

MAHON'S
INDUSTRY GUIDES for
ACCOUNTANTS and AUDITORS

Volume 1

MAHON'S INDUSTRY GUIDES for ACCOUNTANTS and AUDITORS

Volume 1 Contents and Introduction

James J. Mahon
General Editor



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MAHON'S INDUSTRY GUIDES for ACCOUNTANTS and AUDITORS

VOLUME 1

<i>Guide</i>	<i>Industry</i>
1	Commercial Banks
2	Mutual Savings Banks
3	Savings and Loan Associations
4	Consumer Loan and Finance
5	Real Estate
6	Retail Trade
7	Hospitals
8	Hotels and Motels
9	Restaurants and Other Food Services

INTRODUCTION

Mahon's Industry Guides for Accountants and Auditors are designed to fill the need professional accountants have long felt for in-depth information about various industries. Information is needed not only about the technical accounting and tax peculiarities of any industry but its general characteristics as well—structure, products, processes, operations, and “economics.” Indeed, the general characteristics are becoming increasingly important as the courts and the SEC continue to stress the auditor's need for sufficient knowledge of an industry to enable him to evaluate management's representations within an industry context. This need is stressed by the SEC in Accounting Release 173 (1975) and by the AICPA in Statements on Auditing Standards 4 (1974) and 22 (1978). The 1978 report of the Commission on Auditors' Responsibilities (the Cohen Commission) further emphasizes the importance of industry knowledge and understanding.

Aside from the technical aspects of their work, accountants have begun to recognize the value of industry knowledge and competence in *marketing* their services and expanding their practices. Every client or potential client considers his business and industry unique. He regards knowledge of his industry as vital, and his confidence in an accountant is influenced by the presence or absence of this knowledge. Indeed, familiarity with the business' nature and its jargon is expected of an accountant upon his first appearance on the premises.

All too often this familiarity is lacking. Younger staff accountants, for example, are frequently assigned to an audit without prior knowledge or training in the client's industry. Consequently, client personnel must devote valuable time each year to describing their particular business or industry to the outside auditors—something they feel should be done beforehand by the accounting firms. One electric utility executive has remarked that some fledgling auditors he has had to “educate” barely understood the difference between a generator and an insulator when they first appeared on the audit. Indeed, with the growing practice of periodic rotation of partners as well as staff, the need for industry familiarity extends to *all* levels of auditors.

The information needed by professional accountants for industry briefings has been widely scattered and not easily accessible. Some accounting firms maintain extensive files on industry problems they encounter. Others have produced special studies or books on the accounting, tax, or auditing aspects of particular industries. The AICPA has set up industry committees that have issued some sixteen industry audit guides over the past decade. These guides focus mostly on the relatively narrower accounting, auditing, and tax facets; they do not cover the broad aspects of the industry—how it works and where it fits in the overall industry spectrum. Something comprehensive has been needed. *Mahon's Industry Guides for Accountants and Auditors* are designed to meet these needs. They will enable the professional accountant to quickly gain familiarity with the particular industry as well as its unique accounting, auditing, and tax aspects before he performs an audit or other service for a client in the industry. The guides, which will be updated regularly, act as a broad supplement to the technically intensive AICPA *Industry Audit Guides*.

The guides are valuable to other professions as well. They will help loan officers of banks and other lenders acquire an understanding of a prospective borrower's business. They will help lawyers obtain a working knowledge of a new or prospective client's industry. And they will supply financial analysts and business writers with the backgrounds of industries they are interested in.

Corporate business libraries will find the guides a valuable adjunct to their reference shelves. And various companies and institutions will find their particular industry's guide helpful in training new personnel. Industry associations, too, will wish to distribute the guides on their industries to members and others.

In sum, while the industry guides were designed initially to meet the needs of professional accountants and financial executives, they will prove equally useful to many others.

Authors

Each guide is prepared by an expert or team of experts on the industry using a standard outline and format. The guides average about seventy-five printed pages, with roughly 70 percent of each guide being devoted to the general or nonaccounting aspects of the industry (Part A) and the balance to the accounting, auditing, and tax facets (Part B).

Most of the Part A authors are from institutions or companies in the industry, as well as industry associations and academia. Part B authors are from professional accounting firms. Biographies of the authors appear in the respective guides.

The Editor and His Associates

JAMES J. MAHON is the general editor of the *Industry Guides*. Mr. Mahon is a certified public accountant and was a long-time senior partner of Coopers & Lybrand, where he was involved with taxes, international services, and firm development—first in Philadelphia and later in New York. He is the author of many articles, books, and studies on financial reporting, management, and taxes. He was editor of the tax column in the *Journal of Accountancy* in the 1950s, as well as *Working with the Revenue Code* and the *Lybrand Newsletter for Executives*. He was author of *State Taxation of Corporations in Pennsylvania*.

And he was chairman of the AICPA's International Relations Committee when it developed and published *Professional Accounting in 25 Countries*, a 600-page volume on foreign accounting, auditing, and reporting practices. His most recent work is *The Marketing of Professional Accounting Services*, John Wiley & Sons, September 1978.

Mr. Mahon has dealt with a wide variety of businesses in a great many industries during his professional career. And as partner in charge of his firm's industry specialization program, he was heavily involved in identifying and classifying the various industry characteristics that are of importance to the professional accountant.

R. KIRK BATZER is the Associate General Editor of the *Industry Guides*. Mr. Batzer retired as a partner of Coopers & Lybrand in 1978 after an extensive and varied professional practice career in the United States and abroad. He has participated in the work of professional organizations for many years and has been involved in the formulation of important pronouncements on accounting and auditing matters, including the AICPA's Codification of Statements of Auditing Procedure—1963. He is Feature Article Editor of the *CPA Journal* and author of the *State and Local Governments Industry Guide*.

R. KEITH MARTIN, Ph.D., P.E., is an Associate Editor of the *Industry Guides*. Dr. Martin is Professor of Accounting and Assistant to the Dean, School of Business, Fairfield University. A specialist in computer-based information systems, Dr. Martin has developed curricula at both the undergraduate and graduate levels. He was the first Director of the Management Systems Department at the University of Washington and was Manager of Management Advisory Services at Price Waterhouse & Co. He has a continuing consulting relationship with several industrial and professional organizations. The author of numerous monographs and articles in professional journals, Dr. Martin is a registered professional engineer and holds the professional Certificate in Data Processing.

EDWARD M. MAZZE, Ph.D., is an Associate Editor of the *Industry Guides*. Dr. Mazze is Dean of Temple University's School of Business Administration and Professor of Marketing. He was formerly Dean and Professor of Business Administration at the W. Paul Stillman School of Business, Seton Hall University, and a former faculty member at Virginia Polytechnic Institute and State University, West Virginia University, and the Graduate School of Business of the University of Pittsburgh. Dr. Mazze is author of nine books in the areas of management, marketing, and international business and over 100 articles for professional and trade publications. He serves on the editorial board of two business journals and is a contributing author to the *Encyclopaedia Britannica Book of the Year* and the *Compton Yearbook*.

FRED P. PETERS is an Associate Editor of the *Industry Guides*. Mr. Peters is a former Executive Vice-President of Reinhold Publishing, former chairman of the Technical, Scientific and Medical Book Publishers Association, and a former member of the faculty of the School of Business of Seton Hall University. Mr. Peters is now a consultant on book and magazine publishing with BCMA Associates, Inc. of New York. He is a member of the editorial board of *The Advocate*, Newark, N.J., of the President's Advisory Council, School of Business, Seton Hall University, and of the boards of directors of Dowden, Hutchinson &

Ross and Inprop Publishing Company. He is the author of the *Book Publishing Industry Guide*.

ANNETTE E. GONELLA is a Book Editor for Warren, Gorham & Lamont and was responsible for coordinating this project for the publisher.

Format and Contents

The *Industry Guides* are not strictly uniform, but they are sufficiently alike for the reader to become quickly familiar with the standard coverage and order.

Generally the guides contain the following chapters:

Part A: Description of Industry

1. Overall structure of the industry and representative members.
2. Regulatory and supervisory environment.
3. Organization and management of a typical industry unit.
4. Description of products or services and operations.
5. Profit factors, margins, and trends.
6. Current developments or concerns in the industry.

Part B: Accounting and Taxes

7. Accounting, forms of internal operating statements, unique accounts, and records.
8. Typical computerized data processing applications.
9. Tax characteristics.
10. Critical auditing points.

This standard order coupled with extremely detailed tables of contents in all the guides eliminates the need for separate topical indexes.

All tables, tabulations, charts, and other graphics material are simply referred to as "exhibits" and numbered consecutively. They are listed in a separate table of contents.

Most guides contain a bibliography.

The emphasis accorded the various topics in the standard outline varies among guides. The history of an industry, for example, may not be fundamental to understand the industry today, but where it is relevant, the guides devote significantly more space to history.

The guides endeavor to stress the unique organizational characteristics of each industry.

Government regulation is becoming increasingly pervasive, and coverage in the guides reflects this. Most authors deplore the mounting costs and stifling influence of bureaucracy, showing specific ways that regulation affects their industries.

The extent of coverage accorded the accounting aspects of an industry in Part B of the guides is also influenced by the uniqueness of the industry's accounting principles and practices.

The coverage of auditing is influenced by similar factors. If the accounting for an industry is complex, the auditing will surely follow and more space must be devoted to it.

Where the auditing facets are already spelled out in AICPA *Industry Audit Guides*, they are simply highlighted in the corresponding industry guides.

Tax differences among industries vary similarly. Some industries have special deductions, credits, and computations or special rules for recognizing income. Here again, it is the unique aspects of the industry that govern the extent of coverage accorded. Where an industry has no unusual tax characteristics, little space is devoted to the subject.

Judgment of course plays an important part in determining the relative emphasis to be accorded the various industry characteristics. The authors and editors have endeavored to be both complete and concise.

Highlights of the Guides in Volume 1

There are two multi-industry families or groups in this volume: Banking and Finance, and Food and Lodging. The reader interested in any one industry in these groups may find it desirable to read the related guides as well. While the guides are self-contained and complete, additional perspectives can be gained from each author's emphasis.

In addition to these groups, there are three "free-standing" industry guides included: *Hospitals*, *Real Estate*, and *Retail Trade*.

Banking and Finance

According to *Business Week*, April 23, 1979, lenders of every type are fighting ferociously to attract consumer deposits and make consumer loans. Savings and loan associations and mutual savings banks, who have long depended on consumers' business are simply stepping up their efforts. But commercial banks, which primarily have served business, are also stepping up the intramural competition by shifting their emphasis toward the consumer market. And, adds *Business Week*, the big battle for consumer dollars is attracting near-bank competitors such as consumer loan and finance companies who are not inhibited by "the quagmire of depression era regulations" that prohibit banks from branching across state lines. This fierce competition is reflected in the four industry guides in the banking and finance group. The Depository Institutions Deregulation and Monetary Controls Act of 1980, which greatly affects the competitive environment, is also highlighted in the guides.

The *Commercial Banks Guide*, by Dr. Charles F. Haywood, cites the statutory limits on the types of financial business that can be conducted by commercial banks as contrasted with their principal competitors. And it describes in depth the historic conflict between the federal government and the states that spawned the dual regulatory structure of commercial banking today. The guide's description of bank operations and services is built around the simple concepts of "liabilities management" and "assets management" and the delicate relationship between the two.

The *Mutual Savings Banks Guide* and *Savings and Loan Associations Guide*, by Dr. John J. Harrington, Jr., carefully delineate the services and activities permitted these "thrift" organizations by law and regulation. Because both types of organizations stress mortgage loans, particularly residential mortgages, as investments, the guides emphasize this aspect. The intermittent outflows of deposits and resulting lack of lendable funds is also discussed.

Part B of the *Commercial Banks Guide*, by Roger C. Schultz, describes the highly special accounting and the critical auditing points as well as the unique tax characteristics of banks. But the accounting requirements and tax characteristics of savings and loans and mutual savings banks are even more complex. Indeed, the favored tax treatment of the "thrifts" depends upon intricate quantitative determinations, demonstrated in the guide. Bruce B. Charles and Anthony F. Paparella, authors of the respective "B" sections of the *Savings and Loan Associations Guide* and *Mutual Savings Banks Guide*, outline the accounting and tax aspects appropriately—but differently. The reader interested in either savings and loans or mutual savings banks can obtain a comparative view by reading the "B" sections of both guides.

The *Consumer Loan and Finance Industry Guide*, by George M. Williams, describes the foresight of the pioneers of that industry in waging a state-by-state campaign for higher interest rates. By opting for the relatively lesser regulatory authority of the states and forsaking customer deposits as a source of funds, the consumer loan and finance industry achieved a marked competitive advantage in the consumer loan market. The author's confidence in the integrity of the small borrower emerges throughout the guide. And his confidence in his industry's ability to meet ever-changing forms of competition without diminution of profits, is implicit in his description of the profit factors involved in "getting the money out, getting it back, and holding down expenses." The consumer loan and finance industry lacks the regulatory complexities of commercial banks and thrifts. Its accounting and tax complications are virtually nonexistent. Accordingly, Part B, by Raymond J. Harter, Jr., contains few surprises. It is a straightforward and complete description of accounting and taxes for consumer loan and finance companies coupled with a concise rundown of typical management reports and data processing applications.

Real Estate

To refer to real estate as a single industry is a simplification of heroic proportions. It includes various classes of people or organizations who are involved in one way or another with multiple forms of real property which in turn are invested with a variety of interests and rights.

Part A of the *Real Estate Industry Guide*, by Harris E. Lawless, identifies, classifies, and describes all parties and products of this sprawling industry and cites many of the practices and techniques used in real estate investing.

Part B of the guide, by Kenneth A. Mounce, covers the most important aspects, i.e., accounting for rental operations and for subdividers and developers, while still putting the reader on notice concerning other facets. His tax chapter is a comprehensive checklist for the investor.

Retail Trade

The retail trade industry is marked by many small operations, which require little more to manage than a cash register, a checkbook, and an annual inventory count. But it also contains many department stores and chains, which require finely tuned management systems and adroit decision making to turn a profit in an intensely competitive environment.

Part A of the *Retail Trade Industry Guide*, by Ellen R. Harris, identifies all types of retailers and what they sell, and it defines the forms of organization appropriate for stores and chains of various sizes. But the guide is at its best when it deals with the economics of retailing—measuring and achieving profitability.

Part B of *Retail Trade*, by Leslie S. Chick, details the management, accounting, and reporting infrastructure that is required to monitor and control the myriad items that are bought, inventoried, and sold in a large retail operation—including the application of LIFO (Last-in, First-out) accounting to retailers. It concentrates particularly on the implications of auditing the new electronic point-of-sale systems, which are increasingly used to capture departmental and merchandise data.

Hospitals

The advent of Blue Cross in the 1930s spurred many hospitals to adopt business oriented accounting controls and techniques. And the increasing presence of experienced businessmen on hospital governing bodies contributed to the adoption of sophisticated management practices. But it took the stringent governmental cost accounting and reporting requirements of Medicare to complete the job.

It is evident from the *Hospital Industry Guide*, by Jack W. Owen, that hospitals are using up-to-date management methods. Still, they are unique. To understand them and their nomenclature requires knowledge of types of hospitals, the galaxy of overlapping regulations and regulatory agencies they are subject to, their dual governing bodies, (laymen on the one hand and physicians on the other), and their various departments. The accounting and reporting systems used are sophisticated and complex. They emphasize both the stewardship need for maintaining special funds and the management need for operating information. These and the stringent accounting requirements of Medicare are appropriately explained in Part B by CPA authors Arthur L. Brien and Thomas P. Donnelly.

Food and Lodging

Author Eric F. Green's international career in hotel management is apparent in both the *Hotel and Motels* and *Restaurant Industry Guides*, particularly when he describes typical industry units and profit factors and controls. His career in public accounting in both England and America is reflected in the types of statistical data he recommends for management use in controlling costs and monitoring operations. While running a motel or restaurant may be a seat-of-the-pants operation at the "mom-and-pop" level, Mr. Green, who wrote Part A and Part B in both guides, makes it clear that solid profits in the hospitality and food services industries are just as dependent upon sophisticated management concepts as in any other industry.

Because of the visibility of hotels and restaurants, the guides properly include only what is unique without belaboring that which is common knowledge.

The Authors

CHARLES F. HAYWOOD, author of Part A, is Professor of Finance in the College of Business and Economics at the University of Kentucky and was Dean of the College from 1965 to 1975. He has served intermittently as analyst and consultant to the American Bankers Association and was director of economic research for the Bank of America. He also has held important posts in the State of Kentucky's Department of Finance and its Development Function among other Kentucky activities. Dr. Haywood has written extensively on banking.

ROGER C. SCHULTZ, author of Part B, is a certified public accountant in the State of New York. He currently is a senior manager with Price Waterhouse & Co., assigned to the Banking Industry Services Group. Mr. Schultz has over a decade of experience servicing and consulting with the commercial banking industry. He is a member of the American Institute of Certified Public Accountants, National Association of Accountants, and the New York State Society of Certified Public Accountants where he is a member of the Committee on Cooperation with Bankers.

STANLEY E. SHIRK, reviewer of Part A, is a certified public accountant and former partner of Peat, Marwick, Mitchell & Co.

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TABLE OF CONTENTS

Part A — Description of Industry

Chapter 1

INDUSTRY STRUCTURE AND COMPOSITION

	<i>Page</i>
Early History	1-1
Bank of North America—1780	1-1
(First) Bank of the United States—1791 to 1811	1-2
Second Bank of the United States—1816-1836	1-2
Diversity of State Banking—Middle 1830s to 1860s	1-3
National Banks Established—National Bank Act of 1863	1-3
Directors Accorded Important Role	1-4
State Banks' Note-Issuing Powers Curbed	1-4
Deposit Banking and Use of Checks Grows	1-5
Improvement in Bank Lending Techniques—"The Three C's"	1-5
Commercial Banking Today	1-6
Number of Banks	1-6
Branch Banking	1-6
Bank Holding Companies	1-7
Federal Holding Company Legislation—1956	1-8
Relative Size of Banks	1-9
Mergers and Acquisitions	1-9
Retail Versus Wholesale Banking	1-10
Industry Associations	1-11

Chapter 2

REGULATORY AND SUPERVISORY ENVIRONMENT

Comptroller of the Currency	1-12
Federal Reserve System	1-13
Federal Reserve Act of 1913	1-13
Present Structure of the Federal Reserve	1-14
Board of Governors	1-14
The Twelve Federal Reserve Banks	1-14
Activities of the Federal Reserve	1-15
Formulation of Monetary Policy—Open-Market Operations	1-15
Check Clearing	1-15
Currency and Coin Issuance	1-15
Regulation of Member Banks—Examinations	1-16

	<i>Page</i>
Federal Deposit Insurance Corporation	1-16
Structure and Functions	1-17
Premiums and Coverage	1-17
Handling of Losses—Deposit Payoff Versus Deposit Assumption	1-17
Deposit Insurance Fund	1-18
“Early Warning” Systems	1-18
State Banking Departments	1-19
The Overall Examination Function	1-19
Scope and Procedures	1-20
Corrective Actions	1-20
Special Examinations	1-21
Nonbanking Agencies	1-21

Chapter 3

BANK ORGANIZATION AND MANAGEMENT

Functional Versus Administrative Organization	1-22
The Top Echelon	1-22
The Evolving Structure	1-23
Emergence of Separate Staff and Line Functions	1-23
Departmentalization of Line Functions	1-24
Development of New Services	1-24
Trust Departments	1-24
Correspondent Banking	1-24
Government Relationships	1-25
International Departments	1-25
Affiliation With Holding Company	1-25
Divisionalization	1-26

Chapter 4

OPERATIONS AND SERVICES

Overview of Production Process	1-27
Liabilities Management	1-27
Limitations on Interest Rates Payable on Deposits	1-27
Protecting the Thrift Institutions	1-28
Attracting Profitable Deposits	1-30
Introduction of Certificates of Deposit	1-30
Increasing the Number of Banking Locations	1-31
Automated Teller Machines	1-31
Automating Paper Work—Computers	1-31
Purchase and Sale of Federal Funds—Repurchase Agreements	1-32

	<i>Page</i>
Assets Management	1-32
Primary Reserves	1-33
Secondary Reserves	1-33
Loan Account	1-33
Business Lending	1-34
Consumer Lending	1-36
Real Estate Lending	1-36
Investment Account	1-36
Trading Account	1-36
Restrictions	1-37

Chapter 5

INCOME AND PROFITABILITY	1-39
---------------------------------------	-------------

Chapter 6

CURRENT DEVELOPMENTS AND CONCERNS

Federal Reserve Membership	1-44
Consolidation of Regulatory Agencies	1-46
Credit Allocation	1-46
Deposit Interest Regulation	1-47
NOW Accounts	1-48
Share Draft Accounts	1-48
Automatic Transfer Accounts	1-48
Money Market Certificates	1-49
Loan Rate Ceilings	1-49
Electronic Funds Transfer Systems	1-49
Interstate Branching	1-50
Foreign Banking in the United States	1-50
The 1980 Crisis	1-51
Depository Institutions Deregulation and Monetary Control Act of 1980	1-52

Part B — Accounting and Taxes

Chapter 7

ACCOUNTING CONSIDERATIONS AND MANAGEMENT REPORTING

Regulatory Bodies	1-53
Chart of Accounts	1-53
Balance Sheet Accounts	1-54

EXHIBITS

<i>Exhibit</i>	<i>Page</i>
1 A Diagram of the Production Process of Commercial Banking	1-28
2 Percentages of Assets, Liabilities, and Equity Capital of Insured Commercial Banks Operating Throughout 1977 in the United States	1-29
3 Ratios of Income of Insured Commercial Banks in the United States, 1972-1977	1-40
4 Ratios of Income of Insured Commercial Banks Operating Throughout 1977 in the United States	1-41

Part A: DESCRIPTION OF INDUSTRY

Chapter 1

INDUSTRY STRUCTURE AND COMPOSITION

The main business of commercial banks in the United States is providing deposit services and extending credit to businesses, individuals, and federal, state, and local government entities. Until the early 1970s, the unique feature of commercial banking was the offering of demand-deposit, or checking account services. Recently, through several types of deposit accounts on which drafts can be drawn, some mutual savings banks, savings and loan associations, and credit unions have become competitors in the checking account business for individuals. Today, the feature of commercial banking that sets it apart as a distinct line of commerce is the combination or variety of financial services offered to the public.

Reflecting the range of services offered to the public, commercial banks are sometimes characterized as "department stores of finance." However, there are well-defined statutory limits on the types of financial business that commercial banks can conduct. To characterize them as "department stores of finance" involves some exaggeration. But it does distinguish them from their major competitors. Mutual savings banks, savings and loan associations, credit unions, finance companies, insurance companies, and investment banking houses compete in varying degree with commercial banks, but each type of organization is limited to a somewhat specialized set of financial services in comparison to commercial banks.

Although many changes were yet to come in banking structure and operating methods, the fundamentals of the present day system were in place by the end of the nineteenth century. There was a "dual" system of chartering, regulation, and supervision of banks, i.e., state and federal. Both the national and state components of this system were growing rapidly, as large numbers of new banks were chartered in both systems between the late 1870s and World War I. Deposit banking attained dominance over note-issue banking (i.e., issuance of paper currency), and mechanization was brought to operating procedures. Lending, while still based on character, and often on collateral, was increasingly based on evaluations of capacity, as indicated by accounting records and credit investigations and reports. Banks were thus engaged in their main business—providing deposit services and extending credit to businesses, individuals, and federal, state, and local government entities.

Within commercial banking there is much diversity in size of banks, organizational form, market orientation, product mix, and operating procedures. The structure of commercial banking today is the result of a long history of interaction between economic and regulatory influences and the conflict between the federal government and the states. That history has many interesting chapters. The following discussion is necessarily limited to a brief review of the major developments that shaped the structure of the industry as it exists today.

Early History

Bank of North America—1780

The development of banking institutions in America had been suppressed by the British during the Colonial period. Indeed, frustration over the growing need for banking facilities

in the Colonies had contributed to the discontent that ultimately culminated in the American Revolution. There were, as would be expected, various attempts to establish banking facilities, either in defiance or circumvention of British rule, but all were short-lived or ultimately suppressed.

The first bank in the United States—the Bank of North America—was organized in Philadelphia in the closing days of 1780. As its purpose was to help finance the Revolution, the bank received a charter of incorporation from the Continental Congress. There being some doubt about the power of the Continental Congress to charter a bank, a grant of corporate powers was also obtained from the Pennsylvania general assembly.

(First) Bank of the United States—1791 to 1811

During the 1780s several states proceeded to charter banks, the first being the Bank of New York in 1784. And acting on recommendations from Treasury Secretary Hamilton, the U.S. Congress approved a twenty-year charter for a Bank of the United States, which commenced operations in 1791 in Philadelphia. Partly owned by the government, the Bank served as the government's fiscal agent while also engaging in a private banking business. However, competition between the Bank and the increasing number of state-chartered banks, not only in the private banking business but also in the issuance of banknotes as paper currency, gave rise to controversy over the constitutional power of the federal government to charter a bank. The constitutional issue was ultimately resolved in favor of the federal government in Chief Justice Marshall's famous decision in *McCulloch v. Maryland*, which gave broad interpretation to the "incidental powers" clause of the Constitution. The political issue, however, was temporarily resolved by the Congress on the side of the states, for in 1811, the federal charter of the Bank of the United States was permitted to expire.

Second Bank of the United States—1816 to 1836

Reconsideration by Congress of the need for a federal bank was prompted by difficulties affecting the stability of the state-chartered banks during the War of 1812 and by the government's need for a fiscal agent bank to put its war-distressed financial affairs in order. The Second Bank of the United States was chartered by the Congress in 1816. Again the Bank was beset by controversy, reflecting dissatisfaction with its operating procedures and management as well as its powerful competitive position as the government's bank. Moreover, the Bank established branches in leading commercial centers without regard to the state boundaries limiting its rivals.

President Jackson's veto of the Bank's charter-renewal bill in 1832 provided the major issue of that year's presidential campaign. And Jackson's defeat of Clay sealed the doom of the Second Bank. The government's deposits were withdrawn from the Bank in 1833 after the resignation of one Treasury Secretary and the firing of another who declined to do the President's bidding. The expiration of the Bank's federal charter in 1836 was mere epilogue.

Many of the features of the commercial banking system in the United States today are grounded in this conflict between federal and state power in the first half-century of the Republic. The system is often characterized as a "dual banking system" meaning that both the federal government and the states legislate and regulate in matters affecting banking.