REPORT OF THE COMMITTEE

TO CONSIDER

FINAL ACCOUNTS OF BANKS

RESERVE BANK OF INDIA
BOMBAY
1985

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CHAPTER I

INTRODUCTORY

1.1 Banks publish their annual accounts in the formats prescribed under the Banking Regulation Act, 1949. There

Background were suggestions that having regard to the large scale expansion in banking operations and to improve the presentation of the accounts, there was need for revising these formats. The question of banks moving towards greater or full disclosure in the published accounts was also raised. Before taking a decision on these issues, it was felt that a Committee of Experts should go into them. Accordingly in March 1982 the Reserve Bank of India appointed the following Committee to consider these and certain other related issues -

1.	Shri A. Ghosh Dy. Governor Reserve Bank of India Central Office BOMBAY	Chairman
2.	Shri V.S. Natarajan Managing Director State Bank of India Central Office BOMBAY	Member
3.	Shri R.Raghupathy Chairman Syndicate Bank MANIPAL	-do-

4.	Shri M.V. Subba Rao Chairman Indian Bank MADRAS	Member
5.	Shri R.Srinivasan Chairman Allahabad Bank CALCUTTA	-do-
6.	Shri Sampat P. Singh Professor National Institute of Bank Management BOMBAY	-do-
7.	Shri Abhijit Sen Dy.Chairman National Insulated Cable Co. of India Ltd. NICCO HOUSE 2 Hare Street CALCUTTA	-do-
8.	Shri N.Balasubramanian Director (Banking) Government of India Ministry of Finance NEW DELHI	-do-
9.	Shri Y.H. Malegam, FCA M/s. S.B.Billimoria & Co. Chartered Accountants BOMBAY	-do-
10.	Shri N.V. Sundaram Principal Legal Adviser Reserve Bank of India BOMBAY	-do-
11.	Shri M.L. Inasu Addl.Chief Officer Reserve Bank of India BOMBAY	Member Secretary

Consequent upon retirement/resignation of Sarvashri V.S. Natarajan, R.Raghupathy, M.V. Subba Rao and N.V. Sundaram, the following were coopted as members to the Committee:-

1. Shri M.N. Goiporia
   Chairman
   Bank of Baroda
   BOMBAY

2. Shri B.Ratnakar
   Chairman
   Canara Bank
   BANGALORE

3. Shri R.Narasimhan
   General Manager
   State Bank of India
   Central Office
   BOMBAY

4. Shri V.G. Hegde
   Principal Legal Adviser
   Reserve Bank of India
   BOMBAY

1.2 Terms of reference

The terms of reference of the Committee were as follows :-

(a) to examine the desirability of greater or full disclosure in the published accounts of banks, having regard to the need for disclosure, public accountability of banks, requirement of maintenance of confidentiality between banker and customer and the requirement of maintaining the reputation and creditworthiness of banks,

(b) to suggest if greater or full disclosure is not considered necessary or appropriate whether it is necessary to make any further provisions in the existing laws,

(c) to suggest suitable changes/amendments in the formats of balance sheet and profit and loss accounts having regard to:-

i) the need for greater or full disclosure,

ii) the expansion of banking operations both area wise and sector-wise over the period,

iii) the need for improving the presentation of accounts,

iv) the presentation of accounts of other companies, etc,

(d) to look into broadly the practices followed by banks in accounting/classifying various items of liabilities and assets as well as income and expenditure and to suggest standard accounting concepts which would facilitate uniform, comparable presentation of such items in the published accounts and compliance with various statutory requirements,

(e) to consider the question of evolving suitable norms for creating provisions for various purposes more particufor income tax and other taxes, bad and doubtful debts, depreciation in Government securities, etc on a scientific basis, and

(f) to make any other recommendations which are incidental or related to the above terms of reference.

The Secretariat of the Committee was provided by the Department of Banking Operations and Development, Reserve Bank of India, Central Office, Bombay.

1.3 The Committee was expected to submit its report within a period of nine months. However, due to various

Reasons for the delay in submitting the report

delays in getting the information from banks and difficulties in holding the meetings looking to the convenience of the members, the report could not be submitted in time. Besides, some of the terms of reference of the Committee, particularly that relating to disclosure were sensitive issues with far reaching implications and needed thorough and detailed discussions at various levels and study of the practices prevailing in other countries.

1.4 The first meeting of the Committee was held on 11th May 1982 in Bombay when the modalities for conducting the studies for the purpose of examining the various terms of reference were finalised. The Committee thereafter issued a detailed questionnaire to banks, accountancy bodies and others interested in the subject for eliciting their views on the various terms of reference. The Committee subsequently held discussions with Chairmen of banks/representatives of the Institute of Chartered Accountants of India, Institute of Cost and Works Accountants of India, Chambers of Commerce, etc at Bombay, Calcutta, Bangalore, Madras and New Delhi on the various points covering the terms of reference.

Committee Meetings

1.5 In Chapter II, the first two terms of reference of the Committee relating to the desirability of greater or full disclosure in the published accounts of banks the various aspects of disclosure and the differences in the extent and quality of disclosure in different countries are examined. In Chapters III, IV and V, the three broad aspects of disclosure viz., truth and fairness concept disclosure of particulars of significant items by way of analytical data and disclosure

Scheme of the Report

accounting policies are discussed. In Chapter VI, the next two items in the terms of reference relating to formats of published accounts and standard accounting concepts which are interlinked have been examined. The topics of the fifth term of reference of the Committee relating to the question of evolving suitable norms for creating provisions for various purposes, more particularly for income tax and other taxes, bad and doubtful debts and depreciation in Government securities have been examined in Chapter VII. Chapter VIII discusses the contents of the annual (or directors') report of the banks which forms an integral part of the annual accounts. In Chapter IX, certain miscellaneous issues are discussed and a summary of the recommendations is given in the final Chapter.

1.6 The Committee would like to make it clear that the discussions and recommendations in the report are mainly related to commercial banks, both in the public and private sectors. It has not considered the position of regional rural banks and co-operative banks separately. The structure of the assets and liabilities of co-operative banks, differ materially from that of commercial banks and the Banking Regulation Act also provides for separate formats for the financial accounts of such institutions. As regional rural banks are commercial banks, the findings of the Committee may be made applicable to them with modifications, where necessary.

* 1.6.2

1.7.1 The Committee gratefully acknowledges its thanks to the Chairmen of banks, representatives/members of Central and Regional Councils of Institute of Chartered Accountants of India, **Institute** of Cost & Works Accountants of India, Chambers of Commerce, Management Institutes, etc for the help rendered to the Committee in discussing the various items of the terms of reference of the Committee and also in formulating the revised formats of the balance sheet and profit and loss account for banks.

Acknowledgements

1.7.2 The Committee has also made substantial use of the findings of the Financial Times 1982 World Survey of Bank Annual Reports and the published balance sheets of various foreign banks in examining the practices prevalent in foreign countries in the matter of bank accounting. The Indian branches of some of the foreign banks have also helped the Committee with notes on the systems and practices prevailing

* 1.6.2 The report was finalised before the presentation of Union Budget for 1985-86 and the amendments proposed in the Finance Bill have not been taken into account. While discussing some of the topics in the report like provisions for bad and doubtful debts in respect of advances at rural branches, etc.

in foreign countries including their parent countries.

1.7.3 The Committee would also like to place on record its appreciation of the excellent work done by Shri M.L. Inasu, Member-Secretary and the Secretariat of the Committee provided by the Reserve Bank of India particularly, Shri N.D. Parameswaran, Joint Chief Officer and Shri H.L. Kotian, Banking Officer.

CHAPTER II

ASPECTS OF DISCLOSURE

Terms of reference

2.1 The first two terms of reference of the Committee relate to the desirability of 'greater or full disclosure' in the published accounts of banks and the necessity to make any further provisions in the existing laws, if such 'greater or full' disclosure is not considered necessary or appropriate. The various issues involved in these two terms of reference are intricate and interlinked. For the sake of a clear exposition of the issues involved and discussed, a brief outline showing how the Committee has dealt with the subject will be helpful.. The two terms of reference are discussed in four chapters. In this chapter the various aspects of disclosure and the differences in the extent and quality of disclosure practised in different countries are brought out. In the next three chapters, the three broad aspects of disclosure, namely truth and fairness concept, disclosure of particulars of significant items by way of analytical data and disclosure of accounting policies are discussed. The legal aspects are discussed in a later chapter. At the beginning of each chapter the broad areas covered by the chapter are also indicated.

Financial Statements

2.2. A business entity has normally three types of accounting information :-

- operating information giving details of operations

- management accounting information used mainly for internal control and planning.
- financial accounting information which is used both by the management and external users.

The end products of the financial accounting process are mainly two financial statements viz. the balance sheet and the profit and loss account. A third statement usually furnished along with the balance sheet and profit and loss account now-a-days is the statement of changes in the financial condition. The balance sheet is a 'status report', as of a particular moment of time. The other two are 'flow' statements summarising the flows over a specified period of time, usually a year. In the case of banks the statement of changes in the financial condition may not be of much practical use. In the first instance a conventional funds flow statement showing changes in financial position can hardly reflect the enormous volume of transactions that takes place in a bank in the course of a year. Secondly, many of the transactions like guarantees, letters of credit, acceptance business, etc undertaken by a bank cannot be adequately reflected in the funds flow statement. At best the funds flow statement of a bank can reflect only movements in its infrastructural assets and capital resources. We may, therefore, ignore this statement for the purposes of our analysis.

Non-financial reports

2.3 While the accounting statements of banks would then be mainly the balance sheet and profit and loss account, significant information and analytical study are also provided in the 'annual reports' of banks. Such annual reports also are deemed to be an integral part of the general purposes reporting system of a unit. According to the universally accepted philosophy of 'general purposes reporting' the annual reports and the financial statements included therein are intended not only for the benefit of the shareholders but also for meeting the information needs of the other users of the report. These other users include financial market analysts, press and media, depositors and creditors, other banks (including foreign banks and financial institutions), central banks and supervisory authorities, employees, government and tax authorities. While it is idle to hope that the information needs of all sections of the users would be fully met by the general purposes reports, certain minimum standard information should be available in the balance sheet, profit and loss account and annual reports which together should give a total, true and fair view of the status and profitability of the unit, background information which would enable the users to appreciate the data furnished in the financial statements as well as other material particulars relating to its operations and future prospects.

2.4 In pursuit of one of its principal objectives, viz. the harmonisation of accounting standards through its member bodies around the world the International Accounting Standards Committee (IASC) brought out in 1980 a Discussion Paper on guidelines for disclosures in financial statements of banks. A copy of the Discussion Paper and the Summary of Responses to the Discussion Paper issued by IASC in March 1982 is given in Annexure I. The guidelines for disclosure in the Discussion Paper relate to classification of assets and liabilities by nature, analysis of assets and liabilities by maturities, concentration of assets and liabilities, income statement, loan losses, trust activities, commitments and undisclosed reserves. The Discussion Paper also gives an appendix indicating the structure of the balance sheet items, income statement items, as well as other areas of disclosures. These requirements are minimal.

IASC Discussion Paper & Response

2.5 The question whether the banks are unique organisations deserving the right to an exception from the general reporting principles which could mean a privilege to conceal sensitive information like 'hidden reserves' leading to under statement of profits is still undecided. In certain countries the stance in this regard of the accounting bodies and Government has crystallised against any special treatment for banks while in several others banks are still treated on a separate footing. The financial and non-financial information revealed in bank reports thus varies widely in coverage, content and quality from country to country and even within the country from bank to bank. This has been vividly brought out in the findings of the Financial Times 1982 World Survey of Bank Annual Reports. The survey covered 100 of the largest banks in the world and the results of final gradings in descending order are as follows :-

Variations in quality and extent of reporting

Country	No.of banks obtaining grades					
	A	B	C	D	E	Total
U.S.A.	1	23	-	-	-	24
Japan	-	-	2	15	-	17
Germany	-	-	-	8	2	10
U.K.	-	-	6	-	-	6
France	-	-	3	2	1	6
Others(including Canada, Spain, Switzerland, Australia, Netherlands, Argentina, Brazil, Hong-Kong, Korea, etc.)	-	-	11	21	5	37
Total	1	23	22	46	8	100

2.6 The authors of the survey have indicated in their

Elements of Disclosure

report that they were looking for the following information in the annual reports of banks in order to assess the quality of reporting by different banks.

Financial Statements

- A consolidated balance sheet and profit and loss account providing detailed information (either on the face of the accounts or in the notes).
- Analysis of advances and deposits, split between banks and other customers and a maturity analysis.
- A clear statement of all material accounting policies, including consolidation methods and valuation rules; changes in policies should be prominently displayed and their effect quantified.
- Segmental data by geographical area and customer group covering revenue earnings, deposits and advances.
- Accounting data adjusted for the impact of changing prices for revenue, operating profit advances, total assets, deposits, reserves, current profit attributable to shareholders and earnings per share.
- All information in the financial statements covered by an independent audit opinion.

Non-financial statement

- An employment report, giving details of employment objectives, industrial relations, employee welfare and training, profit sharing, employment costs and statistics.
- A statement of prospects, with some evaluation of likely future results and details of planned future development.
- A statement outlining the general business background and conditions, against which the results for the past year can be judged.

The above items of information should normally be sufficient to meet the test of adequacy of disclosure and the fact that banks got widely different rankings on these bases would go to indicate that the quality and content of disclosure differ very much between banks.

Broad analysis of disclosure requirements

2.7 The very nature of financial statements, both balance sheet and profit and loss account, is such that they can be either very cryptic or open, cautious or optimistic. By a system of grouping and aggregation, netting and offsetting it is possible to conceal quite a lot of material information from the financial statements, while by a process of disaggregation or through explanatory notes and supplementary schedules, the same set of financial statements can be made to reveal all the required information. Keeping in view the basic objectives of general purposes reporting that the financial statements should show a 'true and fair' view of the state of affairs and profit and that the information furnished should be adequate for the purpose of users, the Committee feels that the basic disclosure requirements may be grouped into three main areas as follows:-

I. Financial statements (Profit & Loss Account and Balance Sheet) should show a true and fair view of the net profit and the position of the assets and liabilities.

II. To ensure that the information contained in these statements would be adequate for the purpose of users, they should contain, to the extent necessary, sectoral, segmental and geographical analysis of the major items included in these statements.

III. For a proper appreciation of the financial position, the accounting principles and policies adopted in the preparation of the financial accounts should be clearly spelt out, where necessary. These three broad aspects, namely,

- Truth and fairness
- Analytical data
- Accounting policies

are discussed in detail in the following three chapters.

CHAPTER III

TRUTH AND FAIRNESS CONCEPTS

3.1 Introductory In this chapter, the main aspects of the 'truth and fairness' concepts are discussed under the following broad heads -

- Secret reserves and loan loss provisioning
- Grouping and offsetting practices
- Window dressing

Under each head after discussing the issues, the general practices prevailing in other countries have been described. Thereafter the situation as is in vogue in India and the Committee's observations and conclusions are given.

3.2 Truth and Fairness Concept If the financial statements are to give a true and fair view, the income and expenditure items and the assets and liabilities will have to be shown at their correct monetary value in the statements of accounts without any attempt at concealment. The object of concealment may either be to show a better picture than is warranted or to tone down a good performance. In either case, there is a violation of the concept of truth and fairness and the auditors can legitimately take objection to such a presentation of accounts particularly if by such means the management derives any undue advantages. There are, however, certain circumstances where, either by convention or by statute, a view has been taken that concealment will be in the best interests of the unit. In the case of credit institutions like banks, where the continuing growth of the unit is very much dependent on public confidence, several authorities hold the opinion that concealment of income with the objective of utilising such concealed income to even out profits position in periods of stress, can be beneficial to the unit itself. If such concealment is not to enable the management to secure any advantage but to project an even sustained growth of the institution it can be justified as a necessary mechanism to protect the interests of the company and its shareholders. Many authorities thus consider banking as distinct from other manufacturing or service activities and advocate creation of secret reserves by banking units.

3.3 The essence of creation of secret reserves (sometimes described as 'hidden reserves' or 'inner reserves') is the retention of profits without disclosure of such retention in a manner that would reveal its character of being a reserve. The general objective is 'evening out' of the disclosed profits for meeting unusual losses without disclosing in the balance sheet either the nature or the extent of such losses. There is a 'passive' creation of secret reserves when an asset like property appreciates in value by

Secret Reserves - Passive and active creation effluxion of time. As accounts are prepared on 'historical cost' basis, such appreciation will not be reflected in the financial statements unless inflation accounting data are furnished. Occasionally such assets are revalued and the profit on revaluation is booked; the 'secret reserves' then become disclosed. The real value of such 'secret reserves' will, however, depend on several factors like inflation, replacement cost, etc. Secret reserves are otherwise 'actively' created only out of earned income. In some cases, a part of the earned income is suppressed from the income and expenditure account say, by undervaluing assets like inventory or by writing off of capital expenditure as revenue expense. In some other cases a part of the earned income, though taken in the books of account, is directly deducted from the relevant income heads while preparing the final accounts and transferred to a contingency account. The contingency account is not separately disclosed in the balance sheet but clubbed together with some other liability item. Under this system neither the existence of secret reserves nor the amount thereof will be disclosed nor inferred from the financial statements. A variation of this form of creation of secret reserves is to credit the whole income in the accounts but simultaneously create compensatory expenditure by making excess provisions for certain items of assets where provisions are traditionally made, like depreciation in the value of assets, income-tax, provision for bad and doubtful debts, etc. The excess provision in such cases, will constitute the secret reserves. 'Prudence' demands that banks make adequate provisions for such items. If such provisions are created in excess of the estimated requirements and if such excess provisions are not separately shown in the financial statements, it would amount to creation of secret reserves.

3.4 Whatever be the mode of creation of secret reserves,

Implications of creation of secret reserves

it has two implications :

- secret reserves will have a deflationary effect on the real income in that particular year.
- the assets will be under-stated to the extent of the secret reserves or the liabilities will be over-stated to that extent.

Creation of secret reserves thus goes counter to the concept of 'truth and fairness' in income and position reporting.

3.5 The advances portfolio being the principal asset of a bank, excess loan loss provisioning is fairly commonly

Creation of secret reserves through loan loss provisioning

resorted to for creation of secret reserves. Advances cannot obviously always be reported in the balance sheet at their book value for some of them may have become un-collectible or may have ceased to earn interest. Bad debts are incidental to banking and such bad debts, though booked in a particular year, may have become bad not necessarily in that year but over a period of time. Banks have, therefore, a tendency to create provisions for that part of the debts, which in their opinion may have to be recognised as bad debts in the future. Moreover, such provisions can be made either in respect of specific advances considered by the management as bad or doubtful or by way of general provisions as a percentage of the total advances in the light of the past experience. To the extent that provisions are made for specific advances, the provisions may be considered as normal or necessary. The amount of general provisions based on past experience may also be partly a 'necessary' provision, but such general provisions could also include an element of 'surplus' provision. In case provisions for losses in advances are made consciously in excess of actual estimated requirements, again secret reserves are created. The question whether such excess reserves and the amount thereof will be reflected or can be inferred from the financial statements will depend on the manner in which they are treated in the accounts.

3.6 There are no universally accepted guidelines regarding provisioning principles and it is, therefore,

Accounting practices and disclosure requirements of loan loss provisioning

necessary for banks to indicate the principles adopted by them in making provisions, whether as a matter of prudence or in compliance with statutory requirements and conventions. Some of the more commonly accepted accounting principles relating to loan loss provisioning, however, are:

(a) Banks should exercise prudence in selecting appropriate accounting policies in regard to the loan loss provision in order to recognise the uncertainties inherent in business decisions.

(b) Interest and other revenues arising from holding of assets should be recognised only when no significant uncertainty as to measurability or collectibility exists.

(c) The basis on which provision for loan loss is made is to be disclosed.

Ideally, the disclosure requirements on the loan loss provisioning principles and accounting practices should stipulate:

(a) Provisions should relate to existing losses on bad and doubtful loans and should not take into account future losses. The specific and general provisions should be separately disclosed and there should not be an element of hidden reserves in such bad debts provisions.

(b) Balance in the provision account and movements in such provisions should be disclosed including recoveries of amounts previously written off. The provisions should also be analysed according to the type of business.

(c) Information relating to non-performing loans and the relative policy should also be disclosed.

3.7 The practices obtaining in different countries, however, do not conform to the principles enumerated above. This is probably due to the fact that there are no standard accounting policies on provisioning which are internationally accepted and the system of keeping secret reserves in vogue in several countries depends upon banking legislation, company law and taxation rules. In most of the countries, provisions made for bad debts are allowed either fully or partly as items deductible from income for tax purposes. The actual tax implications, however, differ. In some countries, the supervisory authorities require banks to make certain minimum provisions and these are accepted by the tax authorities. In some other countries, the tax authorities prescribe certain levels upto which banks may make provisions, which are allowed for tax purposes. Although, theoretically banks are required to make provisions according to their perceptions about the recoverability of a debt confirmed by the opinion of auditors, in practice, the regulatory provisions of the supervisory authorities and the tax regulations have a great say on

Practices on loan loss provisioning in different countries management decisions in making actual provisions for loan losses. In most of the countries, particularly like Austria, Belgium, Germany, Korea and Switzerland, no information is given in the financial statements on the accounting policies in regard to the loan loss provisions, while in countries like Hongkong and Japan, the disclosure of policies is not very meaningful. In Austria, Germany, Switzerland, etc where the policy is not disclosed in the financial statement, statutory provisions enable banks to keep 'secret reserves'. In Argentina, Canada, France and Spain, only some of the banks disclose their accounting policies. In Australia, Brazil, Italy, U.K. and U.S.A. the accounting policies in respect of loan loss provisions are indicated in the financial statements of banks. In some other countries, banks indicate only the fact that apart from specific provisions, general provisions are also made in respect of loan losses. Banks in countries which do not disclose accounting policies and a few others which make only partial disclosure in this regard do not also fully disclose the quantum of provisions made, movements therein and the amounts actually written off. Although banks in some countries like France and Germany give certain information relating to quantification of provisions charged to income, apparently such amounts are shown after netting and also, include other losses which affect the clarity of the data furnished. Banks in some of the countries like U.K. and U.S.A. which disclose the policy regarding provisions also disclose the amounts of provision and movements in the provision accounts. On the whole, the practices relating to disclosure in regard to the quantification of provisions, movements in such provisions and the charges to profit and loss accounts by way of provision and write-offs, differ and the information furnished is often by no means comprehensive. Many of the banks except those in U.S.A. do not indicate the policy regarding non-performing loans nor the amount of such loans. The interest element of such non-performing loans and their sectoral classification, etc are also generally not furnished.

3.8 The general conclusion that could be arrived at on the basis of the above discussion is that by and large the user community of financial statements do not get full information of all types of secret reserves. They would like banks to give a true picture of their loan loss provisioning practices, the quantum of specific and general provisions and the full details of the movements in such provisions. Another area where users would like detailed information is in regard to non-performing loans, interest on such loans and sectoral and country-wise break-up of such loans. On the other hand the perception and practices of the banking community on these issues are divided.

3.9 Excepting American and U.K. banks, full disclosure of secret reserves and loan loss provisioning is not practiced by many banks. The extent and quality of disclosure by these banks also vary from country to country and even from bank to bank. This is tellingly brought out by the following extract from Financial Times 1982 World Survey of Bank Annual Reports.

"A reasonably disinterested judgement on the likely existence or otherwise of hidden reserves in banks of the countries covered by the survey is as follows:-

Country	Inner res-erves	Undervaluation of assets other than loans	Comments
1	2	3	4
ARGENTINA	No	Not significant	-
AUSTRALIA	No	Not significant	In some banks the general element of loan provision could be hidden reserve
AUSTRIA	Yes	Yes	Hidden reserves permitted by law
BELGIUM	Yes	Yes	Inner reserves takes form of "internal security fund"
BRAZIL	No	Not significant	Obligatory 3% loan provision means potential over-provision
CANADA	No	Not significant	-
FRANCE	Yes	Not significant	Inner reserves take the form of undisclosed reserves in current liabilities.
GERMANY	Yes	Yes	Hidden reserves permitted by law
HONGKONG	Yes	Yes	Hidden reserves permitted by law

1	2	3	4
ITALY	No	Not significant	Tax-allowed provisions may be excessive
JAPAN	No	Yes	-
KOREA	No	Yes	-
NETHERLANDS	Yes	Not significant	-
SPAIN	No	Yes	-
SWITZERLAND	Yes	Yes	-
U.K.	No	Not significant	General element of loan provision may be excessive
U.S.A.	No	Not significant	Unallocated loan loss provision may be excessive"

It will be apparent from the above statement that despite the professed policy stand against secret reserves in some countries banks in these countries still manage to have secret reserves in some form or other. The findings of the survey are that such secret reserves may not be significant in some cases, but these observations are qualified by the notes given in the 'comments' column. What is not practised by such countries is probably maintenance of undisclosed contingency accounts, but undervaluation of assets and excess provisions in loans are not uncommon even in these countries.

Views on secret reserves in different countries

3.10 The various issues relating to secret reserves, however, created, have been examined by several authorities but no consensus has emerged as yet. In the United Kingdom, the Jenkins Committee in 1962 recommended by a majority vote that secret reserves should be maintained. The Companies Act of 1967 of the U.K. left the matter to the discretion of the Board of Trade.

The London clearing banks are now voluntarily making full disclosure and not maintaining any secret reserves. In the United States, the Saxson Committee recommended full disclosu a practice now being followed by most of the American banks. In Canada, enquiries by the House of Commons Banking & Commerce Committee in 1944 and 1954 concluded that publicati of unexpected and exceptionally high losses in any one year might adversely affect confidence in a bank or even in the banking system as a whole. Later, however, the Porter Commission (1964) observed: "It is our view that there is no compelling case against disclosure and we are satisfied to leave the matter in the hands of the authorities and shareholders concerned . . . . tax paid reserves should in any event be incorporated in published shareholders equity." As a whole, the Canadian banks are also not resorting to creation of secret reserves at present. On the other hand, most of the European banks like those in France, Germany, Austria, Belgium and Netherlands do maintain secret reserves and the local statutes do not object to this practice. There are also equally strong advocates for maintenance of secret reserves by banks. Mr. Colin Martin, Commissioner of Banking, Hongkong in his paper submitted to the International Conference of Banking Supervisors in September 1981, has stated " ..... for in Hongkong we fully subscribe to the concept of inner reserves for our locally incorporate banks to which transfers are normally made before publishing a profit figure. In fact, we not only allow, but positively encourage our banks to maintain inner reserves, full information on which is available to me as Commissioner of Banking but not to the public. Indeed, this principle is enshrined in our laws relating to the preparation of annual accounts of banks incorporated in Hongkong and I would not wish it to be otherwise". Mr.Hugo Colje of Nederlands Bank in his paper to the same Conference also indicated "...... The real question, therefore, would seem to be whether hidden reserves should or should not be permitted. What should the answer be? It must be admitted that the presence of hidden reserves makes it more difficult for outsiders to assess and compare banks in terms of their financial position. However, it must be admitted at the same time that in periods of temporary difficulties due to bad debts and unforeseeable expenses, which could undermine confidence in, or even lead to a run on a bank which is basically sound, hidden reserves may most certainly prove useful. Nonetheless care must be taken to ensure that no improper use is made of this possibility".

3.11 According to the Discussion Paper issued by IASC

IASC Discussion Paper

in 1980 (vide Annexure I) "Local circumstances or legislation may require or allow undisclosed free reserves to be maintained in addition to such amounts as may be necessary to cover loan losses . . . . in order to absorb unusual losses without disclosing their amount. Such reserves may result in opportunities to distort, in varying degrees, the reported earnings of a bank and to cause uncertainty as to the full extent of shareholders' interests. In some countries where undisclosed reserves are maintained it may be that the use of such reserves and their impact on financial statements may be restricted to certain specified items. Nevertheless, financial statements cannot present a true and fair view as to financial position or results of operations if there are undisclosed overstatements of liabilities, undisclosed understatements of assets or undisclosed accrual of amounts for general or unspecified business risks". The response to the Discussion Paper also revealed different perceptions on this issue. Many respondents endorsed the statements in the Discussion Paper. Some respondents, however, repeated the assertions reported earlier that undisclosed reserves are necessary to preserve the stability of the banking system. In particular, smaller banks argued that the uneven incidence of bad debts in their business required a facility to cover losses from undisclosed reserves. It was pointed out that in some countries for political and economic reasons disclosure of reserves was not required and that the truth and fairness concept in the view of these countries was not impaired provided the financial statements comply with legal and regulatory requirements.

Views in India

3.12 In India, the Banking Commission had gone into this question in some detail. According to it, the main reason for the maintenance of secret reserves is the assumption that such reserves will act as a cushion for meeting the unforeseen demands. However, the validity of secret reserves being able to meet unforeseen demands remains to be tested. The present trend abroad is to discontinue the maintenance of such secret reserves. The Commission has examined the position obtaining in different countries and observed that the reason that secret reserves may be required as a cushion to meet unforeseen contingencies does not apply to the national banks. The Commission thus concluded "In the result, the provisions relating to the balance sheet and profit and loss account of banks may be modified to ensure full disclosure by banks of all their assets and liabilities. Consequentially, Section 34A of the Banking Regulation Act, 1949 may have to be repealed. Having regard to the purpose for which the secret reserves are maintained, such reserves of banks, existing on the dates on which the provisions providing for full disclosure become effective, should be required to be transferred to the ban general reserves". The recommendations of the Banking Commission were not, however, accepted by the Reserve Bank on the ground that it would not be worthwhile for even publ sector banks to discontinue the existing practice, especia when they have embarked on large scale financing of weaker sections in fulfilment of their social objectives and also on the ground that the creation and maintenance of secret reserves cannot have any undesirable repercussions in nati banks. The Working Group on Banking Costs, Operational Efficiency & Profitability of Banks (PEP Committee) did not go into this question specifically but, according to t formats suggested by it for the Profit and Loss Account, banks are to be permitted to deduct from income "usual and necessary provisions" implying thereby that the Committee considered it necessary for banks to maintain secret reser

Arguments for secret reserves

3.13 The more important arguments for and against the practice of creating secret reserves have been highlighted in several forums and also during the discussions on the subject within the Committee and with bank managements and other professional connected with bank accounts and managements. The argumen for the system are :-

(a) The stability of the banking system is vital national interest and as such the confidence depositors within the country as well as of the outside world in the system should outweigh the interests of shareholders. Any large adverse variations in the earnings of banks may raise doubts in the minds of the public and thus affect the stability of the system. By a judicious use of secret reserves, the banks can maintain a position of stability in their income. For this purpose banks should be free to build up reserves during good years and draw on these reserves during periods of adversity without in any way affecting the confidence of the public in their stability.

(b) Disclosure of write off, etc could give rise to incorrect and misinformed inferences with unfortunate consequences. A bank has to take credit risks in the ordinary course of business. The bad debts written off do not necessarily relate to a particular year and their effect has to be spread over a period of time and provisions are created not only for specific bad debts but also as a cover for the "latent risk" inherent in advances. Full disclosure will overlook these fundamental characteristics of banking activities and the quantum of bad debts written off or provided for in a year will be highlighted. uninformed criticism at various levels which follow the full disclosure of bad debts will a psychological impact on the bank management particularly at the field level and they woul tend to become overcautious and conservative. Their attitude towards existing loans and investments which are in an unsatisfactory condition and towards making fresh loans to sectors which carry more than the normal eleme of risk will be affected. The 'secret reserve system encourages bank managers to take risks undertake innovative banking which they might unwilling to assume, had they to disclose shar variations in income which a venturesome polic might entail. An apprehension has also been expressed that in certain extreme cases it is likely that disclosure of certain information m go against the spirit of confidentiality of the dealings of a customer with the banker. Thus there could conceivably be a violation of the privity of contract between the banker and cust

(c) It is difficult in any event to determine bank earnings unlike in the case of other units sinc the result of bad judgements may become apparen much later. The need for having secret reserves is, therefore, more important for banks than for other units.

(d) One of the arguments against maintenance of secret reserves is that it enables bank managements to escape public accountability by concealing losses caused by their ineptitude and misdeeds by recourse to secret reserves. The existence of secret reserves and the amount thereof will be largely known to the supervisory authorities controlling the banking system and it would not be easy for banks to misuse such hidden reserves. To that extent, this argument will not hold good.

(e) After all, the balance sheet is the status statement at a particular moment of time and it is made available to the public after the lapse of a few months. The position of banks can change substantially during the intervening period and the disclosure of secret reserves in the balance sheet by itself will not be, therefore, of much significance to most of the users of the financial statements unless the subsequent developments are also reported, which in many cases may not be possible.

(f) Even in countries where full disclosure is practised, banks are maintaining secret reserve to some extent in some form or the other. The argument that many countries are now practising full disclosure is thus only partly true.

3.14 The more common arguments against maintenance of secret reserves are -

Arguments against secret reserves

(a) Maintenance of secret reserves will preclude ba from showing the true and fair position to the shareholders and other users of the annual rep In particular the share value will be affected such non-disclosure. The shareholders have a right to know how the company and its managemen are performing.

(b) Secret reserves will enable the functional executives and the management of banks to cover losses incurred by their ineptitude and misdeed It may not also be possible for the users of th balance sheet to make a critical assessment and comparison about the performance of banks and therefore the management would escape accountability for any deterioration in the performance. It also enables unscrupulous managements to exploit such situations to project an image of a bank which may not be warranted by its performance.

(c) Where the practice of secret reserves is in vogue, the users are lulled into a belief that banks would be having secret reserves. In reality they may or may not have any significant reserves and consequently the users do not try to make any objective assessment of banks' performance.

(d) Full disclosure of reserves will enable banks to augment their published reserves and to that extent the image of banks - domestic and international - would improve. This is particularly important at this juncture as the capital - assets ratio has been showing a steady decline during the last few years.

(e) The psychology of full disclosure will necessitate the management to be alert and consequently would improve the quality of management. The discipline of public disclosure is good for management.

(f) The argument that public confidence will be affected by sharp variations in income reporting is not valid, because the public is now well enough informed to accept occasional large losses as a normal part of banking business.

3.15.1 So far, we have discussed only the general aspects relating to secret reserves and loan loss provisioning and the practices prevailing in other countries. Before we make any recommendations in regard to these items, it will be necessary to have an appreciation of the practices prevailing in India.

Indian Practices - General

For obvious reasons, the Committee has not attempted to make a study of the quantum of secret reserves available in the banking system. All the same, it is possible to give a genera picture of the practices obtaining in the banking system in this regard. As the law permits, banks deduct the usual and necessary provisions according to their discretion from incom heads. The practices though not strictly uniform have a fair degree of commonality. The items usually deducted from income heads are provision for taxes, provision for depreciation in the value of government securities, provision for loan losses, and in ~~the~~ some cases direct write off of loans, extraordinary losses, etc. In addition, banks also transfer certain funds for general contingency from income heads, if the profit position permits. The deductions are mostly made from 'interest' income and to some extent from 'exchange and commission'. By tradition and convention, banks are not inclined to show any sharp variation in profits in any one year as well as in the amount of dividend/transfer to Government, which does not in any event constitute a significant proportion of the published income. The profit and loss account thus tends to be a chimerical exercise; it conceals, as far as trend and quantum of actual profits are concerned, more than what it reveals.

3.15.2 The elements of secret reserves available in the Indian banking system are mainly under the following heads:

- Provision for bad and doubtful debts.
- Provision for depreciation in the value of securities.
- Undisclosed contingency funds.
- Appreciation in the value of fixed assets.

3.16 In India, the charge to the profit and loss account of a provision for bad debts is not a deductible item for tax purposes. Banks, therefore, provide for the gross amount of debts considered irrecoverable. When the relative debts are actually written off, banks get the tax benefit. There is thus a substantial cushion for banks in the bad debts provision representing at the current level of taxation about 55% of the amount of provision created. Again tax laws stipulate that all efforts for recovery should be made before debts are written off. The credit insurance agencies also expect banks to make reasonable efforts before writing off bad debts. The

Indian practices - Provision for bad and doubtful debts supervisory authorities too usually frown upon large scale write-offs, unless banks have examined in detail the circumstances under which debts have become bad and as a rule write offs even for comparatively small amounts have to be approved by the boards of banks. All these cause delay and the usual tendency among banks is to postpone the write-off as far as possible even though they would be getting substantial tax benefits by resorting to it. This gives rise to accumulation of debts to be written off and consequently the tax paid provision for such debts. The concealed amount of reserves in such provision for bad and doubtful debts for the system as a whole could be fairly substantial.

Indian practices - Provision for depreciation in the value of securities

3.17 The depreciation on securities also can conceal some secret reserves. Almost the entire amount of the investment portfolio of banks consists of Government or Government guaranteed securities called "approved securities". The proportion of approved securities to be maintained by banks is not determined by individual banks according to their discretion and on considerations of operational efficiency, but is determined by the monetary authorities according to economic compulsions and is on any reckoning much more than what is warranted by liquidity and safety considerations. Of late, the coupon rate has been increasing, bringing down in its wake the market value of the scrips. The banking legislation provides that banks should disclose the market value in the balance sheet unless exempted. The amount of depreciation in approved securities is substantial and providing for such depreciation every year in the context of increasing coupon rate and compulsorily-imposed increasing holdings becomes a difficult task for banks and as a result the practices adopted by banks to cope with the situation also differ. Some of them try to provide for such depreciation in full, provided the profits permit. Some others provide for such depreciation in part. A few undertake market operations, book a part of the loss and leave the balance depreciation uncovered. The tax benefits differ in each case. Banks are considered to be dealers in securities for tax purposes and they are permitted to follow a consistent system of valuing the securities either at cost or at cost or market price, whichever is less. Any change in the system will require approval of the tax authorities. In the circumstances, a bank which values the securities at cost, may not get any tax benefit if it makes only part provision for depreciation in securities. If it has to change over to a system of cost or market price, whichever is less, it has to provide for full depreciation, which may not be possible if profits are inadequate. On the other hand a bank which values the securities at cost or market price whichever is less can get full tax rebate on depreciation, provided every year it follows the same mode of valuation, which again becomes difficult unless there are adequate profits. A bank which provides in full for depreciation on securities and does not shuffle the portfolio much can have substantial secret reserves, as on maturity the securities will yield full face value. These reserves, are, however, subject to tax payment, as on maturity the difference between realisation proceeds and book value will have to be offered for tax. A bank which provides for depreciation in part can also have secret reserves which materialises on maturity. A bank which actually deals in security and which tries to book as much loss as possible by sale of depreciated securities and purchase of fresh issues at par will not have much secret reserves, as the redeemable value and book value will not in such cases be showing much difference. In fine, the element of secret reserves in the investment portfolio depends on the accounting practices adopted by banks.

Indian Practices - Undisclosed contingency funds

3.18 After providing for bad debts and depreciation on securities, the surplus, if any, in the real profits over what is required for the proposed appropriations is transferred to the contingency account. The amount of such contingency funds and the transfers thereto in recent years are not considered to be large.

3.19 Another area where banks have secret reserves will be in the value of its fixed assets. The banks in India do not normally revalue their investments in immovable property but it is generally recognised that the properties of the banks have substantially appreciated in value. Considering that the investments of the public sector banks on premises and buildings in 1982 was of the order of Rs.138 crores constituting about 23% of their capital and reserves, the extent of secret reserves in properties for the system as a whole can be substantial in the context of the upward movements in property prices.

Indian practices - Appreciation in the value of fixed assets

3.20 The surplus provision for bad and doubtful debts can be estimated only if the bad debts are themselves estimated. The surplus provision in securities is again a nebulous concept; the surplus can be estimated against book value or redemption value. Both have limitations and at best can show the position only at a particular moment of time. The contingency funds can be ascertained, as these are kept in separate accounts and will not be representing any outside liability. The surplus available in the value of properties can also be ascertained with some degree of objectivity; but the availability of such surplus as a cushion for losses is limited on a going concern

Indian practices - Measurement of secret reserves basis. Still the properties can be revalued and the surplus can be used to cover unforeseen losses. Even assuming that an evaluation of the various elements of secret reserves is possible, the real value of such 'secret reserves' will again depend upon various other 'imponderables'. A reserve - published or secret - exists only if the realisable value of the total assets exceeds the total outside liabilities by an amount more than the book value of the paid-up capital. Such a valuation is possible not by valuing the various components of secret reserves as indicated above but by making an evaluation of all the assets and liabilities.

Indian procedures - Exchangeable value of secret reserves

3.21.1 Although the Reserve Bank of India does not call for any specific returns from banks relating to their secret reserves, an attempt is invariably made during inspections of banks to find out the real or exchangeable value of their paid-up capital and reserves. In effect this exercise involves an evaluation of the various items of assets on the going concern basis and estimation of the outside liabilities including contingent liabilities which are likely to crystalli or materialise into actual liabilities. The difference between the realisable value of assets and the estimated outside liabilities will represent the real or exchangeable value of the owner's funds. Although the going concern basis is adopted, the method of valuation of different items of assets is such that a strict evaluation of the secret reserves by this process may not be feasible. Thus, while advances are valued on the basis of their realisability according to the perception of the inspecting officer, there are no hard and fast rules regarding such valuation and the estimated realisable value of the advances can possibly vary depending upon the perceptions of the individual inspecting officer. Moreover, bad debts are estimated on a gross of tax basis. Similarly investments in securities are valued on the basis of their market value. In a 'going concern' concept, this basis of valuation may not be very realistic in Indian conditions where banks do not make any distinction between 'dealing' and 'investment' securities and where the level of investments is determined by considerations other than liquidity and solvency. Premises and other assets are valued at the book value and the appreciation in their market value is not taken into account.

3.21.2 Valuation on the above basis may not, strictly speaking, reflect the true element of secret reserves built up by the system but at the same time it gives a limited idea of the true value of reserves. A rough conclusion can be drawn that excess of the real or exchangeable value over the published owned funds could be the secret reserves. It could be actually more, assuming that the properties which are valued at book value would have a higher market value and that the investments would fetch much more on maturity. On the basis of the evaluation of assets and liabilities adopted for inspection purposes, the position in regard to the secret reserves available in banks has been found to differ materially from bank to bank. By and large, it would also be correct to say that the provisions actually made by bank for loan losses are generally not up to the expectations of the inspecting officers. This, is, however, without taking into account the tax benefit that would accrue to the banks when the advances are actually written off.

Discussion on secret reserves and bad debts provisioning with banks and professionals

3.22.1 The various aspects relating to the 'truth and fairness' concepts, namely, the necessity for creating secret reserves and the need for disclosing the relevant information regarding loan loss provisioning have been discussed by the Committee with bankers and professionals in the context of Indian conditions. The replies to the questionnaire issued to banks have also been taken into consideration. Broadly, the view point expressed by banks during the discussions and their replies to the questionnaire is that they should not be required to disclose their contingency funds and provisions for loan losses.

Apart from the arguments in favour of maintenance of secret reserves indicated in para 3.13, banks have stated that in Indian conditions there is hardly any need for disclosure of such secret reserves. The banking system, except for an insignificant proportion, is under public ownership. The question of shareholders' interests being jeopardised by the system of secret reserves has, therefore, not much validity in India. The interests of the depositors and other creditors are also fully protected either by virtue of public ownership of banks or by the Deposit Insurance Scheme. Moreover, in Indian conditions, the Government who are the owners and Reserve Bank who are the supervisory authority both have access to the information relating to secret reserves. They have also their nominees on the boards of the banks. Even the employee sector, which is another user of the financial statements of banks, has representation on the Board. On the whole, in India, all the major user segments of bank financial statements have thus access to the information relating to secret reserves. Only the general public do not have such information and their interests in any case are protected. The disclosure of secret reserves is thus not necessary in Indian conditions.

3.22.2 According to banks, not only is disclosure not necessary in Indian conditions but disclosure might be counter-productive. The role of a bank and the objectives set before it in the context of social banking are not necessarily determined by profit motives or 'operational' efficiency considerations, but by the need to subserve the social goals. Extension of credit facilities to the weaker sections is one of the most important of such social objectives. Normally, as such credits are 'high risk, low yield' areas, if left to themselves, banks would be guided by profit motives and considerations of operational efficiency and in consequence the relative proposals would receive very low priority in their hands. In order to goad them into undertaking such activity, the system provides banks with risk insurance and refinance facilities. Nothing should be done which may turn out to be a disincentive to banks in undertaking such tasks. Full disclosure may prove such a disincentive. For, under full disclosure, banks may have to reveal the aggregate provisions made, the charge to the profit and loss account for creating provisions and the advances written off. This could lead to uninformed criticism and bank managements in order to forestall such criticism may try to go slow and play safe on such sponsored policies. The field staff who are likely to be faulted for the bad debts incurred while implementing the policies may also lose heart. This tendency can really become a disincentive and can impede the implementation of the government sponsored socially oriented policies. The above line of argument may look somewhat tenuous and can be countered by saying that the defaulting personnel can be changed. The Committee, however, feels that the apprehensions expressed, though based on psychological considerations to a large extent, cannot be brushed aside on that count. These fears and apprehensions have been brought to the notice of the Committee in all sincerity by people who are in the know of things and who are vitally concerned with such matters and should be given due weightage.

3.22.3 The accounting and management professionals have, however, certain reservations on the system of secret reserves and concealment of bad debts and provisions. Their arguments were more or less on the lines indicated in para 3.14. In particular, the accounting profession has argued that maintenance of secret reserves and non-disclosure of bad and doubtful debts provisions go counter to the basic tenet of 'truth and fairness' of general purposes reporting. They, however, agree that professionally they cannot have any objection to banks maintaining secret reserves, if the legislation enables banks to do so and the financial statements make the position clear. Another argument advanced by accountants as well as by representatives of Chambers of Commerce and Management Institutes is that non-disclosure discourages accountability. It is not only Government and the Reserve Bank but also the general public (who, under public ownership, are the real owners of these institutions) and market analysts acting on their behalf who should have the information regarding secret reserves. Unless the management are exposed to public scrutiny and allowed to be evaluated publicly by their performance as reflected in the financial statements there cannot be any true inter se comparison of the performance of banks and their managements. For such comparison and evaluation, actual figures without any sort of adjustments are necessary. Any management that does not have to be so accountable to the public and which conceals its ineptitude through the mechanism of secret reserves cannot be effective or purposeful. In the interests of healthy competition - a principle which is recognised by the fact that the various public sector banks operate as separate entities - it is only just and proper that banks reveal their true position. Such disclosure will also create a psychological atmosphere of alertness in the management and will be good for the overall efficiency of the banking system. Another valid argument which emerged during the discussions is that social banking is not without a cost. By not disclosing the true state of affairs, the public wrongly gain an impression that everything is fine with the system, while in reality social banking may have eroded the profitability of banks. Unless the true state of affairs is brought home, the clamour for banks doing more and more 'high risk, low income' social banking will only tend to increase and may ultimately lead to an intolerable situation. They, however, agree that proper monitoring of secret reserves by Government and Reserve Bank of India can go a long way in improving the system, even if it may not be as effecitve and purposeful as an exposure to informed public evaluation. They also concede that an exposure to general public scrutiny of loan loss data can lead to uninformed criticism which can be a disincentive to certain areas of innovative social banking.

3.22.4 By and large the trend of opinion is that full disclosure is a healthy objective and should be the ideal to be aimed at. In Indian conditions, however, in the context of social banking, there is a strong case for continuing the system of secret reserves for some more time. The position should, however, be reviewed periodically. In the meantime there should be a systematic, continuous monitoring of secret reserves by the Reserve Bank which has access to the information, with a view to preventing any misuse of the system by bank managements for concealing losses or erosion in profits caused by their ineptitude and lack of operational efficiency in the unit.

Committee's conclusions on secret reserves

3.23 The Committee agrees with the above views that in Indian conditions the time is not yet opportune for practising full disclosure in respect of secret reserves. The need for such full disclosure is also not as strong as in countries where the banking system is under private ownership. The issue, however, requires to be reviewed in due course.

3.24.1 As full disclosure in respect of secret reserves is not considered by the Committee to be in the best interests of

Partial Disclosure

the banking system at the present juncture, the question whether any partial disclosure will be desirable may now be examined. One main drawback in not having full disclosure is that the true trend of the income is not reflected in the accounts. As substantial deductions are made from gross 'interest income', the interest income often does not indicate the trend of the interest earned. Thus, despite the substantial hiking of interest rates and rise in the volume of advances, the interest income does not show a proportionate rise. This style of presentation could lead to wrong inferences that interest income is not rising proportionately because bad debts provisions are large or the non-performing loans are on the increase; while in reality the situation could be the result of syphoning of larger funds to undisclosed reserves. In extreme cases, this manner of presentation of accounts could also lead to an anomalous situation where the interest earned is less than the interest paid. Obviously, some modifications in the style of presentation of accounts are necessary to take care of such anomalies. One suggestion that has been made in this connection is that the correct income should be reported in the profit and loss account and the amount transferred to contingencies be shown along with various other items such as provisions for depreciation in investments, income tax, specific provision for bad debts, etc as a 'conglomerate' item on the expenditure side. These provisions will also not be disclosed in the balance sheet separately but will be shown as at present or in some other modified form without, however, disclosing in any manner the nature of the various provisions held or the balances in such provisions. Under this system the income will thus be reported correctly and it will then reveal the true trend of income and at the same time the procedure will not reveal the amount of secret reserves held by banks. Some foreign banks have more or less a similar practice.

3.24.2 The above proposal was also discussed with banks and representatives of other professional bodies. While the latter have endorsed the proposal keeping in view its general aims, banks have expressed some reservations mainly on the ground that presentation in the above manner might defeat the purpose of maintaining secret reserves. Their argument is that disclosure of even consolidated figures of provisions will enable an intelligent analyst to make out a fairly reasonable assessment of the secret reserves and provisions for loan losses over a period of time. Moreover, the consolidated figure will be so large that it could be the third biggest item on the expenditure side. The item will show, depending upon the actual profit level, substantial fluctuations. By the very nature of secret reserves, which implies large transfers during periods of prosperity and less or negative transfers during periods of adversity, it is to some extent true that the consolidated figure will show substantial fluctuations and that itself will kindle the curiousity of the users of the financial statements. Even assuming that legal protection is given to banks for not giving the break-up of such consolidated figure, the inferences that would be drawn from the fluctuations in this omnibus item may be more adverse than even a full disclosure.

3.24.3 It has to be conceded that the consolidated item of provisions will be large and will show substantial variations; the apprehension that it will reveal the quantum of bad and doubtful debts provisions or secret reserves over a period of time is, however, unfounded. In this connection a statement has been prepared showing the disclosure of profit and loss items under the existing and proposed methods in three cases for two years, which is given in Annexure II. It will be observed therefrom that the amount of provisions which is now proposed to be shown separately will be a significantly large item on the expenditure side. This item also shows significant variation during the two years covered in the study which, however, is to be expected in an item of this nature. The variation is not however not out of tune with the variations in the other items. It will be further seen from the statement that in the case of all the three banks the balance of profit disclosed during the years 1982 and 1983 do not differ materially whereas the gross income shows substantial increases. The increase in the gross income is set off by increase in expenditure in two cases and in the third case partly by such increased expenditure and partly by increased provisions. The existing procedure does not reflect correctly the changes in the quantum of provisions made, while the proposed procedure will indicate such changes. Further, in two cases the profit before provisions has actually decreased, although the published profit has been disclosed at a marginally higher level. The proposed procedure will indicate the true trend of growth in income and expenditures as also the amount of provisions made. Considering all aspects, the Committee feels that the principles underlying the proposed change are sound and also necessary from the point of view of proper accounting. Accordingly the proposal is incorporated in the suggested formats of profit and loss account and balance sheet discussed later.

3.25.1 A second area where the truth and fairness concepts are infringed is in the aggregation, netting and offsetting practices adopted by banks. If, particulars of such

Grouping and nettings

aggregations and nettings and the amounts involved are disclosed in the financial statements, there cannot be any valid objection to the practice, as for the sake of compactness in reporting, such aggregations and nettings are necessary. But very often such particulars are not furnished and the practice leads to concealment of vital information. According to IASC Discussion Paper, "significant items should not be grouped with other items without separate identification. Offsetting of items would only be appropriate if a legal right of set-off exists and offsetting represents the expectation as to the realisation or settlement of the asset or liability". On the Income statement the Discussion Paper of IASC states "offsetting of income and expenditure items would not be appropriate". In order to give a better understanding of the composition of and reasons for changes in net interest income, interest income and interest expense should be disclosed separately.

3.25.2 With the increasing trend towards greater disclosure in published accounts, by and large, the use of groupings and aggregations, nettings and offsettings for concealing vital information is on the decline. If at all such practices are still in vogue it may mainly be due to the compulsions of the formats prescribed for reporting and the defect can be rectified only by changing the format.

3.25.3 In India the more conspicuous practices of groupings and nettings are resorted to mainly for the purpose of preserving the secret nature of hidden reserves.. Though the accounting practices are not necessarily uniform, there is a fair degree of similarity in the procedures adopted by banks. Thus the item "current accounts, contingency accounts" etc on the liability side includes secret reserves (often called contingency funds), although obviously such secret reserves are not in the nature of deposits. Similarly the provisions for bad debts to the extent required by auditors or considered necessary in the opinion of the management as well as provision for depreciation in investments are netted off against advances/ securities and excess provisions are again shown along with contingencies under the head 'Deposits & other accounts'. In the Income and Expenditure statement, as already indicated earlier, the amount of secret reserves created during the year are deducted from the income heads like 'Interest & Discount' or 'Commission, Exchange and Brokerage', more commonly the former, and the amount transferred to contingency accounts. These practices are by and large resorted to for the purpose of maintaining secret reserves.

3.25.4 Other instances of nettings and groupings adopted by banks are mainly to comply with the requirements of reporting indicated in the specific formats. Even though the formats are prescribed, there is still an element of diversity in the practices adopted by banks in grouping of items under the various heads of the formats. Standardisation of such practices is necessarily a function of the formats and the notes/schedules attached to such formats. The Committee feels that such rationalisation of the practices is desirable and has also considered it necessary to give suitable clarifications when disparate items are grouped together or netted. These aspects have been taken care of while recommending the revised formats and schedules for preparing the balance sheet and profit and loss account.

3.26.1 Window dressing is the third area where the 'truth and fairness' concept is often flouted in corporate reporting.

Window Dressing Window dressing involves inflating some of the key items of assets and liabilities, particularly those items which are considered as growth indicators, with a view to showing a better picture of the growth of the institution than what is actually the case. It can also involve manipulation of income by not adjusting for income earned in advance or postponing expenditure incurred during the year to the next accounting period. Published profits can also be enhanced by not making adequate conventional provisions or transfers from out of the secret reserves. So long as the system and establishment permit 'secret reserves', a certain degree of adjustments of profits is unavoidable and may have the sanction of the concerned authorities.

3.26.2 Other forms of 'window dressing' and 'cosmetic accounting' to show a better picture of the growth and structural pattern of assets and resources do not have such justification. Still many banks in different countries resort to such practices. The key areas where such window dressing is very commonly resorted to are -

- increasing resource base items like deposits to indicate that the bank has attained substantial growth in comparision with its competitors
- showing larger amounts of liquid assets like cash and bank balances and securities and reducing the volume of advances to show better liquidity position
- jacking up various items of assets and liabilities to show a better aggregate of balance sheet assets and liabilities and hence working funds. Where the banks are graded on the basis of working funds, this practice enables them to promote their rankings in such lists
- manipulating the profit and loss accounts to show a better picture than is actually the case by measures not permitted by the requirements of maintaining secret reserves
- manoeuvring data to show compliance with legal or prudential norms of supervisory authorities.

3.26.3 To a certain extent, because of balance sheet and year end adjustments, the financial statement figures are bound to be more impressive than the intervening period data. Like in other manufacturing and service industries, in banks also, there is a general tendency for the figures to pick up towards the end of the closing period. This is due to a variety of reasons. Traditionally, the achievement of targets is assessed at the year end (intervening reviews are provisional in nature) and the field staff put in extra efforts to beat the targets towards the year-end showing in the process genuine better results. Some of the bank clients also have a feeling that they should increase their deposits with their banks and reduce their loan outstandings at the year end. Without any conscious effort on the part of the bank management or field staff, the year-end figures thus get distorted enabling banks to project a picture they like to reveal. It may be difficult to take any strong objection to such year-end phenomena, though they contribute to window dressing in banks, to some extent.

3.26.4 The more objectionable feature is, however, the practice of banks consciously resorting to unethical measures in boosting up their deposit and/or the total asset position. Instances of reciprocal funding between banks, merely by resort to book entries, are common. It is also not uncommon for banks to delay or prepone making entries which will otherwise adversely affect the final picture. For instance, cheques and bills to be debited to deposit accounts are held over to the new year while similar instruments received for credit to an account are booked before realisation during the year by debit to a suspense account. Other instances are by way of postponement of entries to inter-branch or inter-bank accounts to the new year. Similar tactics are adopted even in respect of contra items, to show these figures at a higher level. Banks have even been found to resort to creation of temporary advances and suspense account entries in the names of certain constitutents to raise deposits. Similarly large withdrawals towards year end are suppressed from deposit accounts again by resorting to suspense entries. While these practices are considered by banks as 'innocuous' as they do not undertake any risk in the process, the practices adopted are nevertheless unethical; more so, is the tendency of banks to show better profits by taking into account income properly attributable to next year or by postponing the accounting of expenses rightly to be accounted for during the year or by not making adequate provisions on a prudent basis for items like loan losses, depreciation in investments, etc.

3.26.5 Window dressing in any form does not help individual banks or the banking system. The disadvantages are obvious. If all the banks follow the same practice, there is no comparative advantage to any one bank. The only way one can get some leverage is to resort to a greater degree of window dressing. The system thus begets greater cosmetic manipulations. If once such practices are resorted to, a bank is willy-nilly compelled to resort to them again and again, lest the subsequent figures show a decline in growth. Very often the officer who has resorted to window dressing in one year is probably transferred before the next year-end and his successor finds it difficult to sustain the previous year's growth without resorting to cosmetic manipulations. In a situation where the next incumbent has to give explanations for the fall in deposits, the morale of the staff is also likely to be affected. Where the supervisory authorities monitor mid-term data on weekly or monthly basis, banks often find themselves in an unenviable position, of having to explain the sudden decline in deposits, liquid assets, etc after the year end. On all counts, therefore, window dressing serves no purpose and the argument that it helps the public to have confidence in in the institution looks specious.

3.26.6 The issue was discussed with banks and the professionals connected with bank management and there is almost a consensus that in Indian conditions there is no case for window dressing at all. It has been pointed out during the discussions that even the dubious argument that executives of banks get a better chance of promotion or extension of service by resorting to window dressing, is not valid in Indian conditions, as continuous performance monitoring including inspections by the supervisory authorities precludes the hopes of the derelictory management of concealing the true state of affairs from the authorities concerned. Moreover, whenever such instances come to the notice of the supervisory authorities, invariably explanations are called for and displeasure conveyed to bank managements by the authorities. As a result of such salutary measures, the extent of window dressing in banks has considerably declined lately, although the practice has not been completely rooted out.

3.26.7 Some of the suggestions made during the discussions for doing away with even the remnants of such practices are -

- The Reserve Bank should do away with rankings of banks on the basis of deposits. Ranking, if necessary, should be on the basis of various parameters like growth in average deposits and advances, compliance with the social objective guidelines regarding extension of credit to weaker sections and preferred sectors, expansion of banking to the lesser developed centres, profitability, innovative banking measures introduced, etc.

- The auditors should be advised either to qualify the report where banks have consciously resorted to window dressing or even to adjust the figures to the extent of such window dressing. Failure to do so by the auditors should be considered as professional misconduct.

  Banks should be asked to disclose average figures also in the financial statements and give explanations if the average figures are not in alignment with year-end figures.

3.26.8 The Committee, however, feels that in the present circumstances where bank managements themselves are fully seized of the pitfalls of window dressing, there is no case for any drastic measures. In exceptional cases, where bank managements resort to such practices, the Reserve Bank should continue to pull up the concerned management. It could also in extreme cases of indiscretion take punitive action against the delinquent officers. Besides, the Committee has recommended elsewhere, in the context of the overall requirements of disclosure, that banks should indicate in the annual reports their average deposits and advances and the growth in such average figures.

3.26.9 A more disturbing feature of cosmetic accounting, however, is the propensity of bank management to suppress losses so that the working results show some reasonable profit. Unfortunately, banks both in the public and private sector in India are very reluctant to show any operational loss in their income and expenditure statement, even though circumstances may warrant such a course. Though rare, there have been instances where the banks have concealed their true state of operational results by suppressing certain items of losses which have already been incurred or by not providing for debts which have already crystallised into bad debts. To the extent such losses are extraordinary and are taken care of by secret reserves, the practice may have some justification. But if such is not the case, the Committee is of the opinion that the financial statements as well as the auditors' report should indicate the true state of affairs in unambiguous terms. In the case of public sector banks, this is not likely to affect the confidence of the public in the institution, while in the case of private sector banks, if the overall position is that bad, it should be made known to the public.

3.26.10 An apprehension has been expressed that in the case of private sector banks, disclosure of the actual state of affairs may lead to a run and the eventual closure of some banks. The supervisory authorities, who in any case would be aware of the situation through their monitoring and inspection system, should take necessary steps to see that the banks concerned are not allowed to continue in an insolvent state. The Banking Regulation Act provides for various remedial measures in such situations and the Reserve Bank should take recourse to such powers in the long term interests of the banking system without hesitation.

CHAPTER IV

ANALYTICAL DATA

4.1 As indicated in paragraph 2.1, one of the major areas of disclosure in financial statements relates to disclosure of particulars of significant items of assets and liabilities and income and expenditure by way of supplemental data. The balance sheet according to a simplistic view is a catalogue of the items of assets and liabilities on a particular date and the income and expenditure account, a flow statement indicating the aggregates of incomes and expenditures for a specified period classified under certain broad heads and hence it is possible to prepare balance sheets and profit and loss accounts in different forms and on different bases. The utility of these financial statements will however depend on the extent and quality of information that is revealed in these statements. As a rule the more compact the size of a balance sheet, the lesser the information it is likely to contain. This is also true for the profit and loss account. In actual practice it is, therefore, customary to strike a balance between extreme compactness and extreme comprehensiveness. The balance sheet and profit and loss account usually classify all like items together and all such significant and material groups are shown in the financial statements separately. Where necessary supplementary data are furnished by way of notes on the significant item-groups.

Details are furnished on significant items by giving break-up of such items on the basis of accounting groups, type of business, source of funds or income, geographical and sectoral distribution, etc. The main objective of giving such analytical data is to enable the users to appreciate the position of the reporting unit intelligently and meaningfully. Such data give an insight to a limited extent into the quality and character of the assets and liabilities and income and expenditure which the consolidated quantitative data alone may not reveal. Comparison of peer groups is facilitated by such supplementary data and an evaluation of the performance and future prospects also becomes possible again to a limited extent.

4.2.1 Coming to bank accounts, an analysis of the types of business undertaken by banks will indicate that they raise funds

Bank Data

from various sources like owners' funds, deposits and borrowings and deploy them in liquid assets, investments, advances and infrastructural assets. In addition, banks also have various contingent accounts, especially where they act as agents and trustees and data regarding such business are also to be incorporated in the financial statements to some extent. Ideally the supplementary data furnished by banks, therefore, should show:

- liquidity of funds, their maturity and ownership.
- break-up of investments to show concentration,

liquidity and possibilities of depreciation.

- particulars of advances to indicate liquidity, type of borrowers, country-wise exposure, concentration of risk, securities available.
- particulars of other assets.
- particulars of deposits indicating maturity, ownership and country-wise break-up.
- particulars of other liabilities.
- break-up of income and expenditure on the basis of activity and source and also on geographical basis.
- particulars of commitments and contingencies.

4.2.2 The particulars required by way of supplemental data are in some cases presented by the reporting formats themselves or are disclosed by suitable notes. It is also very rare that all the supplemental data are furnished by all banks; very often, depending on their own perceptions, traditions and statutes, only a few items which are considered important by them are furnished by banks in their accounts. In the following paragraphs, the general practices prevailing amongst international banks in respect of disclosure of the above broad items are discussed. Certain additional particulars disclosed by banks are also indicated. The extent to which such supplementary data should be furnished by Indian banks will depend on the format, the Committee proposes to prescribe for financial accounts and has been examined in a later Chapter. The objective of this Chapter is therefore mainly to indicate the general requirements mentioned in IASC Discussion Paper (Annexure I) and the practices adopted by foreign banks.

4.3 One of the primary functions of the financial statements of a bank is to display its liquidity and solvency, the relative degree of risk that may attach to different assets and liabilities and the concentration of assets and liabilities. While it may be difficult to furnish all information that is relevant for an assessment of liquidity and solvency within the confines of the financial statements, the IASC Discussion Paper has indicated certain guidelines in this regard. These include grouping of like items in the balance sheet and listing of assets and liabilities in the approximate order of liquidity/maturity. Investments are to be classified into 'dealing' and 'investment' securities. In regard to profit and loss account the Discussion Paper states that income should be classified by its type rather than by its source. Analysis by source would be a useful additional disclosure. Although thus there are no internationally accepted norms indicating what are the items to be necessarily shown in the financial statements and the manner of their presentation,

IASC guidelines

IASC Discussion Paper has indicated certain items to be specifically disclosed in the final accounts.

Practices in other countries

4.4 Almost all the recognised banks in the world at present give information relating to the significant groups of assets and liabilities and income and expenditure in financial accounts, but the quality and extent of supplemental data furnished differ materially. The practices obtaining in regard to some of the major items are discussed in the following paragraphs.

Liquid assets

4.5 The manner in which cash and bank balances are shown by some of the foreign banks is indicated in Section A of Annexure III. The scope and range of the items included under this head vary from country to country and there is also no uniformity in the supplementary data furnished in respect thereof. The predominent practice is to include under this head cash, balances with Central Bank and other banks in current account and term deposits, money at call and short notice, etc.

Investments

4.6 The method of presentation of this item followed by banks in some of the foreign countries is illustrated in Section B of Annexure III. By and large, the investment particulars given in the balance sheet reveal classification by source of issue, market valuation and in some cases maturity classification as well. Classification of investments on the basis of 'dealing' and 'investment' securities although recommended by IASC Discussion Paper is not a uniform practice. Obviously in many countries, banks do not make such a distinction and the question of such classification may not therefore arise. The system of valuation of securities also differs from country to country and market values are not uniformly disclosed. However, the mode of valuation is generally indicated in the relative accounting policies or otherwise. Investments in subsidiaries are not included in investments but shown separately by some banks.

Loans and advances

4.7.1 Although the loaning practices and the terminology used in the balance sheet vary from bank to bank and it is not uncommon to see some banks including odd items of debit balances also in advances, there is generally no difficulty in identifying what items constitute loans in the balance sheet. The loans portfolio is the single largest item in the balance sheet on the assets side in all the balance sheets studied. According to the IASC Discussion Paper banks are expected to disclose maturity analysis, geographical analysis and sectoral analysis in respect of loans. The national banking legislation and customs in different countries however differ and the reporting systems also, therefore, do not show any uniformity in presentation of this item in the balance sheet. Some instances of presentation of this item in the balance sheet are given in Section C of Annexure III.

4.7.2 Most of the banks provide some sort of analysis of loans by maturity. However there is no consistency in this regard. In some countries banks classify them on the basis of original maturity whereas in other countries banks classify maturity according to the period of loan that remains outstanding at the balance sheet date. There is also no clear-cut difinition of 'short' 'medium' and 'long term' loans. Different banks have different local meanings assigned to such terms. A few banks do not provide any sort of maturity analysis at all. Information regarding loans by way of type of borrowers is also not provided by many banks. Even where it is provided in the accounts there is little uniformity in the presentation; however amounts due from banks and non-bank customers are separately given in a number of cases. A few banks also give a classification based on the type of advances like loans given for agriculture, commercial and industrial activities, loans given to other banks, etc.

4.7.3 Disclosure of security-wise and geographical break-up of advances is by and large poor. An analysis of the loans given by banks based on the degree of economic development of the borrowers' base country, it is stated, can be very useful as it will indicate to what extent the exposure is on underdeveloped, less developed and developed countries. Very rarely, however banks attempt such an analysis. The degree of disclosure in respect of loan loss provisioning, non-performing advances, etc varies from country to country.

4.8 Other assets Most of the banks do not give much information under 'other assets' excepting -

a) Categorisation of the major items included under this head

b) Information relating to premises and equipments depreciation charged on such fixed assets, etc.

A few instances of presentation are furnished in Section D of Annexure III.

4.8.2 By and large the other assets form a very insignificant proportion of the total assets, constituting less than 5% of the assets and it may not be, therefore, essential to give detailed information regarding these items in the balance sheet. Premises and equipments in any case constitute a large proportion of other assets and the particulars regarding mode of valuation depreciation charged, etc of such assets are usually furnished by banks.

4.9.1 Deposits The mode of presentation of deposits also varies from bank to bank and certain illustrations are furnished in Section E of Annexure III.

4.9.2 As loans are a bank's principal asset, so are deposits its principal liability. Because of differing national and regional banking practices and traditions, banks usually raise different types of deposits and quasi-deposits. By and large, however, banks do not face any problems in classifying different forms of deposits received by them under the general head 'deposits'. Some banks also include in current deposits inner reserves and a few of them further indicate by way of notes that inner reserves and provisions are included under this head. There are no specific international standards for reporting of deposits. A few banks give maturity-wise analysis of deposits as well as classification of deposits by type of business. The maturity classification is not, however, indicated by specific time periods and very often the maturity is indicated in general terms by classifying deposits as time deposits, demand deposits, instalment deposits, negotiable certificates of deposits, savings deposits, other time deposits, etc. The practice of classifying deposits by type of business is also prevalent only in some countries although a broad classification of deposits from banks and others is not uncommon. In a few countries like France, the standard format gives analytical data of source of deposits like private individuals, banks and financial institutions, etc.

4.10.1 Other liabilities | Apart from deposits and stock holders funds there is no uniform practice among banks in the manner of presentation of other items on the liability side of the balance sheet. Section F of Annexure III shows how these items are presented by some banks.

4.10.2 The normal practice is to show the material items separately. Such material items will vary according to the type of business handled by the banks. Some of the more common items included under other liabilities and shown separately are borrowings, notes and debentures, bills, acceptances, sundry creditors, interest payable, suspense account, sundries, securities account, tax and dividend payable.

4.11.1 Most of the banks give particulars regarding

Income and Expenditure

the items of income and expenditure as indicated in the IASC Discussion Paper. The major items of income and expenditure that the Discussion Paper requires to be disclosed in the income and expenditure statement are

- interest income
- interest expense
- fees for services
- dealings results
- investments gains and losses
- net charge or credit to the provisions (for loan losses)
- employee costs
- taxes on income

4.11.2 The manner of disclosure again varies from bank to bank and country to country. In some countries, there is no separate income and expenditure account and only an 'appropriation' account is furnished. Particulars of the major items of income and expenditure are, however, disclosed by way of notes. The practices followed by some of the banks in different countries are explained in Section G of Annexure III. It will be seen therefrom that banks generally give not only the minimum information required to be given according to the IASC Discussion Paper but also particulars of all the major heads of income and expenditure. Many banks also show source-wise break-up of the principal heads of income and expenditure, particularly interest income and interest expense. Disclosure of geographical distribution of income and expenditure is rather rare.

4.12.1 In the ordinary course of business banks enter into many types of transactions that generate financial contingencies or commitments. The existence and extent of such contingencies and commitments have to be reported as they have potential to generate significant losses. The items usually reported under these heads are:

Contingencies and Commitments

- pending legal matters and actions
- guarantees
- stand-by facilities

- letters of credit and acceptances
- forward foreign exchange business
- other forward business
- undrawn loan facilities
- future market positions

4.12.2 According to the IASC Discussion Paper, a bank should normally disclose the existence of uncovered contract positions and the existence and the amount of guarantees, letters of credit and stand-by letters of credit issued and irrevocable commitments to extend credit that cannot be withdrawn at the discretion of the bank without incurring expense or loss. Some instances of reporting are given in Section H of Annexure III.

4.12.3 By and large, banks show the nature and the extent of such commitments in their balance sheets. The quality of the disclosure is, however, not uniform. In some countries, banks are either permitted or required to disclose certain categories of contingent liability on the face of the balance sheet as contra items. In other countries the practice is to show these items at the bottom of the balance sheet without including them in the totals.

Concluding observations

4.13 In the preceding paragraphs, the Committee has analysed the general manner of presentation of the main items of balance sheet and profit and loss account of banks in some of the developed countries and the additional particulars furnished in respect of such items.

Except in some core areas, there is hardly any uniformity among banks in the presentation of their accounts. Still the broad aspects discussed above have been kept in mind while considering the formats of the balance sheet and profit and loss account for the Indian banking system, which are discussed in Chapter VI.

CHAPTER V

ACCOUNTING POLICIES

5.1.1 Introductory — Another major area of disclosure relates to 'accounting policies'. Financial statements are prepared on different bases to comply with local conventions and statutes. Banks, therefore, feel that there is no need to explain their accounting policies in the financial statements. However, to the users of the financial statements, who are not well acquainted with local customs and statutes, want of such information will cause difficulties in understanding the published data and appreciating them in a correct perspective.

5.1.2 According to the IASC standards, three basic assumptions that underlie the preparation of financial statements need not be mentioned as apart of the accounting policy, unless they are not followed. These are the concepts of -

a) going concern (that the enterprise will continue in operation in future)

b) consistency (the accounting policies adopted are in agreement with the policies adopted earlier)

c) accrual basis and not cash basis (revenue and expenses are recognised as they are incurred and not dealt with on a cash basis).

The IASC standards also require that financial statements should provide clear and concise disclosure of all significant accounting policies preferably at one place. Changes in accounting policies should be clearly indicated. Comparative figures for the preceding periods should also be disclosed.

5.1.3 An examination of the financial statements of some of the international banks indicates that the accounting policies outlined in their reports refer mainly to the following items :-

- Basis of accounts, consolidation of accounts of subsidiaries and treatment of investments in associate companies.
- Investments - amortisation and valuation.
- Fixed and other miscellaneous assets - mode of valuation and basis of depreciation.
- Provisions - basis of provisioning for loan losses, unforeseen risks, contingencies, etc.
- Translation of foreign assets and liabilities and revenue and expenditure.
- Taxation - basis of taxation and deferred taxation.

5.1.4 The Committee discussed the question of disclosure of accounting policies with the members of the auditing profession and banks. By and large, the consensus has been that disclosure of accounting policies is desirable and necessary and even if the banks are permitted to maintain secret reserves, there should be no objection to disclosing the accounting policies. Although most of the foreign banks disclose their accounting policies under the broad heads indicated in the preceding paragraph, the manner and degree of disclosure vary from bank to bank and country to country. Comments on the accounting policies disclosed by some of the foreign banks on a representative basis are given in subsequent paragraphs. The Committee has also recommended under each head the manner in which accounting policies may be disclosed by Indian banks. It may be clarified in this context that banks usually show their accounting policies at one place and the Indian banks also may disclose such policies at one place along with notes on the accounts.

Basis of accounts, consolidation of accounts of subsidiaries and treatment of investments in associate companies

5.2.1 In certain countries like U.K., U.S.A., Australia, Japan, etc some form of consolidation of group accounts is mandatory, while in some others like Belgium, France, Italy, etc there are no such statutory provisions. The methods of integration adopted in the case of subsidiaries are total integration and proportional integration. In the first method, the corresponding assets, liabilities and profit and loss items of the subsidiaries are added to those of the parent company after eliminating material intra group transactions. The outside interests are shown separately. In the second method, the proportionate value of the assets, liabilities and profit and loss items of the subsidiary represented by the value of the interest in the equity of the subsidiary by the parent company is added to the respective items in the final accounts of the parent company. No minority interest need therefore be shown separately. In the case of associate companies, there will be no consolidation either on total or proportionate basis in the accounts of the principal company. The equity method of presentation is usually adopted in such cases. The equity owned by the principal company in the associate company is thus shown as investment at the book value, adjusted for changes in the aggregate profit/loss of the associate companies, subsequent to the date of the acquisition of shares.

5.2.2 Excerpts from a few typical cases showing how banks have indicated their accounting policies in this regard are given in Section A of Annexure IV. Banks generally indicate under this head the basis of presentation, consolidation of the accounts of subsidiary companies and manner of presentation of the investments in associates. The basis adopted by most of the banks in presenting their accounts is the historical method. A few banks, however, indicate some data relating to inflation accounting. Several methods like current/constant purchasing power method and current cost accounting method have been adopted by banks for measuring the effect of inflation on the financial position and the working results. Some of the countries have prescribed either by statute or through their accountancy institutions certain norms for inflation accounting. Most of the banks do not, however, give any realiable information regarding inflation accounting in their financial statements.

5.2.3 In the Indian conditions, banks follow the historical cost accounting. Indian banks have also very few subsidiary companies or associate companies in which they have substantial interest. The question of prescribing consolidated or group accounts may not be of much relevance to Indian banks. For our puposes, it will be, therefore, sufficient if banks follow the historical cost method of presentation of investments in associates and subsidiaries. This can be so indicated in the accounting policy statement on investments.

In addition, the banks may give in their financial statements by way of a note a list of their subsidiaries and/or associates in which they hold substantial financial and management interest and indicate the extent of their holdings in such units.

5.3.1 Investments constitute the bulk of the liquid assets of a bank and it is customary for banks to give **Investments** the accounting policies adopted by them in reporting this item in the balance sheet. Here again, the practices are dictated by local statutes and/or conventions. Excerpts of accounting policies furnished by some banks in their annual reports are given in Section B of Annexure IV.

5.3.2. It will be seen from the annexure that essentially the accounting policy should indicate the basis of valuation of different securities and the manner of treatment of discount and premium. There should not be any difficulty for Indian banks to abide by this requirement.

5.4.1 Here also the accounting policy disclosure by banks mainly relates to mode of valuation, depreciation **Fixed and other miscellaneous assets** charged, etc as will be seen from Section C of Annexure IV.

5.4.2 As the disclosure practice regarding accounting policy in respect of fixed and other miscellaneous assets is thus only to indicate the mode of valuation and depreciation method adopted the Indian banks should not have any difficulty in furnishing such information.

Provisions - basis of provisioning for loan losses, unforeseen risks, contingencies, etc.

5.5.1 Banks which maintain secret reserves give very little information regarding the accounting policies followed by them in regard to provisioning for loan losses, unforeseen risks, contingencies, etc. The information furnished by such banks is largely of a general and innocuous nature. The banks which do not maintain secret reserves, however, furnish detailed information in this respect. The excerpts given in Section D of Annexure IV are illustrative of both the methods.

5.5.2 By and large, the accounting policies disclosed by banks in respect of loan loss provisioning only indicate on what basis accounts are treated as bad and doubtful and provided for and how they are treated in the accounts. It should not be difficult for Indian banks also to describe generally the circumstances under which the debts are provided for and how such provisions are deducted from the advances amounts in the balance sheet. If provisions are made on the basis of guidelines framed by the Reserve Bank of India/Government that fact also may be disclosed. The practice of making ad hoc provisions for rural advances also may be disclosed generally.

Translation of foreign assets and liabilities and revenue and expenditure

5.6.1 Here also the practice is to indicate mainly the basis on which currency translations have been effected for the purpose of the financial statements. Certain excerpts are given in Section E of Annexure IV.

5.6.2 The accounting policy disclosed by banks in regard to currency translation is mainly a statement of the practice followed by the banks in the matter and the Indian banks should not have any difficulty in furnishing this information in the financial statements. By and large, the Indian practice is also in conformity with international practice in this regard.

Taxation - basis of taxation and deferred taxation

5.7.1 The disclosure made by some of the banks regarding taxation are illustrated in Section F of Annexure IV. Many banks indicate the procedure adopted by them in respect of taxation in the accounts. As the taxation provisions vary from country to country, an enunciation of taxation practice adopted by the bank will be helpful to understand the financial statements properly. The Indian banks may also adopt this practice.

5.8.1 Before we conclude this discussion it may be mentioned that apart from the items discussed in the

Other items

foregoing paragraphs, some banks disclose their accounting policies in respect of certain other items also. The practice is mainly to indicate the manner in which the relative items are accounted for in the books. Some of these items are :

- lease financing
- staff benefits

As banks are not undertaking leasing business in India directly, the question of disclosing the accounting policy in this regard does not arise at present. Under the head, 'staff benefits', Indian banks may indicate whether the retirement benefits are accounted for on cash basis and whether the liability is funded.

5.8.2 On the basis of the discussions in this chapter, the Committee has prepared a specimen form in which accounting policies may be disclosed in the financial statements (Annexure V). It is customary to include such enunciation of the accounting policies adopted in the preparation of accounts in the "Notes on the accounts" attached to the financial statements. The items to be included in the "Notes on the accounts" other than 'accounting policies' are discussed in Chapter VI.

The accounting policy statement as proposed, with necessary modifications to suit individual cases will form part of the final accounts.

CHAPTER VI

FORMATS OF BALANCE SHEET/ PROFIT AND LOSS ACCOUNT

6.1.1 The next two items in the terms of reference relate to formats of published accounts and standard introductory accounting concepts. The terms of reference indicate that the changes/amendments in the formats of the balance sheet and profit and loss account of banks are to be examined, having regard to the need for greater or full disclosure, the expansion of banking operations both area-wise and sector-wise over the period, the need for improving the presentation of accounts, the presentation of accounts of other companies, etc. The standardisation of accounting concepts has been suggested in the context of the need for a uniform, comparable presentation of the items of assets and liabilities as well as income and expenditure in the published accounts. These two terms of reference are interlinked and have been examined jointly to the extent possible. Certain other aspects of standardisation of accounting concepts are examined elsewhere in the report.

6.2.1 The balance sheet from an accounting point of view may be defined as a formal arrangement of facts

Object of Balance Sheet

and figures in an intelligible manner, showing the total values of assets owned and total amount of liabilities owed by a business on a particular date or at the end of a particular period, so that the net worth of the business may be ascertained. In some countries, it is also known as 'Statement of Financial Position'. The function of a balance sheet is to show the share capital, reserves (distinguishing those which are available for distribution as dividends from those not regarded as so available) and liabilities of the company at the date at which it is prepared and the manner in which the total moneys representing them are distributed over the several types of assets. A balance sheet is thus a historical document and does not, as a general rule, purport to show the net worth of an undertaking at any particular date or the present realisable value of such items as goodwill, land, plant and machinery, nor except in cases where the realisable value is less than the cost, does it normally show the realisable value of stock-in-trade. According to the Companies Act, every balance sheet of a company shall give a 'true and fair' view of the state of affairs of the company and every profit and loss account shall give a true and fair view of the profit or loss of the company. Although the above requirements do not strictly apply to the banking companies, as they are exempted from disclosure of certain matters by the statute under which they operate, the auditors nevertheless report in the case of bank accounts also on the 'true and fair' aspect of the final accounts subject to such limitations of disclosure.

6.2.2 Strictly speaking, it cannot be said that the balance sheet shows the true financial position, unless the assets and stock are revalued as on the date of the balance sheet. As the Cohen Committee pointed out, if the balance sheet were to attempt to show the net worth of the undertaking, the fixed assets would require to be revalued at frequent intervals and the information thus given would be deceptive since the value of such assets while the company is a going concern, will in most cases have no relation to their value if the undertaking fails.

6.3.1 Banks in India are set up and governed by different

Statutory provisions relating to balance sheet

statutes. Thus the State Bank of India is set up under the State Bank of India Act, 1953, the associate banks under the State Bank of India

(Subsidiary Banks) Act, 1959, the first group of 14 nationalised banks under the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970, the second group of 6 nationalised banks under the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 and the private sector banks under the Companies Act. These statutes under which they are set up, however, do not govern the formats of balance sheet and profit and loss account to be prepared by them. Separate formats for such final accounts by banks have been prescribed under the provisions of the Banking Regulation Act. In terms of Section 29(1) of Banking Regulation Act, "at the expiration of each calender year every banking company incorporated in India in respect of all business transacted by it and every banking company incorporated outside India in respect of all business transacted through its branches in India shall prepare with reference to that year a balance sheet and profit and loss account as on the last working day of the year in the forms set out in the Third Schedule or as near thereto as the circumstances admit". Sub-section(3) of Section 29 of the Banking

Regulation Act further provides: "notwithstanding that the balance sheet of a banking company is under sub-section (1) required to be prepared in a form other than the form set out in Part I of Schedule VI to the Companies Act, 1956, the requirements of that Act relating to the balance sheet and profit and loss account of a company shall, in so far as they are not inconsistent with this Act, apply to the balance sheet or profit and loss account, as the case may be, of a banking company".

6.4.1 The question of presentation of final accounts by banks was examined by the Banking Commission (Chairman Shri R.G. Saraiya).

Earlier Examination - Banking Commission

The Banking Commission opined that the provisions relating to balance sheet and profit and loss account of banks might be modified to ensure full disclosure by banks of all their assets and liabilities. In effect the Commission recommended doing away with the practice of banks maintaining secret reserves. The Reserve Bank, however, did not accept this recommendation.

6.5.1 The P.E.P. Committee had also considered certain aspects relating to the existing format of balance sheet

P.E.P. Committee

and profit and loss account of banks, the presentation of annual accounts, etc. and proposed restructuring of the formats, their design and manner of presentation so as to bring them in tune with the role, functions and responsibilities of banks. In this context, it had suggested simplified and revised formats of balance sheet and profit and loss accounts. The Committee's suggestions and the rationale for the revision as also the concepts were circulated by Reserve Bank among the larger banks, including foreign banks and the Indian Banks' Association for their views. As there were divergent views on certain concepts/items, such as, undisclosed provisions held, valuation of investments in securities, as also treatment of certain items of income and expenditure, the matter was not pursued.

6.6.1 During the last two decades considerable changes have taken place in the scope, perspective and objectives

Need for change

of banks and banking. The ownership of major banks which were in the private sector has been taken over by Government upon nationalisation of 20 major commercial banks in two stages. The banks are now called upon to cater to the needs of a vast multitude of borrowers including those of hitherto neglected sectors. Banks have, in recent years, enlarged their operations both functionally and territorially which have brought in their wake structural changes in their management and organisation. There has been thus a sea-change in the operations, coverage, management and organisational structure of banks. The balance sheets of other companies have undergone substantial changes during this period and the presentation and formats of their final accounts have been streamlined and standardised to a large extent. The practices in other countries have also changed in accordance with the changing needs of time. The formats and presentation of accounts of banking companies in India have, however, remained virtually unchanged since 1949, i.e. after the enactment of Banking Regulation Act. The existing formats of profit and loss account and balance sheet do give information relating to the significant items laid down in the IASC Discussion Paper (vide Annexure I) and to that extent the coverage may be considered to be satisfactory. All the same, the general opinion in banking circles as well as the auditing profession is that the formats are lengthy, do not present in a correct and intelligent manner the status position and operational results and do not reflect the extent of social banking activities undertaken by banks nor the cost of such activities, etc. Some of the more specific limitations of the present formats brought to the notice of the Committee relate to the following aspects :-

i) The profit and loss account does not reflect the true trend of profits. While this is partly due to the fact that banks are exempted from disclosing certain items in their published accounts, even within such constraints, it should not be difficult for banks to show a true trend of their profits.

ii) The main items of the profit and loss statement - interest income and interest expenditure - do not give a comprehensive view of the sectoral break-up, source analysis, etc with the result that the real cost of different activities undertaken by banks does not get reflected in their annual accounts.

iii) The present classification of advances on the basis of security and types of borrowers like director/ officer connected categories of borrowers, etc is less relevant to modern requirements than classification on the basis of types of borrowers based on activities, when banks are undertaking concessional lending to priority and weaker sectors.

iv) Banks do not follow a uniform procedure in regard to accounting and treatment of various items of assets and liabilities. Hence standard accounting practice, not only in regard to accounting and presentation of various items of assets and liabilities but also the system of making provisions for different purposes, etc have to be evolved so that the final accounts of different banks can be compared with some degree of exactitude.

v) The publication of the present formats in full is unnecessary and costly and such publication of a summary version will yield comparatively better cost-effective results.

vi) The categorisation of data given in the statutory returns like returns under section 42 of Reserve Bank of India Act, returns under section 27 of Banking

Regulation Act and that furnished in the existing formats of balance sheet and profit and loss account are not strictly identical in respect of a number of items. It will be necessary to have uniformity in the matter of presentation of various items in the returns as well as in the balance sheet.

Proposed formats

6.7.1 The Committee has had detailed discussions on the subject with bankers, Chambers of Commerce, auditors and others who are associated with bank accounts. There was a consensus on the need for changing the existing formats of balance sheet and profit and loss account. The formats suggested by the P.E.P. Committee are generally acceptable to them, subject to certain modifications. The Committee has accordingly considered the various aspects and it is of the view that the formats suggested by the P.E.P. Committee with certain modifications can form the basis for the revised formats of balance sheet and profit and loss accounts for banks. In devising the formats and schedules, the Committee has taken into consideration disclosure requirements practised by international banks, the recommendations in the IASC Discussion Paper, legal and customary requirements in India, the Committee's views on disclosure requirements expounded in earlier chapters and other relevant factors. The revised formats proposed by the Committee are given in Annexure VI. This Annexure consists of three parts : summary version and schedules of balance sheet, summary version and schedules of profit and loss account and notes and instructions for compilation. Comments on the various items are furnished in the following paragraphs under certain main heads.

General

6.8.1 The balance sheet and profit and loss account will be presented in a vertical form instead of 'T' form as at present. The Companies Act also provides for a vertical form of presentation of accounts for other companies. While the format prescribed for companies may not be suitable for presenting bank accounts, the pattern can be adopted for banks too. The formats suggested by the Committee contain broad heads giving a summarised statement of significant items of assets and liabilities and income and expenditure. For the sake of discussion this part is called the summary version. Details will be given by way of schedules. Comparative figures for previous year will also be given in the final accounts.

The amounts in the balance sheet and profit and loss account will be rounded off to the nearest thousand rupees. Generally, it is the practice among the international banking community to present the various items of assets and liabilities in the order of liquidity of assets and the period of maturity of liabilities. Thus most liquid assets like cash and bank balances are shown first on the assets side followed by investments, advances, fixed assets, etc. On the liability side, the order of presentation in some cases is deposits, borrowings, term liabilities and stock holders' funds. The Committee, however, feels that, as there is no uniform practice among banks in this regard, our existing pattern may continue. Although the formats include all usual items, it is not necessary that banks which do not have any particular item to report should include such item in the relative statements and show 'nil' balances against them. If no amount is to be reported against any item, the concerned item may be excluded.

6.9.1 In the existing format of balance sheet, capital

Capital of public sector banks is shown as under:

Capital

(Paid up capital wholly owned by Central Government).

In the private sector banks, the following particulars are given :

Capital

Authorised

(shares of Rs. each)

Issued

(shares of Rs. each)

Subscribed

(shares of Rs. each)

Paid up

(shares of Rs. each)

6.9.2 Only paid up capital will be shown in the summary version of the proposed format. In the case of nationalised banks the capital is wholly owned by Central Government. The schedule to this account will show the capital owned by the Central Government as on the date of the balance sheet. Addition to the capital during the year by fresh contributions made by the Government as also by capitalisation of Reserve Fund will be shown in the notes. In the case of private sector banks authorised, issued, subscribed and called-up capital may be given separately. Calls in arrears will be deducted from the called-up capital while the paid up value of

.forefeited shares will be added, thus arriving at the paid up capital. Where necessary, items which can be combined may be shown under one head, for instance, 'issued and subscribed capital'. The changes in the above item, if any, during the year may be given in the notes.

6.10.1 The **particulars** in regard to "Reserve Fund and Reserves and Surplus Other Reserves" are presently given in the balance sheet as under :

Reserve Fund and Other Reserves

No further details are prescribed in the format, although some banks show 'Reserve Fund' and 'Other Reserves' separately.

6.10.2 In the proposed summary version of the balance sheet format, all the published reserves including balance in the Profit and Loss Account, will be shown under the head 'Reserves and Surplus'. In the relative schedules details will be furnished under the following heads :

i) Statutory Reserves
ii) Capital Reserves
iii) Share Premium
iv) Revenue and Other Reserves
v) Balance of Profit

Additions and deductions, if any, during the year should be shown under the relevant heads as indicated in the schedule. Statutory reserves will include all reserves created in terms of section 17 or any other section of the Banking Regulation Act. Capital Reserves which are not free for distribution will be shown separately. All other reserves created by the bank including surplus provisions in excess of the provisions required for various purposes and which are intended to be disclosed are to be clubbed together and shown under "Revenue and Other Reserves". Reserves and surplus provisions which are not intended to be disclosed are, however, not to be included under this head. The balance of profit may be shown separately. Loss balance, if any, will be shown as a deduction item in this section.

6.11.1 The deposits are presently shown in the balance sheet more commonly as under :

Deposits

Deposits and other Accounts

Fixed Deposits

i) From banks

ii) From others

iii) Participation Certificate Deposits

Savings Bank Deposits

Current Accounts, Contingency Accounts, etc.

i) From banks

ii) From others

6.11.2 In the proposed format, total of all deposits will be included under the head 'Deposits' in the summary version. In the relative schedule, deposits under three broad heads viz. Demand, Savings and Term will be shown separately. Deposits from other banks under Demand and Term deposits will also be shown separately. A separate classification of deposits in India and Outside India will also be given. The deposits will include apart from current, savings and fixed deposits, all other types of deposits like cumulative and recurring deposits, cash certificates, in-operative deposits, non-resident deposits, annuity deposits, deposits mobilised under various schemes, ordinary staff deposits, matured cash certificates, etc. Interest payable on deposits may not be included under this head but may be shown under the head 'Other Liabilities'. Deposits, repayment of which is subject to restrictions, by their very nature, like margin deposits, security deposits from staff, etc may not also be included under deposits, but may be shown under the head 'Other liabilities and provisions'.

6.11.3 The classification of deposits under the above broad heads with separate data for bank deposits should be adequate to meet the internationally accepted requirements of disclosure. In India, the deposits under the three main broad heads have definite repayment connotations and a further classification on the basis of maturity may not be necessary. The notes to the accounts may further clarify the interest payable on different categories of deposits.

Borrowings

6.12.1 At present 'borrowings' are being classified on the basis of location, i.e. 'In India' and 'Outside India' and as 'secured' and 'unsecured' as under :

Borrowings from other Banking Companies, Agents, etc.

a) In India

b) Outside India

Particulars :

i) Secured (stating the nature of security)

ii) Unsecured

6.12.2 In the proposed summary version of the format, the total amount of bank's borrowings as indicated above will be shown under the head 'Borrowings'. 'Borrowings' will include all borrowings by a bank from Reserve Bank of India, State Bank of India, subsidiaries of State Bank of India, nationalised banks, other banks (including co-operative banks) as also refinance obtained from various financial institutions. Borrowings from outside India will also be included under this head. In the relative schedule, borrowings will be broadly classified under two main heads - 'Borrowings in India' and 'Borrowings outside India'. The first category will again be sub-divided to show the sources and will thus indicate borrowings from Reserve Bank of India, banking system, other financial institutions like Industrial Development Bank of India, Export-Import Bank of India and National Bank for Agriculture and Rural Development and others. Presently, the refinance obtained by banks from Reserve Bank and various institutions is being deducted by most of the banks from advances and only net figure shown under 'Advances' on the assets side of the balance sheet. As refinance obtained is in the nature of borrowings and is repayable according to terms irrespective of whether the corresponding advance is repaid or not, it is being brought under the head 'Borrowings'. This will also ensure that the advances will be shown at the gross amount. The security aspect in regard to bank's borrowings has little relevance at present and in any case the source of borrowings will largely indicate the security. Information relating to the total secured borrowings is, however, to be given in the schedule.

6.13.1 The note to the existing proforma of balance sheet says, "Under this head may be included such items as the following :

Other liabilities and provisions

Pension or insurance funds, unclaimed dividends, advance payments and unexpired discounts, liabilities to subsidiary companies and any other liabilities".

6.13.2 The existing proforma shows 'Bills Payable' as a separate item of liability in the Balance Sheet. As the amount shown under 'Bills Payable' is not usually sizeable, there is no particular need to show this item as a 'significant' separate head in the balance sheet. It may conveniently be included under the head 'Other Liabilities'.

6.13.3 At present there is no uniformity among banks in classifying items under this head. Some of the items included under this head by some banks are included under deposits by others. It is necessary to ensure a degree of uniformity in the classification of this item.

6.13.4 The main items under " Other liabilities and provisions" in the proposed proforma will consist of -

i) Bills payable

ii) Inter-Office adjustments (net)

iii) Interest accrued

iv) Others (including provisions)

'Bills Payable' will include drafts, telegraphic transfers, mail transfers payable, pay slips, bankers cheques and other miscellaneous items. A classification of the item 'Bills Payable' into bills payable in India and those payable outside India is not necessary. The balance in inter-office adjustments, if in credit, may be shown as a separate item under this main head. Only the net position of inter-office accounts, inland as well as foreign, will be shown here. It is not intended that credit and debit outstandings are to be shown separately on the liabilities and assets sides. For arriving at the net balance all connected inter-office accounts should be aggregated. For instance, some banks have separate inter-office accounts for originating debits, local branches adjustments, etc. All such accounts will be aggregated and the net balance only will be shown in the balance sheet representing mostly items in transit and unadjusted items.

iii) At present banks have no uniform and consistent accounting procedure in the matter of interest due and payable and interest accrued but not payable on deposits. Some banks classify them as deposits, while others include them in 'Other liabilities'. For the sake of uniformity, it will be desirable to show this item separately under the broad head 'Other liabilities'. The bulk of the interest payable item will relate to term deposits of different types and the practice adopted by banks in accounting for such interest differs. In some cases, the interest due is credited to the relative deposit account at periodical intervals when the interest is calculated, while in other cases the interest due is kept in a separate interest payable account. Some banks calculate such interest for the purpose of balance sheet separately but the entries are reversed after the closing of balance sheet. For the sake of uniformity it is suggested that

a) In savings bank accounts, interest should be credited to the account at the stipulated intervals.

b) In the case of term deposits, interest on running accounts like recurring deposits, daily deposits, etc where credits are received in the account during the life period of the account, periodical interest should be credited to the account at stipulated intervals fixed by the bank in accordance with the instructions of the Reserve Bank. A similar procedure can be adopted in all such cases where under the terms of the contract the interest is payable only with the principal amount or on closure of the account, for instance, cash certificates. Where such deposits are paid prematurely adjustments may be made at the time of such premature payment.

c) Interest on other term deposits, where there will not be any subsequent credits to the account like fixed period deposits, should not be credited to the deposit account but kept in the Interest payable account at the stipulated intervals. In cases where interest is payable separately and such payment is not necessarily linked with the repayment of the principal amount also, the same procedure can be adopted. As and when interest is paid on such accounts, the debit will be made to the interest payable account. The interest payable account should be periodically balanced along with the principal amounts and the amount outstanding will be shown in all returns including balance sheet under the head 'interest payable'.

d) For the purpose of balance sheet, it may become necessary to calculate interest for broken periods and banks may not necessarily work out the interest payable in individual accounts in such cases but may make ad-hoc provision for such accrued interest on the basis of balances outstanding, past experience of average interest paid, period to run till the balance sheet date, etc. Such provisions for interest are usually reversed after the closing of books. For the sake of convenience banks may show such ad-hoc provision for the broken period as 'interest accrued' in all cases and reverse the entry after the closing of books. The amount of interest which will become due and payable at stipulated intervals will thereafter be credited on due dates to the deposit account or 'interest payable' account as appropriate.

e) In effect, the interest accruing on all deposits, whether the payment is due or not, should appear as a liability, in one form or the other, namely deposit, interest payable or interest accrued, in the balance sheet.

iv) "Others (including provisions)" will be the next main item under 'Other liabilities'. So far banks have been including surplus provision for bad and doubtful debts, contingency funds and secret reserves as part of deposits. As we are proposing to show only pure deposits under the head 'Deposits', it becomes necessary to show all provisions, which are not netted off against the relative assets, under a common head 'Provisions'. These provisions will include

a) Provision for interest tax and taxes on income.

b) Surplus provision in bad debts provision account. The 'necessary' provision as required by auditors will be netted off against the advances.

c) Surplus provisions for depreciation in securities. The 'necessary' provision to show the value of securities at the adopted valuation will be set off against securities.

d) Contingency funds which are not disclosed as reserves but are actually in the nature of secret reserves.

e) Other liabilities which are not disclosed under any of the other major heads. Such items will include unclaimed dividend, provisions and funds kept for specific purposes, unexpired discount, outstanding charges like rent, conveyance, etc., certain types of deposits like staff security deposits, margin deposits, etc where the repayment is not free. This item will be, thus partly in the nature of 'secret reserves' and partly an outside liability.

Assets Side

6.14.1 Presently in the balance sheet 'Cash' is shown

Cash & balances with Reserve Bank of India	as the first item on the assets

side as under:

Cash

In hand, with Reserve Bank of India and State Bank of India (including foreign currency notes)

In the proposed summary version of the format, 'cash and balances with the Reserve Bank of India will include cash on hand including foreign currency notes as well as balances maintained with the Reserve Bank of India in Current Account. The relative schedule will show separately -

i. Cash in hand (including foreign currency notes)

ii. In current account with Reserve Bank of India.

No further particulars are considered necessary.

6.15.1 The second item in the existing balance sheet

Balances with other banks and money at call and short notice

format is 'Balances with other banks' showing whether on deposit or current account. The other particulars required to be shown are :

In India

Outside India

Funds placed in inter-bank market are shown as a separate item on the assets side of the balance sheet at present under the head 'Money at call and short notice". No further particulars are given under the head.

6.15.2 In the proposed format, balances held with various types of banks/financial institutions will be clubbed together and shown under the head 'Balances with banks and money at call and short notice'. However, in the relative schedule the particulars will be furnished as under :

I. In India

i) Balances with Reserve Bank (other than in current account)

ii) Balances with other banks in India

Current Accounts

Deposit Accounts

iii) Money at call and short notice

With banks

With other institutions

II. Outside India

Current accounts

Deposit accounts

Money at call and short notice

Balances held outside India will include balances held by foreign branches and balances held by Indian branches of the banks outside India. The money market funds will include funds kept with banks and other institutions approved for dealing in the inter-bank money market. Balances held with foreign branches by Indian and other foreign branches will not be shown under this head but will be included in inter-branch accounts. The question whether 'short notice' should be defined was considered by the Committee. According to the present practice, deposits repayable within 15 days' or less than 15 days' notice are treated as money at call and short notice. The deposits for longer periods of notice as well as term deposits are not to be included under this head but are to be shown separately. Schedules to the proposed format require funds placed in current accounts and deposit accounts to be shown separately. The funds placed in inter-bank markets in India will also be shown separately. As the terms are now more or less well defined and understood, the Committee is of the view that the existing practice can continue. In foreign countries, however, the 15 days' notice concept is not in vogue. Balances with foreign banks may, therefore, be classified as current accounts, deposit accounts and money at call and short notice, as is normally understood in such countries. The Committee is further of the opinion that balances with the Reserve Bank of India only need be shown separately and balances with the other banks can be grouped together.

6.15.3 The classification of the balances in India and outside India indicates broad sources and maturity pattern of the item. A segmental and sectoral classification on the above basis would be sufficient to make an assessment of the liquidity and realisability of these funds.

6.16.1 In the present balance sheet format, the particulars of investments are to be shown as under :

Investments

Investments

i) Securities of the Central and State Governments and other Trustee Securities, including treasury bills of the Central and State Governments.

ii) Shares (classifying into preference, ordinary, deferred and other classes of shares and showing separately shares fully paid and partly paid-up)

iii) Debentures or bonds

iv) Other investments

v) Gold

In case where the value of the investments shown in the outer column of the balance sheet is higher than the market value, the market value shall be shown separately in brackets.

6.16.2 Some of the particulars of investments being given are not relevant at present. The summary version of the proposed format will give the total amount of investments of a bank under the head "Investments". In the relative schedule, classification of investments such as investments in Central and State Government securities, other approved securities, shares and debentures, and other investments may be given. Investments outside India may be given separately.

6.16.3 It has been provided in the note (f) appended to the form of balance sheet prescribed under Banking Regulation Act that when the book value of investments of banks is higher than the market value, the market value should be shown separately. At present almost the entire investment portfolio of banks consists of Government or Government-guaranteed securities and other 'approved securities'. The proportion of approved securities to be maintained by banks is not determined by individual banks according to their discretion and on considerations of operational efficiency; but is determined to a large extent by the monetary authorities according to economic compulsions. Of late, the coupon rate has been enhanced from time to time bringing down the market value of scrips. The banking legislation provides that banks should disclose the market value in the balance sheet unless exempted. Considering that the depreciation in such cases is largely notional and also that fluctuations in the market value of securities are caused by changes in Government/monetary policy, it may not be necessary to disclose the market value of all investments of a bank. The mode of valuation of investments has been separately discussed in Chapter VII.

6.16.4 According to the IASC requirements, banks are required to show 'dealing' and 'investment' securities separately. Investment securities are securities acquired for long term purposes and dealing securities are securities acquired with the intention of reselling them in the short term. These securities are valued differently but the basis of classification and valuation should be disclosed. It is expected that in both the types the market value will be disclosed, if different from the carrying amount, in the financial statement. Although this is the recommended approach, many banks do not have such classification nor do they indicate the market value. This issue as well as the incidental question relating to the system of making provisions for depreciation in securities has been considered in Chapter VII. It is also proposed to provide suitable clarification regarding valuation in the accounting policy statement and notes on account.

6.17.1 In the existing format, under the head 'Advances'

Advances and Bills purchased and discounted the particulars of advances are being shown as under :

Advances (other than bad and doubtful debts for which provision has been made to the satisfaction of the auditors)

I) Loans, Cash Credits, Overdrafts etc.

i) In India

ii) Outside India

II) Bills purchased and Discounted (excluding treasury Bills of the Central and State Government)

i) Payable in India

ii) Payable outside India

Particulars of Advances :

i) Debts considered good in respect of which the Banking Company is fully secured.

ii) Debts considered good for which the Banking Company holds no other security, other than debtors' personal security.

iii) Debts considered good, secured by the personal liabilities of one or more parties in addition to the personal security of the debtors.

iv) Debts considered doubtful or bad, not provided for.

v) Debts due by directors or officers of the Banking Company or any of them either severally or jointly with any other persons.

vi) Debts due by companies or firms in which the directors of the banking company are interested as directors, partners, or managing agents, or, in the case of private companies as members.

vii) Maximum total amount of advances including temporary advances made at any time during the year to directors or managers or officers of the banking company or any of them either severally or jointly with any other persons*

viii) Maximum total amount of advances, including temporary advances granted during the year to companies or firms in which the directors of the banking company are interested as directors, partners or managing agents or, in the case of private companies as members*

ix) Due from banking companies

* Maximum total outstanding balance in all such accounts as a unit on any day during the year should be given under this heading.

6.17.2 It may be observed that the existing classification of advances is elaborate and some of the particulars like advances to directors, officers, etc of the company are no longer relevant. Besides, security-wise classification of advances also is not very material in the present context, particularly when banks have changed their system of lending from 'security oriented' basis to 'purpose oriented' basis. In several instances banks are specifically instructed not to ask for extra securities other than the assets created out of the lendings.

In such a context it may not be appropriate to require banks to classify advances from the security point of view particularly those granted to priority sectors. All the same, a broad security-wise spectrum will be necessary for the purpose of assessing the overall realisability of advances.

6.17.3 At present, refinance obtained by banks is sometimes deducted from total amount of advances and the net figure is shown under the head 'Advances'. As already stated in paragraph 6.12.2, refinance obtained by banks including rediscounting of bills is now proposed to be shown under 'Borrowings' on the liabilities side and gross amount of advances on the assets side in the balance sheet.

6.17.4 The advances presently shown in the balance sheet are other than bad and doubtful debts for which provision has been made to the satisfaction of auditors. In effect, the advances which have become bad and for which provision is made by a bank are allowed to be deducted from the total amount of advances.

6.17.5 Detailed sectoral classification of advances on the basis of size, maturity, etc. involves considerable time and labour and such classification may not serve much useful purpose. All the same, particulars regarding advances portfolio will have to be available in the balance sheet for a proper assessment of the general character and overall realisability and liquidity of advances. This can be done by giving (a) a broad maturity-wise pattern by showing bills, loans repayable on demand and term loans separately (b) a broad security-wise analysis of the advances (c) a geographical break-up of advances showing advances in India and outside India separately and (d) a sectoral break-up of advances.

6.17.6 Advances constitute the principal item of assets of a bank and for a proper assessment of the true position, it would be essential that this item should be stated at the "true and fair" value. The true and fair value does not necessarily mean the face value of the advances, as some of the advances may be uncollectible. It is, therefore, necessary to make provisions for advances which are considered as not realisable. The question whether such provision should be shown separately or should be netted against advances has been considered by the Committee. The Committee feels that in the Indian conditions where it has already recommended that the practice of secret reserves should continue, the advances are not to be shown gross of provisions but will have to be necessarily shown after, deducting the amount of **provisions from** the advances. This is more or less the practice in other countries as well.

6.17.7 In order to give an idea of the realisibility of the advances portfolio banks may also mention in their accounting policies that certain types of advances are guaranteed by Deposit Insurance and and also broadly indicate in the notes to the account the obligations cast on them by the Government guidelines on social banking. It may not be practicable to classify the advances according to the interest rates ranges, but the notes can spell out the range of interest chargeable on various sectors of lendings.

6.18.1 Presently 'Premises and Furniture and Fixtures etc.' are shown separately on the assets side of the b balance sheet as under :

Fixed Assets	Premises less depreciation
	Furniture & Fixtures less depreciation

In addition "Non-banking assets acquired in satisfaction of claims (stating mode of valuation)" has also to be shown separately. In the relative notes, it has been stated "Premises wholly or partly occupied by the banking company for the purpose of business should be shown against "Premises less depreciation". In the case of fixed capital expenditure, the original cost, and additions thereto and deductions therefrom during the year should be stated, as also the total depreciation written off. Where sums have been written off on a reduction of capital or revaluation of assets, every balance-sheet after the first balance sheet subsequent to the reduction or revaluation should show the reduced figure with the date and amount of the reduction made.

6.18.2 It is further provided in the case of 'non-banking assets' that value shown shall not exceed the market value and in cases where the market value is not ascertainable, the estimated realisable value. A typical instance showing how these requirements are met with in practice is given below :

Premises less depreciation
Cost upto last Balance sheet
Addition/transfers during the year
Deductions/transfers during the year
Less : Total depreciation to date.

The item 'Furniture & Fixtures' is also shown in a similar manner. The non-banking asset is shown 'Non-Banking assets acquired in satisfaction of claims (at book value)'.

6.18.3 In the proposed summary version, however, the total amount of premises and other capital expenditure will be clubbed together and shown against 'Fixed Assets' The relative schedule of fixed assets shows separately (i) Premises (ii) Other fixed assets (including furniture and fixtures). Premises wholly or partly occupied by a banking company for the purpose of business should be shown, against 'Premises'. Under each head, the previous balance, additions thereto and deductions therefrom during the year as also the total depreciation written off may be shown as at present. Where adjustments have been made in the value of the assets on a reduction of capital or revaluation of assets, every balance sheet after the first balance sheet subsequent to the reduction or revaluation should show the revised figures with the date and amount of the revision made. Non-banking assets, being insignificant need not be reported separately but may be included under "Other assets". The mode of valuation of fixed assets and the method of depreciation adopted may be indicated in the accounting policy; particulars of revaluation and rate of depreciation charged may be given in the notes on account.

6.19.1 The note to the existing proforma of balance sheet says "under this heading may be included such items Other Assets as the following, which must be shown under headings suitably described : preliminary, formation and organisation expenses, development expenditure, commission and brokerage on shares, interest accrued on investments but not collected, investments in shares of subsidiary companies and any other assets".

6.19.2 Like 'Other liabilities', there is no uniformity among banks in classifying these items. The main items under 'Other Assets' now being shown consist of inter-office Adjustments (net debit balance), interest accrued on investments/advances, tax paid in advance and tax deducted at source and other miscellaneous items. Other miscellaneous items will include prepaid expenses, deposits with Government departments, rent/commission/exchange receivable, clearing adjustments, sundry debits, stationery, etc. A typical instance indicating how this item is being shown at present is given below.

<u>Other assets including silver</u>

Branch adjustments

Interest accrued on investments

Tax deposited, paid in advance and deducted at source less provision

Stamps, stationery and printed materials

Sundries (Temporary advances/suspense, security deposits, outstanding rents, clearing and other adjustment accounts, etc.)

6.19.3 In the summary version, all assets not classified under any other major heads will be grouped and shown under the head 'Other assets'. Although a residual, conglomerate item, it is necessary that adequate particulars are furnished under this head, as in many cases the amount shown under this heading is quite substantial. The relative schedule should therefore give particulars under the following major sub-heads -

i) Inter-office adjustments (Net)

ii) Interest accrued

iii) Tax paid in advance/tax deducted at source

iv) Stationery and stamps

v) Others

(i) Inter-office adjustments (net debit balance) is corresponding to credit balance under this head shown under 'Other liabilities' and the remarks relating to that item will also apply to this item mutatis mutandis.

(ii) Interest accrued corresponds to the 'interest accrued' under other liabilities. On the assets side, this will represent mainly interest accrued but not due on investments and advances and interest due but not collected on investments. Accrued interest normally may not arise in the case of advances as banks charge interest on advances on or about the balance sheet date. There could be, however, certain instances where interest may have been taken to profit and loss account but not debited to party's account due to some reason or other. Such amounts should be shown under 'others'. Banks should ensure that only such interest as is realisable in the ordinary course is shown under this head. This is a basic assumption and no notes or policy statements in this respect are considered necessary.

(iii) The net amount of tax paid in advance or deducted at source, i.e. the amount of such taxes less provision, if any, made towards relative tax dues, if the balance is in debit, only will be shown against this item. If the net position is in credit, the relative amount will be shown under other liabilities.

(iv) The stocks of stationery and stamps on hand should be shown on a realistic basis. Normally the practice is to treat most of the stationery items as revenue and only exceptional items of expenditure like bulk purchases of security paper, loose leaf or other ledgers, etc are shown as quasi-asset to be written off over a period of time. Banks should ensure that the various items included in this head do not take into account any subsequent cost escalation, as such items are meant for internal consumption only.

(v) 'Others' will include mainly unadjusted sundry/ suspense debits, clearing items, debit items representing addition to assets or reduction in liabilities, which have not been adjusted for technical reasons, want of particulars, etc and also all income other than interest which has accrued. Non-banking assets will also be included under this head.

6.19.4 It may not be necessary to prescribe any further particulars in respect of this item in the balance sheet. Banks should be advised by the Reserve Bank to ensure that the items shown under this head are realisable to the full extent of their book value. Thus doubtful items like law charges, recoverable expenses not adjusted, etc should be adequately provided for and such provisions should be netted off against the relative debit items included under this head.

6.20.1 A contingent liability exists when a current situation may result in a liability upon the occurrence

Contingent Liability

of some future event, but the possibility of the event occurring cannot reasonably be predicted as of the balance sheet date. It is customary to show the volume of such transactions in the balance sheet to show the contingent future liability inherent in such transactions. The existing format of balance sheet provides for showing such contingent liabilities separately in the balance sheet under the following heads :

i) Claims against a banking company not acknowledged as debt.

ii) Money for which the banking company is contingently liable showing separately the amount of guarantee given by the banking company on behalf of directors or officers.

iii) Arrears of cumulative preference dividend.

iv) Liability on bills of exchange discounted

v) Liability on account of outstanding Forward Exchange Contracts.

6.20.2 The contingent liabilities normally shown by international banks relate to items like

- Guarantees
- Standby facilities
- Letters of Credit
- Forward Exchange Positions
- Other forward positions
- Undrawn loan facilities
- Future market positions

6.20.3 The IASC recommendations also indicate that a bank should normally disclose the existence of uncovered contract positions and the existing amount of guarantees, letters of credits and standby letters of credit issued and irrevocable commitments to extend credit that cannot be withdrawn at the discretion of the bank without incurring expenses or loss. Several banks, however, only report the existence and nature of these contingencies but do not indicate the amount involved. Many banks also do not show them as part of the balance sheet, but as a note to the accounts. Considering all aspects and the practice adopted by other companies in India, the Committee feels that the banks may show these items as a schedule to the balance sheet. The items to be shown need to be confined to the following broad heads.:-

i) Claims against the bank not acknowledged as debts

ii) Liability for partly paid investments

iii) Liability on account of outstanding forward exchange contracts

iv) Guarantees given on behalf of constituents

v) Acceptances, endorsements and other obligations

vi) Other items for which the bank is contingently liable

6.20.4 It is not considered necessary to have a separate heading for the arrears of cumulative dividends as the amount involved, if at all, will be very nominal. The obligations under the under-writing commitments may not also be large and need not therefore be shown separately. The above items can be included, where necessary, under item (vi). Guarantees in India and outside India will be shown separately.

6.20.5 In Indian conditions where bulk of the advances is given under Cash Credit or Overdraft system it may not be possible for banks to indicate the extent of commitments made to extend credit. Similarly it may not also be feasible to show the amount of undrawn loan facilities.

Such data are also not furnished uniformly by all banks. Taking all factors into consideration the Committee does not consider it necessary to adopt this practice in India.

Contra accounts

6.21.1 Two items presently being shown as contra items are :

	Liabilities side	Assets side
i)	Bills for collection being Bills receivable, as per contra	i) Bills receivable being Bills for collection as per contra
ii)	Acceptances, endorsements and other obligations, as per contra	ii) Constituents' liabilities for acceptances, endorsements and other obligations as per contra

Although these items may represent actual liability (and a corresponding asset) of a bank and the liabilities and (the corresponding claims) may be on different legal entities and cannot be, therefore, set off, basically they do not represent a crystallised liability (or asset) on the balance sheet date. If they had crystallised, they would have been treated as liabilities and assets in the ordinary course. Thus at a point of time, these items indicate business transactions of a particular nature in hand as at that time, but the liabilities and assets, represented by them should be deemed to be of a nature different from other liabilities and assets. It is quite conceivable that in individual cases a liability may crystallise while the corresponding asset may not materialise. It will, however, be inappropriate for the sake of covering the possibility of such exceptional cases to include all such contra items in the balance sheet as assets and liabilities. Moreover, in cases where a liability is likely to crystallise and an asset not likely to be realised, it is customary to provide for the eventual liability, in which case the provisions made will be reflected in the balance sheet. Some items like guarantees and acceptances are shown by banks, sometimes under contra items, sometimes under contingent liabilities and still sometimes under both heads. The Committee is of the opinion that it is not normally necessary to show any item, including guarantees and acceptances twice in the balance sheet. Items which are shown in contingent liabilities need not be, therefore, included in the contra items. Guarantees and acceptances are proposed to be shown as contingent liability and need not, therefore, be again shown as contra items. Bills for collection may be shown separately in the summary version and not as part of the total assets and liabilities.

Profit and Loss Account - General

6.22.1 The profit and loss account (or statement of income and expenditure) is an integral part of the annual reporting system of business entities. According to the IASC Discussion Paper the profit and loss account of banks should show separately the following major significant items

- interest income
- interest expense
- fees for services
- dealing results
- investments gains or losses
- net charge or credit to the provisions for loan losses
- employee costs
- taxes on income

6.22.2 Having regard to the fact that the Committee is in favour of Indian banks maintaining secret reserves, banks in India may not be required to show in their profit and loss account some of the above items particularly "net charge or credit to provision for loan losses" and "taxes on income". Subject to these important qualifications, the accounts prepared by banks in India at present in the format prescribed in Form B in the Third Schedule to the Banking Regulation Act, by and large, furnish all material information required by the IASC Discussion Paper. However, apart from the data so furnished in the prescribed format, banks do not give any additional material or supplementary information.

6.22.3 In order to provide the users of this statement with a meaningful picture of the operational results, it is necessary to give in this statement adequate particulars of the main heads of income and expenditure, which are 'interest received' and 'interest paid'. One of the incidental points discussed by the Committee and which has been consistently brought to its notice during the meetings by professionals connected with bank accounts is that income should be classified according to the source as well as the type of activities. Another suggestion that has been made is that the interest income and interest expenditure should be classified according to the customer segments as well as the interest ranges. Apart from the question whether a detailed break-up of income on such different bases would be of material assistance for the user community of the financial statements, there is a basic difficulty in complying with the suggestions, because the present accounting practices in banks do not generate such sector-wise and segmental information readily. Unlike in the case of banks in foreign countries where the accounts are computerised and the required data can be produced with ease along with the completion of the accounts for the financial year, in Indian conditions preparation of any information that is not readily available from the account books will pose problems. Even if the information is available readily in the account books, consolidation of the data at the Head Office level involving thousands of branches will be a time consuming affair and it will be difficult for banks to consolidate such data in time for inclusion in the financial accounts. Moreover, foreign banks also do not uniformly give such data. Taking an overall view, the Committee does not consider it necessary that banks should furnish such detailed supplementary information in regard to the main items of income and expenditure. The question whether banks should give any geographical classification of income and expenditure was also examined by the Committee. While it was not considered necessary to give any detailed geographical break-up of the various items in the profit and loss account, it would be desirable if the profit and loss account indicates the share of the foreign branches of a bank in the total income and expenditure.

6.23.1 The formats prepared by the Committee and furnished in Annexure VI - Part II take into account the various constraints and the Committee's considered views on these issues. As proposed in the case of the balance sheet, the proposed format of the profit and loss account is to be prepared in a summarised form duly supported by schedules giving additional information, where required. The figures are to be furnished for two years and the amounts need be shown only in thousands of rupees. The aggregate income and expenditure of foreign branches will be indicated by a note in the summary version of the profit and loss account. The summary version also shows the appropriation of profits.

Formats

6.23.2 At present, the income of a bank is shown in the profit and loss account after deducting the

Income

provisions made during the year for bad and doubtful debts and other usual or necessary provisions. The various items which appear under the head 'Income' in the profit and loss account at present are as under :

1. Interest and Discount
2. Commission, Exchange and Brokerage
3. Rents
4. Net profit on sale of investments, gold and silver, land premises and other assets (not credited to Reserves or any particular Fund or Account).
5. Net profit on revaluation of investments, gold and silver, land and premises and other assets (not credited to Reserve or any particular Fund or Account)
6. Income from non-banking assets and profit from sale of or dealing with such assets.
7. Other receipts
8. Loss (if any)

6.23.3 In the proposed format of profit and loss account, the income is split into two broad heads i.e. 'Interest earned' and 'Other Income'. In the summarised version of the format gross amount of 'Interest earned' and 'Other income' only will be shown. No deductions will be made from income heads for usual and necessary provisions. Interest income will consist of interest and discount on all bank balances, securities and loans and advances. 'Other Income' will include all other incomes, in particular, commission and exchange, rent, net profit on sale of investments and other assets and net profit on exchange transactions.

6.23.4 In the schedule relating to 'Interest earned', a break-up of the amount under certain broad heads may be given as follows :

i) Interest/discount on advances/bills

ii) Income on investments

iii) Interest on balances with Reserve Bank of India and other inter-bank funds

iv) Others

6.23.5 The schedule relating to 'other income' is intended to give a break-up of the major items under this head. As such income will not be significant, it is not customary nor is it necessary to give any detailed break-up of such items. All the same, the nature of the items included under this head is expected to give an idea of the different sources of income and the types of operations undertaken by a bank. On this basis, the schedule may contain the following information which is to a large extent available in the present format.

i) Commission, exchange and brokerage

ii) Rent

iii) Net profit on sale of investments, land and buildings and other assets

iv) Net profit on exchange transactions

v) Miscellaneous income. All income not classified under any of the specific categories listed in the schedule will be included under this head. In case any of the items included under this head exceeds 1% of the total income, particulars should be furnished in the notes to the accounts.

6.23.6 In the existing format of the profit and loss Expenditure account, the expenditure side consists of the following items :

1. Interest paid on deposits, borrowings, etc.

2. Salaries and allowances, Provident Fund and gratuity contribution

3. Directors' and Local Committee Members' Fees and Allowances

4. Rent, Taxes, Insurance, Lighting, etc.

5. Law charges

6. Postage, Telegrams and stamps

7. Auditors' Fees

8. Depreciation on and repairs to the bank's property

9. Stationery, Printing, Advertisement, etc.

10. Loss from sale of or dealing with non-banking assets

11. Other expenditure

Most of the items given in the existing format except interest paid and salaries and allowances are comparatively insignificant and many inter-national banks do not give particulars of such items, although some of them do give some such information. In the proposed summary version of format, therefore, expenses may be divided into three broad groups viz. 'Interest Expended', 'Operating Expenses' and 'Provisions and contingencies'. In the relative schedules, necessary break-up of the first two items may be given. As it is our intention to permit banks to maintain secret reserves, the break-up of provisions will not be furnished in the published accounts.

6.23.7 Interest expended will include interest on all types of deposits, discount/interest on borrowing and refinance from banks and other institutions and all other interest payments like interest on participation certificates, penal interest paid, etc. The relative schedule will give a break-up of this item under the following heads :-

i) Interest on deposits

ii) Interest on Reserve Bank/inter-bank borrowings

iii) Others

No further classification of the source of payment of interest is considered necessary. It is also not necessary to indicate separately interest on different types of deposits and borrowings. The payment of interest to different types of clients like banks, non-bank clients, etc will also not be material. As in Indian conditions, interest rates are administered, a break-up of customer-wise source of interest paid is not likely to be of much use. The notes to the accounts will, however, indicate this position as well as the range of interest rates on different types of deposits.

6.23.8 'Operating Expenses' in the summary version will include personnel expenses, rent, taxes and lighting, printing and stationery, depreciation and all other overheads. Apart from personnel expenses, the other items included under this head are not usually substantial. All the same, it is customary for Indian business units to indicate separately certain categories of expenses like, directors' fees, auditors' fees, etc. This discipline is also made applicable to banks in the existing formats and the Committee is of the opinion that this practice can profitably continue. A scrutiny of the profit and loss account shows that apart from the items mentioned above, the other significant overhead charges are postal charges, advertisement and publicity, law charges, repairs and maintenance and insurance. The relative schedule may, therefore, give a break-up of this item under broad sub-heads like :

i) Payments to and provisions for employees

ii) Rent, taxes and lighting

iii) Printing and stationery

iv) Advertisement and publicity

v) Depreciation on bank's property

vi) Directors' fees, allowances and expenses

vii) Auditors' fees and expenses (including branch auditors' fees and expenses)

viii) Law charges

ix) Postage, telegrams, telephones, etc.

x) Repairs and maintenance

xi) Insurance

xii) Other expenditure

The 'other expenditure' is a residual composite item and in case any particular item under this head exceeds 1% of the total income (for the sake of convenience, the reference is made to total income and not expenditure), the nature and amount of such items should be shown in the notes to the accounts as in the case of 'miscellaneous income'.

Appropriation Account

6.24.1 The third part of the Profit and Loss Account gives a summary of the proposed appropriation of the available profit including profit/loss carried over from the previous year. At present this part of the accounts is being shown in the balance sheet. With the proposed change in the balance sheet format, it is necessary to include this item in the profit and loss account

Foreign currency transactions

6.25.1 Foreign currency transactions and operations now-a-days constitute a significant proportion of the total working of banks and accounting for such transactions, therefore, assumes considerable importance in corporate reporting of banks. Two aspects are involved in this issue : firstly accounting of the foreign exchange business handled from the domestic base and secondly the consolidation of the accounts of the foreign offices with those of the parent unit. In the normal course of business a bank, even though it may not have any foreign branch, may enter into transactions denominated in foreign currencies. To facilitate the recording of these transactions in the accounts of the bank, they have to be translated into domestic currency. In the case of banks which have foreign offices, while preparing the final accounts of the bank as a whole, the position of such foreign branches has also to be incorporated in the final accounts. Such consolidation of the accounts of foreign offices with those of the parent company will involve translation of the foreign currency into home currency both for revenue and balance sheet items. The accounting policies and practices followed by banks in both these spheres are not uniform.

6.25.2 The two common approaches in accounting for transactions denominated in foreign currencies are the "time of settlement" method and "time of transaction" method. The time of settlement method treats a transaction (i.e. sale or purchase) and its settlement (i.e., cash receipt or disbursement) as a single event. The difference arising from fluctuations in exchange rates that occur before settlement is accounted for as part of the transaction and not as a separate exchange gain or loss. The "time of transaction" method treats a transaction and its settlement as separate events. The date of transaction establishes the exchange rate to be used in translation and, unless covered by specific forward exchange contract, any fluctuation in the exchange rates between the date of transaction and its settlement gives rise to a foreign exchange gain or loss which is accounted for separately. The 'time of transaction' method by and large is used around the world. Where the "time of transaction" method is applied, transactions denominated in foreign currencies are translated and recorded in the books at the date of the transaction using current exchange rates. Subsequent adjustments may be required to the amounts in local currency initially recorded for monetary assets and liabilities resulting from foreign currency transactions. (Monetary assets and liabilities are those that represent money or claims to money, e.g., cash, receivables and payables). In the case of non-monetary assets, liabilities and income statement items resulting from foreign currency transactions no subsequent adjustments are normally required to the amounts in local currency initially recorded. (Non-monetary assets and liabilities are those that do not represent money or claims to money, e.g., plant, machinery and inventory).

6.25.3 The foreign exchange business handled by Indian banks mainly relate to transfer of funds, collection and negotiation of import and export bills, forward transactions, dealings in foreign currencies and ancillary business like letters of credit and guarantees. The transactions are accounted for on the "time of transaction" basis. Normally, the business that is undertaken by banks in India does not create any non-monetary assets and liabilities at the end of the accounting period. Certain monetary assets and liabilities like balances with foreign banks, outstanding bills and forward transactions, etc would, however, be created. The income earned on account of difference in foreign exchange rates on completed transactions is recognised as exchange income and recorded in the income statements by banks all over the world and in India also this practice is in vogue. The income or loss on account of rate changes in respect of outstanding monetary assets which go into the foreign currency position including forward transactions is usually arrived at by applying the closing rate of exchange for translation and the resultant profit or loss on such outstandings also is usually taken into account by banks in the income statement. The practice in respect of booking the profit or loss on forward transactions is not however, uniform. In India, also there is no uniformity in the practice of booking the profit or loss on forward transactions; some banks do not book such profit or loss, while others do; a few others provide only for loss on such transactions and not for profit. Although thus, the basic principles adopted in arriving at the gain or loss on foreign exchange business of Indian banks are on par with those commonly adopted in other countries, there are variations in the detailed procedure followed by banks, for instance, in arriving at the components going to make the exchange position, rate of exchange to be adopted for translation, periodicity of income reckoning, etc. It is understood that a technical group is working under the aegis of Foreign Exchange Dealers Association of India (FEDAI) in evolving certain standard practices for adoption by our banks in the booking of profit and loss on exchange business. The Committee recommends that banks in India should follow the 'time of transaction' approach for accounting and should also book the profit/loss on forward transactions. Subject to these general principles, the technical group of FEDAI may work out standardised procedure to be adopted by banks in determining valuation base, the components of currency position, periodicity of valuation, valuation date, valuation rate, etc.

6.25.4 While incorporating the financial statements of foreign based entities in the consolidated accounts, the financial statements of the foreign entities may have to be restated in order to comply with accounting principles applied in preparing the consolidated financial statement and they will also have to be translated from the local currency into the currency in which the consolidated financial statement are expressed. Two different approaches are adopted for translation of foreign currency. (a) Current Rate Approach and (b) Current/ Historical Rate Approach. Under the Current Rate Approach the translation method is the current rate method (also known as closing rate method). The current rate is the exchange rate prevailing at the balance sheet date. Under this method, all balance sheet items, except shareholders equity are translated at the exchange rates in effect at the balance sheet date. Income statement items are either translated at the closing rates or at an average rate for the reporting period. Under the Current/Historical Rate Approach, monetary assets and liabilities are translated at closing rate and others at historical rates. According to the Financial Times 1982 World Survey of Bank Annual Reports the main methods of translating foreign currency amounts are :

"The monetary/non-monetary method (temporal method): monetary assets and liabilities are translated at the closing (i.e. current) rate of exchange and non-monetary assets are translated at historical rates.

The closing rate method : All assets and liabilities are translated at closing rates of exchange".

The survey findings came to the conclusion that "almost half the banks surveyed disclose no information about their foreign currency translation policies. Even amongst those that do disclose a policy, the information is often inadequate or unclear".

6.25.5 The Indian banks' foreign presence is very limited compared to international standards and most of them also do not have any substantial holding of non-monetary assets and liabilities. At the same time, the profits of the foreign branches of Indian banks are not insignificant compared to their profits from domestic operations. In order to ensure that fluctuations in exchange rates do not distort their operational results, it will be desirable if banks do not take into account any profit or loss on conversion of non-monetary assets and liabilities. In effect this would mean the adoption of Current/Historical Rate Approach. Specifically, the banks will translate the various items in the balance sheet and profit and loss account of branches as follows:

a) Monetary assets and liabilities representing money and claims will be translated at closing rate.

b) Non-monetary assets like premises and other fixed assets etc. which are carried at historical cost in the books will be translated at the historical rate. If they have been revalued, the rate adopted at the time of revaluation will apply.

c) Profit and loss items will be translated at closing rate for the reporting period.

d) The profit and loss on translation of monetary assets and liabilities may be taken to the income statement.

The accounting policy statement (vide annexure V) will indicate the position suitably.

6.26.1 While discussing accounting policies and individual items of the balance sheet and profit and loss account, it has been indicated in some cases that certain particulars are to be given by way of notes.

These relate to :

a) holdings in subsidiaries

b) changes in capital during the year

c) interest rates on different categories of deposits

d) valuation of securities

e) guidelines regarding sectoral allocation of advances and rates of interest on different types of advances

f) particulars of revaluation and depreciation charged on fixed assets

g) particulars of larger items of miscellaneous income

h) particulars of larger items of 'other expenditure'

A specimen form in which such notes may be incorporated in the accounts is indicated in Annexure V which also includes accounting policies. Needless to say, some of the items in the specimen form of accounting policy statement and notes on account in Annexure V are to be appropriately amended to suit the requirements of individual cases.

CHAPTER VII

NORMS FOR CREATING PROVISIONS

7.1. The fifth term of reference of the Committee relates to the question of evolving suitable norms for creating provisions for various purposes, more

Introductory

particularly for income tax and other taxes, bad and doubtful debts, depreciation in Government securities, etc on a scientific basis. Some aspects of this issue, which is closely interlinked with the other terms of reference, have been discussed in passing in the earlier chapters. In this chapter, the focus will be mainly on the need for prescribing norms for various types of provisions. While considering the question of evolving suitable norms for making provisions for various purposes the accounting practices and conventions and the statutory requirements including guidelines issued by the regulatory bodies will have to be taken note of.

7.1.1 A distinction needs to be made between "Reserves" and "Provisions" since these terms are

Reserves and Provisions

often indiscriminately used. According to the Companies Act, the expression 'provision' shall mean any amount written off or retained by way of providing for depreciation, renewals or dimunition in value of assets, or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy. The expression 'Reserve' shall not include any amount written off or retained by way of providing for depreciation, renewals or dimunition in value of assets or retained by way of providing for any known liability. A "Reserve" is thus a sum set aside from divisible profits and retained in the business in order to meet any unexpected or unknown losses or to strengthen the financial position. "Provisions" are amounts which are in effect charged to revenues either by direct debit to profit and loss account or by deduction from income heads to meet any identified or likely losses or to meet any specific liability or to meet any dimunition in the value of any item of assets.

7.1.2 A distinction needs to be also made between 'general provisions' and 'specific provisions'. General

General and Specific Provisions

provisions will be those created to meet a loss or liability which is known to exist but which cannot be quantified precisely. It is a provision in the sense that the loss, according to the best of one's knowledge, is known to exist but the amount is dependent on several imponderables. Thus it is generally known that advances involve risks and in a portfolio containing different types of credit risks, a part is bound to turn out bad in course of time. Past experience may indicate some rough relationship between the amount of provision required for such eventual bad debts and the total outstandings; but the amount to be provided for will not be known definitely. Such general provisions may also include general provisions created in terms of any statutory requirements like provision for advances granted at rural branches in India. The general provisions once created are meant to be utilised for the purpose for which they are created. Specific provisions on the other hand are created for known losses where the amount also has been estimated with some degree of exactitude. Thus if a particular debt has become bad, the provision created for the relative loss will be a specific provision.

Purpose for which provisions are made

7.1.3 The prescribed format for the profit and loss account in the Third Schedule to the Banking Regulation Act permits banks to show income less amounts set aside for making 'usual and necessary provisions'. On this basis, banks have been making various provisions as indicated below, either by direct charge to profit and loss account or by deducting from income heads, mainly "interest and discount" and to a lesser extent 'commission and brokerage':

(i) provision for bad and doubtful debts;

(ii) provision for depreciation in securities;

(iii) provision for retirement benefits to staff;

(iv) provision for income-tax and interest-tax; and

(v) certain funds like exchange fluctuation fund, development fund, contingencies, etc.

Usual and necessary provisions

7.1.4 The term 'necessary provisions' connotes an element of compulsion while the term 'usual' provision connotes an element of discretion. These terms could be considered to have some-what the same significance as "specific" and "general" provisions. The purpose and the amount of 'necessary provisions' will be specific. In practice, however, no such fine distinction is made and banks in India create provisions for various purposes as mentioned above and often specific and general provisions are combined. For example, the account "provision for bad and doubtful debts" may comprise provisions made for identified doubtful debts and also ad-hoc or floating provisions. Broadly speaking, the necessary or specific provisions do not have any element of surplus over what is required while the general provisions may include such an element of surplus and to that extent may be deemed to be 'reserves'.

7.1.5 Section 15 of the Banking Regulation Act provides that a banking company shall not pay dividend on its shares until all its capitalised expenses (including preliminary expenses, organisation expenses, share selling commission, brokerage, amounts of losses incurred and any other items of expenditure not represented by tangible assets) have been completely written-off. However, a banking company may pay dividend on its shares without writing off i) the depreciation, if any, on the value of its investments in approved securities, where such depreciation has not actually been capitalised or otherwise accounted for as loss ii) the depreciation, if any, in the value of its investments in shares, debentures or bonds (other than approved securities) where adequate provision for such depreciation has been made to the satisfaction of the auditors of the banking company and iii) bad debts, if any, where adequate provision for such debts has been made to the satisfaction of the auditors of the banking company.

Legal aspects

7.1.6 Section 38(1) of the State Bank of India Act provides that after making provision for bad and doubtful debts, depreciation in assets, equalisation of dividend, contribution to staff and superannuation funds and for all other matters for which provision is necessary by or under the Act or which are usually provided for by banking companies, the State Bank of India may, out of its profits, declare a dividend. There is a similar provision for the associates of State Bank of India in the State Bank of India (Subsidiary Banks) Act. The Nationalisation Acts also provide that after making provision for bad and doubtful debts, the depreciation in assets, contriubtion to staff and superannuation funds and for all other matters for which provision is necessary by or under the Act or which are usually provided for by banking companies, a nationalised bank shall transfer the balance of profit to the Central Government. There are no indications in the various acts as to the manner in which such provisions may be made. However, the scheme of the above provisions seems to indicate that adequate provision shall be made to the satisfaction of the auditors.

Provision for bad and doubtful debts

7.2.1 The main business of a bank is dealing in credits; advances, therefore, not only form its principal asset but they are also the principal earning asset. Since risk is inherent in lending, the question of evaluation of the portfolio, assessment of risk, identification of doubtful/bad debts and making adequate provision therefor is of paramount importance. If by any chance an advance has turned out to be bad, both the income and the real value of the owners' funds will be affected. It is, therefore, generally recognised that it would not be correct to show the advances/loans at the book value, if ~~they~~ Some of them are likely to prove irrecoverable, or to account for the interest on such advances in the income. There is, however, no consensus as to the basis on which necessary provisions should be made for the purpose. The problem seems to arise due to the fact that a loan may become irrecoverable over a period of time, although its position as a bad debt may be given recognition only in a particular year. Further an assessment of realisability of the collaterals is also not possible to be made with any precise degree of accuracy, in all cases. Basically, the assessment of individual advances, the amount of provision to be set aside, etc are determined by the perception of the management of a bank itself, independently verified to some extent by auditors. The disclosure of accounting policies as set out in Chapter V of banks in various countries also does not indicate the precise manner in which provisioning is done, unless such provisions are made in terms of legal requirements.

Practice in India

7.2.2 Generally, banks in India make provision for individual advances which in the judgement of the management are considered as bad or doubtful of recovery. Provision is made to the extent the relative advances are considered as irrecoverable. In addition, provision is made on such of the advances as are identified by the auditors as bad or doubtful of recovery. To the extent additional provision is required during a year, the relative amount is deducted from income heads and credited to provision for bad and doubtful debts. Such provisions are not deductible in computing taxable income. In addition banks make ad hoc general provisions by way of contingencies. They are also subject to payment of tax. Banks are permitted to make ad hoc provisions in respect of advances at rural branches to the extent of 1.5% of their total advances at such branches. In the opinion of some banks, such provisions may be made every year to the extent of 1.5% of the total advances at the end of every year. Banks having foreign branches and approved for the purpose are also permitted to create a special reserve upto 40% of their income. Such provisions and reserves are deductible in computing taxable income. While the practice as described above is more or less uniformly followed by all banks, there are certain nuances in the manner of making provision, particularly in respect of advances covered by the Deposit Insurance and Credit Guarantee Corporation Ltd. (DICGC) and Export Credit Gurantee Corporation(ECGC). Some banks make provision for the entire amount considered irrecoverable ignoring the likely reimbursement of losses from the Corporations, others make provision only for the net amount. Although the former procedure is much more prudent and provides an in-built cushion, the Committee feels that there is no need for such over-provisioning and suggests that provision need be made only to the extent that such debts are not covered by DICGC/ECGC. The practice followed may, however, be disclosed in the accounting policy.

Provision - Net or Gross of tax

7.2.3 Another aspect of the question is whether provisions for bad and doubtful debts should be made on a gross or net of tax basis. While banks may recognise a debt as bad or doubtful of recovery in a particular year and make a provision therefor, such provision may be allowed as deduction by the tax authorities only after the relative debts have been established to have become bad and deduction is postponed until all steps for recovery are finally exhausted and the debt is actually written-off in the books. The Committee discussed this matter with the representatives of banks as well as professionals like Chartered Accountants and Cost Accountants. The general feeling was that while providing for debts on a gross basis, one should take into account the tax laws as they stand and ignore the anticipated tax gains. The tax gains should be recognised only in the year the debt is actually written off and deduction is permitted by the tax authorities. This is in consonance with the fact that the funds flow takes place only in the year the deduction is allowed. On the other hand, if provision is made on a net-of-tax basis, credit is taken in the current profit and loss account for anticipated tax benefit which may accrue in future years.

While the Committee recognises that the question involved is one of timing and the position may even out over a period, it is of the view that as the tax laws stand, banks should make provision on a gross basis. In this context, the Committee notes that the PEP Committee appointed by the Reserve Bank had gone into the question and had recommended that the Government might be moved to amend the tax laws so that banks could be allowed to charge the amount of provision made for specific advances, which either in the judgement of the management or that of the statutory auditors had proved or would prove irrecoverable, in the year in which the debts were so recognised and provided for.

7.2.4 An analysis of the position of the debts considered bad or doubtful of recovery of banks

write off of bad debts

shows that there is a considerable time lag between the recognition of a debt as bad or doubtful of recovery and its ultimate write off with the result that banks generally carry a large amount of such debts at any point of time in their books. In the year 1982 for instance, the total amount of bad debts written off constituted only about 1% of the total provision. The amount written off every year is thus insignificant with the result that the amount of fully provided bad debts carried in the books is substantial. There seem to be several reasons for this position. Mainly the situation is due to the tax laws. The relative debts should be established to have become bad before they are allowed as a deduction by the tax authorities. This means that the banks have to exhaust all possible avenues for recovery of a debt, including legal recourse. The present framework of law is such that recourse to collaterals such as stock-in-trade and fixed assets without the intervention of court is difficult save in exceptional cases. The legal proceedings tend to get delayed; instances of borrowers taking advantage of the delays are also common. These difficulties also make bank officials lethargic in vigorously pursuing legal action. Bank managements, having made necessary provision, also leave things to take their normal course. In some cases, it also happens that only a part of the advance has become bad. Such part write-offs are also not very popular with banking circles and very often, therefore, in such cases, the bank management is satisfied with making provisions for such part bad debts.

7.2.5 The above situation has certain far reaching implications on the socio-economic objectives of banking. Banks are required by the policies enunciated by Government and Reserve Bank to ensure that certain proportion of their advances should be extended to priority sectors and very weaker sections, etc. As long as such levels are related to the total outstanding advances, inclusion of bad and doubtful debts, albeit fully provided for, in the total advances and the various sectoral classifications, would reduce the quantum of fresh disbursements to the priority sectors. As the funds in blocked accounts are not recycled, the number of new beneficiaries of bank loans under these sectors would also be not as many as it should have been, were the funds recycled or were the irrecoverable advances written off. There is, therefore, a need to ensure that debts recognised as bad are written off within a reasonable time after such recognition.

Norms for provisioning

7.2.6 The Committee has considered the question whether there is need for any norms or guidelines in the matter of making provisions for bad and doubtful debts. The system of review of the quality of advances portfolio and identification of doubtful debts would be the crucial aspects to be considered for the purpose. Banks being dealers in credit incidence of bad debts is inherent in banking businees and with the growing volume of the advances portfolio and their multifarious nature such bad debts may constitute a substantial charge on profits. With the obligations cast on the banking system to achieve certain socio-economic objectives and the exhortation to banks to extend credit on the basis of viability of a project rather than security, banks not only have per force to enter a higher credit risk area but also have to deal with a very large number of such borrowers. Similarly, over the years banks have also had to carry accounts of a large number of sick units involving the blocking of substantial amounts. As at the end of June 1983, the number of sick units reported by the banking system is in the region of 66,000 and the amount involved is about Rs.2793 crores constituting 7.9% of the advances of the banking system in India. Of these, 463 units involving an amount of Rs.1913 crores are comparatively larger sick units with limits of Rs.1 crore and above. A number of such sick units come under nursing/ rehabilitation programmes. Viewed in this context, the task of assessing the quality of individual advances and identifying potential doubtful debts becomes a difficult exercise. But a viable system for achieving these objectives is necessary so that not only a proper follow-up of advances is ensured but also the necessary provisions made from current profits each year. Apart from the management of individual banks, the statutory auditors and the Central Banking authority are concerned with these aspects. The statutory auditors would be primarily interested to see that adequate provisions are created to absorb likely loan losses and the profit and loss account shows a true and fair balance of profit or loss. The Central Banking authority's primary concern will be with the solvency of the individual banks and to ensure that they are in a position to pay the depositors in full as and when their claims accrue. The management, while equally concerned with these aspects, will in addition be interested in early identification of difficult advances, proper adherence to loan policies and performance of officers at the field level.

7.2.7 In the light of the foregoing, the Committee

Health code for advances

addressed itself to the question of evolving a suitable system of appraisal of the advances portfolio and review of individual advances. One aspect of the question is whether there should be a system of classification of individual advances according to their quality and if so what should be the criteria to be followed for such classification and the manner in which the system could be used for assessing loan losses. The Committee understands that the Pendharkar Working Group on the system of inspection of banks has recommended for introduction in banks a system of health coding for accounts. Briefly, the accounts would be classified into the following categories -

(i)	satisfactory	(iv)	advances recalled
(ii)	irregular	(v)	suit filed accounts
(iii)	sick/sticky accounts	(vi)	decreed debts

Detailed guidelines formulated by that Committee on the classification are given in the Annexure VIII.

7.2.8 The Committee is of the view that the system of classification should be applied to all advances irrespective of the amount. This is considered necessary as the small advances in the aggregate constitute a significant proportion of the total advances of a bank and this will continue to be the position in future also. A statement showing the size-wise pattern of borrowal accounts as at the end of 1980 is given below:

(Rs. in crores)

Credit Limit Range	DECEMBER 1980 No. of accounts	% to total	Amt. outstanding	% to total
Rs.10,000/- and less	18920000	93.5	3453	14.6
Above Rs.10,000/-and upto Rs.1 lakh	1119000	5.5	4054	14.0
Above Rs.1 lakh to Rs.5 lakhs	157600	0.8	2656	11.2
Above Rs.5 lakhs to Rs.1 crore	47000	0.2	6479	27.3
Above Rs.1 crore	2900	-	7759	32.8
Corporate and unclassified	875	-	28	0.1

The number of small advances with limits upto Rs.1 lakh is large and constitutes about 99% of the total number, although they account for only 28.6% of the outstanding balances. The number of advances with limits ranging between Rs.1 lakh and Rs.5 lakhs and Rs.5 lakhs and Rs.1 crore is also not insignificant (eventhough they constitute only 1% of the total number); they account for 38.5% of the outstanding balances. The number of accounts with balance of Rs.1 crore and above is limited but they account for 32.8% of the total outstandings. The spread of accounts will thus tend to show that classification of accounts will have to be distributed over different tiers of the bank like branch, regional office, zonal office, Local Head Office(if any) and Central Office. The exact limits upto which such classification is to be done at different tiers of organisation will depend upon the size of the bank, distribution of branches and the pattern of advances within different limit ranges. The exact organisational arrangements for classification may therefore be left to the discretion of the bank. The system should however provide for verification at a higher level of the classification done at a lower level and all advances with limits above Rs.1 crore should be referred to the Board for confirmation. As regards checking by external auditors/Reserve Bank of India, it may be sufficient if the system of classification is studied and a test-check done of classification of individual advances. Advances above Rs.1 crore where the number will be very limited may be seen individually by them. It is also desirable to introduce simultaneously a system of review of the health code classification every year. The review should be evenly spread throughout the year.

7.2.9 As regards making adequate provisions, the necessity to make provision will arise only in advances in categories (iii) to (vi) which may be considered as unsatisfactory advances. In the case of a well run bank, these categories of advances could be between 5% to 10% of the total advances and very rarely will this ratio go beyond 20% of the total advances. It will be necessary to assess the amount of doubtful debts in respect of larger advances with balances of Rs.5 lakhs and above individually and to provide for the same. In respect of smaller advances to the extent possible, the provisions may be made on actual basis but as the number of such advances may be large provision may also have to be made on a percentage basis depending on the loan loss experience of the bank. The percentage needs to be reviewed periodically, say, once in three years. The above scheme, the Committee feels, will enable banks to have satisfactory control over the credit portfolio and minimise losses, apart from ensuring that adequate provision is made for doubtful debts. The Committee would, however, emphasise that the banks need not disclose full details of the system of classification and more particularly the aggregate amount under each category. If need be, the banks should be given protection from disclosing this information except to the Reserve Bank/Government and auditors.

7.3.1 A related issue is the question as to when interest should cease to be charged to the advances and credited to income. As stated earlier, the loans and advances form the principal revenue earning assets of a bank. Revenue recognition is, therefore, very important. According to the International Accounting Standards Committee, "Interest and other revenues arising from holding of assets should only be recognised when no significant uncertainty as to measurability or collectability exists". The explanatory notes state "when the uncertainty relates to collectability and arises subsequent to the time of sale or rendering of the service, it is more appropriate to make a provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded".

Provisioning for interest

7.3.2 By and large, banks in India follow the practice of not charging interest on advances which have been recalled or where legal proceedings have been initiated to recover the dues unless the amount is realised. Besides, interest is also not charged on loans where the principal amount, either partly or wholly, is doubtful of recovery. As in the case of making provisions for loans and advances, there is an element of ad-hocism in this area as well. In the Committee's view, there is necessity to have a systematic procedure, as otherwise, the income for a year could easily be understated or overstated. For this purpose, the suggested system of classification of advances should be helpful in deciding on this aspect as well. Generally, no interest should be taken into account unless realised on recalled advances, suit-filed accounts and decreed debts. As regards sick/sticky advances (category-(iii)) the question of charging interest will depend on the assessment of realisability. Ideally, no interest should be charged on such advances in this category where the principal amount is considered as bad or doubtful in part or in full except on a realisation basis. But the Committee sees no objection to interest being charged on such advances as are not considered bad or doubtful either in whole or part. As regards smaller advances in the category, the Committee would advocate that to the extent provision is made, interest also should not be taken into account.

7.3.3 In this context, the Committee is given to understand that banks face certain problems in the matter of accounting interest on such advances vis-a-vis the tax authorities. One of the methods followed by banks is not to treat interest charged on such advances as income and instead credit the same to a suspense account. This practice is based on the sound accounting principle of not treating as income any item, the realisability of which is doubtful. The Central Board of Direct Taxes had issued a circular in 1952 to the tax officers to the effect that interest accruing to a money lender on loans considered doubtful of recovery need not be included in the taxable income if the income-tax officer was satisfied that there was little possibility of the loan being repaid and the same principle was to be applied to banks which credited the interest charged on advances to a suspense account. On the basis of these instructions, banks were being allowed a suitable reduction from the taxable income. Following a judgement in one of the High Courts, the tax officers have sought to disallow such interest credited to suspense account. On the basis of this, some of the banks have changed the procedure and ceased charging interest altogether. For the sake of proper control and prevention of leakage of income, it would be desirable if the interest on such advances is booked and credited to interest suspense account. To tax income which is not likely to be realised merely because it is accounted for in the books for the sake of convenience and better control is also not consistent with sound accounting practice. Banks have represented against the revised decisions of the tax authorities.

Tax rebates on bad debts and provisions, etc.

7.4.1 In the preceeding paragraphs the Committee has discussed various issues relating to bad debts provisioning, interest on bad and doubtful debts and the relative taxation practices. Thus, according to the taxation practices in India, tax rebate on bad debts is allowed only when a debt is written off, after exhausting all measures for recovery. Similarly there is also some uncertainty about the allowance of rebate on interest charged to bad and doubtful debts, when such amount is not taken to profit and loss account but kept in suspense. In accordance with the prevailing practices in several countries, the Committee feels that it would be desirable if the tax rebate is given to banks in India also when a provision is made for bad and doubtful debts. This principle has already been accepted in the case of advances at rural branches. Thus banks are being given tax rebate at present on ad hoc provisions in respect of advances at rural branches to the extent of 1.5% of such advances. The Committee would suggest that this concept may be extended to all advances. In order, however, to ensure that banks do not make over provisions to reduce their taxable profits, a ceiling could be imposed on the maximum outstandings in such provisions. If this principle is acceptable, it could be extended also to interest charged on bad and doubtful debts, kept in suspense account. The Committee therefore suggests that all provisions made for bad and doubtful debts and provisions made by way of interest on bad and doubtful debts kept in suspense account should be exempt from tax, provided the aggregate outstandings in such provisions do not exceed 5% of the total outstanding advances at the end of the relevant period. This procedure would also enable banks to write off debts recognised as bad within a **reasonable** period of such recognition and to that extent would remove the disadvantages inherent in the system of carrying the bad debts in the books indefinitely.

7.5.1 According to section24 of the Banking Regulation Act, banks have to maintain in India cash, gold and unencumbered approved securities to the extent of 25% of their total demand and time liabilities in India. This provision is also referred to as the statutory liquidity ratio (SLR) of banks. Although the Act fixes SLR to be maintained by banks at 25% of the liabilities, in practice the banks were directed by the Reserve Bank of India from time to time to maintain a higher level of SLR. By the 1984 amendments to the Banking Regulation Act, the Reserve Bank has been now vested with power to raise SLR from 25% upto 40%. Currently the SLR is fixed at 36%. As cash and gold are non-earning assets, by and large, banks comply with the requirements of SLR by maintaining an adequate level of approved securities. Approved securities are mainly securities of the Central and State Governments and those guaranteed by them. A scrutiny of the investment portfolio of banks shows that the approved securities constitute virtually the total investment portfolio and the other securities comprising mostly shares, debentures,etc. constitute only an insignificant portion of the total investments

Investments Depreciation provision - General roughly about 1% of the total investments. Other investments are usually being valued by banks at market rate if they are quoted or at estimated realisable value if they are not quoted. Banks usually provide for full depreciation in the value of such securities. This method of valuation and provisioning for depreciation of such securities is more or less universally accepted and the Committee considers that the existing practice may continue.

Approved securities

7.5.2 The great bulk of the investments of banks would be in Government and other approved securities. An analysis of the investments in Government and approved securities of the larger banks reveal that such investments constitute about 38% of their demand and time liabilities. Currently, the SLR to be maintained by banks is 36% of the demand and time liabilities. Thus, banks comply with the SLR requirements practically by means of investments in Government and approved securities. In this context, the accounting of investments and the treatment of such investments in the annual accounts become very relevant. Most banks carry such investments to maturity. A few banks, however, do actively trade in such investments; others confine their operations to subscriptions to new issues. Switch operations are, however, usually carried out by many banks with a view to having a balanced portfolio, improving current yield, etc.

7.5.3 Banks follow different practices in accounting of investments. Broadly, the practices are -

Accounting practices in India

(a) At the time of purchase, the investment account is debited with cost plus interest for the broken period. At the time of sale, the investment account is credited with the total amount realised including interest for the broken period and the resultant loss or profit on each transaction in the account is thus recognised.

(b) At the time of purchase, cost excluding interest accrued for the broken period is debited to investment account. Interest for broken period is debited to Profit and Loss Account. (In some cases, the broken period interest is debited to an Interest Suspense Account which is adjusted when the interest is actually realised). At the time of sale, interest for the broken period is credited to the profit and loss account and the balance of the sale proceeds, is credited to the investment account and profit or loss on the transaction is recognised in the Profit and Loss Account. The Committee feels that it will be desirable to follow a uniform practice in this regard and suggests that banks may follow the practice described at (b) above. It is understood that some Income-Tax Officers have taken objection to the practice outlined at (b) on the score that interest accrued on purchase of securities will have to be capitalised. The Committee, however, recommends that in the interest of sound accounting practices, the Income Tax authorities may be requested not to take objection to the practice recommended by the Committee.

Accounting in Balance sheet and Section 24 of Banking Regulation Act, - Legal position

7.5.4 As regards accounting of investments in balance sheets, the prescribed format provides that the mode of valuation i.e. cost or market value, etc. should be indicated. In case the value of investment shown in the balance sheet is higher than the market value, the market value shall be shown separately in the balance sheet. However, the Central Government is empowered to give exemption to banks on the recommendations of Reserve Bank of India from showing the market value and such exemptions are usually given freely. For the purpose of section 24 of the Banking Regulation Act, that portion of the investments required for complying with the minimum statutory liquidity ratio of 25% prescribed under Section 24 is valued at market value. The balance of the securities reckoned for the purpose of the excess liquidity requirements is to be valued at book value less provision, if any, made for depreciation in the value of such investments. Under the amended provisions the approved securities are to be valued at a price determined in accordance with such one or more or combination of the following methods of valuation, namely, valuation with reference to cost price, market price, book value as may be specified by the Reserve Bank from time to time. It is also provided that the market price of approved securities shall be the price as on the date of the issue of the Notification or as on any earlier or later date as may be notified from time to time by the Reserve Bank in respect of any class or classes of securities. It will be thus seen that for the purpose of section 24 of the Banking Regulation Act, the Reserve Bank has substantial powers to prescribe the mode of valuation of the securities.

7.5.5 Banks follow two main modes of valuation of investments in Government and other approved securities.

Valuation of securities for balance sheet

Some banks carry such investments at cost regardless of the changes in the market value. Any gains or losses are recognised only at the point of sale, unrealised losses or gains being ignored. The argument for not valuing the securities at current market value is that the securities are generally held till maturity and there will be no loss on maturity. Some of these banks, however, provide for depreciation to the extent possible depending on the availability of profits.

7.5.6 The other method followed is to value the securities at cost or market value whichever is lower. The valuation is, however, done by some banks on the basis of stock exchange quotations while others take the Reserve Bank of India rates as the basis. Similarly some banks take into account only the depreciation, ignoring appreciation, if any, while the others take the net position. The tax authorities permit either of the modes of valuation, provided the method is followed consistently.

7.5.7 The Committee has given considerable thought to the question of valuation of securities. Except for a limited portion, the investments are in approved securities (including Central Government, State Government and other approved securities) and in such case there will be no eventual loss if such securities are carried to maturity provided they are carried in the books at face value or less. Moreover in the absence of an active market, the market quotations may not be realistic nor may it represent the true realisable value. On these considerations, it has been argued that there should be no objection to banks carrying the securities at cost, unless a security was acquired at a premium or discount; if they are so acquired the book value could be adjusted for discounts/premiums over the period till maturity. Contrariwise it may be considered prudent to value the securities at lower of cost or market value, particularly in a period of continuous depreciation in market value, as a bank's ability to realise these securities or raise finance against them will be related to their realisable value and not the holding value. Unless the securities are valued at their current market value, the principle of 'true and fair' position may also be violated. The main difficulty in accepting this practice, particularly at a time of continuous decline in prices, is the non-availability of adequate profits to book the depreciation, which is substantial. The Committee made a detailed study of the depreciation in the investment portfolio of a few selected banks as at the end of 1983. The position as revealed by the study is indicated in the following statements:

I. Pattern of investments

(Rs. in crores)

Bank No.	Book value of investments in securities of Central Government	State Government	others (approved)	Total
(1)	(2)	(3)	(4)	(5)
1.	602 (55.1)	46 (4.2)	445 (40.7)	1093
2.	555 (42.6)	181 (13.9)	568 (43.5)	1304
3.	531 (69.8)	128 (16.8)	102 (13.4)	761
4.	227 (59.6)	53 (14.0)	101 (26.4)	381
5.	2886 (54.0)	693 (12.9)	1769 (33.1)	5348
Total:	4801 (54.0)	1101 (12.4)	2985 (33.6)	8887

(Figures within brackets in columns 2, 3 and 4 represent % of the respective category to total)

II. Depreciation in securities

(Rs. in crores)

Bank No.	Central Government	% of depreciation in Central Government Securities to total depreciation	State Government	Others (approved)	Total
(1)	(2)	(3)	(4)	(5)	(6)
1.	64 (10.7)	92.75	-	5 (1.1)	69
2.	76 (13.7)	85.39	-	13 (2.3)	89
3.	47 (8.9)	97.92	-	1 (1.0)	48
4.	33 (14.5)	100.00	-	-	33
5.	336 (11.6)	100.00	-	-	336
Total:	556 (11.6)	96.70	-	19 (0.6)	575

(The figures within brackets under columns 2 & 5 indicate percentage of depreciation to the book value of each category)

III. Maturity Pattern of Central Government securities and depreciation

(Rs. in crores)

Bank No.	0 - 10 years			11 to 15 years			Over 15 years			Total	
	Book value	Depreciation	Depreciation as % of book value	Book value	Depreciation	Depreciation as % of book value	Book value	Depreciation	Depreciation as % of book value	Book value	Depreciation
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
1.	79.03 (13.12)	3.04 (4.72)	3.85	126.73 (21.03)	12.53 (19.44)	9.89	396.73 (65.85)	48.90 (75.85)	12.33	602.49	64.47
2.	123.28 (22.22)	5.72 (7.52)	4.69	87.83 (15.83)	8.07 (10.62)	9.19	343.79 (61.96)	62.23 (81.86)	18.10	554.90	76.02
3.	289.27 (54.45)	9.16 (19.35)	3.17	84.33 (15.88)	11.52 (24.33)	13.66	157.61 (29.67)	26.67 (56.33)	16.92	531.21	47.35
4.	29.80 (13.14)	1.45 (4.46)	4.87	48.01 (21.17)	4.26 (13.10)	8.87	148.94 (65.68)	26.82 (82.45)	18.01	226.75	32.53
5.	54.35 (1.88)	6.63 (1.97)	12.20	322.70 (11.18)	20.36 (6.06)	6.31	2508.58 (86.94)	308.85 (91.96)	12.31	2885.63	335.84
Total:	575.73 (11.99)	26.00 (4.67)	4.52	669.60 (13.95)	56.74 (10.20)	8.47	3555.65 (74.06)	473.47 (85.12)	13.32	4800.98	556.21

(Figures within brackets under columns 2, 5 and 8 indicate the percentage of each maturity-wise category of investments to total investments in Central Government Securities. The figures in brackets under columns 3, 6 and 9 indicate the % of depreciation in each group to total depreciation)

It will be observed from the above statements that the great bulk of the investments in approved securities in the case of all the banks studied is in Central Government securities and 'other approved' securities. The State Government securities held by banks varied between 4.2% to 16.8% of the total approved securities. In the case of four out of the five banks the share of the Central Government securities constituted more than 50% of the securities. In the case of three out of the five banks, 'other approved' securities constituted more than 33%. Only in the case of one bank the 'other approved' securities were less than the amount of the State Government securities. In the case of all others, the 'other approved' securities exceeded the investment in State Government securities substantially. Although there is no definite set pattern among the banks in their holding in Central Government, State Government and 'other approved' securities, the study reveals that as a rule banks prefer Central Government and 'other approved' securities to State Government securities. This is apparently due to various factors including availability of scrips, considerations of eligibility for raising finance, marketability and interest yield.

7.5.6 Of the total depreciation in the investment portfolio, the Central Government securities accounted for the bulk. In two of the five cases, the whole amount of depreciation was accounted for by Central Government securities while in the remaining three cases they accounted for more than 85%. State Government securities did not show any depreciation. In the case of "other approved securities" also, the depreciation was not significant compared to their book value. As the market for State Government and approved securities is not active, the market quotations for such securities may not be realistic and very often may not represent the current yield pattern. Moreover, as many such securities are not quoted, market value is often based on quotations received from brokers which may not necessarily represent the real market value. These factors could partly account for such securities not showing any depreciation. The amount of depreciation in the Central Government securities constituted roughly about 12% of the value of the Central Government securities; the individual percentage varied from 8.9% to 14.3% depending upon the proportion of securities held in different maturity bands.

7.5.7 The maturity-wise analysis of the Central Government securities indicated that in the case of only one bank the proportion of investment in Central Government securities maturing within a period of 10 years to total such securities was more than 50%, the ratio of the holdings in securities of 10 years and less to the total investments in Central Government securities in three cases ranged between 13.12% and 22.22% and in the remaining case the proportion was as low as 1.88%. The depreciation on this group of securities was generally not material. The investment in the maturity group of 11 to 15 years of the five banks varied between 11.18% to 21.17% of the total. This group accounted for depreciation to the extent of 6.06% to 24.33% of the total depreciation. The amount of depreciation constituted about 9 to 10 per cent of the book value of the investments in this group except in two cases where the relative percentages were 13.7% and 6.3%. The investments in the group with a maturity period of over 15 years form more than 50% of the total securities in Central Government securities except in the case of one bank where the percentage was 29.67%. This sector accounted for more than 3/4th of the total depreciation of Central Government securities except in the case of the bank which had only 29.67% investment in this maturity group. The depreciation in this group worked out to generally more than 15% of the book value; the actual range being between 12.31% and 18.10%.

7.5.8 Although there is no clear-cut set pattern in the types of securities held by banks in different segments like Central Government, State Government and other approved securities, nor in the maturity ranges of the investment, the study does indicate that the depreciation in the investment portfolio is mainly on account of Central Government securities and that too in respect of securities with a maturity period of more than 10 years.

7.5.9 Although the Committee was made to understand that in the past several banks were valuing the securities at cost or market value, whichever is less, since the continuous hike in the coupon rate and the consequent depreciation in the market value of securities coupled with the obligation cast on banks to invest larger and larger share of their resources in approved securities, many banks have not been lately providing for the full depreciation in the value of their securities. While some banks do still provide depreciation in full, many others provide for such depreciation only partly and some do not make any substantial provision for such depreciation at all. There is thus no uniformity in the matter of valuation of securities and provisioning for depreciation on such securities whereas for the sake of comparability of data such uniformity is essential. In this context, the Committee considered various alternatives for valuation of securities and making provisions for depreciation.

7.5.10 One method is obviously the recognised prudent method of valuing the securities at lower of cost or market value. This obviously has become well-nigh impossible for banks to attempt. Even the few banks which are adopting this method at present may eventually find it difficult to continue with the practice unless the market value of securities picks up substantially.

7.5.11 Another method would be to value the securities at book value, the book value being the cost price adjusted for depreciation, if any, provided not necessarily to the full extent. The argument for adopting this method of valuation is that the depreciation in Government securities in relation to market value is notional and so long as the book value is not more than the face value there will be no eventual loss to banks. In this context, a point has been raised whether it is at all necessary to book the depreciation and whether banks could not value the securities for tax purposes at lower of cost or market value and claim depreciation without booking depreciation in the accounts. While this may be in order as a matter of tax management, the Committee does not endorse this suggestion. For ensuring uniformity of income reckoning, if at all this method is to be acceptable, the Reserve Bank will have to indicate the extent of depreciation that should be charged by banks. This could be on the basis adopted by Reserve Bank of India for the purpose of valuation of securities under section 24 of the Banking Regulation Act. This procedure will then ensure that the securities will be valued on a uniform basis for section 24 of the Banking Regulation Act and for balance sheet purposes.

7.5.12 Another proposal for valuation of securities suggested is the 'lower of cost or redeemable value' method. Normally, redeemable value is the same as face value and as such the proposal is more or less to value the securities at cost or face value, whichever is less. This method of valuation may be easy to implement and would ensure that banks would not suffer any loss on their investments on maturity. How far this method will conform to the concept of prudence is, however, a moot point. Under this method, banks will have to provide for depreciation only if the cost price is more than the face value/ redeemable value and the burden will practically be nil in the case of all the banks studied.

7.5.13 Another proposal considered by the Committee in this context is the bifurcation of investments into two categories viz., permanent investments and current investments more or less on the model of 'Investment securities' and 'dealing securities' propounded in the IASC Discussion Paper. The proportion of such investments will be determined by Reserve Bank of India in Indian conditions. On this basis, banks will classify the existing investments into two categories, all subsequent purchases will also be classified suitably. No interchange of categories will be permitted. Banks will have to provide for depreciation, if any, in the investments in the 'current' category in full. No provision is necessary in respect of the depreciation in the 'permanent' category' which will be valued at cost or face (or redemption) value, whichever is less. Sale of investments in permanent category will be permitted with the proviso that any loss on sale of the relative investment will be booked. The loss will be a charge on profit and loss account, but the profit, if any, will be transferred to capital reserves. Considering the high proportion of liquid assets which banks have to maintain and the rather restricted market for Government securities the scheme has much to commend itself. There are, however, certain disadvantages in the system to be reckoned with. There may be no advantage in introducing the scheme for banks which value the investments on the balance sheet date at lower of cost or market value. There will also be a tendency to book securities with larger depreciation in 'permanent' category and bulk of the depreciation in the overall portfolio will then remain unprovided. The scheme may not, therefore, alter the position materially while at the same time circumscribing the discretion of banks in the matter of sale of securities. This position can however be countered by fixing an appropriate proportion for levels of 'permanent' and 'current' components. If the level of 'permanent' category is pitched high, by transferring the long dated Central Government securities to this class, banks may get some substantial relief in depreciation. By pitching the level of permanent securities at a low level, the amount of depreciation to be charged may be raised. The proportion between 'permanent' and 'current' categories may have to be prescribed by the monetary authorities and for the sake of uniformity, the levels will have to be uniform for all banks. In appropriate cases, banks will have also to be given time to make the change over to the new system.

7.5.14 Another aspect that has to be considered if the procedure in the preceding paragraph is adopted, is the 'amortisation of depreciation'. The normal concept of the amortisation practice followed by some of the UK and USA based banks is to spread the premium or discount on purchase of a security (in relation to the face value) over the period of the life of the security. This practice, which is followed only in respect of 'investment' securities and not 'dealing' securities, virtually means that at the time of maturity, there will be no loss or gain and the loss or gain accruing on the redemption of a security in the investment category over the purchase price will be spread over a period of time, that is the remaining life of the security. It may not be, however, necessary to introduce this concept in Indian banks at this stage.

7.5.15 By adopting the concept of 'permanent' and 'current' categories for investments as indicated in the preceding paragraphs, it may be ensured to some extent that banks charge depreciation on a minimum proportion of their securities. The concept is also in accordance with the proposals in the IASC Discussion Paper. As the method can be adopted for valuation of securities for the purpose of Section 24 of the Banking Regulation Act also, there would be uniformity in the valuation of securities for the purposes of balance sheet and Section 24 of the Banking Regulation Act. The mechanism of fixing the proportion between the two categories may also to some extent serve as a credit regulatory measure, as by altering the proportions suitably banks may be required to have more or less funds in their investment portfolio.

Considering all aspects, the Committee is of the opinion that the valuation basis proposed in the preceding paragraphs after bifurcating the investments into 'permanent' and 'current' categories' will be an appropriate method of treatment of investments by banks for balance sheet purposes. For the purpose of final accounts, the permanent investments will be valued at lower of cost or redemption value and the current investments at lower of cost or market value. Banks would be required to make provision for depreciation on investments to comply with the above mode of valuation. The accounting policy statement to be attached to the annual accounts will indicate the above basis of valuation. The notes on account will further indicate the difference between the book value and the valuation adopted. The actual level upto which the securities **should be** held in the permanent and current categories may be decided by the Reserve Bank from time to time depending upon the prevailing circumstances.

Retirement benefit to staff

7.6.1 Normally, banks have two retirement benefits, viz., Provident Fund and Gratuity. A few banks also have pension schemes and in such cases, employees who are eligible also for gratuity under the Payment of Gratuity Act may have three benefits. Most of the banks have set up recognised Gratuity or Pension Funds to fund the relative liability. The practices in this regard have, by and large, stabilised. The Committee would emphasise the need for estimating such liabilities on an actuarial basis and for funding such commitments every year irrespective of the availability of profit.

Provision for income-tax

7.7.1 By and large, banks follow a uniform practice in the matter of making provision for income-tax. One of the issues raised is whether provision for payment of income-tax should be made in respect of accrued interest on investments. The practice followed by banks is that credit is taken in the accounts for interest received, interest accrued due but not collected and interest accrued but not due. For tax purposes, however, the interest accrued, but not due is not taken into account since under the law it is taxable only in the year in which it becomes due. The Committee would suggest that the entire interest taken to profit and loss account should be taken into account for making provision for taxes also.

7.7.2 The assessment of income-tax by the authorities is understood to be in arrears for several years in many banks. This position adversely affects the liquidity position of many banks. In the normal course because of the large amount of tax deducted at source on their investment portfolio, banks are not required to pay any tax; on the other hand they are expected to get substantial refunds on completion of their assessment by the authorities. By not taking out assessment in time, the banks are thus deprived of timely refund and their funds are unnecessarily blocked with the Income Tax Department. The Committee, therefore, suggests that the assessments of banks be taken up expeditiously by the Department and refunds given to banks without delay.

7.7.3 According to the existing practice tax is deducted at source on Government securities @ 20% (and surcharge 2.5%) of interest. In the majority of cases, the tax deducted at source on investments of banks is substantially more than the tax payable by them. Several banks do not have to, therefore, make any separate advance payment of taxes and instead they have to obtain substantial refunds on completion of their assessments. As such refunds are generally made only after completion of the assessment, fairly large funds of banks are blocked in tax deducted at source without earning any interest. This affects both the liquidity and profitability of banks. With the increase in the costs of banks and the rise in the percentage of funds invested in securities for meeting requirements of statutory liquidity ratio, the taxable profits of the bank as a percentage of total income has significantly declined and a rate of deduction at source of 22.5% is no longer realistic. To give some relief to banks, the Committee feels that there is a case for doing away with the practice of deducting tax at source on Government securities held by them. In case it is not possible to do away with such deduction of tax at source totally, at least the rate at which the deduction is made will have to be substantially reduced, say to 10% or so.

7.7.4 As regards the accounting aspects, while some banks show the aggregate provision on the liabilities side of the balance sheet under "other liabilities" or under "current, contingency accounts,etc." and the advance tax paid and tax deducted at source on the assets side, some others net out the position and the net amount is shown on the liabilities or assets side, as the case may be. The Committee would suggest that the practice of netting off may be followed uniformly by all banks. In the proposed format such net amount is to be shown in the balance sheet under the head 'other liabilities and provisions' or 'other assets'.

7.8.1 Besides the items discussed in the earlier paragraphs which could be considered as necessary provisions, several banks have the practice of creating provisions/funds for specific purposes like Exchange Fluctuation Fund, Dividend Equalisation Fund, Development Fund and Contingencies. These are in the nature of discretionary provisions and often take the character of free reserves, created mainly to meet unforeseen contingencies and/ or to strengthen the inner financial position. Some of these items are currently disclosed in the balance sheet separately while others are added to 'contingency' accounts and included in deposits. Being discretionary, creation of such items is best left to the judgement of individual banks and the Committee would not like to make any suggestions in this regard. However, these provisions should be shown under 'Other Reserves', if the banks intend to disclose them in the balance sheet. If they partake the character of reserves and banks do not intend to disclose them in the balance sheet separately, they should be treated as secret reserves and dealt with accordingly in the final accounts.

CHAPTER VIII

DIRECTORS' REPORT

Introductory

8.1 Apart from the two financial statements, viz. the balance sheet and profit and loss account, the general purposes reporting system includes also the directors' report to the owners. In the earlier chapters, the two financial statements viz. profit and loss account and balance sheet have been discussed and in this chapter it is proposed to discuss the directors' report. In addition to the annual accounts and report, it may be mentioned, in some companies there is also a practice of circulating a copy of the Chairman's speech to the shareholders. The text of the Chairman's speech to be delivered by him in the annual general meeting usually contains information relating to the accounts, proposed allocations, material developments in the working of the company since the date of the closing of the accounts till the date of the annual general meeting, future prospects, etc. In some companies, there is also a practice of dealing with some aspect of topical importance to the company's operations in the Chairman's speech. By and large, in India except in the case of a few banks, the Chairman's speech normally does not constitute a significant component of the reporting system to the shareholders. The Committee does not, therefore, consider it necessary to make any specific recommendations on this part of the reporting system.

8.2 Although the annual reports of banks in different countries in most cases include the financial accounts, notes, statistical information, statutory details to be furnished, independent auditors' report and also a communication to the shareholders from the management, the details furnished in such reports vary from country to country. In U.K., U.S.A. and other western countries, either by convention or by statute, the directors' report included in the annual reports contains information relating to material changes during the reporting period in the activities of the company, its assets and liabilities portfolios, working results of the year and the financial position, the number of persons employed and the remuneration paid, donations and grants, directors' interest in the shares of the company and in contracts, if any, with the company and any other information which in the opinion of the directors warrants disclosure. The banks also follow the above system of general purposes reporting. Thus, a perusal of the published annual reports of international banks reveals that the American banks generally include in such reports President's letter to stock-holders, corporate and financial overviews, financial accounts and notes thereon, auditors' report, selected statistical information, information required to be furnished under the statute, information relating to board and management,

Position in foreign countries

etc. While the accounts and notes thereto cover the operations and changes in the financial position of the unit during the year including data that are required to be given under different statutes, the President's letter and the corporate and financial overviews give a detailed picture of the economic environment of the domestic and foreign areas of operations of the unit, technological developments, developments in the coverage of financial services rendered, corporate aims, achievement of goals and future prospects, etc. In U.K., the annual report includes a statement by the Chairman, a regional business survey covering particular geographical segments where the bank operates, a report of the directors, financial account analysis, notes on accounts and other statutory and statistical information, report of independent auditors, etc. As in the case of American banks, the statement by the Chairman, the directors' report and the regional and business survey cover the economic environment of the domestic and foreign areas of operations of the bank, (in many cases countrywise profiles are also given) as well as detailed information regarding the corporate developments and position both in domestic and foreign areas of activities of the bank. The reports of the other continental, Japanese and more recently constituted Arab banks are also patterned on the same model but contain comparatively less details than those of their counterparts in U.K. and U.S.A.

8.3.1 The Bhabha Company Law Committee made the following observations in regard to the 'Board's report':

Position in India - Legal provisions

"As the Cohen Committee pointed out, most directors' reports are colourless documents, which do little to inform or educate the shareholders. It is difficult to make any 'a priori' recommendations as to how the directors' reports should be designed and prepared; the matter is one that must be necessarily left to the initiative and judgement of the directors of a company. There is nothing to prevent them from conveying such information as they like to the general body of shareholders. All that we can suggest is that in addition to the information which the directors' report must contain under sub-section (1) of Section 131A it should also contain information on all changes which may have taken place in nature of the company's business or in the business of its subsidiaries or in the class of business in which the company has an interest, whether a member of another company or otherwise, during its financial year in so far as such information is in the opinion of the directors material to an adequate understanding of the company's affairs by its members and is not harmful to the business of the company or of its subsidiaries".

8.3.2 Section 217 of the Companies Act reads as follows:

(1) There shall be attached to every balance sheet laid before a company in general meeting, a report by its Board of Directors, with respect to -

(a) the state of the company's affairs;

(b) the amounts, if any, which it proposes to carry to any reserves in such balance sheet;

(c) the amount, if any, which it recommends should be paid by way of dividend;

(d) material changes and commitments, if any, affecting the financial position of the company which have occurred between the end of the financial year of the company to which the balance sheet relates and the date of the report.

(2) The Board's report shall, so far as is material for the appreciation of the state of the company's affairs by its members and will not in the Board's opinion be harmful to the business of the company or of any of its subsidiaries, deal with any changes which have occurred during the financial year -

(a) in the nature of the company's business;

(b) in the company's subsidiaries or in the nature of the business carried on by them; and

(c) generally in the classes of business in which the company has an interest.

(2A)(a) The Board's report shall also include a statement showing the name of every employee of the company who -

(i) if employed throughout the financial year, was in receipt of remuneration for that year which, in the aggregate, was not less than thirty-six thousand rupees; or

(ii) if employed for a part of the financial year, was in receipt of remuneration for any part of that year, at a rate which, in the aggregate, was not less than three thousand rupees per month.

(b) The statement referred to in clause (a) shall also indicate -

(i) whether any such employee is a relative of any director or manager of the company and if so, the name of such director, and

(ii) such other particulars as may be prescribed.

(Explanation - "Remuneration" has the meaning assigned to it in the Explanation to Section 198).

(3) The Board shall also be bound to give the fullest information and explanations in its report aforesaid, or in cases falling under the proviso to section 222, in an

addendum to that report, on every reservation, qualification or adverse remark contained in the auditors' report.

(4) The Board's report and any addendum thereto shall be signed by its Chairman if he is authorised in that behalf by the Board; and where he is not so authorised, shall be signed by such number of directors as are required to sign the balance sheet and the profit and loss account of the company by virtue of sub-sections (1) and (2) of section 215.

Certain provisions relating to penalties for non-compliance with the above provisions are also included in the section.

8.4 It will be thus observed that the provisions of the Companies Act have spelt out broadly the nature of the contents of the directors' report and have also further indicated certain items which should be specifically related in the report, like remuneration paid to certain categories of employees and information and clarifications of the management on adverse notes and remarks contained in the auditors' report. Conventionally, the directors' report of good companies also contain in addition to what is required by the statute a wealth of information regarding corporate affairs. Thus, apart from proposed allocations for dividend, bonus, reserves, etc the directors'

Practice in India - Companies

report discusses the current economic environment with particular reference to Government policies and other important developments affecting the main activities of the company and its financial results. It is also customary for the company to review the operations of the company during the year, in some cases on a division-wise basis where the company has more than one activity. Such observations on operations refer to the technological and human resources developments and also the position regarding supply of raw materials, cost aspects, market conditions for the finished products of the company, etc. The Government's fiscal and other policies and their impact on the activities of the company are also dealt with in the directors' report and sometimes even critically discussed. Other areas covered by the report are the proposed new investments, mobilisation of additional resources, modernisation plans, changes in directorships, appointment of auditors and industrial relations. The mandatory requirements of furnishing particulars of employees required under section 217(2A) of the Companies Act, giving comments on auditors' observations, etc are also complied with.

Position relating to banks

8.5 In tune with the general practice prevalent among companies in respect of their directors' reports, banks also by and large cover in such reports certain broad areas like the economic scenario and environments, the policies of the monetary authorities and Government in relation to banking in general, operations and working results of the bank in the domestic and international spheres, compliance with the various socio-economic objectives, changes in the organisational structure, development of human resources and man-power planning, changes in directorships, appointment of auditors, information regarding employees, etc. In India, the reporting system in the directors' report of banks in the public and private sector differs to some extent. The rules applicable to companies in general also apply to banking companies in the private sector and consequently, such banks include in their directors' report the items which are normally included by companies in general in their directors' reports. Although, the provisions of Section 217 of the Companies Act are not applicable as such to the public sector banks, which are incorporated under separate statutes, they also prepare the directors' report on a similar pattern as adopted by companies. The instructions issued by the Reserve Bank to nationalised banks by its circular letter dated 29th April 1970 regarding accounts contain, inter alia, certain guidelines in regard to the preparation and contents of the report of the directors. By and large the guidelines were on the basis of the provisions of the Companies Act and the practices and usages prevalent before nationalisation.

The objectiv s of nationalisation were however kept in view and banks were specifically required to indicate in the report the progress made in the achievement of the socio-economic goals entrusted to them. Thus the guidelines indicated:

"It is considered necessary that the Directors' Report..... should form part of the printed balance sheet and profit and loss account. While it is not the intention to prescribe any standardised form for the relevant report, it will be helpful if they follow a generally comparable pattern. Subject to essential modifications necessitated by the circumstances of each case, it may, therefore, be ensured that the report covers the aspects outlined in the Annexure".

The Annexure prescribed that the following points might be covered by the report.

(a) General economic and banking developments of the period covered by the report including data regarding the growth of deposits, advances and investments of the scheduled banks in general.

(b) Bank's business.

Efforts and achievements of the bank during the year towards attaining objectives of nationalisation should cover:

(i) Deposit mobilisation

(ii) Advances to the neglected sectors. The data regarding separate sectors may be given at appropriate places in the body of the report, as in the case of the State Bank and its subsidiaries while discussing the growth of the advances to the respective sectors, instead of giving as an appendix or annexure to the report.

(iii) The banks may also present in their report data showing the extent to which small business has been assisted and the impact of such assistance; a break-up of the limits sanctioned, percentage of total advances to small sector (for example: agriculturists holding 5 acres or less; small scale units with investments of less than, say, Rs.1 lakh, etc) to the total advances in that sector, volume of production of the neglected sectors financed by the bank, typical instances (example: village adoption scheme) where bank finance has helped a community to improve their lot, etc will give a picture of the role played by the banks in the financing of the neglected sectors.

(iv) Arrangements made for accelerating developmental activities - staff aspect, training programme, branch expansion - Bank's role in the lead bank scheme, branch expansion particularly in rural areas, introduction of special schemes for deposit mobilisation and diversification of credit, improvement in service to customers, etc.

(c) Review of bank's general growth - deposits, advances, investments, foreign exchange, any other particular field compared to previous year and compared to the performance of the scheduled banks as a class.

(d) Profit and loss - comments on larger/lesser profits - analysis of operating costs if of any particular significance.

(e) Other general matters.

It was also indicated that the advances to the neglected sectors should contain data relating to the current and previous year in respect of the number of accounts, limits sanctioned and balance outstanding to various categories of priority sector lendings and also exports.

Present position obtaining in banks

8.6 Although thus an attempt was made by the Reserve Bank after nationalisation to bring about some degree of uniformity in the structure of the directors' report, the position was not reviewed subsequently. The post-nationalisation era has witnessed several significant developments in later years and policies have undergone material alterations. In the absence of any uniform guidelines on the reporting of such later changes, individual banks developed their own independent style of relating such aspects in the directors' report. The reports of most of the public sector banks at present do contain all material developments relating to the bank during the reporting period and are fairly exhaustive and informative documents. A perusal of the directors' report of the major banks in India shows that they contain detailed information regarding the operations of the bank, achievement of social objectives by them and other items of information which are normally given by other companies in India as well as banks all over the world. The contents of the reports may be classified into three broad sections. In the section on economic environment, banks give certain broad economic indicators and the changes in the economic and monetary policies that have taken place during the year. In another section, the overall position of the banking industry, the changes that have been brought about in the sector by the banking and credit policies of the monetary authorities, the overall scenario of the banking system, the growth in deposits and advances, branch banking and other general material developments are covered. In the third section, which again is subdivided into suitable sub-sections, the reports cover the various facets of the bank's domestic and foreign activities. Thus, banks broadly discuss in this section under appropriate sub-heads, the overall position of the bank, the tempo of growth in mobilisation of resources, in the dispensation of credit and in specialised activities like foreign exchange, financing of exports, merchant banking, etc. The profit and loss position, appropriations, changes in capital and reserves, investments and other assets and liabilities are also reported. In some banks the social, community and innovative banking aspects are discussed in a separate sub-section while in certai others these aspects are dealt with under other appropriate topics like advances, branch expansion, etc. In almost all cases, however, the various aspects of social and community banking, the goals set and the achievements made are dealt with in extenso. Thus, this section covers the advances to priority sectors under various sub-sections, implementation of the socio-economic schemes like Differential Rate of Interest, Integrated Rural Development Programme, Village Adoption Scheme, Lead Bank Scheme, bank's own development schemes, etc. The extension of the bank's services particularly to underdeveloped and undeveloped areas, licences received and utilised, population groupwise classification of branches, position of the regional rural banks sponsored by the bank and other developmental activities are also discussed. In certain cases, where banks have a large number of foreign branches, a separate sub-section is included in the annual report dealing with the international operations of the bank; in other cases the operations of the foreign branches are dealt with under branch expansion. In addition to the specific topics mentioned above, the reports also comment on the organisational structure of the bank, changes brought about during the year, manpower planning and development aspects, donations and grants given, changes in directors and auditors, where applicable, special features, if any, et al.

8.7 By and large thus the directors' reports of major banks in the country as stated earlier, are fairly exhaustive and cover major areas that ought to be covered. All the same, in the absence of uniformity of presentation of data in the annual reports, a comparative study of the performance of banks on the basis of such reports has not been easy. It is in this context that the PEP Committee in its report observed that though a few instructions have been issued occasionally on matters to be brought out in the report, particularly in respect of public sector banks, there was no uniformity in the actual presentation of the salient aspects of the working of each bank during the year. As such, an assessment of the comparative performance of banks was rendered difficult. That Committee,

P.E.P.Committee's observations

therefore, recommended that the Reserve Bank should lay out the actual skeleton of the annual report which should be followed by all banks and it should cover, inter alia, some highlights on the actual performance of the bank for the year as compared to the broad objectives set before it, future strategies of growth, branch expansion, particularly specifying the rural and semi-urban areas covered; cost of bank funds, commentary on the human aspects, their deployment and training the bank's future plans in this regard and any other topical issues. The Committee also suggested that the form of the annual report should be reviewed periodically and such changes effected as the situation demanded so as to ensure that the standardisation was made adequately flexible to accommodate changes which may take place in the banking industry. The Committee, however, opined that banks should be free to add any pertinent information to highlight individual performance in areas not covered by the standardised report.

Committee's views

8.8 In the context of the practices prevailing in the foreign countries as well as in India, the relevant provisions of the Companies Act applicable to private sector companies and the special characteristics of the public sector banking system, which is the predominant component of the banking industry in the country, the Committee addressed itself to the question whether there is any need for further standardisation of the directors' report and if so whether it would be advisable to prescribe any skeleton format for such report, as suggested by the PEP Committee. The only advantage in prescribing a standardised form of directors' report will be that, to some extent, the process will ensure inter se comparability of the position reported by banks. This is, however, a moot point, While data furnished in a standardised format may be compared, the same cannot be said of descriptive passages indicating progress achieved in different fields, even if they are presented in a uniform pattern. If the authorities would require to make a comparative assessment on the working of individual banks on the basis of their annual working, the best way would be to call for a specific return in a predetermined format for the purpose. The directors' report cannot be a mechanism for such comparative assessment. Moreover different banks would be showing different levels of achievements in different fields of activities and an evaluation of the comparative performance of banks on the basis of directors' report alone may not be a very successful exercise. In any event, prescribing a skeleton format even with concessions for incorporating special characteristics of individual banks will make the reports dull and colourless and may not be in the overall interests of good reporting. This is particularly relevant as most of the reports have to circulate outside India also. If banks have the freedom to report whatever they consider important, it is quite likely that they would try to improve upon the reporting every year not only in the light of their own experience and perceptions but also on the basis of what others have reported and all banks endevouring to improve their reporting system in this manner could cumulatively achieve much more than what the prescription of skeleton format, however, well conceived, can achieve. The Committee is, therefore, not in favour of prescribing any rigid skeleton format for the directors' report.

8.9 Having said this, the Committee still appreciates the object which PEP Committee had in view while recommending the skeleton format. This objective of a certain minimum standard coverage in the annual report could be useful so long as it does not become a set pattern to be adopted rigidly and banks are not precluded in the process from trying to report nothing more and nothing less than what is contained in the skeleton. With this limited objective of ensuring some minimum coverage in the report, an attempt has been made to devise a pattern mainly on the basis of what good reports cover at present and the expected objectives of such reports. In the suggested pattern, banks will cover the following main areas.

Suggested model

(a) economic background

(b) banking developments

(c) position of the bank

i) Accounts, appropriation and position of the bank

ii) Deposits

iii) Advances

iv) Material changes in other items of assets and liabilities and specialised activities like foreign exchange, export financing, merchant banking, etc.

v) Social and community banking

vi) Branch banking

vii) Organisational structure and changes

viii) Recruitment and training of staff, man-power planning and development

ix) International Banking Operations

x) Others

8.10 Some of the more important observations banks may make under various heads are broadly indicated in the subsequent sub-paragraphs.

(a) Economic background

While giving the broad economic parameters and discussing economic and monetary policies, banks are expected to get their facts and figures from published official records. Unfortunately in the past there have been occasions when different banks depending upon different sources have given different sets of figures in respect of some economic indicators. Banks should as far as possible use data contained in official publications of Government and Reserve Bank of India only. Banks may also give their comments and conclusions based on their own perceptions of the implications of the policies of the authorities; needless to say, such comments should be in good taste and form.

(b) Banking developments

The performance of the banking system in general in respect of deposit mobilisation, credit disbursement, branch expansion, attainment of social obligations, etc may be usefully mentioned under this head. This is to enable banks to evaluate their own performance in comparison with that of the system as a whole. The important developments in respect of banking and monetary policies and banks' own perceptions of the implications of such changes may also be covered in this section.

(c) Position of the bank

The various aspects covered under this section may be divided into suitable sub-sections with appropriate headings as indicated earlier. Broadly the report may cover the following aspects.

(i) Accounts, appropriation
and position of the bank

The working results and the proposed appropriations and how they compare with earlier appropriations, general observations about position of the bank and any developments during the period that have affected its fortunes in particular may be furnished under this heading.

(ii) Deposits

The tempo of growth in deposits may be dealt with under this head. Normally, banks should give under 'deposits' the comparative growth rate over a period and the bank's performance in relation to the growth of the system as a whole, number of accounts and amounts as well as growth in various categories of deposits, progress achieved through special schemes of deposit mobilisation, etc. While commenting on the growth of deposits banks should also give apart from comparative year-end figures, the comparative position in respect of the fortnightly average deposits. Wide discrepancies in year-end and average figures should also be suitably explained.

(iii) Advances

Comparative data as in the case of deposits, rate of expansion of the credit portfolio in general and advances to various sectors are to be broadly covered in this section.

The comparative position of growth in fortnightly average credit also should be indicated and where necessary, reasons for wide variations, if any, between year-end and average credit figures should be furnished.

(iv) Material changes in other main items of assets and liabilities

In this sub-section developments in regard to other items in the balance sheet like capital and reserves, other sources of funds, investments, premises, etc and also other features relating to specific activities of the bank, which it wants to highlight like foreign exchange business, export financing, merchant banking and other specialised functions and financial services on which the bank has something to relate may be reported. Improvement in efficiency achieved during the year in functional areas (for instance, cash and funds management, staff efficiency indicators, economy in expenditure, etc) may also be brought out in this section under suitable headings.

(v) Social and Community banking

Normally, there should be a separate section dealing with the progress achieved by the unit on social and community banking. At present some banks cover these aspects under advances and branch banking. Considering that one of the primary objectives of bank nationalisation has been extension of credit to the needy and weaker sections of the society, it is but appropriate for banks to deal with this aspect in the directors' report in detail. This section may, therefore, give an overview of the bank's performance in priority sector lending viewed in the context of the targets fixed, as also detailed comments on the progress made in various sub-sectors like agriculture, small-scale industry, transport operators, professional and self-employed persons, small business, retail trade, education, housing, etc.

It is the general practice among banks to give separate detailed comments on the major groups of priority sector lendings like agriculture, small-scale industry, etc. This practice may continue. Banks should also give in this section comparative data for at least 3 years in respect of the number of accounts, limits and outstandings apart from the latest data vailable. Banks may analyse in this section the goals expected to be reached and the actual performance, studies made in evaluating the success of the various schemes implemented by them, comments on specific schemes introduced by Government, Reserve Bank and other institutions like National Bank for Agriculture and Rural Development, Industrial Development Bank of India, etc for the benefit of the weaker sections. In particular specific comments would be useful on certain aspects like performance in implementing schemes of national importance like Differential

Rate of Interest Scheme, Integrated Rural Development Programme, Village Adoption Scheme, Lead Bank Scheme, District Credit Plans, 20 Point Economic Programme, etc and other developmental schemes which banks themselves have introduced from time to time. The observations under this section would be interesting if banks could give instances of success stories under various schemes, financial and analytical studies made, difficulties observed in the implementation of the schemes and how they have been overcome.

(vi) Branch banking

Banks may give in this part an overall position of the bank's branch position, the population group-wise break-up of the branches, penetration achieved in the underdeveloped and undeveloped areas, the licences received during the period under review, branches opened and other details. The operations of the specialised branches, if any, and the impact made by the bank's branches in development of rural and semi-urban areas, suggestions for improving the banking services to the community through branch banking and specialised branches may also be incorporated in this section. In addition, the comments on the working of the regional rural banks sponsored by the bank may also be included here under a separate heading.

(vii) Organisational structure

The changes in the structural set-up of the bank during the period of the report, changes in the areas of control and functional responsibilities of the various tiers of the organisation, changes and improvements effected in the internal working in keeping with the developing demands on the banking sector, etc may be covered in this section.

(viii) Staff recruitment and training, man-power planning and development

Apart from indicating the overall position of staff in various categories, changes in their employment terms and other related matters, banks should also report under this head their achievements in the implementation of Government/Reserve Bank guidelines on recruitment and training of Scheduled Caste/Scheduled Tribe personnel, handicapped persons, women and such other particulars as are necessary. In addition, banks may also give particulars of the training arrangements obtaining in the bank, the progress made in establishing training institutions and in imparting training to the increasing number of candidates and other relevant aspects relating to human resources development, staff relations, etc.

(ix) International banking

Banks which have significant presence abroad may like to have a separate section to report the developments in their international banking activities. In other cases banks may include the relative comments under foreign exchange operations, branch licensing, etc. In this section banks may review generally the international developments that have taken place in the foreign countries which have an impact on its operations in these countries. More importantly this section should cover a detailed analysis of the performance of their branches in different countries, the growth in their deposits and other resources, advances, significant changes in other assets and liabilities, working results, etc. Material changes in the activities of the bank in different countries may also be reported in this section. Apart from giving country-wise operational data, this section should also give a consolidated picture of the foreign operations as well.

(x) Other features

This section deals with other aspects that are not covered in the earlier sub-headings. Typically, this section may include the progress made in the use of Hindi, donations and grants made during the year and other special features like reaching a particular mile-stone (say diamond jubilee), awards and recognition won during the reporting period, etc. In addition this section should also include customary or mandatory items to be reported by companies like changes in directorate, auditors, remuneration paid to staff over certain limits and management's explanation on the qualifications made by auditors, etc. Items of topical interest currently exercising the minds of public, government, etc (for example balancing of books, inter branch reconciliation, mechanisation, frauds and other mishaps, customer service, etc.) may also be highlighted in this section. The endeavour should be to bring out these aspects in their proper perspective and to indicate the steps taken by the management to set right the position where corrective action is called for.

8.11 The Committee would again make it clear that it is not its intention to prescribe any particular skeleton format for the directors' report. It has only indicated certain topics which could profitably be dealt with in the directors' report and the order in which they may be presented. If the board of any particular bank in its wisdom decides to incorporate additional data and information in their report, it would be its prerogative and the Government and Reserve Bank should not, in the opinion of the Committee, interfere with that freedom.

* In Chapter IX, the Committee has recommended deletion of this item from the directors' report. If this recommendation is accepted, such particulars may not be furnished in the report.

CHAPTER IX

MISCELLANEOUS ISSUES

9.1 Introductory — In this chapter certain legal and other issues relating to the terms of reference are discussed.

9.2.1 Publication of annual accounts of banks — In terms of Section 31 of the Banking Regulation Act, the accounts and balance sheet together with the Auditor's Report shall be published in the prescribed manner, which has been indicated in Rule 15 of the Banking Regulation (Companies) Rules, 1949. According to the Rules, the balance sheet and profit and loss account together with the Auditor's Report shall be published within a period of six months from the period to which they relate in a newspaper which is in circulation at the place where the banking company has its principal office. The object of this Rule is to give publicity to the accounts of a banking company so that its depositors and the public should know the financial position of the bank as disclosed by its published balance sheet, etc.

9.2.2 The PEP Committee which had examined the issue suggested that only an abridged form of balance sheet and profit and loss account need be published. In February 1979, the public sector banks were advised by the Reserve Bank that while they should publish the balance sheet and profit and loss account in full, together with the Auditor's Report in one newspaper to comply with the statutory requirements of Section 31 of Banking Regulation Act, they should, where it is considered necessary to give a wider coverage to the salient features of the banks' operations, abridge the balance sheet and profit and loss account suitably for the purpose of publication in additional newspapers, journals, etc. This was done at the Government's suggestion basically for effecting economy in the expenditure of public sector banks.

9.2.3 The basic purpose of publishing the balance sheet and profit and loss account is to give publicity to the accounts of a bank so that its depositors and public should come to know of its financial position. The summarised version of the proposed formats of balance sheet and profit and loss account (without the various schedules, accounting policy statement notes and auditor's report attached thereto) suggested by the Committee would be best suited for the purpose of publication in the newspapers i.e. for compliance with Section 31 of Banking Regulation Act. For this purpose suitable amendments to Section 31 of Banking Regulation Act and Rule 15 of Banking Regulation (Companies) Rules, if necessary, may be made. These summarised formats will give to the depositors and public all the vital information relating to the working/financial position of the banks on a uniform basis. This will also bring about reduction in the cost of publishing lengthy statements as is being done at present.

9.3.1 While the requirements of publication under Section 31 of the Banking Regulation Act will be met by publishing the summarised version of the balance sheet and profit and loss account as indicated in the preceding paragraphs, banks will be required to submit as returns to the Reserve Bank the full set of final accounts in the proposed formats including the schedules thereto, accounting policy statement, notes on accounts as proposed by the Committee, as also the auditor's report. Having regard to this objective while amending the Act for introducing the revised formats, only the summarised version and schedules thereto will be prescribed as forms

Amendments to the Banking Regulation Act for introduction of the revised formats in the Third schedule. For the sake of convenience and flexibility, the Reserve Bank should be vested with powers to give instructions to banks generally or any bank in particular regarding compilation of accounts, accounting policies, notes on accounts and other guidelines to be followed. The Reserve Bank may issue such guidelines and instructions for compilation on the basis of the recommendations made by the Committee. Suitable amendments to the Banking Regulation Act may have to be effected for the purpose.

9.3.2 It may be mentioned in this context that under Sub-Section(4) of Section 29 of the Banking Regulation Act, the Central Government may after giving appropriate notice amend the formats set out in the Third schedule. Government may consider whether the format of balance sheet and profit and loss account proposed by the Committee can be substituted for the existing formats, pursuant to the amending powers conferred on it by sub-section (4) of Section 29 of the Banking Regulation Act, or an amendment to the Act itself will be necessary for the purpose. Even if the former alternative is feasible, the Act may have to be amended to ensure that the full sets of final accounts are submitted to the Reserve Bank of India as returns and also to enable Reserve Bank to issue necessary guidelines to banks regarding compilation of the accounts, accounting policy statement and notes on account.

Guidelines to Auditors

9.4.1 Sub-Section (1B) of Section 30 of the Banking Regulation Act confers on the Reserve Bank limited powers of giving direction to auditors of the bank requiring them to audit the accounts in relation to any specific transaction or class of transactions. These provisions have not been made applicable to the public sector banks by Section 51 of the Banking Regulation Act. The Committee is of the view that it would be desirable if the Reserve Bank is entrusted with powers to direct special audit, in certain cases, similar to those conferred on the Central Government under Section 233A of Companies Act. No doubt, the grounds on which the Reserve Bank may issue such directions may, in keeping with the policy and the scheme of the Banking Regulation Act, be somewhat different from those contained in Section 233A of the Companies Act. The provision to be enacted on the lines of Section 233A should be made applicable to all banks. Sections 30 and 51 of the Banking Regulation Act need to be suitably amended for the purpose.

9.4.2 Section 619 of the Companies Act provides that in the case of a Government company the Comptroller and Auditor General of India shall have powers to direct the manner in which the company's account shall be audited and to give instructions to the auditor in regard to any matter, relating to the performance of his functions as such. As the Reserve Bank may also be required to give such guidelines to bank auditors in respect of particular transactions to be covered by the audit, the Committee considers it desirable to amend the Banking Regulation Act to vest similar powers in the Reserve Bank of India to issue suitable guidelines to bank auditors.

Legislative provisions regarding amendment of forms of balance sheet and profit and loss account

9.5. Sub-Section (4) of Section 29 of the Banking Regulation Act (prescribing Forms of balance sheet and profit and loss accounts for a banking company, vide Forms A and B of the Third Schedule to the Banking Regulation Act, 1949) provides that the Central Government, after giving not less than three months' notice of its intention so to do by a notification in the Official Gazettee may from time to time by a like notification amend the Forms set out in the Third Schedule. In pursuance of the provisions contained in this sub-section, two notifications have to be published by the Government of India after receiving proposals from the Reserve Bank of India. First such notification containing the draft amendments published by Government will be for putting every banking company on its guard so that it may not be inconvenienced by amendments suddenly thrust on them. The final notification will be published by Government three months after the date of first publication. The amendment actually effected must be substantially the same as that of which notice was given. The Committee does not consider it necessary to make any changes in the existing provisions. As the instructions to be issued by the Reserve Bank of India to banks regarding compilation of accounts, accounting policies and notes on account will not form part of the statute or rules thereto, no legal formalities will be required for amending such instructions.

9.6.1 The format of the profit and loss account

Particulars of remuneration paid to the Chief Executive Officer and certain categories of employees

prescribed under the Banking Regulation Act requires banks to furnish a note containing particulars of remuneration relating to the Chief Executive Officer under certain prescribed heads. Banks are complying with this requirement currently by attaching a statement to the profit and loss account containing such information. The remuneration of the Chief Executive Officers of the banks in the public and private sectors is fixed by Government/ Reserve Bank of India and such remuneration is standardised. There is therefore no need for including the information relating to the remuneration of the Chief Executive Officer in the profit and loss statement. The Committee has not accordingly made any provision for inclusion of such data in the revised formats.

9.6.2 Similarly in terms of Section 217 of the Companies Act, the report of the Board of Directors should give particulars of the remuneration paid to the employees of the company drawing a remuneration of not less than Rs.36,000/- per annum during the financial year or not less than Rs.3,000/- per month in the case of employees employed for part of the year.

Although the requirements of Section 217 of the Companies Act are not applicable to the public sector banks, which are not covered by the Companies Act, and they do not therefore give such particulars in their directors' report, in the case of private sector banks, it is necessary to incorporate such particulars in the directors' report and most of the banks give such data in a separate statement attached to the directors' report. The remuneration of employees of private sector banks are, as in the case of public sector banks, governed by settlements and awards. They are also standardised and are well known to the public at large. There does not therefore appear to be any particular need for giving such information in the directors' report in the case of private sector banks also. Suitable amendments may be made to the Companies Act/Banking Regulation Act to give effect to this recommendation.

Creation of special reserve

9.7.1 Section 36 of the Income Tax Act, 1961 has been amended by the Finance Act, 1982 by adding a sub-clause in terms of which a scheduled bank (other than a bank incorporated by or under law of a country outside India) which is engaged in banking operations outside

India will be entitled to deduction in the computation of its taxable profits in respect of any special reserve created upto 40% of its total income. However, this provision applies only to such scheduled banks as are approved by the Central Government for the purpose of this clause, having regard to its capital **structure, the extent of the** operations outside India, its need for resources for operations outside India and other relevant factors.

9.7.2 It may be recalled that the PEP Committee in its report had recommended that banks be allowed to transfer at least 40% of the disclosed profits to reserves, free of tax. The James Raj Committee had also made a similar recommendation. The recommendation was made in the context of the need for increasing the capital base of Indian banks, which is very low.

9.7.3 The Committee agrees with the above recommendations, as there is need to increase the capital base of all banks i.e. banks both in the private and public sectors. As such, the benefit should ideally be made available to all scheduled commercial banks irrespective of whether they have offices outside India or not. It may be added that this benefit has since been extended to all State

Financial Corporations. For this purpose, the Committee is of the view that necessary amendments should be made to the Income Tax Act as early as possible.

Revaluation of premises etc.

9.8.1 Some of the foreign banks (including banks which have branches in India) have been revaluing their immovable properties on the basis of market value and the difference between the written down book value before the revaluation and the appreciated value is being transferred to 'capital reserve' to strengthen their capital base.

9.8.2 It may be relevant here to mention that the Reserve Bank had advised all commercial banks in 1969 that the profit on sale of fixed assets like land, premises, etc should, from the point of view of accounting principles and sound banking practice, be treated as capital reserves, not available for payment of dividend, etc. In the case of Indian branches of foreign banks such remittances of capital nature are also not allowed.

9.8.3 There is no provision in the Companies Act prohibiting companies from revaluing their fixed assets like buildings, premises, etc and many companies are observed to be resorting to this practice lately. However, in the case of a banking company, the position is somewhat different. An assessment of the assets and liabilities of a bank is made primarily to see whether the bank is complying with the requirements of Sections 11 and 22 of the Banking Regulation Act. A revaluation of assets will inflate the real or exchangeable value of their paid-up capital, reserves, provisions and other items not in the nature of outside liabilities, unless such reserves created out of revaluation of properties are not reckoned as part of the owned funds.

9.8.4 However, it is now the practice in some foreign countries as well as companies in India to revalue their properties and take the resultant appreciation to Capital Reserve Account. As compared to foreign banks the equity base of the Indian commercial banks is very low. Indian commercial banks are at present in a disadvantageous position because of their low capital base particularly as this is one of the important factors taken into account for securing agency/borrowing arrangements outside India and for participation in loan syndication activities. Considering all relevant factors, the Committee suggests that it would be desirable if the Indian banks are allowed to revalue their properties, subject to Reserve Bank clearance, by professional valuers at periodical intervals, provided the consequential profits are transferred to capital reserves. To some extent, such periodical valuations may help in giving an inflation adjusted assessment of the principal non-monetary assets of banks. Revaluations if resorted to should be clearly indicated in the balance sheet and/or notes attached thereto of the bank. Where assets are revalued, depreciation should be provided on the revalued figure. There should however be no objection to the additional depreciation due to revaluation being transferred each year from the Capital Reserve to the profit and loss account or to the general reserves.

CHAPTER X

SUMMARY OF RECOMMENDATIONS

10.1 The Committee's major observations and recommendations on the various terms of reference are given in the following paragraphs:

Disclosure in published accounts

10.2.1 The Committee has considered the disclosure requirements from three broad aspects, viz. (a) truth and fairness concept, (b) analytical data and (c) accounting policies. While examining the 'truth and fairness' concept, three main aspects have been covered and they are (a) secret reserves and loan loss provisioning, (b) grouping and offsetting practices and (c) window dressing (Chapters II to V).

Secret reserves and loan loss provisioning

10.2.2 The Committee is of the view that in Indian conditions the time is not yet opportune for practising full disclosure in respect of secret reserves and loan loss provisioning. The issue, however, may be reviewed in due course. It is, however, of the opinion that correct income should be reported in the profit and loss account and the amount transferred to contingencies may, therefore, be shown along with various other provisions for depreciation on investments, income tax, specific provisions for bad debts, etc as a 'conglomerate' item on the expenditure side. This would reveal the true trend of income and at the same time the procedure would not reveal the amount of secret reserves and loan loss provisions held by banks. (Paragraphs 3.23, 3.24).

Grouping and nettings

10.2.3 The Committee considers that rationalisation of the practices relating to grouping and offsetting is necessary and that clarifications should be given when disparate items are grouped together or netted. These aspects have been taken care of while devising the formats for final accounts. (Paragraphs 3.25.1 to 3.25.4).

Window dressing

10.2.4 The Committee is of the opinion that by and large bank managements are fully seized of the pitfalls of window dressing and considers that there is no case for any drastic measures to weed out the practice. In exceptional cases where bank managements resort to such practices, the Reserve Bank should continue to caution the concerned management. It could also in extreme cases of indiscretion take punitive action against the delinquent officers. (Paragraph 3.26.1 to 3.26.10).

Analytical data in the annual accounts

10.3 The Committee has looked into the general practices obtaining in some of the developed countries in the matter of presentation of analytical data along with the final accounts and finds that there is no uniformity among banks in such presentation. However, there are certain broad areas where such analytical data are usually furnished by banks and the Indian banks also may gainfully adopt the practice. (Paragraph 4.1 to 4.12).

Accounting Policies

10.4 The Committee is of the view that the Indian banks may disclose their accounting policies at one place under the head 'Principal Accounting Policies' and has prepared a specimen form for the enunciation of accounting policies pursued. These will cover, inter alia, the following areas.

a) Basis of presentation of accounts
b) Basis of valuation of securities
c) Practices relating to loan loss provisioning and contingency funds
d) Mode of valuation of fixed and other miscellaneous assets and depreciation
e) Practices adopted in making provision for staff benefits
f) Adjustments made before disclosing net profit

(Paragraphs 5.1 to 5.8 and Annexure V).

Formats of Balance Sheet and Profit and Loss Account

10.5.1 For the sake of uniformity in the presentation of accounts and having regard to the need for disclosure of adequate information in the published accounts, the Committee has suggested revised formats of balance sheet and profit and loss accounts. The formats consist of summary versions of balance sheet and profit and loss accounts, supported by schedules. The Committee has also indicated the coverage and contents of the various items in the balance sheet and profit and loss accounts and has prepared necessary guidelines for compiling the final accounts with a view to ensuring that the final accounts so prepared by different banks will be on uniform, standardised basis. (Paragraphs 6.1 to 6.24 and Annexure VI).

10.5.2 The Committee has further suggested a standardised procedure for reckoning foreign exchange income and for consolidation of accounts of foreign offices in the final accounts. (Paragraph 6.25).

10.5.3 The Committee has also indicated where clarificatory notes are to be given in respect of the balance sheet and profit and loss items and a specimen form in which such notes on accounts may be furnished by banks has also been prescribed. Such notes cover increase in capital, interest rates on deposits, investments in subsidiaries/associates, valuation of other investments, requirements of sectoral allocation of advances and interest rates on different classes of advances, revaluation of assets and major heads of miscellaneous income and other expenditure.(paragraph 6.26 and Annexure V).

10.6 The Committee's recommendations on provisioning are mainly as follows.

Norms for creating various provisions and accounting practices - Loan loss provisioning

a) Provisions for bad and doubtful debts need be made only to the extent such debts are not covered by credit insurance agencies (Paragraph 7.2.2).

b) As the tax laws stand at present, banks should make provisions on a gross of tax basis.(Paragraph 7.2.3).

c) Debts recognised as bad should be written off within a reasonable time after such recognition. (Paragraph 7.2.5).

d) A suitable system of appraisal of the advances portfolio and review of individual advances is considered necessary by the Committee in the context of standardisation of the procedure for loan loss provisioning. The Committee is of the opinion that bank advances should be classified on the basis of health codes. Such classification would facilitate identification of debts where provisioning is necessary. (Paragraph 7.2.7 and Annexure VIII).

e) It will be necessary to assess the amount of doubtful debts in respect of larger advances with balances of Rs.5 lakhs and above individually. In respect of smaller advances to the extent possible, the provisions may be made on actual basis but as the number of such advances may be large, provision may also have to be made on a percentage basis depending on the loan loss experience of the bank. The percentage needs to be reviewed periodically, say once in three years. (Paragraph 7.2.9).

f) Generally, no interest should be taken into account unless realised on recalled advances, suit-filed accounts and decreed debts. As regards sick/sticky advances the question of charging interest will depend on the assessment of realisability. Ideally, no interest should be charged on such advances in this category where the principal amount is considered as bad or doubtful in part or in full except on a realisation basis. But there is no objection to interest being charged on such advances as are not considered bad or doubtful either in whole or in part. As regards smaller advances in the category, to the extent provision is made, interest also should not be taken into account. (paragraph 7.3.2).

g) One of the methods followed by banks in the matter of accounting interest on advances not considered as realisable in full is not to treat interest charged on such advances as income and instead credit such amount to a suspense account. In view however of some income tax ruling, banks have since changed the procedure and ceased charging interest on such accounts. For the sake of proper control, the interest on such advances should be booked and credited to interest suspense account.
(Paragraph 7.3.3).

h) All provisions made for bad and doubtful debts and provisions made by way of interest on bad and doubtful debts kept in suspense account should be exempt from tax, provided the aggregate outstandings in such provisions do not exceed 5% of the total outstanding advances at the end of the relevant period. (Paragraph 7.4.1).

Valuation of Investments

i) Investments should be segregated into 'permanent' and 'current' categories. The actual level upto which the securities should be held in the permanent and current categories may be decided by the Reserve Bank of India from time to time depending upon the prevailing circumstances. The permanent investments will be valued at lower of cost or redemption value and the current investments at the lower of cost or market value. (Paragraph 7.5.15).

Retirement benefits to staff

j) Liability in respect of post retirement benefits like Gratuity and Pension Funds should be estimated on an actuarial basis and such commitments should be funded every year irrespective of the availability of profit. (Paragraph 7.6.1).

Assessment of tax by the Tax Authorities

k) The assessments in regard to tax payable by banks should be taken up expeditiously by the Income-Tax Department and refunds given to banks without delay. (Paragraph 7.7.2)

1) There is also a case for doing away with the practice of

Deduction of tax at source on Government securities

deducting tax at source on Government securities held by banks; at least the rate at which the deduction is made will have to be substantially reduced, say to 10% or so. (Paragraph 7.7.3).

10.7. The other major recommendations made by the Committee are as follows :

a) The Committee does not consider it necessary to prescribe

Directors' Report format and contents

any skeleton format for the Directors' report. Certain topics which could profitably be dealt with in the Directors' report and the order in which they may be presented are however indicated. (Paragraphs 8.8 to 8.10).

b) For the purpose of complying with the statutory requirements of publication of balance sheet and profit and loss accounts,

Publication of annual accounts of banks/ Returns to Reserve Bank

the Committee suggests that only the summarised version of the formats (without the schedules, accounting policy statement, notes and auditor's report) would be best suited. Banks will be required to submit as returns to the Reserve Bank the full set of final accounts in the prescribed formats including the summary version, schedules attached, accounting policy statement, notes on account and also the auditor's report. (Paragraph 9

c) In order to give effect to the changes in the formats of balance sheet and profit and loss account as also the publication of only the summarised version, it may be necessary to make certain changes in the Banking Regulation Act. (Paragraph 9.3.1).

Amendments to Banking Regulation Act

d) It would be desirable if the Reserve Bank is entrusted with powers to direct special audit in the case of all banks and also to give guidelines to bank auditors. (Paragraphs 9.4.1 to 9.4.2).

Guidelines to auditors

e) There is no need for giving particulars of remuneration paid to the Chief Executive Officer in the profit and loss statement of banks nor for furnishing the information relating to remuneration paid to certain categories of staff in the directors' report of private sector banks. (Paragraph 9.6.1).

f) The Committee is of the view that the benefit of creating tax free special reserves conferred by amendment of Section 36 of the Income Tax Act, 1961, should be made available to all scheduled commercial banks whether they have offices outside India or not. (Paragraphs 9.7.1 to 9.7.3).

Creation of Special Reserve

Revaluation of premises, etc.

g) Indian commercial banks may be allowed to revalue their properties, subject to Reserve Bank clear by professional valuers, at periodical intervals, provided the consequential profits are taken to capital reserves. (Paragraphs 9.8.1 to 9.8.4).

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Chairman

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B. Ratnakar
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Sampat P. Singh
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Y.H. Malegam
Member

R. Narasimhan
Member

V.G. Hegde
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M.L. Inasu
Member-Secretary

Bombay
March 1985.

Annexure I

DISCUSSION PAPER: Disclosures in financial statement of banks

This Discussion Paper is issued by the International Accounting Standards Committee for discussion only and does not necessarily represent the views of the Governing Bodies of its members.

In pursuit of one of its principal objective, the harmonisation of accounting standards through its member bodies around the world, the International Accounting Standards Committee (IASC) has initially selected for study topics applicable to business enterprises generally. The IASC Board recognises that effective harmonisation of accounting standards will also involve the study of appropriate accounting practices for particular industries; this Discussion Paper is concerned with the banking industry. As a result of discussions with the Committee on Banking Regulations and Supervisory Practices of the Group of Ten major industrialised countries and Switzerland (the Basle Committee of Banking Supervisors), who perceived a need to devise a standard letter for confirming inter-bank balances. It was thought that it would be helpful as a first step to prepare a paper dealing with classifications and disclosures in the financial stements of banks. Accordingly, IASC agreed to undertake this project. Both the IASC Board and the Basle Committee of Banking Supervisors recognise that harmonisation of methods of valuation and income measurement of banks will require further study, but they agree that a first step is that of the extent of disclosures in the financial statements of banks.

This Discussion Paper is put forward by the International Accounting Standards Committee for discussion and comment. The issue of the paper as a contribution to the general debate is welcomed by the Committee on Banking Regulations and Supervisory Practices of the Group of Ten major industrialised countries and Switzerland in recognition of the benefits that they believe are to be derived from work directed towards the harmonisation of the financial reporting practices of banks throughout the world. However, the contents of the paper do not necessarily represent the views of the governing bodies of the members of IASC or of Basle Committee of Banking Supervisors. It is possible that, in due course, the IASC may issue a Statement of International Accounting Standards on the matters covered in this Discussion Paper.

The preparation of a standard inter-bank confirmation request is being dealt with by the International Auditing Practices Committee of the International Federation of Accountants.

INTRODUCTION: 1. A bank, or similar credit institution, is generally understood to be an enterprise with the primary function of taking deposits and borrowing with the objective of lending and investing for gain.

2. To the extent that an enterprise's activities correspond to those discussed and illustrated in this Discussion Paper or are within the scope of banking or similar legislation in its own country, the contents of this Discussion Paper would be relevant whether or not the enterprise has the word 'bank' in its name.

3. The contents of this Discussion Paper are in two main sections: first, a consideration of the need to harmonise bank financial reporting standards and second, guidelines, for the development of disclosures in financial statements of banks.

HARMONISATION OF FINANCIAL REPORTING OF BANKS:

4. Through-out the world existing requirements for disclosure in the financial statements of banks are most often established by legislation and by practice encouraged by governments through their official regulatory

authorities. To date, few pronouncements on bank financial reporting have been made by accountancy bodies and internationally consistent practice have not yet developed for the form of, and disclosures in, the financial statements of banks. This is because differing views are taken in individual countries of the need for desirability of, extensive disclosures of financial information, either as to the nature and details of bank's activities or to the extent to which capital resources may be understated through the maintenance of hidden reserves. Reasons for this diversity include the differing degrees of importance attributed to the role of disclosure in financial statements of banks and its contribution to maintaining stability in the banking sector and to an efficient supervisory function.

5. A central question in considering the financial reporting of banks is whether banks should fall outside normal accounting conventions and, to whatever degree be

treated differently from other enterprises, both as regards disclosure of information and continuance of the practice of maintaining hidden reserves. This question will continue to be debated. Even if it is considered that banks should conform to normal accounting conventions, the disclosures in the financial statements of banks will differ from those of other commercial and industrial enterprises because of different nature of the transactions and operations of banks.

6. In preparing this Discussion Paper, it has been recognised that developments in bank financial reporting are taking place in many different parts of the world. This Discussion Paper represents the International Accounting Standards Committee's initial contribution to and participation in those developments.

7. The next section of this Discussion Paper sets out guidelines for the future for achieving consistency of disclosure and in the presentation of the financial statements of banks. These guidelines are proposed on the basis of what is believed to be best

practice capable of practical application by banks, aside from any constraints imposed on reporting by local law.

GUIDELINES FOR DISCLOSURES IN FINANCIAL STATEMENTS OF BANKS:

8. This Discussion Paper does not propose a specific format for the presentation of financial statements of banks, but certain minimum disclosures are suggested. An appendix to this Discussion Paper gives an illustration of some specific disclosures.

9. The guidelines are framed on the basis that every International Accounting Standard applies to banks unless such a standard excludes banks from its applicability.

10. All banks do not use the same methods of valuation and income measurement. While harmonisation of these methods is a desirable objective, it is beyond the scope of this Discussion Paper. However, International Accounting Standard 1. Disclosure of Accounting Policies, requires disclosure of the methods of valuation and income measurement to enable the users of financial statements to understand the basis on which they are prepared.

BALANCE SHEET:

11. Among the major considerations in requiring disclosure in the financial statements of banks are the demonstration of liquidity and the solvency of the bank and the relative degree of risk that may attach to different assets and liabilities and to concentrations of assets and liabilities. Not all aspects of a bank's liquidity solvency and potential risk can be demonstrated in financial statements. However, many informative disclosures can be made, such as those discussed in the following paragraphs:

Classification of assets and liabilities by nature:

12. The most common approach to classifying assets and liabilities in the balance sheet is to group them by their nature and list them in the approximate order of their liquidity, which may equate broadly to their maturities. Different categorisations and groupings of assets and liabilities are found in the balance sheet and may include distinctions between current and non-current dealing securities and investment securities and balances with other banks and balances with non-banks.

Categorisations such as these have varying degrees of usefulness and applicability in the financial statements of banks. It is generally found that the current:non-current distinction has limited usefulness because of the nature of a bank's business.

13. It is generally considered important in the financial statements of banks to distinguish between dealing and investment securities. Investment securities are securities acquired for the long term and dealing securities are securities acquired with the intention of reselling them in the short term. Different methods of valuation exist and it is usually considered important that whatever categorisations are used, the basis of classification and valuation adopted is clearly disclosed. For example it is expected that the market value of both dealing and investment securities would be disclosed if different from the carrying amount in the financial statements.

14. Many banks distinguish between their business with other banks and their business with non-banks. This distinction is relevant because of the different type of business and to give an understanding of a bank's relations with, and dependence on, other banks. However, making this distinction may not always be possible, for example, in the case of deposits or funds obtained through the issue of a bank's own certificates of deposit or other negotiable paper.

15. The content of, and therefore the terminology used in, the financial statements of banks differ in many instances from those in the financial statements of other industrial and commercial enterprises. Consequently, it is important to make clear the nature of significant items within the balance sheet captions of a bank's financial statements. The following examples illustrate some of the items that typically may be included under certain of a bank's balance sheet headings:

Cash

Notes and coin

Money market paper

Treasury paper.

Certificates of deposit.

Loans and advances

Commercial loans, Personal loans

Overdrafts, Leasing receivables.

Accounts with depositors

Sight or demand deposits, Time Deposits,

Fixed term depsits.

Acceptance and promissory notes

Own acceptances, Promissory notes,

Other negotiable paper issued.

Significant items should not be grouped with other items without separate identification. Offsetting of items would only be appropriate if a legal right of set-off exists and the offsetting represents the expectation as to the realisation or settlement of the asset or liability.

Analysis of assets and liabilities by maturities

16. As well as listing assets and liabilities in their approximate order of liquidity, a further useful disclosure is an analysis of individual assets and liabilities by maturities. The maturities of assets

and liabilities and the ability to replace, at an acceptable interest cost, interest bearing liabilities as they mature are important factors in a bank's liquidity management, which involves having access to sufficient funds to meet deposit withdrawals and to repay borrowings as they become due.

17. Banking practices and the availability of funds to banks vary from country to country. In some countries short term funds are available, in the normal course of business or in emergency, from the national market or from the central bank, while in other countries this is not the case. Accordingly, such evaluation of liquidity as is possible from a bank's financial statements is made in the context of knowledge of local banking practices.

18. Much of the business of banks is of uncertain term. In many countries, deposits made with a bank may be withdrawn on demand and advances given by a bank may be repayable on demand. However, in practice, deposits made with a bank and advances given by a bank are often maintained

for long periods without withdrawal or repayment. Although the contractual repayment period is often not the effective period, either for deposits made with a bank or for loans and advances given by a bank, a means of analysis of maturities in the financial statements should be established the problem of contractual as opposed to effective maturity applies equally to both assets and liabilities. The remaining period to the agreed repayment date is most often used for the purposes of analysis in the financial statements of banks.

19. Maturity groupings that may be applied to individual assets and liabilities can differ between banks and in their appropriateness to particular assets and liabilities, examples of periods used may include some of the following:

Sight (maturing on the next business day) or demand.

Less than eight days.

From eight days to one month.

From one month to three months.

From three months to one year.

From one year to five years.

From five years and over.

Frequently these periods are combined; in the case of loans and advances, for example, by grouping those under one year and those over one year. When repayment of an asset or liability is spread over a period of time, the allocation of each repayment to maturity groupings should be based on the remaining period to the agreed repayment date of each instalment.

20. The matching and controlled mismatching of the maturities of assets and liabilities is fundamental to the management of a bank. This is because it is unusual for banks ever to be completely matched since business transacted is often of uncertain term and of different types and an unmatched position potentially enhances profitability. However, whatever maturity groupings are used by a bank in its financial statements, it is most useful if the periods adopted for the analysis are similar for assets and for liabilities in order to make clear the extent to which the maturities of assets and liabilities are matched and the consequent dependence on other sources

of liquidity. For a full understanding, such information may need to be supplemented by information as to the likelihood of repayment within the remaining period.

Concentration of assets and liabilities:

21. Uses of the financial statements of banks are likely to be interested in whether there is substantial concentration either in the distribution of the bank's assets or in the source of its liabilities. Such substantial concentration of assets and liabilities, which might increase the likelihood of risk to the bank, is unusual but, if such concentration exists, disclosure might usefully be made. Analysis by geographical areas or by customer group, such as government, public authorities and private enterprises, might be examples of this disclosure. It may also be appropriate to accompany such disclosures with an explanation of the circumstances.

INCOME STATEMENT :

22. The principal types of income arising from the operations of a bank are interest income, fees for services, and dealing results. Disclosures in the income statement of a bank are most appropriately made by type of income rather than by source of, income, although any further analysis would usefully include disclosure by source. Offsetting of income and expense items would not be appropriate.

23. In order to give a better understanding of the composition of and reasons for changes, in net interest income, interest income and interest expense should be disclosed separately. Since net interest income is a factor both of interest rates and of the amounts of borrowing and lending, a useful understanding may often only be obtained if further information is given, for example, of average interest rates, average interest earning assets and average interest bearing liabilities for the period.

LOAN LOSSES :

24. It is inevitable that in the ordinary course of business banks suffer losses on loans, advances and other commitments as a result of their becoming partly or wholly uncollectable. Losses on loans and advances can have an important effect on the results of a bank, and banks generally make provisions, by charges against income, for possible loan losses. These provisions are available to absorb both write downs of specific receivables considered to be uncollectable and to cover other loans and advances presently seemingly collectable, which in view of the inherent probability **based on experience** may subsequently prove uncollectable. Such a provision allows a matching of accounting income and expense by adjusting for timing differences between the receipt of income on loans, advances or other commitments and any subsequent defaults and by providing for the as yet unidentified losses in a bank's present loans, advances and other commitments. While an assessment of the requirement for a provision for losses on loans, advances and other commitments depends on the

judgement and experience of the bank's management, the provision should be established and maintained on a consistent basis.

25. It is considered important that disclosure is made of the basis on which provision for loans losses is made and of both the movements in the provision and the amount of the provision at the balance sheet date. These disclosures are necessary to give an indication of the impact that loan losses can have on the results of a bank and its financial position.

TRUST ACTIVITIES :

26. Banks commonly act as trustees and in other fiduciary capacities that result in holding or placing assets on behalf of individuals, trusts, pension funds and other institutions. Such activities do not encompass safe custody functions. Provided the trustee or similar relationship is legally supported, these assets are not assets of the bank and therefore should not be included in the balance sheet of the bank. If the bank is engaged in significant trust activities, a statement to that effect should be made in

the financial statements because of the potential liability to the bank if it fails in its fiduciary duties.

COMMITMENTS :

27. In the ordinary course of business banks enter into many types of commitments, some of which are not binding, while others are irrevocable. The user of financial statements of banks will need to know at least about any irrevocable commitments because of the possibility of potential losses inherent in the commitments and because of the demands the commitments may put on the bank's liquidity and solvency. Thus a bank should normally disclose the existence of uncovered contract positions and the existence and amount of guarantees, letters of credit and standby letters of credit issued and irrevocable commitments to extend credit that cannot be withdrawn at the discretion of the bank, without incurring expense or loss. When the amount of guarantees given by a bank is disclosed, some explanation of the nature of the guarantees is useful.

UNDISCLOSED RESERVES:

28. Local circumstances or legislation may require or allow undisclosed free reserves to be maintained, in addition to such amounts as may be necessary to cover loan losses (see para 24), in order to absorb unusual losses without disclosing their amount. Such reserves may result in opportunities to distort, in varying degrees, the reported earnings of a bank and to cause uncertainty as to the full extent of shareholders' interests. In some countries when undisclosed reserves are maintained it may be that the use of such reserves and their impact on financial statements may be restricted to certain specified items. Nevertheless, financial statements cannot present a true and fair view as to financial position or results of operations if there are undisclosed over-statements of liabilities, undisclosed under-statements of assets or undisclosed accrual of amounts for general or unspecified business risks.

29. An acceptable alternative found in some countries is for part of shareholders' interests to be identified separately as a disclosed contingency reserve. Charges or credits to such a reserve would form part of net income disclosed in the income statement.

Appendix : Illustration of specific disclosures :

Specific disclosures by banks might include :

(I) Balance sheet items

Cash, Balances with central banks,

Money market paper, Bills of exchange,

Delaing securities, stating the market value if different from the carrying amount in the financial statements, Investment securities,

Marketable, stating the market value if different from the carrying amount in the financial statements

Others

Loans and advances, Property held for resale, Investments in associated companies,

Bank premises and equipment

Customers' acceptance liability

Accounts with depositors, Promissory notes

Taxation, Acceptances outstanding

Capital notes and debentures, subordinated loans, Shareholders' interests.

(II) Income statement items :

Interest income, Interest expense, Fees for services, Dealing results, Investment gains and losses, Net charge of credit to the provisions loan losses, Employee costs, Taxes on income.

(III) Other disclosures :

(a) Provision for loan losses at the Balance Sheet date and movements of the period in the provision, including charges and recoveries, and additions or releases.

(b) Amount of Letters of credit and standby letters of credit.

Guarantees, indemnities and similar obligations.

Irrevocable commitments to extend credit.

(c) Existence of :

Trust and fiduciary accounts (assets and liabilities in respect of such accounts should not be included within the bank's balance sheet totals). Foreign exchange, commodities or similar dealing, and any uncovered contract position.

SUMMARY OF RESPONSES TO DISCUSSION PAPER "DISCLOSURES IN FINANCIAL STATEMENTS OF BANKS" FIRST PUBLISHED 1 MARCH 1980

INTRODUCTION

1. In March 1980 the IASC Discussion Paper "Disclosures in Financial Statements of Banks" was published as a contribution to the general debate on financial statement disclosures and as such was welcomed by the Committee on Banking Regulations and Supervisory Practices of the Group of ten major industrialised countries and Switzerland. In the foreword to the Discussion Paper it was stated that "both the IASC Board and the Basle Committee of Banking Supervisors recognise that harmonisation of methods of valuation and income measurement of banks will require further study, but they agree that a first step is that of the extent of disclosures in the financial statements of banks."

2. In addition the paper recognised that "developments in banks financial reporting are taking place in many parts of the world". Examples of recent and current developments in this field are to be found in Australia, Canada, the European Community ("EEC") and the U.S.A.

3. It is in the context of these changes and of the general rather than detailed nature of the Discussion Paper that the comments on the paper should be read. Responses came from banks, banking associations, a banking officers' group, professional

bodies, professional accounting firms and individuals, but with one exception were not made by central bank or supervisory authorities; the appendix to this summary lists the countries from which responses were received.

4. Responses fell into three broad categories: those based on argument of a political or economic nature or influence, those raising practical difficulties of implementation and those of detail in interpretation. While there was support for certain of the broad objectives of the paper, strong opposition was expressed on a number of points on political or economic grounds. This summary deals only with matters of particular significance. The lesser points which would also need to be taken into account in the event of the issuance of a standard are also listed in the appendix.

5. Because of the many present developments, not least the proposed EEC banking directive, the IASC does not intend currently to issue an exposure draft relating to financial statement disclosure by banks. It will, however, review the position from time to time in the light of developments and of the application of other International Accounting Standards to banks.

Harmonisation of Financial Reporting of Banks

(Discussion Paper - Paragraphs 4 and 5)

Responses

6. Comments on this subject drew attention to the differences that exist both between banking business and other forms of trade and commerce and between the activities of banks in different countries or sometimes even in the same country. In the words of one respondent :

> "By the nature of their business, banks frequently fall outside the normal accounting conventions. Unlike industrial companies, the composition of their balance sheets may be radically changed within the course of a single day. A further distinction is that in terms of numbers, creditors and potential creditors of banks are likely to exceed shareholders by a large margin".

For these reasons and because of the overriding importance of banking viability for the economy, the business of banks is in all countries monitored to a greater or lesser extent by the supervisory authorities. Respondents pointed out, however, that the differing systems of control exercised by the authorities of various countries themselves introduced disparities into reporting by banks and the interpretation of their reports. It was, therefore, not sufficient to harmonise disclosures in financial statements if the reader was not made aware of the valuation systems underlying the disclosures and of the implications of the disclosures in the context of the supervisory system.

7. Some respondents argued that, since the detailed information on banking operations required by the authorities was not suitable for public disclosure, it was misleading to look to the financial statements for a critical appraisal of a bank's liquidity and solvency. Such an appraisal would require highly specialised knowledge of the banking industry not easily accessible to laymen.

8. Respondents from continental Europe referred frequently to the need not only for adequate but also for hidden reserves as an essential element in the maintenance of public confidence in the banking system. A similar argument was also put forward against particular disclosures that could disturb the public, who might not be able to interpret them in their proper context. The following quotation from Germany is typical of comments received on this point:

> "The special sensitivity of banks to public confidence conflicts with a requirement for unrestricted disclosure of reserves maintained for providing for risks as well as with a requirement for a full explanation of the valuation methods in the published financial statements".

9. One respondent from India suggested that in less developed countries, where banking procedures were less complex, existing reporting conventions should be allowed to continue with minimum modifications.

IASC Comment

10. The Discussion Paper clearly recognised the different interests in disclosures in the financial statements of banks and the legislation and other developments taking place throughout the world.

11. The responses emphasise the special characteristics of the business of banks, the need to supervise them, the political and economic reasons against greater disclosure and as a consequence the respondents' belief in the impracticability of harmonisation. The arguments put forward in support of this view are based on political or economic concerns but do not have regard to the need to have meaningful and informative financial statements which may serve as a bsis for commercial judgements by investors, depositors and other interested parties. Furthermore, a better understanding of the special characteristics of the business of banks would be provided by greater disclosures.

12. Although the supervisory authorities will, naturally, be better informed on certain details of a bank's operations than the reader of its financial statements, the existence of such supervision does not permit an investor to make a rational choice between different banks or between banks and another industry sector. A bank acquiring an interest in or making a deposit with a foreign bank may itself look to the financial

statements of that other bank for information on its performance and the manner in which it conducts its operations. The supervisory authorities may also have to rely in some measure on financial statements when information is required on the activities of the foreign parent of a local branch.

13. The role of the supervisory body and the context in which it exercises its control is clearly of great importance in maintaining a stable banking sector. However, it is not necessarily wholly understood by a reader of a bank's financial statements. It could, therefore, be of benefit if a bank's financial statements, or the report in which the financial statements are included, were to describe the nature of the bank's operations in its national environment and the effect on those operations of supervisory and prudential controls.

Market Value

(Discussion Paper Paragraph 13)

Responses

14. Few comments were received on this topic, perhaps because only a passing reference to it was made by the Discussion Paper, which suggested that the market value of both dealing and investment securities would be disclosed if different from the carrying amount in the financial statements.

15. Although respondents on this point agreed that disclosure of market value was appropriate for dealing securities, some raised queries on the usefulness of such disclosure for investment securities. It was argued that the market value of investment securities was irrelevant and that the often severe fluctuations in such values could mislead the user of the financial statements. Furthermore, for a large portfolio market values did not necessarily correspond to realisable values. One respondent believed that such disclosure was inconsistent with the treatment of very similar long-or medium-term loans that were not executed as debt securities.

IASC Comment

16. While the responses underline the problems of determining market value and the appropriateness of its application to particular types of asset, it is considered that practical difficulties should not preclude the disclosure of such value where it differs from the carrying amount, together with any necessary qualifying information. The disclosure of such amount gives an indication of both the potential position as regards liquidation of the asset and current investment yields.

Maturities

(Discussion Paper Paragraphs 16-20)

Responses

17. Comments on this topic reinforced the warnings given in the Discussion Paper that analysis by maturities needed careful planning and appropriate qualification since maturity dates were not always what they seemed.

18. Reference was made to that element of demand and short-term deposits which was of a continuing nature and one respondent suggested that an attempt might be made to identify this element for the purposes of the financial statements. It was claimed that a simple classification of assets and liabilities by maturities could give a misleading picture where, for example, a bank was funded largely through the inter-bank market or had access to the Central Bank to obtain finance even for long-term bonds. A comment from Sweden explained that deposits from the public varying from demand to 24 months could always be withdrawn on payment of a certain fee. On the assets side, although Swedish banks were legally required to reserve the right to require repayment of all loans within one year, in practice much longer periods were agreed.

19. Some respondents expressed doubts whether balance sheet disclosures which are made at single point in time could provide information that would convey an understanding of a bank's policies regarding the matching and mismatching of assets and liabilities. In particular, it was felt that detailed analysis of very short-term maturities existing at the balance sheet date was inappropriate for financial statements published several months afterwards.

20. Although most comments on these paragraphs concentrated on maturity dates as an indicator of liquidity, a few drew attention to their significance for the purpose of interest rate management - a point touched on in passing by the Discussion Paper. Respondents pointed out that the existence of 'floating rate' assets and role-over dates on which interest rates may be revised may suggest that classification by final maturity date is misleading.

21. The question whether a maturities analysis should provide a classification by residual maturity or by the original contractual term was raised by one respondent from the Netherlands. The respondent argued that for assets and liabilities of a substantial nature and considerable diversity, such as deposits and medium-term loans, classification by contractual repayment period could be the more useful as it gives a better insight into the business policy.

IASC Comment

22. The difficulty of presenting certain information in financial statements in such a way as to avoid the possibility of misinterpretation of misunderstanding is not a sufficient reason for non-disclosure. To avoid the risk of misinterpretation, it is important that maturity disclosures be appropriate to the business and that any factors relating to the context in which they are disclosed should also be clearly stated. They will help in demonstrating the nature of a bank's business and its committed position; disclosure of the original contract period of certain assets and liabilities may also help to indicate the way in which the bank is conducting its business.

23. Apart from providing an indication of the deployment of the assets and liabilities, maturity information may also be of relevance in relation to interest levels and hence to future profitability.

Concentrations of Assets and Liabilities

(Discussion Paper Paragraph 21)

Responses

24. Most of the comments received on this subject supported the suggestion made in the Discussion Paper that when concentrations of assets or liabilities exist they should be disclosed. One respondent recommended that to allow the readers of a bank's financial statements to obtain 'negative'

comfort from the absence of such disclosure, criteria should be established to determine whether or not a substantial concentration exists.

25. A number of respondents claimed that an analysis of concentrations of assets and liabilities could only provide an adequate indication of risk if it descended to detail and was supported by information on such matters as collateral received and the existence of credit insurances or other guarantees. Disclosures at this level, however, could be damaging to a bank by providing too much information on its business policies. A respondent from Switzerland commented that Swiss law and the guidelines of the Federal Banking Commission require a thorough examination of risk concentration to be made by the independent auditor.

26. Other respondents stated that a broad analysis by geographical area or customer grouping would be acceptable and not breach banker/customer confidentiality if made at this level. One banking respondent from the United Kingdom claimed that such information could be useful in assessing the risks involved in lending to other banks.

27. There was some discussion among the comments of the difficulty of classifying a risk when the location or status of a guarantor differed from that of the prime borrower.

IASC Comment

28. In some countries limits may be placed by supervisory authorities on the holding of some assets and liabilities. The reader of a bank's financial statements is unlikely to be aware of these, hence the suggestion in paragraph 13 above that a statement about the effect of supervisory controls could be helpful.

29. Clearly the nature of disclosure of any concentration of assets or liabilities needs to be accompanied by sufficient additional information to ensure that its relevance and importance is understood. Since there may be doubt as to what constitutes a concentration of assets there could be merit in requiring the regular provision of analyses on the lines of paragraph 21 of the Discussion Paper.

Income Statement Disclosures

(Discussion Paper Paragraphs 22-23)

Responses

30. Most respondents commenting on this item supported the suggestion in the Discussion Paper that interest income and interest expense should be separately disclosed. Some referred to the difficulty in many cases of drawing a distinction between dealing results and interest income.

31. There was less agreement over the suggested disclosure of average interest rates together with average interest bearing assets and average interest bearing liabilities for the period. Some argued that the reader of the financial statements lacked the necessary background knowledge to judge such factors. Others believed that information on average positions and rates of return was particularly relevant for the user of financial statements of a bank in view of the greater volatility of its assets and liabilities compared to those of a non-financial company. It was recognised that a meaningful analysis of net interest income was only possible if average rates were disclosed. One respondent urged that disclosure of comprehensive average balance sheet data for the year should be required in place of the statement of changes in financial position, which provided little insight into a bank's activities. Disclosure of information on averages was also seen as going some way towards overcoming the problem of "window dressing".

IASC Comment

32. IASC is pleased to note the support for the separate disclosure of interest income and interest expense. In the light of the comments on average positions and average rates of return, it continues to be of the opinion that disclosure of this further information would be of benefit.

33. The Discussion Paper recognised the difficulties which could exist in distinguishing different types of income and suggested that additional information would usefully include disclosure by source. Linking two or more types of income to a source could be helpful in assessing the quality of earnings from that source. Examples would be the results of foreign exchange trading or investment dealing.

Loan Losses and Hidden Reserves

(Discussion Paper Paragraphs 24, 25, 28 and 29)

Responses

34. Many respondents endorsed the statement in the Discussion Paper that "financial statements cannot present a true and fair view as to financial position or results of operations if there are undisclosed over-statements of liabilities, undisclosed under-statements of assets or undisclosed accrual of amounts for general or unspecified business risks". Some respondents, however, repeated the assertions reported earlier that undisclosed reserves are necessary to preserve the stability of the banking system. In particular, smaller banks argued that the uneven incidence of bad debts in their business required a facility to cover losses from undisclosed reserves.

35. It was pointed out that in some countries for political and economic reasons disclosure of reserves is not required and that the truth and fairness concept in the view of these countries is not impaired provided the financial statements comply with legal and regulatory requirements.

36. A Netherlands respondent referred to the practice in that country regarding the separate provision for general risks which is maintained as part of creditors. Transfers to the provision from income are reported but neither transfers out nor the size of the balance is disclosed.

37. A number of respondents who supported non-disclosure of the general provision for bad debts explained that they were nevertheless opposed to the maintenance of undisclosed reserves through the manipulation of asset valuations.

IASC Comments

38. The approach to the way in which specific and, in particular, the general elements of the loan loss provision are provided is dependent on a variety of factors, such as tax regulations, regulatory requirements and whether disclosure is required.

39. The disclosure of loan loss provisions is a matter which may be of concern from a political or economic point of view but, because of the potential significance of such provisions on

operating results, it is desirable that they should be disclosed. For the same reason, amounts set aside in excess of requirements, as reserves, to cover future contingencies and the extent of their use to absorb losses, should be disclosed. While it is recognised that in practice making a distinction between justifiable provisions and excess reserves may be difficult, the user of financial statements is entitled to expect that management has exercised its judgement and experience in determining its requirements.

APPENDIX

A. Countries from which responses were received

Responses were received from banks, banking associations, a banking officers' group, a regulatory authority, professional bodies, professional accounting firms and individuals located in the following countries :

Australia
Bahamas
Belgium
Canada
Denmark
Germany
Hong Kong
India

Italy
Malaysia
Netherlands
New Zealand
Pakistan
Sri Lanka
Sweden
Switzerland
United Kingdom and Ireland
United States.

Additional matters which would require consideration in connection with the development of an accounting standard on banking disclosures.

(1) Some specific items which might be considered for disclosure (see the illustrative list in the Appendix to the Discussion Paper) are :

- balances with banks, balances with associates, money at call, leasing transactions;
- segregation of non-banking items in the income statement, disclosure of depreciation;
- irrevocable stand-by credits and total amounts of assets and liabilities in foreign currencies.

(2) Definitions of specific items where appropriate.

(3) Whether certain disclosures, for instance on average positions and average rates, were required within the basic financial statements or as supplementary informatio[n]

(4) The treatment for reporting purposes of assets held in a fiduciary capacity.

(5) The extent of disclosure appropriate for various kinds of commitments. In determining disclosure requirements, attention would have to be paid to the interpretation of certain kinds of commitment in the light of the business environment in which those commitments operated. For example, it was pointed out by certain respondents to the Discussion Paper that a disclosure requirement covering all commitments to extend credit was too broad, since under normal banking practice such commitments were rarely taken up to their full extent.

(6) The extent of foreign operations of a bank.

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ANNEXURE III

Manner of presentation of assets and liabilities by banks in foreign countries

Section A

Liquid assets

The American banks show these items under the following broad heads.

(i) Cash and due from banks

(ii) Time deposits with banks

Sometimes the classification is:

(i) Cash and non-interest earning deposits

(ii) Interest earning deposits

The French banks also have a similar system.

An **illustrative** classification is:

(i) Cash, issuing banks, treasury and post office accounts

(ii) Banks and other institutions authorised to deal on the money market

(a) demand deposits

(b) time deposits and loan

(In French accounts, some of the items show both debit and credit balances).

In Germany, the classification of this item is somewhat more elaborate as follows:

(i) Cash in hand

(ii) Balance with Deutsche Bundesbank

(iii) Balances with foreign Central Banks

(iv) Balances in postal cheque accounts

(v) Cheques on other banks, matured bonds, interest and dividend coupons and items received for collection.

In United Kingdom, the classification in the balance sheet is more compact:

(i) Cash and short-term funds

(ii) Money at call and short notice

(iii) British and other Government treasury bills

Some banks also include under this head separately items like bills eligible for rediscount, commercial bills, negotiable certificates of deposits, certificates of tax deposits, special deposits with the Central Bank, etc.

Section B

Investments

The American banks show investments under the following three broad heads with some supplemental data.

(i) Funds sold and other temporary investments

(ii) Investment securities -

U.S. Treasury securities

Obligiations of States and political sub-divisions

Other securities

(iii) Trading account securities

The book value and market value during the current year and previous year are shown in the notes.

The French banks also have a similar pattern. The headings are:

(i) Treasury bills brought from or under resale agreement

(ii) Securities transaction accounts

(iii) Investment securities

(a) Government bonds and debentures

(b) Other investment securities

(iv) Investments in subsidiaries and other holdings.

The German banks show more detailed information under this item as follows:

(i) Treasury bills and non-interest bearing treasury bonds

(a) of the Federal Republic and Laender

(b) others

(ii) Bonds and debt investments

(a) with a life upto four years

(aa) of the Federal Republic and the Laender

(ab) of credit institutions

(ac) of others

(b) with a life of more than four years

(ba) of the Federal Republic and Laender

(bb) of credit institutions

(bc) of others

(iii) Securities not included in other items

(a) shares marketable on a stock exchange and investments funds certificates

(b) other securities

Value of bonds eligible as collateral for Bundesbank advances and foreign central bank advances is also shown separately.

In United Kingdom the classification is more compact. Particulars of investments are given either in the body or by way of notes and show valuation of securities of, or guaranteed by, the British and other national Governments, those listed in Great Britain, those listed overseas and unlisted. The unlisted securities are valued at directors' estimate.

Section C

Loans and Advances

The American books show the advances in the balance sheet under the head 'loan'(net of unearned income of $.....). In the relative notes, particulars given include data regarding U.S. operations and International operations separately under the following sub-heads:

U.S. operations (i) Commercial, industrial and financial

(ii) Real estate - Construction

(iii) Real estate - Others

(iv) Consumer instalment

International operations

(i) Commercial and industrial

(ii) Government and official institutions

(iii) Banks and other financial institutions

(iv) Loans to affiliates

(v) All others

Unearned income is also shown under the two main heads. The notes also give an analysis of the reserve for uncollectible accrued interest receivable and the related year-end loan principal balances. The particulars of renegotiated loan and the income thereon are also given. Movements in the reserves for credit losses are also furnished.

The French banks show the advances under the head 'Loans to customers' with the following break-up.

Commercial banks

Other short-term loans

Medium term loans

Long term loans

Customers' accounts in debit.

Some data regarding provisions for short term loans and those for medium and long term loans are also furnished in the notes.

The German banks furnish in the body of the balance sheet advances by way of bills discounted, claims on credit institutions, claims on customers separately. Under the head Bills discounted, particulars regarding bills rediscountable at the Deutschesbank are given. Under the other two heads, particulars regarding agreed life of the loans are also given. In the relative notes, classification of the total volume of credit under short and medium term, long term discounts, lending to credit institutions and claims on customers is also given.

In United Kingdom, the advances are shown under the head 'Advances and other accounts'. In the relative notes, bills, loans, equipment leasing, etc are shown separately. Movements in the reserve for bad and doubtful debts are also given in the notes. 'Exceptional items' are also separately reported where applicable.

Section D

Other assets

In the case of the German banks the 'other assets' include land and buildings, office furniture and equipments, sundry assets, and transit items. Some particulars regarding depreciation are furnished in the relative notes.

The American banks show separately

- Premises and equipments
- Accrued interest receivable

A break-up of the 'Premises and Equipments' items is given by way of a note indicating the value of (a) land (b) premises including capitalised leases (c) lease-hold accounts (d) equipments and furniture.

The depreciation and amortisation and maintenance and repairs expenses for the last three years are given separately and the total accumulated depreciation and amortisation are deducted from the gross value of the assets to arrive at the figures shown in the balance sheet.

The French banks show under 'other assets' different heads like -

(a) Suspense Account and Sundries

(b) Premises and other fixed assets.

Some details are also furnished.

U.K. banks show 'fixed assets' separately. Some of the 'other assets' are included under the head 'advances and other accounts'. A note is given in regard to premises and equipments showing the cost at the beginning of the year, exchange adjustments, additions, disposals and write offs and depreciation particulars arriving at the net book value at the end of the year. The particulars of the premises are given in respect of lease hold over 50 years unexpired and lease hold upto 50 years unexpired separately. The valuation basis is also indicated.

Section E

Deposits

The French banks show deposits under the heads:

Bank and financial institutions

Current accounts

Borrowings and term accounts

Customers accounts in credit

Corporations and individual proprietorships:

current accounts

time accounts

Individuals

current accounts

time accounts

Sundries

current accounts

time accounts

Special savings accounts

Certificates of deposits

In Germany, liabilities to credit institutions and other creditors are shown separately. Particulars of liabili showing maturity wise grouping are also given under both the main groups.

The American banks give deposits under the heads-

- demand

- savings and time

- overseas offices

The notes to the accounts give additional information as follows:

Deposits consist of United States Operations

Individuals, partnerships and Corporations

U.S. Government

States and political sub-divisions

Commercial banks

Others

International operations

Banks in foreign countries

Foreign Governments and Official Institutions

Other foreign-demand

Other foreign-savings and time

In U.K., banks show deposits in the body of the balance sheet under the head "current, deposits and other accounts"

In the notes to the balance sheet, particulars of this item are given as follows:

Current, deposits and other accounts

Current and deposit accounts

Notes in circulation

Current taxation

Other accounts including accruals and exchange risks

Provisions for estimated pension fund deficiencies

Items in transit, net.

Section F

Other liabilities

The American banks show the following other items of liabilities in their balance sheet -

- Federal funds purchased and securities sold under repurchase agreements.
- Commercial paper
- Other short-term borrowings
- Liability on acceptances
- Interest payable
- Other payables and accrued liabilities
- Intermediate non long-term debts.

Some banks also furnish notes on some of these items like particulars of the funds borrowed, position regarding tax liability, particulars of the notes payable, etc.

The French banks show, apart from deposits, amounts due to banks and financial institutions, equity funds, notes and debentures, etc the following items as 'other liabilities

Accounts payable on collection

Equalisation accounts, provisions and sundry

Security dealings.

The British banks show apart from deposits and shareholders funds, the following items on the liability side of the balance sheet -

- loan capital
- taxation
- creditors, etc.

Notes are given to indicate the taxes and deferred tax position and particulars of 'Current deposits and other accounts' also include some items of 'other liabilities'.

Section G

Income and expenditure

The American banks show the total interest revenue, the total interest expenses and the net interest revenue in their profit and loss account. They also show separately provision for loan losses (as a deduction from net interest income).

Other items of incomes shown are :

- Trading securities
- Profit and commission
- Profit on foreign exchange activities
- Service charges on deposit accounts
- Fiduciary activity fees
- Business service fees
- Other revenues

On the expenditure side they show personnel expenses, occupancy expenses, equipment rentals, depreciation and maintenance and other expenses. The appropriation of profit shows income-tax, extra ordinary items, etc. A break up of interest received under different heads is furnished, showin particulars like interest on loans, loan fees, interest and dividend on investment securities, interest on trading accou securities, interest on federal funds sold and securities purchased under re-sale agreement and net leasing revenue. Similarly interest on deposit liabilities, interest on other short-term borrowings, interest on intermediate term debts and interest on long-term debts are given under the head 'interest expenses' in the body of the accounts. Notes cont interest paid on domestic savings accounts, domestic time accounts and foreign deposits separately. A summary of the provision for taxes is also furnished in the notes.

The British banks show in the profit and loss accou the trading profit before tax, tax and extraordinary items a the profit for the year. An illustrative case is:

Profit before tax

(Tax)

Profit after tax

(Minority interest)

Profit after tax and before extraordinary items

(Extraordinary items)

Profit for the year

(Dividends)

Profit retained

(Items within brackets are deductions)

The particulars given in the notes show -

- interest and leasing income receivable
- income from investments

  listed

  unlisted
- share of profits of associated companies
- net profit on sale of realisation of premises.

Particulars of 'charges' show:

Interest payable on

- Deposit and other short-term interest
- Loan capital

Provision for doubtful debts (net of recoveries)

Depreciation

- Leased assets
- Premises
- Equipment

Auditors' remuneration

Directors' emoluments

Amount written off premium arising on acquisitions, etc.

The tax particulars given in the notes show taxes in U.K. and overseas tax and the impact of deferred tax, etc.

In the case of another U.K. based bank, interest income, interest expenses, other income, provisions for ba doubtful debts, staff costs, premises and equipments costs other costs, exchange losses on translation of overseas working capital, interest on loan capital are the major it shown in the accounts. The taxation particulars are also given.

In the case of French banks, the 'Trading account' shows separately banking income, income from related transactions, non-recurring income and recovery of provisic Under the 'banking income' head, income from short-term and inter-bank transactions, income received from customers' accounts, income from leasing transactions, income from securities portfolio and sundry income are shown separately

Similarly on the expenses side, the main heads are

- banking expenses
- personnel costs
- taxes and duties
- general operating expenses
- depreciation
- provisions less recoveries
- non-recurring costs
- provision for non-banking items
- staff profit sharing scheme
- income-tax

The banking expenses show separately

- cost of short-term borrowings
- and inter-bank transactions
- interest paid on customers' accounts

- cost of leasing operations
- interest on debentures
- other operating costs

The German banks show in their income and expenses statement, income from lending and money market transactions, commission and other receipts from service transactions, other receipts including writing back of provisions for loan losses and other purposes, writing back of reserves, etc. On the expenses side the main heads shown are interest and similar expenses, salaries and wages, other establishment expenses, taxes, depreciation and adjustments on claims and securities and allocation to provisons, etc.

Section H

Contingencies and Commitments

American banks do not show any item in the balance sheet under the head 'contingencies'. 'Customers' liability for acceptances' and 'liability on acceptances' are shown in the body of the balance sheet. Under the heads "commitments and contingencies", by way of notes to the balance sheet, some remarks like the following are given:

(i) In the normal course of business there are outstanding a number of commitments to extend credit, letters of credit, guarantee and letters of indemnity as well as contractual obligations to purchase or sell securities or foreign exchange. In the opinion of the management these agreements do not represent unusual risk for the Corporation and losses, if any, resulting from the will not be material. At December 31, 1981 commitments under outstanding standby letters of credit $.........

The Corporation and its subsidiaries are defendants in a number of legal proceedings arising in the normal course of business. Among these are actions brought in 1976 $......

(ii) As of December 31, 1982 and 1981 commitments under standby letters of credit approximated $....... and $....... respectively.

The parent is not a party to any material legal proceedings. The bank and certain subsidiaries because of the nature of their business are at all time subject to numerous legal actions, threatened or filed..........

The French banks show under the head contingent liabilities in the balance sheet separately.

- guarantees and other endorsements in favour of financial intermediaries
- guarantees and other endorsements received from financial intermediaries
- letters of credit confirmed in favour of customers
- guarantees, endorsements and security in favour of customers
- other commitments in favour of customers

equipment leasing agreements

- property leasing agreements

The U.K. banks show under the head "contingencies other obligations" in the notes to the balance sheet figures relating to

(a) bills rediscounted

(b) confirmed credits and other engagements on behalf of customers.

It also indicates "......... there were also liabilities under forward exchange contracts entered into as part of the normal provision of banking services to customers". No figures are, however, given for this item.

In Germany, banks show contingent liabilities like "endorsement liabilities on rediscounted bills" and liabilities arising from guarantees given, etc by way of notes as well as by way of particulars of the coverage of certain items included in the balance sheet.

Annexure IV

Section A

Basis of accounts, consolidation of accounts of subsidiaries and treatment of investments in associate companies

i) U.K. based bank :

The accounts are prepared under the historical cost convention and are in compliance with Section 149A and 159A of, and Schedule 8A to the Companies Act, 1948 applicable to banking companies. In view of this, the accounts do not comply with certain requirements of the United Kingdom and International Accounting Standards and information based on current costs as required by United Kingdom Statement of Standard Accounting Practice No.16 is not given. The consolidated accounts are prepared from the accounts of............. and its subsidiaries upto 31st December 1982.

ii) U.S.A. based bank :

The consolidated financial statements include the accounts of ...., its wholly owned subsidiary .... and their majority owned subsidiaries, after the elimination of all material inter-company transactions.

Affiliates which are 20% to 50% owned are carried under the equity method of accounting and the prorata share of their income (loss) is included in other revenue. Income for investments in less than 20% owned companies is recognised when dividends are received.

Gains and Losses on disposition of branches, subsidiaries, affiliates and other equity investments (including ventures capital investments) and charges for management's estimate of permanent improvement in value are included in other revenue.

iii) <u>U.S.A. based bank</u> :

The consolidated financial statements include the accounts of .... and its subsidiaries after elimination of significant inter-company balances and transactions. In the financial statements of .... investments in subsidiaries are accounted for by the equity method.

<u>Section B</u>

<u>Investments</u>

i) <u>U.K. based bank</u>

British Government and other securities redeemable at fixed dates, other than those held on a short term basis, are stated at cost adjusted to give effect to amortisation of premiums and discounts on purchase over periods to redemption on a straight line basis.

Listed investments, other than those dealt with as described above, are stated in the aggregate at lower of cost and market value and unlisted investments at cost less amounts written off.

ii) Hongkong based bank

Quoted equity investments other than in subsidiary and associated companies are stated at the lower of cost and market value.

Investments in securities redeemable at fixed dates and which are being held to maturity are stated at cost adjusted to give effect to amortisation of premiums and accretion of discounts on purcahse over periods to redemption.

This is a change in policy from the previous year when such securities were stated at the lower of cost and market value.

Undated securities and those held for short-term purposes are stated at the lower of cost and market value.

Other unquoted investments are stated at cost less amount written off.

iii) U.S.A. based bank :

Investment securities are carried at cost adjusted for amortisation of premiums to call date and accretion of discounts to maturity. Gains and losses on sales of investment securities (computed on a specific identified cost basis) and the related tax effect are stated in a separate caption immediately preceding net income in the parent company only and consolidated statement of income.

Trading account securities (including related future and forward transactions) are carried at market. Domestically, such securities principally represent the inventory of .... in its operations as a dealer in U.S. Government and state and municipal debt obligations buying and selling for its own account. Outside the United States, certain branches or subsidiaries engage in similar type activities, principally in securities issued by foreign governmental units. The liability incurred in short sale transactions, representing obligations to deliver securities, is included in other liabilities. Interest on trading account securities is included in interest revenue net of interest expenses on securities sold short, and gains and losses from all securities trading activities, both realised and unrealised, are included in trading account profits and commissions.

No transfers are made between trading account securities and investment securities.

iv) Japanese based bank :

Marketable national and local government bonds and corporate bonds (other than convertible bonds) owned by the Bank are carried at cost. Other marketable securities are carried at cost or market value whichever is lower. Unlisted securities owned by the Bank are valued at cost. Securities owned by the consolidated subsidiaries are carried primarily at cost.

Section C

Fixed and other miscellaneous assets

i) Hongkong based bank :

Bank premises and other properties are stated at cost or valuation less depreciation calculated to write off the assets over their estimated useful lives. The following principal depreciation rates are applied to land and buildings :

- Freehold land and land held on leases with more than 50 years to expiry is not depreciated.
- Land held on leases with 50 years or less to expiry is depreciated over the unexpired terms of the leases.
- Buildings and improvements thereto are depreciated at the higher of 2% per annum on a straight line basis or over the unexpired terms of the leases.

- Furniture, fittings and equipment are stated at cost less depreciation calculated on a straight line basis to write off the assets over their estimated useful lives.

ii) U.S.A. based bank :

Premises and equipments, including leasehold improvements, are carried at cost less accumulated depreciation and amortisation. Generally, depreciation and amortisation are computed on the straight line basis over the estimated useful life of the asset or the lease term. Maintenance and repair costs are expensed as incurred.

iii) Japanese based bank :

Depreciation of premises and equipment of the Bank is computed by the declining balance method for buildings, furniture and fixtures, and by the straight line method for other depreciable assets, based on the estimated useful lives. Additional depreciation is provided for buildings in accordance with the Accounting Standards for Banks issued by the Ministry of Finance of Japan.

Depreciation of premises and equipment owned by the consolidated subsidiaries is computed primarily by the straight line method over the estimated useful lives.

Section D

Provisions - basis of provisioning for loan losses, unforeseen risks, contingencies, etc.

i) Hongkong based bank :

Provision is made for doubtful debts as and when they are so considered and in addition amounts have been set aside as general provisions for doubtful debts. These provisions are deducted from advances to customers.

ii) U.S.A. based bank :

Commercial loans are stated at their face value, net of unearned discount and the allowance for possible losses on commercial loans.

Additions to the allowance are made by means of the provision for possible losses on commercial loans charged to expense. Loan losses are deducted from the allowance and subsequent recoveries are added. The level of net loan losses for the year is a significant factor in determining the appropriate level for the provision for possible losses on commercial loans. Based on Management's judgement as to the appropriate level of the allowance for possible losses, the amount actually provided may be greater or less than the net loan losses for the year. The determination of the amount by which the provision should exceed or be less than net loan losses is based on management's current evaluation of the anticipated impact of domestic and international economic conditions, changes in the character and size of the portfolio, past and expected future loss experience and other pertinent indicators.

When it is determined as a result of evaluation procedures that the payment of interest or principal on a commercial loan is doubtful of collection, the loan is placed on a nonaccrual basis. In any case where interest on principal is past due for 90 days or more, the loan is automatically placed on nonaccrual basis unless an affirmative determination is made by senior credit management that the condition is not indicative of doubt as to the collectibility of principal or interest. Any interest accrued on a loan placed on a nonaccrual basis is reversed and charged against current earnings. Interest on nonaccrual loans is thereafter included in earnings only to the extent actually received in cash.

Consumer loans are stated at their face amount net of unearned discount and the allowance for consumer credit losses.

Consumer loans are written off automatically upon reaching a predetermined number of days past due on a contractual basis. The number of days is set at an appropriate level by loan product and by country so as to result in the recognition of losses on a basis which makes the likelihood of subsequent recovery of those losses to fall between 20% to 30%. Consumer credit loss expenses charged to earnings is built up as a composite of three factors: (a) the actual net consumer credit losses, (b) a factor statistically calculated to reflect the likely losses associated with the most recent growth in the portfolio and (c) a further adjustment in anticipation of potential losses that likely exist in the portfolio but which are not fully anticipated by the first two items.

Interest on discount loans is accrued on a declining basis which results in an approximate level rate of return over the term of the loan. Interest accrued on nondiscount loans is based on the principal amount of loan outstanding.

iii) U.S.A. based bank :

Loans are carried at the principal amount outstanding. Related loan fees are generally amortized into income over the applicable loan or service period. Immaterial amounts of fees are credited to income as received.

Interest revenue on nondiscounted loans is generally accrued based on principal amount outstanding. Interest revenue on discounted loans is accrued based on other methods that generally approximate the level yield method.

The reserve for possible loan losses is based on a monthly evaluation of the loan portfolio by management.

In its evaluation, management considers numerous factors, including, but not necessarily limited to, general economic conditions, loan portfolio composition, prior loan loss experience and management's estimation of future potential losses.

iv) Japanese based bank :

The reserve for possible loan losses of the Bank is provided in accordance with the Accounting Standards for Banks issued by the Ministry of Finance of Japan, at the rate of 0.5 per cent and 0.7 per cent as of March 31, 1982 and 1981, respectively, of the aggregate of call loans, bills discounted, loans, foreign exchange assets and certain other assets.

Consolidated subsidiaries determine the provision at the reasonable amount based on management's assessment of their loan portfolio.

v) U.K. based bank :

Provisions against identified bad and doubtful debts are made on the basis of year-end reviews of advances. In addition, further provisions are maintained against the risks which, although not identified, exist in the portfolios of advances. The amounts of such further provisions are related primarily to past experience and current levels of advances and augmented, when appropriate, having regard to economic conditions in particular territories or trading sectors and taking into account potential taxation relief where this is not immediately available. Provisions are applied to write off advances when all security has been realised and all further recoveries are considered to be unlikely other than in the U.S. where in accordance with the revenue practices and regulatory requirements provisions are applied when the probability of loss has been identified.

Section E

Translation of foreign assets and liabilities and revenue and expenditure

i) U.K. based bank :

Assets and liabilities in foreign currencies, including fixed assets are translated into sterling at rates of exchange approximating those current at the end of the year. Overseas profits remitted to the U.K. during the year are dealt with at rates of exchange ruling at date of remittance. Other overseas profits are translated at rates approximating those current at the end of the year. Any net deficit or surplus arising on revaluation of the opening Group foreign currency net assets as a result of exchange rate fluctuations, after taking account of any unrealised profit or losses arising from the foreign currency exchange agreements referred to in Note No.24 is dealt with through reserves.

ii) Hongkong based bank :

Foreign currency balances are principally translated into Hongkong dollars at approximately the rate ruling at 31st December.

iii) U.S.A. based bank :

Assets and liabilities of overseas offices are translated to US dollars at exchange rates current at year-end, except for premises which are translated at exchange rates prevailing at dates of acquisition. Revenue and expense, except depreciation and amortisation of overseas offices are translated to U.S. dollars at applicable monthly rate of exchange. Foreign exchange position, including spot and forward contracts, are valued monthly at prevailing market rates. Gains and losses resulting from translating the accounts of overseas offices and from related hedging arrangements and foreign exchange trading income are included in foreign exchange profits and commissions.

The Board of Governors of the Federal Reserve System requires that investments by .... in overseas subsidiaries and affiliates be carried at a value not in excess of underlying book value. (Bank)..... charges retained earnings with the amount of goodwill associated with these investments to the extent required. In accordance with generally accepted accounting principles, this write-off of goodwill is not reflected in the .... balance sheet. Goodwill is generally amortised over the estimated period to be benefitted not exceeding forty years.

iv) Japanese based bank :

The financial statements of all foreign subsidiaries and affiliates have been translated into yen at the exchange rates prevailing at the end of the fiscal year of each company except for the beginning balances of their earned surplus, which are translated at the exchange rates prevailing at the end of the previous fiscal year of each company in 1982. The beginning balances of their earned surplus were translated at the end of the Bank's previous fiscal year in 1981. Foreign exchange losses arising from translation of earned surplus as of the beginning of the year are charged to earned surplus.

Assets and liabilities of the Bank and its subsidiaries as of the year-end denominated in foreign currencies are translated into each domestic currency at the exchange rates prevailing at the end of each fiscal year. Income and expenses denominated in foreign currencies are translated into each domestic currency at the exchange rates prevailing at the time of each transaction.

Section F

Taxation - basis of taxation and deferred taxation

i) U.S.A. based bank :

Provision for deferred taxes is made for items of revenue and expense reported in the financial statements in different years than for tax purposes, including an appropriate provision for taxes on undistributed income of subsidiaries and affiliates.

Investment tax credits on leased equipment are recognised over a period of time related to the recovery of the lease investment which gives rise to such credits. Other investment tax credits are recognised in the year the asset is acquired.

(Bank) and its subsidiaries file consolidated federal income tax returns. The provision for federal income taxes of (Bank) and of each subsidiary is recorded on the basis of filing separate income tax returns, making appropriate adjustments arising out of the consolidated federal income tax return regulations.

ii) U.S.A. based bank :

A consolidated U.S. federal income tax return is filed by the parent and includes the parent, the bank (including foreign branches), and their domestic subsidiaries. State, local and foreign income-tax returns are filed according to the taxable activity of each unit. A combined return is filed in California.

Generally, the consolidated and combined tax liabilities are settled between companies as if each company had filed a separate return. Payments are made to the parent by those companies with tax liabilities on a separate basis. Companies with separate losses and excess tax credits that are usable in the consolidated or combined returns receive payment for these benefits from the parent. Each company's income-tax provision reflects this settlement policy.

Applicable income taxes represent the aggregation of federal, state, local and foreign provisions for income taxes based on the book income of each entity in the consolidated group. The liability for income taxes is included in other payables and accrued liabilities.

Differences between tax income and book income arise from certain transactions which are reportable for tax purposes in different years than reflected in book income (timing) and transactions which are only reportable for either tax or book purposes (permanent). Timing differences caused the tax provision to differ from the actual tax payable on the current year's tax return, resulting in deferred taxes. Transactions creating deferred taxes include lease financing income, the provision for loan losses, the investment tax credit, and undistributed earnings of certain foreign companies.

Permanent differences cause the tax/provision to be different than it would be based on stututory tax rates. The major permanent difference is nontaxable interest income received on state and local government obligations.

A U.S. tax provision is computed on the undistributed earnings of foreign joint ventures and affiliates. This provision is recorded in applicable income taxes. Because these earnings are not taxed in the U.S. until the funds are remitted the corresponding tax liability is recorded as deferred tax.

No U.S. tax is provided on the undistributed earnings of foreign companies in which the corporation has more than a 50 per cent interest, since these earnings are generally reinvested for an indefinite period; if remitted, available credits would substantially reduce the taxes otherwise payable.

Credits against the current year's tax liability are received for investments in qualified assets during the year. For financial reporting purposes, tax credits are amortized over the lives of the assets. The aggregate amortized amount is recorded as a credit to applicable income taxes.

iii) Japanese based bank :

The bank is subject to corporate (national), enterprise and inhabitants' (local) taxes based on income, which normally result in an effective tax rate of approximately 56 per cent (54 per cent for the year ended March 31, 1981). There are limitations for certain expenses on the amounts deductible for tax purposes, while reduced tax rates are allowed on the portion of income which is paid out as dividends. The enterprise tax, one of the Japanese local Government income taxes, is included in "General and Administrative Expenses" in the accompanying statement of income.

Deferred income taxes are not provided for timing differences between the Bank's financial and tax reporting in the accompanying financial statements, although such deferred income taxes are reflected in the financial statements of major consolidated subsidiaries.

iv) U.K. based bank :

Provision is made on the liability basis for the tax effects arising from all timing differences other than for those deferred liabilities which are expected with reasonable probability to continue to be deferred into the foreseeable future. No provision is made for any taxation which would be payable if reserves retained in overseas subsidiary and associated companies were distributed to the U.K.

ANNEXURE-V

SPECIMEN FORM OF ACCOUNTING POLICIES AND NOTES ON ACCOUNT

1. Principal Accounting Policies

(1) General

The accompanying financial statements have been prepared on the historical cost basis and conform to the statutory provisions and practices prevailing in the country.

(2) Transactions involving foreign exchange

(a) Monetary assets and liabilities have been translated at the exchange rates prevailing at the close of the year. Non-monetary assets have been carried in the books at the historical cost.

(b) Income and expenditure items in respect of Indian branches have been translated at the exchange rates ruling on the date of the transaction and in respect of overseas branches at the exchange rates prevailing at the close of the year.

(c) Profit or loss on pending forward contracts has been accounted for.

(3) Investments

(a) Investments in Government and other approved securities in India consist of

(i) Permanent investments which are intended to be held till maturity and

(ii) Current investments which are intended to be held as liquid assets which may be sold before maturity.

Permanent investments are valued at the lower of cost or redemption value. Current investments are valued at the lower of cost or market value.

(b) Investments in subsidiary companies and associate companies (i.e. companies in which the bank holds at least 25% of the share capital) have been accounted for on the historical cost basis.

(c) All other investments are valued at the lower of cost or market value.

(4) Advances

(a) Provisions for doubtful advances have been made to the satisfaction of the auditors:-

(i) in respect of identified advances, based on a periodic review of advances and after taking into account the portion of advance guaranteed by the Deposit Insurance and Credit

Guarantee Corporation, the Export Credit and Guarantee Corporation and similar statutory bodies.

(ii) in respect of general advances, as a percentage of total advances taking into account guidelines issued by the Government and the Reserve Bank of India.

(b) Provisions in respect of doubtful advances have been deducted from Advances to the extent necessary and the excess has been included under "Other liabilities and provisions".

(c) Provisions have been made on a gross basis. Tax relief which will be available when the advance is written off will be accounted for in the year of write off.

(5) Fixed Assets

(a) Premises and other fixed assets have been accounted for at their historical cost. Premises which have been revalued are accounted for at the values determined on the basis of such revaluation made by professional valuers. Profit arising on revaluation has been credited to Capital Reserve.

(b) Depreciation has been provided for on the straight line/diminishing balance method.

(c) In respect of revalued assets, depreciation is provided for on the **revalued figures** and an amount equal to the additional depreciation consequent on revaluation is transferred annually from the Capital Reserve to the General Reserve/Profit and Loss Account.

(6) Staff Benefits

Provision for gratuity/pension benefits to staff has been made on an accrual/cash basis. Separate funds for gratuity/pension have been created.

(7) Net Profit

(a) The net profit disclosed in the profit and loss account is after :-

(i) Provision for interest tax and taxes on income in accordance with statutory requirements.

(ii) provision for doubtful advances

(iii) adjustments to the value of "current" investments and other investments valued at lower of cost or market value.

(iv) transfers to contingency funds

(v) other usual or necessary provisions

(b) All the above provisions/adjustments have been grouped in the Profit and Loss Account under "Provisions and contingencies".

(c) Contingency funds have been grouped in the Balance Sheet under the head "Other Liabilities and Provisions".

(II) Notes on Accounts

(1) Capital

Capital has been increased during the reporting period as follows:

By issue of fresh capital

By capitalisation of reserves

By contribution from Government

(2) Deposits

The interest rates on deposits in India are fixed by the Reserve Bank of India from time to time and were as follows on the balance sheet date.

Demand deposits

Savings Bank Deposits

Term deposits

(3) Investments in Subsidiaries/associates

Name of subsidiary/ associate (1)	Paid-up capital (2)	Bank's holding in the paid-up capital of the subsidiary/associate (3)	
		Face value Rs.	Cost Rs.

(4) Other investments

(a) In respect of permanent investments, the redemption value exceeds the book value by Rs.

(b) In respect of current investments and other investments valued at the lower of cost or market value, the market value exceeds the book value by Rs.

(5) Advances

(a) According to prevailing instructions of the Government and the Reserve Bank of India, the bank is required to advance about 1% of its advances to the very weak sectors of society and not less than 40% of its advances to the 'priority' sectors.

(b) The rates of interest on different types of advances which have been fixed from time to time by the Reserve Bank of India were :

In respect of the very weak sectors of society		......%
In respect of advances to the priority sectors	between	......%
	and	......%
In respect of others	between	......%
	and	......%

(6) Fixed assets

(a) Premises having a book value of Rs.________ have been revalued on the basis of revaluation made by professional valuers on ________. Capital Reserves shown in Schedule 2 includes profit on such revaluation to the extent of Rs.________

(b) The rate of depreciation charged on premises during the year ranges from _______ to ___________ and on the other assets from ___________ to ___________.

(7) Net profit/loss on sale of investments, land and buildings and other assets.

This item includes profit/loss on revaluation of ________________ (indicate nature of assets) to the extent of Rs.________.

(8) Miscellaneous income

In schedule 2 attached to the Profit and Loss account, the item 'Miscellaneous income' includes the following items (indicate nature and amount)

____

____

____

(9) Other expenditure

In schedule 4 to the Profit and Loss account, the item 'Other expenditure' includes the following items (indicate nature and amount)

____

____

____

Annexure VI

Part I

Proposed Format

of

BALANCE SHEET

(000's omitted)

Capital & Liabilities	Schedule	As at 31.12 current year	As at 31.12. Previous year
Capital	1		
Reserves & surplus	2		
Deposits	3		
Borrowings	4		
Other liabilities and provisions	5		
Total			
Assets			
Cash and balances with Reserve Bank of India	6		
Balances with banks and money at call and short notice	7		
Investments	8		
Advances	9		
Fixed Assets	10		
Other Assets	11		
Total			
Contingent liabilities	12		
Bills for collection			

Schedule 1 - CAPITAL

	As at 31.12. Current year	As at 31.12. Previous year
FOR NATIONALISED BANKS		
Capital (Fully owned by Central Government)		
FOR OTHER BANKS		
Authorised Capital		
(shares of Rs. each)		
Issued Capital		
(shares of Rs. each)		
Subscribed Capital		
(shares of Rs. each)		
Called-up Capital		
(shares of Rs. each)		
Less : Calls unpaid		
Add : Forfeited shares		

SCHEDULE 2 - RESERVES & SURPLUS

	As at 31.12. Current year	As at 31.12. Previous year
I. Statutory Reserves		
Opening Balance		
Additions during the year		
Deductions during the year		
II. Capital Reserves		
Opening Balance		
Additions during the year		
Deductions during the year		
III. Share Premium		
Opening Balance		
Additions during the year		
Deductions during the year		
IV. Revenue and Other Reserves		
Opening Balance		
Additions during the year		
Deductions during the year		
V. Balance of Profit		
Total		

SCHEDULE 3 - DEPOSITS

		As at 31.12. Current Year	As at 31.12. Previous Year
A I.	Demand Deposits		
i)	From banks		
ii)	From others		
II.	Savings Bank Deposits		
III.	Term Deposits		
i)	From banks		
ii)	From others		
	Total		
B. i)	Deposits of branches in India		
ii)	Deposits of branches outside India		
	Total		

SCHEDULE 4 - BORROWINGS

	As at 31.12. Current Year	As at 31.12. Previous Year
I. Borrowings in India		
i) Reserve Bank of India		
ii) Other banks		
iii) Other institutions and agencies		
II. Borrowings outside India		
Total		

Secured borrowings included

above Rs.

SCHEDULE 5 - OTHER LIABILITIES & PROVISIONS

	As at 31.12. Current year	As at 31.12. Previous year
I. Bills payable		
II. Inter-Office adjustments (net)		
III. Interest accrued		
IV. Others (including provisions)		
Total		

SCHEDULE 6 - CASH AND BALANCES WITH RESERVE BANK OF INDIA

	As at 31.12. Current year	As at 31.12. Previous year
I. Cash in hand (including foreign currency notes)		
II. In current Account with Reserve Bank of India		
Total		

SCHEDULE 7 - BALANCES WITH BANKS AND MONEY AT CALL AND SHORT NOTICE

	As at 31.12. Current year	As at 31.12. Previous year
I. In India		
i) Balance with Reserve Bank of India (other than in current account)		
ii) Balances with other banks in India		
Current Accounts		
Deposit Accounts		
iii) Money at call and short notice		
With banks		
With other institutions		
Total		
II. Outside India		
i) Current Accounts		
ii) Deposit Accounts		
iii) Money at call and short notice		
Total		
Grand total		

SCHEDULE 8 - INVESTMENTS

	As at 31.12. Current year	As at 31.12. Previous year
I. Investments in India		
i) Government securities		
ii) Other approved securities		
iii) Shares		
iv) Debentures and Bonds		
v) Investments in subsidiaries/associate companies		
vi) Others		
Total		
II. Investments outside India		
i) Government securities (including local authorities)		
ii) Others		
Total		
Grand total		

SCHEDULE 9 - ADVANCES

	As at 31-12- Current Year	As at 31-12- Previous Year
A. i) Bills purchased and discounted		
ii) Cash credits, overdrafts and loans repayable on demand		
iii) Term loans		
Total		
B. i) Secured by tangible assets		
ii) Covered by Bank/Government Guarantee		
iii) Unsecured		
Total		
C. I. Advances in India		
i) Priority sectors		
ii) Public sector		
iii) Banks		
iv) Others		
Total		
II. Advances outside India		
i) Due from banks		
ii) Due from others		
Total		
Grand Total		

SCHEDULE 10 - FIXED ASSETS

	As at 31-12- Current Year	As at 31-12- Previous Year
I. Premises		
At cost as at 31st December		
Additions during the year		
Deductions during the year		
Depreciation to date		
II. Other Fixed Assets (including furniture & fixtures)		
At cost as at 31st December		
Additions during the year		
Deductions during the year		
Depreciation to date		
Total		

SCHEDULE 11 - OTHER ASSETS

	As at 31.12. Current year	As at 31.12. Previous year
I. Inter-Office adjustments (net)		
II. Interest accrued		
III. Tax paid in advance/tax deducted at source		
IV. Stationery and stamps		
V. Others		
Total		

SCHEDULE 12 - CONTINGENT LIABILITIES

		As at 31.12. Current year	As at 31.12. Previous year
I.	Claims against the bank not acknowledged as debts		
II.	Liability for partly paid investments		
III.	Liability on account of outstanding forward exchange contracts		
IV.	Guarantees given on behalf of constituents		
	a) In India		
	b) Outside India		
V.	Acceptances, endorsements and other obligations		
VI.	Other items for which the bank is contingently liable		
	Total		

Annexure VI - Part II

Proposed Format
Of

PROFIT AND LOSS ACCOUNT (000's Omitted)

Profit and Loss Account for the year ended 31st December

	Schedule No.	Year ended 31-12- Current Year	Year ended 31-12- Previous Year
Income			
Interest earned	1		
Other income	2		
Total			
Expenditure			
Interest expended	3		
Operating expenses	4		
Provisions and contingencies			
Total			
Appropriations			
Net profit (Loss) for the year			
Profit (Loss) brought forward			
Total			
Transfer to statutory reserves			
Transfer to other reserves			
Transfer to Government/ Proposed dividend			
Balance carried over to balance sheet			
Total			

NOTE: 1. The total income includes income of foreign branches at Rs.

2. The total expenditure includes expenditure of foreign branches at Rs.

SCHEDULE 1 - INTEREST EARNED

		Year ended 31.12. Current year	Year ended 31.12. Previous year
I)	Interest/discount on advances/bills		
II)	Income on investments		
III)	Interest on balances with Reserve Bank of India and other inter-bank funds		
IV)	Others		
	Total		

SCHEDULE 2 - OTHER INCOME

		Year ended 31.12. Current year	Year ended 31.12. Previous year
I)	Commission, exchange and brokerage		
II)	Rent		
III)	*Net profit on sale of investments, land and buildings and other assets		
IV)	*Less: Net loss on sale of investments, land and buildings and other assets		
V)	*Net profit on exchange transactions		
VI)	*Less: Net loss on exchange transactions		
VII)	Miscellaneous income		
	Total		

* as applicable

SCHEDULE 3 - INTEREST EXPENDED

	Year ended 31.12. Current year	Year ended 31.12. Previous year
I) Interest on deposits		
II) Interest on Reserve Bank of India/inter-bank borrowings		
III) Others		
Total		

SCHEDULE 4 - OPERATING EXPENSES

	Year ended 31.12. Current year	Year ended 31.12. Previous year
I) Payments to and provisions for employees		
II) Rent, taxes and lighting		
III) Printing and stationery		
IV) Advertisement and publicity		
V) Depreciation on bank's property		
VI) Directors' fees, allowances and expenses		
VII) Auditors' fees and expenses (including branch auditors' fees & expenses)		
VIII) Law charges		
IX) Postage, telegrams, telephones, etc.		
X) Repairs and maintenance		
XI) Insurance		
XII) Other expenditure		
Total		

Annexure VI - Part III

NOTES AND INSTRUCTIONS FOR COMPILATION

General instructions

1. The formats of balance sheet and profit and loss account cover all items likely to appear in these statements. In case a bank does not have any particular item to report, it may be omitted from the formats.

2. Corresponding comparative figures for the previous year are to be disclosed as indicated in the formats. The words 'current year' and 'previous year' used in the formats are only to indicate the order of presentation and may not appear in the accounts.

3. Figures should be rounded off to the nearest thousand rupees. Thus a sum of Rs.19,75,821.20 will appear in the balance sheet as Rs.19,76.

4. Unless otherwise indicated, the term 'bank/s' in these statements will include banking companies, nationalised banks, State Bank of India, Associate Banks and all other institutions including cooperatives carrying on the business of banking, whether or not incorporated or operating in India.

5. The Hindi version of the balance sheet will be a part of the annual report.

Item	Schedule	Coverage	Notes and instructions for compilation
Capital	1	**Nationalised Banks** Capital (Fully owned by Central Government)	The Capital owned by Central Government as on the date of the balance sheet should be shown.
		Other Banks (Indian) Authorised Capital (..........Shares of Rs. each) Issued Capital (..........Shares of Rs. each) Subscribed Capital (..........Shares of Rs. each) Called up Capital (..........Shares of Rs. each) Less: Calls unpaid Add : forfeited shares Paid up Capital	In the case of Other Indian banks, Authorised, Issued, Subscribed, Called up capital should be given separately. Calls-in-arrears will be deducted from the called-up capital while the paid-up value of forfeited shares should be added thus arriving at the paid-up capital. Where necessary, items which can be combined should be shown under one head for instance 'Issued and Subscribed Capital'.
		Banking Companies incorporated outside India	In the case of Banking Companies Incorporated outside India, the amount of deposit kept with Reserve Bank of India, under sub-section 2 of section 11 of the Banking Regulation Act,1949 should be shown under the head 'capital'; the amount, however, should not be extended to the outer column. Notes - General The changes in the above items, if any, during the year, say, fresh contribution made by Government, fresh issue of capital, capitalisation of reserves, etc may be explained in the notes.

...2.

Item	Schedule	Coverage	Notes and instructions for compilation
Reserves and Surplus	2	I) Statutory Reserve	Reserve created in terms of Section 17 or any other section of Banking Regulation Act must be separately disclosed.
		II) Capital Reserves	The expression 'capital reserves' shall not include any amount regarded as free for distribution through the profit & loss account. Surplus on revaluation or sale of fixed assets should be treated as Capital Reserves.
		III) Share Premium	Premium on issue of share capital may be shown separately under this head.
		IV) Revenue and other Reserves	The expression 'Revenue Reserve' shall mean any reserve other than capital reserve. This item will include all reserves, other than those separately classified. The expression 'reserve' shall not include any amount written off or retained by way of providing for depreciation, renewals or dimunition in value of assets or retained by way of providing for any known liability.
		V) Balance of Profit	Includes balance of profit after appropriations. In case of loss the balance may be shown as a deduction. Notes - General i) Movements in various categories of reserves should be shown as indicated in the schedule.

...3.

Items	Schedule	Coverage	Notes and instructions for compilation
Deposits	3	A.I. Demand Deposits	
		i) from banks	Includes all bank deposits repayable on demand
		ii) from others	Includes all demand deposits of the non-bank sectors. Credit balances in overdrafts, cash credit accounts, deposits payable at call, overdue deposits, inoperative current accounts, matured time deposits and cash certificates, etc are to be included under this category.
		II. Savings Bank Deposits	Includes all savings bank deposits (including inoperative savings bank accounts).
		III. Term Deposits	
		i) from banks	Includes all types of bank deposits repayable after a specified term.
		ii) from others	Includes all types of deposits of the non-bank sector repayable after a specified term. Fixed deposits, cumulative and recurring deposits, cash certificates, annuity deposits, deposits mobilised under various schemes, ordinary staff deposits, foreign currency non-resident deposits accounts, etc are to be included under this category.

...3A

Item	Schedule	Coverage	Notes and instructions for compilation
		B. i) Deposits of branches in India ii) Deposits of branches outside India	The total of these two items will agree with the total deposits

Notes - General

a) Interest payable on deposits (whether accrued and due and accrued but not due) should not be included but shown under other liabilities. Deposits, repayment of which is subject to restrictions by its very nature, like margin deposits, security deposits from staff, etc also should not be included under deposits but shown under 'other liabilities'.

b) Matured time deposits and cash certificates, etc should be treated as demand deposits.

c) Deposits under special schemes should be included under term deposits if they are not payable on demand. When such deposits have matured for payment they should be shown under demand deposits.

d) Deposits from banks will include deposits from the banking system in India, co-operative banks, foreign banks which may or may not have a presence in India.

...4.

Item	Schedule	Coverage	Notes and instructions for compilation
Borrowings	4	I. Borrowings in India	
		i) Reserve Bank of India	Includes borrowings/refinance and rediscount obtained from Reserve Bank of India
		ii) Other banks	Includes borrowings/refinance and rediscount obtained from commercial banks (including co-operative banks)
		iii) Other institutions and agencies	Includes borrowings/refinance and rediscount from Industrial Development Bank of India, Export-Import Bank of India, National Bank for Agriculture and Rural Development and other institutions, agencies (including liability against participation certificates, if any)
		II. Borrowings outside India	Includes borrowings and rediscounts of Indian branches abroad as well as borrowings of foreign branches.
		Secured borrowings included above	This item will be shown separately. Includes secured borrowings/refinance in India and outside India.

Notes - General

i) The total of I & II will agree with the total borrowings shown in the balance sheet.

ii) Inter-office transactions should not be shown as borrowings.

iii) Funds raised by foreign branches by way of certificates of deposits, notes, bonds, etc should be classified, depending upon documentation, as 'deposits', 'borrowings', etc.

iv) Refinance obtained by banks from Reserve Bank of India and various institutions are being brought under the head 'Borrowings'. Hence advances will be shown at the gross amount on the assets side.

...5.

Item	Schedule	Coverage	Notes and instructions for compilation
Other liabilities and provisions	5	I. Bills Payable	Includes drafts, telegraphic transfers, mail transfers payable, pay slips, bankers cheques, other miscellaneous items, etc.
		II. Inter-Office adjustments (net)	The inter-office adjustments balance, if in credit, should be shown under this head. Only net position of inter-office accounts, inland as well as foreign, should be shown here.
		III. Interest accrued	Includes interest due and payable and interest accrued but not due on deposits and borrowings.
		IV. Others (including provisions)	Includes net provision for income tax and other taxes like interest tax (less advance payment, tax deducted at source, etc), surplus provision in bad debts provision account, surplus provisions for depreciation in securities, contingency funds which are not disclosed as reserves but are actually in the nature of reserves, proposed dividend/transfer to Government, other liabilities which are not disclosed under any of the major heads such as unclaimed dividend, provisions and funds kept for specific purposes, unexpired discount, outstanding charges like rent, conveyance, etc. Certain types of deposits like staff security deposits, margin deposits, etc where the repayment is not free, should also be included under this head.

Notes - General

i) For arriving at the net balance of inter-office adjustments all connected inter-office accounts should be aggregated and the net balance only will be shown, representing mostly items in transit and unadjusted items.

ii) The interest accruing on all deposits, whether the payment is due or not, should be treated as a liability.

iii) It is proposed to show only pure deposits under the head 'deposits' and hence all surplus provisions for bad and doubtful debts, contingency funds, secret reserves, etc which are not netted off against the relative assets should be brought under the head 'Others (including provisions)'.

...6.

Item	Schedule	Coverage	Notes and instructions for compilation
Cash and balances with the Reserve Bank of India.	6	I. Cash in hand (including foreign currency notes)	Includes cash in hand including foreign currency notes and also of foreign branches in the case of banks having such branches.
		II. In Current Account with Reserve Bank of India.	Includes the balances maintained with the Reserve Bank of India in Current Account.

Item	Schedule	Coverage	Notes and instructions for compilation
Balances with banks and money at call and short notice	7	I. In India	
		i) Balances with Reserve Bank of India (other than in current account)	Includes balances held with the Reserve Bank of India other than in current accounts, if any.
		ii) Balances with other banks in India	Includes all balances with banks in India (including co-operative banks). Balances in current accounts and deposit accounts should be shown separately.
		Current accounts	
		Deposit accounts	
		iii) Money at call and short notice with banks and other institutions.	Includes deposits repayable within 15 days or less than 15 days' notice lent in the inter-bank call money market.
		II. Outside India	
		i) Current accounts	Includes balances held by foreign branches and balances held by Indian branches of the banks outside India. Balances held with foreign branches by other branches of the bank should not be shown under this head but should be included in inter-branch accounts. The amounts held in 'current accounts' and 'deposit accounts' should be shown separately.
		ii) Deposit accounts	
		iii) Money at call and short notice	Includes deposits usually classified in foreign countries as money at call and short notice.

Item	Schedule	Coverage	Notes and instructions for compilation
Invest-ments	8	I. Investments in India	
		i) Government securities	Includes Central and State Government securities and Government treasury bills.
		ii) Other approved securities	Securities other than Government securities, which according to the statute are treated as approved securities, should be included here.
		iii) Shares	Investments in shares of companies and corporations not included in item (ii) should be included here
		iv) Debentures and Bonds	Investments in debentures and bonds of companies and Corporations not included in item (ii) should be included here.
		v) Investments in subsidiaries/associate companies	Investments in subsidiaries/associate companies should be included here. A company will be considered as an associate company for the purpose of this classification if more than 25% of the share capital of that company is held by the bank.
		vi) Others	Includes residual investments, if any, like gold.
		II. Investments outside India	
		i) Government securities (including local authorities)	All foreign Government securities including securities issued by local authorities may be classified under this head.
		ii) Others	All other investments outside India may be shown under this head.

...9.

Item	Schedule	Coverage	Notes and instructions for compilation
Advances	9	A. i) Bills Purchased and Discounted ii) Cash credits, overdrafts and loans repayable on demand iii) Term loans	In classification under Section 'A', all outstandings - in India as well as outside - less provisions made, will be classified under three heads as indicated and both secured and unsecured advances will be included under these heads.
		B. i) Secured by tangible assets	All advances or part of advances which are secured by tangible assets may be shown here. The item will include advances in India and outside India.
		ii) Covered by Bank/Government Guarantee	Advances in India and outside India to the extent they are covered by guarantees of Indian and foreign governments and Indian and foreign banks are to be included.
		iii) Unsecured	All advances not classified under (i) and (ii) will be included here.
		C. I Advances in India i) Priority sectors ii) Public sector iii) Banks iv) Others II Advances outside India i) Due from banks ii) Due from others	Advances should be broadly classified into 'Advances in India' and 'Advances outside India'. Advances in India will be further classified on the sectoral basis as indicated. Advances to sectors which for the time being are classified as priority sectors according to the instructions of the Reserve Bank are to be classified under the head 'Priority sectors'. Advances to Central and State Governments and other Government undertakings including Government companies and corporations which are, according to the statutes, to be treated as public sector companies are to be included in the category "Public sector". All advances to the banking sector including co-operative banks will come under the head 'Banks'. All the remaining advances will be included under this head 'Others' and typically this category will include non-priority advances to the private, joint and co-operative sectors.

....9a.

Item	Schedule	Coverage	Notes and instructions for compilation
			Notes - General i) The gross amount of advances including refinance but excluding provisions made to the satisfaction of auditors should be shown as advances. ii) Term loans will be loans not repayable on demand iii) Consortium advances would be shown net of recoveries from other participating banks/institutions.

...10.

Item	Schedule	Coverage	Notes and instructions for compilation
Fixed Assets	10	I. Premises	Premises wholly or partly owned by the banking company for the purpose of business including residential premises should be shown against 'Premises'. In the case of premises and other fixed assets, the previous balance, additions thereto and deductions therefrom during the year as also the total depreciation written off should be shown. Where sums have been written off on reduction of capital or revaluation of assets, every balance sheet after the first balance sheet subsequent to the reduction or revaluation should show the revised figures with the date and amount of revision made.
		II. Other Fixed Assets (including furniture and fixtures)	Motor vehicles and all other fixed assets other than premises but including furniture and fixtures should be shown under this head.

...11.

Item	Schedule	Coverage	Notes and instructions for compilation
Other assets	11	I. Inter-Office adjustments (net)	The inter-office adjustments balance, if in debit, should be shown under this head. Only net position of inter-office accounts, inland as well as foreign, should be shown here. For arriving at the net balance of inter-office adjustment accounts, all connected inter-office accounts should be aggregated and the net balance, if in debit, only should be shown representing mostly items in transit and unadjusted items.
		II. Interest accrued	Interest accrued but not due on investments and advances and interest due but not collected on investments will be the main components of this item. As banks normally debit the borrowers' account with interest due on the balance sheet date, usually there may not be any amount of interest due on advances. Only such interest as can be realised in the ordinary course ~~only~~ should be shown under this head.
		III. Tax paid in advance/tax deducted at source	The amount of tax deducted at source on securities, advance tax paid, etc to the extent that these items are not set off against relative tax provisions should be shown against this item.
		IV. Stationery and stamps	Only exceptional items of expenditure on stationery like bulk purchase of security paper, loose leaf or other ledgers, etc. which are shown as quasi-asset to be written off over a period of time should be shown here. The value should be on a realistic basis and cost escalation should not be taken into account, as these items are for internal use.
		V. Others	This will include non-banking assets and items like claims which have not been met, for instance, clearing items, debit items representing addition to assets or reduction in liabilities which have not been adjusted for technical reasons, want of particulars, etc, advances given to staff by a bank as employer and not as a banker, etc. Items which are in the nature of expenses which are pending adjustments should be provided for and the provision netted against this item so that only realisable value is shown under this head. Accrued income other than interest may also be included here.

...12.

Item	Schedule	Coverage		Notes and instructions for compilation
Contin-gent liabili-ties	12	I.	Claims against the bank not acknowledged as debts	-
		II.	Liability for partly paid investments	Liability on partly paid shares, debentures, etc will be included in this head.
		III.	Liability on account of out-standing forward exchange contracts	Outstanding forward exchange contracts may be included here.
		IV.	Guarantees given on behalf of constitutents a) In India b) Outside India	Guarantees given for constituents in India and outside India may be shown separately.
		V.	Acceptances, endorsements and other obligations	This item will include letters of credit and bills accepted by the bank on behalf of its customers.
		VI.	Other items for which the bank is contingently liable	Arrears of cumulative dividends, commitments under underwriting contracts, estimated amount of contracts remaining to be executed on capital account and not provided for etc are to be included here.
Bills for Collect-ion	-		-	Bills and other items in the course of collection and not adjusted will be shown against this item in the summary version only. No separate schedule is proposed.

Profit and Loss Account

Item	Schedule	Coverage	Notes and instructions for compilation
(1)	(2)	(3)	(4)
Interest earned	1	I. Interest/discount on advances/ bills	Includes interest and discount on all types of loans and advances like cash credit, demand loans, overdrafts, export loans, term loans, domestic and foreign bills purchased and discounted (including those rediscounted), overdue interest and also interest subsidy, if any, relating to such advances/bills.
		II. Income on investments	Includes all income derived from the investment portfolio by way of interest and dividend.
		III. Interest on balances with Reserve Bank of India and other inter-bank funds	Includes interest on balances with Reserve Bank and other banks, call loans, money market placements, etc.
		IV. Others	Includes any other interest/discount income not included in the above heads.
Other income	2	I. Commission, exchange and brokerage.	Includes all remuneration on services such as commission on collections, commission/exchange on remittances and transfers, commission on letters of credit and guarantees, commission on Government business, commission on other permitted agency business including consultancy and other services, brokerage, etc on securities. It does not include foreign exchange income.
		II. Rent	Includes rent on properties, lockers and other leases.
		III.*Net profit on sale of investments, land and buildings other assets. IV. *Less: Net loss on sale of investments, land and buildings and other assets	Includes profit/loss on sale of securities, furniture, land and buildings, motor vehicles, gold, silver, etc. Only the net position should be shown. If the net position is a loss, the amount should be shown as a deduction. The net profit/loss on revaluation of assets may also be shown under this item.

* as applicable

(1)	(2)	(3)	(4)
		V. *Net profit on exchange transactions VI. *Less: Net loss on exchange transaction.	Includes profit/loss on dealing in foreign exchange, all income earned by way of foreign exchange, commission and charges on foreign exchange transactions excluding interest which will be shown, under interest. Only the net position should be shown. If the net position is a loss, it is to be shown as a deduction.
		VII. Miscellaneous income	Includes recoveries from constituents for godown rents, security charges, insurance, etc and any other miscellaneous income. In case any item under this head exceeds one percentage of the total income, particulars may be given in the notes.
		* as applicable.	
Interest Expended	3	I. Interest on deposits	Includes interest paid on all types of deposits including deposits from banks and other institutions.
		II. Interest on Reserve Bank of India/inter-bank borrowings	Includes discount/interest on all borrowings and refinance from Reserve Bank of India and other banks.
		III. Others	Includes discount/interest on all borrowings/refinance from financial institutions. All other payments like interest on participation certificates, penal interest paid, etc may also be included here.
Operating Expenses	4	I. Payments to and provisions for employees	Includes staff salaries/wages, allowances, bonus, other staff benefits like provident fund, pension, gratuity, liveries to staff, leave fare concessions, staff welfare, medical allowance to staff, etc.
		II. Rent, taxes and lighting	Includes rent paid by the banks on buildings, vehicles and other municipal and other taxes paid (excluding income tax and interest tax) electricity and other similar charges and levies. House rent allowance and other similar payments to staff should appear under the head 'Payments to and provisions for employees'.
		III. Printing and stationery	Includes books and forms and stationery used by the bank and other printing charges which are not incurred by way of publicity expenditure.

(1)	(2)	(3)	(4)
		IV. Advertisement and publicity	Includes expenditure incurred by the bank for advertisement and publicity purposes including printing charges of publicity material.
		V. Depreciation on bank's property	Includes depreciation on bank's own property, motor cars and other vehicles, furniture, electric fittings, vaults, lifts, leasehold properties, non-banking assets, etc.
		VI. Directors' fees, allowances and expenses	Includes sitting fees and all other items of expenditure incurred on behalf of directors. The daily allowance, hotel charges, conveyance charges, etc which though in the nature of reimbursement of expenses incurred may be included under this head. Similar expenses of local Committee members may also be included under this head.
		VII. Auditors' fees and expenses (including branch auditors' fees and expenses)	Includes the fees paid to the statutory auditors and branch auditors for professional services rendered and all expenses for performing their duties, even though they may be in the nature of reimbursement of expenses. If external auditors have been appointed by banks themselves for internal inspections and audits and other services the expenses incurred in that context including fees may not be included under this head but shown under 'other expenditure'.
		VIII. Law charges	All legal expenses and reimbursement of expenses incurred in connection with legal services are to be included here.
		IX. Postage, telegrams, telephones, etc.	Includes all postal charges like stamps, telegram, telephones, teleprinter, etc.
		X. Repairs and Maintenance	Includes repairs to bank's property, their maintenance charges, etc.
		XI. Insurance	Includes insurance charges on bank's property, insurance premia paid to Deposit Insurance & Credit Guarantee Corporation, etc to the extent they are not recovered from the concerned parties.

(1)	(2)	(3)	(4)
		XII. Other expenditure	All expenses other than those not included in any of the other heads, like, licence fees, donations, subscriptions to papers, periodicals, entertainment expenses, travel expenses, etc may be included under this head. In case any particular item under this head exceeds one percentage of the total income particulars may be given in the notes.
Provisions and contingencies	-	-	Includes all provisions made for bad and doubtful debts, provisions for taxation, provisions for dimunition in the value of investments, transfers to contingencies and other similar items.

ANNEXURE VII

Guidelines on Health Codes for Classification of Advances

Code 1 : Satisfactory

This category covers all borrowers where

a) conduct of the account is satisfactory:

b) all terms and conditions (like punctual submission of stock statements quarterly operating statement wherever applicable balance-sheets for annual review, etc. execution of annual acknowledgement of debt and security, etc.) are complied with;

c) all accounts of the borrowers are in order ;

d) the safety of the advance is not suspected.

Code 2 : Irregular

This category of borrowers covers those accounts where the safety of the advances is not suspected, though there may be occasional irregularities which may be considered as a short-term phenomenon, viz.

i) The accounts are overdrawn beyond the drawing power (based on the value of security less margin) or the sanctioned limit for a temporary period. It should be noted that frequent overdrawings in accounts are not to be construed as a short-term phenomenon.

ii) Instalments/interest/retirement of import

Bills under L/C, meeting the commitments under Deferred Payment Guarantee if they are overdue for a period not exceeding 3-6 months.

iii) Some of the bills advanced against (not exceeding 10% - 15% of the total outstandings in the bills purchased/discounted account of the borrower) are overdue for payment beyond the due date by 3 months and/or refund in respect of unpaid bills is not forthcoming.

Code 3 : <u>Sick/Sticky</u>

Accounts of borrowers under this category are those where the irregularities mentioned above persist beyond a period of say 6 months and there are no immediate prospects of regularisation. Alternatively or in addition the accounts could throw up some of the usual signs of incipient sickness, such as,

(i) apparent stagnation in the business as reflected by slow/negligible turnover in the account;

(ii) frequent requests for overdrawings or issue of cheques without ensuring availability of funds in the account;

(iii) undue delay/failure in payment of bills payable the borrower and/or in realisation of bills drawn by him;

(iv) bills purchased/discounted drawn by the borrower remaining overdue beyond 2/3 months or returned unpaid and/or the recovery of such bills from the borrower posing difficulties;

(v) unexplained delays in submission of stock-statements/quarterly operating statements/balance-sheets and other information required by the bank;

(vi) slow movement/stagnation of stocks observed during inspections;

(vii) low/negligible level of activity observed during inspections or suspension/closure of the business;

(viii) persistent delay/non-compliance of vital requirements like execution of documents, producing additional security when required, etc

(ix) diversion of funds to sister units/acquiring capital assets not relevant to the business/large personal withdrawals.

(x) avoidable non-adherance to project schedules lending to substantial cost-escalations and requirement of additional term finance;

(xi) pressure on the liquidity lending to non-payment of wages to workers/statutory dues/rents of office and factory premises;

(xii) any grave features observed by the auditors of the Bank which remain to be rectified;

(xiii) basic weaknesses revealed by the financial statements of the unit such as continued cash losses beyond one year.

It should be noted that the above indications are not exhaustive and not all of them may simultaneously be observed.

The Branch Manager should essentially rely on his judgement based on the above guidelines while classifying the borrower. Sick units, which are considered potentially viable and put under a nursing programme by the Bank will also come under this category.

Code 4 : <u>Advances recalled</u>

This category consists of those accounts where the repayment is highly doubtful and nursing is not considered worthwhile. If a decision has been taken (or likely to be taken) to recall the advance such borrowers will be classified under this code.

Code 5 : <u>Suit-filed Accounts</u>

This category consists of accounts where legal action or recovery proceedings under the Public Debt Recovery Act wherever applicable has been initiated.

Code 6 : <u>Decreed Debts</u>

Those advances where suits have been filed and decree obtained will come under this category.