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In this article, I shall endeavor to present an outline of the general accounting principles peculiar to bank-holding corporations, although in many cases there are special considerations to be met, which demand special treatment. Certain of the accounting practices discussed are debatable. No uniformity exists at the present time. The statements, therefore, should be considered merely as personal opinion as to what is desirable and practical. The present study is not intended to be an exhaustive analysis of bank-holding corporation accountancy. No previous study of a similar nature has come to my attention. The accountancy work involved in the consolidation of two or more independent banks is frequently quite difficult, but when such consolidations are effected by an exchange of stocks through the medium of a holding company, the accounting difficulties are considerably simplified, since the absorbed banks continue business as distinct legal entities.

The analysis presented in this article is limited because of the incompleteness or lack of comparability of much of the published data. Further segregation of balance-sheet data as well as income and expense accounts is desirable. If further detail were available, a more satisfactory examination of the operating performances of the various banking groups would be possible.

Significant Balance-sheet Problems with Relation to the Capital Stock and Investment Accounts

One of the first things that holding companies must do is to issue at least part of their authorized capital stock. This stock may be issued for cash or in exchange for stock of a bank it desires to acquire. (It should be noted that the ownership of the stock of a bank, or of any other corporation, does not render the stockholding company the direct owner of the property or income.) If the stock is issued for cash at par, the operation in brief is simply a cash entry crediting capital stock, but if the stock is issued at a premium, the amount of the premium will be credited to the paid-in or capital surplus account, in contrast with the earned surplus account. Should the stock have no par value, and be issued for cash, the entire amount received will be credited to the capital account.

If stock is issued in exchange for the stock of a bank and cash does not enter into the transaction, the capital account may be credited with the total par value of the stock issued, and a suitable account such as "investment in stocks of subsidiary banks" or "investment in affiliated banks" will be charged or debited for a like amount.

However, it is preferable to set up the stock thus acquired at its break-up or book value and charge the difference between this value and the par value of the newly issued stock to a goodwill account. While this is the more conservative way of handling the transaction, it does not seem to find much favor in practice, and consequently the consolidated balance-sheet is usually advocated. Banks, of course, do not set up goodwill accounts among their assets because of conservatism and custom, but there is no reason why a holding company should not include this item of goodwill if it has been purchased. In other words, where a company has paid an amount in excess of the tangible or break-up value of the stock, it is buying something in addition to the actual tangible assets. This something may be designated as goodwill. As this method can not be readily applied in all cases with consistency, it will not be elaborated further, but in any case the highly inflated values that are sometimes applied to acquired stocks can not be regarded favorably.

Now, if the stock which the holding company is to exchange is without par value, the question arises as to what amount should be credited to its capital account to represent the value of its investment. While some alternatives are available, it is believed desirable to value the acquired stock on a net-worth basis, as disclosed by the balance-sheet of the acquired bank at the date of acquisition. This procedure is seldom adopted in actual practice, although it is sound theoretically.

To illustrate these points, assume that a given holding company acquires the entire capital stock of a small bank and that the balance-sheet on the day of acquisition is as follows:

Assets

Loans and discounts	$300,000
U. S. bonds and other securities	225,000
Banking house and equipment	68,000

Accrued interest	$ 4,000
Cash and with banks	40,000
	$637,000

Liabilities

Capital stock	$100,000
Surplus	50,000
Undivided profits	24,000
Reserve for interest, taxes, etc.	13,000
Deposits	450,000
	$637,000

The holding company will be assumed to issue 2,000 shares of its no-par capital stock in exchange for the entire capital stock of the above bank. It would then credit its capital account with $174,000 and debit its investment-in-affiliated-banks account with a like amount, comprising the capital, surplus and undivided profits of the affiliated bank. On the other hand, if the holding company issues 2,000 shares of $100 par value, the capital account of the holding company would be credited with $200,000 and the bank-stocks or bank-investments account would be charged for a similar amount, which, of course, would represent the cost of the acquired stock. So far as the holding company is concerned, it will be seen that this gives the same final result as if it had sold 2,000 of its shares to the public at par and then with the proceeds had purchased the 1,000 shares of the bank at a price of $200 a share.

It will be noted that while it may be desirable to carry the stock holdings at cost, the cost may vary considerably from the actual book value of the assets acquired and in most cases will greatly exceed it. Having regard to the facts which may lie behind the figure of cost, it would appear that the cost method, in many cases, is not as satisfactory a method of valuing stock holdings as might be desired. However, it is difficult to conceive of any other basis which would be of use in all cases.

Outstanding Income-statement Problems

The ordinary holding company or investment trust in most cases purchases its holdings in the market and may carry them at cost or revalue them at periodic intervals in accordance with the ruling market values. All cash dividends received from them are taken up in the profit-and-loss statement. This is not, or should not be, the case with the bank-holding company. Since acquisitions are primarily the result of special deals, the stocks of affiliated banks should not be subjected to such revaluations. While cost value, in relation to the income statement, may possibly be subjected to adjustment in special circumstances, it should be handled in a different manner, which is discussed subsequently in conjunction with the undivided-profits statement of Bank-Holding Corporation "Y."

When the holding company purchases the entire capital stock of a bank, it potentially acquires the whole of the reserves, surplus, and undivided profits. In so far as a dividend is declared out of the reserves and undivided profits in existence at the date of acquisition by the holding company, they are not income but capital in the hands of the latter and should be so handled, either by writing down the cost of the acquired stock, or by creating a capital reserve. (By capital reserve is meant reserves which are set up to offset over-valuations of investments. This account could be shown on the asset side of the balance-sheet as a deduction from the investment in stocks-of-affiliated-banks account or on the liability side as capital reserve.)

For purpose of illustration, the above balance-sheet is suitable. Undivided profits at the date of acquisition by the holding company amounted to $24,000. Assume that the bank then declares a dividend of 10% on its capital stock, or $10,000, out of these undivided profits. This dividend can not, in my opinion, be correctly considered as income or profit in the hands of the holding company, but rather as a reduction of the cost value of the unit bank's stock. The holding company should only consider as income dividends declared out of profits earned by the affiliated or subsidiary banks subsequent to the date of acquisition. While this rule is possibly more respected theoretically than practically, it is sound, conservative accounting practice and therefore is to be recommended.

With hypothetical figures, it is of course difficult to go into anything approaching full details, but it is hoped that the main line of reasoning has been shown in the outstanding balance-sheet and income accounts which have been considered.

Financial Statements of Bank-holding Corporations

In considering the published statements of bank-holding companies, it should be remembered that they are issued with the alleged purpose of giving information to the stockholders. How far they answer this purpose can be determined by examining specific statements. However, it should be said that frequently the trend of affairs in some concerns during the period between the publication of successive statements is obscure. The position revealed by some statements is not quite clear, if not oftentimes actually misleading. Probably bank-holding companies' balance-sheets in practice are not subjected to adjustment or manipulation to any greater extent than balance-sheets of other organizations. However, there is little doubt that such possibilities exist in the case of the former to a greater extent than is generally supposed. Furthermore, where holding company balance-sheets are being adjusted or manipulated (I use this word without derogatory significance), it is difficult for the outsider to trace it.

There is, of course, no single remedy for this condition but much can be accomplished by a demand on the part of stockholders for more details, and by a general knowledge of the outstanding features of bank-holding company accountancy. Those investors in group systems, who wish to keep informed as to the actual value of their investment, should endeavor to familiarize themselves with the particular method of presentation of accounts followed by their corporations. In cases where the holding company owns outright or has a substantial majority control, two balance-sheets should be submitted; first, its own balance-sheet as shown by the books;—in other words, a balance-sheet made up of figures taken from the general ledger—and, second, a consolidated balance-sheet of the holding company and its subsidiaries, prepared in the generally accepted manner for preparing consolidated balance-sheets, both statements having due regard for the seven points enumerated later.

Bank-holding Corporation "A"

The following balance-sheet and income statements of this corporation are a very good example, in my opinion, of how such statements should not be presented.

Total Resources and Liabilities of Banks and Trust Companies Affiliated with Bank-holding Corporation "A"

Resources

Loans and discounts	$35,643,964
Bonds and securities	7,986,521

Real-estate mortgages	$ 8,633,969
Cash and due from banks	6,604,104
Advances to trusts	435,819
Customers' liability letters of credit and acceptances	42,901
Customers' securities	1,625,043
First mortgage bonds—trust fund	863,129
Banking house equipment, etc.	1,905,969
Other resources	36,744
	$63,778,163

Liabilities

Capital stock	$ 4,975,634
Surplus	5,143,965
Undivided profits	1,796,758
Reserves	349,672
Total invested capital	$12,266,029
Bills payable	5,584,624
Letters of credit and acceptances	31,697
Customers' securities-safekeeping	1,900,760
Mortgage bonds	603,931
Repurchase agreements	350,900
Circulation	701,692
Other liabilities	641,340
Deposits	41,697,190
	$63,778,163

INCOME STATEMENT

Aggregate gross earnings of the units of the group amounted to	$ 5,906,431
From which all expenses (including taxes of all kinds and depreciation of buildings and equipment) were paid to the amount of	4,790,584
Leaving net earnings from operations (after writing off known losses) in the amount of	1,115,847
Or at the rate of 23.45% on outstanding capital stock of 237,900 shares of $20 par value.	
Of this amount there was set aside reserves for unforeseen contingencies in the amount of	140,367
Leaving available for dividends	975,480
(Or at the rate of 20.50% on outstanding capital stock or 237,900 shares of $20 par value.)	
Of this amount there was paid out in dividends during the year by the group or by the member banks prior to affiliation with the group	470,609
Leaving for additions to surplus or undivided profits	504,871

Certain points in these statements might lend themselves to unfavorable interpretation in relation to the accounting policy of the group. While the balance-sheet presents substantial figures, it is not the type of statement which can be readily analyzed by stockholders. Since it merely totals the respective accounts and presents aggregates for all the banks in the group, certain calculations in relation to the stock of the holding company itself are practically impossible. The income statement should similarly be criticized and may even be said to be misleading. (Not with intent to deceive, however. It has evidently been drawn up in accordance with what the corporation considers good accounting practice.) It represents as profits and income to the stockholders in the holding company a figure which actually represents only partly income, the remaining portion being assets or capital, which the holding company bought and for which it paid. No correct basis is given, therefore, on which to base analyses. The asset value behind each share of stock, for example, can not be calculated on a correct basis. Neither is it possible accurately to determine what the corporation earned per share.

An elaborate report of thirty-five pages is given, which, it would appear, fails in the purpose it purports to serve. A more satisfactory balance-sheet as well as profit-and-loss statement for the holding company, both as shown by the books of the company, should be prepared as already described, and in accordance with the seven general rules given later. Furthermore, these statements should be supplemented by a consolidated balance-sheet of the group, prepared in accordance with the recognized practice of preparing consolidated statements, and not merely a general statement of total resources and liabilities. Earnings per share, asset value per share, etc., could then be determined on the basis of the holding company stock.

Bank-holding Corporation "B"

The following statement has its good points and may give a good picture of the financial condition of the corporation even though it is not taken from the books of the company. Another objection is that the corporation simply incorporates the surplus and profits of the subsidiary banks with its own surplus and undivided profits. The facts do not justify such a procedure. In other words, as stated above, the ownership of the stock of a subsidiary bank does not render the holding company the owner of the property of the bank. Inasmuch as the banks controlled are independent institutions, retaining their own identity, their earnings should become part of the income of the holding company only when they have been declared and paid as a dividend on stock and when such earnings are from operations subsequent to the acquisition of the bank. Furthermore, the surplus should be segregated, showing the paid-in surplus and the earned surplus, or undivided profits, separately. The corporation does not follow the desired policy of submitting a profit-and-loss statement.

BANK-HOLDING CORPORATION "B"

Resources

Book value of capital surplus and undivided profits of the 10 Bank-holding Corporation "B" Banks	$7,612,793	
Less minority interest therein (including directors qualifying shares)	145,640	
Bank-holding Corporation B's ownership therein		$ 7,467,153
Other receivables and assets, net		29,300
Cash in banks and in transit		6,670,080
Total resources		$14,166,533

Liabilities

Capital stock outstanding (809,468 shares)	$ 8,094,680
Surplus and undivided profits (Dividend of $242,840.40 paid Dec. 31, 1929)	6,071,853
Total liabilities	$14,166,533

Bank-holding Corporation "C"

The balance-sheet of Bank-holding Corporation "C" appears to have been taken from the books of the corporation, and for this reason it is preferred to the previous two. Furthermore, it is drawn up in the generally accepted accounting manner. This statement was prepared by a reputable accounting firm. It appears that statements audited by public accountants tend to conform to practices recommended in this article.

Balance-sheet

Assets

Cash and call loans	$ 4,853,390
Stocks and bonds, at lower of cost or market	2,393,150
Dividends, notes and accounts receivable	3,619,510
Investment in stocks of banks and subsidiary companies, at cost	123,800,460
Total	$134,666,510

Liabilities

Dividend payable January 1, 1930	$ 1,434,960
Capital and surplus:	
Represented by 22,346 shares of initial non-par-value stock and 803,904 shares of fully participating non-par-value stock....	133,231,550
	$134,666,510

The paid-in capital and the earned surplus should be segregated and not grouped in a single item. It would also be interesting to learn how the cost of investments in subsidiaries was determined, in view of the fact that the stock is without par value and was issued, it may be presumed, largely in exchange for the stock of the subsidiaries. (Such an explanation, of course, need not be incorporated in a balance-sheet.) On referring to the combined statement of condition of banks owned, it appears that the total of the capital stock, surplus and undivided profits of the subsidiaries amounts to $65,139,469, as against an investment in stocks of banks and subsidiary companies of $123,800,460. This indicates that stock which has a book or break-up value of the former figure is carried at the latter. As stated above, in a properly prepared consolidated statement of the holding corporation and subsidiaries, the difference should be carried as goodwill.

This corporation does not present an independent income statement but gives a combined summary of income, in which, for present purposes, we are not interested since it is not indicative of the position of the holding corporation itself.

Bank-holding Corporation "D"

The data given in the annual report of this company are sufficient and require little comment. The following commendable statement appears in the report: "We have obtained from each bank in the group an earnings statement for the entire year of 1929, and where the bank was not in operation for the full year, its income has been carefully estimated. Based on these figures, the annual net operating profit accruing to the corporation, after deducting all expenses and taxes, will amount to $———— or $4.73 per share of our stock. It is not to be understood that these earnings have actually been received by the corporation; nor will they be received hereafter. It is the policy of your officers to ask dividends from the several banks only sufficient to meet our own dividend requirements, and to allow the excess earnings to remain in the several banks in the form of surplus or reserves, thus continuously strengthening the component parts of the entire organization." It is stated that the item "stocks" represents the valuation at the time of the purchase of equities in affiliated corporations.

Balance-sheet[1]

Resources

Cash on hand	$ 976,343	
Bonds and commercial paper	2,167,930	
Bills receivable	1,430,094	
Accounts receivable	95,640	
Total quick assets		$ 4,670,007
Furniture and fixtures		4,340
Stocks		55,894,709
Accrued interest (net)		3,110
		$60,572,166

Liabilities

Capital*	$38,500,614
Surplus and undivided profits	21,730,546
Dividend payable, January 1, 1930	341,006
	$60,572,166

Bank-holding Corporation "X"

The following statement is fairly typical of the statements rendered by bank-holding corporations. It appears to have been accurately taken from the books of the corporation and to have been submitted in the usual condensed form.

Financial position of Bank-holding Corporation "X"

Resources

Commercial paper, call loans, and cash	$ 2,147,240
Notes receivable (secured)	3,614,227
Bonds	1,876,125
Accounts receivable	19,800
Stock of affiliated companies	43,006,840
Total resources	$50,664,232

Liabilities

Capital	$40,174,850
Surplus	8,500,000

[1] This is a statement of the holding company itself independent of subsidiaries.
* The report states that there was outstanding a total of 1,540,024.56 shares of an authorized capitalization of 5,000,000 shares of a par value of $25 on December 31, 1929.

Reserve for contingencies	$ 700,000
Reserve for dividends	1,289,382
	$50,664,232

The annual report states that the corporation had outstanding 803,497 shares of capital stock with a par value of $50.00 a share, thereby giving desired data regarding the capital account. While the combined financial statement of affiliated institutions discloses capital stock, surplus and undivided profits aggregating $24,763,940 as of December 31, 1929, according to the balance-sheet, it appears that stocks of affiliated companies are carried at $43,006,840, or practically double the tangible or break-up value of these stocks as disclosed by the combined financial statement of affiliated institutions. The corporation does not give its own statement of earnings; instead it gives the combined statement of the earnings of the group. As stated before, the latter gives no indication of what will be considered as income by the holding company.

Bank-holding Corporation "Y"

The following accounts present to stockholders in proper form all the required information. In this case the holding company does not own outright any of its subsidiaries and consequently no consolidated balance-sheet is required. Nevertheless, the balance-sheet containing the account "bank stocks at cost" should state the market value of these stocks, since it is information that should be given to stockholders. However, the main account, to which attention should be drawn, is the adjustment of cost of bank stock account in the undivided profits statement. This indicates that out of the dividends received, $8,653 were earned prior to acquisition by the holding company, and that this amount has now been properly applied to reduce the cost of bank stocks. This company is the only one, which has come to my attention, that has incorporated such an account in financial statements.

Balance-sheet

Assets

Bank stocks, at cost	$12,490,687
U. S. government and municipal bonds at cost	834,767
Other investments, at cost	65,040
Cash in banks and on call	1,106,293
Accrued interest receivable	45,676
	$14,542,463

Liabilities

Provision for federal and other taxes		$ 75,000
Dividends payable, January 2, 1930		267,000
Capital shares:		
200,000 shares no par value amount paid thereon	$14,000,000	
Undivided profits	200,463	
		$14,200,463
		$14,542,463

Income Account [1]

Income:		
Dividends		$ 435,610
Interest		263,900
Miscellaneous		1,004
		$ 700,514
Less:		
Expenses paid, including compensation of Bank-holding Corporation "Y"		
For services	$90,000	
Fees	1,200	$ 91,200
		$ 609,314
Provisions for federal and other taxes		35,004
Net income		$ 574,310

Undivided Profits

Balance, December 31, 1928	$ 32,506
Deduct: Adjustment of cost of bank stock	8,653
	$ 23,853
Add: Net income for the year ended December 31, 1929	574,310
	$ 598,163
Deduct: Dividends paid	450,000
Undivided profits	$ 148,163

Bank-holding Corporation "Z"

The following balance-sheet is significant not only in that it gives all desired information, but because it is the statement of a large bank-holding corporation.

Balance-sheet

Assets

Investments:	
Bank of A, and A Company	$120,001,091
B Company of America	225,324,640
Bank of B, and B Corporation	6,124,965

[1] Incidentally in this case also the accounts were prepared by a reputable accounting firm.

Bank of C, and C Company		$ 4,306,701	
I Company		600,000	
E Fire Insurance Company		1,410,603	
E Mortgage Company		250,000	
G Agricultural Credit Corporation		325,000	
The "H" Joint Stock Land Bank		742,000	
K Holding Company (now M Corporation)		200,000	$359,285,000
Cash:			
On deposit and due from banks			2,100,000
Receivables:			
Declared dividends—"D" Company		50,000	
Advances—"B" Company		5,640,000	5,690,000
			$367,075,000
Liabilities			
Dividend payable January 25, 1930:			
In cash			$ 3,000,000
Accrued:			
State corporate taxes, etc. (not payable until after date of balance-sheet)			25,000
Capital stock and surplus:			
Authorized 20,000,000 shares	$400,000,000		
Less:			
Unissued 12,000,000 shares	240,000,000		
Issued and outstanding 8,000,000 shares	$160,000,000		
Fractional share scrip 37,500 shares	750,000		
		$160,750,000	
Paid-in surplus:			
From sales and exchanges of stock	$300,000,000		
Less: Stock dividend paid (100%)	100,000,000		
		200,000,000	
Profit-and-loss surplus:			
Consolidated net profit for the year ended December 31, 1929	$ 20,300,000		
Less: Earnings for year of companies included in above but not taken into income of Bank-holding Corporation "Z"	1,200,000		
	$ 19,100,000		

Deduct:				
Dividends paid and declared:				
Cash..............	$12,300,000			
Stock.............	3,500,000	$ 15,800,000	$ 3,300,000	$364,050,000
				$367,075,000

It will be noted that the desired elaboration of the capital-stock and surplus accounts has been given, and there is some indication as to how the value of investments was ascertained.

Justification for Contemporary Practices

After presenting and criticizing a number of the published statements of important bank-holding companies, it might be advisable to consider possible reasons why some of these statements are prepared as they are. In the first place banks are in a position different from that of most business organizations. They have a large number of depositors to consider and have to produce accounts which all may understand. They enjoy a reputation of being conservative in their business, and they can not afford to be radical even in the method of presentation of accounts. The perpetuation of a method of presentation which is well understood is calculated to preserve that confidence which is so essential to the life of a bank. Therefore, bankers, when they organize a holding company, endeavor to present its accounts in the form to which they have been long accustomed. This tendency, of course, will gradually diminish when it is recognized that it is a large number of stockholders and not of depositors which the holding company has to consider.

Fortunately, however, many holding companies have now realized that it is with the investing public that they, as holding companies, are primarily concerned, and accordingly they present their accounts in the accepted form. Their example will no doubt be followed sooner or later by all the others, leaving the individual or even the combined banks to issue statements independently for the benefit of depositors.

Many of the holding companies whose accounts have been considered had been recently organized and were presenting their first annual reports. They adopted the combined form as they were desirous of submitting a good statement. This obviated the necessity of their having to disclose inconvenient facts and gave them a full operating period of six months to put their house in order. During this time they also had the opportunity to study the reports of their contemporaries.

It has been noticed that there is a tendency to the holding company to give a combined balance-sheet of its various subsidiary banks, together with a combined profit-and-loss account, supplemented by the various balance-sheets of the individual banks. This method of presentation of accounts is applicable to branch banking, where a parent operating bank controls a number of branches. It is particularly applicable in such cases inasmuch as it shows the depositors all the facts in such a way that they can quickly and easily understand, but it should not be used in group banking.

It is reported that the economic policy commission of the American Bankers Association is endeavoring to develop a proper method of preparation and presentation of financial statements.

Summary of Recommended Accounting Policies for Bank-holding Corporations

A brief and general discussion of certain outstanding bank-holding corporation accounts has been presented. While many more examples might be given, the same general principles would apply. They all indicate the advisability of a conservative but thorough statement. In order to accomplish this purpose, the following points should be stressed: (1) give such particulars as will disclose the general nature of the assets and liabilities and how the values have been computed; (2) organization expenses and goodwill should be separately stated; (3) investments in banks held for the purpose of control should not be combined with other investments; (4) loans to or from affiliated banks should be stated separately in the aggregate; (5) loans and investments should not be combined; (6) a complete summary of the capital stock should be given; and (7) expense and income accounts should be made available in considerable detail.

Balance-sheet data are stressed because some leeway exists and certain arbitrary figures could be set up. Furthermore, sundry assets can be combined in such a manner as to conceal their identity. On the other hand, in the profit-and-loss statement, the various accounts are simply the balances of such accounts shown by the books. While some arbitrary grouping may take place the net result is not affected.