

## CHAPTER - I

### I N T R O D U C T I O N

Banks cannot consider themselves as exclusive financial institutions. They are also harbingers of social welfare. The individual is the single most important constituent of any organisation - be it commercial, social, political or financial. It is with the people and for the people they work. While dealing with people it is essential to have an intense involvement i.e., the human touch.

Despite the importance of international banking, there is little information concerning international banking activities that is useful in making comparison. The international operations of banks have not regularly reported much information to the public. In fact, relatively little information has been collected and organised in a manner that makes comparison possible.<sup>1</sup>

One of the most frustrating aspect of banking developments is the inability to use the available fragmentary information. The data are, in most instances, not comparable. As a consequence, bank analyst must grope in the dark, and, in the absence of information, rely on their own judgment to provide missing pieces.<sup>2</sup>

---

1. Tracy G. Herrick, Bank Analyst's Handbook, John Wiley & Sons, New York, 1978, p. 240.

2. Ibid., p. 241.

Today there is a general acceptance, of the value of fair reporting in the business community. Much progress has been made in the past few years in raising general standards of corporate reporting. Users of financial statements, whether they be creditors, bankers, shareholders, analysts, advisors, employees, the press or the general public, have become aware of such improvements. In this enlightened environment, should the reporting of the pillars of the financial community remain an anachronism? As fair reporting brings with it motivation, increased competitiveness, comparability and credence, disclosure of prudent banking practices is the only way to build confidence<sup>1</sup> and to have the human touch rather than conjecture. Thus there seems to be little question concerning the need for serious research in the area of reporting practices of commercial banks.

The tone of bank accounting and reporting, in general, has been influenced by the economic history of banks in each country, which from the very beginning has been punctuated by panic and bank failures. Bank failures have had social as well as economic effect upon bank depositors who outnumbered by far the bank owners. It is no wonder then that bank supervisors have always established the protection of the bank depositors. They have concentrated almost exclusively on solvency, statutory compliance, and adequate reserves and capital. They have in almost all cases emphasised

---

1. John Rule, "Merchant banks' accounts - the need for disclosure," The Banker, December 1972, pp. 44-45.

conservatism. The accounting and reporting practices of banks have been greatly influenced by this kind of thinking. Assets are stated at low or nominal valuation. In many cases the write-downs necessary to reduce asset values never passed through the earnings account, and instead were charged directly against reserves or undivided profits. The nature of banking, in many respects, quite different from commercial enterprises, has, thus, created a distinct emphasis on conservatism.

#### FINANCIAL STATEMENTS :

The financial statements, the end-product of financial accounting, report financial position and operating results of an entire business at the end of an accounting period. Essentially, financial statements are interim reports, presented annually, and reflect a division of the life of an enterprise into more or less arbitrary accounting period - more frequently a year.<sup>1</sup> These statements are again not based on recorded transactions alone; they do incorporate events as judged by the management. Again, quantification of transactions and events in financial terms does not rest on one generally accepted theory of accounting; rather, these reflect a number of basic concepts, conventions and principles which are more or less commonly accepted as useful guides. Their degree of acceptance stems from their usefulness to those

---

1. Robert N. Anthony, Management Accounting - Text and Cases, Revised ed., Richard D. Irwin Homewood, Illinois, p. 57.

making decisions involving accounting data. This usefulness is determined in turn by the convention's congruence with the social and economic conditions, needs, and concepts of the time. As these factors change over time, so must accounting conventions.

The financial statements present a summation of the various concepts, conventions and principles governing the recording of financial transactions. Though preparing a complete and classified list of accounting concepts, conventions and principles would be a most complex and difficult task; yet, the following may appropriately be considered here.

1. BUSINESS ENTITY : Financial statements are for a business entity which is separate and distinct from its owners. What happens to its owners' affairs is irrelevant.

2. GOING CONCERN : Unless evidence suggest otherwise, those preparing financial statements for a business entity assume it will continue operations into the foreseeable future.

3. MONETARY MEASUREMENT : Financial statement is a measurement process - dealing with only events which can be measured in monetary terms.

4. ACCOUNTING PERIOD : For decision making purposes, management and investors need periodic 'test reading', of the progress of their business. Financial statements recognise these needs and break the flow of business activities into a series of reporting

periods.

5. **CONSISTENCY** : Similar transactions would be reported in consistent fashion from period to period.

6. **HISTORICAL COST** : Business transactions would be normally measured in terms of the actual prices or costs at the time the transaction was consummated.

7. **REALISATION** : Revenue is realised during the period either when the services or goods are exchanged for a valuable consideration or when the amount of revenue can be verified with a reasonable degree of objectivity.

8. **MATCHING OF COSTS AND REVENUES** : Accounting profit is the net result of the accountant's trying to match their related costs and revenues of the period. This process can be described as matching "Effort and accomplishment", where costs measure effort and revenues the related accomplishment.

9. **DISCLOSURE** : Financial statements disclose enough information so that they are not misleading to those readers who are careful and reasonably well informed in financial matters.

10. **SUBSTANCE OVER FORM** : In order to reflect economic activities, financial statements emphasise the economic substance of events, even though the legal form differ from the economic substance and suggest a different treatment.

11. CONSERVATISM : Anticipate no profit and provide for all possible losses.

Financial statements convey the impression of finality, completeness and exactness. But in fact these statements are not final because the ultimate gain or loss can be ascertained only when the business is completely sold or liquidated. These are certainly interim reports prepared for an accounting period usually consisting of twelve months. These statements are neither complete nor accurate as flow of incomes and expenses is artificially cut off at the balance sheet date. Moreover, numerous difficulties arise in the apportionment of costs. Personal judgment has to be exercised which implies that financial statements cannot be exact and cannot in all circumstances be measured accurately. Financial statements fail to record events like credit rating of company, unfilled customer orders, sources and commitments for materials and merchandise, loyalty of management etc. Though, these events cannot be expressed in money values, these do affect heavily the financial position of a business enterprise. Further, these statements are prepared on historical cost basis and as such the impact of price level changes is completely ignored. These statements are accounting for past rather than accounting for future and as such are of little value to the management's task of decision taking. It seems, therefore, unrealistic to expect that the financial statements can record the full scope of business operations. The limitations show the tentative character of

financial statements which is to be considered while arriving at the correct conclusion from the techniques of financial analysis.

In spite of the limitations from which the financial statements suffer, these continue to be the most important source of regular communication between a business entity and the stakeholders. Such financial statements have to contribute to various information needs of the stakeholders, identified by 'The Corporate Report' as following<sup>1</sup> :

- a. Evaluating the performance of the entity.
- b. Assessing the effectiveness of the entity in achieving objectives established previously by its management, its members or owners or by society. This includes but is by no means limited to, compliance with stewardship obligations.
- c. Evaluating managerial performance, efficiency and objectives including employment, investment and profit distribution plans.
- d. Ascertaining the experience and background of company directors and officials including details of other directorship or official positions.
- e. Assessing the economic stability and vulnerability of the reporting entity.

---

1. ASSC, The Corporate Report - A discussion paper, Accounting Standards Steering Committee, London, 1975, pp. 26-27.

- f. Assessing the liquidity of the entity, its present or future requirements for additional fixed and working capital, and its ability to raise long and short term finance.
- g. Assessing the capacity of the entity to make future reallocations of its resources, for either economic or social purposes or for both.
- h. Estimating the future prospects of the entity, including its capacity to pay dividends, remuneration and other cash outflows and crediting future levels of investment, production and employment.
- i. Assessing the performance, position and prospect of individual establishment and companies within a group.
- j. Evaluating the economic function and performance of the entity in relation to society and the national interest, and the social costs and benefits attributable to the entity.
- k. Attesting to compliance with taxation regulations, company law, contractual and other legal obligations and requirements ( particularly when independently varified ).
- l. Ascertainning the nature of the entity's business and products.
- m. Making economic comparisons, either for the given entity over a period of time or with other entities.

- n. Estimating the value of users' own or other users' present or prospective interest in or claims on the entity.
- o. Ascertaining the ownership and control of the entity.

OBJECTIVE :

The objective of this research is three-fold :

1. To determine whether commercial banks have substantially improved their financial reporting practices.
2. To obtain and analyse empirical evidence to ascertain the opinions of experts concerned with the financial reporting practices as to :
  - a. the existence of any deficiencies in reporting by commercial banks;
  - b. the amount or extent of these deficiencies; and
  - c. the importance of these deficiencies.
3. To determine how far international harmonisation of financial reporting practices exist in various areas of information and to suggest for further improvement where it is feasible and practicable.

Harmonisation, not strict uniformity, is the goal prescribed by some leading internationally-minded accountants. To quote, H.I. Ross, past president of the Canadian Institute of Chartered

Accountants,

"Harmonisation suggests comparison, coordination, and reconciliation but does not imply a rigid uniformity - especially in details. It implies also that a sense of proportion is needed in attempting to bring standards and procedures into line."<sup>1</sup>

The present research covers reporting practices of commercial banks in U.S.A., U.K., Canada, Australia and India. The reasons for inclusion of these five countries in the present sample are the following :

1. There was a general availability of an English language version of the annual reports for the years 1978 to 1982.
2. These countries have many common elements in historical back-ground.
3. Each country has an institute of professional accountants. Among the common purposes of these institutes are : (a) to prescribe and maintain standards for the profession; (b) to control admission to profession through examination procedures, and (c) to take appropriate action in case of malpractice.
4. Each country has branches of commercial banks in other countries.

---

1. H.I. Ross, "The International Harmonization of Auditing Standards and Procedures," Canadian Chartered Accountant, November 1967, p. 350 quoted by A.P. Johnson in his Dissertation, Comparative Study of Auditing Standards in Australia, Canada . . . . ., University Microfilms, Ann Arbor, Michigan, 1969, p. 3.

5. Each country is a member of the International Accounting Standards Committee.<sup>1</sup>

A thorough review of the literature on accounting and banking in India reveal that no work in this direction has been done before to the best of the knowledge of this researcher.

SCOPE :

The scope of this study is concerned with the examination of 280 published annual reports of banking companies in U.S.A., U.K., Canada, Australia and India. The Study exhibits the reporting practices of commercial banks on sixteen specific areas of information as stated in the methodology. This study also includes an opinion survey of experts, bankers ( preparers ), chartered accountants ( examiners ) and stock exchange members ( users ), in U.S.A., U.K., Canada, Australia and India to determine : (a) the existence of any deficiencies in reporting practices of commercial banks, (b) the extent of these deficiencies, and (c) the importance of these deficiencies.

A review has been made of a number of publications by governmental agencies, international institutions, and professional organisations in the fields of accounting, law, finance and manage-

---

1. The objectives of IASC are "to formulate and publish in the public interest, standards to be observed in the presentation of audited financial statement and to promote their worldwide acceptance and observance," Supplement to The Management Accountant, March 1973, p. 3.

ment in support of the improvement of the reporting practices of commercial banks.

METHODOLOGY :

First part of the study began with the collection of annual reports of commercial banks from U.S.A., U.K., Canada, Australia and India. With this end in view the Australian and British Deputy High Commissioners, Calcutta, the Canadian High Commissioner, New Delhi and the Chief Librarian, United States Information Service, Calcutta, were requested to furnish the names and addresses of at least ten leading commercial banks of each of their country. Accordingly, names and addresses of forty leading commercial banks were furnished by them. All these forty banks were requested to send their annual reports for the years 1978 to 1982. In case of India twenty-five leading commercial banks were requested to send their annual reports for the years 1978 to 1982.

The main criteria for the selection of a bank to be included in the sample was the general availability of the annual reports for the years 1978 to 1982. A total of 280 reports were obtained from the banks of these five countries.

A list of the individual banks included in the sample is presented in Appendix A.

The criteria selected for evaluating the annual reports were the requirements set forth in the "Illustrative Forms of Bank

Financial Statements" presented in the AICPA Industry Audit Guide-  
Audits of Banks.<sup>1</sup> Researcher's choice was further based on the  
feasibility of these criteria as Strawser<sup>2</sup> had used them in his  
important contribution - 'An Enquiry into the Financial Reporting  
Practices of Commercial Banks.'

Three basic accounting models have been alluded to in the  
international accounting literature. These models are the  
American, British, and the Continental, mainly France.<sup>3</sup> Out of  
the above three models, France is outside the scope of the present  
study. Out of the remaining two models, American model is admitted  
as superior to British model on the following grounds :

The U.S. disclosures are the most valuable to the readers.  
The second best, i.e., the British disclosures, are also an improve-  
ment over the widely prevalent present basis of non-disclosure.  
So much effort has been focussed on the question of disclosure in  
the United States that the standards that have been set there  
provide a good yardstick.

In a study conducted by Alfred Kahl and Ahmed Belkaoui on  
seventy commercial banks of eighteen different countries, disclo-  
sure adequacy was measured by the extent to which thirty selected

- 
1. AICPA, Audits of Banks, An AICPA Industry Audit Guide,  
New York, 1968, pp. 63-67.
  2. Robert H. Strawser, An Enquiry into the Financial Reporting  
Practices of Commercial Banks, Dissertation, University  
Microfilms, Ann Arbor, Michigan, 1970, p. 53.
  3. Alfred Kahl and Ahmed Belkaoui, "Bank Annual Report Disclo-  
sure Adequacy Internationally," Accounting and Business  
Research, Summer 1981, p. 189.

information items were presented in the annual reports for the year 1975. The results indicated that the extent of disclosure was relatively different among the countries examined, with U.S. banks leading the list. Nine of the top ten banks were located in the U.S.<sup>1</sup>

It was, therefore, hypothesised in the present research that the U.S. banks would be the leaders in disclosure adequacy, followed by those using the British model. With this end in view the present researcher adopted the Strawser's model in evaluating the annual reports ( Chapter III ) and analysing the questionnaire responses ( Chapter IV ).

The following model questions were used in evaluating the annual reports of each of the banks included in the present research :

1. Does auditors' opinion appear in the annual report?
2. Does the income statement include gains and losses on the disposal of securities?
3. Does the report indicate that gains and losses on the disposal of securities are presented net of the related tax-effect?
4. Does the report indicate that premium on securities are amortized?

---

1. Kahl and Belkaoui, op. cit., p. 192.

5. Does the report indicate that discount on securities are amortized?
6. Does the report disclose the composition ( i.e., central, state, municipal and others ) of the securities portfolio?
7. Does the report disclose the market value of securities?
8. Does the report disclose the income from tax-exempt securities?
9. Does the report indicate that fixed assets are carried in accordance with generally accepted principles of accounting?
10. Does the report disclose that the provision for loan losses is included in the income statement?
11. Does the report disclose that the provision for loan losses is off-set against the related asset account?
12. Does the report include an analysis of the changes in the provision for loan losses account?
13. Does the report include an analysis of the changes in the capital account?
14. Does the report indicate that the financial statements are consolidated?
15. Does the report indicate that there are any unconsolidated subsidiaries?
16. Does the report include statement of source and application of funds?

82703  
- 8 SEP 1986

UNIVERSITY LIBRARY  
SAYA RAKORUNFO

The annual reports were studied; problem areas in general were considered; the present practices of reporting by the commercial banks in each country were identified and compared; areas of harmonisation indicated; deficiencies were located and areas of further improvement suggested.

The second part of the study consists of mail questionnaires. In order to ascertain the experts' opinion samples of the bankers ( preparers ), chartered accountants ( examiners ) and stock exchange members ( users ) were selected at random from the 'membership directory' of the respective organisations in the U.S.A., U.K., Canada, Australia and India. Only twentyfive members each from the category of bankers ( except in Canada, where there were only ten chartered banks ), chartered accountants and stock exchange members of five countries - (U.S.A., U.K., Canada, Australia and India) were chosen and questionnaires (Appendix - B) were mailed to them accordingly.<sup>1</sup>

In the questionnaire mailed to the experts a request was made to provide the ratings for each of the following items :

- a. How much information do you feel banks are now providing with regard to the item?
- b. How much information do you feel that banks should provide with regard to the item?

---

1. The sample size in respect of each category of each country was necessarily limited to twentyfive ( except Canada bankers ) due to heavy cost of postages. A copy of the questionnaire used may be found in the Appendix - B.

c. How important is information regarding this item  
in your opinion?

For each of the above items the respondents were requested to circle a number on a rating scale which extended from 1 to 7. In the seven point scale low numbers represented lower amounts and high numbers represented higher amounts of importance in the following manner :

None	Very Little	Little	Average	Good Amount	Great Amount	Maximum Amount
1	2	3	4	5	6	7

The primary purpose of the enquiry was to ascertain the opinions of the respondents as to the deficiency in financial reporting by commercial banks. The amount of the perceived deficiency for each of the sixteen items was arrived at subtracting the rating for item A from the rating for item B. The perceived deficiency was calculated to minimise the bias observed in rating for the item C. Since the deficiency score was obtained by subtracting the rating for item A from the rating for item B, the objectives associated with the absolute scores ( none, very little, little, average, etc. ) no longer applied. The assumption was that larger the difference ( when item A was subtracted from the rating for item B ) the larger the degree of dissatisfaction or smaller the degree of satisfaction with the financial reporting practices of commercial banks and the vice-versa.

For each question, the arithmetic mean of assigned weights was calculated for each category of respondents ( Bankers, chartered accountants and stock exchange members ). The results of the analyses of the questionnaires have been presented in Chapter IV.

The items included in the questionnaire grouped by subject area were as given below :

A. Investment Securities :

1. Information regarding gains and losses on the disposal of investment securities.
2. Information regarding premiums ( and the related amortization ) on investment securities.
3. Information regarding discounts ( and the related amortization ) on investment securities.
4. Information on the composition of the portfolio of investment securities.
5. Information regarding the income from tax-exempt securities held in the investment portfolio.
6. Information regarding the market value of the securities included in the investment portfolio.

B. Bank Loans and Related Losses :

7. Information regarding losses from bank loans.
8. Information regarding the reserve for loan losses.
9. Information regarding 'discount' loans ( i.e., the interest is deducted in advance and the borrower receives the net amount ) related earnings.

C. Fixed Assets and Depreciation :

10. Information regarding property, plant and equipment and the related depreciation.

D. Capital ( Equities ) :

11. Information regarding the composition of 'reserve' amount ( other than the reserve for loan losses ) and charges made thereto.
12. Information regarding the distinction between contributed capital and accumulated earnings.

E. Subsidiaries :

13. Information regarding affiliated companies.

F. Others :

14. In general, the disclosure of information in the income statement.
15. In general, the disclosure of information in the balance sheet.<sup>1</sup>
16. Information regarding source and application of funds.

LIMITATIONS :

This study is not intended to be a comprehensive analysis of all aspects of reporting by banking companies. It is designed to make a contribution to the growing body of knowledge to determine whether commercial banks in U.S.A., U.K., Canada, Australia and India have improved their financial reporting practices in some specific areas mentioned in the methodology. The researcher has developed this idea based upon the implicit assumption that the accounting information need of the users is almost the same throughout the world.

---

1. Strawser, op. cit., pp. 76-79.

In any study where testing under controlled laboratory conditions is impossible, there are certain inherent limitations. One of these limitations is the bias involved in presentation and analysis of questionnaire. Faulty construction is the primary source of bias which causes some partiality to be injected into the answer of a respondent.

Bias in the analysis of responses could occur because of a misinterpretation of the meaning of a reply or from intentional desire to support a certain position by the analyst.

Respondent bias is another type of bias that may be present in choosing the universe to be sampled. This type of bias can be either deliberate or intentional; however, it can never be completely eliminated. However, an attempt has been made to minimise this bias through proper construction of questionnaire. In using a sample to test entire population, an automatic limitation occurs because of the lack of information about the non-respondents. Every effort had been made to overcome this limitation by mailing follow-up requests to non-respondents. The follow-up requests did not eliminate non-response; it only reduced their number. Also, in a statistical sampling there is possibility of choosing a sample that is not representative of the population which is known as sample error. Effort can be made to overcome this limitation by using random numbers to select a sample but it is admitted here that due to lack of informa-

tion about the exact population of the universe, and due to heavy cost of postage and time factor, the researcher was compelled to drop the idea of drawing a statistical sample based on random numbers.

PLAN OF THE STUDY :

The present study consists of five chapters of which the remaining four have been arranged in the following manner :

**Chapter**

- II Financial Reporting Practices of Commercial Banks : A Review of Literature.
- III Survey of Annual Reports.
- IV Survey of Opinions.
- V Summary and Conclusions.