Statement on the Financial Reporting of Commercial Banks

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A STATEMENT ON THE FINANCIAL REPORTING OF COMMERCIAL BANKS
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The financial reporting of commercial banks has been significantly improved by the new rules for determining net income.

The new requirements call for banks to report net income on an all-inclusive basis, just as other commercial enterprises are required to do. Heretofore, commercial banks have instead reported a figure labeled "net operating earnings," which has not included gains and losses from security transactions or any provision for loan losses. The new rules specifically require that these items be included in net income.

These rules resulted from joint discussions among the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, the American Institute of Certified Public Accountants, and -- it should be noted -- a committee of the American Bankers Association.

Despite the participation of the American Bankers Association in the development of these rules, some bankers now complain about the new requirements.
Investors in debt securities, including banks, assume certain risks to obtain earnings on funds not otherwise employed. One of the normal risks of holding obligations with a fixed maturity value is that of interest rate changes with resultant fluctuations in the market value of the securities. The interest income from these investments is properly included in net income; the gains and losses on these securities are also part of the results of the investment decision.

Although losses could be avoided by holding the securities to maturity when they would be paid at par, there are good reasons why this is not always done. Management may want to sell some of the bank's securities in order to reinvest in securities or loans with higher yield, to meet some desired liquidity position, or to use the funds for some other purpose.

This is part of a bank's normal and expected operating pattern, and the income resulting from a management decision to use the funds in some other fashion should not be isolated from the results of the security transaction which made the funds available.

The ultimate in this matching process would be to carry the securities at market in the balance sheet
and to recognize all changes in market price currently in net income. Accountants and, I think, bankers and the Federal Regulatory Agencies have been generally reluctant to go this far. However, I believe it may ultimately be the accepted method.

It is logical that a bank's investment program be considered an integral part of its operations and that the figure reported as net income should include not only interest income but any gains and losses on security sales resulting from a change in its holdings for whatever reason. If a bank management wants to disclose separately the effect on its net income, resulting from security gains or losses, it should do so. However, primary emphasis should be on the net income amount, for net income is the most significant figure on the income statement.

Recently, some bankers and bank security analysts have complained that the new reporting format has caused confusion. I submit that these critics themselves may be causing the confusion by giving undue emphasis to earnings before security gains and losses. They prefer this figure because they dislike the fluctuating effect on net income caused by securities gains and losses.

These same critics suggest that including the
results of securities transactions in net income allows a bank management to "manage earnings" by discretionary timing of security sales. But the exclusion of security losses in reporting earnings is a more serious form of "managed earnings." This treatment permits a bank to show improved earnings performance by including higher interest income from reinvested funds without reflecting the loss from the transaction that was necessary to make the reinvestment.

Businessmen in many industries would be glad to omit from reported earnings the type of transaction which fluctuates between gains and losses. It would be appealing to report only the portion of earnings which results in a nice steady trend. It would be particularly appealing to omit losses -- and for the last few years, with generally increasing interest rates, banks have incurred more losses than gains from their security sales.

A historic reason banks have given for excluding security transactions when reporting income is that, until now, Federal income tax rules have allowed them to group security gains and losses in alternate years. Under this arrangement, net gains in one tax year were taxed at capital gains rates, and net losses in a succeeding year were offset
against ordinary income, producing a tax advantage not enjoyed by other businesses. The Tax Reform Act of 1969, except for a proration of gains on securities held prior to mid 1969, has eliminated this influence. Tax considerations no longer exert the same influence on decisions of banks to sell securities.

A bank should report a bottom-line figure, just as other businesses do. The Accounting Principles Board of the American Institute of CPAs has issued a formal Opinion stating that banks must conform to its generally applicable pronouncement on reporting income and earnings per share. This means that audited financial statements of banks have to report net income and related earnings per share that include all elements of income.

The work of the American Institute in improving the financial reporting of banks is but a part of a much broader effort to improve financial reporting for all businesses. This effort has been undertaken in response to the demands of many interested groups, including professional accountants, security analysts, financial writers, and commercial bankers themselves. Indeed, prominent bankers have been among those most vehemently calling for faster action by the accounting profession to improve the financial reporting practices of other businesses.
In developing the new format for the income statement of banks, the American Institute worked in cooperation with the three federal bank regulatory agencies, the Securities and Exchange Commission, and representatives of the banking industry. The result of this joint effort refuted the view which has sometimes been expressed that regulatory agencies always become dominated by the industries they are supposed to regulate. In fact, the regulatory agencies in this case adhered to the principle that a net income figure should be reported. And notwithstanding some initial resistance to this innovation among the bankers, they also eventually agreed to the consensus position.

Dissatisfaction with the new reporting requirements is not a reflection on the soundness of the consensus position but is a reminder of one of Niccolo Machiavelli's observations: "There is nothing more difficult to carry out, nor more doubtful of success, nor more dangerous to handle, than to initiate a new order of things. For the reformer has enemies in all those who profit by the old order, and only lukewarm defenders in all those who would profit by the new order."
I believe that the "new order of things" in the financial reporting of banks was arrived at after ample exposure to all points of view. I am confident that all parties to the agreement will recognize their responsibilities to the investing public and will be steadfast in its defense. Financial writers and security analysts have consistently supported efforts to improve financial reporting and I hope they will join with us in securing acceptance of the net income concept for banks.

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