FEDERAL RESERVE BANK
OF NEW YORK

Circular No. 9127
August 18, 1981

FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL

Comment Invited on Proposal Regarding
Accrual Accounting by Commercial and Mutual Savings Banks

*To All Commercial and Mutual Savings Banks
in the Second Federal Reserve District:*

The following is quoted from the text of a statement issued August 11, 1981 by the Federal Financial Institutions Examination Council:

> The Federal Financial Institutions Examination Council today requested comment on a proposal that the three Federal banking supervisory agencies represented on the Council adopt an accounting guideline requiring all insured commercial and State-chartered mutual savings banks to maintain their accounts and to report to their supervisory agencies on an accrual accounting basis.
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> The Council asked for public comment on its proposal by October 15, 1981.
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> Currently, banks with assets of more than $25 million must report their condition and income on an accrual basis, but there is no general requirement that they keep their books on the accrual basis.
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> Banks with assets of less than $25 million are permitted to file their Reports of Condition and Income on a modified cash basis, with exceptions for certain items that must be reported on an accrual basis: installment credit loan income, bond premium amortization, depreciation of fixed assets, and income taxes. In recent years, new national banks and State-chartered nonmember banks have been required to adopt accrual accounting as a condition of chartering or FDIC insurance.
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> The proposed guideline, if adopted, would be implemented in two stages. Banks with assets of more than $10 million would be required to institute accrual accounting prior to January 1, 1983, and banks with assets of less than $10 million would be required to institute accrual accounting prior to January 1, 1985.
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> The Council welcomes comment from any source but it is particularly interested in receiving comment from banks currently on a modified cash basis of accounting and from State regulatory authorities, banking trade associations, the accounting profession and users of bank financial data.
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> The Council made its proposal in light of its responsibility to promote uniform and effective supervision of financial institutions.

Enclosed—for commercial banks and mutual savings banks in the Second Federal Reserve District—is the text of the FFIEC's notice requesting comments; the text will be provided to others upon request directed to the Circulars Division of this Bank.

Comments on the proposal must be submitted by October 15, 1981, and should be sent directly to the Federal Financial Institutions Examination Council in Washington, D.C.

ANTHONY M. SOLOMON,
President.

Federal Financial Institutions Examination Council

Proposed Accounting Guideline - Accrual Accounting

Request for Comment

Agency: Federal Financial Institutions Examination Council

Action: Proposed Accounting Guideline - Accrual Accounting

Summary: The Federal Financial Institutions Examination Council has under consideration a proposal to recommend a uniform accounting guideline for adoption by the three federal bank supervisory agencies (the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency). This guideline would require the use of accrual accounting by all insured commercial and state chartered mutual savings banks both for the maintenance of accounts and for reports to the agencies. The Council is considering this proposal in light of its responsibilities to promote consistent and effective supervisory practices among these agencies.

Effective Date: Comments on this proposed accounting guideline must be received on or before October 15, 1981.

Address: Comments should be sent to the Executive Secretary, Federal Financial Institutions Examination Council, 490 L'Enfant Plaza, S.W., Washington, D.C. 20219. (Area code 202-447-0939) Comments will be available for public inspection and photocopying.

For Further Information: Contact Rhoger H. Pugh, Chairman, Reports Task Force, Federal Financial Institutions Examination Council, 490 L'Enfant Plaza, S.W., Washington, D.C. 20219. (Area code 202-447-1587)

Drafting information: The principal drafter of this document was: Rhoger H. Pugh, Chairman, Reports Task Force, Federal Financial Institutions Examination Council.

Supplementary information: The proposal under consideration by the Council is based on concern that accrual accounting is pertinent and necessary to the accuracy of financial reports used for internal management, shareholder, and other public disclosure and regulatory purposes.

If the Council elects to recommend to the agencies that accrual accounting be required, all insured commercial and state chartered mutual savings banks would have to maintain their accounts and prepare their Reports of Condition and Income on an accrual accounting basis. This requirement would become effective as of January 1, 1983 for banks with assets of $10 million or more, and on January 1, 1985 for banks with assets of less than $10 million. However, banks choosing to report Trust Department income on a cash basis could do so.

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Banks in both size categories that currently maintain their books on a modified cash basis would be encouraged to convert to an accrual system prior to the dates specified above.

Accrual accounting means the establishment of recording procedures whereby all material items of income and expense are consistently recognized in the periods in which they are earned and incurred.

Background: Beginning in 1969, banks with assets of more than $50 million were required to file their Reports of Condition and Income on an accrual basis. In 1970, that criterion was reduced to $25 million. Smaller banks have been allowed to report on a modified cash basis since 1969, i.e., income and expenses may be reported on a cash basis except for installment credit loan income, bond premium amortization, depreciation of fixed assets and income taxes which must be reported on an accrual basis. These reporting standards have lead virtually all banks over $25 million in assets to adopt accrual accounting for internal bookkeeping purposes as well. Over the last several years both the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency have required new banks to institute accrual accounting as a condition of being chartered or insured. Furthermore, many banks with assets of less than $25 million have voluntarily adopted accrual accounting.

Rationale for the Proposal: There is some concern that those Reports of Condition and Income filed with the three federal bank supervisory agencies that are prepared on a modified cash basis do not satisfactorily portray a bank's financial position and results of operation, thereby making it more difficult for the agencies to discharge their supervisory responsibilities. Also, to the extent that reports prepared on a modified cash basis are relied upon by the public, there is concern that the financial data presented therein may also be subject to misinterpretation. Furthermore, bank financial records maintained on a modified cash basis may not provide management, including bank directors, with reliable information to measure the bank's financial performance, and reports prepared from such records may not provide shareholders with an adequate presentation of the bank's financial condition.

Accrual accounting requires recognition of revenues and expenses in the periods to which they are attributable. Under a cash basis accounting system, revenues and expenses are recorded when cash is received or remitted. In cases where cash flows associated with assets and liabilities do not occur regularly over the life of an instrument that spans more than one accounting period, significant distortions may result from use of a cash basis.

In the past when interest rates were lower and less volatile, banks with stable patterns of operation were likely to have reported similar results of operation using either accounting method. However, the operating results reported on a cash basis and those derived from accrual accounting may differ significantly in the current environment of rapidly changing banking practices, portfolio patterns, and interest rates. The loss of traditional low cost deposits and increased competition have forced banks to offer new higher cost deposit instruments and services. Financial information derived from cash basis accounting does not reflect the effects of such changes in a timely manner. Conversely, accrual accounting, by recording the effects of such changes as they occur, provides a more timely portrayal of an institution's performance and condition, and is more pertinent to the needs of management, shareholders, and supervisors. Even if, as has been suggested, the managers of small banks have a "good feel" for their institution's performance, or succeed, in an informal way, in adjusting cash basis records to reflect major accrual items for internal bank use, other users of bank financial data, including minority shareholders and regulators, would not have access to such impressions or adjustments.

Cost and Benefits of the Proposal: Requiring smaller banks to adopt accrual accounting would impose some burden on affected institutions. In an effort to minimize the immediate impact of that burden, the Council contemplates a fairly long lead time for the implementation of the proposed guidelines. The smallest of the affected banks, those with assets of less than $10 million, would be given three full calendar years to plan for and implement conversion.

A survey undertaken by the Council in March revealed that of 7,500 banks with resources of less than $25 million, approximately 3,800 were reporting on a modified cash basis. Of these about 2,100 banks have assets of between $10-$25 million and 1,700 have assets of less than $10 million.

Survey Estimates of Number of Insured Commercial Banks

With Assets of Less Than $25 Million

Reporting on Accrual vs Modified Cash Basis

Size Group	Accrual		Modified Cash		Total	
Under $10 million	1,102	39%	1,728	61%	2,830	100%
$10-$25 million	2,617	56%	2,059	44%	4,676	100%
Total	3,719	50%	3,787	50%	7,506	100%

The survey also endeavored to ascertain the costs associated with conversion to and maintenance of an accrual accounting system. The survey results indicated a median cost to convert from a modified cash to an accrual basis of approximately $2,000 per bank plus additional operating costs of $1,000 per year. Thus, the cost to the 3,800 affected banks would aggregate about $8 million, with additional operating expenses for those banks, aggregating $4 million per year.

Since virtually all new banks must adopt accrual accounting, it has been suggested that the continuing effects of inflation would eventually result in a disappearance of cash basis accounting in banks as bank footings grow. However, an analysis of the growth rates of banks in various size groups below $25 million has revealed that it would likely take seven years for the average bank which currently has assets between $10-$25 million to reach the $25 million threshold, and sixteen years for the average bank which now has assets of less than $10 million to attain a size of $25 million.

The adoption of the proposed accrual accounting guideline would assure certain benefits for the banking industry and the public. The accounting records maintained by all banks would conform to general accounting standards for recognition of income and expense. Bank management and directors would be able to evaluate their institution's current performance and plan for the future using financial data free from the distortions associated with cash basis accounting. Publicly available financial data from these institutions would be a more reliable source of information for shareholders and other interested parties. The regulatory agencies would benefit from better and more comparable data for supervisory purposes.

Such benefits, though clearly identifiable and generally acknowledged, cannot be readily measured in dollar terms to make a direct comparison with the costs of conversion and maintenance identified by the survey. There is, however, one element of these benefits accruing to affected banks themselves that can be approximated in dollars. If the regulatory agencies can rely on the monitoring of individual banks through analysis of regularly reported data, the frequency of on-site examinations could be reduced. Such reliance depends in considerable part upon the confidence which the agencies can reasonably be expected to place in the surveillance system used to carry out monitoring of bank financial condition. That confidence is greatly enhanced for those institutions which utilize accrual accounting.

To the extent that well managed institutions are examined less frequently, the costs incurred by these banks in connection with on-site examinations will decrease. Some estimates have indicated that these costs amount to approximately $2,000 per examination for banks under $25 million in assets. If the frequency of examinations were reduced by 20%, and affected 3,500 institutions, it can be calculated that in the aggregate, $1.4 million per year would be saved by these banks. These are rough estimates and the Examination Council is particularly desirous to receive comments on the cost to banks of on-site examinations and on the desirability of limiting them.

Beyond the reduction in costs for affected institutions which might be achieved as a result of decreased examination frequency, the costs of those on-site examinations that are conducted would be reduced if such examinations could be targeted to concentrate on particular problem areas within the bank. The General Accounting Office has urged the bank regulatory agencies to develop systems and procedures to permit such concentration of examination effort. As accrual accounting would improve regulator confidence in monitoring systems, it would also serve this objective as well.

Lastly, monitoring and surveillance systems fulfill a public responsibility which devolves upon the regulatory agencies to identify problem institutions in a timely and efficient manner. Again, to the extent that accrual accounting enhances monitoring systems, this public obligation is served.

Issues for Specific Comment: The Examination Council seeks comments on any and all of the aspects of this proposal, but would particularly appreciate comments addressing the following points:

1. The suitability of applying the proposed guideline to all banks or only to banks over a certain size.

2. The time periods allowed for implementation of the proposed guideline.

3. The estimated costs experienced by banks in connection with on-site examinations.

4. The benefits to be derived by affected institutions in relation to the costs which they would actually incur pursuant to conversion to accrual accounting.

5. The rank or relative worth of the benefits discussed under the heading, "Cost and Benefits of the Proposal."

Comments by affected banks and other financial institutions, the public, banking trade associations, the accounting profession, and state regulatory authorities are earnestly requested.

Dated: August 10, 1981

(signed) Robert J. Lawrence

Robert J. Lawrence
Executive Secretary
Federal Financial Institutions Examination Council