CHAPTER - II

FINANCIAL REPORTING PRACTICES OF COMMERCIAL BANKS : A REVIEW OF LITERATURE.

To identify previous research on the financial reporting practices of commercial banks, an investigation was made in the fields of accounting, finance, banking and economics. Important previous studies that could be identified as directly relevant to our present research are noted in this chapter.

THE BAIN STUDY :

Sherwood E. Bain, a securities analyst made study of the annual reports of fifty largest commercial banks in the United States. Bain studied the annual reports of these banks for the years 1949 and 1950 and concluded that there was no uniformity in the accounting principles employed by the banks in their reporting to shareholders.[1]

A comparable analysis made of the 1952 annual reports of the twenty-eight largest commercial banks by a Committee of the National Federation of Financial Analysts Societies supported Bain's findings and concluded that the variations in content of the reports were so broad as to cause wonder at the methods of reporting to shareholders.[2]

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1. Sherwood E. Bain, "Annual Reports for Banks", Harvard Business Review, vol. XXIX, November, 1959, p. 106, quoted by R. H. Strawser, An Enquiry into the Financial Reporting Practices of Commercial Banks, University Microfilms Inc., Ann Arbor, Michigan, 1970, p. 43.

2. E. J. Larsen, Trends in Financial Reporting by Commercial Banks subsequent to the 1964 Securities Acts Amendments, unpublished D. B. A. dissertation, Dept. of Business, University of Southern California, 1967, quoted by R. H. Strawser, Ibid., p. 43.

THE JOHNSON STUDY :

Walter C. Johnson studied the reporting practices of the fifty largest commercial banks in the United States for the year 1963. Johnson observed that there were serious shortcomings in the financial reporting practices of the commercial banks included in his research. A summary of his major findings being as follows :

1. Three banks failed to present reconciliations of capital accounts.
2. One bank did not present a formal income statement.
3. Thirty-three banks used terminology applicable to cash basis accounting when it was obvious that accrual accounting was employed.
4. Fourteen banks did not disclose the method of accounting for state income-tax.
5. Many banks failed to indicate the basis of accounting for earnings on investment securities, or disclose the effect thereon of accrual of premiums and discounts.
6. Forty-three banks did not disclose the depreciation charges for the period.
7. Thirty-six banks failed to indicate clearly the losses on valuation of investment securities.
8. The method of accounting for gains and losses on the disposal of investment securities was not disclosed by six banks.
9. Thirty-two banks did not disclose the market value of investment securities.
10. The amount of twenty-two reserves established by those banks were not revealed.
11. The financial statement presentation of fourteen reserves was not indicated.

12. Thirty-six banks failed to provide reconciliations of charges in all reserve accounts.

13. Thirty-one banks did not disclose the composition of the loan portfolio in the balance sheet.

14. Nineteen banks did not subdivide total deposits into demand and time components.

The seriousness of these deficiencies were magnified by the fact that they were applicable to the fifty largest commercial banks in the United States.[1]

THE LARSEN STUDY :

E. John Larsen of the University of Southern California evaluated the trends in the financial reporting practices of commercial banks during the year 1963 through 1965.[2] Larsen's study was a follow up of the research by Walter C. Johnson.

Larsen requested annual reports from (i) the fifty largest banks in the United States, and (ii) on random sampling basis from another fifty of the next three hundred fifty largest banks and (iii) another seventy-five from the remaining 13,404 banks. He obtained responses from one hundred thirty-four of the original sample of one hundred seventy-five banks and after eliminating responses with inadequate or incomplete data, was able to study annual reports of eighty-one commercial banks.[3]

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1. W.C. Johnson, Financial Reporting to Stockholders by Commercial Banks, unpublished paper, The American Bankers Association, 1964, quoted by R.H. Strawser, op.cit., pp. 40-41.

2. E.J. Larsen, op.cit., quoted by R.H. Strawser op.cit., p. 38.

3. Ibid., p. 39.

Larsen concluded that improvements in bank reporting since 1963 had been sparce. He noticed that thirty-six or 72.0% of the national banks and eight or 25.8% of the state chartered banks supervised by the Federal Reserve Board or the Federal Deposit Insurance Corporation had made no improvements whatsoever in their annual reports during the test period.[1] Larsen also concluded that commercial banks are reluctant to improve their financial reporting practices despite the various pressures for improvement emanating from both within and without the banking industry. Larsen also noted that prospective investors were denied the basic information required for investment decisions, depositors were not provided with data for evaluating alternative depositories and, thus, the interest of the public at large in the solvency and well-being of the nation's commercial banking system might not be adequately protected.[2]

Larsen made the following four recommendations in this connection :

1. That the Federal Reserve Bank, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency be combined into a single agency in order to promote efficiency and resolve differences in reporting requirements.

2. That efforts of the American Institute of Certified Public Accountants and the professional organisations of bankers be combined to resolve the existing differences in bank accounting principles.

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1. E.J. Larsen, op.cit., pp. 63-64, quoted by R.H. Strawser, op.cit., p. 39.

2. Ibid., p. 39.

3. That uniform bank accounting principles be adopted as required by both the federal and state regulatory agencies.

4. That annual independent audits by public accountants be mandatory for all banks.[1]

THE FINANCIAL ANALYSTS FEDERATION STUDY :

The Financial Analysts Federation of Boston (1965) also studied the annual reports of commercial banks and concluded that there were numerous areas in which disclosure could be improved. The Federation made a number of suggestions of which the most important were as follows[2] :

1. Additional balance sheet information :

   A 'Statement and Statistics' section of the annual report should include for investment securities (1) the maturity distribution at year end, (2) the total cost, maturity value and average maturity of bonds purchased at discounts, and (3) the average yield on a fully-taxable basis at year end and on a daily average basis. For deposits, the daily average amounts and average rates of interests should be disclosed.

2. Comparative data :

   A ten-year summary of significant financial statement data including average daily balances for balance sheet items should be included in the report. Additional data to be presented in the summary are the number of banking offices, employees, and stockholders, and a description of investment and real estate com--panies affiliated with the reporting bank.

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1. E.J. Larsen, <u>op.cit.</u>, p. 76-78, quoted by R.H. Strawser, <u>op.cit.</u>, p. 42.

2. W.C. Johnson, Quoted by R.H. Strawser, <u>op.cit.</u>, p. 41.

3. Report Comments :

Matters that should be commented upon in the Bank's report are :

a. Economic conditions affecting operations.

b. Special factors affecting trends shown in the financial statements.

c. Changes in character of business, such as expansion in time and savings deposits.

d. Size of trust department and nature of its operations.

e. Significant departmental developments.

f. Importance of foreign operations and extent to which foreign earnings have been remitted.

g. Automation plan and progress.

h. Changes in directors and senior managements.

i. Personnel relations, including benefits.

j. Dividend policy.

k. Capital fund adequacy.

l. Outlook.

THE DONATO STUDY :

Another doctoral research was conducted by Rivera Lebron Donato[1] of the Graduate School of Business Administration, New York University. The annual reports of 28 of the largest commercial banks in the United States, for a period of four years (1966-1969) were examined in detail to determine the quality of those reports as an informative representation of management to their stockholders. The

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1. R.L. Donato, A Critical Evaluation of Annual Reports furnished by Large Commercial Banks in the United States to their Shareholders, University Microfilms Inc., Ann Arbor, Michigan, 1972, pp. 116-117.

examination was made to determine not only the deficiencies but also to consider how these information deficiencies persisted during the period. The major deficiencies noted by Donato were as follows :

1. Different banks used different methods of accounting for specific item, i.e., some banks accrued bond-discount on securities purchased below par, while others did not accrue such a discount and reported the whole amount as a capital gain upon sale or redemption of such securities.

2. Different banks gave different detailed breakdown of major loan categories, i.e., some banks reported loans in total only, while others indicated the major categories of loans that had been made.

3. Different banks presented similar items differently in the financial statements, i.e., some banks deducted the reserve for loan losses from total loans, while others presented such reserves under a separate caption between liabilities and capital. There were some banks that showed such an item together with the liabilities, and there was one bank that showed it as a part of the capital funds.

4. Lack of uniformity as to where to disclose particular items, i.e., some banks subtracted the provision for depreciation of fixed assets from the fixed asset figure in the statement of condition, while others presented the assets net of depreciation and mentioned the amount of accumulated depreciation in a note to the financial statements; still others gave no information as to the amount of depreciation or the basis of presentation in the statement of condition.[1]

Donato concluded that adequate disclosure on the part of banks was an attainable goal. Some of the annual reports examined gave an excellent account of the story they are intended to relate.

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1. Donato, op.cit., pp. 116-117.

If all banks could attain the excellence in all areas of reporting that some had already achieved, the question of the inadequacy of disclosure by the banking industry would disappear as an issue.[1]

THE STRAWSER STUDY :

Robert H. Strawser of the Graduate School of the University of Maryland, selected fifty largest commercial banks in the United States to ascertain the opinions of preparers (Bankers), examiners (CPAs) and users (CFAs) of the financial statements of commercial banks regarding :

a. The existence of any deficiencies in reporting by commercial banks;

b. The amount or extent of these deficiencies;and

c. The importance of these deficiencies.[2]

His major findings were :

1. While significant improvement had been made in the financial reporting practices of studied commercial banks, the stockholders and depositors of many banks did not have much of the basic information necessary to make informed decisions.[3]

2. Out of the total examined annual reports, the reports audited by Certified Public Accountants presented the greater degree of improvement and were, in general, the more informative. But again, the bankers had traditionally opposed independent audits of their financial statements.[4]

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1. Ibid., p. 158.

2. R.H. Strawser, op.cit., p. 6.

3. Ibid., p. 102.

4. Ibid., pp. 102-103.

3. Most bankers recognised deficiencies in the financial reporting practices of commercial banks, and perceived these deficiencies to be of a much lesser magnitude than both the CPAs and the CFAs.[1]

4. There was substantial agreement among bankers, certified public accountants and chartered financial analysts upon the relative ranking of the fifteen factors[2] included in the study.[3]

THE KAHL AND BELKAOUI STUDY :

The focus of this ~~work~~ study was on the adequacy disclosure which was measured by the extent to which thirty selected information items were presented in the annual report.[4] The seventy commercial banks selected in an international setting represented eighteen countries including Australia, Canada, U.K. and U.S. The main criteria for the selection of a bank included in the sample was the general availability of an English language version of the annual report for the year 1975.[5]

The authors developed a single index based upon the implicit assumption that the nature and importance of the accounting information need about banks by investors was constant throughout the world.

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1. Ibid., p. 104.
2. 1) Gains and Losses on Investment Securities. 2) Amortization of Premiums. 3) Amortization of Discounts. 4) Composition of the Investment Portfolio. 5) Income from Tax-Exempt Securities. 6) Market Value of Securities. 7) Loan Losses. 8) Reserve for Loan Losses. 9) 'Discount' Loans. 10) Accounting for Fixed Assets. 11) Disclosure of Reserve Accounts. 12) Distinction between Contributed Capital and Earned Capital. 13) Operations of Subsidiaries. 14) Income Statement. 15) Balance Sheet.
3. Ibid., p. 105.
4. Alfred Kahl and Ahmed Belkaoui, "Bank Annual Report Disclosure Adequacy Internationally", Accounting and Business Research, Summer 1981, p. 189.
5. Ibid., p. 190.

The index was previously used for the study of Canadian banks.[1]

The study indicated that the extent of disclosure was relatively different amongst the countries examined, with the U.S. banks leading the list, as hypothesised. The superiority of the U.S. banks was due to some items of information considered to be relevant in North America not being accorded the same treatment elsewhere. Out of the ten internationally top ranking banks, nine were located in the U.S.A.; the positions held by the U.K. were 11th, 12th, 14th, 15th, 26th, 28th, 31st and 35th.[2] However, if the data were grouped countrywise the U.S. remained on the top followed by Sweden, Holland, Finland and Norway. The U.K. headed the second group of five countries, followed by Germany, Singapore, Denmark and Australia. Although this inter-country comparison was limited by the constraint that annual reports in English had to be available for the banks to be included in the sample. Despite this limitation, the country by country comparison was illustrative of relative disclosure practices in the different countries and necessary for the investigation of the three accounting models (American, British and continental) hypothesis.[3] The Spearman's rank correlation co-efficient between the relative score and the asset size rankings of each bank suggested that there was relationship between

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1. *Ibid.*, p. 190.
2. *Ibid.*, p. 192.
3. Alfred Kahl and Ahmed Belkaoui, *op.cit.*, p. 193.

size and adequacy of disclosure which was just barely significant at 5% level (critical value of t = 1.675) but highly significant at the 10% level (critical value of t = 1.298).[1]

The authors concluded that the information items, used in the study to measure the disclosure adequacy, when classified according to the consensus between the producers and users of bank financial statements, indicate ten[2] items of low consensus which are also subject to much debate and controversy. Financial managers in banks should focus their attention on these controversial items when formulating and/or revising their disclosure policy.[3]

THE WALKER AND WHITTRED STUDY :

R. G. Walker and G. P. Whittred studied the reporting practices of eight commercial banks in Australia for the years 1977 and 1978. They observed that over the years the reporting practices of Australian banking companies have been governed by regulations from a variety of sources. Initially, disclosure by the pioneering institutions were subject to the terms of the Deeds of Settlement or the specific studies which established them in the nineteenth century. Currently, however, the major source of rules governing reporting by non-state owned banks is Commonwealth legislation.[4]

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1. *Ibid.*, p. 195.
2. a) Disclosure of Pension Plans. b) Details of Leases. c) Basis of Computing Current Tax Provisions. d) Disclosure of Diluted Earnings Per Share. e) Indication of Market Value of Marketable Securities. f) Disclosure of Accrued Income Receivable. g) Disclosure of Loan Losses Ratio. h) Accounting for Inflation. i) Details of Corporate Charter. j) Disclosure of Pro-forma Earnings Per Share.
3. *Ibid.*, p. 195.
4. R.G. Walker and G.P. Whittred, "Bank Disclosures of Secret Reserves: The Impact on the Australian Stock Market", *Accounting and Business Research*, Spring 1983, p. 131.

The Commonwealth legislation provided for minimum disclosure requirements which were far less extensive than those imposed by State laws on companies generally. The Banking Act of 1959 directed that trading and savings banks were to 'prepare and deliver' to government authorities a set of financial statements prepared in accordance with standard forms and directions set out in schedules to the Act. When compared with state legislation, these forms and directions relieved banks of the obligations to disclose such matters as the market price of publicly traded securities, the amount written-off or provided for bad and doubtful debts, the basis of valuing fixed assets, gains or losses accruing from the relation of assets, the amount of any asset write-offs, and amounts transferred from and to the profit and loss account and 'contingency' accounts.[1]

These accounting devices had been made available to the banks to help them to maintain the impression of financial stability. The Australian concessions were similar to those introduced in the U.K. Companies Act of 1948. The U.K. exemptions for banks were embodied in Australian legislation without any substantive analysis of the use of 'secret reserves' by banking companies. The U.K. Companies Act of 1967 empowered the Board of Trade to withdraw exemptions in whole or in part from banking companies, and the major banks, 'voluntarily' surrendered some of their disclosure privileges in February 1970.[2]

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1. Ibid., p. 132.
2. R.G. Walker and G.P. Whittred, op.cit., p. 132.

The major changes in the reporting rules required banks to disclose the extent and particulars of the accumulated reserves and the amounts transferred to reserves during a financial year. However, the banks were not losing all of their special 'privileges' to smooth reported income figures. The draft regulations still permitted the concealment of items which other companies were compelled to disclose by existing State legislation. In particular, the banks were not obliged to disclose the amounts provided for bad and doubtful debts in a given year. Despite this concession the banks voluntarily disclosed this information in their financial reports.[1]

THE AUSTIN, Jr. STUDY :

Another study which appears to be pertinent to the present research was made in 1964 by Warren G. Austin, Jr., of the University of Texas. The stated purpose of Austin's dissertation was to determine :

1. Whether generally accepted principles of accounting for commercial banks existed;

2. The current reporting practices, and reasons, therefore, with regard to certain specific items in the financial statements of commercial banks and whether these practices are in accordance with generally accepted principles of accounting.

3. Whether generally accepted principles of accounting are or should be applicable to each item in the financial statements of commercial banks.

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1. *Ibid.*, p. 132.

Austin surveyed commercial banks, the various state and federal bank regulatory agencies and public accountants throughout the United States. He concluded that the commercial banking industry did not have a body of "generally accepted accounting principles" and that the major problem in developing these principles was the ultra-conservative reporting practices of banks. Austin developed and presented a set of proposed pro-forma financial statements for banks for which, if adopted, would result in substantial uniformity in financial reporting by banks.[1]

THE MILLS AND LUH STUDY :

Robert H. Mills and Frank Luh analysed the problem areas in the financial reporting practices of commercial banks in the light of the requirements of the federal regulatory agencies and recommendations made by the American Institute of Certified Public accountants. Data on net operating earnings and "bottom line earnings" (the amount transferred to undivided profits) for twenty-five major banks were correlated to the market prices of bank stocks for the period 1960 through 1966.

The authors concluded that no strong preference could be assigned to either of the earnings figures from a statistical point of view and that bank stock market prices were not related to long-

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1. Walter G. Austin, Jr., "Financial Accounting and Reporting by Commercial Banks in the United States" (unpublished Ph.D. dissertation, Dept. of Business, the University of Texas, 1964) quoted by R.H. Strawser, op.cit., pp. 43-44.

term trends in earnings. Mills and Luh felt that investors emphasised the relative performance of a bank as compared to other banks rather than earnings per se.[1]

The above survey of literature shows that reporting practices of commercial banks in the U.S.A. have engaged attention of the researchers for a quite long time. Awareness of the problems associated with reporting by commercial banks was also noticed though at a much smaller scale in Australia. Evidence of research in this area was, however, lacking in case of U.K., Canada and India. Our observation regarding U.K. and Canada is based on search of leading accounting journals (pp. A 71-72) for a period of five years (1978 to 1982).

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1. Robert H. Mills and Frank Luh, "Financial Reporting of Commercial Banks", The Journal of Accountancy, vol. CXXVI, July 1968, p. 54, quoted by R.H. Strawser, op. cit., pp.44-45.