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Louis A. MacKenzie

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Should Banks Be Required to Adopt the Reporting Requirements of the SEC?

by Louis A. MacKenzie
Partner, New York Office

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Tonight I have been asked to discuss with you for a few minutes the question, "Should Banks Be Required to Adopt the Reporting Requirements of the SEC?"

Let me be brief. The answer to that one, at least in my opinion, is an unequivocal yes. But, is the answer that simple? For a few minutes, let us consider the recent legislation affecting bank reporting.

About one hundred years ago an event took place that has had a profound effect on the banking industry. That event was the approval by President Lincoln of the Act of February 25, 1863, providing for a system of national banks chartered and supervised by the Comptroller of the Currency, under the general direction of the Secretary of the Treasury. This Act, known as the National Currency Act, and referred to by many as the Free Banking Bill, attracted scant notice in the Nation's press of that day; as a matter of fact, in one New York City daily it was covered by the following three-line insert in a column on Washington miscellany:

> The Free Banking Bill, it is understood,
> was approved by President Lincoln
> early in the week.

In spite of the lack of publicity, I am sure that everyone in this room will agree with me that, with the stroke of a pen, President Lincoln set in motion a chain of events that in time helped to stabilize and strengthen the Nation's economy. Regulation, in short, has been healthy, for the aims of the federal government in its supervision of banks has been to protect depositors' funds and to assure the ability of banks to continue service to their communities.

On August 20, 1964, just a little over a hundred years after the signing of the National Currency Act of 1863, President Johnson signed into law the Securities Acts Amendments of 1964 whereby, among other things, public disclosure provisions concerning certain financial information became applicable to unlisted corporations having $1 million or more of assets and 750 or more stockholders of a single class. These provisions extend to the banking industry.

This Act, unlike the 1863 Act, has received reams of publicity,

particularly as it affects the banking industry; but like the 1863 Act, its effect on the industry will also be profound, as it now appears.

Changes in the industry during the past hundred years have been many, and few would deny that change many times contributes greatly to growth and strength and usefulness.

How will this legislation affect the industry? The Congress has now told an important sector of industry to change its attitudes and policies on accounting.

As background, the powers, functions, and duties vested in the Securities and Exchange Commission to administer and enforce the Acts with respect to the securities of banks are transferred to the federal bank supervisory agencies. These agencies, and the banks reporting to them, are:

AGENCY	*BANK*
Board of Governors of the Federal Reserve System	State-chartered banks that are members of Federal Reserve
Federal Deposit Insurance Corporation (FDIC)	State-chartered banks insured by FDIC but not members of the Federal Reserve
Comptroller of the Currency	National banks
Securities and Exchange Commission	Any other bank not covered by the above-mentioned

Let me repeat, however, that the Acts apply only to those banks with $1 million or more in assets and 750 or more stockholders of a single class. Banking analysts have estimated that about 600 of the country's 14,000 banks are affected by the legislation, of which approximately 200 are State-chartered members of the Federal Reserve, 100 are State-chartered non-member banks, and 300 are National banks. In these figures, however, we may find an anomaly, which to me as a professional accountant is most disturbing. The nationally chartered banks that are required to register their securities may do so by filing with the Comptroller's Office two copies of their annual report, whereas State-chartered banks and members of the Federal Reserve must comply with Regulation F.

The Securities Acts Amendments of 1964 were put together after the SEC made its study of the securities markets and issued its huge report entitled *Report of a Special Study of the Securities Markets.* The Banking authorities, namely, the Federal Reserve and the FDIC, favored the bill; the lone dissenter was the Comptroller of the Currency,

James J. Saxon, who felt that the Act's provisions were not needed for banks; however, in all fairness, he favored the principle of disclosure. He felt that the bill was not needed inasmuch as the various authorities already had the authority to act. But, have they acted? It is fair to say that most of the supervisory authorities have issued regulations and rules that have been primarily for depositor protection rather than for stockholder protection.

William McChesney Martin, Chairman of the Board of Governors of the Federal Reserve System when the congressional hearings on the bill were being held in 1963, stated:

> The commercial banking system is one of the most closely supervised industries in the United States, subject to numerous laws and regulations, detailed examination, and requirements of reports to bank supervisors, both State and Federal. The objectives of bank supervision, however, are fundamentally different from those of the Securities Exchange Act.
>
> 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.
>
> Nevertheless, most of the information about a bank that is developed by the supervisory authorities must necessarily be treated by them as confidential, and the data now available to a bank's shareholders or prospective shareholders do not appear to provide all that they would need in order to make sound investment decisions.

As all of us in this room are aware, banks have over the years employed accounting methods or practices that in their judgment have best suited their purposes. Bank accounting in the past generally has been influenced by panics, bank failures, the bank holiday of 1933, et cetera, and hence the emphasis swung to depositor protection. The enactment of insured deposit legislation and the emphasis on conservative banking practices illustrate the trend. Some of these practices were:

1) Listing of Debits and Credits, which by some was called a statement of condition and was made available for depositors, stockholders, and prospective stockholders. It was an extreme rarity to find published Income Statements as we know and think of them.

2) Fixed assets often were written down; furniture and fixtures were charged off to expense and no depreciation taken.

3) Reserves were used to conceal income. Many times provisions were made to increase reserves in good years so as to take care of losses

in poor years; reserves were then a convenient method of income equalization. Items of income and expense have in the past been masked by transfers to or from reserves. I suppose that in the minds of some bankers such a practice contributed to the maintenance of stability.

4) As to investments, banks have traditionally shown securities at cost less amortization of premiums—premiums amortized to the earliest call or maturity date. Bankers have operated under the philosophy that they are not in the business of buying and selling securities but of lending money through credit. The movement in their portfolios occurs because of the rise and fall of lending requirements. As a result, premiums paid on securities purchased have been amortized, but discounts on purchases have not. Thus, as to discount items, income is recorded on a coupon basis rather than on a yield basis.

Listed below are some of the accounting treatments that commercial banks in the past frequently followed with respect to premiums and discounts on securities.

a) Neither premiums nor discounts on purchases were amortized.
b) Premiums only were amortized.
c) Both premiums and discounts were amortized.
d) Both premiums and discounts were written off immediately.
e) Premiums only were written off immediately.
f) Discounts only were written off immediately.
g) Some premiums were amortized and some premiums were written off immediately.
h) Both premiums and discounts were amortized on U.S. government securities only, and premiums only were amortized on the remaining securities.

To an accountant this diversity is perplexing to say the least. The examples cited are several of many—and it may be true that banks in the past have had almost as many different accounting practices as Cleopatra had charms. Are such practices logical from the viewpoint of the stockholder—from one who expects to invest in the securities of a bank? Has there been a double standard? I'm sure you will agree with me that the banker in making loans expects to receive from his customer adequate financial information, and in many cases requires our opinion on such statements. Should the banker be excused from good accounting and reporting practices, especially when one considers that the banks may be competing for capital funds, debenture issues, equity, etc?

What has been the effect of Regulation F?

1) It is significant, I believe, that the banking industry, through its associations such as the American Bankers Association, NABAC, the New York Clearing House, et al., has been working diligently since enactment to find further agreement on certain difficult accounting problems.

2) Some of the country's leading bankers have taken the position that banks should show the way in making their reports to stockholders clear and consistent so that investors can make an intelligent judgment.

In short: A stockholder of Bank X, or a person who is wondering whether to buy its stock, should be able to find out readily what sort of business the bank conducts, what its assets and liabilities are, the sources of its revenues, and the amount and trend of its earnings, and the many other things that an intelligent investor considers before deciding whether to buy, retain, or sell a security.

The principle laid down by the Securities Act of 1933 was that no one could sell a new security to the public unless the public was first supplied with a prospectus outlining the important facts about the corporation—its business, its financial condition, the people who ran it, and its results of operations to date. The banks however were exempt.

For thirty years banks escaped this impact. Now, however, it appears that full disclosure is here to stay as far as the banking industry is concerned. The composition of investors in bank securities has, like many other things, changed in the past quarter century. Bank stocks are no longer owned only by the relative few; the large middle class as well as the wealthy invest in bank equities. The Securities Acts Amendments of 1964 legislation as applicable to banks was inevitable as in the public interest.

As accountants we nevertheless criticize some of the things in the present regulations—provisos that differ in intent from generally accepted accounting principles. A partial list would include:

1) *Market value of securities*—Under present regulations, market values of bonds of investment grade need not be disclosed. In my opinion market value of *all* bonds should be disclosed for two reasons: (a) to permit the reader to evaluate investment earning power, and (b) to permit the reader to evaluate the portfolio transactions.

2) *The accounting for stock dividends*—Banks generally transfer from earned surplus to capital surplus only the par value of the dividend. Under a generally accepted accounting principle the transfer would be made at market value and surplus account charged therefor.

3) *Provisions for bad debts*—These charges, usually the full

amount permitted for tax purposes, now are all below the net operating earnings line, "net of tax." Although we admit this is an improvement over former practices, it leaves something to be desired. At least that part representing management's best judgment of possible loss should be charged to operating earnings. The bad debt is a cost of doing business.

4) *Recognition of deferred taxes*—Banks presently follow no uniform practice in providing for deferred taxes—some make provision and some do not. I see no reason why all banks should not do so.

5) *All-inclusive income statement*—Regulations fail to call for captioning the final figure as *Net Income for the Year.* Traditionally, however, the banker has considered net operating earnings to be more important.

6) *Security profits and losses*—Treating this item as a non-operating item is in my judgment acceptable as a bridge for the time being between former practice of reserving gains against the contingency of future losses from investments and loans, and including gains and losses in income.

The new era of bank reporting is here and is here to stay, and its capstone is full and fair dsclosure.

As is well known, bank reports need not contain an independent accountants' opinion since the regulations do not require one. Among the major New York banks, however, there appears to be a strong movement for change in this regard. All except one will have opinions from independent accountants in their annual reports for 1965. This trend is a challenge to our profession and we should therefore respond to it. The response should be with one thought in mind—that of rendering a service in accordance with a high standard of excellence.