 5-day extension for a Form 10-Q or 10-QSB. Such extensions are available only upon an appropriate filing with BTB. They are available only for one 15- or 5-day period as appropriate for the type of filing and, as such, no additional extensions of time are available under the regulations.

If appropriate, a savings association may represent its failure to file a timely prescribed report because it is unable to file the report without unreasonable effort or expense. Generally, late reports satisfy prescribed due dates only if the savings association meets all conditions of the rules.

When a savings association is unable to file a report on time, it should promptly consider its general public disclosure obligations. The savings association should determine whether it is appropriate to issue a press release to advise its stockholders and the public markets of material information pertaining to the savings association. The savings association should file late material under cover of Form 8-K. In this regard, savings associations may wish to contact BTB or submit a written statement of the reasons for the delinquency. The statement should include a description of the steps the savings association is taking to come into compliance with the reporting requirements.

*Regional Procedures*

Securities oversight of savings associations is critically important. Regional regulators must alert the BTM attorney responsible for the particular savings association in question, to all supervisory or other regulatory information that affects or may potentially affect securities law disclosure obligations. This reporting may be through e-mail. The use of e-mail provides more time for both the regional and BTM reviews. Also e-mail facilitates the maintenance of the comments in a shared electronic file that is available to the regions, BTM, and APD.

The regional office should provide to the appropriate BTM attorney and APD copies of all nonroutine correspondence to and from the savings association. Further, the regional office should provide copies of documents and internal memoranda that may contain information relevant to a savings association's disclosure obligations. The BTM attorneys and APD review this information to ensure that savings associations promptly comply with all disclosure obligations.

Achievement of successful supervision of savings association securities responsibilities requires uniformity and consistency of action. Regional personnel and BTM shall coordinate supervisory approach prior to initiating discussions with savings associations regarding requests for additional information or requiring corrective action under the Exchange Act. Should it become necessary, BTM will inform Enforcement of Exchange Act or securities offering problems needing enforcement attention.

Regional office personnel are responsible for contacting holding companies that are not filing Form H- (b)11 as required. The inclusion of SEC filings in Form H-(b)11 does not mean that OTS necessarily has a role in performing disclosure review of those documents. Regional regulators should provide any comments to BTM for all securities filings that the holding companies provide and send BTM related correspondence and examination reports upon request.

Regional personnel also should refer all comments or discovery of material information regarding savings and loan holding companies that are subject to Exchange Act filing requirements to BTM. BTM and APD will assess the materiality of the information for purposes of securities law obligations and will work with the regional personnel in deciding an appropriate response under the circumstances. BTM and APD also will assess the information to determine whether a referral to the SEC is appropriate.

You should report information concerning accounting or reporting problems that may affect the Thrift Financial Report (TFR) to the Financial Reporting Division (FRD), Dallas, TX. The staff of the FRD in Washington, DC can answer questions and provide advice concerning the correct completion of TFRs. Institutions may correct TFRs that are less than five months old.

The regional office should determine if savings associations provide timely periodic Exchange Act filings. The regional office should maintain a schedule for each regional Exchange Act registered savings association indicating the due dates of all Exchange Act filings. This Handbook Section lists all common required filings and their respective time requirements. Regional offices should use this information to set up the schedules. BTM and the APD maintain similar schedules and may assist the regional offices in setting up these schedules.

Savings associations must file required reports within prescribed time frames. Before the regional office contacts a savings association to inquire about a missing filing they should first check with the assigned BTM attorney to determine if BTM has the filing. In certain instances a savings association may explain a late filing by filing Form 12b-25. Depending on circumstances, this filing may allow a short extension of time to file certain reports. In addition, a savings association may inadvertently file reports with either BTM or the region, but not both. In such a case, BTM will direct the savings association to immediately file reports as required by the regulations, including Parts 563d and 563g.

Failure to file required reports on a timely basis may indicate deeper problems at a savings association. When regional regulators become aware of serious problems with a registrant savings association, they should immediately alert the BTM attorney and the APD by e-mail.

Regional staff should quickly and promptly review all filings related to savings associations and holding companies to discover any information of supervisory interest. Regional staff should not rely on BTM for this supervisory review. Further, regional staff should not duplicate the work of BTM in reviewing filings for compliance with the Exchange Act and Parts 563b, 563d, and 563g of the OTS regulations. If regulators read the filings promptly they may find serious problems disclosed in filings months before they would otherwise find them. A quick and timely review of filings may result in more timely initiation of a supervisory response that may require a restatement of earnings and financial position. In addition, the timely review of filings may lead to enforcement action such as cease and desist, removal and prohibition, or receivership.

After a review of any filing, regional personnel should prepare a brief memorandum to BTM and the APD describing the review and any related problems. The regional office should promptly provide this memorandum via e-mail to BTM and APD who will include the information in the shared electronic file. If necessary, BTM and APD will prepare and issue a comment letter concerning disclosure problems to the savings association.

The regional office prepares a memorandum to inform BTM and APD that a review is complete. Also, if pertinent, the memorandum discloses the possible existence of supervisory concerns and corrective actions that the regional office recommends. If the regional office notes problems, the filing will receive high priority. In the absence of problems noted, the filing will likely receive a lower review priority.

When a savings association files an offering circular pursuant to Part 563g, BTM generally issues an initial comment letter on the filing within 14 calendar days of the filing date. This comment letter will generally include comments from the BTM attorney assigned to the savings association. Accordingly, regional staff should review offering circulars and provide any relevant information via e-mail to BTM within ten calendar days of filing. Satisfying this time frame will allow BTM to consider such information within the initial review period.

Critical to an effective OTS oversight role is the certainty that regional personnel are thoroughly familiar with the current financial and operational condition of savings associations. Knowledgeable regional personnel promptly review filings for supervisory concerns, and communicate any concerns to BTM and APD. A critical component in BTM's Exchange Act oversight role is ensuring correction, as soon as possible, of any information in a public filing that is inaccurate, misleading, or incomplete. For this reason, regional regulators should promptly review upon receipt — Exchange Act filings, offering circulars, and applications for conversion. Regional personnel should provide relevant supervisory information to BTM and the APD when practicable, rather than wait until completion of the next examination report.

Regional regulators also should be aware of significant events that have occurred requiring the filing of a current report on Form 8-K. The regional directors also should determine if the filing is timely. Consult with a BTM attorney if there is question regarding the necessity of making a filing.

Filers must properly file and receive BTM clearance of proxy-soliciting materials, (or information statements, when applicable), before distribution to stockholders. Regional regulators should note these required steps. In addition, while not necessary, regional regulators may review proxy materials. If they do review proxy material, they should notify BTM and APD immediately by e-mail if they believe any proxy documents contain a material misstatement or omit any material information.

Regional regulators should also be alert to changes in the majority of a savings association's board of directors resulting from actions other than a meeting of the stockholders. Regional regulators should promptly consult

with BTB if questions arise regarding a change in the majority of a board of directors. Also, regional regulators should immediately notify BTB should problems arise.

Regional regulators should identify any savings associations with assets of more than \$5 million that have 300 or more shareholders and a class of stock not registered under the Exchange Act. Also, regional regulators should identify formerly registered savings associations. Interpretive questions sometimes arise as to the meaning of “held of record” or “class” and regional regulators should refer these questions to BTB. If it appears that a savings association should have registered its stock under the Exchange Act, the regional office should advise BTB. The trigger for this inquiry is 300 shareholders because:

- Although 500 shareholders triggers registration under the Exchange Act, the number of shareholders may have increased to 500 or more since the last verification.
- Three hundred shareholders triggers deregistration.

Finally, regional regulators should notify savings association officers and directors of their responsibilities to file reports (with BTB in Washington and the regional office) relating to their ownership in the savings association’s securities. The rules in this area can be extremely complex and there is a large body of judicial precedent dealing with this area. Refer questions regarding interpretation to BTB. Savings association officers, directors and five percent or greater shareholders have ownership and transaction reporting requirements under the Exchange Act. The Exchange Act requires this information on Forms 3, 4, or 5 and Schedule 13D or 14G. Regional regulators should encourage those under obligation to file to consult with their own counsel regarding their filing responsibilities.

A critical component to the implementation of a quality securities oversight function is that any material information on a particular savings association be transmitted to BTB as soon as possible. Regional regulators should contact the appropriate BTB attorney and APD accountant to report information or discuss disclosure issues as needed. Initiate contact while an examination is ongoing, or anytime, not just at the completion of the examination report.

Section 563d.2 of the OTS regulations requires savings associations to file with BTB six copies of certain reports and related correspondence. Savings associations must also file one copy of the report and related correspondence with the appropriate regional office. BTB provides a copy of the reports to the APD.

**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 take 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, and level of earnings. You should also analyze additional factors, such as capital level, credit risk, and interest rate risk, to thoroughly evaluate an association's operational structure.

**Importance of Capital for Mutuals**

Earnings are the accumulation of capital. 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, by themselves, are indicative of a poorly run institution. 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.

You should maintain a sense of balance when analyzing financial statements, avoiding 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*

The UTPR is an analytical tool created for monitoring the financial condition of savings associations. 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, allowing for a virtually limitless combination of options for creating customized reports to analyze exami-

nation 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 52 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 52 hits with more hits indicating 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. You can access RMS from OTS's Intranet using the following link:

<http://ots1dcin8/ra/financialmonitoring/thrift%20screen.asp>

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

Monitoring of savings associations with high-risk profiles will be more extensive and more frequent than that of non-high-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 size, asset

quality, asset composition, operating results, or interest rate risk. For non-high-risk associations, it may be sufficient to limit the review to compliance and summary monitoring reports on a quarterly basis.

Each regional office has an individual or department to coordinate the financial monitoring effort for the region. This department undertakes a quarterly review of the performance of each association. This includes a review of the Quarterly Compliance Monitoring Report and any additional monitoring reports necessary to assess changes in the association's financial condition. You should send any problems or risks identified through monitoring to appropriate regional staff. 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.

Supervisory staff should, as necessary, incorporate in the associations' regulatory profiles a summary of discussion of your 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.

### *Off-Site Monitoring Scope*

To identify weaknesses or deficiencies within associations and to detect all material financial developments at the earliest possible time, periodic monitoring and analysis should focus on the following items:

- Capital adequacy.
- Asset quality and composition.
- Loan and investment portfolio yields.

- Liability mix and rates.
- Earnings trend, composition, and stability.
- Net interest margin.
- Provision for loss on interest-bearing assets.
- Operating expenses.
- Net operating income.
- Noninterest income and expense components.
- Net income.
- Change in retained earnings.
- Adequacy of valuation allowances.
- Activity of significant subsidiaries.
- Regulatory compliance.
- Performance relative to adopted business plans.
- Accuracy of reports to OTS.

### COMPONENTS OF EARNINGS

To obtain a complete and accurate understanding of a savings association's operations, it is essential to know its operating strategy. The regulatory profile identifies the strategy, 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 non-mortgage 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 to 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 margins on products and investments for continued profitability. A NIP that is negative is a more serious weakness since it indicates that interest-costing liabilities are financing non-interest-earning assets.

### 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, professional fees and amortization of goodwill. Controlling costs is a critical management function. A reduction 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 and goodwill amortization. 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 non-recurring 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.

### Operating Income

For financial institutions, operating income is net income before taxes and extraordinary income. Financial institutions adjust operating income to add back the amount of goodwill and other "disallowed" intangible assets that they amortized during the period. Nonfinancial institutions also call operating income earnings before interest expense and taxes. For financial institutions, however, interest expense is an integral part of normal operations, not just the financing of normal operations.

### COMPREHENSIVE INCOME

Besides net income, SFAS No. 130, "Reporting Comprehensive Income," 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 the following amounts, net of income taxes:

- Unrealized gains and losses on available-for-sale debt and equity securities under SFAS No. 115.
- Gains and losses related to qualifying cash flow hedges under SFAS No. 133.
- Minimum pension liability adjustments under SFAS No. 87.
- Foreign currency translation adjustments under SFAS No. 52.

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. Mutual savings associations have no equity capital. Consequently, 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 may receive depositor pressure to convert to stock form but factors other than earnings may be the cause. Mutual savings associations, however, like stock savings associations, must 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 inordinately 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. The need for additional capital during the de novo period has driven requests for business plan revisions from a number of thrifts in the Southeast Region.

### *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 or 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 the strategic and 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, mortgage lender, or other activity. Your earnings analysis should not only provide an assessment of why earnings are poor, 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. Successful mortgage banking operations require higher general and administrative expenses.

### **Three Key Aspects of Earnings**

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

### *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.

## 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 perform it on describe 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 in the ratio. 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 were the result of shrinking assets without a corresponding decline in the fixed operating expenses of the company, or many other reasons, 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 the examination 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 their whole 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 figures. An example of a structural analysis of a statement of condition follows:

**Statement of Condition**  
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 item to itself 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 beneficial 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.

**Table 1**

Volume-to-Rate Variance Analysis			
	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 = $(\$5,000,000 - \$4,000,000) \times 10\%$ = $\$1,000,000 \times .10$ = $\$100,000$		
Rate Variance	= variance in rate times second year base = $(9.0\% - 10.0\%) \times \$5,000,000$ = $-1.0\% \times \$5,000,000$ = $.01 \times \$5,000,000$ = $-\$50,000$		
Volume	= $\$100,000$		
Rate Variance	= $-\$50,000$		
Net Change in Yield	= $\$50,000$		

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.

### 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 (Current Ratio).
- 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 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 non-cash 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

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# Operations Analysis Program

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## Examination Objectives

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

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

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

To evaluate the association's financial performance to determine whether its strategies result in sufficient profitability.

## Examination Procedures

Wkp.Ref.

### Level I

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

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2. 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.

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

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4. Review the UTPR financial schedules. Identify and explain trends, material variances, and other factors affecting earnings. Note any material reporting errors and make notations on the UTPR schedules to ensure appropriate analysis. Include copies in the work papers.

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5. Compare the association's financial data to standard or customized peer group data and explain material variances.

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**Reviewed By:** \_\_\_\_\_  
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## Operations Analysis Program

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6. Review the core financial pages in the ROE. Identify and explain trends, material variances, and other matters, as appropriate.

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7. 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.

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8. 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.

---

9. Evaluate the adequacy of the association's net interest margin. Use standard or customized peer group comparisons as a guide. Identify the sources of changes in net interest margin and attribute trends to rate (net interest spread), volume (net interest position: interest-earning assets minus interest-costing liabilities), or restructuring factors. Consider the long-term effect on earnings potential as a result of any material factors.

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10. Review the association's financial statements and evaluate trends for return on assets, return on equity, net interest margin, and the mix and growth of assets and liability structure. Compare these results with the results in procedure No. 4.

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11. 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 it to the association's operating strategies.

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## Operations Analysis Program

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12. 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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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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14. 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

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

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16. 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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17. Review and evaluate the association's yield spread and compare it 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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18. 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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## Operations Analysis Program

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

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20. For Internet operations determine if the association:

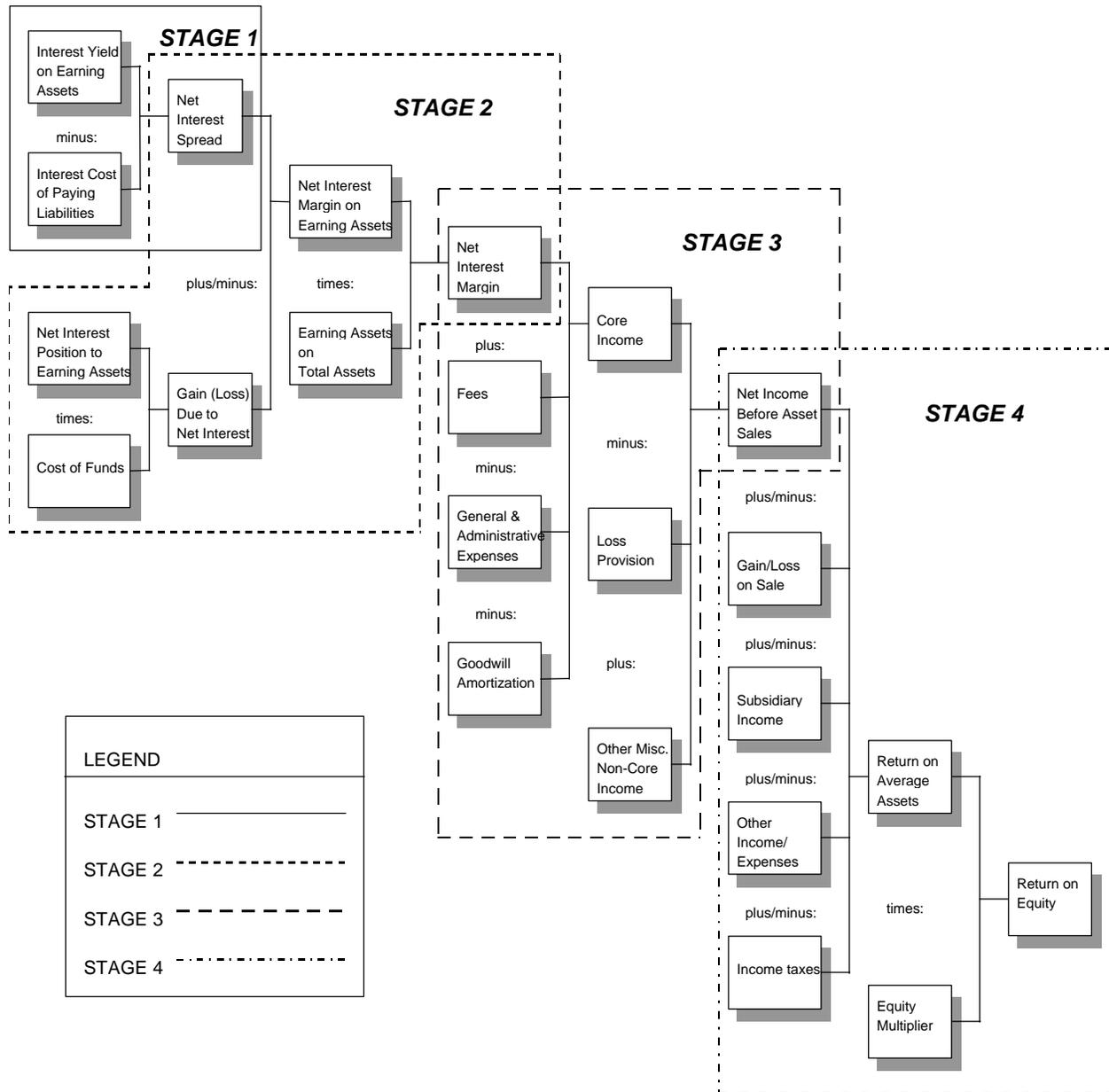
- Periodically (at least quarterly) evaluates its Internet operations and marketing plan.
  - Links its strategic planning process to its Internet operations.
  - Projects the effect of its Internet operations on earnings and capital.
  - Performs cost and benefit analyses of Internet banking activities. Consider start-up, operating costs, required upgrades, customer support, and maintenance costs.
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21. 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.

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**Docket #:** \_\_\_\_\_

Deviation 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 parent and a first-tier subordinate organization if the subordinate had not recognized a \$1 million

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)

	<u>Parent</u>	<u>Subsidiary</u>	<u>Eliminating Entries</u>	<u>Consolidated</u>
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 ( $\$25,000 \times .40$ ). 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 organization 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.