Commercial Bank Accounting and Financial Reporting.

Joseph Anthony Defatta  
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in
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by
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B.S., Centenary College, 1966
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ABSTRACT

Commercial banks have been highly regulated by Federal and state supervisory agencies for many years. Regulations established by these agencies, particularly those of the Comptroller of the Currency, the Federal Reserve Board, and the Federal Deposit Insurance Corporation, have definitely influenced the development of commercial banks' accounting and financial reporting practices.

Prior to 1964, most Federal banking regulations were designed primarily for protecting depositors from losses due to bank failures. Thus, many Federal regulations prompted banks to develop "depositor-oriented" reporting practices which often understated assets, overstated liabilities, and reduced reported operating earnings.

The primary purpose of this study is to determine whether regulatory influences on commercial banks' accounting and financial reporting practices are beneficial from the stockholders' viewpoint. The study also evaluates the effects of Federal regulations on the principal financial statements published by banks--the Income Statement and the Statement of Condition. The major accounting and reporting problems which are unique to the banking industry are also reviewed.

Incorporated into the study are the results of a
survey sent to 100 commercial banks in Louisiana. The questionnaire was concerned with the accounting principles and reporting procedures employed by banks preparing annual reports for stockholders. The questionnaire was classified into five major areas (accounting principles, opinions concerning financial disclosure, securities accounting, loans and loan losses, and fixed assets) which include virtually all of the present controversial issues encountered when preparing bank financial statements. The survey results provide valuable insights into the banking industry's current reporting practices.

Research findings indicate that bank managements have reevaluated their traditional concept that financial statements should be designed primarily for the depositors' benefit. They are becoming increasingly aware of stockholders' interest in their financial condition and results of operations. More and more commercial banks are beginning to have annual audits performed by independent certified public accountants and are including in the annual report the CPA's opinion of the financial statements.

Since the enactment of the Securities Acts Amendments of 1964, Federal banking authorities have been compelled to change their philosophy of bank regulation and reporting. Depositor protection is no longer the sole criterion considered by Federal supervisory agencies when establish-
ing rules and regulations for commercial banks. Both depositors and stockholders are regarded as equal in terms of financial reporting priorities.

In late 1964, the Federal Reserve Board and the Federal Deposit Insurance Corporation adopted almost identical codes, known as Regulation F, for those commercial banks subject to the Securities Acts Amendments. For the first time in the history of banking regulation, Federal supervisory authorities issued regulations specifically intended to inform stockholders more fully of banks' results of operations and financial condition.

Although Regulation F affected only a small portion of the total commercial banks in the United States, it stimulated Federal banking authorities to revise their regulations in order to make them conform more closely to generally accepted accounting principles. In 1969, for example, the three Federal supervisory agencies issued regulations requiring all commercial banks to include the provisions for loan losses in the income statement. This reporting requirement has subsequently resulted in a better matching of banks' revenues and expenses. In addition, Federal supervisory agencies have also adopted a regulation which requires all commercial banks with assets of $25 million or more to maintain an accrual accounting system for financial reporting purposes. These revised regulations and others have sub-
stantially increased the quality of bank accounting and reporting.

Commercial bank accounting and financial reporting has progressively improved since 1965. Informative disclosure for stockholders and the investing public has become both a legal and practical necessity for more and more commercial banks.
CHAPTER I

INTRODUCTION

Commercial banks have traditionally depended on financial statements as a primary source of information for evaluating the debt-paying ability of those business enterprises requesting loanable funds. Understandably, the commercial banking industry has demanded that other industries publish financial statements which reflect fairly the results of their operations.

Ironically, the very group which demands such high reporting standards in other industries' financial statements, and played such an important part in the early development of financial statements, has found its own reports the target of recent criticism from security analysts and professional accountants. These groups have criticized commercial banks' reporting practices for a number of reasons. They cite the lack of disclosure and uniformity in such basic reporting areas as valuing assets, accumulating bond discounts, and recognizing loan losses. Even though many commercial banks are aware of their reporting deficiencies and have taken steps to improve the quality of their reports, other banks continue recording accounting transactions on a cash basis and
report only the minimum information required by law.

Yet, the critics of bank reporting practices should be cognizant of the fact that commercial banks are quasi-public institutions and must conform to the regulations promulgated by Federal and state regulatory agencies. These supervisory agencies share the responsibility with bankers for improving the reliability and uniformity of financial data for the stockholders and general public. Moreover, the three Federal banking supervisory agencies—Comptroller of the Currency, Federal Reserve Board, and Federal Deposit Insurance Corporation—have sufficient statutory authority to bring commercial bank accounting principles and financial reporting practices up to the standards attained by other business enterprises.

Statement Of Purpose

The financial accounting and reporting practices of commercial banks have been influenced by the regulatory requirements of Federal and state agencies. In the past, the rules and regulations established by these agencies have been designed primarily for the depositors' protection. Thus, many Federal banking regulations prompted bankers to develop conservative accounting practices for reporting purposes in response to "calls" for financial statements. These conservative accounting practices were also reflected in the financial statements prepared for
the commercial banks' stockholders.

The primary purpose of this study is to determine whether regulatory influences on commercial banks' accounting and reporting practices are beneficial from the stockholders' viewpoint. Several important questions which are investigated in this study are as follows: Have stockholders been penalized by regulatory requirements designed for protecting depositors? Have regulatory reporting standards improved the quality of bank financial statements? Have regulatory agencies become more aware of stockholders' interest in bank reporting practices?

Besides these basic questions, there are also a number of secondary issues which are reviewed in this study, such as the adherence of banks to generally accepted accounting principles, the degree of uniformity in bank accounting and reporting, the opinions of bankers concerning the status of financial reporting, and the role of the American Institute of Certified Public Accountants (AICPA) in promoting improvements in bank reporting practices.

Scope And Limitation

There are several limitations in the scope of this study. First, this study is limited to the accounting and reporting practices of commercial banks. It will
not delve into those accounting and reporting practices peculiar to other similar institutions, such as the savings and loan associations, mutual savings banks, mortgage banks, or investment banks.

Secondly, the study does not discuss the factors to be considered in performing independent audits of commercial banks. However, the implications and ultimate effects of independent bank audits on bank accounting and reporting is within the scope of the study and is discussed.

Incorporated into this study are the results of a survey sent to 100 commercial banks in Louisiana in which bankers were asked in one section of the questionnaire to present their personal views concerning bank reporting. The personal opinions obtained are those of Louisiana bankers and should not be construed as those which might have been obtained from a national survey. While the universe of the survey is limited to the geographical boundaries of the State of Louisiana, it is believed that the results are typical of responses that would have been obtained from a similar questionnaire in other states.

Louisiana banks of all sizes were sent questionnaires concerning the accounting principles and reporting practices utilized in the preparation of published financial statements. The questionnaire was classified into five major areas—accounting principles, opinions concerning
financial disclosure, securities accounting, loans and loan losses, and fixed assets. These five areas include virtually all of the controversial areas in bank financial statements preparation. The survey results are included in the Appendix to this study.

The study also includes a review of the literature pertaining to bank accounting and reporting practices as found in books, periodicals, research bulletins, and Federal regulations.

Organization Of This Study

The evolution of bank reporting practices is presented in the following chapter. Chapter II's first section briefly reviews some of the major historical events which have molded the United States' commercial banking system. This chapter also traces the development of bank financial statements from the early days of the twentieth century to the present period. A few income statements and balance sheets are illustrated in their early form and serve as a basis for evaluating the progress which has been achieved in bank reporting through the years. The final section in Chapter II enumerates the objectives and supervisory functions of the three Federal banking agencies. In addition, this section describes the scope of each agency's statutory authority and gives some reasons for the establishment of these agencies.
Several recent developments which have influenced bank reporting practices are examined in Chapter III. For example, the effects of an expanding dispersion of bank stock ownership, which has been contributed in part to the increasing number of banks forming one-bank holding companies (OBHCs), are investigated. Important changes in bank accounting and reporting which followed the enactment of the Securities Acts Amendments of 1964 are also reviewed. In addition, the influence of independent bank audits by certified public accountants (CPAs) on bank financial statement disclosure is discussed in Chapter III. The major objections raised against having such audits performed are considered and evaluated in relation to the benefits derived therefrom.

Chapter IV contains an examination and critical evaluation of commercial banks' balance sheet or statement of condition. The customary format of this statement is illustrated in the chapter and those accounts which are unique to the banking industry are explained. Certain accounting practices which were developed in the early days of bank reporting and which have understated balance sheet asset values are discussed. The writer's survey results, which are incorporated into this chapter, give some indication of how extensively these practices are still employed for reporting purposes. This chapter also examines some major criticisms of balance sheets published
by banks and presents various recommendations for improving the quality of this important financial statement.

In Chapter V of this study, another important bank financial statement, the income statement or report of earnings, is examined. The chapter's first section lists several benefits which banks can realize by using an accrual accounting system for internal and external reporting purposes. Supervisory regulations identifying those banks that are required to use an accrual accounting system for reporting purposes are also stated. The "all-inclusive" income statement controversy, as it relates to bank reporting, is reviewed in Chapter V. The Accounting Principles Board's pronouncements concerning the earnings report are also discussed. In this chapter, the major operating income and expense items which are frequently disclosed in published bank income statements are enumerated and described. The chapter's final section critically evaluates the income statement format that banks are presently using for reporting purposes.

The special nature of the banking industry creates a number of accounting problems which are peculiar to that industry. In Chapter VI, the accounting and reporting problems associated with bank securities transactions are examined. This chapter's first section describes the necessity of a bond premium and discount amortization policy. Also discussed in the chapter are various ap-
proaches for reporting the gains and losses on securities transactions. The disclosure of investment securities in the balance sheet is described, and the desirability of establishing security reserves is investigated. The results of the writer's survey pertaining to bank securities accounting and reporting practices are also presented.

Besides the accounting and reporting problems associated with investment securities, commercial banks are also confronted with similar problems regarding loan losses and related reserves. This important aspect of bank reporting is discussed in Chapter VII. The first section of this chapter describes the effects of income tax regulations on the determination of banks' loan-loss provision. Federal banking regulations concerning the disclosure of the provision for loan losses in the income statement are presented. In addition, the various regulatory formulas used by banks to determine their provisions for loan losses are reviewed. Chapter VII investigates some of the reporting problems associated with loan-loss reserve accounts. The writer's survey results concerning loans and loan-loss accounting are also included in this chapter.

The final chapter of this study is in the form of a summary chapter. Conclusions based on research findings are also presented.
CHAPTER II

EVOLUTION OF BANK REPORTING

Accounting and reporting practices for commercial banks have developed through an evolutionary process in a manner common to many American industries. Before reviewing the early bank reports, it seems advisable to discuss briefly the historical developments which have shaped the United States' banking system.

Commercial Banking System In The United States

There are nearly 14,000 banks with combined assets of over $400 billion operating in the United States in 1970. These banks control more funds than any other type of financial institution. All the banks within the system are stockholder owned and have an organizational hierarchy like other private business corporations.

These institutions have definitely played an important part in the United States' economic development. Their most important function is supplying liquidity to the economy. Bank credit supplies money where it is needed and when it is needed, and the repayment of this credit removes money from circulation when the specific need for
it has passed.¹

First American Banks

When the Continental Congress ratified the Constitution in 1789, there were only three incorporated banks in the United States. The first bank chartered was the Bank of Pennsylvania which was founded by Robert Morris and a few associates in 1781. When the bank received a national charter three years later, its name was changed to the Bank of North America. The other two banks, each of which obtained its charter in 1784, were the Bank of New York, New York City, and the Massachusetts Bank, Boston.² All three banks have had a continuous existence since they received their charters, although their names have changed because of subsequent mergers.

Each bank functioned in a manner similar to today's commercial banks, that is, it received deposits, made loans, and handled the clearing of checks. They conducted their business with success and soon gained public confidence.

In 1791 the Federal government entered the bank char-


tering field by creating the first Bank of the United States. Shortly after becoming Secretary of the Treasury, Alexander Hamilton actively promoted the Bank's establishment. The Bank provided invaluable services for the young economy, but its charter was not renewed upon expiration in 1811 because of political pressure. During this period many citizens felt that the Federal government should not issue paper money as the Bank was doing. Others contended that the Bank was becoming so powerful that it would eventually control the nation's economic life.

Growth Of State Banks

When the first Bank of the United States' charter was allowed to expire in 1811, and with the beginning of the War of 1812, the nation was faced with a great demand for more money. To meet the need for additional money, a number of state banks were established. A problem soon arose concerning the proper supervision of these banks. Some states exerted little regulation over banks they chartered. Many state banks were poorly financed, supervised, and managed. As a result many banks issued more

3Horvitz, op. cit., p. 66.

notes than they were able to redeem with the gold and silver retained as reserves.

In 1816 Congress established a second Bank of the United States to cope with the "wildcat" banks. The classic example of how the wildcat banks evolved is evident from the wording of Michigan's free-bank act of 1837 which stated that "... any person or persons resident in the State ... desirous of establishing a bank" could go into the business.\(^5\)

One control procedure adopted by the second Bank was the gathering of wildcat banks' notes and presenting them later for redemption in gold or silver.\(^6\) Needless to say, wildcat bankers complained bitterly about this form of regulation. Their complaints, plus President Andrew Jackson's states' right attitude, led to the second Bank of the United States' demise in 1863 when its charter expired. State banking, therefore, remained the primary form of banking until the Civil War.\(^7\) However, during this period some states established sound rules and regulations for their chartered banks. The Louisiana law of 1842, for example, provided a code which became a model of sound

\(^5\)Robertson, op. cit., p. 175.
\(^6\)Dye, Moore, and Holly, op. cit., p. 192.
and conservative banking. Ross Robertson described the statutes' provisions as follows:

The Louisiana law required banks chartered under it to keep a specie reserve equal to one-third of their combined note and deposit liabilities. Before 1863, several states came to require specie reserve against notes, ranging variously from 5 per cent to 33 1/3 per cent, but except for Louisiana and Massachusetts they did not require reserves against deposit liabilities as well.

A second important provision of the Louisiana act evidenced growing emphasis on the need for liquidity. The two-thirds of all liabilities not covered by specie reserves were to be backed by nonrenewable commercial paper with no more than ninety days to run.®

Both of these provisions emphasized the fact that if a bank's resources were tied up in loans against real estate or in long-term securities, as was the situation in the West and South during this period, insolvency was a real possibility.

Banking Since The Civil War

The Civil War, like the War of 1812, had significant effects on the United States' commercial banking system. In an effort to finance the Civil War and partly to abate the abuses in state banking, Congress in 1863 passed an act establishing the National Banking System. This act provided for "the chartering and supervision of national banking institutions by the newly created Comptroller of

®Robertson, op. cit., p. 176.
the Currency.”

To induce state banks to recharter as national banks, Congress permitted Federally chartered banks to purchase interest-bearing government bonds. These bonds could, in turn, be used as a reserve requirement for the bank's notes. It was hoped that this inducement would encourage state banks to request national charters. Congress' expectations were not realized, however, since the regulations imposed by a Federal charter restricted traditional banking activities. For example, regular bank examinations were mandatory, real-estate loans were restricted, and the minimum reserve requirements were generally more stringent than the reserve requirements of most states.

Once it became obvious that state banks were not anxiously seeking to become Federally chartered, Congress enacted a law which placed a 10% tax on any bank or individual issuing or using state bank notes. "If the interest on a loan were 7 per cent per annum and a bank were required to pay a tax of 10 per cent per annum on the amount of notes outstanding, the bank lost money on the transaction." Consequently, a large number of state banks requested Federal charters.

Even this prohibitive tax of 10% did not stifle the

9Dye, Moore, and Holly, op. cit., p. 192.
10Robertson, op. cit., p. 305.
state banks' growth for a long period of time. By 1869 the number of state banks had begun to increase again. There were several major reasons. First, state bankers began using checks instead of issuing bank notes. By lending deposits rather than bank notes, these banks avoided paying the 10% note tax and were again able to operate on a profitable basis. Secondly, some banks preferred the advantages of unincorporated banking. 11

By 1910 there were twice as many state banks as national banks. Nearly 14,500 banks were doing business at this time without the aid of a central banking system. The result was little coordination of the nation's banking activities. The nearest thing resembling a central banking system was correspondent banking. This arrangement was entirely informal--one in which small banks maintained deposit balances with larger banks in nearby cities. The smaller banks depended upon their correspondent banks to provide the services of a central bank, such as collecting checks, providing credit, and giving technical advice on operating problems.

Correspondent banking, however, was a poor substitute for a true central banking system, and a number of problems arose. For example, when the larger banks were faced with demands for cash, either from the public or their corre-

spendent banks, and if they did not have adequate cash reserves, they would obtain more funds by calling in their loans. This meant less spendable money for business and generally resulted in a financial crisis.\textsuperscript{12}

After a series of financial and banking crises, Congress became increasingly concerned with liquidity in commercial banking. Most parties agreed that the banking system needed some sort of reserve institution or association to hold cash on behalf of its member banks and to pay it out when individual banks were confronted with heavy demands.\textsuperscript{13} Under the circumstances, Congress enacted into law in December, 1913 the Federal Reserve Act which brought into being the Federal Reserve System. This Act was "the most important and revolutionary modification of the country's system of money and banks since the national banking legislation of half a century before."\textsuperscript{14}

Since the establishment of the Federal Reserve System, the commercial banking system and the country's money supply have been subjected to increased Federal control.

\textbf{Early Published Financial Statements}

Commercial banks, like other business enterprises in

\begin{footnotesize}
\begin{itemize}
  \item \textsuperscript{13} \textit{Ibid.}, pp. 157-158.
  \item \textsuperscript{14} \textit{Ibid.}, p. 158.
\end{itemize}
\end{footnotesize}
the early days of the twentieth century, were unwilling to disclose much, if any, information about their activities. During this period, stockholders might have received a condensed report of operations; but employees, customers, and the general public were usually uninformed. Most managers of business enterprises prepared financial statements for their own benefit and considered these reports absolutely confidential.

For many years, it was the general practice of commercial bankers to clothe their affairs with a "veil of mystery." Although there were occasional instances of detailed statements published by banks for public consumption, it was not until the early 1930s that "more and more banks, especially the larger city institutions, began to issue fairly comprehensive statements of condition and became somewhat less grudging in clarifying the basis upon which earnings were derived." The impetus for this movement was undoubtedly influenced by the 1933 and 1934 securities laws as well as public dissatisfaction and pressure.

In 1934 some of New York City's larger banks admit-

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16 Ibid.
ted the press to their annual stockholder's meetings for the first time. This action was a critical turning point in the history of bank reporting practices since financial information concerning the bank's operations was transmitted to a much larger audience than just the stockholders. Even though some progress was being made by larger banks, many bankers continued to maintain an indifferent attitude regarding full disclosure and adequate dissemination of financial information. In fact, a report prepared by the Senate Committee on Banking and Currency in 1934 concluded that the majority of banks which prepared annual reports for their stockholders did not publish an income statement.

**Statement Of Condition**

As early as 1864, the Comptroller of the Currency was requiring banks under its jurisdiction to submit statements of condition for review and evaluation. The Comptroller used the statements to estimate the degree of solvency maintained by the banks for the depositors' protection. Banks realized this and earnestly sought to present the appearance of conservatism, stability, and

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steady growth in their statements of financial condition.

Shown below is a statement of condition, published in 1928 by a New York bank:

**TABLE I**

CENTRAL UNION TRUST COMPANY OF NEW YORK
Statement Of Condition
June 30, 1928

**ASSETS**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash on hand, in Federal Reserve Bank and due from Banks and Bankers</td>
<td>$59,431,540.98</td>
</tr>
<tr>
<td>United States Bonds</td>
<td>$36,132,924.01</td>
</tr>
<tr>
<td>Municipal Bonds</td>
<td>$6,196,169.02</td>
</tr>
<tr>
<td>Loans and Discounts</td>
<td>$237,755,586.04</td>
</tr>
<tr>
<td>Short Term Securities</td>
<td>$12,811,763.81</td>
</tr>
<tr>
<td>Bonds and Other Securities</td>
<td>$1,872,832.10</td>
</tr>
<tr>
<td>Stock in Federal Reserve Bank</td>
<td>$1,275,000.00</td>
</tr>
<tr>
<td>Real Estate</td>
<td>$3,295,000.00</td>
</tr>
<tr>
<td>Customer's Liability Account of Acceptances</td>
<td>$31,688,493.91</td>
</tr>
<tr>
<td>Interest Accrued</td>
<td>$1,788,251.18</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>$392,247,561.05</strong></td>
</tr>
</tbody>
</table>

**LIABILITIES**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital</td>
<td>$12,500,000.00</td>
</tr>
<tr>
<td>Surplus</td>
<td>$30,000,000.00</td>
</tr>
<tr>
<td>Undivided Profits</td>
<td>$7,604,841.86</td>
</tr>
<tr>
<td>Deposits</td>
<td>$307,054,536.35</td>
</tr>
<tr>
<td>Dividend Payable July 2, 1928</td>
<td>$1,000,000.00</td>
</tr>
<tr>
<td>Reserve for Taxes and Interest Accrued</td>
<td>$1,557,967.19</td>
</tr>
<tr>
<td>Unearned Discount</td>
<td>$384,350.92</td>
</tr>
<tr>
<td>Acceptances</td>
<td>$32,145,864.73</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>$392,247,561.05</strong></td>
</tr>
</tbody>
</table>

Source: American Bankers Association Journal, XXI (September, 1928), 240.
Although the statement was deficient in terms of today's standards, this report was superior to most statements of condition published by other banks at the time. Some of the principal deficiencies are as follows: (1) total deposits are not broken down into the category of "Demand deposits" and "Savings and Time deposits," nor classified according to type of depositor, such as individuals, U.S. Government, political subdivisions, or other commercial banks; (2) the amount of reserves for bad debt losses on loans is not revealed on the statement, nor the amount of reserves established for possible security losses; and (3) there is no information concerning methods used in the valuation of the bank's resources. Despite these deficiencies, it is interesting to note that this bank and others were eager to give proof of their "soundness" through the publication of their statements of condition.

In 1947 Daniel Borth, Jr. conducted an examination of twenty-five Chicago banks' statements of condition and concluded that their reports compared "most unfavorably with the published financial reports of industrial and commercial concerns."¹⁹ The results of his survey revealed the following order of arrangement and terminology in the published statements of condition he reviewed:

TABLE II

TYPICAL BALANCE SHEET FORMAT 
USED BY BANKS IN 1947

RESOURCES

Cash and Due from Banks
United States Government Securities
Other Bonds and Securities
Loans and Discounts
Federal Reserve Bank Stock
Bank Premises
Customers' Liability on Acceptances 
and Letters of Credit
Interest Earned, not Collected
Other Resources

LIABILITIES

Capital Stock
Surplus
Undivided Profits
General Contingency Reserve
Discount Collected, not Earned
Reserve for Taxes, Interest, etc.
Dividends Payable
Liability on Acceptances and 
Letters of Credit
Other Liabilities
Deposits

Mr. Borth observed that the general order of arrangement of "Resources" was found to be in the order of liquidity, while "Liabilities" were in a reverse order beginning with "Capital Stock" and ending with "Deposits." Some of his recommendations for improving the statement of condition are still valid today:

20Ibid., p. 289.
1. The bases of valuation of the assets should be clearly set out on the statement of condition.

2. The "Reserve for Interest, Taxes, Contingencies, etc." includes elements of proprietary equities, deferred credits, and true liabilities. This practice of lumping such diverse elements under one statement title deserves the condemnation of all interested in adequate disclosure and the improvement of the quality of published statements.

3. The practice of valuing bank premises (including furniture and fixtures) at nominal amounts... would seem to subordinate the principles of adequate disclosure to the causes of the one-account, all-purpose, outmoded statement of condition and its many limitations.21

Statement Of Earnings

For many years the supervisory agencies were so enthralled with monitoring bank's solvency that the statement of earnings was overshadowed by the statement of condition. It was not until the turn of the twentieth century that earnings reports were called for by regulatory authorities. Furthermore, "only in recent years have most banks voluntarily published summaries of the statement of income in newspapers and included detailed income statements in their annual report to stockholders."22

Generally, those income statements prepared before 1945 were inadequate and in some instances misleading.

21 Ibid., pp. 289-291.
22 Vargo, op. cit., p. 19.
The results of a survey published in 1944 revealed that of 107 banks questioned in various parts of the country, 101 included earnings data. However, 20 of these banks published only a single figure for net profits. Also, the survey indicated that there was no agreement regarding what should be classified in the operating and nonoperating section of the income statement. Only a few banks disclosed nonoperating income and/or revealed the sources and uses of income in any detail. Lastly, the survey established the fact that some bank reporting practices were misleading, such as "charging losses and crediting recoveries and profits on securities sold to reserve accounts without giving any indication in the earnings statement of the extent of such transfers from or to reserve accounts."  

A similar survey was undertaken by the National Association of Bank Auditors and Comptrollers (now the Bank Administration Institute) of the annual reports issued by banks in 1947. Their survey indicated that out of the 125 largest banks in the United States, only 73 issued annual reports for general circulation and only 53 of those reports contained a detailed statement of earnings.  

23Willis, op. cit., p. 218.  
The form and content of bank earnings reports have slowly evolved over the years. Earnings reports prepared prior to 1945 utilized the concept of "net profits" accounting. Reports prepared using this approach "typically began with pre-tax net operating earnings, showing no detail of the revenue and expense items which determined these earnings." Next, transfers to and from the securities and/or loan loss reserves were disclosed in the report. The result was "net profits" as shown in Table III. The discretionary transfers to and from the reserve accounts made this approach susceptible to income manipulation.

TABLE III

EQUITABLE TRUST COMPANY
Income Statement
For the year ended Dec. 31, 1939

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating Income</td>
<td>$704,371.29</td>
</tr>
<tr>
<td>Operating Expense</td>
<td>461,549.43</td>
</tr>
<tr>
<td></td>
<td>$242,821.86</td>
</tr>
<tr>
<td>Plus:</td>
<td></td>
</tr>
<tr>
<td>Profits and Recoveries</td>
<td>$26,293.14</td>
</tr>
<tr>
<td>(Securities and Real Estate)</td>
<td></td>
</tr>
<tr>
<td>Less:</td>
<td></td>
</tr>
<tr>
<td>Transfers to Reserves and</td>
<td></td>
</tr>
<tr>
<td>Write-downs</td>
<td></td>
</tr>
<tr>
<td>Net Nonoperating Income</td>
<td>5,050.35</td>
</tr>
<tr>
<td>Net Profits</td>
<td>$247,872.21</td>
</tr>
<tr>
<td>At the Rate of (per share)</td>
<td>4.13</td>
</tr>
<tr>
<td>Dividends Paid - $3.25</td>
<td>195,000.00</td>
</tr>
<tr>
<td>Net Addition to Undivided Profits</td>
<td>52,872.21</td>
</tr>
</tbody>
</table>


The American Bankers Association (ABA) realized that the "net profit" format lacked detail. They suggested the use of a standard report form, as shown in Table IV, for providing information to present and potential stockholders and the financial press. Apparently, some bankers were making serious efforts to improve their reporting standards.

**TABLE IV**

**CONDENSED REPORT OF EARNINGS**  
**FOR SHAREHOLDERS AND OTHERS**  
**For the year ended Dec. 31, 1942**

<table>
<thead>
<tr>
<th>Current Operating Earnings</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest on Loans</td>
<td></td>
</tr>
<tr>
<td>Interest and Dividends on Securities</td>
<td></td>
</tr>
<tr>
<td>Other Current Operating Earnings</td>
<td></td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Current Operating Expenses</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Paid</td>
<td></td>
</tr>
<tr>
<td>Salaries and Wages</td>
<td></td>
</tr>
<tr>
<td>Other Current Operating Expenses</td>
<td></td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Net Current Operating Earnings</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Reconciliation of Surplus and Undivided Profits</td>
<td></td>
</tr>
<tr>
<td>Surplus and Undivided Profits at beginning of year</td>
<td></td>
</tr>
<tr>
<td>Net Current Operating Earnings (as above)</td>
<td></td>
</tr>
<tr>
<td>Miscellaneous Additions (Net)</td>
<td></td>
</tr>
<tr>
<td><strong>Less:</strong></td>
<td></td>
</tr>
<tr>
<td>Dividends Declared</td>
<td></td>
</tr>
<tr>
<td>Other Deductions</td>
<td></td>
</tr>
<tr>
<td>Surplus and Undivided Profits at end of year</td>
<td></td>
</tr>
</tbody>
</table>


---

The ABA was not the only group advocating a reform in commercial banks' reporting practices. The financial press began pressuring banks to furnish stockholders adequate financial information. In January, 1942 an editorial in *The New York Times* summed up the situation as follows:

... there is still a need for some plan under which all banks would furnish their shareholders with full statement of earnings. This need has become more acute in recent years because of the importance of security profits in bank income. There is no general agreement among banks whether none, part or all of such profits should be included in earnings to shareholders. And there is complete lack of uniformity in the way in which various banks report. Some still provide shareholders with no more information than they can dig out by subtracting the undivided profits of one annual statement from those of the succeeding statement.  

By the mid-50s the "net operating earnings" (NOE) approach was developed and employed by a substantial number of banks. Although the cash basis of accounting was still frequently used, banks were now dividing revenue and expense items into "steady" and "unsteady" categories. The steady flows were used to determine "net operating earnings," while unsteady flows were classified as "capital

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adjustments" and were included in the reconcilement of capital funds statements. The capital adjustments included such items as securities gains and losses and transfers to and from loan loss reserves with their related tax effects.

This approach to reporting earnings was naturally favorable for the banks since it portrayed their earnings trend as stable and steadily growing. Yet, as one critic of the NOE approach indicated, "these unsteady transactions are part and parcel of the operations and performance of a bank, no matter how hard it may be to bring them into the orbit of net earnings." Stockholders wanted to know how these so-called "non-operating" items affected earnings. Therefore, in the mid-60s some banks began to report income under the "neo-net operating earnings" concept. Under this approach the results of investment portfolio transactions and additions to the loan loss reserve were shown below the net operating earnings line rather than disclosed in the reconcilement of capital funds. Table V illustrates this approach. Note that the final figure on the statement is labeled "transferred to undivided profits."

TABLE V

MANUFACTURERS HANOVER TRUST COMPANY
Consolidated Statement Of Earnings
For the year ended Dec. 31, 1965

<table>
<thead>
<tr>
<th>Operating Income</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest and Other Fees on Loans</td>
<td>$201,485,005</td>
</tr>
<tr>
<td>Interest and Dividends on:</td>
<td></td>
</tr>
<tr>
<td>U.S. Government Obligations</td>
<td>$27,431,136</td>
</tr>
<tr>
<td>State, Municipal and Public Securities</td>
<td>$19,339,863</td>
</tr>
<tr>
<td>Other Securities</td>
<td>$3,477,481</td>
</tr>
<tr>
<td>Trust Department Income</td>
<td>$18,885,217</td>
</tr>
<tr>
<td>Service Charges on Deposit Accounts</td>
<td>$10,497,969</td>
</tr>
<tr>
<td>Other Operating Income</td>
<td>$13,350,078</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$294,466,749</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Operating Expenses</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries</td>
<td>$57,719,457</td>
</tr>
<tr>
<td>Profit-Sharing</td>
<td>$4,315,951</td>
</tr>
<tr>
<td>Pension, Social Security and Other Benefits</td>
<td>$8,827,327</td>
</tr>
<tr>
<td>TOTAL STAFF EXPENSE</td>
<td>$70,862,735</td>
</tr>
<tr>
<td>Interest</td>
<td>$104,095,521</td>
</tr>
<tr>
<td>Net Occupancy Expense of Banking Premises</td>
<td>$16,606,535</td>
</tr>
<tr>
<td>Equipment Expenses</td>
<td>$4,058,420</td>
</tr>
<tr>
<td>Other Operating Expenses</td>
<td>$18,790,097</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$214,413,308</td>
</tr>
</tbody>
</table>

| Operating Earnings Before Income Taxes                | $80,053,441 |
| Less: Income Taxes on Operating Earnings              | $29,918,736 |
| NET OPERATING EARNINGS                                | $50,134,705 |

<table>
<thead>
<tr>
<th>Non-Operating Income or (Charges) After Income Taxes</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Gain or (Loss) on Securities</td>
<td>$717,633</td>
</tr>
<tr>
<td>Gain on Disposal of Real Estate</td>
<td>$56,013</td>
</tr>
<tr>
<td>Additions to Reserve for Possible Loan Losses</td>
<td>(907,100)</td>
</tr>
<tr>
<td>Premium on Prepayment of Mortgage</td>
<td>(384,770)</td>
</tr>
<tr>
<td>Net Non-Operating Charges (After Net Income Tax)</td>
<td></td>
</tr>
<tr>
<td>Tax Reduction of $915,325 in 1965</td>
<td></td>
</tr>
<tr>
<td>TRANSFERRED TO UNDIVIDED PROFITS</td>
<td>$49,616,481</td>
</tr>
</tbody>
</table>

Although most commercial banks have made great strides in disseminating financial information to their stockholders, the Committee on Banking and Currency in a 1964 report found that:

... stockholders of banks in many cases received little or no information concerning the financial result of their bank's operations. Less than 50% of all banks publish annual reports .... A financial report is read at the annual meeting of 87% of those banks not publishing annual reports, but 79% of those banks reading such a statement do not mail it later to all stockholders.30

It might be worthwhile at this point to examine briefly some reasons for and against reporting bank's financial activities.

Reasons For And Against Reporting

Some bankers claim that detailed financial disclosure would violate the depositors' trust and might contain information of a damaging nature and would be valuable only to the bank's competitors.31 Others state that banks are reluctant to publish earnings figures for general circulation because such disclosure might precipitate a


"run" on banks in times of economic stress. Another group contends that:

Banks deal with much larger segments of the population than do most manufacturers. They have among their depositors many persons lacking financial training who can misinterpret figures and many persons of foreign extractions who because of unfavorable experience in the past might easily be frightened.32

Lastly, some argue that the public's interest is adequately protected through the intensive bank examinations by the state and Federal regulatory agencies.33

We will now look at some of the advantages of publishing financial statements and consider some rebuttals to the previous statements made. As for "runs" on banks, the commercial banks having the most to gain by a policy of limited or nondisclosure are those operating with unsound banking policies. Their secrecy could easily prevent depositors and shareholders from knowing whether the bank is maintaining adequate primary and secondary reserves to cope with unexpected demands for cash. With a policy of full and adequate disclosure, those depositors and stockholders interested enough to obtain and appraise the facts would have due warning of the bank's solvency deterioration. Furthermore, knowledge that an unsound condi-

32Ibid., p. 104.
33Ibid.
tion could not be kept secret from investors, depositors, and the general public might be a powerful incentive for bankers to operate sound financial institutions. Also, it is doubtful that the reporting of commercial banks' earnings during a major depression, in and of itself, would be sufficient to precipitate a run on banks as some have suggested.

Another reason advanced for limited disclosure was that many persons "lack financial training" to analyze statements properly. Maybe this was a valid argument fifty years ago, but today many investors are capable of understanding financial statements. Moreover, if bank reports were precise and clear, perhaps more readers would be able to understand what is being stated. There are also many competent security analysts willing to help the investor should he need assistance. An increasing number of bankers have come to realize that many investors are capable of understanding comprehensive bank reports. As one banker wrote:

A comprehensive bank report is a very good builder of customer goodwill, and probably has some effect upon obtaining new business, particularly among the large national corporations in the country. Most treasurers want to be extremely well informed with reference to the banks with whom they do business.34

34Ibid.
There are other distinct advantages to comprehensive disclosure. A reporting policy providing information of real significance to the investing public can stimulate new business by heightening public confidence and goodwill. A bank pursuing a full disclosure policy indicates to its audience that it has nothing to conceal. One banker expressed his attitude concerning full disclosure as follows:

A bank has got to be prepared to expect the bad along with the good, and unless banking is willing to tell its full story, it can neither expect nor justify the confidence on the part of those who use banks for the deposit of money, for the administration of trusts, or for the extension of credit.35

Finally, a bank's failure to provide informative reports could possibly affect the future marketability of its securities. Dr. Eugene M. Lerner, while serving as an economist of the House Banking Committee's Subcommittee on Domestic Finance, made the following comments:

Adequate disclosure to stockholders is the necessary foundation for a better market for bank securities. A better market, in turn, will assure banks a lower cost of capital and thereby enhance their ability to assume more risk in their portfolio. Moreover, a better market may reduce the proclivity to merge, for it is likely to lead to high stock prices and greater interest by the entire financial community in the affairs of the bank.36


Governmental Supervision Of Commercial Banks

Commercial banking in the United States operates under a dual banking system of state and Federally chartered banks. The dual system is the result of a still unresolved conflict between Federal power and states' rights. Yet, this structure has permitted flexibility in the banking system and has helped promote a healthy adaptation for an expanding economy.

National banks operate under Federal charters and are under the supervision of the Comptroller of the Currency. These banks are required to become members of the Federal Reserve System and must have their deposits insured by the Federal Deposit Insurance Corporation (FDIC). In 1968 approximately one-third of the 13,679 banks operating in the U.S. were national banks. Although there are fewer national banks than state banks, the former retains more than half of the total deposits held by commercial banks in the U.S.

If a commercial bank does not wish to be Federally chartered, it is chartered by the state in which it oper-


ates. State banks are not required to join the Federal Reserve System. If it elects to do so, the bank places itself under the Federal Reserve Board's jurisdiction and must subscribe to the FDIC. "Also, to qualify for membership in the Federal Reserve System, a state bank, among other things, must meet national bank capital requirements and maintain the prescribed legal reserve balances on deposit with the Federal Reserve Bank of its district."39

If a state bank chooses not to join the Federal Reserve System, it still has the option of having its deposits insured by the FDIC. To date, very few state banks elect not to join the FDIC. "Approximately 97% of all commercial banks, accounting for approximately 99% of total commercial bank assets, are insured by FDIC."40

Every commercial bank is subject to the authority of a state and/or Federal regulatory agency. As part of their supervisory duties, these agencies periodically perform surprise examinations of those banks subject to their control. The following table indicates the general pattern of these examinations:


40 Ibid.
TABLE VI

BANK EXAMINATIONS PERFORMED
BY SUPERVISORY AGENCIES

Supervisory Agency

<table>
<thead>
<tr>
<th>Bank Classification</th>
<th>Comptroller of the Currency</th>
<th>State Banking Department</th>
<th>Federal Reserve Bank</th>
<th>Federal Deposit Insurance Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td>National banks</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>State banks:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Federal Reserve</td>
<td></td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>members (usually</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>joint examination)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-members:</td>
<td></td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>FDIC Insured</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(frequently joint</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>or concurrent exam)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-insured</td>
<td>X</td>
<td></td>
<td>X</td>
<td></td>
</tr>
</tbody>
</table>

Note: Supervisory examinations are usually scheduled annually, except with respect to national banks where three examinations are scheduled in each two-year period.


These examinations are designed to determine the adequacy of the bank's solvency, the management's degree of competence, soundness of the bank's assets, and the bank's compliance to rules and regulations under which it is operating. Since the examination performed by supervisory agencies serves different objectives than audits performed by independent CPAs, obviously the scope
of their examination would not be made in accordance with generally accepted auditing standards. "It would not be usual, for example, for the supervisory examiner to confirm by direct communication with borrowers the existence and amount of loans and related collateral; to confirm deposits by direct communication with depositors; to make detailed tests of transactions affecting assets and liabilities between examination dates; or to perform auditing tests of income and expense transactions."41

We will now trace the historical development of the three Federal regulatory agencies which shape commercial banks' accounting and reporting practices.

Comptroller Of The Currency

The Comptroller of the Currency's office was established by enactment of the Currency Act of 1863. This agency, antedating the Interstate Commerce Commission by twenty-four years, was the first national administrative agency established exclusively for regulating an important industry. The original act authorized the Comptroller to "charter banks, conduct examinations, require reports, permit increases in capital stock, establish and conduct receiverships in the event banks did not redeem their notes, and under certain conditions

41Ibid., p. 14.

During its more than 100 years of existence, this regulatory agency has been empowered with the following statutory authority in supervising the activities of national banks:

1. Supervising, in general, all national banks and the company affiliates of national banks. This includes the issuance of rulings and instructions, the giving of advice and counsel, and the requirement of corrective action.
2. Granting charters to new national banks and approving the title and location of such banks.
3. Consenting to changes in the names and locations of national banks.
4. Approving the reorganization of national banks.
5. Permitting national banks to operate domestic branches.
7. Receiving reports from national banks.
8. Consenting to the conversion of state into national banks.
9. Consenting to the consolidation of national banks, or of state banks with national banks.
10. Granting to national banks permission to increase or decrease their capital stock, or to issue or retire preferred stock.
11. Determining the necessity for placing national banks in receiverships to be conducted by the FDIC.
12. Bringing suit for forfeiture of the charters of national banks which deliberately violates the national banking laws.
13. Supervising all banks and trust companies and credit unions not chartered under the Federal Credit Union Act, doing business
in the District of Columbia.

14. Preparing annual reports to Congress, recommending legislation and reporting on the status of national banks.43

Some of the agency's main supervisory functions are examined briefly. One of the Comptroller's primary functions is the granting of Federal banking charters. Upon receipt of an application, the appropriate district examiner is instructed to direct "an elaborate and exhaustive investigation that reveals the background and resources of the organizers, the present banking facilities available to the area to be served by the proposed banks, and the likely effect of a new firm on competition in that area."44 Findings and recommendations of this investigation are forwarded to the Washington headquarters and constitute the chief basis for the Comptroller's decision. Before reaching his decision, the Comptroller also obtains recommendations from the FDIC and the Federal Reserve Bank of the district concerned.45

43Ibid., p. 130.


45Formerly, but not now, the Comptroller obtained the opinion of the district's Congressman concerning the purported character of the applicant and required the endorsement of the charter by three prominent local officials.
Generally, the chief reason for rejecting applications for charters by the Comptroller has been a lack of community needs. "In all but a few cases of rejection in recent years, the Comptroller judged that the need was insufficient, and in half of the cases he felt that the income prospects were unfavorable; in one out of three cases he concluded that the management outlook was unsatisfactory."^46

In addition to his power of granting Federal charters, the Comptroller also possesses the statutory authority to receive "call" reports from all the national banks in the U.S. The most important reports the Comptroller requests are the "reports of condition" and the "reports of earnings and dividends." These reports must be submitted to the Comptroller's office within ten days after call or the delinquent bank pays a penalty. Also, the report of condition must be published in a newspaper where the national bank is located. This is done by the bank, at its own expense, and proof of publication must be presented to the Comptroller.^47 Each call report of condition must contain a declaration by the president, a vice-president, and the cashier or treasurer that the

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^47 Most state banking authorities have similar requirements for banks under their jurisdiction.
report is true and correct to the best of their knowledge and belief.

Formerly, the reports were regularly called by the Comptroller on the last business day in both June and December. Many banks anticipating a call date began to engage in the practice of "window dressing." By inflating their deposits and resources, some bankers would attempt to improve or maintain the appearance of their relative size. The Comptroller's solution to this problem was "surprise calls." Yet, the Federal Reserve Board and the FDIC did not agree with this policy and preferred to pursue a policy of "moral suasion" and felt that change should be brought about by education rather than pressure. 48

During 1963, the Comptroller of the Currency issued regulations requiring every national bank with deposits of $25 million or more to furnish a written report to stockholders. The annual report was to be received no later than sixty days after the close of the calendar year, effective as of 1963. The regulation also stipulated as a minimum the following financial information:

1. Comparative balance sheets as of the close of the current year and as of the close of the preceding year.

2. Comparative statements disclosing net operating income after applicable federal income taxes, net operating income per share, and cash dividends paid per share for the current year and the preceding year.

3. A comparative reconciliation of capital accounts which summarizes the changes in the capital accounts for the current year and the preceding year.49

The most effective means of supervisory control possessed by the Comptroller is the regular examination of banks. He has statutory authority to make at least twice a year "a thorough examination of all the affairs" of national banks, the domestic branches of these banks, and at his discretion, national banks' affiliates. Knowledge obtained through these examinations is "essential to the Comptroller in his determination of criticisms to be made or remedies to be applied respecting individual banks and in his formulation of fundamental policies applicable to the national banking system."50

The Comptroller has listed nine principal elements his examiners must observe in their examinations. They are as follows:

1. Determination of amount and nature of assets;
2. Determination of amount and nature of liabilities;


50Fox, op. cit., p. 158.
3. Evaluation of assets; determination of estimated losses;
4. Evaluation of management (directors and officers) and policy;
5. Evaluation of practices and procedures;
6. Determination of nature, adequacy, and value of plant and equipment;
7. Analysis of expenses, earnings, and adequacy of capital structure;
8. Compliance with requirements of law;
9. Analysis of trends; recommendations and criticism.  

Federal Reserve System

Following a severe financial crisis in 1907, Congress appointed a National Monetary Commission to study the problems plaguing the banking industry. After several years of thorough consideration, the Commission concluded that the banking system needed an elastic currency, better bank supervision, and a central bank. In 1913, Congress passed the Federal Reserve Act which embodied the committee's recommendations. The Act made no attempt to revamp the private banking system of that period; rather, it superimposed the Federal Reserve System (FRS) upon the existing banking structure. The Act was signed by President Woodrow Wilson on December 23, 1913, and the Federal Reserve Banks opened for business the following year.  

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The original Act's primary function was to regulate the flow of bank credit and money, to afford a means of rediscounting commercial paper, and to supervise more effectively U.S. banking. During its fifty years of existence, the Federal Reserve System's goals have expanded to include:

1. Maximum sustainable economic growth;
2. Reasonable price stability;
3. Maximum practicable employment; and
4. Equilibrium in international payments.\[53\]

The Federal Reserve banks' capital stock is owned by member banks and may not be transferred or sold to others. Every bank within the system must subscribe to the capital stock of its district's Reserve Bank.\[54\] Whenever a member bank increases or decreases its capital or surplus, it must also alter its ownership of Reserve Bank stock in the same proportion. One-half of each member bank's subscription must be fully paid and the remainder is subject to call by the Board of Governors. The member bank's paid-in subscription is an amount equal to 3% of its own capital and surplus.

Banks that become members of the Federal Reserve


\[54\]For administrative purposes, the United States is divided into twelve districts with each district having one Reserve Bank.
System must comply with various Federal laws, regulations, and conditions regarding: (1) the adequacy of capital; (2) mergers with other banking institutions; (3) establishment of branches; (4) relations with holding company affiliates and bank holding companies; (5) interlocking directorates; and (6) loan and investment limitations.55

A major objective of the FRS is keeping informed of the conditions, operations, and management of member banks. One important means of attaining this goal is the bank examination. The scope of the Federal Reserve's bank examination is very similar to the Comptroller's, as described previously. In practice, the Federal Reserve confines its field examinations to state member banks, and whenever practicable, such examinations are performed jointly with state banking supervisory authorities. The established policy is one regular examination of each state member bank every calendar year. "Since national banks are subject to examination by the Comptroller of the Currency, the Comptroller's District Chief Examiners furnish the Reserve Banks with copies of reports of examinations of all national banks in their respective districts, and in this way the two agencies avoid duplicating examinations."56


56 Ibid., pp. 151-152.
To supplement information obtained from the bank examinations, the Federal Reserve also requires its members to submit annually four reports of condition and earnings on dates selected by the Comptroller of the Currency, the Chairman of the Federal Reserve's Board of Governors, the FDIC's Chairman of the Board, or a majority thereof. Two of the reporting dates are selected within the period January to June inclusive, and two within the period July to December inclusive.  

**Federal Deposit Insurance Corporation**

The Federal Deposit Insurance Corporation (FDIC) was established in 1934 to insure deposits of all eligible banks. Every member bank belonging to the Federal Reserve System must have deposit insurance. State banks not in the FRS may receive coverage if they agree to subject themselves to the FDIC's rules and regulations, including periodic bank examinations.

Insured banks are assessed at the annual rate of 1/12 of 1% of their total deposits including interbank deposits but excluding those of the U.S. Treasury. Since 1961 the insured banks have been credited 66 2/3% of their assessments after deducting FDIC's expenses and losses. Orig-

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nally, the FDIC had $150 million capital subscribed by the Treasury and almost an equal amount from the Federal Reserve banks. The FDIC has since retired the capital stock plus interest by payments to the U.S. Treasury.

Losses from bank failures have been inconsequential since the agency's founding. All losses have been paid out of funds received by the FDIC as premiums from its members plus interest earned on these funds. To meet extreme needs, the FDIC may borrow up to $3 billion from the Treasury. Thus far, there have been no borrowings from the Treasury.\(^{58}\)

To avert failures of insured member banks, the FDIC requires that member banks be examined annually and submit reports four times a year concerning their financial condition and operating earnings. In general, the agency examines only those insured banks not subject to examination by another Federal supervisory agency.

When an examination reveals that a bank needs help or when it seeks aid, the FDIC may do one of three things: (1) it may let the bank close and pay each depositor up to $20,000 in cash or a deposit at another insured bank;\(^ {59}\)

\(^{58}\)"Government Loan and Credit Programs," Banking, LVI (April, 1964), 152.

\(^{59}\)In such cases, the FDIC has the right to offset depositors' claims for insured deposits against their loans outstanding in the distressed bank.
(2) it may lend to the bank, purchase assets, or make deposits so that the bank can continue to operate; or
(3) it may arrange merging the bank that is in difficulty with another insured bank guaranteeing the latter against loss.

One of the primary benefits derived from FDIC supervision has been the improved banking standards it has required of smaller banks. Traditionally, this group has suffered the greatest losses during periods of financial panics. For example, it was found that:

Of the 14,000 banks that suspended business between 1921 and 1933, 11,300 were state banks and 2,700 were national banks. Most of the failed banks were small; more than 90 per cent of them were in communities with less than 25,000 inhabitants, and 85 per cent had total assets of less than $1 million. 60

Even though the three Federal supervisory agencies have done much to improve bank operating standards, there have been cases of overlapping responsibilities and functions. A basic problem has been the divergent interpretation and, therefore, varied administration of similar or even identical statutes. The result has been confusion and inconsistency. Some critics have stated that this problem is caused by fragmented authority scattered among a host of Federal and state agencies. The problem

is also complicated when each agency feels convinced that "it alone" knows what is best for the banking industry. This dilemma sometimes forces the banker to ponder the question: "Who is in charge?"^61

Another criticism concerning banking regulation is that it has essentially become a system of Federal regulation. As one writer stated:

State authority is only valid within a federally-directed and structured system. This is to say that state authority is permitted only up to the point where it begins to step on the toes of the central government.62

Yet, in order for the commercial banking system to be one based on flexibility, many feel that bank regulation should be a joint effort between state and Federal authorities. Strong state supervision should complement rather than compete with Federal supervision. Certain state banking commissions should be delegated authority for making those decisions where local interest is of great importance, such as branch banking applications.

One final criticism regarding present bank regulatory structure is that "many of the existing rules and procedures sharply curb the ability of aggressive banks to

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^61 Marvin A. Bryan, "Striking a Balance In Banking Regulation," The Commercial and Financial Chronicle, CCV (June 1, 1967), 17.

62 Ibid.
compete with full vigor with other banks as well as with non-bank competitors. These opponents of strict regulation believe that freer and broader competition would benefit both the public and commercial banks.

Most critics of banking regulation realize, however, that all the blame cannot be charged against the Federal government. Many have indicated that bankers as a group have not vigorously fought for changes in the structure. "It seems that a great many bankers are content to live with competitive restraints so long as their commercial bank competitors are also constrained."^4

Having traced the historical development of bank reports and the Federal banking regulatory agencies, we will now examine some recent developments which have influenced bank financial reporting.


^64 Ibid., p. 16.
CHAPTER III

RECENT DEVELOPMENTS AFFECTING BANK REPORTING

There have been several significant developments in recent years inducing commercial banks to disclose additional financial information and prepare financial reports in accordance with generally accepted accounting principles followed by nonbanking industries.

Expanding Number Of Stockholders

A primary factor prompting changes in bank reporting practices has been a gradually changing profile of bank ownership.

In the early days of the banking system, most banks were locally owned, closely controlled, independent community businesses. The advent of branch banking on a large scale in the 1930s created a broadening ownership base of bank equities. After World War II the ownership dispersion of bank stocks expanded substantially with the rapid growth and increasing need for capital by the banking industry. The need for more capital led, in many cases, to the formation of bank holding companies whose securities received national distribution.

The vast broadening of ownership in the 1960s brought
about a shift in the type of bank stockholders and in the objectives for owning bank shares. Many investors no longer considered bank stocks as an alternative to bonds or savings accounts. Bank common stocks were evaluated in the context of other common stock choices. This new breed of bank stockholders was more interested in the trend of earnings growth, the dividend distribution, and the yield on capital. Many felt that book value per share and heavy reserves were irrelevant.

"This dispersion of ownership and the need by present and prospective stockholders for data to appraise the value of an investment have been responsible for some shift from the use of accounting practices emphasizing depositor protection to accounting procedures resulting in a better determination of results of operations and financial position."¹ For example, numerous banks now disclose net income per share figures in their annual reports. This new information enables investors not only to compare price/earnings ratios between banks but also to compare price/earnings ratios of banks to other businesses.

Securities Acts Amendments Of 1964

Prior to 1964 banks had not been required to comply

with the Securities Acts of 1933 and 1934 on the grounds that they were already being regulated by Federal banking authorities or state banking departments. However, the Amendments of 1964 subjected some banks to the Securities and Exchange Commission's (SEC) registration requirements.

"The decision to bring banks under the amendments to the Securities Acts presumably resulted from recognition of the wide ownership of bank stocks by the general public in all parts of the nation." The SEC's attitude was that as long as banks competed with other industries in the market place for capital funds, banking institutions should be willing to accept the same responsibilities as other corporations.

One primary objective of the Amendments was to afford investors in publicly-held companies, whose securities were traded over-the-counter, the same fundamental disclosure protection available to other investors whose company's securities were listed on an exchange. Moreover, the Amendments extended disclosure, proxy solicitation, and insider trading requirements to banks and other corporations not listed on securities exchanges.

According to the original legislation, a bank had to comply with the new law when it met all three of the fol-

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Fred M. Oliver, "New Horizons in Bank Accounting and Reporting," Banking, LIX (June, 1967), 63.
lowing requirements: (1) had total assets in excess of $1,000,000; (2) had 750 shareholders of record for any class security; and (3) engaged in interstate commerce or in a business affecting interstate commerce, or its securities were traded by the use of the mails or by any means or instrumentality of interstate commerce. The "number of shareholders" requirement dropped to 500 as of May 1, 1967.

The effect of the Amendments within its first two years of enactment was to require new registration by about 3,500 companies of which 600 were banks. "No doubt the nature of banking institutions and the tradition of statutory regulation will mean that new registration requirements will have greater impact on banks than on industrial companies."  

The administration and enforcement of registration and periodic reporting requirements was not vested in the SEC, but rather with the appropriate Federal bank regulatory agency. Thus, the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the


Federal Deposit Insurance Corporation were delegated the authority for executing the provisions of the Act as they relate to commercial banks.

**Regulation F**

In late 1964 the FRB and the FDIC adopted almost identical codes, known as Regulation F, for those banks subject to the Securities Acts Amendments. These regulations contained various instructions relating to the form and content of financial statements called for by these agencies. Major elements covered by the regulations as they pertain to bank reporting are as follows:

1. Accrual accounting is to be employed by reporting banks where practicable;
2. Securities accounts, in both the balance sheet and income statements, are to reflect amortization of premiums and accretion of discounts, except that, if discount is not accreted, the effect on earnings of failure to do so is to be disclosed in a footnote;
3. Market value, as well as book value, is to be disclosed for holdings of common stocks, real estate other than bank premises, and bonds which are not of "investment grade";
4. Fixed assets accounts are to be reconstituted for the last five years, if necessary, to reflect original cost less depreciation. Also, the cost of premises and accumulated depreciation, as recorded for Federal income tax purposes, are to be shown;
5. Gains or losses in bond-trading department activities are to be shown separately from interest income on the bank's investment portfolios; and
6. Allowances and reserves for bad debts and security portfolio losses are
to be disclosed and treated either as deductions from the relevant asset item or as capital contingency reserves depending on their character.\(^6\)

In keeping with the purpose of the Securities Exchange Act to make significant information widely available to investors, Regulation F provided that registration statements and reports of banks be available for public inspection at the FDIC office in Washington and at each of the twelve Federal Reserve banks.

The Comptroller of the Currency also issued new regulations for national banks designed to assure fair presentation of financial condition and results of operations after passage of the Securities Acts Amendments. According to the Comptroller's regulations, when national banks offer additional securities for public sale, they are required to file a registration statement and offering circular with his office. This statement must contain as a minimum such information as "the name and address of the issuer, the number and dollar amount of the securities offered, the proposed means of distribution, the expenses incurred in connection with the offering, and a brief statement of the intended uses of the proceeds."\(^7\)

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addition, the Comptroller requires a brief history of the bank's present and proposed operations, financial statements not more than ninety days old prior to registration, a description of the bank's pension, retirement, and bonus plans, and a listing of the principal shareholders.

Prior to the Securities Acts Amendments of 1964, supervisory authorities had issued regulations designed primarily for depositor protection. In 1963 William McChesney Martin, then Chairman of the FRB, aptly expressed his agency's attitude about bank regulation when he stated:

> Bank supervision is intended to assist in maintaining a sound, serviceable banking structure and to protect bank depositors. As an incident to these principal functions, supervision also benefits bank shareholders in important ways.\(^8\)

The passage of the 1964 Securities Acts Amendments ushered in a new era in bank reporting and regulation. This legislation stipulated that stockholder protection was no longer to be considered an incidental factor in bank regulation and reporting. It, in effect, made the following statement to both bank regulators and commercial bankers:

> You must continue your concern for depositors but financial reporting practices, which have been geared to the protection of depositors, must from now

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on take into account the needs of stockholders and investors as well. The two purposes must be blended. 9

Since the enactment of the 1964 Amendments, regulatory agencies have established accounting and reporting standards far superior to those previously required. Moreover, the Amendments provoked the banking industry through its associations, such as the American Bankers Association and the Bank Administration Institute, to work diligently toward finding further agreement on certain difficult accounting problems. The Bank Administration Institute, for instance, urged all banks, even those not subject to the Securities Acts, to present their financial statements "in a manner that will give sufficient information to stockholders, investors, and depositors so that they can form meaningful judgments on the financial condition of the bank and the results of its operations." 10 Thus, many banks have gone a long way toward the ultimate goal of preparing their financial statements in conformity with generally accepted accounting principles.

Audits By CPAs

Regulation F, as originally proposed, required that


all financial statements submitted with registration statements be examined by independent public accountants. Some bankers believed that the certification requirement was unnecessary. They raised many objections to this requirement, and as a result the regulations were changed. As finally adopted, the regulations "permit the banks to choose whether to have their financial statements 'certified by an independent public accountant or verified by the bank's principal accounting officer and its auditor'."

Some banks have recognized the importance of obtaining professional assistance in preparing their financial statements. In 1964 Manufacturers Hanover Trust Company and Morgan Guaranty Trust Company, two of the country's major banks, included the opinions of independent CPAs for the first time in their annual reports to stockholders. Hopefully, the examination of year-end financial statements by CPAs will become more widespread among banks, even though it is not required by Federal banking regulatory authorities.

Of course, many banks have raised objections to audits by independent public accountants. Probably the two main arguments most often cited are "duplication" and "cost."

Some bankers state that examinations by supervisory

agencies and audits by independent accountants would bring about unnecessary duplication of efforts. However, there is a very clear distinction between the goals of supervisory examinations and independent audits. Mr. K. A. Randall, former chairman of the FDIC, explained the difference between examinations and audits as follows:

The bank audit is a quantitative analysis of a bank's assets and liabilities, its income and expenses, determining what does and does not belong on the books, and whether or not these transactions are accurately reflected in the bank's records.

The examination, on the other hand, is primarily a qualitative analysis, aimed at developing the value of the holdings, their soundness, legality of the bank's actions, the soundness of capital, and the quality of management ....

The examiner and the auditor, because of the basic differences in ultimate objectives, do not even approach their tasks from the same point of view.12

A bank examination includes some auditing procedures, but these are limited in scope and do not approximate a full audit. Thus, there are many audit steps performed by a CPA in an independent bank audit which would not be within the scope of regular bank supervisory examinations. Some of these audit procedures are as follows:

1. Direct confirmation of deposits and loans.
2. Detailed audit to determine that

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the figures which represent assets and liabilities correctly reflect and represent the result of various transactions.

3. Detailed check of income accrued and received, and detailed vouching, for a period, of expenses accrued and paid, to determine whether bank was receiving income to which it was entitled, whether expenses were properly chargeable and paid, and whether taxes were computed correctly.

4. Study of the bank's systems, procedures, records, manuals, personnel effectiveness, work flow, and mechanization to determine costs and overall operating efficiency.13

Since the goals of the bank examination and independent audit are quite different, the argument that audits by CPAs would represent duplication of work performed by supervisory authorities has many weaknesses.

"Some larger banks maintaining internal audit staffs contend that the work of these staffs parallels the procedures of an independent auditor, and thus make independent audits ... overly costly."14 Cost, however, can be held within reasonable limits by effective coordination with internal auditors. Normally, the independent auditor

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limits his procedures when client internal controls are strong. Costliness is more applicable to the small bank lacking adequate internal controls. As one writer stated:

> Of the 14,000 banks in the country, I suspect that less than 1,000 provide the internal control features necessary to make independent audits of their financial statements economically feasible.\(^{15}\)

The cost of independent bank audits must be measured against the obtainable benefits. Many constructive recommendations for improving operating procedures, internal accounting controls, internal auditing, and tax planning have arisen from professional audits. Some banks have also experienced improved investor confidence and a broader reception for their stock.

There appears to be a real potential for additional audit work in the area of commercial banking. Yet, those accountants who are unfamiliar with the banking industry should proceed with caution when preparing for a bank audit. It has been noted that:

> Banking is a highly specialized field of endeavor, and the accountant daring to offer his services must be equipped to handle the engagement. For example, with all but the smallest banking operations, there are so many control points to be covered simultaneously with a cash verification that a staff of several auditors is required, at least for that very critical point in the audit.\(^{16}\)


It would seem that independent audits are desirable for all banks subject to the Securities Acts Amendments. Yet, when a sample of Louisiana bankers were asked: "Do you believe that an annual audit should be performed by an independent CPA and that his opinion of the financial statements should be disclosed to the stockholders?" only 33% of the total respondents answered with an affirmative response, as shown in question 4 of the Appendix. Hopefully, more bankers will begin to realize that as long as they have responsibilities to both depositors and investors, independent bank audits are worthwhile.

**One-Bank Holding Company**

The emergence of the one-bank holding company (OBHC) in recent years has been a most important development in the banking industry. For many years the growth of commercial banks had been restrained by restrictive banking regulations as well as competition from nonbank financial institutions. In their search to find ways of adjusting to a changing economic and financial environment, many banks began forming OBHCs. By mid-1969 more than 110 of these firms had been established or proposed, and in aggregate they held over one-fourth of the deposits of all commercial banks in this country.

Basically, the OBHC formation involves:

... the bank's creation of a business corporation which then establishes a
subsidiary bank. After this, the original bank is merged into the dummy subsidiary and it in effect replaces the subsidiary. The result is that the stockholders of the old bank end up owning shares of a business corporation whose only asset at first is the bank that existed before.  

This new form of organization permits the original bank to continue operating as before, even under its old name.

Ironically, the current OBHC concept was based in part on the U.S. Supreme Court's decision to strike down the proposed merger of Philadelphia National and Girard Trust in 1963. In that case the Court concurred with the Justice Department's contention that banking is a "unique line of commerce" and as such does not compete with nonbank financial institutions. Thus, bank acquisitions in other financial areas would not violate the antitrust laws. Banks could now acquire other businesses which they legally were not considered competing against.  

Holding companies linked to banks are not new, of course. Over the years many large corporations, such as Sears, Montgomery Ward, Baldwin Piano Company, Sperry and Hutchinson, and C.I.T. Financial Corporation, have acquired or established banks to diversify their activities. Pres-  

17 Paul S. Nadler, "The One-Bank Holding Company," Banking, LXI (December, 1968), 34.  
ently there are about 600 of these holding companies. In most cases, however, the banks constitute only a minor part of the corporation's activities or holdings. But in recent years, the pattern has been reversed. Now the banks are forming OBHCs and are the major affiliate of this new breed of holding companies.

The rush to form OBHCs is partly explained by the distinct advantages of this type of organization. First, it enables banks to overcome certain regulatory and supervisory restrictions. The Bank Holding Company Act of 1956 specifically exempts organizations owning only one bank from its provisions and related Federal Reserve regulations. While a registered bank holding company's affiliates may operate only in fields closely related to banking, such as factoring, safe deposit, lease financing, and mortgage servicing, the unregulated OBHC in theory can

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20 Union Bank of Los Angeles was the first major bank in the nation to form the new type of OBHC in late 1967. After Union Bank's move, numerous banks followed suit or announced plans to do so. Some of these banks are: First National City of New York, North Carolina National, Industrial National of Rhode Island, First Pennsylvania Bank, Citizens and Southern National Bank, La Salle National of Chicago, Omaha National Bank, and Southern California First National. A number of smaller banks also announced similar reorganization plans.

21 Some states, however, have laws that regulate or forbid OBHCs.
diversify into any kind of business, whether or not related to banking. But in practice, "it seems likely that most of the subsidiaries that will be acquired or created by the new companies will be engaged in providing financial services of one type or another."22

Secondly, the OBHC permits greater flexibility in raising capital and in improving leverage than that available for a conventional commercial bank. If the latter intends to raise its capital, it may be informed by bank examiners that:

... it must utilize equity capital or that it can only have a certain percentage of debt capital in its structure. The result is that the amount of leverage available is strictly limited and the bank must often dilute its equity to meet supervisory authorities' demands for increased capital.23

A OBHC, however, can borrow as much as the capital market will lend it. By issuing debt at the holding company level in exchange for the affiliate-bank's capital stock, the affiliate's excess capital is reduced and overall organizational leverage is increased.

Thirdly, the OBHC structure makes geographic expansion easier. Banks confined to a single state or subdivision thereof may expand their banking operations nationwide

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23Nadler, "The One-Bank Holding Company," p. 35.
through OBHCs if they so desire. Finally, the OBHC structure may improve investors' opinions of bank stocks. For many years bank stocks have been selling at conservative price earnings ratios. But the prospect of diversification via the OBHCs has been hailed by some stock market observers as tomorrow's "preferred conglomerate" and a new growth investment concept.

The OBHC structure is not without its drawbacks. The Justice Department is reported to be routinely scrutinizing this new banking development for any possible antitrust violations. On two occasions the Justice Department has brought action against commercial banks it felt were violating antitrust laws. "Justice argued in each case the proposed acquisition would eliminate potential competition between the two firms and would tend substantially to lessen competition." Thus, it would appear that the Department will vigorously enforce the antitrust laws and bring action against any substantial expansion via the one-bank holding company formation.

The OBHC's development has created a number of major

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controversial issues. One concerns the question of whether or not such institutions should be regulated. Some of the pros and cons of regulation are presented below.

Chairman Wright Patman (D.-Texas) of the House Banking and Currency Committee has been a strong advocate in favor of extending Federal regulation over OBHCs. In 1969 he introduced a bill, H.R. 6778, which would remove the OEHC's exemption from government regulation. The bill proposed changing "the law to transfer to the Federal Reserve Board regulation of national banks and insured nonmember banks which are subsidiaries of bank holding companies." Patman's bill would require all insured banks to disclose to the SEC quarterly information regarding securities held in their trust departments.

Rep. Patman, in arguing for OBHC regulation, listed some potential dangers of the holding company structure:

1. Unsound lending decisions by banks feeding unwarranted amount of credit to nonbank subsidiaries of the holding company.

2. Loan discrimination by banks in favor of enterprises owned by the holding company and against companies which compete with subsidiaries of the holding company.

3. Banks forcing borrowers, particularly small businesses, to purchase nonbanking services and goods from other subsidiaries of the holding company in order to obtain banking services, thus further tightening

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control and forcing a greater concentra-
tion of economic power.27

The Patman bill did pass in the House of Representa-
tives and the measure then moved into Senate conference. It is impossible at this writing to guess what kind of legislation will finally emerge. But there seems to be little doubt that some form of OBHC legislation will be forthcoming. The real question is, "How stringent will it be?"

Federal Reserve Board's Attitude

The FRB has always disapproved of the OBHC's exemption from the 1956 Bank Holding Company Act. Accordingly, the Board feels that regulation of OBHCs is essential and that banks should not become a part of a conglomerate.

The following summarizes the Board's views on the major issues:

1. Bank holding companies should be allowed to enter certain nonbanking areas specified in statute or agency regulation.
2. It would be most effective for one agency (preferably the Board) to admin-
ister the holding company act with respect to the approval of acquisitions by holding companies; but approval of acquisition of subsidiaries by individual banks should be dispersed among the three banking agencies.
3. Authority over multibank holding com-
pany acquisitions of banks and of nonbanking

activities should remain vested with the Board.\textsuperscript{28}

The Board also believes that OBHCs in existence prior to the recent OBHC trend should receive special consideration.

The Comptroller's Position

"The Comptroller's Office reports that, to date, it has encountered no abuses in the one-bank holding companies involving national banks that it could not deal with effectively and promptly, despite the fact that the current exclusion of one-bank holding companies from direct regulation has been rather commonly referred to as a 'loophole' in the law."\textsuperscript{29}

The Comptroller, therefore, has not been actively seeking new legislation like the FRB. Comptroller William Camp feels that as a supervisor he has all the tools he needs for regulating OBHCs and their affiliate banks. Mr. Camp has said that having adequate controls is not the real issue that concerns those who favor the regulation of OBHCs. "What does concern them is the desire to retard the expansion of banks into related financial fields by blocking the use of one of the more effective devices that may be utilized for this purpose."\textsuperscript{30}

\textsuperscript{28}Bratter, "Legislation Proposed," p. 110.

\textsuperscript{29}Ibid., p. 112.

Comptroller Camp favors giving bankers broad discretion in selecting the services they wish to offer. For example, he approves of banks offering travel services, an old and traditional banking activity. He foresees no harm to the public interest by bank diversification provided that the OBHCs maintain their solvency and liquidity and confine their efforts to the related fields of finance.

The FDIC's Comments

The FDIC agrees that OBHC regulation is desirable and concurs with the FRB on the major aspects of the proposed legislation.

In an address on February 20, 1969 FDIC Chairman Randall made the following comments relative to OBHC regulation:

Definition of the permissible types of activities for one-bank holding companies is perhaps one of the thorniest questions that has been presented to the supervisory authorities by this development.... I think banks should be oriented to supplying services to the nation of a financial nature that are consistent with--and properly related to--the business of banking.

The Federal Reserve Board was charged with the responsibility for supervising multibank holding companies under the Bank Holding Company Act of 1956. It seems to me that it is appropriate to have a single supervisor at the Federal level to deal with the multibank situation. On the other hand, to minimize disruption of present supervisory relationships, it would be desirable for one-bank holding companies to be brought
under the supervision of the agency that presently has jurisdiction over the bank.31

The diversification of activities attainable through the OBHC structure has given the banking industry new dimensions. Undoubtedly, bank reporting practices will be altered as banks broaden their scope of operations in future years.

There was a time when the balance sheet was considered to be an instantaneous picture of an enterprise's financial condition. In many cases it was the only financial statement published since the income statement was regarded as confidential. Yet, today the balance sheet is generally considered less important than the income statement for nonbanking businesses. It has been called a "statement of residuals," implying that its only function is the listing of balances remaining to be charged or credited against results of future periods of operations.

This "residuals" concept applies, however, only to a small part of the bank's assets and liabilities. The liquidity and solvency of a bank is a matter of public interest and "requires that banks take more than usual care that their assets and liabilities are properly classified, properly described, and properly valued."  

The most distinctive characteristic of a bank's statement of condition, as compared with those of nonbanking

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industries, is the absence of a segregation of assets (resources) and liabilities into current and noncurrent categories. This disclosure policy, however, seems entirely appropriate when one considers the nature of a bank's assets and liabilities. "Except for bank premises and equipment and any long-term debt, the assets and liabilities are generally not susceptible to classification as current or noncurrent."²

Table VII on the following page presents a balance sheet for the entire commercial banking system except for noninsured banks. We will now comment briefly upon the accounting for and reporting of the major classes of bank assets, liabilities, and capital accounts.

**Assets**

**Cash.** "Cash" includes four major items. They are as follows:

1. **Vault cash consists of coins and currency on hand in the bank's vault.** It earns no income. Consequently, banks try to keep this item at the minimum level needed to meet their depositors' requests.
2. **Statutory reserves held on deposit with the Federal Reserve, correspondent banks, or other authorized reserves agents also make up part of the cash account balance.**

## TABLE VII

**ASSETS AND LIABILITIES OF ALL INSURED COMMERCIAL BANKS**  
December 31, 1968  
(Amounts in thousands of dollars)

### ASSETS

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash, balances with other banks and cash collection items</td>
<td>$84,004,881</td>
</tr>
<tr>
<td><strong>Securities</strong></td>
<td></td>
</tr>
<tr>
<td>U.S. Government obligations</td>
<td>$64,685,769</td>
</tr>
<tr>
<td>Obligation of States and subdivisions</td>
<td>$58,732,147</td>
</tr>
<tr>
<td>Securities of Federal agencies and corporations</td>
<td>$10,267,943</td>
</tr>
<tr>
<td>Other securities</td>
<td>$2,769,996</td>
</tr>
<tr>
<td>Loans and discounts, gross</td>
<td>$273,342,909</td>
</tr>
<tr>
<td>Banks premises, furniture and fixtures, and real estate—net</td>
<td>$7,015,191</td>
</tr>
<tr>
<td>All other miscellaneous assets</td>
<td>$9,045,078</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>$504,637,017</td>
</tr>
</tbody>
</table>

### LIABILITIES

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business and personal deposits</td>
<td>$364,112,765</td>
</tr>
<tr>
<td>Government deposits</td>
<td>$41,590,854</td>
</tr>
<tr>
<td>Domestic interbank deposits</td>
<td>$23,452,731</td>
</tr>
<tr>
<td>Foreign government and bank deposits</td>
<td>$8,332,452</td>
</tr>
<tr>
<td><strong>Total deposits</strong></td>
<td>$437,488,802</td>
</tr>
<tr>
<td>(Demand</td>
<td>$230,523,917</td>
</tr>
<tr>
<td>(Time</td>
<td>$206,964,885</td>
</tr>
<tr>
<td><strong>Other liabilities</strong></td>
<td>$29,986,478</td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td>$467,475,280</td>
</tr>
</tbody>
</table>

### CAPITAL

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital accounts</td>
<td></td>
</tr>
<tr>
<td>Capital notes and debentures</td>
<td>$2,159,520</td>
</tr>
<tr>
<td>Preferred Stock</td>
<td>$94,917</td>
</tr>
<tr>
<td>Common Stock</td>
<td>$9,921,928</td>
</tr>
<tr>
<td>Surplus</td>
<td>$16,371,220</td>
</tr>
<tr>
<td>Undivided Profits and Reserves</td>
<td>$8,614,152</td>
</tr>
<tr>
<td><strong>Total Liabilities and Capital</strong></td>
<td>$37,161,737</td>
</tr>
<tr>
<td><strong>Total Liabilities and Capital</strong></td>
<td>$504,637,017</td>
</tr>
</tbody>
</table>

3. Deposits in other commercial banks are treated as "cash." Such deposits may bring no income directly but are maintained to establish a line of credit for present or possible future requirements.

4. The fourth is "cash items in the process of collection." Each bank will include here checks on banks which it has received from its depositors and which it has sent for payment (collection) but for which it has not yet received funds. Despite the development of excellent facilities for speeding the movement of checks, the total in collection at any one time is substantial.\(^3\)

Included also are other items in process of collection, such as matured bond coupons.

The term "statutory reserves" in item two above deserves some explanation. Member banks of the Federal Reserve System must have reserves equal to a specified percentage of their deposits. "Until recently, only deposits with the Federal Reserve Bank counted toward the legal reserve requirements, but holdings of currency in the vaults of the banks now also are counted."\(^4\)

The original purpose of reserve requirements was to afford some protection for depositors by forcing banks to maintain a reasonable degree of liquidity. "Now they are

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generally considered to be a control device through which the Federal Reserve can influence the monetary system. 5

**Investment Securities.** "Investment securities" make up a second major group of bank assets. Most banks' securities are Federal government obligations. Nevertheless, some obligations of states and localities or corporate debt will be found among the assets of many banks.

Commercial banks must consider three factors in making their investments: safety, liquidity, and profitability. These factors often create investment problems for commercial bankers. For example, those assets which are the most liquid generally provide the lowest yields and vice versa.

Although all business firms face the basic problem of balancing the needs for liquidity and profitability, the problem is particularly acute for bankers. One reason for this can be observed by comparing banks' balance sheets with the balance sheets of nonbanking enterprises. The latter invariably have capital comprising a much greater proportion of the equities side of the balance sheet. As one writer commented:

... the capital accounts of commercial banks average less than 10% of their deposit liabilities. Only a slight depreciation in the value of assets

5Ibid.
could make a commercial bank technically insolvent, i.e., reduce the value of its assets below the level of its liabilities.\textsuperscript{6}

Furthermore, whereas nonbanking institutions' liabilities are due at specified times in the future, a bank's liabilities, for the most part, are subject to payment on demand. For these reasons the financial management of commercial banks has traditionally been conservative. This conservative attitude often affects the manner in which commercial banks report investment transactions. This important aspect of bank reporting, however, is discussed in Chapter VI.

**Loans And Discounts.** The largest single group of bank assets is loans. Making loans is the heart of a bank's activities and is its major source of revenue. Bank loans, which are usually due within a year, may be classified according to that presented in Table VIII on the following page.

A detailed classification of loans is very useful for analytical purposes when compared to a single figure for "Loans and Discounts" as shown by many banks in their "condensed" statement of condition. Some 78% of the banks responding to the writer's survey indicated that they report loans as one condensed figure on the balance sheet,

\textsuperscript{6}Ibid., p. 105.
TABLE VIII

CLASSIFICATION OF LOANS AND DISCOUNTS
OF ALL COMMERCIAL BANKS
December 31, 1968
(Amounts in thousands of dollars)

<table>
<thead>
<tr>
<th>Loans and discounts, gross—tootal</th>
<th>$273,342,909</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real estate loans</td>
<td>65,696,232</td>
</tr>
<tr>
<td>Loans to commercial and foreign banks</td>
<td>2,206,944</td>
</tr>
<tr>
<td>Loans to other financial institutions</td>
<td>13,784,510</td>
</tr>
<tr>
<td>Federal funds sold</td>
<td>6,747,333</td>
</tr>
<tr>
<td>Loans to brokers and dealers in securities</td>
<td>6,625,467</td>
</tr>
<tr>
<td>Other loans for carrying securities</td>
<td>4,114,267</td>
</tr>
<tr>
<td>Loans to farmers (excluding real estate)</td>
<td>9,732,847</td>
</tr>
<tr>
<td>Commercial and industrial loans</td>
<td>98,970,808</td>
</tr>
<tr>
<td>Other loans to individuals</td>
<td>58,638,265</td>
</tr>
<tr>
<td>All other loans</td>
<td>6,826,236</td>
</tr>
</tbody>
</table>


As shown in question 15 of the Appendix. Only 20% stated that they classify their loans according to the type of customer, thus giving the reader a description of the types of loans in the portfolio.

Other important accounting and reporting practices associated with bank loans are discussed more fully in Chapter VII.

Bank Premises, Equipment, And Real Estate. Land, buildings, and equipment used by banks for their operations are generally classified in the "Bank Premises" account. The worth of such physical items is much smaller, as a percentage of assets, than it is for most nonbanking business firms.
Many banks in the past have arbitrarily written off or have written down their bank premises and equipment while pursuing a conservative public image. This practice not only results in an understatement of the bank's assets and capital accounts in a balance sheet presentation, but more importantly, it also relieves future fiscal periods of proper depreciation charges. The AICPA Banking Committee has also found that:

In most cases, the resultant overstatement of operating earnings is aggravated by the income tax treatment of the transactions. For tax purposes, the write-downs are ignored and depreciation is claimed on the basis of cost. Accordingly, in addition to being relieved of depreciation charges, future fiscal periods benefit from the reduction in taxes resulting from depreciation deductions not reflected in the financial statements.7

Another practice followed by banks, previously quite prevalent but now subsiding, has been to charge furniture, fixtures, and equipment to operating expenses in the fiscal period in which the purchases were made. This also results in an understatement of the bank's assets and capital funds. The effect of this practice distorts the fair presentation of operating results. In those years in which purchase charge-offs exceed the amounts which would have been charged against revenue by a policy of

capitalization and depreciation, net operating income is understated.

Regulatory agencies were aware that neither of the above practices conformed to generally accepted accounting principles. Therefore, in 1964 the Federal Reserve Board and the FDIC instituted new regulations requiring the capitalization and depreciation of bank premises and equipment. These regulations stipulated that all fixed assets are to be reported at cost less accumulated depreciation. An exception is provided in the regulations with respect to acquisitions prior to January 1, 1960. If such assets have not been accounted for on the basis of cost less depreciation, they may be stated at book value as long as there is an accompanying footnote explaining the accounting basis of these properties.

The Comptroller of the Currency has issued regulations requiring the capitalization and depreciation of fixed assets which differ from the FRB and FDIC's regulations. The Comptroller's regulations require that fixed assets purchased after June 30, 1967 be carried on the basis of cost less depreciation.

The recommendations of the AICPA Committee on Bank Accounting and Auditing are all inclusive and are not limited to assets acquired after a certain arbitrary date, as was the case with the regulations promulgated by the three Federal regulatory agencies. "In those instances
where properties have been arbitrarily written down or have been expensed at time of purchase and are still being used for the purpose for which acquired, the Committee believes that they should be reinstated in the accounts at cost, less accumulated depreciation to date of reinstatement, with an offsetting credit to the undivided profits account." ⁸

According to the writer's survey, many bankers do not concur with the Committee's recommendation concerning reinstatement of written-down assets. As shown in question 6 of the Appendix, 78% of the total respondents indicated that they would not favor such actions. The smaller banks were overwhelmingly against any reinstatement of written-down assets.

Even though most bankers in the survey do not wish to reinstate any assets, the results of questions 19 and 20 indicate that there appears to be a diminishing use of the extreme conservative practices of fixed asset write-downs and write-offs. Nearly 75% of the total respondents to question 20 of the Appendix stated that their buildings are disclosed on the balance sheet at cost less accumulated depreciation. Some 21% of the smaller banks responding, however, are still reporting their fixed assets at nominal values. Responses to question 19 reveal the trend away

⁸Ibid., p. 50.
from excessive conservatism. Only 20% of the respondents apply occasional write-offs of fixed assets in addition to the regular depreciation charges.

Sometimes bank properties are owned by an entity not associated with the bank and are occupied by the bank under a lease arrangement substantially equivalent to an installment purchase. Regarding this matter, Opinion No. 5 of the AICPA Accounting Principles Board states:

Leases which are clearly in substance installment purchases of property should be recorded as purchases. The property and the obligation should be stated in the balance sheet at an appropriate discounted amount of future payments under the lease agreement.9

There is no apparent reason why this opinion is not applicable to commercial banks. Therefore, those banks which are not currently reporting leasehold assets and liabilities should be required to conform to generally accepted accounting principles.

Liabilities

The largest bank liability is its depositors' balances. These deposits are ordinarily classified as "Demand Deposits" and "Time and Savings Deposits." Demand deposits are payable whenever the depositor demands payment, while the

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bank has a legal right to wait thirty days before making payment on its time deposits. Consequently, the reserve requirements that must be kept against time deposits are much less than those for demand deposits. Banks also pay interest on time deposits but not on demand deposits.

Remaining liabilities, as a rule, are relatively small in total though not unimportant. Some banks which are members of the FRS have a liability disclosed on the balance sheet designated "Federal Funds Purchased." A bank acquires this liability by borrowing another member's excess deposits in the Federal Funds market to build up its own reserves which are below the legal requirement.

Miscellaneous liabilities include such items as reserves for securities and loan losses, unearned discounts, taxes payable, and interest payable on time deposits or borrowed funds.

Capital Accounts

The capital funds section of a bank's statement of condition basically includes capital stock (common), surplus, and undivided profits. It may also include contingency reserves, capital notes or debentures, and preferred stock accounts.

Capital Notes. Traditionally, commercial banks have obtained capital funds by means of equity financing. In
recent years many banks, particularly major banks and bank holding companies, have been issuing debt securities to obtain additional needed capital.

Capital notes have varying maturities, rates, and terms depending on the size of the bank, its credit rating, and the market (local, regional, or national) in which the bank intends to sell its securities. These notes are generally long-term debt issues. Many have a final maturity of twenty years after issuance. Some are convertible into common stock but are almost always subordinated in right of payment to depositors' claims.\(^\text{10}\)

Most banks having outstanding capital notes disclose them in the capital funds section rather than in the liability section. Although these notes are debt obligations, this accounting treatment does appear appropriate since the notes have more of the characteristics of equity capital than of debt capital in comparison to other bank liabilities.\(^\text{11}\) However, "in those instances where the notes are not subordinated, they should be excluded from the capital funds section and should be included among the liabilities in the balance sheet."\(^\text{12}\)

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\(^{11}\)Committee of Bank Accounting and Auditing, *op. cit.*, p. 53.

\(^{12}\)Ibid.
The Comptroller of the Currency has similarly stated: "The proceeds of capital notes, capital debentures or similar obligations issued by a National Bank, which are subordinate in the right of payment to the prior payment in full of all deposit liabilities of the bank, may be included as part of the aggregate amount of unimpaired capital stock."\(^{13}\)

The interest on such debt securities is tax deductible for the issuing bank. Thus, these notes provide low-cost capital funds on an after-tax basis, as compared with equity capital, and afford tax-free leverage for owners of the bank's common stock.\(^{14}\)

**Capital Stock.** Commercial banks may issue preferred stock in addition to common. Insured commercial banks had about $0.9 billion of preferred stock outstanding as of December 31, 1968 compared to $9.9 billion of common stock. It is apparent that most banks prefer issuing


\(^{14}\)Leverage in bank stocks is nothing new. Bank common stocks traditionally have been highly leverage equities since a substantial portion of banks' funds are derived from deposits. The banking industry is characterized by a low profit margin on a large volume of business; yet the great leverage factor enables commercial banks to earn a respectable return on stockholder's investment. In 1967, for example, all insured commercial banks reported net income after taxes of only 0.75% on their total assets. But this meager return on total assets amounted to nearly 10% of total capital.
common stock.

Federal and state law prescribes minimum amounts of required capital. This minimum amount is usually related to the population of the place in which the bank is located. For national banks the provisions are as follows: $50,000 if the population is under 6,000; $100,000 if the population is from 6,000 to 50,000; $200,000 if the population exceeds 50,000. In addition, paid-in surplus must be equal to 20% of capital stock.

Although bank capital does protect the depositor against loss, it is also important for other reasons. As one writer stated:

The essential function of bank capital ... is to keep the bank open so that time and earnings can absorb losses; to inspire sufficient confidence in the bank on the part of depositors and the supervisor so that it will not be faced with costly liquidation. In this sense, capital serves to protect the stockholder as much as, if not more than, the depositor.15

The Banking Act of 1933 and subsequent amendments have essentially eliminated the "double liability" requirement formerly attached to bank capital stock. "Assessment liability, however, levied pro rata upon holders of common stock of still open and operating National Banks, to re-

store impairment in capital, still continues."16

**Surplus And Undivided Profits.** The "Surplus" account, as used by most banks in their financial statements, represents a combination of both capital surplus and earned surplus. Capital surplus is derived through the sale of capital stock, which is ordinarily issued at a premium, and by periodic transfers from income or undivided profits. These periodic transfers to the surplus account are in compliance with statutory requirements. For instance, national banks must have surplus equal to 20% of their outstanding capital stock before they are permitted to declare dividends on common stock.

Regardless of its source, banks consider the surplus balance as part of its permanent capitalization. The AICPA Banking Committee believes that:

> Since the entire surplus balance is considered to constitute a part of a bank's permanent capitalization, there appears to be no compelling reason for segregating it in the financial statements into its capital and earned components. Such segregation, however, might constitute an informative, though not essential disclosure. In any event, the balance in undivided profits account should be stated separately from that in the surplus account.17

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16Garcia, op. cit., p. 43.
17Committee on Bank Accounting and Auditing, op. cit., p. 54. See also John H. Myers, "Accounting for Bank Capital," *Auditgram*, XLI (September, 1965), 8-11.
The "Undivided Profits" account is used to record the net income or net loss for the period, dividend payments, unusual losses, and all other changes in capital that do not involve the capital stock or surplus accounts. This account has often caused confusion for stockholders analyzing the balance sheets of newly organized banks. These banks frequently, in accordance with the suggestions of regulatory agencies, transfer to the undivided profits account a portion of the initial paid-in surplus. Thus, it is possible for the bank to have undivided profits even before it is open for business. The purpose of such transfers is to avoid having a deficit in the undivided profits account during the early, usually unprofitable, periods of a bank's existence.

This practice is not often found in other industries and would ordinarily constitute a departure from generally accepted accounting principles. Where such a transfer has been made, the AICPA's Banking Committee recommends that the undivided profits section of the balance sheet be presented in a manner which clearly shows the amount of paid-in capital therein and its reduction by accumulated losses. The Committee also believes that the amount of paid-in capital included in undivided profits accounts should be restored to the surplus account as rapidly as profitable operations permit.18

18 Ibid., pp. 54-55.
Even though there have been significant changes in the banking business in the last two decades, some of the old terminology still persists today. In some cases, its use does not result in proper and adequate disclosure. "Undivided Profits," for example, has been charged as being a misnomer.¹⁹

Most readers of banks' balance sheets would look upon undivided profits as the retained earnings of a bank. This, however, is not completely accurate and has probably led to some misconceptions. Undivided profits is basically that amount regulatory authorities permit a bank to declare as dividends without restriction. As stated previously, portions of capital surplus are allowed to be transferred into undivided profits. Also, undivided profits can be reduced by transfers to surplus to build up the permanent capital of the bank.

The bank's stockholder should not be misled into thinking that undivided profits is the same as retained earnings. Any transfers to and from undivided profits should be adequately explained in notes to the bank's financial statements.

Many banks commonly disclose accrued liabilities as accrual reserves. It would be preferable for banks to use a title similar to "Accrued Taxes Payable" rather

¹⁹Claude R. Erickson, "What's Wrong With 'Undivided Profits'?" *Banking*, LV (January, 1963), 54.
than an account titled "Reserve for Taxes."

Another major criticism of the statement of condition is that in many cases the basis of valuation of the principal assets is not shown on the statement nor described in the accompanying text. While most industrial firms disclose their fixed assets at cost less accumulated depreciation, it is a rare bank that shows in its statement of condition anything except the net amount of the bank premises, furniture, and fixtures.20 This fact was substantiated in the results of the writer's survey. As shown in question 17 of the Appendix, 76% of the total respondents stated that their bank did not disclose the basis of valuation of its premises and equipment for the stockholders.

The market valuation of bank securities is seldom disclosed in the reports to stockholders.21 When asked their opinions regarding the disclosure of the market value of bank securities, nearly 60% of the total respondents answered that they are against this reporting practice. As shown in question 5 of the Appendix, only 26% of the small banks favored revealing market values. It seems that in the interest of informative reporting this

20Henry P. Hill, "Tailoring Banks' Annual Reports for Both Depositors and Stockholders," Banking, LI (April, 1959), 40.

In an effort to eliminate the aforementioned criticisms involving the statement of condition, representatives of the banking industry, the Federal regulatory authorities, the Securities and Exchange Commission, and the AICPA met in 1969 for a series of discussions. The statement of condition shown in Table IX on the following page was considered suitable for inclusion in annual reports to stockholders by the group.

There is much information to be obtained from the bank's statement of condition. Understandably, this statement is considered important by the bank's depositors and shareholders. With proper classification and accurate terminology, the value of this statement can be substantial.

**Capital Funds Statement**

The capital funds statement as presented by most banks is similar to a statement of retained earnings of nonbanking organizations. Some statements, however, present only transactions affecting total capital funds and exclude those transactions wholly effected within the capital funds accounts.

The results of the writer's survey indicated that many banks do include the capital funds statement in their report to stockholders. Of the total responding banks, 76% indicated that they report a reconciliation of capital
# TABLE IX

**BALANCE SHEET FORMAT**  
**APPROVED BY REGULATORY AUTHORITIES**

<table>
<thead>
<tr>
<th>Assets</th>
<th>December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Current Year</td>
</tr>
<tr>
<td>Cash and due from banks</td>
<td>$9,000,000</td>
</tr>
<tr>
<td>Investment securities:</td>
<td></td>
</tr>
<tr>
<td>U.S. Government obligations</td>
<td>4,000,000</td>
</tr>
<tr>
<td>Obligations of states and political subdivisions</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Other securities</td>
<td>150,000</td>
</tr>
<tr>
<td>Loans</td>
<td>18,442,000</td>
</tr>
<tr>
<td>Stock of Federal Reserve Bank</td>
<td>67,500</td>
</tr>
<tr>
<td>Bank premises and equipment</td>
<td>360,000</td>
</tr>
<tr>
<td>Accrued interest receivable and other assets</td>
<td>152,500</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$34,172,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>December 31</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Current Year</td>
</tr>
<tr>
<td>Demand deposits</td>
<td>$22,300,000</td>
</tr>
<tr>
<td>Savings deposits</td>
<td>4,260,000</td>
</tr>
<tr>
<td>Other time deposits</td>
<td>4,000,000</td>
</tr>
<tr>
<td><strong>Total deposits</strong></td>
<td>30,560,000</td>
</tr>
<tr>
<td>Borrowed funds</td>
<td>100,000</td>
</tr>
<tr>
<td>Accrued taxes and other expenses</td>
<td>220,000</td>
</tr>
<tr>
<td>Other liabilities</td>
<td>60,000</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td>30,940,000</td>
</tr>
<tr>
<td>Reserve for loan losses</td>
<td>442,000</td>
</tr>
<tr>
<td>Capital funds:</td>
<td></td>
</tr>
<tr>
<td>Capital stock</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Surplus</td>
<td>1,250,000</td>
</tr>
<tr>
<td>Undivided profits</td>
<td>540,000</td>
</tr>
<tr>
<td><strong>Total capital funds</strong></td>
<td>2,790,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$34,172,000</td>
</tr>
</tbody>
</table>

accounts to the stockholders. As shown in question 24 of the Appendix, the majority of each class answered this question on an affirmative basis.

For full disclosure purposes, it would appear that either all transactions affecting capital accounts should be disclosed in the capital funds statement or "a statement of undivided profits should be presented, with any changes in other capital funds accounts appropriately disclosed in a separate financial statement, in footnotes to the financial statement, or in some other manner."\(^{22}\)

CHAPTER V

REPORT OF EARNINGS

Bank earnings serve to protect the stockholder's investment in times of economic adversity. Bank earning power has proven to be the first line of defense against the risks inherent in banking. "Even the staggering losses of the 1930s were ultimately absorbed out of earnings when banks were not forced into liquidation."¹

We will now examine the statement of earnings issued by commercial banks for stockholders and review some of the basic underlying concepts employed in its preparation and presentation.

Accounting Basis

Most of the nation's smaller banks still maintain their records on a cash or partial cash basis. The ease of cash basis recording has probably perpetuated this type of accounting system. A great many banks, however, have recognized the deficiencies of the cash basis especially as it applies to certain accounting areas, such as the recording of income from securities and installment loans.

As a consequence, accrual systems have evolved within these institutions. The extent to which a bank adopts an accrual accounting system may vary from the accrual of only the major income and expense items (interest income and interest expense) to the accrual of every income and expense item.

Accrual accounting is an accounting system which gives recognition to income and expenses in the period to which they relate. Income is recorded during the period earned, regardless of when collected, and expenses are recorded when incurred, regardless of when paid. The basic purpose of accrual accounting is the "matching" of income and expenses in the applicable accounting period.

Advantages Of Accrual Accounting

The advantages of an accrual basis system are many. If either income or expenses fluctuate widely, accrual accounting information is especially meaningful. By leveling out the peaks and valleys of income receipts and expense payments, a more accurate picture of a bank's financial operations is presented. This is obviously beneficial to depositors, shareholders, potential investors, and bank supervisors.

Some banks have recognized the deficiencies of the cash basis, especially as it applies to income from securities. Recording interest income only when it is collected,
rather than when earned, produces substantial fluctuations in monthly operating earnings reports. These distortions exist since banks receive interest payments in irregular patterns. In some months a bank may receive significant interest payments, while in other months that same bank might receive relatively few payments or possibly none.

Cash accounting would make it appear that in some months no interest was earned even though a bank did have interest-bearing securities in its investment portfolio. The fact that the bank has not received cash is misleading as a criterion for income determination. As one writer put it:

> When operating statements fail to reflect significant portions of income as it is earned ..., their usefulness must be questioned. It might safely be said that more often than not, such statements only result in considerable confusion, particularly when they are prepared on a basis designed to compare one accounting period with another.2

Accrual accounting is also helpful for banks preparing budgets. It provides a realistic estimate of income and expense items, thereby permitting a reasonable comparison of one accounting period with another. Trends are sooner revealed and more clearly defined. "Monthly comparative reports of income and expense are easily related to the balance sheet and afford better managerial control of the

---

major income-producing functions." Thus, bank management can quickly take corrective steps to bring actual operating results back in line with budget estimates.

In addition, the accrual system is an adjunct to an effective internal audit system. In recognizing income when earned, the bank automatically establishes a check upon future cash receipts. Conversely, an expense recorded when incurred creates a liability which provides a basis for a disbursements control. These independent calculations of income and expense are a control feature that can strengthen a bank's audit program.

 Probably one of the major reasons most smaller banks have not adopted the accrual method is their apprehensive attitude concerning costs necessary to maintain the system. Yet, accrual accounting is not as burdensome and complicated as it may appear to these banks. For the many banks with assets under $25 million, monthly accrual would be adequate. Only the larger banks need to accrue daily. Moreover, most banks find it necessary to accrue only major items of income and expense. For example, the major expense items, such as interest on deposits, prepaid insur-


4"Banks and Accrual Accounting," Banking, LX (February, 1968), 48.
ance, property taxes, profit sharing or pension expense, bad debt provisions, Federal income tax, and depreciation, should be accrued by most banks.

Some banks, however, continue to use the cash basis of accounting as they feel that the disadvantages of the accrual system exceed its advantages. Of the banks responding to the writer's survey, only 56% stated that they were reporting on an accrual basis, as shown in question 22 in the Appendix. An additional 20% stated that they were on a hybrid basis (a combination of cash and accrual). Some 48% of those banks with less than $15 million in assets indicated they were on a cash basis accounting system.

Since there is a significant amount of divergence in the accounting system employed by banks of various sizes, it would seem that banks should indicate to readers of their financial statements the accounting basis used in the preparation of financial reports. Yet, as shown in question 26 of the Appendix, only 41% of the total banks responding to the survey stated that they inform the readers of the accounting system maintained for reporting purposes. It is interesting to note that of all the groups reporting, only Class II (banks with deposits of $99.9-$25 million) had a majority of its group informing the readers of the basis of accounting employed.

Although many small banks continue to use the cash basis, the number of large and medium size banks using the
accrual basis is increasing significantly. Undoubtedly, the increasing use of accrual accounting has been spurred on by the new supervisory requirements of the three Federal regulatory agencies.

**Supervisory Requirements**

Beginning in 1964 all commercial banks with $1 million or more in total assets and 750 or more stockholders were required to submit annual reports on an accrual basis. In 1969 the three Federal bank regulatory agencies revised their regulations pertaining to call reports and annual reports.

Under the new regulations, all insured banks must use an accrual basis for installment loan income in reports prepared subsequent to December 31, 1968. An alternative is offered in the regulations whereby banks may disclose, in a published memorandum to their reports of condition, the amount of unearned income on installment loans carried in undivided profits or other capital accounts. ⁵

Furthermore, all insured banks with total resources of $50 million or more were required to prepare their 1969 call reports of income and financial condition on an accrual basis. Beginning January 1, 1970 all insured banks with total assets of $25 million or more must prepare their

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⁵"The Revised Condition and Income Reports," *Banking*, LXI (June, 1969), 32.
reports on an accrual basis. A regulatory exclusion clause, however, states that:

... where the results would not be significantly different, these banks may use a cash basis of reporting for particular accounts. And, at the option of the reporting bank, trust department income may be reported on a cash basis.6

In compliance with another requirement, all insured banks must use an accrual basis for the current year's tax provisions for reports issued after December 31, 1968. These banks are required to report their income tax liability on a current basis with the accrued tax liability allocated between current operating earnings and nonoperating adjustments.7

Proper income tax allocation is certainly important in arriving at a meaningful net income figure. Misleading financial reports can result from improper tax allocation procedures. Consider the bank that reports negligible income taxes against substantial pre-tax net operating earnings.8


7A bank may remain on a cash basis for Federal income tax purposes even though a banking regulatory agency requires it to change its books and records to an accrual basis. Yet, the taxpayer must keep permanent books and records which will support the determination of taxable income and which reconcile the tax accounting method with the book accounting method.

8For example, one income statement which the writer received disclosed pre-tax net operating earnings at $909,531. Yet, there were no applicable income taxes reported on these operating earnings. Furthermore, there was no explanation in the report explaining this apparent inconsistency.
Sound reporting requires that "the tax allocation in the operating statement be based ... upon the items of revenue and expense that enter into the determination of net operating earnings."\(^9\)

The issuance of disclosure regulations by the Federal Reserve Board, the FDIC, and the Comptroller of the Currency requiring general adherence to accrual accounting principles by banks has done much to encourage the use of accrual accounting systems. Although some bankers may look upon the new reporting requirements with apprehension, accrual accounting will provide more meaningful financial statements and operating information for both stockholders and management.

**Income Statement Form And Content**

A comprehensive statement of earnings is essential to the fair presentation of a commercial bank's financial condition and the results of its operations. Proper form and content of the bank's income statement are necessary prerequisites for fair and adequate disclosure.

**Consolidation Of Subsidiaries**

Prior to 1964 very few of the nation's banks prepared consolidated financial statements. A survey of 50 large

banking organizations' 1963 annual reports revealed that only 5 of these organizations consolidated subsidiaries in their financial statements. The survey also revealed that investments in subsidiaries were usually stated at cost (or less) in the bank's financial statements.

The Securities Acts of 1964 and the resulting regulations of the Federal Reserve Board and the FDIC urged many large banks to publish their annual financial statements on a consolidated basis. Regulation F requires that the operations of majority-owned bank premises subsidiaries and any other majority-owned "significant" domestic subsidiaries be consolidated by the parent bank when reporting to the FRB and FDIC. The regulation also stipulates that intercompany accounts and transactions should be eliminated for reporting purposes. For example, loans by a parent bank to a subsidiary or deposits in the parent bank by a subsidiary should not be included among assets and liabilities in any report in which the subsidiary's accounts are consolidated with those of the parent bank. However, "the accounts of domestic commercial banks that are subsidiaries of the reporting bank and which must file condition reports to any state or Federal bank supervisory

authority should not be consolidated.\textsuperscript{11}

A "significant" subsidiary, according to Federal regulations, is one meeting either of the following tests:

1. Any majority-owned subsidiary in which the bank's investment represents 5% or more of the equity capital accounts of the parent bank, or
2. Any majority-owned subsidiary whose gross operating revenues amount to 5% or more of the gross operating revenues of the parent bank.\textsuperscript{12}

Any majority-owned domestic subsidiary not meeting the above significance test may be consolidated at the option of the reporting bank, as long as a consistent consolidation policy is followed in subsequent reports. Also, every majority-owned foreign banking subsidiary must be consolidated with that of the reporting bank, irrespective of whether it is a significant subsidiary.

The most common type of subsidiary company in the banking industry is the so-called "bank-premises subsidiary." It has been noted that in the past:

... where a subsidiary was utilized to hold title to all or part of the bank's premises, the investment in the subsidiary was frequently included in the amount captioned as bank premises in the bank's balance sheet. Any outstanding mortgages on the properties


\textsuperscript{12} Ibid.
accordingly did not appear on the bank's balance sheet.13

Thus, failure to consolidate the bank-premises subsidiary resulted in financial statements which were not on a comparable basis with those prepared by a bank directly owning its premises.

Fortunately, current regulations require all insured commercial banks to consolidate every majority-owned, bank-premises subsidiary for reporting purposes. These subsidiaries should also be consolidated in accordance with generally accepted accounting principles. As Opinion No. 10 of the Accounting Principles Board states: "The accounts of all subsidiaries (regardless of when organized or acquired) whose principal business activity is leasing property or facilities to their parents or other affiliates should be consolidated."14

Consolidated statements generally present more meaningful information to the investor than unconsolidated statements. Most accountants would probably agree that in the majority of instances such statements are essential to a fair presentation of financial position and results.


of operations. Yet, according to the writer's survey a number of bankers still have some reservations about the usefulness of consolidated statements. As shown in question 3 in the Appendix, 67% of the total respondents felt that their bank's financial statements should be prepared on a consolidated basis. However, of all the questions in the survey, this question had the largest percentage of non-response answers. Apparently, some bankers are not quite certain about all the advantages and disadvantages of consolidated statements.

Nevertheless, there appears to be no logical reason why the principles of consolidation are not wholly applicable to the financial statements of banks.

"All-Inclusive" Statement

Prior to 1964 the vast majority of banks followed the "current operating performance" concept in reporting their results of operations. The final amount shown on the earnings statement was designated "Net Operating Earnings." Excluded from the determination of this amount were such items as securities profits and losses and provisions for loan losses. No amount in either the income statement or the statement of changes in capital accounts was disclosed as "Net Income."

Yet, proponents of the "all-inclusive" income concept maintained that such items as loan-loss provisions and
securities profits and losses were directly related to normal operations and should be included in the determination of net income. Advocates of this theory felt that a single amount should be clearly designated as the net income for the period. They also stressed the dangers of possible manipulation of annual earnings figures if such items were omitted from the determination of net income.

Regulation F, issued in late 1964, represented a compromise between the two opposing philosophies. It required the inclusion of loan-loss provisions and securities profits and losses in a "non-operating additions and deductions" section of the income statement following the amount designated as "Net Operating Earnings." The final figure on the income statement was captioned "Transferred to Undivided Profits." In effect, the required presentation constituted an "all-inclusive" income statement but avoided the designation of any figure as net income. Some observers felt that the provisions of Regulation F were not completely adequate. They stated that loan losses and security transactions should not be recorded below the net operating line as stipulated in Regulation F.

In 1966 the groundwork was established for an all-inclusive bank income statement when the Accounting Principles Board of the AICPA issued Opinion No. 9. The
Board concluded that "net income should reflect all items of profit and loss recognized during the period."\textsuperscript{15} The opinion, however, specifically exempted banks from reporting an all-inclusive net income figure until a further study was completed. In 1969 the exemption was withdrawn with the issuance of APB Opinion No. 13. This opinion requires banks to report earnings on an "all-inclusive" basis and subjects commercial banks to Opinion No. 9. These new provisions require banks to deduct a provision for loan losses and recognize realized gains or losses on security transactions as part of reported net income.

Since a large number of banks do not have audits performed by CPAs, the pronouncements of the APB did not directly affect their reporting practices. However, broad sweeping accounting and reporting revisions for the entire industry were announced in July, 1969 by the SEC, the three Federal bank regulatory agencies, the American Bankers Association (ABA), and the AICPA Committee of Bank Accounting. The revised regulations which were incorporated in the 1969 annual reports to stockholders are briefly summarized as follows:

1. Loan losses are to be treated as an operating expense. Any portion not allocable against current opera-

tions should be charged directly to the undivided profits account.

2. Net gains and losses on investment securities are to be reported after the computation of operating income. The securities transactions are to be reflected in the report of income for the period in which such results are realized.16

3. The last line in the income statement should be designated as "net income."

The new format changes a bank's income statement to a form more closely resembling that of other business enterprises. Table X, on the following page, illustrates the new disclosure regulations. One writer describes the major benefit of the new format as follows:

Even to a casual reader of financial statements, the revised format must seem more understandable. The income statement, before revision, did not clearly identify the net addition to shareholders' equity as net income.... The revised format of the income statement clearly discloses the impact of results of operations on shareholders' equity.17

Operating Income

There are three primary classifications of operating

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TABLE X

THE BANK OF NEW ORLEANS
Statement Of Income
For the year ended December 31, 1969

<table>
<thead>
<tr>
<th>OPERATING INCOME</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest and Fees on Loans</td>
<td>$ 8,649,399</td>
</tr>
<tr>
<td>Income on Federal Funds Sold</td>
<td>403,813</td>
</tr>
<tr>
<td>Interest on Investments:</td>
<td></td>
</tr>
<tr>
<td>U.S. Treasury Securities</td>
<td>724,860</td>
</tr>
<tr>
<td>Other U.S. Agencies</td>
<td>194,556</td>
</tr>
<tr>
<td>Obligations of State and Political Subdivisions</td>
<td>526,263</td>
</tr>
<tr>
<td>Other Securities</td>
<td>11,557</td>
</tr>
<tr>
<td>Trust Department Income</td>
<td>24,601</td>
</tr>
<tr>
<td>Service Charges on Deposit Accounts</td>
<td>632,108</td>
</tr>
<tr>
<td>Other Service Charges</td>
<td>217,700</td>
</tr>
<tr>
<td>Other Operating Income</td>
<td>561,237</td>
</tr>
<tr>
<td><strong>TOTAL OPERATING INCOME</strong></td>
<td><strong>$ 11,946,094</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>OPERATING EXPENSES</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries and Wages</td>
<td>$ 2,487,523</td>
</tr>
<tr>
<td>Other Employee Benefits</td>
<td>267,446</td>
</tr>
<tr>
<td>Interest on Deposits</td>
<td>3,396,652</td>
</tr>
<tr>
<td>Expense of Federal Funds Purchased</td>
<td>912,400</td>
</tr>
<tr>
<td>Interest on Capital Notes</td>
<td>123,362</td>
</tr>
<tr>
<td>Occupancy Expense</td>
<td>452,883</td>
</tr>
<tr>
<td>Furniture and Equipment</td>
<td>464,368</td>
</tr>
<tr>
<td>Provision for Loan Losses</td>
<td>531,860</td>
</tr>
<tr>
<td>Other Operating Expenses</td>
<td>1,769,547</td>
</tr>
<tr>
<td><strong>TOTAL OPERATING EXPENSE</strong></td>
<td><strong>$ 10,406,041</strong></td>
</tr>
</tbody>
</table>

| Income Before Taxes and Securities Gains (Losses)     | $ 1,540,053 |
| Applicable Income Taxes                               | 506,150 |
| **Income Before Securities Gains (Losses)**           | **$ 1,033,903** |
| Net Securities Gains (Losses), Less Related Tax Effect of $22,850 | 68,607 |

| NET INCOME                                           | **$ 1,102,510** |

<table>
<thead>
<tr>
<th>EARNINGS PER SHARE</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Before Securities Gains (Losses)</td>
<td>$ 5.00</td>
</tr>
<tr>
<td>Net Income</td>
<td>$ 5.33</td>
</tr>
</tbody>
</table>
income reported in the comprehensive statements of earnings issued by most banks. They are: (1) interest and fees on loans, (2) interest and dividends on investments, and (3) other income. Information concerning the classification of operating income, as reported in 23 annual reports received by the writer from Louisiana banks, is disclosed in Table XI below.

Table XI

OPERATING INCOME CLASSIFICATION IN 1969 ANNUAL REPORTS

<table>
<thead>
<tr>
<th>Number of Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest and fees on loans (single caption)</td>
</tr>
<tr>
<td>Interest and dividends on investments:</td>
</tr>
<tr>
<td>Single caption</td>
</tr>
<tr>
<td>U.S. Government obligations</td>
</tr>
<tr>
<td>Obligations of State and political subdivisions</td>
</tr>
<tr>
<td>Other securities</td>
</tr>
<tr>
<td>Other U.S. Agencies</td>
</tr>
<tr>
<td>Federal Reserve Bank Stock</td>
</tr>
<tr>
<td>Other income:</td>
</tr>
<tr>
<td>Single caption</td>
</tr>
<tr>
<td>Service charges on deposit accounts</td>
</tr>
<tr>
<td>Interest on Federal Funds Sold</td>
</tr>
<tr>
<td>Trust Department Income</td>
</tr>
<tr>
<td>Other operating income</td>
</tr>
<tr>
<td>Other collection fees and charges</td>
</tr>
</tbody>
</table>

**Interest And Fees On Loans.** All the banks that sent an annual report disclosed the interest and fees on loans as a single caption. Interest on loans is the major source of income for banks and was appropriately listed as the
first item of income in all the annual reports received.

Some analysts feel that interest earned should be broken down into interest from mortgages and interest from loans. They argue that this sub-classification is desirable in order to determine what portion of a bank's income is derived from long-term mortgages. 18

This income account also includes interest on commercial paper purchased in the open market and interest on loan paper which has been rediscounted with the Federal Reserve and other banks.

Interest And Dividends On Investments. As shown in Table XI only 3 banks disclosed interest and dividends on securities held as one figure. The majority of banks classified their interest and dividends according to three sources: U.S. Government obligations, obligations of state and political subdivision, and other securities. Several banks also disclosed income received on Federal Reserve Bank stock and securities of other U.S. agencies. This latter classification includes income from all bonds, notes, and debentures of U.S. Government corporations and agencies, such as Export-Import Bank, Federal Intermediate Credit banks, Federal Land banks, Federal Home Loan banks, and Merchant Marine Bonds.

Other Income. Included in the classification of "Other Income" are: interest on Federal funds sold, service charges on deposit accounts, other collection fees and charges, trust department income, and other operating income. Only 2 banks disclosed other income as a single caption whereas 6 banks classified other income into the five categories mentioned above. Nearly 70% of the banks which sent annual reports disclosed income derived from service charges on deposit accounts.19

Interest on Federal funds sold was disclosed by 9 banks in the income statement. This interest represents income generated by the sale of excess reserves in the Federal funds market.

Other collection fees and charges include: commissions on the sale of insurance policies and collection of premiums; charges for collecting bills of public utilities and other firms; fees for negotiating loans for customers or correspondents; commissions on the underwriting and sale of securities as permitted by statute; servicing fees of real estate mortgages or other loans held by others; equipment leasing and rental fees; data processing service charges; and reimbursements received for services in redeeming United States

19Service charges may be levied against deposit accounts a variety of ways. Two common methods are: (1) a flat charge made against those accounts whose average balance falls below a fixed amount, and (2) charges based on the number of checks drawn and deposits made.
savings bonds. 20

Trust department income represents gross income from services rendered by the bank in any fiduciary capacity. The activities of a trust department include acting as executor and trustee under wills, trustee in personal and corporate matters, transfer agent and registrar. Most banks normally use the cash rather than the accrual basis of accounting for reporting trust department fees. "The reasons for such a policy are that in many cases the fees are collected only after a relatively long-term commitment has been completed or the fees to be received may not be determinable at the time the trust agreement is entered into." 21

Some 20 banks out of 23 sending annual reports classified a portion of their income as other operating income. Many banks use this category to report rentals on real estate temporarily held; income from safe deposit boxes; interest on time deposits with other banks; and regular operating credits, such as net tellers overages or forgery recoveries.


Operating Expense

Prior to 1965 commercial banks were sharply criticized for the insufficient information in the operating expense section of their income statements. The accused banks previously classified all of their operating expenses under one heading. By 1969 most banks had ceased using this condensed method of reporting. Major expense classifications found in many bank statements are helpful for a proper evaluation of the bank's activities by stockholders and prospective investors.

Salaries And Employee Benefits. All 23 banks submitting annual reports classified a portion of their operating expenses in the "Salaries And Employee Benefits" category. As shown in Table XII on the following page, 19 banks separately disclosed salaries and employee benefits in their income statement. This breakdown provides more useful information than a single caption.

Banks should also inform the stockholders of the available employee benefits. Yet, only 4 banks included any information about their pension plan. It would appear that this type of information should be adequately disclosed in a footnote to the statements explaining some provisions of the plan. "Pension costs should not be used as one bank president stated that he used his: 'To adjust my total expense so that the net income will be
what I want.22

TABLE XII

OPERATING EXPENSE CLASSIFICATION
IN 1969 ANNUAL REPORTS

<table>
<thead>
<tr>
<th>Category</th>
<th>Number of Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries and Employee Benefits:</td>
<td></td>
</tr>
<tr>
<td>Combined in single caption</td>
<td>4</td>
</tr>
<tr>
<td>Salaries &amp; Employee Benefits shown separately</td>
<td>19</td>
</tr>
<tr>
<td>Interest Expense:</td>
<td></td>
</tr>
<tr>
<td>On deposits and borrowed funds combined</td>
<td>15</td>
</tr>
<tr>
<td>On deposits and borrowed funds disclosed separately</td>
<td>8</td>
</tr>
<tr>
<td>Provisions for loan losses:</td>
<td></td>
</tr>
<tr>
<td>As an operating expense</td>
<td>17</td>
</tr>
<tr>
<td>As a nonoperating item</td>
<td>6</td>
</tr>
<tr>
<td>Other operating expenses:</td>
<td></td>
</tr>
<tr>
<td>Single caption</td>
<td>3</td>
</tr>
<tr>
<td>Net occupancy--Bank Premises</td>
<td>19</td>
</tr>
<tr>
<td>Equipment Rentals, Depreciation, and Maintenance</td>
<td>17</td>
</tr>
<tr>
<td>Expense of Federal Funds Purchased</td>
<td>5</td>
</tr>
<tr>
<td>Other Expenses</td>
<td>20</td>
</tr>
</tbody>
</table>

Interest Expense. This is the largest single cost item reported by most banks in the operating expense section. As shown in Table XII above, 15 banks disclosed interest on time deposits and borrowed funds as a single caption in their annual reports. As a minimum, banks should disclose the interest on deposits and borrowed funds.

funds separately. Further disclosure could be provided by classifying interest expense into two subcategories, such as interest on short-term and long-term debt. This breakdown would better inform the stockholders of how heavily the bank is engaged in either type of borrowing.

Provision For Loan Losses. In a 1968 survey of the annual reports issued by 96 of the nation's largest 100 banks, the provision for loan losses was disclosed by 92 banks as a nonoperating deduction in the income statement.23 Yet, most accountants would agree that this expense should be reported in the operating expense section since it is a normal, recurring expense of the banking business.

More and more banks are reporting the provision for bad debts as an operating deduction because of recently revised bank regulations mentioned previously. Table XII shows that 17 of the Louisiana banks sending 1969 annual reports disclosed the provision for loan losses in the operating expense section. Also, when asked whether the income statement of commercial banks should include as an operating expense a provision for loan losses, 85% of those banks responding to the writer's survey were in favor of this reporting method. Nearly 75% of the banks

with less than $15 million in assets were agreeable to such a move, as shown in question 8 in the Appendix.

More informative reporting is certainly achieved when a "reasonable" provision for loan losses based on management's careful evaluation is included as an operating expense in the income statement for stockholders.

Other Operating Expenses. Only 3 banks classified all of their other operating expenses into a single caption. Most of the banks submitting income statements reported the net occupancy expense of bank premises and the furniture and equipment expense. Some banks also disclosed the expense of Federal funds purchased in their operating expense section.

Net occupancy expense of bank premises represents the difference between rental income from bank premises owned by the bank or its consolidated building subsidiary, and gross occupancy expense. Gross occupancy expense usually includes: salaries and supplementary benefits of building employees; recurring depreciation and leasehold improvements; maintenance, repairs, and uncapitalized alteration costs of bank premises; all current expenses connected with the use of bank premises, such as the cost of heat, light, water, outside janitor services, fire insurance, and similar expenses; and all property and other taxes paid or accrued related to bank premises and
leasehold improvements.

Furniture and equipment expense includes: normal and recurring depreciation charges applicable to the particular assets; the rental cost of office machines; ordinary repairs to furniture and equipment; and the cost of furniture and equipment not placed on the books as an asset.

Twenty of the banks disclosed a portion of their operating expenses as "Other Expenses." Expenses in this category are: fees paid to directors; premiums on fidelity insurance; office supplies bought; cost of examinations by supervisory authorities; retainer fees; losses from counterfeit money, forged checks or net cash shortages; and deposit insurance assessments.

Net Securities Gains Or Losses

In 1969 supervisory authorities decided that banks must disclose the net results of all securities profits and losses realized during the year. This disclosure must be reported below "Income before securities gains or losses," as shown in Table X. Previously, most banks followed the practice of transferring gains and losses on securities transactions directly to undivided profits or to a general security reserve account. This procedure, however, permitted the effect of such transactions to completely bypass the income statement. Thus, the revised
regulations definitely require more informative reporting standards in this area than in the past.

Securities profits or losses arise from the sale, exchange, redemption, or retirement of bonds and other securities at prices above or below book values. These securities gains and losses represent adjustments of yields on investments and, ideally, should be included in the net operating earnings proportionately over the holding period of the investments.

The accounting and reporting problems unique to bank securities are discussed in much greater detail in the following chapter.

Extraordinary Charges Or Credits

The effects of material events and transactions not related to prior periods are required to be disclosed in the nonoperating section of the income statement according to bank regulations. These material events must be of a character significantly different from the bank's customary activities. Some examples of these events are: (1) material gains or losses from the sale or abandonment of buildings or premises, and (2) gains or losses from a major revaluation of a foreign currency.

Similar to the requirements issued by the Federal banking authorities, Opinion No. 9 of the APB states: "Extraordinary items should be segregated from the results
of ordinary operations and shown separately in the income statement, with disclosure of the nature and amounts thereof."^{24}

Net Income

After disclosing the extraordinary items, if any, "Net Income" is derived. This new disclosure policy clearly identifies the net results of operations of the period's activities.

A substantial majority (83%) of Louisiana banks responding to the writer's survey indicated that they favor designating the final figure in the income statement as "Net Income." As shown in question 9 in the Appendix, only 26% of the small banks responding were opposed to this new terminology in the income statement. Some various reasons that bankers and others oppose the new regulations of the Federal supervisory agencies are discussed below.

Criticisms Of Revised Format

Some analysts have been very critical of the new format for reporting bank earnings. They argue that the new "Net Income" figure is of questionable value and "in some cases can be downright misleading to unsophisticated investors."^{25}

^{24}Accounting Principles Board, "Reporting the Results of Operations," p. 113.

They argue that including securities gains and losses in the determination of net income will cause wide fluctuations in reported earnings from year to year. Moreover, profitability ratios will rise and fall and will not give a meaningful reading in any given year. Many banks, however, are aware of this fact and have appropriately informed the users of their financial statements that a change has taken place in the method of reporting earnings.

Other analysts charge that neither of the present pair of reported income figures ("Income Before Securities Gains And Losses" and "Net Income") have "the analytic stature to serve as an ultimate single figure."\(^{26}\) This group contends that reporting two income per share figures is unworkable in practice. They state: "Though some segments of the trade press ... may regularly report and analyze bank results on a basis of the two numbers, most consumers of bank shareholder reports have neither the attention span nor the grasp of fundamentals to regularly use a two-number income concept."\(^{27}\)

Some observers also contend that the new reporting regulations will unfavorably affect the asset management of banks' bonds and securities. They state that bank


\(^{27}\)Ibid., p. 24.
management will attempt to make the net income figure less volatile, once this figure becomes the common denominator of bank financial reports, by lowering the volume of security transactions. Thus, if banks are prompted by the new disclosure regulations to reduce their securities transactions, there is a strong likelihood that future earnings potential will decline.  

Nevertheless, it appears that the 1969 regulatory revisions have improved bank reporting. A substantial number of insured banks must now report their accounting transactions on an accrual basis. They must also report their provision for loan losses as an operating expense. These new regulations have done much to bring bank accounting and reporting practices up to the standards followed by nonbanking industries.

Surveys indicate that the financial statements published in annual reports of the nation's largest banks provide a great deal of financial information for the stockholders and analysts. Most of these banks report a detailed breakdown of the assets and liabilities. Some


banks also disclose in their annual reports principal balance-sheet items based on weekly averages, thus avoiding a "window dressing" criticism. In addition, the new emphasis in bank reporting can be seen in the breakdown of revenue and expense items in the income statement. Some large banks include in their annual reports a record of average, annual yields on various type loans and securities for five to ten year periods.

One major bank, Crocker-Citizens National Bank (San Francisco), even presents in its annual report key financial statement ratios, such as Net operating earnings to total resources; Net operating earnings to deposits; Net operating earnings to equity capital; Equity capital to deposits; Total capital accounts to deposits; and Total loans to deposits. Many of the larger banks are also disclosing more data regarding the maturities of their investment securities. The market value of securities held is often disclosed in addition to the percentage breakdown of securities maturing in one year or less, one to five years, and so on. Other banks have discussed the impact of specific legislation on banking, the basic duties of each bank department, and how the bank serves its customers and community.

It would appear that many of the nation's largest banks are making a serious effort to improve the quality of their financial reports. Their actions might possibly
stimulate many regional and local state banks to upgrade their reporting practices.

A survey of the 23 annual reports received from Louisiana banks, however, revealed that some banks report a minimum of information to their stockholders. Fortunately, there were some banks which followed a policy of full disclosure. For example, 5 banks presented comparative statements of condition and income ranging from five to ten years. One of the 5 banks also included a detailed breakdown of its loans and securities holdings and also presented a schedule showing the percentage of securities maturing in the near future. Another bank included key financial statement ratios for a five-year period.

There are a number of things some banks could do to improve the quality of their reporting practices. First, more banks should begin to include comparative data in their reports. Key financial ratios covering five to ten year periods would provide especially meaningful information. Secondly, more widespread use of "Notes to Financial Statements" should be employed by banks. Notes can be effectively used to explain: basis of consolidation; changes in reporting requirements; basis of valuing bank premises and equipment; pension or profit sharing plans; allowance for loan loss provisions; stock options and dividends; lease commitments; depreciation and amortization policy; basis of securities; and method of determining
Federal income taxes. Lastly, more banks should imitate industrial companies and indicate their goals in their annual reports. For example: How does the bank expect to achieve its future earnings? Does it intend to open new branches in the next few years? As another example: Does the bank intend to enter the trust business in a year or two? Or, if it already has a trust department: Does it intend to strengthen its trust business? Very few banks sending annual reports to the writer disclosed their future goals to stockholders.

Hopefully, the trend toward offering more informative data and including meaningful ratios in the annual report will continue unabated by both large and small banks.
CHAPTER VI

ACCOUNTING FOR SECURITIES

Bank securities accounting has received considerable attention in recent years. Most banks' investment portfolios consist primarily of U.S. government obligations and obligations of states and localities. Although interest on loans is the banking industry's major source of revenue, investment securities also generate a significant part of banks' total earnings. The proper accounting and reporting of securities transactions can greatly affect the reported results of the bank's operations to stockholders and the general public.

**Bond Premiums And Discounts**

Premiums and discounts on bonds represent an adjustment of the coupon interest rates to the market yield prevailing at the time of purchase. Proper income accounting requires amortization of premiums and discounts in order that operating earnings will reflect yields based on purchase costs rather than coupon interest rates. An amortization policy systematically adjusts the carrying values of the securities, during the time they are held, to par value at maturity. The amortization period should
extend from the date of purchase to the maturity date or to an earlier call date.

**Premium Amortization**

Many banks have historically amortized premiums on securities purchased above par. For example, in a 1962 survey involving 270 banks of all sizes, it was found that 90% of the banks surveyed amortized premiums.1 Similarly, nearly 90% of the respondents in the writer's survey of Louisiana banks reported that premiums are amortized for reporting purposes. As shown in question 10 of the Appendix, 59% of the banks indicated that only premiums are amortized while another 28% of the respondents indicated that both premiums and discounts are amortized. It is interesting to note that even 69% of the responding banks with less than $15 million in total assets amortize bond premiums. Some of the smaller banks probably amortize premiums against operating revenue since such a policy results in the more conservative presentation of operating results.

While the majority of banks amortize bond premiums to reduce coupon interest income, some banks still follow the practice of writing off premiums directly to undivided profits or a security reserve. This policy stabilizes

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operating revenues and completely relieves the earnings statement of an amortization adjustment to interest income. The intermediate effect of premium write-offs is an overstatement of operating income.

Premium write-offs should not be employed for external reporting purposes. All banks should be required to amortize premiums on bonds held in their investment portfolio. Any departure from this practice should be fully disclosed in a note to the financial statements.

Discount Accumulation

Even though a majority of commercial banks amortize premiums, the practice of discount accumulation has not been so widespread. For instance, only 28% of the respondents to the writer's survey indicated that they accrue discounts for reporting purposes, as shown in question 10 in the Appendix.

Some reasons responsible for more banks not accumulating discounts are as follows:

1. Conservative accounting. Bankers have traditionally been reluctant to adopt a practice that would result in a "write-up" of assets.

2. Income tax treatment. Whereas for tax purposes premium amortization on other than tax-exempt securities is allowable as a deduction from ordinary income, bond discounts are disregarded until the date of the securities'
3. Attitude of supervisory authorities. For many years, representatives of the supervisory authorities viewed discount accumulation as unfavorable, resulting in investment accounts stated in excess of cost.\(^2\)

Since 1965, however, the Federal regulatory agencies have encouraged banks to accrue discounts. In addition, various banking trade associations and the AICPA's Committee on Bank Accounting have also advocated the use of discount accumulation for external reporting purposes. As a result of these influences, some banks have started to amortize discounts, as well as premiums, in order to disclose more accurately income from securities.

**Securities Gains And Losses**

Securities gains and losses represent an adjustment of yields on investments. "A gain or loss on the sale of a security (assuming premium and discount amortization) represents the immediate realization of the total discounted difference to maturity between the effective rate of earnings on the security (that is, the coupon rate adjusted for premium or discount amortization) and the prevailing

market interest rates. Over an extended period of years, they are as much a part of over-all investment results as are interest earnings.

Until quite recently, most banks followed the practice of carrying directly to undivided profits or to a general security reserve gains and losses on securities transactions together with the applicable income tax effect. This practice of excluding securities gains and losses from the determination of net income was supported by two principal reasons. Bankers argued that gains and losses were "not the results of normal operations and, secondly, their inclusion would have a distortive effect on the net income reported for a period and, perhaps more important, would make comparisons from year to year almost meaningless."

Some smaller banks still carry profits and losses on securities transactions directly to undivided profits or to a security reserve account. As shown in question 11 in the Appendix, 27% of the banks in Class IV (assets less than $15 million) reported that they transfer profits and losses directly to undivided profits. This accounting

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treatment completely bypasses the income statement and leaves much to be desired in terms of full disclosure. Some 55% of the total respondents, however, disclose profits and losses on securities transactions in the nonoperating section of the earnings statement. Looking at individual groups, 100% and 72% of those banks responding in Classes I and II, respectively, indicated that they report the results of securities transactions below net operating earnings in the nonoperating section.

Tax laws have had a significant effect on the timing of profit and loss realization on securities sales. A brief discussion of tax laws as they pertain to bank securities transactions is presented in the following section.

Tax Background

The tax status of commercial banks was for many years unique as compared to nonbanking industries. In the early years of World War II, Congress passed legislation permitting banks to offset security losses against ordinary income for tax purposes.\(^5\) This provision, in effect, made losses deductible at the bank's regular tax rate.

Short-term gains (on securities held less than six

months) were taxed as ordinary income, but long-term gains were taxed at the lower capital gains rate. Thus, a bank could earn the difference between the long-term capital gains tax rate and the ordinary tax rate by realizing losses and long-term gains of the same magnitude. To maximize their tax benefits, banks therefore established "gain" and "loss" years and attempted to realize only net losses or long-term gains during the same year. Under these tax laws, securities transactions and net income figures did vary considerably from year to year.

A recently passed tax-reform bill, however, provides that capital gains taking place after July 11, 1969 are to be taxed as ordinary income. Whether this reduction in the appeal of tax exchanges will lower the volume of securities transactions is indeterminable at this time. It is predicted, however, that for the year 1970 and thereafter the income from securities transactions will tend to fluctuate less from year to year.

**Completed-Transaction Approach**

The regulations of the three Federal supervisory authorities require the recognition of securities gains and losses at the time of their realization. These gains and losses, together with the related income tax effect, are to be disclosed in the nonoperating section of the income statement. This separate presentation of securi-
ties gains and losses should not be interpreted as indicating that they are extraordinary items as defined in APB Opinion No. 9. Where extraordinary items exist, securities gains and losses should be presented before those items.

The recognition of securities gains and losses at the time of their realization conforms with generally accepted accounting principles and is similar to the practices followed in nonbanking industries. The practice is based on the theory that "the sale of a security constitutes the completion of the transactions relating to the holding of that security and that the gain or loss represents an adjustment of the earnings on the investment recognized in the accounts during the period it was held." The immediate recognition of realized securities gains and losses is also strongly supported by a substantial segment of the banking industry.

Deferral And Amortization Methods

Other methods of accounting for securities gains and losses have been proposed in recent years. Most of these methods would include gains and losses in net operating earnings over more than one fiscal period.

Five-Year Averaging Technique. Some analysts have

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Committee on Bank Accounting and Auditing, op. cit., p. 37.
recommended that security gains and losses should be averaged over an arbitrary period, such as five years. This simple averaging method could be accomplished by allocating realized capital changes over subsequent years' income during a five year period. This technique is designed to accomplish two objectives:

1. Apply a common denominator to the investment performance of banks regardless of accounting format, and
2. Bring total investment performance into the orbit of earnings analysis, on the theory that revenue, profit-and-loss, and tax planning are merely complementary and interchangeable methods of maximizing portfolio return.7

As mentioned previously, the revised Federal banking regulations no longer permit the amortization of gains and losses as it had prior to 1969. However, very few banks had amortized capital gains and losses and those that did followed no common pattern. Citizens and Southern National Bank (Atlanta), for example, prorated after-tax gains and losses over the life of the issue sold while Union Bank of Los Angeles amortized the after-tax capital changes over the life of the issues bought. The Bank of the Southwest (Houston) allocated profits on bond transactions into investment income but rarely prorated realized losses.8

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The main advantage of this approach is that it would eliminate extreme year-to-year fluctuations in the amounts of gains and losses recognized. The chief disadvantage of five-year averaging is that this arbitrary period will rarely catch complete cycles of profit-and-loss. As one writer explained:

The practical result will then be to weigh any given period toward loss or profit. This will be particularly true if the period happens to contain an extraordinary year, whether profit or loss.  

Although the method outlined above would help to reduce the fluctuations of securities transactions, the AICPA's Committee on Banking is of the opinion that this method cannot be supported logically.

AICPA Banking Committee's Proposal. The AICPA Committee on Banking believes that the deferral and amortization of security gains and losses can be supported in certain cases. The Committee contends, for example, that gains and losses resulting from sales and subsequent reinvestments of equal quality securities would be eligible for amortization. The Committee, however, feels that the deferral and amortization method should be limited to those  

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9 Cates, op. cit., p. 38. For example, in 1958 profits on securities exceeded $691 million while losses were $94 million. Yet, in the following year profits were only $75 million while losses exceeded $745 million. See John T. Masten, "The Determinants of Bank Income and Profit," The Bankers Magazine, CXLVII (Spring, 1964), 71.
securities transactions involving immediate reinvestment of the proceeds in comparable securities. Thus, where the proceeds of security sales are invested in loans or used to meet depositor withdrawals, the Committee believes that there could be no justification for deferral of gains and losses realized by such sales.\textsuperscript{10}

"The basic theory of the deferral and amortization method of accounting for securities gains and losses is that such gains and losses represent modifications of interest earnings during the period from the date of sale to the maturity date of the securities sold."\textsuperscript{11} Proponents of the deferral and amortization practice maintain that gains or losses are offset in future accounting periods by a corresponding decrease or increase in interest income from the securities acquired in the reinvestment process.

Although the deferral and amortization approach is supportable in certain circumstances, the use of this method for reporting securities gains and losses is questionable. One major unfavorable effect of the approach is that it results in the inclusion of amounts (unamortized gains and losses) in the balance sheet applicable to assets

\textsuperscript{10}Committee on Bank Accounting and Auditing, \textit{op. cit.}, p. 40.

no longer held. Moreover, according to generally accepted accounting principles, gains and losses on securities transactions should be recognized once a sale or exchange has taken place. In addition, one questions the desirability of adopting a deferral and amortization method that tends to delay the effects of changing interest rates when, at the same time, such changes are currently reflected in the interest banks pay for interest bearing deposits and borrowed funds.

Federal banking authorities are opposed to the deferral and amortization method. They require banks to recognize fully gains or losses following completed securities transactions. Furthermore, securities gains and losses must be disclosed in the nonoperating section of the income statement.

On the other hand, the AICPA Banking Committee recognizes the acceptability of both the completed transaction and the deferral and amortization methods. Nevertheless, all concerned with this particular aspect of bank reporting would agree that the results of securities transactions, whether gains or losses, should enter into the determination of banks' net income and should not be charged directly to undivided profits.

Balance Sheet Disclosure

Most banks disclose three major categories of invest-
ments in the balance sheet. Some 96% of the banks responding to the writer's survey indicated that they categorize investments securities by major classification, namely U.S. Government obligations, obligations of states and political subdivisions, and other securities, as shown in question 13 of the Appendix.12

Basis Of Valuation

Most securities held by banks are free from the risk of default. If they are held to maturity, they are redeemed at an amount equal to their amortized cost. Accordingly, securities should be stated at cost, adjusted for discount accumulation and premium amortization. Bank securities should be valued for reporting purposes according to the "going concern" basis and not on a liquidation basis.

In the past banks would arbitrarily write down securities by charges against undivided profits or valuation reserves, merely because market values at a particular time were temporarily below carrying values. Such practices were in most cases unnecessary and misleading. As one writer stated:

... from the standpoint of the shareholders there is no point in writing down to market a security that may be selling below par at

12 Banks that are dealers in securities generally employ a fourth classification, "trading account securities."
the moment because it carries a low coupon rate. Such a write-down simply transfers income from one accounting period to another.13

Fortunately, this practice is diminishing.

Security Reserves

Many banks carry reserves against securities. These reserves are created in various ways. They may be established by profits realized in securities transactions, appropriations of undivided profits, or provisions charged to earnings. Basically, reserves are disclosed for the following reasons: (1) to set aside securities profits to absorb possible losses in the future, and (2) to set up reserves pursuant to banking supervisory regulations.

The logic employed in setting up a reserve to absorb possible losses is evidenced in the following comment:

A bank's portfolio contains securities with appreciation as well as depreciation. When a bank takes profits it leaves itself with potential of future losses. In light of this, it does not seem wise to increase undivided profits. It is prudent to set aside profits in a reserve to avoid significant fluctuations in undivided profits when these future losses may occur. This, in fact, will encourage a bank to take losses when it is investment wise to do so.14

13Henry P. Hill, "Tailoring Banks' Annual Reports for Both Depositors and Stockholders," Banking, LI (April, 1959), 126.

There are basically two kinds of security reserves used by banks, a "valuation reserve" and a "reserve for contingencies."

**Valuation Reserve.** According to supervisory regulations the valuation reserve is "an account established through an appropriate charge representing management's judgment as to possible loss or value depreciation in a specific class of assets, such as loans or investment securities."  

Considering the types of securities held by banks, it is questionable whether a valuation reserve is required under normal circumstances. For most of the securities held by banks, the credit risk is almost negligible. The other risk that banks must consider is market depreciation. Most accountants would agree, however, that temporary and cyclical depressions in the investment markets do not give cause for the establishment of valuation reserves. A few circumstances in which this type reserve could be considered are: (1) a severe market decline, causing a depreciation in security values, which promises to be of long duration and relatively permanent, and (2) a situation in which an element of measurable credit risk has been established.

Valuation reserves, provided pursuant to wishes of

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banking regulatory authorities such as reserves for possible loss of accrued discount not yet realized, are "an ultra-conservative practice that is not in accordance with generally accepted accounting principles and cannot be supported under the 'going concern' concept." 16

Frequently, these reserves were used to absorb charges which should have been made against income and, in many cases, resulted in material misstatements of reported net income.

**Reserve For Contingencies.** Often, banks establish reserves for possible security losses as precautionary measures against future contingencies. Such reserves should be classified in the balance sheet within the capital funds section as it represents an appropriation of undivided profits.

The AICPA Banking Committee has issued the following recommendations concerning the proper accounting treatment for this type reserve:

If the eventuality for which the reserve was created materializes, the resultant loss should be charged to income and the reserve restored to undivided profits. Similarly, if it becomes evident that the contingency will not materialize, the reserve should be restored to undivided profits. Under no circumstances should

the reserve be used to absorb losses or other charges.17

Commercial banks should report to their stockholders a reconciliation of valuation reserves and contingency reserves so that the transactions affecting the reserve accounts will be properly disclosed. Some 61% of the banks responding to the writer's survey, as shown in question 25 of the Appendix, stated that they publish a reconciliation statement for their stockholders.

Disclosure Of Market Values

Some bank officials contend that no useful purpose is served by disclosing the market values of a bank's investments.18 They feel that in certain instances market values might actually contribute to a misinterpretation of the bank's financial soundness. For example, disclosure of substantial unrealized market depreciation in the bank's investment portfolio, reflecting rising interest rates, might unjustifiably undermine public confidence in the bank's soundness.

Undeniably, the above argument does have merit. On the other hand, "an advantage of disclosing market values is that it helps a reader of a bank's financial statements

17Committee on Bank Accounting and Auditing, op. cit., p. 52.

to evaluate the potential earning power of the bank's investments, since such potential earning power is governed by prevailing market interest rates applied to the market, and not the book, value of its invested assets.19

Apparently, many Louisiana banks do not feel that disclosure of market values is essential for a fair presentation. Some 57% of the total respondents answered negatively to the question, "Should the market value of the bank's investment securities be shown in the report to the stockholders?" As shown in question 5 in the Appendix, 74% of the banks with total assets of $15 million or less disfavored disclosing market values.

One final comment concerning the proper reporting of securities transactions--the first and most important thing commercial banks must do when reporting to stockholders is to succinctly outline the principles of investment accounting employed in the preparation of their financial reports.

19 Committee on Bank Accounting and Auditing, op. cit., p. 43.
CHAPTER VII

LOAN LOSSES AND RELATED RESERVES

Loan losses sustained by commercial banks can be broadly classified into two categories—those of a recurring nature and those which occur at infrequent, irregular, and unpredictable intervals. Losses of the latter type historically have been larger and have been realized with less advance warning than those of the first type. Typical of the latter group were the severe losses during the economic depression of the 1930s.

Provision For Loan Losses

A serious problem area in bank accounting and reporting is loan losses. Bank management and regulatory authorities, as well as accountants, agree that timely provisions for loan losses are a necessary requirement for a sound financial management program. Disagreement arises, however, regarding the method of determining a periodic charge and its classification in the income statement.

From a practical viewpoint, the amounts provided by most banks for loan losses are influenced considerably by income tax regulations. Maximum amounts allowable as
tax deductions are computed using a formula established by the Treasury Department.

**Treasury Tax Formula**

Prior to 1969, banks were permitted to make deductions for tax purposes until their reserve accounts equaled 2.4% of loans outstanding. Banks whose reserves exceeded this percentage were temporarily unable to deduct any amount. Also, according to previous tax regulations, the maximum amount allowable in any taxable year was limited to 0.8% of outstanding loans.¹

The Tax Reform Act of 1969, effective for the calendar year 1970, produced important changes relating to loan-loss accounting. The Act changes the method of computing allowable deductions for loan losses and tends to reduce the amount of loan-loss reserves that banks may establish. The new law permits two methods of calculating additions to the reserve account: the "percentage method" and the "experience method." "The percentage method is optional through 1987 after which all banks will maintain reserves based on the experience method."²

The percentage method provides for reserve balance

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limitations as follows:

<table>
<thead>
<tr>
<th>Period</th>
<th>Percentage of Eligible Loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970 through 1975</td>
<td>1.8%</td>
</tr>
<tr>
<td>1976 through 1981</td>
<td>1.2%</td>
</tr>
<tr>
<td>1982 through 1987</td>
<td>0.6%</td>
</tr>
</tbody>
</table>

In any case, the allowable deduction may not exceed 0.6% of eligible loans outstanding.

The term "eligible loan," as defined in the Act, specifically excludes:

1. Loans to banks and savings and loan associations.
2. Loans secured by deposits in the lending bank or other financial institutions ... if the lending bank has control over withdrawal of such deposit.
3. Loans to, or guaranteed by the United States, a possession or instrumentality of the United States, or a state or political subdivision.
4. Loans evidenced by securities such as bonds, debentures, notes or other evidence of indebtedness issued by a corporation or by a government or political subdivision with interest coupons or in registered form.
5. Loans of Federal funds.
6. Commercial paper, including short term promissory notes that may be purchased on the open market. 3

In contrast to the percentage method, the experience method allows a bank to calculate its individual loan-loss experience ratio. This ratio which is applied to year end loans outstanding is based on the following formula:

\[
\frac{\text{Accumulated Six Year Net Charge-offs}}{\text{Accumulated Six Year Loans Outstanding}} = \text{Experience Ratio (Percentage)}
\]

The "0.6% allowable deduction limitation" does not apply.

3Ibid., p. 33.
to this method.

Some 17% of the total banks responding to the writer's survey (as shown in question 16 of the Appendix) indicated that annual provision for loan losses reported in the income statement is the same as the amount used for tax purposes. There are two likely explanations for this finding. First, tax regulations stipulate that the provision for loan loss must be recorded in the books before it is deductible for tax purposes. Secondly, some bankers may fear a reduction in their allowable tax deductions if they do not use the same amount for both financial reporting and tax purposes.

Yet, "the fact that a deduction, allowable for tax purposes, may be more or less than the amount of the provision that should be charged as an operating expense of the period for reporting purposes, should not prevent the recording of provisions that satisfy both requirements." Tax deferral accounting rules are well established and can be employed if the tax deduction for loan losses exceeds the provision established in accordance with generally accepted accounting principles.

Regulation F

Before 1964 many banks carried their provisions for

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loan losses, less the related income taxes effect, directly to undivided profits. Other banks disclosed the annual provision in the nonoperating section of the income statement.

**Nonoperating Deduction.** Regulation F required those banks subject to the Securities Acts Amendments of 1964 to treat their loan-loss provisions as a nonoperating deduction in the income statement. Thus, the regulation excluded loan losses from the determination of net operating earnings. Since many banks were already including loan losses in the nonoperating section, this particular aspect of Regulation F was accepted without much criticism.

Proponents agreed that the entire loan-loss provision should be excluded when determining net operating earnings. They maintained that the nonrecurring portion of the provision was not related to the current period's operations and therefore should not affect reported net operating earnings. Rather than classifying a portion of the provision as an operating expense and the remainder as a nonoperating item, they preferred to disclose the entire provision as a single amount in the income statement's nonoperating section.²

"Another argument advanced for excluding the loan-loss provision from operating expenses is that the provisions allowable for tax purposes may vary widely from year to year and that their inclusion in operating expenses could distort the amounts reported as net operating earnings in a given year." On the other hand, if interest earned on loans is properly treated as part of net operating earnings, then the provision for loan losses should logically be deducted in arriving at net operating earnings.

Operating Expense. One important reason explaining why many banks had not reported the loan-loss provision as an operating expense is that they were not required to do so according to Federal regulations. This reason, however, is no longer valid since all three Federal supervisory agencies changed their regulations pertaining to loan losses in late 1969. The revised regulations now require all insured banks to include the annual provision for loan losses in the income statement's operating expense section. Banks must also elect one of the following methods for reporting their loan-loss provision:

1. Five-year moving average ratio. Under this method a ratio is computed based on the aggregate total of net charge-offs and

6Ibid.
the aggregate total average loans for the current year and the preceding four years. This ratio is then applied to average loans outstanding during the current year to determine the minimum amount to be charged to operating expense.

2. Five-year forward moving average. Beginning with the year 1969 the ratio of net charge-offs to average loans outstanding is computed. Each successive year thereafter, and up to and including 1973, the current year's net charge-offs and average loans outstanding are added to those of the previous years. A new ratio is calculated and applied to average loans outstanding for the current year. By 1973 this method of calculating the minimum loan loss expense factor becomes the same as the first method.

3. Actual net charge-offs as experienced in the current year. Banks not on the reserve basis for loan losses are required to use this method.

If an amount in excess of that computed by any of the above methods is deemed necessary by the bank's management, it is permitted provided that adequate disclosure is furnished in a note to the financial statements.

According to the writer's survey, 35% of the respondents indicated that they use method (1) as shown above for reporting their loan losses, while both methods (2) and (3) are used by 17% of the respondents as shown in question 16 of the Appendix. The five-year moving average ratio (method 1) is most frequently used by Classes I and II banks.

Although the AICPA's Committee on Banking agrees

7Bryant, op. cit., p. 33.
with the revised regulations, it has also issued the following statement concerning loan-loss provisions:

The Committee ... recommends that each bank management determine a method (based on past loss experience, adjusted for such factors as known changes in the character of the loan portfolio, in management credit policies, and in economic conditions) which will result in systematic loan-loss charges to operations on a consistent basis. This recommended approach is designed to serve the objective of presenting fairly the results of operations in conformity with generally accepted accounting principles.8

There is no disagreement that substantial precedents already exist for the Committee's recommendation. Bad-debt provisions based on management estimations have been a regular practice in nonbanking industries for many years. However, a uniform formula for determining loan losses, as recommended in the revised regulations, does provide some distinct benefits for the users of bank financial statements. First, the formula is based on actual loan losses over a five year period and thus avoids the use of any subjective criteria in its determination. Secondly, it will help bring about greater uniformity in bank reporting practices. Also, the revised regulations in most cases would produce the same results as those obtained by management's estimation of loan losses. For these

reasons, it would seem that banks should use a five-year average ratio for determining their loan-loss provisions.\footnote{Any addition to the loan-loss reserve in excess of the amount determined by the prescribed formula could be charged to undivided profits with appropriate disclosure provided in the notes to the financial statements.}

**Reserve For Loan Losses**

Disclosure of the "reserve for loan losses" is also a controversial issue in bank accounting. Before the revised regulations were issued in 1969, the majority of banks deducted their loan-loss reserves from the loan account balance in the statement of condition. Other banks carried the reserve in either the balance sheet's liability or capital section.

The revised regulations require banks to disclose the reserve for loan losses in a separate section on the balance sheet's credit side, below total liabilities and above capital funds. Accordingly, a majority of banks (57%) responding to the writer's survey stated that they disclose loans at their gross amount with the reserves on the credit side of the balance sheet. As shown in question 14 in the Appendix, 100% and 72% of the banks in Classes I and II, respectively, disclose their loans in this manner, while 47% of Class IV banks report their loans at gross without an accompanying reserve.
The reserve for loan losses under the revised regulations generally consists of a valuation portion and a contingency portion. The valuation portion of the loan-loss reserve is established by banks to meet anticipated loan losses which take place in normal operations. The establishment of this type reserve should properly be reflected as a charge against net current earnings on the income statement. This reserve should be deducted from total loans to determine the "net realizable value" of the outstanding loans. Reserves that are established to absorb unpredictable losses should not be considered valuation reserves. Such "contingency" reserves should be classified in the capital funds section of the balance sheet.10

The revised regulations, however, require all insured banks to report the valuation and contingency portion of the loan-loss reserves in one account on the credit side of the balance sheet. Although this requirement is contrary to generally accepted disclosure policies, the effect in most cases is immaterial on the fair presentation of a bank's financial condition. "In the rare instances where the effect of such classification on the presentation of financial position is material, the rele-

vant facts should be disclosed in a note to the financial statements and referred to in an exception in the auditor's opinion."

The revised regulations of the three Federal supervisory agencies have improved bank reporting standards relating to loan losses. Provisions for loan losses must now be reported as an operating expense, thus providing a better matching of revenues and expenses for reporting purposes.

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11 Committee on Bank Accounting and Auditing, Audits of Banks: Supplement, p. 3.
CHAPTER VIII

SUMMARY AND CONCLUSIONS

Commercial banks are an absolutely essential element of the nation's economic system. These institutions create the largest portion of the United States' money supply by extending credit to individuals, corporations, and governmental bodies. Banks also provide flexibility and mobility for the money supply by maintaining the interchangeability of currency and bank deposits. Since commercial banks are the major creators and custodians of the United States' money supply, they are considered quasi-public institutions and consequently are highly regulated. Thus, bank accounting principles, practices, and statement formats have developed to a large degree along the lines required by Federal banking authorities.

As originally envisioned, the primary responsibility of bank supervisory authorities was to protect depositors against bank failures. This study has attempted to determine whether depositor protection still remains the sole responsibility of bank supervisory authorities and whether their resulting regulations have stimulated the progress of bank financial reporting to stockholders. The conclusions reached in this study are partially derived from the
results of a survey sent to a representative sample of Louisiana banks. The questionnaire was classified into five major areas--opinions concerning financial disclosure, securities accounting, loans and loan losses, fixed assets, and accounting principles.

Summary

Early Bank Reporting

Commercial banks, like many other business enterprises in the early days of the twentieth century, were unwilling to disclose much, if any, information about their financial activities. During this period the banking system was comprised of many locally owned, closely controlled, independent community banks. Since there were very few reasons to cater to stockholders outside the controlling group, most banks cloaked their affairs in a "veil of secrecy" and considered their financial reports absolutely confidential.

It was not until the early 1930s that more and more banks, especially larger city institutions, began to issue fairly comprehensive statements of condition. These published statements were designed wholly for the depositors' benefit. Accordingly, banks earnestly sought to present an appearance of conservatism, stability, and steady growth. This early emphasis on depositor protection was strengthened by the banking failures of the great depres-
sion and by the bank holiday of 1933.

As a result, banks over the years employed accounting and reporting practices that best suited the goals of a conservative public image. Some practices which are no longer permitted included: writing down of land, building, and equipment to nominal values; immediate charge-off of furniture and equipment in the period purchased; and using reserves to camouflage the results of security transactions and loan losses.

For many years, the balance sheet was the primary financial statement published by banks. Moreover, bank income statements prepared before 1945 were generally inadequate and in some instances misleading. Prior to 1945, only a few banks disclosed nonoperating income and/or revealed the sources and uses of income in any detail. Most banks simply disclosed a single "Net Profits" figure.

By the mid-50s a substantial number of banks were reporting income based on a "net operating earnings" approach which divided revenue and expense items into "steady" and "unsteady" categories. Steady flows were used to determine net operating earnings while unsteady flows were included in the capital funds statement. Although this approach portrayed banks' earnings as stable and steadily growing, stockholders wanted to know how the so-called "unsteady items" affected earnings. Therefore, in the mid-60s some banks began to report the results of securities
transactions and the provisions for loan losses in the income statement below the net operating earnings line. Banks were beginning to move toward an "all-inclusive" income statement.

There is little doubt that the emphasis on depositor protection during the early days of bank reporting was sanctioned by the Federal bank regulators—the Comptroller of the Currency, the Federal Reserve Board (FRB), and the Federal Deposit Insurance Corporation (FDIC). These agencies' policies and requirements were designed to assure protection of bank deposits through strict examination and insistence on adequate capital in individual banks. As early as 1864, the Comptroller of the Currency, the oldest of the three agencies, was requiring banks under its jurisdiction to submit statements of condition to determine the soundness of each bank's assets. The Federal Reserve and the FDIC have also used "call reports" to estimate the degree of solvency maintained by banks for depositor protection.

Recent Developments

There have been several developments in recent years which have had a significant effect on bank accounting and reporting.

A primary factor inducing changes in bank reporting has been the gradually changing profile of bank ownership.
Since World War II, bank stock ownership has expanded substantially as a result of the rapid growth experienced by the banking industry. A wider dispersion of bank stock ownership has also been caused by the increasing number of banks which have formed one-bank holding companies (OBHCs). This new organizational form enables banks to overcome certain regulatory restrictions since the Bank Holding Company Act of 1956 specifically exempts the OBHC from its provisions and related Federal Reserve regulations. Many OBHCs are listed on major stock exchanges and their stocks are widely distributed geographically throughout the United States.

As the number of bank shareholders increased, their demands for more financial information to appraise the value of their investments received increasing attention by banks which were desiring additional capital funds. Consequently, many banks began using accounting principles and reporting practices which would better reflect operating results and financial condition.

The banking industry was particularly affected by the Securities Acts Amendments of 1964 which extended the coverage of the Securities Acts of 1933 and 1934 to many companies whose securities were widely held. Commercial banks had previously been exempted from the Acts on the premise that they were already being regulated by Federal banking authorities. The 1964 Amendments applied to all
banks with total assets in excess of $1,000,000 and those with 750 shareholders of record. The shareholder requirement dropped to 500 as of May 1, 1967.

In late 1964, the FRB and the FDIC adopted almost identical codes, known as "Regulation F," for those banks subject to the Securities Acts Amendments. These regulations contained detailed instructions relating to the form and content of financial statements published by state chartered banks subject to the Securities Acts. One of Regulation F's major provisions was that it required banks to adopt an accrual accounting system. It also prohibited the arbitrary write-down of fixed assets.

The Comptroller of the Currency also issued rules, similar to Regulation F, for national banks designed to assure fair presentation of financial condition and operating results.

Prior to 1964, bank supervision and Federal reporting requirements had been designed primarily for depositor protection. The enactment of the Securities Acts Amendments, however, ushered in a new era of bank reporting and regulation. This legislation stipulated that the stockholder was no longer to be considered an incidental factor in bank reporting and regulation. Both the depositors and stockholders were to be regarded as equal in terms of financial reporting priorities. The 1964 Amendments also stimulated the banking industry to work toward further
agreement on certain difficult accounting problems through its trade associations.

Another recent development which has influenced bank reporting is the increasing number of independent audits being performed by certified public accountants for commercial banks. Some bankers state that examinations by supervisory agencies and audits by independent accountants bring about unnecessary duplication of efforts. These same bankers, however, fail to realize that only in unusual circumstances will the scope of supervisory examinations approach that of an audit made in accordance with generally accepted auditing standards. Moreover, banks receive two major benefits from independent audits: improved investor confidence and a variety of internal control improvements arising from outside objective evaluations.

Hopefully, independent audits by CPAs will become more widespread among banks of all sizes, even though they are not required by Federal regulations. As a minimum, it would seem that independent audits should be required for all commercial banks subject to the Securities Acts Amendments.

Statement Of Condition

The most distinctive characteristic of a bank's statement of condition, as compared to the balance sheet of nonbanking industries, is the absence of a segregation
of assets (resources) and liabilities into current and noncurrent categories. This lack of segregation, however, seems entirely appropriate considering a bank's assets and liabilities. Except for bank premises and equipment and long-term debt, most bank balance sheet items are not susceptible to a classification as current or non-current. For example, most deposit balances can be withdrawn on demand.

For many years there has been a major criticism of bank balance sheet reporting. In many cases the basis of valuation for principal balance sheet items is not disclosed. This is a serious omission of significant information and such information could readily be provided in notes to the financial statement. It is encouraging to note that many banks are now disclosing information about their basis of valuation in their annual reports.

The statement of condition is considered more important in the banking industry than in most nonbanking industries since it provides informative data concerning a bank's liquidity and solvency. Therefore, banks must take more than usual care to make certain that their assets and liabilities are properly classified and valued for reporting purposes.

Report Of Earnings

Until recent years, the vast majority of commercial
banks employed a statement of operating earnings when reporting their results of operations. This type of earnings report did not disclose the bank's provision for loan losses or the gains and losses on securities transactions realized during the year. Advocates of this "current operating performance" presentation contended that it portrayed the results of a bank's normal operations, and that the inclusion of loan-loss provisions and security gains and losses would create wide fluctuation in reported net operating earnings.

On the other hand, proponents of the "all-inclusive" income statement maintained that a single figure should be clearly designated as the net income for a given accounting period, and that all items of profit and loss should be recognized and included in the income statement.

Regulation F, as issued in 1964, represented a compromise between the two opposing philosophies. It required loan-loss provisions and securities gains and losses to be disclosed in a "non-operating additions and deductions" section in the income statement. The final amount on the statement was captioned "transferred to undivided profits." In effect, this presentation constituted an "all-inclusive" income statement but avoided designating any figure as net income.

The accounting profession was also very interested in the "current operating" versus "all-inclusive" income
statement controversy. In December, 1966 the Accounting Principles Board of the American Institute of CPAs issued Opinion No. 9 entitled "Reporting the Results of Operations." This opinion stipulated that net income should reflect all items of profit and loss recognized during the period. Opinion No. 9, however, was not applicable for commercial banks pending further research by the AICPA Committee on Bank Accounting. In 1969 the exemption was withdrawn with the issuance of APB Opinion No. 13. This opinion requires commercial banks to report earnings on an "all-inclusive" basis and subjects banks to the provisions of Opinion No. 9.

Federal supervisory authorities were interested in having bank reporting conform to generally accepted accounting principles. After a series of discussions with representatives of the banking industry, the Securities and Exchange Commission, and the AICPA, the three Federal regulatory authorities issued in July, 1969 sweeping accounting and reporting revisions for the entire banking industry. The revised regulations require that a provision for loan losses be included in operating expenses while securities gains and losses must be disclosed in the non-operating section of the income statement. The regulations also stipulate that the final amount on the income statement must be labeled "Net Income." These revised regulations have converted the bank income statement to a form
that more closely resembles that of other business enterprises organized for profit.

Not too many years ago, most commercial banks were employing a cash basis of accounting. Beginning in 1964, banks subject to Regulation F were required to establish accrual accounting systems for reporting purposes. Many more banks have inaugurated accrual accounting systems as a result of revised regulations mentioned above. Beginning January 1, 1970 all insured banks with total assets of $25 million or more must prepare their financial reports from an accrual accounting system. This requirement will definitely improve the quality of bank reporting practices. Even banks with assets of less than $25 million should seriously consider using accrual basis accounting for reporting purposes.

**Accounting For Securities**

Bond premium amortization has long been recognized as a desirable practice and widely followed in the banking industry. This has probably been a widely accepted accounting practice since it results in a more conservative presentation of operating results.

Although most commercial banks amortize premiums, discount accumulation has not been so widespread. One possible reason for this inconsistent treatment of similar items is that bankers have traditionally been reluctant
to adopt a practice that would result in a "write-up" of assets. Also, according to Federal banking regulations discount accumulation is optional rather than compulsory. Lastly, some banks do not accumulate discounts since such discounts are disregarded for tax purposes until sale or redemption of the securities.

Discount accumulation, however, is just as necessary to a fair presentation of net income as premium amortization. Therefore, both premium amortization and discount accumulation should be required for reporting purposes in order that operating earnings reflect market yields rather than coupon interest rates. It is encouraging to note that there has been an increasing number of banks over the past several years amortizing both discounts and premiums for reporting purposes.

Until quite recently, many banks followed the practice of carrying securities gains and losses directly to undivided profits or to a general securities reserve. This practice completely bypassed the income statement and left much to be desired in terms of full disclosure. Currently, Federal banking authorities require all insured banks to immediately recognize securities gains and losses arising from the sale, redemption, or retirement of investment securities. The regulations also stipulate that the gains and losses, together with the related income tax effect, are to be disclosed in the nonoperating section of the banks'
Recognizing securities gains and losses at the time of their realization conforms with generally accepted accounting principles and is similar to the practices followed in nonbanking industries.

Many banks carry a "reserve for contingencies" against securities. These general reserves are established as precautionary measures for possible security losses. Such reserves should be treated as appropriations of undivided profits. Contingency reserves should not be used to absorb actual losses and should be restored to undivided profits when no longer needed.

**Loan Losses**

Bankers, regulatory authorities, and accountants agree that loan losses are a natural incident of extending credit and that such losses should enter into net income determination. Disagreements arise, however, concerning how the loan-loss provision should be determined.

Bankers naturally wish to report maximum amounts allowable as tax deductions. Therefore, in the past most banks made provisions for loan losses in amounts approximating the maximum amounts allowable for income tax purposes. The Treasury tax formula had permitted banks to accumulate a loan-loss reserve equal to 2.4% of their total loan portfolio. The maximum amount allowable in a taxable year was limited to 0.8% of outstanding loans.
The Tax Reform Act of 1969, however, reduced the maximum amount allowable as a tax deduction. According to the new law, banks are permitted to accumulate loan-loss reserves equal to 1.8% of eligible loans and allowable deductions may not exceed 0.6% of eligible loans. Banks should not ordinarily use the Treasury tax loan-loss provision for financial reporting purposes. Tax deferral accounting rules are well established and should be employed if the tax deduction for loan losses exceeds the provision established in accordance with generally accepted accounting principles.

Before 1964 many banks carried their provisions for loan losses directly to undivided profits. This reporting practice was clearly not in agreement with the generally accepted accounting concept of matching revenues and expenses. If interest earned on loans is properly treated as part of net operating earnings, then the provision for loan losses should logically be deducted in arriving at net operating earnings. Accordingly, Federal banking authorities now require all insured banks to include their provision for loan losses in the operating expense section of the income statement.

In addition, the revised regulations provide that a minimum loan-loss provision must be computed according to a prescribed formula, such as a five-year average ratio of net charge-offs to total loans. Banking authorities
expect this approach to result in greater uniformity and comparability of bank reporting practices. If a larger provision than that determined by the formula is deemed necessary by a bank's management, it is permitted as long as adequate disclosure is furnished in a note to the financial statements.

Conclusions

The three Federal bank regulatory agencies definitely have a considerable impact on commercial banks' financial accounting and reporting practices. Historically, the philosophy of Federal regulation seemed to emphasize protection of the depositors' interest. Regulations leaned toward conservative bank policies which often understated earnings and asset values. Since the passage of the Securities Acts Amendments of 1964, Federal regulators have become more cognizant of the stockholders' interest in bank financial reporting.

Within recent years, the Federal authorities have made serious efforts to improve the standards and quality of bank accounting and reporting practices. In 1969, for example, all three supervisory agencies amended their regulations to make them conform more closely to generally accepted accounting principles.

The banking industry is also actively participating in the development of their accounting and reporting prac-
Various banking associations are working closely with Federal authorities and the accounting profession to improve bank financial statements. These associations are urging all banks to become more aware of their responsibilities to both stockholders and depositors when preparing their annual reports.

Moreover, bank managements should quickly implement those reporting practices which are designed to inform more fully stockholders and depositors of the bank's financial condition and results of operations. Banking is a dynamic industry and its accounting and reporting practices must change to keep abreast of new developments.

Many banks are beginning to realize that they must disclose as much financial information as nonbanking businesses in order to compete successfully for capital funds. Accordingly, the days of the condensed balance sheet and income statement are numbered. Many large banks are now preparing annual reports which are as comprehensive and informative as those prepared by nonbanking business firms. More and more smaller banking institutions are beginning to prepare annual reports for their stockholders (all the banks with assets of $25 million or more responding to the writer's survey indicated that they publish an annual report).

In conclusion, present day indications are that bank managements have become increasingly aware of the stock-
holders' interest in published financial information. Banks of all sizes are reevaluating the traditional concept that financial statements should be designed primarily for the depositors' benefit. Bankers are beginning to realize that informative reporting in accordance with generally accepted accounting principles serves equally well the interests of both depositors and stockholders.
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And Publications


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Miscellaneous


### TABLE I
CLASSIFICATION OF BANKS IN THE SURVEY

<table>
<thead>
<tr>
<th>Class</th>
<th>Total Deposits As Of December 31, 1968</th>
<th>Number Of Banks</th>
<th>Responding Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>Over $100 million</td>
<td>10</td>
<td>8</td>
</tr>
<tr>
<td>II</td>
<td>$99.9 - $25 million</td>
<td>19</td>
<td>14</td>
</tr>
<tr>
<td>III</td>
<td>$24.9 - $15 million</td>
<td>24</td>
<td>13</td>
</tr>
<tr>
<td>IV</td>
<td>Below $15 million</td>
<td>47</td>
<td>19</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>100</strong></td>
<td><strong>54</strong></td>
<td><strong>54</strong></td>
</tr>
</tbody>
</table>

### TABLE II
OPINIONS OF BANKERS CONCERNING FINANCIAL DISCLOSURE (Per Cent)

<table>
<thead>
<tr>
<th>Class</th>
<th>I</th>
<th>II</th>
<th>III</th>
<th>IV</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Do you believe that banks should disclose as much information to their stockholders as industrial firms normally do?</td>
<td>100</td>
<td>86</td>
<td>38</td>
<td>58</td>
<td>67</td>
</tr>
<tr>
<td>A. Yes</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>100</td>
</tr>
<tr>
<td>B. No</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>14</td>
</tr>
<tr>
<td>2. Should banks be required to publish both the Statement of Condition and Earnings Statement for the general public (that is, those other than stockholders)?</td>
<td>12</td>
<td>14</td>
<td>23</td>
<td>--</td>
<td>11</td>
</tr>
<tr>
<td>A. Yes</td>
<td>88</td>
<td>86</td>
<td>77</td>
<td>100</td>
<td>89</td>
</tr>
<tr>
<td>B. No</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>42</td>
</tr>
<tr>
<td>3. Do you feel that the bank's financial statements should be prepared on a consolidated basis?</td>
<td>75</td>
<td>64</td>
<td>69</td>
<td>63</td>
<td>67</td>
</tr>
<tr>
<td>A. Yes</td>
<td>13</td>
<td>22</td>
<td>16</td>
<td>32</td>
<td>22</td>
</tr>
<tr>
<td>B. No</td>
<td>12</td>
<td>14</td>
<td>15</td>
<td>5</td>
<td>11</td>
</tr>
<tr>
<td>Did not answer</td>
<td>12</td>
<td>14</td>
<td>15</td>
<td>5</td>
<td>11</td>
</tr>
<tr>
<td>Class</td>
<td>I</td>
<td>II</td>
<td>III</td>
<td>IV</td>
<td>Total</td>
</tr>
<tr>
<td>-------</td>
<td>---</td>
<td>----</td>
<td>-----</td>
<td>----</td>
<td>-------</td>
</tr>
<tr>
<td>4. Do you believe that an annual audit should be performed by an independent CPA and that his opinion of the financial statements should be disclosed to the stockholders?</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Yes</td>
<td>50</td>
<td>50</td>
<td>15</td>
<td>26</td>
<td>33</td>
</tr>
<tr>
<td>B. No</td>
<td>50</td>
<td>50</td>
<td>85</td>
<td>74</td>
<td>67</td>
</tr>
<tr>
<td>5. Should the market value of the bank's investment securities be shown in the report to stockholders?</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Yes</td>
<td>63</td>
<td>50</td>
<td>46</td>
<td>26</td>
<td>43</td>
</tr>
<tr>
<td>B. No</td>
<td>37</td>
<td>50</td>
<td>54</td>
<td>74</td>
<td>57</td>
</tr>
<tr>
<td>6. Do you believe banks, which have written down their land and buildings to very low figures, should be required to reinstate the written-down assets?</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Yes</td>
<td>37</td>
<td>36</td>
<td>23</td>
<td>5</td>
<td>22</td>
</tr>
<tr>
<td>B. No</td>
<td>63</td>
<td>64</td>
<td>77</td>
<td>95</td>
<td>78</td>
</tr>
<tr>
<td>7. Do you believe stockholders are entitled to more detailed financial and operating information than is presently required to be published by regulatory agencies?</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Yes</td>
<td>37</td>
<td>43</td>
<td>15</td>
<td>32</td>
<td>31</td>
</tr>
<tr>
<td>B. No</td>
<td>63</td>
<td>57</td>
<td>85</td>
<td>68</td>
<td>69</td>
</tr>
<tr>
<td>8. Do you believe that the income statement of commercial banks should include as an operating expense a provision for loan losses?</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Yes</td>
<td>100</td>
<td>93</td>
<td>85</td>
<td>74</td>
<td>85</td>
</tr>
<tr>
<td>B. No</td>
<td>--</td>
<td>7</td>
<td>15</td>
<td>26</td>
<td>15</td>
</tr>
<tr>
<td>9. Do you believe that the final figure in the income statement should be captioned &quot;Net Income (Loss)&quot; for the period?</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Yes</td>
<td>88</td>
<td>86</td>
<td>92</td>
<td>74</td>
<td>83</td>
</tr>
<tr>
<td>B. No</td>
<td>--</td>
<td>--</td>
<td>8</td>
<td>26</td>
<td>11</td>
</tr>
<tr>
<td>Did not answer</td>
<td>12</td>
<td>14</td>
<td>--</td>
<td>--</td>
<td>6</td>
</tr>
</tbody>
</table>
### TABLE III

#### SECURITIES ACCOUNTING

(Per Cent)

<table>
<thead>
<tr>
<th>Class</th>
<th>I</th>
<th>II</th>
<th>III</th>
<th>IV</th>
<th>Total</th>
</tr>
</thead>
</table>

#### 10. In reporting on securities acquired at a price different than par:

- **A. Premiums only are amortized**
  - 63 43 62 69 59
- **B. Both premiums and discounts are amortized**
  - 37 43 23 16 28
- **C. Neither are amortized**
  - -- 7 15 5 7
- **D. Other**
  - -- 7 -- 5 4
- **Did not answer**
  - -- -- -- 5 2

#### 11. Profits and losses on sales of "investment securities" after applicable income taxes are:

- **A. Shown as a separate item in the nonoperating section of the earnings statement**
  - 100 72 62 21 55
- **B. Shown as an operating income and expense item**
  - -- 21 15 42 24
- **C. Charged directly to undivided profits**
  - -- -- 8 27 11
- **D. Charged directly to a security reserve account**
  - -- 7 15 5 6
- **Did not answer**
  - -- 7 -- 5 4

#### 12. Is the disclosure of income from tax exempt securities shown separately in the earnings statement?

- **A. Yes**
  - 75 50 77 79 70
- **B. No**
  - 25 50 23 16 28
- **Did not answer**
  - -- -- -- 5 2

#### 13. Are investment securities shown on the balance sheet by major classification (that is, U.S. Government obligations, state and local securities, and other bonds)?

- **A. Yes**
  - 100 93 100 95 96
- **B. No**
  - -- 7 -- -- 2
- **Did not answer**
  - -- -- -- 5 2
TABLE IV
LOANS AND LOAN LOSSES
(Per Cent)

<table>
<thead>
<tr>
<th>Class</th>
<th>I</th>
<th>II</th>
<th>III</th>
<th>IV</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>14. Loans are shown on the balance sheet at:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Gross amount</td>
<td>--</td>
<td>14</td>
<td>38</td>
<td>47</td>
<td>30</td>
</tr>
<tr>
<td>B. Gross amount with reserve shown on the liabilities side</td>
<td>100</td>
<td>72</td>
<td>54</td>
<td>32</td>
<td>57</td>
</tr>
<tr>
<td>C. Gross amount less reserve for bad debts</td>
<td>--</td>
<td>14</td>
<td>8</td>
<td>21</td>
<td>13</td>
</tr>
</tbody>
</table>

| 15. Are bank loans classified on the balance sheet according to the type of customer? |   |    |     |    |       |
| A. Yes                         | --| 14 | 8   | 42 | 20    |
| B. No                          | 100| 86 | 84  | 58 | 78    |
| Did not answer                 | --| -- | 8   | -- | 2     |

| 16. The annual provision for loan losses as an operating expense is made on the basis of: |   |    |     |    |       |
| A. A charge equivalent to a five-year average ratio of losses computed on the basis of net charge-offs to total loans over the past five years | 50 | 43 | 31  | 26 | 35    |
| B. A charge equivalent to an average ratio of losses computed on the basis of a forward moving average beginning with the year 1969 | 12 | 14 | 23  | 16 | 17    |
| C. Actual net charge-offs as experienced in the current year | --| 14 | 23  | 21 | 17    |
| D. Treasury tax formula        | 25 | 15 | 15  | 16 | 17    |
| E. Other                      | 13 | 7  | 8   | 11 | 9     |
| Did not answer                | --| 7  | --  | 10 | 5     |
### TABLE V
**BANK PREMISES, EQUIPMENT, AND OTHER REAL ESTATE**
*(Per Cent)*

<table>
<thead>
<tr>
<th>Class</th>
<th>I</th>
<th>II</th>
<th>III</th>
<th>IV</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>17.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Is the basis of valuation of the bank's premises and equipment disclosed either in caption or by footnote?</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Yes</td>
<td>13</td>
<td>29</td>
<td>15</td>
<td>26</td>
<td>22</td>
</tr>
<tr>
<td>B. No</td>
<td>87</td>
<td>71</td>
<td>85</td>
<td>69</td>
<td>76</td>
</tr>
<tr>
<td>Did not answer</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>5</td>
<td>2</td>
</tr>
</tbody>
</table>

| 18.   |     |     |     |     |       |
| Profits and losses on disposition of bank premises and equipment are: |     |     |     |     |       |
| A. Shown as an operating expense or income item | 25  | 29  | 31  | 58  | 39    |
| B. Charged directly to undivided profits | 25  | 21  | 15  | 16  | 19    |
| C. Shown as a separate item in the nonoperating section | 37  | 29  | 31  | --  | 20    |
| Not applicable | 13  | 21  | 8   | 21  | 17    |
| Did not answer | -- | -- | 15  | 5   | 5     |

| 19.   |     |     |     |     |       |
| Depreciation expense is determined by: |     |     |     |     |       |
| A. Applying a reasonable rate consistently | 50  | 29  | --  | 32  | 26    |
| B. Applying a reasonable rate consistently plus occasional write-offs | --  | 7   | 38  | 26  | 20    |
| C. Same as on Federal Income Tax Return | 50  | 64  | 62  | 42  | 54    |

<p>| 20.   |     |     |     |     |       |
| Bank buildings are disclosed on the balance sheet at: |     |     |     |     |       |
| A. Cost less accumulated depreciation | 74  | 93  | 85  | 53  | 74    |
| B. Nominal value | -- | 7   | 21  | --  | 9     |
| C. Other | 13  | --  | 15  | --  | 6     |
| Not applicable | 13  | --  | --  | 21  | 9     |
| Did not answer | --  | --  | --  | 5   | 2     |</p>
<table>
<thead>
<tr>
<th>Class</th>
<th>I</th>
<th>II</th>
<th>III</th>
<th>IV</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>21. Accounting principles applied in the preparation of financial statements conform primarily to:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Those formulated by regulatory agencies</td>
<td>88</td>
<td>50</td>
<td>77</td>
<td>85</td>
<td>74</td>
</tr>
<tr>
<td>B. Income tax regulations</td>
<td>12</td>
<td>14</td>
<td>15</td>
<td>5</td>
<td>11</td>
</tr>
<tr>
<td>C. Pronouncements of NABAC/Bank Administration Institute</td>
<td>--</td>
<td>14</td>
<td>--</td>
<td>--</td>
<td>4</td>
</tr>
<tr>
<td>D. Pronouncements of the American Institute of Certified Public Accountants</td>
<td>--</td>
<td>22</td>
<td>8</td>
<td>5</td>
<td>9</td>
</tr>
<tr>
<td>Did not answer</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>5</td>
<td>2</td>
</tr>
</tbody>
</table>

| 22. The accounting basis for the preparation of financial statements with the exception of the trust department's functions is primarily: | | | | | |
| A. Accrual | 75 | 93 | 46 | 26 | 56 |
| B. Hybrid (Combination of Cash and Accrual) | 25 | 7 | 23 | 26 | 20 |
| C. Cash | -- | -- | 31 | 48 | 24 |

| 23. Are changes in accounting principles or practices which are made during any period for which financial statements are prepared and that will affect comparability of such financial statements with those of prior or future annual periods, disclosed in a note to the appropriate financial statements? | | | | | |
| A. Yes | 100 | 71 | 70 | 42 | 65 |
| B. No | -- | 29 | 15 | 53 | 30 |
| Did not answer | -- | -- | 15 | 5 | 5 |
### TABLE VI (Continued)

<table>
<thead>
<tr>
<th>Class</th>
<th>I</th>
<th>II</th>
<th>III</th>
<th>IV</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>24. Does the bank report a comparative reconciliation of capital accounts to the stockholders for the latest fiscal year and the preceding fiscal year?</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Yes</td>
<td>100</td>
<td>86</td>
<td>69</td>
<td>63</td>
<td>76</td>
</tr>
<tr>
<td>B. No</td>
<td>--</td>
<td>14</td>
<td>23</td>
<td>37</td>
<td>22</td>
</tr>
<tr>
<td>Did not answer</td>
<td>--</td>
<td>--</td>
<td>8</td>
<td>--</td>
<td>2</td>
</tr>
</tbody>
</table>

| 25. Does the bank report a comparative reconciliation of valuation reserves and contingency reserves to the stockholders for the latest fiscal year and the preceding fiscal year? | | | | | |
| A. Yes | 100 | 57 | 54 | 53 | 61 |
| B. No | -- | 26 | 46 | 47 | 37 |
| Did not answer | -- | 7 | -- | -- | 2 |

| 26. Does the bank indicate to readers of the financial statements whether an accrual or cash basis has been used in the preparation of the reports? | | | | | |
| A. Yes | 37 | 64 | 31 | 32 | 41 | |
| B. No | 63 | 29 | 69 | 68 | 57 |
| Did not answer | -- | 7 | -- | -- | 2 |

| 27. Does the bank publish an annual report for its stockholders? | | | | | |
| A. Yes | 100 | 100 | 77 | 53 | 78 |
| B. No | -- | -- | 23 | 47 | 22 |
VITA

Joseph Anthony DeFatta, the son of Mr. and Mrs. Joe L. DeFatta, was born in Shreveport, Louisiana on February 26, 1945. He graduated from Jesuit High School, Shreveport, Louisiana in May, 1962. In January, 1963 he entered Centenary College of Louisiana in Shreveport. He completed all academic requirements in January, 1966 and received the degree of Bachelor of Science in Business on May 29, 1966.

He enrolled in the Graduate School of Louisiana State University in Baton Rouge in January, 1966. He received the Master of Science degree in Accounting in May, 1967.

In June, 1967 he reentered the Graduate School of Louisiana State University in Baton Rouge. From September, 1967 to January, 1970 he served as a Graduate Assistant in the Department of Accounting. He is presently a candidate for the degree of Doctor of Philosophy in Accounting.
Candidate: Joseph Anthony DeFatta

Major Field: Accounting

Title of Thesis: "Commercial Bank Accounting and Financial Reporting"

Approved: 

[Signature]
Major Professor and Chairman

[Signature]
Dean of the Graduate School

EXAMINING COMMITTEE:

[Signatures]

Date of Examination: July 14, 1970