1969

Accounting Research Association Newsletter, Volume II, Number 3, March 26, 1969

American Institute of Certified Public Accountants. Accounting Research Association

Accounting Research Association newsletter

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, 666 FIFTH AVE., NEW YORK, N.Y. 10019

Vol. II, No. 3 March 26, 1969

ACCOUNTING FOR BANKS: APB Opinion No. 13 (ARA Newsletter March 12,) which makes the provisions of Opinion No. 9 applicable to commercial banks, means that independently audited banks will be reporting a net income figure in their 1969 financial statements. As a result of intensified interest in accounting for loan losses and gains and losses on security transactions sparked by this Opinion, the Institute's committee on bank accounting and auditing is preparing a supplement to *Audits of Banks*.

The supplement does not retract any of the positions taken in the guide but sets forth additional methods of accounting and reporting which are considered acceptable. The proposals in the supplement are summarized below.

Securities Gains and Losses: Where a bank elects to defer and amortize investment grade securities gains and losses, it is now recommended that all such gains and losses be amortized to the maturity date of the security sold. But for ease of application banks may elect to amortize these results over a reasonable number of years, such as six years. Or, banks may use a moving average of recent years, such as the most recent six year period. Consistent amortization over a reasonable period, other than to maturity, should not produce results which are materially different, except in rare cases.

In the infrequent cases where proceeds of the sale have been permanently diverted from reinvestment, deferral and amortization would not be appropriate.

If the amortization is not reflected in the operating earnings section, it may be presented following a caption labeled: *Net operating earnings, exclusive of amortization of securities gains and losses*. Banks may include these results in the income statement, but may not be permitted by regulatory requirements to defer these results in their balance sheets. Generally this failure to defer will not have a material effect on a bank's financial condition, and where this is the case, the auditor will not be required to qualify his report. Under such circumstances the unamortized balances should appear in the capital funds section.

Although the committee prefers that the deferral and amortization method be applied retroactively to all years being presented, application from the year the method was adopted is also acceptable.

Loan Losses: The proposed supplement reaffirms the position taken in the Guide that a systematic and consistent method for charging loan losses to operating earnings should be determined by each bank. A moving average of recent years' experience (six years is used as an illustration) would be considered appropriate. Recognition should be given, however, to changes in the character of the loan portfolio, credit policies and to current economic conditions.

Loan loss provisions may follow the heading: *Net operating earnings, exclusive of provisions for loan losses*, if excluded from the operating expense section of the income statement (inclusion recommended in the Guide.)

(continued)

Illustrative financial statements in the supplement include a combined statement of income and undivided profits showing, among other things, the following key captions:

Net operating earnings, exclusive of provision for loan losses and amortization of securities gains (losses)
Net income
Net increase in undivided profits before dividends

The capital funds section of the balance sheet includes an account called "Contingency reserve for loan losses" which is an appropriation from undivided profits.

The committee and the banking industry are near agreement on these methods, and there is reason to believe the regulatory agencies will permit statements to be filed using these methods. Some banks may wish to apply the supplemental guidelines to first quarter 1969 statements.

EARNINGS PER SHARE -- The proposed Opinion on Earnings Per Share, (ARA Newsletter March 12) is now in the final stages. The exposure draft has been rewritten -- most of the revisions are concerned with organization and clarification of the text, but some substantive changes have been made as follows:

...Determination of common stock equivalency (residuality) should be made only at the time of issuance. (After considering the question of possible changes in status subsequent to issue, the Board believes that such possible dilution should be included only in the fully diluted earnings per share figure, rather than in the primary earnings per share.)

...Convertible securities are common stock equivalents if the cash yield at issuance is less than: 60% of bank prime interest rate (for convertible debt); 66 2/3% of prime rate (for convertible preferred stock). (The initial exposure draft proposed an "investment value" test, with the possible alternative use of "market parity." The Board has since concluded that these methods are too subjective and often impracticable. In the interests of simplicity and objectivity, the percentage of prime rate tests are being proposed. The differential in rates is to give recognition to the fact that debt and preferred stock command somewhat different cash yields in the marketplace.)

...Options and warrants are considered to be common stock equivalents at all times because they derive their value entirely from the right to obtain common stock for an extended period. The primary earnings per share should be determined by the "treasury stock method," which assumes that the options and warrants were exercised during the period and the funds obtained thereby were used to purchase common stock at the average market price for the period. Such treatment would be called for only when the market price of the stock exceeds the exercise price for three consecutive months before the end of the period for which earnings per share are reported.

...Dilution of less than three per cent need not be recognized in the computation of per share earnings. This would avoid unnecessary computations when the results would not have a material effect on reported per share earnings.

...The effective date of December 31, 1968 has been modified to cover convertible securities issued between that date and May 1, 1969. A company may elect either to continue to classify all outstanding convertible securities on the basis existing as of April 30, 1969, regardless of the criteria set forth in the proposed Opinion, or to classify all such securities in keeping with the provisions of the Opinion.

APB action is expected in April with the Opinion to be issued soon thereafter.