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The Case of U.S. Multinational Banks

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Strong global competition, extreme interest rate and exchange rate volatility, and deregulation have prompted banks to enter into new fields and implement preferable accounting methods to meet their targeted profit growth. Unfortunately, the financial accounting disclosure requirements have not kept pace with the financial reporting creativity of the multinational banking system. Under these circumstances, it is no surprise to see comments concerning possibly misleading bank financial statements. Lissaker notes in a 1982 *Washington Post* article that "bank stocks have climbed in the bull market of recent months as the banks have reported higher earnings. (In some cases, banks exaggerate their profit reports by failing to cover potential losses.)" [p. C4]. Moreover, a *Wall Street Journal* article states that "the stock market is sending a message to the big banks. We don't believe your earnings" [Hertzberg, p. 23]. Throughout 1985 and 1986, and now in 1987, multinational banks (MNBs) have continued to make headlines.

MNB profits are affected by a variety of factors. This paper discusses several important financial practices (e.g., foreign currency translation, and off-balance-sheet commitments and contingent liabilities) as they affect the income statements and balance sheets of U.S.-based MNBs. This discussion is important to accounting practitioners, financial analysts, MNB managers and academicians.

The twelve largest U.S.-based MNBs were analyzed relative to their foreign currency translation (FCT) reporting practices for the years 1982 through 1985. These MNBs were inconsistent in the method and degree of disclosing their FCT gains (losses). Part of this problem rests with the flexibility allowed in defining the functional currency.

Assuming that the parent company is based in the U.S., management can define the functional currency of the non-U.S. subsidiary as the U.S. dollar; thus, the FCT adjustments are recognized in the income statement. If management defines the functional currency of the non-U.S. subsidiary as any currency but the U.S. dollar, FCT adjustments are reported in the balance sheet.

In this way, reported earnings can reflect managerial preference, rather than a transaction or event external to the firm. For financial accounting, a change of the functional currency is similar to a change in estimate. For tax purposes, the Tax Reform Act of 1986 deems this same change as a change in accounting principle.

For 1982, 1983, and 1984, massive FCT losses were reported by nearly all of the twelve largest U.S. banks (See Table 1). For example, BankAmerica reported FTC losses of \$32.2 million (\$.22 per share), \$46.6 million (\$.31 per share), and \$44.8 million (\$.30 per share) for 1982, 1983, and 1984, respectively. These sizable losses appear in BankAmerica's balance sheet but not in the income statement.

Unfortunately, the financial accounting disclosure requirements have not kept pace with the financial reporting creativity of the multinational banking system.

In 1982, when the recession and deregulation adversely affected the banking industry, all but one of the twelve largest U.S. MNBs elected to exclude net FCT adjustments from their income statements. The bank choosing to continue including translation adjustments in the income statement was First Interstate. Beaver and Wolfson [1984] questioned the appropriateness of banks excluding translation adjustments from their income statements:

> Banks make borrowing and lending decisions at a multinational level to exploit "perceived" violations of interest rate parity among currencies. If the objective is to take advantage of interest rate disparities, however, exclusion of translation gains and losses from earnings will obscure an evaluation of effectiveness of this speculative activity [p. 33].

If MNB financial accounting practice is providing an unobscured view of performance, the FCT adjustment should correlate with economic reality. When the U.S. dollar was strengthening against other currencies, which was the case for 1982 through 1984, FCT losses should

TABLE 1
Largest Twelve U.S. Multinational Banks
Net Translation Gain (Loss) or Adjustment for the Year
In Dollars (in Thousands) and Per Share

	1982	1983	1984	1985
Citicorp	(13,000)	(39,000)	(63,000)	18,000
per share	(.10)	(.32)	(.50)	.13
BankAmerica	(32,182)	(46,572)	(44,773)	27,113
per share	(.22)	(.31)	(.30)	.18
Chase Manhattan	(13,921)	(8,420)	3,611	(3,535)
per share	(.21)	(.12)	.05	(.05)
Manufacturers Hanover	(184)	a	a	a
per share	(.01)			
JP Morgan	(5,000)	(4,000)	(11,000)	3,000
per share	(.12)	(.09)	(.13)	.03
Chemical	(6,281)	(13,692)	(5,897)	(1,622)
per share	(.22)	(.43)	(.11)	(.03)
Security Pacific	(6,739)	(3,763)	(8,935)	5,300
per share	(.22)	(.10)	(.12)	.07
Bankers Trust	(4,263)	(6,960)	(1,895)	65
per share	(.16)	(.24)	(.06)	.001
First Interstate	a	a	a	a
First Chicago	(1,062)	(1,904)	(1,462)	(8,252)
per share	(.03)	(.05)	(.03)	(.17)
Mellon	(429)	(419)	(877)	(1,388)
per share	(.02)	(.02)	(.03)	(.05)
Continental Illinois	(4,638)	(5,542)	-0-	(3)
per share	(.12)	(.14)	-0-	(.01)

Source: Compiled by authors from annual reports
a = Information not disclosed in annual report

have occurred. With the exception of Chase Manhattan in 1984, this indeed was the case for all of the banks studied (see Table 1). In 1985, when the U.S. dollar fell in value (relative to other currencies), FCT gains should have occurred. This was the case for Citicorp, BankAmerica, J.P. Morgan, Bankers Trust and Security Pacific. The other MNBs analyzed either did not report (i.e., First Interstate) or reported net losses. The latter is probably attributable to the combination of incorrect anticipation of the direction of exchange rate movements and the engagements in forward exchange contracts and swaps which recently have grown in importance.

The spectacular growth in the present decade of several new financial instruments has further obscured evaluation of bank earnings partially due to diverse disclosure practices. For example, the combined interest rate and currency swap (called a cross-currency interest swap) is not addressed by the FASB [Wishon and Chevalier, p. 68].

Under the current provisions of Statement of Financial Accounting Standards (SFAS) No. 52, exchange gains or losses for net investment hedges or foreign currency commitments are excluded from net income determination. Management can, however, remove these hedges at any time while continuing deferral of the related exchange gains or losses. Thus, for currency swaps and forward exchange contracts (covered under SFAS No. 52), the established criteria "created the possibility that transaction gains or losses that should be reported in net income currently may instead be reported as translation adjustments or deferred as hedges of commitments" [SFAS No. 52, p. 22].

Discretion in financial accounting disclosure of swaps and forward exchange contracts is a dilemma that is magnified by the reporting practices for standby letters of credit and guarantees. These are generally classified as off-balance-sheet commitments and contingent liabilities, which are exposed to the fluctuating foreign currency exchange rates.

An analysis of the 1985 annual reports of those twelve largest MNBs previously mentioned, reveals diversity in the manner and magnitude of disclosure of the off-balance-sheet financial instruments. A similar transaction may be omitted or disclosed differently by the MNBs. Despite the different financial position and risk exposure created by the various kinds of swaps ("unmatched," "matched," "hedged," and "offsetting" swaps that are different methods of valuation and income recognition) [Wishon and Chevalier, p. 74], not all of the MNBs disclosed which method they applied in accounting for swaps and the recognition of the gains or losses resulting from the changes in value. Nor did all of the MNBs display the separate amounts of their standby letters of credit.

In 1982, when the recession and deregulation adversely affected the banking industry, all but one of the twelve largest U.S. MNBs elected to exclude net FCT adjustments from their income statements.

Fee revenue generated from these off-balance-sheet commitments can be recognized currently or over the life of the contracts. However, out of the twelve MNBs examined, not all of the MNBs disclosed the timing recognition of fees received from standby letters of credit. The related fees were recognized over the life of the contracts. Some MNBs recognized fees received from interest-rate swap arrangements currently, while other MNBs recognized these fees over the term of the matched swap agreements.

However, out of the twelve MNBs examined, not all the MNBs disclosed the charging of these possible losses to the Reserve for Possible Loan Losses or the incorporation of the risks associated with standby letters of credit or off-balance-sheet agreements and obligations in their credit loss estimations.

Banks act as both intermediaries and guarantors for these instruments. Possibly customers will default on their obligations. However, out of the twelve MNBs examined, not all of the MNBs disclosed the charging of these possible losses to the Reserve for Possible Loan Losses or the incorporation of the risks associated with standby letters of credit or off-balance-sheet agreements and obligations in their credit loss estimations. MNBs' diverse disclosure practices for potential losses may be due to the lack of specific financial accounting guidelines for these banking services.

Summary and Conclusion

This paper provides a context for understanding how some U.S. multinational banks account for and disclose foreign currency translation, off-balance-sheet commitments and contingent liabilities. Financial accounting practices, in light of SFAS No. 52, have been analyzed for the years 1982 through 1985. This analysis reveals that although SFAS No. 52 may have settled some issues, many issues remain. Fortunately, the Financial Accounting Standards Board is addressing the issue of improving "disclosures about financial instruments and off-balance-sheet financing and hedging arrangements" [News Report, p. 14]. However, unless the accounting profession acts promptly to curb the wide diversity in disclosure and measurement practices used by the multinational banking community, the credibility of both the financial accounting profession and the MNBs will be in jeopardy. Ω

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