UNIT 17 ACCOUNTING POLICIES AND STANDARDS

Objectives

The main objectives of this unit are to:

- understand the importance of Accounting Policies and Standards in preparation of accounting statements;
- explain General Accounting Concepts and Conventions in preparation of accounting policies;
- provide an overview of Accounting Standards in general;
- highlight the important Accounting Standards related to banking industry.

Structure

17.1 Introduction

17.2 Need for Accounting Policies and Standards

17.3 Accounting Concepts and Conventions

17.4 Overview of Accounting Standards

17.5 Accounting Standards for Banking Industry

17.6 Summary

17.7 Self-Assessment Questions

17.8 Further Readings

Appendices

17.1 INTRODUCTION

The use of the double entry book keeping is Centuries old. The double entry book keeping system has originated from Italy during the 15th century. The book keeping was done in long accounting books with left side of the book representing the Debit and right side of the book for the Credit. In other words, this system involves making at least two entries for every transaction: a debit in one account, and a corresponding credit in another account. The sum of all debits should always equal the sum of all credits. This provides an easy way to check for errors. This system was first used in medieval Europe.

The tradition continued for a long time till man invented computers. Certainly the invention of the computers had revolutionised the book keeping system. Over the years when business started to grow in size and complexity the use of accounting packages made the job easier. The information recorded as double entry book keeping were summarised and used in summary form for decision making purpose.

For instance, the information about material usage, inventory, record of assets information were required to make decisions like when to purchase more inventory, how much of inventory of finished goods were sold during the year and how much more assets need to be purchased to keep up the operations. In the same way information on the personnel, processing , etc., was also needed to be maintained. The availability of information technology made possible the real time accounting. This is required because not only the information is used by the insiders and managers, external investors; the creditors, the government, the tax authorities, etc., also demand information about the company business. Book keeping was then regulated. Finally the accounting information made available must be reliable and feasible enough to generate meaningful conclusions.

17.2 NEED FOR ACCOUNTING POLICIES AND STANDARDS

Though the book keeping rules are based on the underlying economics of the transactions, the regulatory authorities preferred to lay out common set of rules and guidelines in preparing the accounting or financial statements. This was required in order to compare the statements of companies within the same industry. Hence, standard accounting practices were laid down. Different countries have their own Generally Accepted Accounting Practices laid down within their country. Despite that the International Accounting Standards Board had brought out Accounting Standards which it considered to be the Standard practice for all countries. However, it is optional for the countries to redraft the same to suit their economy, based on their needs and requirements.

However, the Accounting Standard Board(s) of each of the country make sure that the accounting or the financial statements from the companies in a similar industry provide reports based on the generally accepted standards so as to enable easy comparison of the reports. This enables investors, creditors and government to compare the performance of the companies, which may not be possible otherwise if they are allowed to report the statements based on the discretion of Management of the company.

Accounting is the language of business. Accounting information is gathered for decision-making purposes as stated earlier. For instance the decision on how much loan to be granted for different types of industries like small industries or those belonging to core sector shall be taken basing on the accounting information provided by the company. Hence it is very essential that the accounting books are based on policies and standards.

Activity 1

1) Illustrate 5 main points as to why do we need accounting standards and policies for book keeping?

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2) Why do the accounting principles differ drastically based on the industry? Illustrate with examples.

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17.3 ACCOUNTING CONCEPTS AND CONVENTIONS

Imagine that you are the CEO of a bank, and you provide copies of your financial records (‘books’) to six different accountants. You ask each one to calculate your profit for the year. A fortnight later each of them provides you with their answers. There are six different profit figures, with very wide variations between them.

Will you be comfortable when you face such a situation while you are trying to invest your money in a particular industry and the top 6 companies profits reported are drastically different and they all followed different policies, rules and regulations to

calculate the profit. Will you be able to compare them and make a decision as to in which company to invest. You will not be able to decide which one of the six is performing better.

To avoid this kind of situation arising from various rules, accepted ways of reporting the statements evolved. These rules are known as ***'concepts'*** and ***'conventions'***. The concepts and conventions define the underlying principles under which a decision needs to be made and the manner in which they have to be accounted for.

Accounting principles are evolved by humans. Unlike the principles in chemistry, physics, and other natural sciences, accounting principles cannot be deduced from basic axioms nor can be verified by observations and experiments. Instead they are evolved. This evolutionary process goes on constantly. The general acceptance of an accounting principle usually depends on how well it meets three basic criteria namely, relevance, objectivity and feasibility.

Some of the major concepts and Conventions are listed below:

1. **Going Concern Concept**

The company or business is presumed to be healthy and likely to continue in business for the foreseeable future. Under this assumption most of the transactions are recorded. For instance, a company has produced 100 units of a TV for the year 2004 at a cost of Rs.10,000 (lets keep the number small for simplicity). And by the end of the year the company could sell about 60 TVs at a price of Rs.100 each without making any profit on the transaction. Now, the question arises as to what the company will do with the unsold 40 TVs at the end of 2004. We treat Rs.6000 as sales, and Rs.10,000 as cost of production. What about the Rs.4000 which is not yet accounted for? Should the company charge the entire cost of Rs.10,000 on the units sold? What will happen to the unsold TVs in that case? Will the company destroy them and close down the shop or business or company? No. The company or business is assumed to exist in the foreseeable future and sell the unsold 40 TVs. So we would end up treating it as inventory and sell it in the next year.

2. **Materiality Concept**

This concept indicates that not every transaction taking place in an organization gets reported in the financial statement as it is. For instance, the purchase of stationery every month will not get reflected in the profit and loss account. These transactions will be summarized at the end of the year and will appear as expenses towards stationery for the accounting year. Further, in certain cases confusion occurs as to the treatment of the transaction as an expense or an asset. For instance the administrative manager of a cement manufacturing firm purchases few hangers to hang the coats of the employees. This transaction is treated as an expense. However, purchase and sale of hangers by any retailer or a firm specializing in manufacturing and sales of coat hangers will treat it as an asset or inventory and not as an expense. So the treatment varies depending on the materiality.

3. **Consistency Concept**

Consistency concept indicates that the company cannot keep changing its accounting policies quite often. For instance, if a company decides to depreciate its assets on a straight line basis of accounting, then it is expected to continue the same for few years. A company cannot depreciate an asset on Straight line basis in year 1 and adopt written down value in year 2. This is strictly not allowed. So, once a firm has chosen a particular method in accounting, it should adhere to that method in the future, so as to allow for the most meaningful comparisions on a year-by-year basis. Only when there

are compelling reasons a change should be adopted, and that change should be reported in the notes to accounts along with the financial reports. However, with regard to different accounting methods, a company can adopt Straight Line Method (SLM) for reporting purposes and written down value for tax purposes. In India, like in the US, companies are permitted to prepare two sets of books, one for tax purpose and one for reporting to shareholders. However, they need to reconcile the two and make necessary adjustments and reveal the differential accounting involved.

4. **Accrual Concept**

Accrual concept helps the companies to report the statements as and when the transaction is due and occurs. For instance, salaries to be paid for the year in which the services of the employees have been extracted, the expense need to be shown in the year in which the service occurred or the expense is due. This applies even if the salaries are not paid in cash. Whatever is due has to be reported for, during the year. If not paid in cash, it will appear as salaries outstanding in the liability side of the balance sheet. As against this there is a cash basis of accounting, as per which companies record transactions for which cash were paid out. This might suit well for a sole proprietorship form of business where there would not be much difference between the cash expenses and expenses accrued for the year. The profit amount varies for the two methods. But the generally accepted accounting principle requires companies to prepare financial statements based on the accrual concept. Because by this method, it helps an investor to understand better the profit earned during a year.

5. **Realization Concept**

The realization concept illustrates well as to when the profit on a transaction need to be realized. In the accrual concept we saw that the investors would be able to get a better picture of the profit earned for the period. However, lot of confusion occurs as to when a profit must be realized for any transaction. The confusion occurs more so for business types which are a typical. For instance in the software service industry, it is very difficult to determine when to realize the profit. In the same way for the construction industry the question arises as to when to realize the profit for the construction contract. In some cases the contract runs for about 4 to 5 years. It may not be feasible for a company to wait until 4 or 5 years to realize and record the profit. As the company has to release financial statements every year, should the company report zero profit just because it did not complete the only contract it had. Accounting standards and rules laid down clearly different methods of recognizing revenue and profit for the construction contract and various services industry. There are methods like completion of contract method of accounting, percentage of completion accounting etc., for construction services. Hence the company has to go by the rules laid down for its industry.

6. **Money Measurement Concept**

Money measurement concept illustrates that only transactions that can be measured on monetary basis can be recorded in the financial statements. In other words, those events that cannot be measured in money terms cannot be entered in the books. For instance, when a merger takes place between two companies, we record many transactions. Like the purchase of assets from the other company and payment for these assets by cash or equity or convertible bonds. All such transactions are recorded. Even the premium paid over and above the value of the net assets acquired, though intangible is also recorded as it can be measured on a reasonable basis. However, during the course of merger, the events like employees' non satisfaction of the merger and dissatisfaction of both the managements cannot be measured in money terms and not relevant for the financial statements.

7. **Business Entity Concept**

This concept illustrates that the business is separate and distinct from its owners. The accounts and statements reported show the affairs of the business but not that of the owner. This however does not apply for the sole proprietorship form of business. Because in this case if the business is not able to pay, the creditors have the right to claim from the sole proprietor. His personal assets are sold to pay the creditor. Whereas in a company form of business, the management, the shareholders (or the owners), the board are distinct from the business. However, the owner's benefits and loss restrict to the extent of the shares they own in the company.

8. **Dual Aspect Concept**

Dual aspect concept explains that every transaction taking place in the business has to be recorded on a double entry basis. The double entry bookkeeping has atleast two entries made for every transaction. For instance, the company raises equity capital to the extent of Rs. 1,00,000 and the investors paid the money in cash. Hence the company would increase the asset side of the balance sheet i.e, the cash by one lakh and also simultaneously increase the liability side of the balance sheet i.e. the equity capital account by one lakh. This makes the balance sheet balanced.

9. **Historical Cost Concept**

This concept explains how the value of any transaction should appear in the books. For instance it explains how the fixed assets like the plant value, the machinery, the equipments value should appear in the books subject to the depreciation in the value of the asset because of the usage. This concept claims that the historical cost of the asset for which it was purchased reduced by the depreciation value or the extent of usage value be shown in the balance sheet. However these days, this concept has seen lot of changes. The historical cost makes no sense, consider a plant purchased at cost of one lakh rupees having a book value of Rs. 20,000 whereas replacement cost of the plant as of today is Rs. 2.5 lakhs. Hence new accounting standards on asset impairment has been introduced. And the recording of the assets on the fair value or market value basis is still debated.

10. **Conservative Convention**

The conservatism convention suggests that the profits should not be realized and recorded until it occurs or should not be anticipated. The profits should be earned and accrued. However, losses can be anticipated and provided for. For instance, if the company believes that they are not going to receive the dues from some of its credit sales then it can provide for them as bad debts from the profits. This is to make sure that the profits reported from the credit sales are meaningful and represent true quality of the assets lying in the balance sheet.

Activity 2

1) Why do we need concepts and conventions?

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2) What are the major concepts and conventions that help in making the accounting information comparable across firms.

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17.4 OVERVIEW OF ACCOUNTING STANDARDS

In India, the accounting standards are laid down by the Accounting Standard Board of the Institute of Chartered Accountants of India (ICAI). Practicing Chartered Accountants (CAs) and who clear the CA exam, become members of the ICAI and start providing services like auditing, tax, litigation support, consulting and other financial advisory services. Companies not only have to abide by the accounting standards laid down by the ICAI but must also fulfil the listing requirements laid down by the Securities and Exchange Board of India (SEBI).

SEBI regulates the stock exchanges and the companies that get listed in the stock exchanges for trading. These listing requirements do not restrict by laying down the rules and regulations on the way the financial reports need to be filed, the limits on equity capital, etc. Most of the times when any new accounting standard is needed to be introduced, it is first made mandatory as a listing requirement. For instance, the accounting standard on segment reporting was first introduced as a listing requirement and subsequently ICAI brought it as AS-17 on segment reporting. This occurs when there are conflicts between the companies and the regulatory authorities on regulating the new Accounting Standards. If companies find that the proposed accounting standards reveal their weakness and tarnish their strengths, they would plead to the Government to drop the Standard. In such circumstances, SEBI takes the lead role for protecting investor interests and makes the same as mandatory for listing requirements. Subsequently, if the Companies Bill for the proposed standard gets accepted, then a new Accounting Standard is passed by the ICAI.

There are about 29 Accounting Standards in India as of March 2004. The list of accounting standards has been given below:

A.S. No.	Accounting Standard
1	Disclosure of Accounting Policies
2	Valuation of Inventories
3	Cash Flow Statements
4	Contingencies and Events Occurring After the Balance sheet Date
5	Net Profit or Loss for the Period or Prior Period and Extra Ordinary Items and Changes in Accounting Policies
6	Depreciation Accounting
7	Accounting for Construction Contracts
8	Accounting for Research and Development
9	Revenue Recognition
10	Accounting for Fixed Assets
11	Accounting for the Effect of Changes in Foreign Exchange Rates
12	Accounting for Government Grants
13	Accounting for Investments
14	Accounting for Amalgamations
15	Accounting for Retirement Benefits in the Financial Statement of Employees
16	Borrowing costs
17	Segment Reporting
18	Related Party Transactions
19	Leases
20	Earnings Per Share
21	Consolidated Financial Statement
22	Accounting for Taxes on Income
23	Accounting for Investments in Associates in Consolidated Financial Statements
24	Discontinued Operations
25	Interim Financial Reporting
26	Intangible Assets
27	Financial Reporting of Interests in Joint Ventures
28	Impairment of Assets
29	Provisions, Contingent Liabilities and Contingent Assets

The accounting standards in India are set as per the standards laid down by the International Accounting Standards (IAS). Every country has its own accounting standards laid down based on the Generally Accepted Accounting Practices (GAAP) in that country. While the developing countries like India, Malaysia, and Singapore, and African countries follow the IAS, UK and US and some other European nations have their own GAAP quite different from the IAS. For instance, the United States (US) GAAP is considered to be more stringent than the IAS.

In the US, the CPAs and CMAs are the practicing accountants just like the CAs in India. The Accounting Standard setting bodies in US are the American Institute of Certified Public Accountants (AICPA), The Financial Accounting Standards Board (FASB), The Government Accounting Standards Board (GASB) and Federal Accounting Standards Advisory Board. Apart from these agencies, the Securities Exchange Commission performs similar role in US like that of SEBI in India. In UK, the Accounting Standard setting bodies are the Institute of Chartered Accountants of England and Wales, and the Institute of Chartered Accountant of Scotland.

Activity 3

1) List down the regulatory agencies that determine the Accounting Standards and Policies in India?

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2) How do the Indian GAAP and US GAAP differ?

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17.5 ACCOUNTING STANDARDS FOR BANKING INDUSTRY

"*Banks represent a significant and influential sector of business worldwide. Most individuals and organizations make use of banks, either as depositors or borrowers. Banks play a major role in maintaining confidence in the monetary system through their close relationship with regulatory authorities and governments and the regulations imposed on them by those governments. Hence there is considerable and widespread interest in the well-being of banks, and in particular their solvency and liquidity and the relative degree of risk that attaches to the different types of their business. The operations, and thus the accounting and reporting requirements, of banks are different from those of other commercial entities.*" This statement was taken from the proposed new Accounting standard for Financial Institutions from the Australian Accounting Standards Board. However, this Accounting standard remains still pending.

The ownership structure of the banks is quite different from the manufacturing companies. We need to understand why it is different. For instance, not all public sector commercial banks have gone public and got listed in the stock exchanges. The process of going public is taking place very slowly. The Bank Nationalization Act of 1970 was amended in 1994 and it enabled the banks to go public. These days many banks are coming out with their Initial public offers. Once listed, the public sector banks are not only governed, by the principal regulator, the Reserve Bank of India, but also by the stock exchanges through the listing agreement, and by the Securities

and Exchange Board of India for all matters pertaining to the capital market. Though they were allowed to go public, the shareholders were not allowed the voting rights. Shareholders of listed public sector banks are only permitted to discuss the annual reports at the annual general meetings which is in contrast to the practice of annual reports of companies adopted by shareholders.

When banks default, it is the RBI and the Government which are held responsible, because banks failure can cause the economy of the country to a down trend. We very well saw the instance of the Government interfering and rescuing the US-64 scheme of the Unit Trust of India. Banks perform business as per the Banking Regulation Act and as per the guidelines laid down by the Reserve Bank of India. The formats of balance sheet and profit & loss account have been prescribed in the Banking Regulation Act, 1949, and banks have to strictly comply with this (Please refer Schedule III of the ACT). The accounts and balance sheets are required to be duly audited by statutory auditors (including branch auditors) appointed with the approval of RBI. While international accounting standards are broadly followed, specific valuation standards have been prescribed in respect of investments and foreign exchange positions.

The task of moving towards greater disclosure by banks in India was taken up in 1982 when the formats of the financial statements were revised and expanded. Following the liberalization measures introduced in the beginning of this decade, the process and extent of disclosure by the banking system has been further enhanced. Over the past few years, banks have been advised to disclose key information on capital adequacy and composition, NPAs, provisions, investments, and shareholding of Government. Banks are also required to disclose certain critical financial ratios on profitability and efficiency. More recently, banks have been asked to disclose maturity pattern of assets and liabilities, movement in NPAs and exposure to sensitive sectors.

Now that we realize that the accounting policies and standards differ for the manufacturing firms and the financial services industry, we will look into the areas where the differences occur. To understand the differences, we need to know how the financial statements differ between a manufacturing industry and a financial institution. **Appendix 17.1** provides the financial statements, both the balance sheet as well as the Income statement, of the Corporation Bank. The bank's income is mainly from the interest it earns from the lending and the expenses are basically the interest paid on the deposits and the loans taken by the bank. However, most concepts and conventions described in the earlier sections apply to the banks as well. The Accounting policies of the Corporation Bank taken from its annual report are given in **Appendix 17.2**. Let us discuss the accounting policies and standards generally observed in the preparation of Balance Sheet and Income Statement.

(A) BALANCE SHEET

1) Preparation of Balance Sheet

The Balance Sheet should present fairly all assets, liabilities, and stockholders' equity as on the balance sheet date in order to show clearly the financial position of the entity. The Balance Sheet should comprise sections of assets, liabilities, and stockholders' equity. Assets and liabilities should be presented in the order of their liquidity in principle, but operating characteristics of the entity should be also considered. Major categories of assets and liabilities should be presented in the order of their liquidity. The order of accounts within each category should be determined on the basis of business characteristics and relative importance of accounts. The rationale for such presentation is that the usefulness of accounting information can be enhanced by presenting assets and liabilities in terms of business characteristics because most assets and liabilities of financial institutions are to be collected or redeemed in the near

future. When securities are sold or bought in a standardised transaction, the date of contracting should be used as a transaction date.

a) ***Grouping and Classification of Assets***

Assets should be classified into cash and dues from banks, trading securities, investment securities, loans, fixed assets, and other assets.

i) **Cash and Dues from Banks**

Cash and dues from banks include the following:

- Cash
- Cash in foreign currency
- Dues from banks in local currency
- Dues from banks in foreign currency

Cash refers to currency and cheques.

Cash in foreign currency refers to foreign currency held by a foreign exchange bank.

Dues from other banks refers to deposits made at other financial institutions (all legal entitles that have financing as its main operating activity) under a contract of bailment subject to consumption.

Dues from banks in foreign currency refers to foreign currency deposited at overseas banks, other domestic foreign exchange banks, and the Central Bank.

ii) **Trading Securities**

Trading securities include those securities, which have been acquired for short-term capital gains. Among equity securities such as stocks and investment in capital, only marketable equity securities should be included. However, stocks issued by parties having a special relationship with the banks and debt securities purchased with the intention of holding to their maturity date (held-to-maturity debt securities) should not be included in trading securities. Trading securities encompass stocks, government and municipal bonds, corporate bonds, beneficiary certificates, and foreign trading securities. Foreign trading securities should be classified by currency and by type and disclosed in the accompanying notes to financial statements.

iii) **Investment Securities**

Investment securities refer to those securities, which do not belong to trading securities. Investment securities include stocks, investments in capital, government and municipal bonds, corporate bonds, beneficiary certificates, and foreign investment securities. Foreign investment securities should be classified by currency and by type and disclosed in the accompanying notes to the financial statements.

iv) **Reclassification of Securities**

Classification of trading versus investment securities should be made at the time of acquisition and they should be accounted for accordingly. Trading securities may be reclassified later to investment securities, but reclassification of investment securities is not allowed. The reason for not allowing investment securities to be reclassified later is that gains or losses on valuation of trading securities are reported in the income statement, while gains or losses on valuation of investment securities are reported as capital adjustments in the balance sheet. Thus, reclassification of investment securities is not allowed to prevent possibility of earnings manipulation.

v) **Loans Receivable**

Irrespective of the form of transaction, funds lent with the intention of receiving interests and with an agreement of paying back the principal and interests should be treated as loans. Indemnity receivables arising from payments on guarantees should also be classified as loans. Loans include the following:

– Loans in local currency
– Loans in foreign currency
– Notes purchased
– Foreign drafts purchased
– Payments on guarantees
– Factoring receivables
– Credit card receivables
– Securities purchased under resale agreements
– Other loans

Loans to other financial institutions (all legal entities whose main operating activity is financing) should be classified by type and disclosed in a note to the financial statements.

vi) **Fixed Assets**

Fixed assets encompass investment assets, tangible assets, intangible assets, and non-operating assets. Investment assets include those assets which have been acquired for investment purposes such as investment properties and other investment assets, but do not include investment securities. Non-operating assets include non-operating real estate and personal properties, which have been acquired by exercising rights on collateral assets.

vii) **Other Assets**

Other assets are those assets, which do not belong to any of the above classifications. These assets include the following:

– Guarantee deposits (leasehold rights, telex and telephone subscription rights, leasehold deposits and operation guarantee deposits, etc.)
– Other receivables
– Accrued revenues
– Prepaid expenses
– Deferred income tax charge

Other assets may be combined together and be shown as miscellaneous assets if their amount is not material, such as supplies, security deposits, receivables in transit between other banks, precious metals, unsettled debit of domestic exchange (receivables arising in the settlement process in domestic currency transactions), deposits held in an agency relationship, investment in capital. The contents of miscellaneous assets should be described in the accompanying notes.

b) ***Classification of Liabilities***

Liabilities should be classified into deposits, borrowings, bonds payable, and other liabilities.

i) **Deposits**

When a financial institution receives funds from customers such as the general public, business enterprises or public institutions with an agreement to pay specified interest

in return by issuing deposit certificates or through deposit accounts, these funds should be classified as deposits. Deposits are further classified into deposits in local currency, deposits in foreign currency, negotiable deposits, and other deposits. Deposits received from other financial institutions (whose main business is financing) are classified by type and disclosed in the accompanying notes.

ii) **Borrowings**

Borrowing of funds with collateral or on credit with an agreement to pay the principal and the interests over a specified period or at the end of the period should be classified as borrowings, regardless of the form of transactions or the use of account titles. Borrowings include the following :

- Borrowings in local currency
- Borrowings in foreign currency
- Securities sold under repurchase agreements
- Notes sold
- Credit card receivables sold

iii) **Bonds Payable**

Financial bonds issued to raise funds should be classified as bonds payable. Bonds payable include bonds issued in local currency and bonds issued in foreign currency.

iv) **Other Liabilities**

Other liabilities refer to all the other liabilities that do not belong to any of the above classification as follows:

- Provision for accrued retirement benefits
- Provision for losses on acceptances and guarantees
- Borrowings from trust accounts
- Remittance pending in foreign currency
- Other accounts payable
- Accrued expenses
- Unearned revenues
- Factoring payables
- Deposits received
- Deferred income tax credit

(B) INCOME STATEMENT

1) **Revenue Recognition**

In principle, interest revenues earned on dues from banks, loans, and securities should be recognised as time passes. However, depending on the degree of collectibility, different methods of revenue recognition may be employed. Gains or losses on disposition of securities arising from a standardised transaction should be recognised at the time of trade contracting.

In case different methods of revenue recognition are employed, because of the collectability problem, recognition of interest revenue should be done as follows:

Interest revenue accrued from collectible receivables may be recognised as accrued interest revenue because it is realisable. However, interest revenue accrued from uncollectible receivables should not be recognised as accrued interest revenue because realisation is unlikely. For other receivables, past experience and industry practice

should be the basis for deciding whether to recognise interest revenue or not. This rule should be applied consistently in subsequent periods. In recognising interest revenue arising from held-to-maturity bonds, the difference between the acquisition cost and the face value should be amortised over the remaining term using the effective interest method. The amortisation of premium or discount should be added to or deducted from the acquisition cost and interest revenue should be recognised accordingly. Gains or losses on disposition of securities arising from a standardised transaction should be recognised at the time of trade contracting since benefits and risks of the securities are transferred at that time.

2) **Preparation of Income Statement**

In order to present the results of business operations fairly, the income statement should present all revenues earned in the current accounting period, and all matching expenses incurred in generating the revenues. The income statement should be divided into the following sections: operating income (operating loss), ordinary income (ordinary loss), income before income taxes, income tax expense, and net income (net loss) for the period. Operating income (operating loss) should be presented by subtracting operating expenses from operating revenues. Ordinary income (ordinary loss) should be presented by adding non-operating income to, and deducting non-operating expenses from operating income (operating loss). Income before income taxes should be presented by adding extraordinary gains to, and deducting extraordinary losses from ordinary income. Net income for the period should be presented by deducting income tax expense from income before income taxes.

i) **Operating Revenues**

Operating revenues are revenues earned from main operating activities of financial institutions. Operating revenues encompass interest revenues, fees and commissions, and other operating revenues.

Interest revenues shall include the following:

- Interest on dues from banks
- Interest on trading securities
- Interest on investment securities
- Interest on loans
- Other interest revenues

Fees and commissions are the inflows received by the financial institutions in return for services rendered in conjunction with their ordinary operating activities. Fees and commissions include the following:

- Commissions revenue
- Acceptances and guarantees fees
- Termination fee on trust accounts
- Other fees

Other operating revenues include the following:

- Gain on disposal of trading securities
- Gain on valuation of trading securities
- Dividend revenue on trading securities
- Dividend revenue on investment securities
- Gain on foreign exchange transactions
- Fees from trust accounts

– Recovery of provision for acceptances and guarantees loss
– Miscellaneous operating revenues

ii) **Operating Expenses**

Operating expenses are expenses incurred from main operating activities of financial institutions. They should be classified into interest expense, fees and commissions expense, other operating expenses, and selling and administrative expenses.

Interest expenses include the following:

– Interest on deposits
– Interest on borrowings
– Interest on bonds payable
– Other interest expenses

Fees and commissions expense refers to commissions and fees which financial institutions pay in return for the services rendered by external parties in conjunction with ordinary business activities of financial institutions. Fees and commissions expenses include commission's expense, credit card fees, and other fees and commissions.

Other operating expenses include the following:

– Loss on disposal of trading securities
– Loss on valuation of trading securities
– Loss on foreign exchange transactions
– Contribution to funds
– Bad debt expense
– Loss on investment of trust accounts funds
– Current accrual of provision for acceptances and guarantees losses
– Other miscellaneous operating expenses

Selling and administrative expenses refer to various expenses that are incurred for conducting revenue generating activities and administrative activities. These expenses include the following:

– Salaries (officers' salaries, employees' salaries, wages and various allowances);
– Retirement allowance;
– Other employee benefits;
– Rent expense;
– Promotion expense;
– Depreciation expense;
– Amortisation of intangible assets;
– Taxes and dues;
– Advertising expense;
– Research expense;
– Ordinary development expense.

In case only the total amount of selling and administrative expenses is presented in the income statement, a supplementary schedule showing the detailed accounts should be presented in a note to the income statement.

iii) **Non-Operating Revenues and Expenses**

Non-operating revenues include the following:

- Gain on disposition of tangible assets;
- Rental income;
- Gain on valuation of investments using the equity method of accounting;
- Gain on disposal of investment securities;
- Restoration of investment securities impairment loss;
- Gain on valuation of investments;
- Other non-operating revenues.

Non-operating expenses include the following:

- Loss on disposition of tangible assets;
- Loss on valuation of investments using the equity method of accounting
- Loss on disposal of investment securities;
- Investment equity securities impairment loss;
- Investment bonds impairment loss;
- Loss on valuation of investments;
- Other non-operating expenses.

iv) **Extraordinary Gains and Losses**

Extraordinary gains should include unusual and non-recurring gains, gain from assets contributed, gain on exemption of debts, gain on insurance settlements and other extraordinary gains. Extraordinary losses should include unusual and non-recurring losses, casual losses and other extraordinary losses.

(C) MEASUREMENT OF ASSETS AND LIABILITIES

1) **Valuation of Trading Securities**

For equity securities classified as trading securities, acquisition cost should be determined by adding incidental costs to the purchase price, and applying the weighted average or moving average method. These securities should be reported at fair value in the balance sheet. For debt securities (bonds) classified as trading securities, acquisition cost should be determined by adding incidental costs to the purchase price, and applying the specific identification method, weighted average or moving average method. These securities should be reported at fair value in the balance sheet. In determining the unit cost of trading securities, the weighted average or moving average method should be applied by each class of securities. For debt securities (bonds), information about face value, acquisition cost, carrying amount adjusted by applying the effective interest method and fair value should be disclosed in the accompanying notes. Such information should be presented by category of the method of measuring fair value.

The fair value of trading securities should be measured as follows:

For trading securities other than bonds, fair value should be the closing market price as of the balance sheet date. In the case that no closing price exits at the balance sheet date, the most recent closing price before the balance sheet date should be used.

Fair value of bonds should be measured on the basis of an objective and reasonable price selected from the following:

- Closing market price at the balance sheet date;

- Closing market price on the most recent transaction day quoted by a generally accepted price survey;
- Value estimated from the average yield for valuation of bonds
- Value estimated from the yield for valuation of bonds disclosed by bond dealers.

2) **Valuation of Investment Securities**

The acquisition cost of equity securities classified as investment securities should be determined by adding incidental purchase expenditures to the purchase price, and applying the weighted-average or moving-average method to each class of securities.

Marketable equity securities classified as investment securities should be reported at fair value in the balance sheet.

Investment in equity securities which gives the investor company the ability to exercise significant influence over the investee company, the investment amount evaluated under the equity method should be used as the balance sheet amount. The difference between the carrying value and the restated balance sheet amount should be accounted for as follows. The difference due to the investee's net income or loss should be recognised as gain or loss on valuation using the equity method of accounting in the income statement. The difference due to changes in the investee's retained earnings should be reported as the increase or decrease in the investor's retained earnings. When the difference results from changes in the investee's capital surplus or capital adjustments, it should be reported as the increase or decrease in the investor's capital adjustments.

In case the fair value of investment in equity securities (excluding equity securities subject to valuation by the equity method) has declined and the decline is not restorable, the difference between the previous book value and the fair value should be reported as investment stocks impairment loss in the income statement. If equity securities are not marketable securities, the net asset value of the investee company is used as fair value.

The acquisition cost of debt securities (bonds) classified as investment securities should be determined by adding incidental purchase expenditures to the purchase price, and applying the specific identification method, weighted average or moving average method to each class of securities.

For investment in bonds whose face value differs form the acquisition cost, the difference should be amortised using the effective interest method, and the unamortised cost should be reported in the balance sheet. However, when the acquisition cost of bonds other than held-to-maturity bonds ("available-for-sale bonds") differs from their fair value, the fair value should be reported in the balance sheet. (For bonds whose acquisition cost and face value differ, fair value should be compared with the unamortised cost.)

Gain on valuation of investment securities (excluding gain on valuation using the equity method and gain on valuation of investment) should be offset against loss on valuation of investment securities (excluding loss on valuation using the equity method and loss on valuation of investment), and the net gain or loss should be reported as a capital adjustment in the balance sheet.

In case the fair value of investment in bonds has declined and the decline is not restorable, the difference between the previous book value and the fair value should be reported as investment bonds impairment loss in the income statement.

In case of reclassification of trading securities to investment securities, investment securities should be reported at fair value as of the balance sheet date. The difference between the carrying value of previous trading securities and the balance sheet amount

of investment securities should be recognised as gain or loss on valuation of trading securities in the income statement. Investments in bonds should be classified as either held-to-maturity bonds or available-for-sale bonds at the time of their acquisition, depending on management's intention. In the following cases, however, held-to-maturity bonds should be reclassified into available- for-sale bonds:

1. When a portion of held-to-maturity bonds are sold, the remaining bonds;
2. Bonds which have to be sold before maturity by law;
3. Bonds on which an impairment loss is to be recognised

Gain or loss on valuation of investment securities reported as a capital adjustment should be netted against additional valuation gain or loss arising in subsequent periods. Information on such netting should be disclosed in a note to the financial statements. Gain or loss on valuation of investment securities should be deducted from or added to the gain or loss on disposal of investment securities when the investment securities are disposed. In case the carrying value of investment securities is written down and an impairment loss is recognised, the previously recognised valuation gain or loss should be deducted from or added to the investment securities impairment loss.

3) **Establishment of Allowance for Bad Debts**

For loans (including accrued interest revenues thereof) whose collectibility is doubtful, allowance for bad debts should be established based on percentage of bad debts estimated on a reasonable and objective basis. Different percentages uncollectable may be applied to loans with different probabilities of collectibility, but the estimated percentages should be applied consistently in subsequent periods unless there is no special reason to change.

Uncollectable loans should first be written off against the allowance for bad debts, and, if the allowance is not sufficient to absorb uncollectable loans, the amount in excess of the allowance should be accounted for as bad debt expense.

Allowance for bad debts may be presented as a deduction from the related loan account or the aggregate amount may be presented as a single deduction from the total of loans and other assets. In the latter case, details of allowance for bad debts should be disclosed in the accompanying note.

A note disclosure should be provided on the following items:

1. Criteria used to classify debtors' credit rating;
2. Amounts of collectable loans, doubtful loans and uncollectable loans respectively, and criteria used to classify them;
3. Estimates of bad debts and percentage uncollectable, and bases for estimation;
4. Details of uncollectable loans for which legal expiration dates have not arrived or claims are still effective;
5. Ratio of allowance for doubtful accounts to total loans outstanding over the past three years;
6. Other significant accounting policies related to uncollectable loans.

Classification of loans into collectable loans, doubtful loans and uncollectable loans should be made as follows:

1. Based upon the debtor's financial position, debtors should be classified into normal debtors, debtors under observation, and delinquent debtors;
2. Of the loans made to normal debtors, loans on which principal and interests are not in arrears should be classified as collectible loans. The remaining loans should be classified as either collectable loans or doubtful loans in accordance with Item 3 below;

3. Of the loans made to debtors under observation, loans, whose collectivity is deemed certain considering the value of collateral assets and the guarantor's ability to pay, should be classified as collectable loans, and all other loans should be classified as doubtful loans. Even if loans have not been secured, the fair value of debtor's assets in excess of debtor's obligations to the senior creditors may be included in collateral assets.
4. Of the loans to delinquent debtors, loans, whose collectivity is deemed certain considering the value of collateral assets and the guarantor's ability to pay, should be classified as collectable loans, and all other loans should be classified as uncollectable loans.

Classification of debtors into normal debtors, debtors under observation or delinquent debtors may be done based upon past experience or industry practices. Debtors under observation can be further divided. The criteria used to classify debtors should be applied consistently in subsequent periods unless there is a special reason to do otherwise. Debtors belonging to the following categories should be classified as delinquent debtors:

1. A debtor with payments on loans in arrears for more than six (6) months;
2. A debtor classified as a red-rated customer (a customer with the lowest credit rating) by the credit information exchange and management covenant of financial institutions;
3. A corporate debtor who is in the process of (or has applied for) a reorganisation under the relevant law;
4. A corporate debtor who is in the process of (or has applied for) a composition under the Composition Act;
5. A debtor whose business has been closed for more than six months;

4) **Translation of Assets and Liabilities Denominated in Foreign Currencies**

Assets and liabilities denominated in foreign currencies should be translated into the local currency at the appropriate exchange rate in effect as on the balance sheet date. Gain or loss should be recognised as gain or loss on foreign exchange transaction in the income statement.

5) **Translation of Foreign Currency Financial Statements of Overseas Branches**

The appropriate exchange rate in effect at the balance sheet date should be used in translating the foreign currency financial statements of overseas branches into the reporting currency. Accounting for transactions at overseas branches should be done in accordance with the generally accepted accounting principles of the local country. However, when there is a significant difference between this Standard and the local generally accepted accounting principles, and its impact on the financial statements is material, the standard followed by the parent bank should be applied.

6) **Notes to Financial Statements**

The following should be disclosed in the notes to financial statements:

1. Significant accounting policies;
2. Detailed information on loans by nature of loan
3. The following information useful in understanding the company's relationship with the other banks and the financial market:
   - Government and municipal bonds, and other debt securities that can be discounted with Central Bank;
   - Transaction balances with the Central Bank;

- Dues from other banks;
- Dues from other financial institutions (all corporations other than banks, of which the main operating business is financing);
- Deposits received from other banks;
- Deposits received from other financial institutions (all corporations other than banks, of which the main operating business is financing);
- Other deposits received.

4. The nature of contingent liabilities (acceptances and guarantees, etc.) including the following items and the amount of obligation by class of commitments should be disclosed. Contingent liabilities should be divided into those with determined principal obligation and those with undetermined principal obligation:
   - General guarantees of indebtedness and obligations under standby letters of credit;
   - Guarantees on performance, tender, and product related to specific transactions;
   - Contingent liability from accepting bills of exchange issued in conjunction with exports;
   - Obligations on sales and repurchase that have not been recognised in the body of financial statements;
   - Obligations concerning derivative financial instruments;
   - Limit on note issuance, limit on new stock acceptance, and other commitments.
5. A schedule of assets (due from banks and loans, etc.) and liabilities (deposits, borrowings and bonds payable, etc.) over the period from the balance sheet date until the maturity (redemption) date;
6. The percentage composition of loans, securities, and acceptances and guarantees broken down by major countries, customers, and industries;
7. Material foreign currency assets and liabilities in the local functional currency, and amounts translated into U.S. dollars;
8. Class of assets provided as collateral, their carrying value, and the related liability amounts;
9. Of the difference between the carrying value and the fair value of trust accounts with agreements to guarantee the principal amount or the fixed dividend, the amount that should be covered by the inherent account;
10. Names of related parties and description of major transactions with them (beginning balance, increase or decrease during the accounting period, ending balance, etc.) with policies in making loans to them;
11. Bases for recording provision for losses on guarantees and acceptances and amounts of provision by type;
12. Amounts and terms of subordinated borrowings (including borrowing of funds through issuing bonds) by creditors;
13. Types and amounts of loaned securities;
14. Other items which have a significant influence on the financial statements, and items which need disclosure for understanding the financial statements.

As stated earlier, most countries follow the International Accounting Standard; **Appendix 17.3** gives a list of International Accounting Standards for the financial services industry. The accounting standards in India mostly follow the International accounting standards. There are no specific accounting standards laid out for banks.

There is an interesting article highlighting difficulties in the absence of separate regulation for banking industry, which we have provided in **Appendix 17.4**. However, wherever required, Accounting Standards have dealt with issues related to banking industry separately. Important provisions of Accounting Standards relating to banking industry are given below:

A.S. 9 : Revenue Recognition

Revenue arising from the use by others of enterprise resources yielding interest, royalties and dividends should only be recognised when no significant uncertainty as to measurability or collectability exists. These revenues are recognised on the following bases:

i)	**Interest**	**:**	**On a time proportion basis taking into account the amount outstanding and the rate applicable.**
ii)	**Royalties**	**:**	**On an accrual basis in accordance with the terms of the relevant agreement.**
iii)	**Dividends from investments in shares**	**:**	**When the owner's right to receive payment is established.**

A.S. 3: Cash Flow Statement

Cash flows arising from each of the following activities of a financial enterprise may be reported on a net basis:

a) ***cash receipts and payments for the acceptance and repayment of deposits with a fixed maturity date;***

b) ***the placement of deposits with and withdrawal of deposits from other financial enterprises; and***

c) ***Cash advances and loans made to customers and the repayment of those advances and loans.***

A.S. 18 : Related Party Disclosure

In the context of this Statement, the following are deemed not to be related parties:

the parties listed below, in the course of their normal dealings with an enterprise by virtue only of those dealings (although they may circumscribe the freedom of action of the enterprise or participate in its decision-making process):

i) providers of finance;

ii) trade unions;

iii) public utilities;

iv) Government departments and government agencies including government sponsored bodies.

Related party disclosure requirements as laid down in this Statement do not apply in circumstances where providing such disclosures would conflict with the reporting enterprise's duties of confidentiality as specifically required in terms of a statute or by any regulator or similar competent authority.

In case a statute or a regulator or a similar competent authority governing an enterprise prohibits the enterprise to disclose certain information which is required to be disclosed as per this Statement, disclosure of such information is not warranted. For example, banks are obliged by law to maintain confidentiality in respect of their customers' transactions and this Statement would not override the obligation to preserve the confidentiality of customers' dealings.

However, it has to be noted that, the accounting standards laid down by the ICAI are not the only guiding basis for disclosure of the statements. In most cases, the same has to be approved by the RBI. For instance, in the case of segment reporting (AS-17), while the manufacturing and other services company were forced to comply with the standards laid down by the ICAI and as per the listing rules of SEBI, banks could get waived from disclosing the segment reports as the bill submitted to RBI on approving the standards was pending. Most public sector commercial banks stated that "Segment Reporting as per AS-17 of ICAI shall be given on finalisation of RBI guidelines."

Activity 4

1) Get the list of Sensex and Nifty companies. Find out how many banks form part of the indices.

   ……………………………………………………………………………………

   ……………………………………………………………………………………

   ……………………………………………………………………………………

2) Get the annual reports of any one public sector bank and also a private sector bank. Do you see any difference in the disclosure of the two categories? Are there major differences in accounting polices. If so list them.

   ……………………………………………………………………………………

   ……………………………………………………………………………………

   ……………………………………………………………………………………

17.6 SUMMARY

Accounting policies guide the accountants in preparation of financial statements. Accounting Standards and guidelines provided by accounting professional bodies like ICAI and regulatory authorities like Reserve Bank of India aims to ensure uniformity in preparation of accounting statements. While making accounting standards and policies, the standard setters and regulating agencies follow standard accounting conventions like conservatism and try to ensure 'true and fair view' of financial statements. Since accounting statements are extensively used for various decision making by several users, accounting standards and polices play a critical role in deriving such decisions. In the context of banking industry, some of the critical issues in preparation of financial statements are revenue recognition, provisioning of non-performing assets/loans and valuation of securities. The treatment relating to interest accrued but not received for different kinds of loans is a critical area of concern in revenue recognition. Similarly, the definition of non-performing assets and its treatment is another area of concern affecting the profitability of the bank. Since banks invest large amount in securities and also trade securities as a part of treasury activities, valuation of securities on account of changes in market value of securities is another area of concern. Accounting polices and standards address some of these concerns.

17.7 SELF ASSESSMENT QUESTIONS

A) **Fill in the blanks**

1. If a firm believes that some of its debtors may "default" it should act on this by making sure that all possible losses are recorded in the books. This is an example of the .... concept in operation.

2. The fact that a business is separate and distinguishable from its owner is best explained by the .... concept.

3. It is true that everything a firm owns it also owes out to somebody. This co-incidence is explained by the .... concept.

4. Suppose the cashier of a company buys a cash book to keep his firms books, he would not try to account for every single sheet of paper in the book because of the .... concept.

5. The .... concept states that suppose the straight-line method of depreciation is used by a company in one year, then it should use SLM in the next year too.

6. A firm may hold stock which is heavily in demand. Consequently the market value of this stock may be increasing. Normal accounting procedure is to ignore this because of the .... concept.

7. You receive an order for goods and your company would not include the value of it in our sales figures (yet) owing to the .... concept / convention.

8. Suppose your company makes loss for the second year running, the .... concept tells us that it will carry on doing the business, unless you are notified to the contrary.

9. Profit calculation is based on expenses incurred during the period rather than those paid. This statement described best the .... concept.

10. The management of your company are remarkably incompetent, but the firm's accountants cannot take this into account when preparing the books because of the .... concept.

11. The profit of ABC motor company for the year 2003-04 was reported as Rs.35, 000. The financial reports were released during April 2004. Subsequently, in May, it was discovered that particular shop equipment that costed about Rs. 5,000 was reported as an expense. The equipment was estimated to last for five years, after which it would be worthless. The amount that should have been charged as an expense for the year 2003-04 is .... which would give a correct profit figure of .... The relevant concept that should be applied here is ....

12. The CEO of XYZ Corporation Ltd. reports a profit of Rs. 65,000 for the year 2003-04. This includes an amount of Rs. 7000 relating to an order just received. The real profit figure to be reported is ...., because of the .... concept.

13. During the year 2003-04, one of the store managers, Ms. X, has taken home some clothing stock from her boutique, in order to wear it herself. She has included the cost of this stock costing Rs. 4000 as a business expense and reported profits as Rs. 32,500. Ms. X should apply the .... concept here and should report the profit as ....

Answers

1. (Conservatism), 2. (Business Entity), 3. (Dual Aspect), 4 (Accrual),
5. (Consistency), 6. (Materiality), 7. (Conservatism), 8. (Going Concern),
9. (Accrual), 10. (Business entity), 11. (1,000, 39,000, Accrual concept),
12. (58,000, Realisation concept), 13. (Business Entity, 36,500)

B) **True or False**

1. The business entity concept states that the business should be registered as an entity for the purpose of conducting the business. (True / False)
2. The Chartered Accountants are professionals from and members of ICAI. (True / False)
3. FASB stands for Federal Accounting Standards Board. (True / False).
4. The accrual concept requires that the profit and loss statement should be prepared at regular intervals for tax purpose. (True / False)
5. Banks main revenue is from interest income charged on the loans. (True / False).
6. Shareholders of the Public sector banks in India can vote in the annual general meeting. (True / False).
7. All countries have the same accounting standards laid down by the International Accounting Standards Board. (True / False)
8. GAAP refers to Generally Accepted Accounting Principles in accounting. (True / False).

Answers

1. False, 2. True, 3. False, 4. False, 5. True, 6. False, 7. False, 8. True.

C) **Short Questions**

1) Explain the objectives of Accounting policies in preparation of financial statements.
2) What are the critical areas in which you feel accounting standards play a major role in preparation of financial statements of banking industry?
3) Do you think accounting policies and standards followed by Indian banks are in harmony with international standards?
4) How investments in securities of a bank are classified and how are they valued?
5) How bad and doubtful debts are determined in banking industry? What is the provisioning requirement?
6) Briefly explain policies relating to disclosure of guarantees.
7) "Banking industry being a special type of industry and the number of banks are increasing, it is important to have a separate set of accounting standards for the banking industry" - Do you agree with this statement?
8) Briefly discuss accounting regulations relating to foreign exchange transactions.

17.8 FURTHER READINGS

Epstein, Barry J. IAS 2004: *Interpretation and Application of International Accounting Standards* 2004, John Wiley & Sons.

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Weygandt, Jerry J., 1997, *Accounting Principles*, John Wiley, New York.

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Appendix 17.1 : Financial Statements of Corporation Bank

(Profit and Loss Account, and Balance Sheet)

(Rs. in crores)

	Mar. 00	Mar. 01	Mar. 02	Mar. 03
Income	1835.86	2049.24	2275.69	2562.91
Interest income	915.34	1060.69	1945.69	2102.53
Investment / dividend income	697.86	754.36	18.07	37.40
Others	222.66	234.19	311.93	422.98
Other income	39.24	47.37	27.14	37.61
Non-recurring income	14.43	0.01	25.58	33.76
Total	**1889.53**	**2096.62**	**2328.41**	**2634.28**
Expenditure				
Interest expended	1146.09	1223.21	1320.48	1310.38
Personnel cost	177.26	200.00	213.90	255.91
Prov. for contingencies, NPA.	70.00	98.77	128.67	174.19
Insurance premium	7.65	8.57	9.37	10.89
Other expenses	122.40	148.07	163.67	207.44
Non-recurring expenses	5.51	0.00	0.00	0.00
PBDT	360.62	418.00	492.32	675.47
Depreciation	21.78	21.51	31.97	48.86
PBT	338.84	396.49	460.35	626.61
Tax provision	105.40	134.65	152.25	210.62
PAT	233.44	261.84	308.10	415.99
Appropriation of profits				
Dividends	56.34	52.90	52.11	72.82
Retained earnings	177.10	208.94	255.99	343.17
Liabilities + Equity				
Paid-up equity capital	120.00	120.00	143.44	143.44
Reserves & surplus	1024.76	1227.70	1902.80	2226.76
Free reserves	730.66	871.49	1386.75	1463.48
Specific reserves	294.10	356.21	516.05	763.28
Deposits	14279.62	16560.13	18924.27	21724.57
Demand deposits	1910.09	2136.66	2314.03	2922.44
Saving deposits	1957.72	2246.90	2609.06	3275.50
Term deposits	10411.81	12176.57	14001.18	15526.63
Borrowings	296.28	594.95	1423.54	803.35
Other liabilities & provisions	1041.62	1200.42	1281.60	1440.2
Total liabilities	**16762.28**	**19703.20**	**23690.71**	**26367.52**
Assets				
Cash & bank balance	2453.33	3184.37	3346.12	2429.05
Investments	5790.93	6860.34	8143.00	10765.44
Advances & loans	7777.47	8666.11	10987.42	12029.17
Deferred tax assets	0.00	0.00	0.00	0.00
Other assets / stocks	1.52	1.08	1.41	1.44
Receivables	595.56	819.33	1013.42	909.47
Net fixed assets	143.47	171.97	199.34	232.95
Intangible/ DRE not written off	0.00	0.00	0.00	0.0
Total assets	**16762.28**	**19703.20**	**23690.71**	**26367.52**

Corporation Bank

ACCOUNTING POLICIES FOR THE YEAR ENDED 31ST MARCH, 2003

1. ACCOUNTING CONVENTION

The financial statements are prepared by following the going concern concept on historical cost basis and are in conformity with the statutory provisions and standard accounting practices, except wherever otherwise stated.

2. ADVANCES

a) Provisions for performing and non-performing advances are made on the basis of asset classification and provisioning requirement under the prudential norms laid down by the Reserve Bank of India.

b) Provisions in respect of non-performing advances under various categories are made on gross basis and deducted proportionately from the advances.

c) In respect of consortium advances, the borrowal accounts are classified as per performance of the accounts with the Bank.

3. INVESTMENTS

In accordance with the guidelines issued by Reserve Bank of India:

a) Investments are grouped and shown in Balance Sheet under the following six classifications:

   i) Government Securities

   ii) Other Approved Securities

   iii) Shares

   iv) Debentures & Bonds

   v) Investments in Subsidiaries/R.R.B./joint Ventures

   vi) Others (units of Mutual Funds, Commercial Papers and Certificate of Deposits)

b) Investments are categorised into

   i) Held-to-Maturity

   ii) Available-for-Sale

   iii) Held-for-Trading

The Bank decides the categorisation of each investment at the time of acquisition. The transfer of securities from one category to another, if done is at the least of the acquisition cost/book value/market value on the date of transfer.

c) Investments classified under "Held-to-Maturity" include the following:

   i) Recapitalisation Bonds received from the Government of India towards the recapitalisation requirements.

   ii) Investments in shares of subsidiaries.

   iii) Investments in Debenture/Bonds which are deemed to be in the nature of advance.

   iv) Investments in Central/State Government/other securities subject to the maximum of 25% of total investments excluding investments specified at (i), (ii) and (iii) above.

d) Investments classified under "Held-to-Maturity" have not been marked to market and carried at lower of acquisition cost or book value. In case the acquisition cost/book value is more than the face value, the premium is amortised over the remaining period to maturity.

e) Investments classified under "Available-for-Sale" category are revalued and marked to market at quarterly intervals. The appreciation if any, under each classification in 3 (a) above were set off against the depreciation, if any, under the same classification and if there is still any appreciation the same is ignored. The net depreciation under each of the six classifications as stated in 3 (a) above (excluding Investments in subsidiaries which are classified under held to maturity) is recognised in the profit and loss account. The book value of the individual strips is not changed after revaluation during the year.

f) Investments classified under "Held-for-"Trading" are revalued and marked to market at monthly intervals. The appreciation if any, under each classification in 3 (a) above were set off against the depreciation if any under the same classification and if there is still any appreciation the same is ignored. The net depreciation under the each of the six classification stated in 3 (a) above (excluding investments in subsidiaries which are classified under held to maturity) is recognised in the profit and loss account. The book value of the individual strips is not changed after revaluation during the year.

g) For the purpose of valuation of investments including shares, debentures, bonds, mutual funds, units, etc., stock exchange quotations, if available, are taken as market rates. Where the market quotations are not available, the same are valued at Yield to Maturity (YTM) rates/guidelines prescribed by FIMMDA/PDAI as follows:

1. Central Government Securities

   At YTM basis

2. State Government Securities Govt. Guaranteed SLR Securities

   At separate YTM rates prescribed and for this purpose

3. Treasury Bills At carrying cost

4. Equity Shares

   At book value ascertained from the latest available Balance Sheets. In cases where Balance Sheets are not available, the same are valued at Rupee one for each Company.

5. Preference Shares

   At a spread over the sovereign risk free yield curve at the time of issue marked up by 25% added to the YTM rates applicable to Government Securities of similar residual tenor or the dividend rate of preference shares whichever is higher.

6. Bonds/Debentures/Rated At average credit spreads over the YTM

7. Bonds/Debenture of Manufacturing Corporations and Tier II Bonds issued by Banks

   At rates prescribed by FIMMDA/PDAI applicable to the respective rating below ten different tenors from "AAA" to "BBB" and un-matured periods of Bonds/Debentures.

8. Rated Bonds/Debenture of Non-Manufacturing, Development Financial Institutions and other Finance Companies.

   At an additional spread of 15 basis points, 25 basis points and 25 basis points respectively over the YTM rates applicable to respective rated Bonds/ Debentures of similar residual tenor furnished by FIMMDA/PDAI.

9. Un-rated Government Guaranteed Non-SLR Bonds

   At YTM rates applicable to corresponding rated Bonds/Debentures plus the spread over the sovereign risk free yield curve at the time of issue marked-up by 15% if the issue is more than 12 months old.

10. Un-rated Bonds

    Where the corresponding rated Bond/Debenture of the issuer exists, all un-rated Bonds/ Debentures are valued by marking up the credit spread by a minimum of 20% over the YTM rates applicable to the equivalent rated Bonds/Debentures of similar tenor furnished by FIMMDA/PDAI. When the corresponding rated Bond/Debenture of the issuer does not exist, these Bonds / Debentures other than Private Sector Bonds are valued at a YTM applicable to GOI securities furnished by FIMMDA/PDAI plus a spread over the sovereign risk free yield curve at the time of issue marked up by 25 or current credit spreads of "AAA" bond of similar residual tenor furnished by FIMMDA/ PDAI whichever is higher.

11. Bonds having special features- Tax Free Bonds

    The coupon is grossed up by a factor equal to the applicable income tax rate

12. Debentures/Bonds with call and put options

    The maturity dates are preponed to the nearest call or put option dates for price/ YTM calculation. Priority Sector Bonds are valued at YTM applicable to "AAA" rate corporate bonds.

13. Mutual Fund Units

    At the latest re-purchase price declared by the mutual fund and where the same is not available at the latest NAV declared by the fund in each of the schemes.

14. Commercial Paper/Certificate of Deposits — At the carrying cost
15. Investment in RRBs — At the carrying cost
16. Investment in RIDF — At the carrying cost
17. Securitised Debts — As applicable to a rated corporate bond

h) Non-Performing Assets in Investment Portfolio

   i) Securities with guarantees of Central Government/State Government: These are treated as performing investments notwithstanding arrears of principal/interest payments. However, interest if not realised for more than 180 days from the due date, it is recognised as income only on cash basis. Further, post maturity, if the principal is not paid beyond one year from the due date, every, year thereafter, 25% provision is created on such overdue securities.

   ii) Securities not guaranteed by Central Government/State Governments: Where the principal/interest is due but not paid for a period more than 180 days such investments in all categories are valued by applying the NPA norms for "Classified Advances" as per Reserve Bank of India guidelines.

   iii) The depreciation/provision requirement in respect of non-performing securities is not set off against the appreciation in respect of other performing securities.

i) Profit or Loss on sale of investments in any category is taken to the profit and loss account. In case of profit on sale of investments in "Held-to-Maturity" category, an equivalent amount is appropriated to the "Capital Reserve Account".

j) In accordance with the guidelines of the Reserve Bank of India, to maintain the Investment Fluctuation Reserve (IFR) at a minimum of 5% of the Investment Portfolio (excluding the value of investments in the "Held-to-Maturity" category) within a period of 5 years starting from financial year 2001-02, appropriation to/ from the Investment Fluctuation Reserve is being made annually.

k) The provisions arising on account of Depreciation in the "Available-for-Sale" category is debited to "Provisions & Contingencies" and if required, an equivalent amount (net of taxes and statutory reserve) or the balance available in IFR whichever is less, is transferred from IFR to the Profit and Loss Appropriation Account.

In the case of write back of excess provision of depreciation under "Available-for-Sale" category, the same is credited to "Provisions and Contingencies" and an equivalent amount (net of taxes and statutory reserve) is appropriated to IFR.

l) Brokerage/commission/incentives received on subscriptions are deducted from the cost of securities, whereas brokerage paid in connection with acquisition of securities is treated as revenue expenditure.

m) The broken period interest on sale or purchase of securities is treated as revenue item as per the guidelines of the Reserve Bank of India.

n) The method of accounting of Repo transactions is as follows: Monies received/ paid during the year on repo transactions are credited/debited to Investment Account and reversed on maturity of the transaction. Costs and revenue thereon are accounted as interest expenditure/income, as the case may be.

Repo transactions outstanding at the year end are not considered as the Investments of the Bank. Monies received on such outstanding transactions are first appropriated towards Investment Account at book value and the balance amount is transferred to Sundry Liabilities.

4. **FIXED ASSETS**

a) Premises and other Fixed Assets are accounted for at historical cost.

b) Depreciation is provided on diminishing balance method (pro-rata) in accordance with and at rates specified in Schedule XIV to the Companies Act, 1956 except on computers.

c) Depreciation on computers is provided on straight-line method at 33 1/3 % per annum on additions (pro-rata) as well as on opening block as per Reserve Bank of India guidelines.

d) Depreciation on premises is provided on composite cost, wherever the value of land and building is not separately identified.

5. **REVENUE AND EXPENDITURE RECOGNITION**

According to the guidelines issued by the Reserve Bank of India, the Bank generally follows the accrual method of accounting for items of Income and Expenditure.

6. **TRANSACTIONS INVOLVING FOREIGN EXCHANGE**

a) Outstanding Forward Exchange Contracts and Nostro Accounts other than Non-position accounts are valued on the balance sheet date at the rates notified by FEDAI and the resultant gain/loss on revaluation is included in Profit and Loss account.

b) Currency Deposits like FCNR (B), EEFC, RFC, Foreign Currency Loans etc., including accrued interest on Deposits at branches are stated at national rates.

c) Income and Expenditure items are accounted for at the exchange rates prevailing on the date of transactions.

7. TRANSACTIONS INVOLVING PRECIOUS METALS

a) Income from precious metals transactions is accounted for as “Other Income”. In case of metals received on consignment basis, the same is recognised at the time of sale.

b) Commodity loans to the constituents and deposits from the public under the Gold Deposit Scheme in the form of precious metals are translated at market related rates prevailing at the close of the period and shown under the head “Advances” and “Deposits” respectively.

c) Closing stock of precious metals (own dealing) is valued at lower of cost or market value.

d) Closing stock of gold held under Gold Deposit Scheme is valued at market related rates, as per RBI guidelines.

8. STAFF BENEFITS

Provision for Gratuity, Pension and Leave Encashment are made on accrual basis as per actuarial valuation.

9. TAXES ON INCOME

a) Current tax is measured at the amount expected to be paid to the taxation authorities, using the applicable tax rates, tax laws and favourable judicial pronouncements/legal opinions.

b) Deferred tax, comprising of tax effect of timing differences between taxable and accounting incomes for the period, is recognised keeping in view the consideration of prudence in respect of deferred tax assets.

10. EARNINGS PER SHARE

The Bank reports basic and diluted Earnings per Equity Share in accordance with Accounting Standard 20-Earnings per Share, issued by the Institute of Chartered Accountants of India.

11. TREATMENT OF VOLUNTARY RETIREMENT SCHEME EXPENDITURE

In accordance with the guidelines issued by the Reserve Bank of India, the expenditure incurred under the Voluntary Retirement Scheme has been treated as deferred revenue expenditure to be written off over a period of five years, starting from the current year.

Appendix 17.3: International Accounting Standards for Financial services` industry*

IAS 30: Disclosures in Financial statements of Banks and similar Financial Institutions

This AS prescribes appropriate presentation and disclosure standards for banks and similar financial institutions, which supplement the requirements of other Standards. The intention is to provide users with appropriate information to assist them in evaluating the financial position and performance of banks and to enable them to obtain a better understanding of the special characteristics of the operations of banks.

Presentation and Disclosure

A bank's income statement should group income and expenses by nature. [IAS 30.9]

A bank's income statement or notes should report the following specific amounts: [IAS 30.10]

1. interest income
2. interest expense
3. dividend income
4. fee and commission income
5. fee and commission expense
6. net gains/losses from securities dealing
7. net gains/losses from investment securities
8. net gains/losses from foreign currency dealing
9. other operating income
10. loan losses
11. general administrative expenses
12. other operating expenses.

A bank's balance sheet should group assets and liabilities by nature and list them in liquidity sequence. [IAS 30.18] IAS 30.19 sets out the specific line items requiring disclosure.

IAS 30.13 and IAS 30.23 include guidelines for the limited circumstances in which income and expense items or asset and liability items are offset.

A bank must disclose the fair values of each class of its financial assets and financial liabilities as required by IAS 32 and IAS 39. [IAS 30.24]

Disclosures are also required about:

1. specific contingencies and commitments (including off-balance sheet items) requiring disclosure [IAS 30.26]
2. specified disclosures for the maturity of assets and liabilities [IAS 30.30]
3. concentrations of assets, liabilities and off-balance sheet items [IAS 30.40]
4. losses on loans and advances [IAS 30.43]
5. general banking risks [IAS 30.50]
6. Assets pledged as security [IAS 30.53].

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* For more details on the International Accountings Standards, please refer to www.iasplus.com

Appendix 17.4: Accounting standards for banks need review*

P. S. V. Chari and P. S. Narasimhan

ACCOUNTING STANDARDS have come in for a great deal of contention in the reports submitted by statutory auditors for commercial banks. With such qualifications a rarity in the audit reports relating to other business enterprises, there is a feeling among the lay public that banking is a sector where established standards of accounting are least adhered to. The scams which keep popping up with a sickening regularity have not helped things either. Here we will examine the relevance of qualifications in the audit reports vis-à-vis accounting standards.

The accounting standards which have come in for contention are:

Coming to AS-9, the major aspects which are of relevance to commercial banks are:

1. Accounting for their main source of income namely interest — the standard states that it should be recognised on a time proportion basis; 2. In the case of other receipts, the focus should be whether the service has been provided, 'once for all' or 'on a continuing basis' and the standard goes on to state that if at the time of raising any claim it is unreasonable to expect ultimate collection, revenue recognition should be postponed.

It is essentially in the case of interest being reckoned on cash basis on non-performing assets that the audit fraternity is yet to come to terms on whether such accounting is in conformity with AS-9 or not. In spite of the Institute of Chartered Accountants of India (ICAI) assuring the members that it would indeed be so, the qualification in the audit report on that count has not abated.

As far as commission income on guarantees and letters of credit, finality as to whether the service rendered in those cases are 'one time' or 'continuing' is yet to be reached. Also the underlying philosophy of accounting standards that they are intended to be applied only to items which are material has not had all that glitter, which is reflected in items such as locker rent, property tax, telephone bills, and electricity dues being held under a microscope. The latest to be added to this list is the 'insurance claim' which is said to fall under the accrual concept.

The conflict underlying AS-11 is essentially due to two factors: (a) As per Federation of Exchange Dealers Association of India (FEDAI) guidelines, outstanding foreign exchange contracts have to be revalued on balance sheet date as per their rates and resultant profit or loss is to be reflected in the profit and loss account, and (b) As per Reserve Bank of India guidelines, banks which have branches overseas, should translate the figures on the balance sheet date at the closing rate and the difference, if credit should not be taken credit for and loss, if any, should be absorbed in the accounts during the year.

As against these methods, AS-11 prescribes the translation difference in the case of outstanding forward exchange contracts to be recognised as income or expense as the case may be over the life of the contract and in the case of translation of overseas branches, the resultant difference is to be recognised in the profit and loss account for the year.

There are, of course, other minor differences between AS-11 and those prescribed for banks such as rates to be adopted for translation of certain accounts (EEFC/RFC/FENR) and in the case of foreign branch, the rate to be adopted for translating fixed and non-monetary assets.

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* *Source:* The Hindu, September 6, 2001

One would notice that the prescription of AS-11 is conservative when compared to FEDAI guidelines and RBI guidelines sound conservative when it comes to treatment of translating the financials of overseas branches. Banks being bound by the regulator have adopted what has been prescribed to them.

Under AS-15, the bone of contention has been the treatment of leave encashment benefits. Most of the banks have proceeded on a logic which has not found favour with the ICAI. The standard requires the liability on this count to be accounted on an accrual basis arrived at actually while banks have opted for 'pay as you go' method. The ICAI sought to telescope AS-5 as well while dealing with accounting for leave encashment benefits of retirees, asking the professionals to highlight the prior period quantum. As far as depreciation accounting is concerned, the relevant accounting standard requires the depreciation for the year for each class of asset to be disclosed.

The present format prescribed under Schedule III of the Banking Regulations Act provides for disclosure of depreciation for the year for all assets in entirety. To that extent there lies a deviation which has been called to question in the balance sheets of a few private sector banks.

In addition, during 2000-01, the RBI directed that banks depreciate computers added during the year over a three year period and also wanted to write off the balance which existed as of March 31, 2000 under the head Computers over the next three years. In the process, the life of the asset got restated in different ways and consistency, a virtue prescribed under AS-6, got derailed.

A fundamental accounting concept called 'prudence' came in for close scrutiny in the case of some banks. As per the present method of valuation of investments prescribed for banks, investments held under 'held for trading' get restated periodically based on the market rates and as an offshoot, the resultant appreciation/depreciation gets recognised.

Some auditors have felt that such an accounting treatment is in negation of 'prudence' and have questioned the wisdom of taking credit for such notional appreciation. Interestingly, in one particular case where the management did not reckon the appreciation, choosing to be ultra conservative, the auditors chose to qualify their report on the score that the RBI directive has not been followed.

One would, by this time, be aware that in all the above cases, banks had no option but to follow the regulator's directive. Under the circumstances, the question arises whether the professionals are right in qualifying their reports on the grounds of non-adherence to accounting standards.

Again, the necessity of any standard is to bring about uniformity among all players of a particular industry. As long as that is achieved through a regulator's directive, should ICAI insist on having it say, one wonders?

The ICAI itself states that local customs, usage, and regulations would take precedence over its standards but yet is unwilling to give such a tag to RBI's directives. This would be clear if one peruses ICAI's exhortation of its members on the treatment to be extended for translation of the figures of overseas branches. Till it comes out with a set of standards applicable exclusively for the banking industry, the ICAI can identify such of those standards from which the banking industry can be exempt as it did with the accounting standards concerning investments.

The professionals on their part have also got to display their independence keeping the concept of materiality in mind before plunging into 'qualify' their report. These are days of summit talks and perhaps one between the regulator and the ICAI should clear the air.