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RURAL FINANCE PROJECT

Bangladesh Bank-Agricultural Credit Department

(USAID Project No. 388 - 0037)

ISSUES IN RURAL BANK ACCOUNTING AND FINANCIAL REPORTING SYSTEMS

Prepared for

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SECTION A : INTRODUCTION

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A.1 Robert R. Nathan Associates, Inc (RRNA) of Washington DC, USA performs as prime contractor on the Bangladesh Bank's (BDB) Rural Finance Project (RFP) which is funded by USAID/Dhaka. The RFP commenced on 02 October 1984 and is scheduled to terminate on 01 September 1986. During 23 months of RFP, S.F. Ahmed & Co (SFACO), Chartered Accountants and Management Consultants, acts as sub-contractor to RRNA providing entire local professional, administrative and logistical support to the RFP including such support of a national sample Rural Branch and Bank User Survey (RBBUS) covering 100 rural bank branches and 1500 rural households. The RBBUS looked closely into various features of the rural banking system and was specially directed towards gathering data on rural deposit mobilization and loan recovery problems.

A.2 This report relates to an RFP requirement that bank accounting systems be studied with a view to determining how they might be changed so as to give a clearer, more useful (for planning and control purposes) picture of the financial condition of the banks from branch level to headquarters. Special attention was intended to be given to the accounting of lending operations. While all observations and recommendations contained herein are based on SFACO's 28 years of professional practice as chartered accountants, tax advisors and management consultants to a majority of banking organizations operating in the country including the BDB, it should be noted that this report benefits from full familiarity with other RFP research, reports and presentations and continuous consultative dialogue with all senior members of the RFP professional staff.

SECTION B : OBSERVATIONS

B

B.1 Accounting Systems

B.1.1 Provision for bad loans and accounting of interest income

Accrual basis of accounting (where all expenditures incurred, even if not actually paid in cash, and all income, even if not likewise actually received in cash to the date of drawing up of accounts, are accounted for) is followed by all banks in the country as elsewhere in the world. This system of accounting presupposes an accurate stocktaking of all payables and receivables at accounting date in order to ignore items not considered payable and items not considered receivable by means of making adequate provision in accounts at that date.

While expenditures are generally correctly reported, there is much to be desired in the sphere of reporting of income. Items of income not receivable are not adequately provided for - the principal item being interest accrued on advances and loans and provision made for bad and doubtful loans in accounts.

B.1.2 Mechanism of providing for bad loans

Provision for bad loans is now made in accounts following specific instructions of BDB contained in their BCD Circular No. 41 of 1985 (Appendix 1 to this report). This requires classification of loans by BDB loan inspectors and prescribes provision thereagainst as follows :

	Loan classification		
	Substandard	Doubtful	Loss
Prescription for provision in accounts in the year report of BDB inspectors is received	Nil	50%	100%
Prescription for accounting of interest income in the year the said report is received	To be treated as income for first 2 years from date of classification by BDB inspectors	To be treated as income only when actually realized from customers.	

BCD 41 goes on to state that -

- banks should raise the minimum level of provision to 4% of their total outstanding loan portfolio by accounting year 1989 at following scale beginning from accounting year 1985

  .. at end of 1985 .... 2%

  .. in each of years 1986 through 1989 .... 0.5%

- from accounting year 1990, banks should provide at above prescribed scale against advances as classified by BDB loan inspectors or at 4% of total loan portfolio, whichever is higher.

BCD 41 further states that above guidelines for provision and application of interest will also be applicable to similar classification of loans if done by banks themselves. In practice, however, this is rarely done by banks, which throws these matters back to prescribed scale and percentages. This policy will have following drawbacks subsequently in matter of determining amount to be provided for bad loans -

- only a few representative branches are covered by BDB loan inspectors
- there is often a big time gap between dates of examination by inspectors and date on which provisions are effected in accounts by banks. During this gap, position of loans may significantly change for better/worse
- opinion of branch managers is never taken in respect of making provisions.

B.1.3 Accounting for interest income

In accordance with BCD Circular No. 41 of 1985, if any stuckup advance, classified by BDB inspectors as "sub-standard", continues to remain stuckup, without any recovery of principal or interest for 2 years or more after date of inspection, interest accrued on such account from 3rd accounting year and onward after inspection will cease to be treated as income of a bank. This means that prior to that point of time, a bank will be fully justified in treating interest on such stuckup accounts as its income.

Time lag thus provided by BDB is quite long and the matter is not entirely left to discretion of individual banks whose accounts are annually audited by chartered accountants and reported on. It is more so because the condition "without any recovery of principal or interest" described above has been very badly abused by branch managers who often manipulate borrowers to put in a paltry sum in their accounts toward very end of accounting year in order that such accounts get out of the net of stuckup accounts and managers can freely take interest on such accounts to income to show an inflated result of branch for their own employment record, promotion, transfer to urban branch, increment, entitlement to annual bonuses, etc.

B.2 Accounting Procedures and Banking Practices

B.2.1 Loan analysis

Criteria of ageing and preparing breakdowns of loans for various accounting and banking purposes have not yet been standardized and therefore these were found to be at variance at different banks and, more importantly, at different branches of the same bank. This tends to create confusion when one attempts to meaningfully analyse loan portfolios.

B.2.2 Mode of adjustment of loan recoveries against various elements of loans

A loan balance comprises elements like principal, interest, penal interest, service charge, other charges, overdues, etc and there has to be standardized guideline prescribing order in which loan collections should be adjusted against these various elements. No such standardized guideline exists, as a result of which banks adjust loan collections in different order; neither are loan ledgers provided with separate columns for recording these loan elements.

B.2.3 Accounting at branch level

Following expenses are never considered in accounts at branch level as a result whereof financial and operational result of branch is always incomplete and distorted making branch accounting statements useless for branch evaluation purposes -

- provision for bad loans
- loan and other writeoffs
- accrued expenditures
- allocation of head office overheads.

While no system exists of charging branches with a portion of head office overheads, first three items are always accounted for at head office level while preparing annual accounts of a bank.

B.2.4 Detailed accounting procedures

Steps involved in flow of accounting data from vouchers to cash book/ledger(which forms the basis of preparation of weekly statement of affairs or trial balance) at the branch differ between banks because of varying instructions issued by their respective head offices or procedures adopted by branch managers themselves for sake of convenience. In some branches this results in extra work load.

B.2.5 Formats and ledgers

Formats for weekly statement of affairs (trial balance) designed by respective head offices for reporting various items of income and expenditures differ between banks which makes interbank comparison very difficult. Different types of accounting ledgers were found at branches. Some branch managers seemed to prefer loose leaf ledgers while others liked these bound.

B.2.6 Mechanization

While at some head offices mechanization (including use of computers) of accounting and data processing is observed to some extent, most of their branches have introduced very little mechanization. Some branches do not even have electronic pocket calculators. This results in unnecessary and avoidable delays in accounting and data processing.

B.2.7 **Inter-office interest rate**

Rate of interest on inter-office transfer of funds (head office to branch and branch to head office) was observed to differ between banks. While Pubali charged 14%, Rupali adopted 12½%.

B.2.8 Circulars and instructions

BDB as the central bank of the country operates under functional and administrative control of Ministry of Finance (MOF) of Government of Bangladesh (GOB). Various circulars and instructions are from time to time issued by BDB, MOF and GOB. Rarely at any office or branch these circulars and instructions were found to have been gathered chronologically with any sequential and rational order.

B.2.9 Branch log book

Not very long ago in the past a permanent record called Branch Diary/Branch Log Book used to the maintained at all branches. This record used to be confidentially maintained and updated by managers themselves wherein a profile of branch was recorded covering features like command area of branch, customers, employees, etc. This used to give a very good picture of different aspects of banking potentials, untapped customers, staff quality and performance, etc but, sadly enough, this record was found to have been discontinued and was not found at any branch. Most managers seemed not to even heard of it.

B.2.10 Manuals

Each bank follows its own Book of Banking Instructions (BBI) and various manuals relating to banking, accounting, auditing, reporting, etc. In most cases these were not found updated.

B.2.11 Filing and indexing

Filing and indexing systems observed at branch level were found to be very inadequate and apparently neglected.

B.2.12 Storage and security

Facilities observed to be available at branches regarding storage and security of records and collaterals placed by customers were very poor. Quite often vaults or strong rooms, where important files and valuables were kept, were found to be very insecure and inadequate. Important records were often seen lying on floors.

B.2.13 Branch manager

Branch manager, specially one working in rural areas, operates with a number of constraints and handicaps some of which may be summarized as follows :

- Major part of his office time is spent at his desk engaging in official and clerical work with no or very little time left for business promotional activities. It was observed that, on an average, rural branch manager spends 2 days in a month with customers (mostly non-agricultural) while rural or agricultural customers are handled by rural credit officers employed on a full time basis for rural branches.

- The manager, even if he wants to, cannot establish and maintain his contacts with his clients owing, specially, to transport and communication problems.

- Quite frequently he is interfered and is under pressure from local social/political elements in matters of granting and recovery of loans. Security measures being deplorably weak at that level (rural branch), he finds no wisdom in antagonizing local influential elements primarily because he lives in their locality with his family members.

- He has very little authority and discretionary powers vested in him. For every little matter he has to seek permission and clearance of either head office or zonal or principal office. Since he seeks prior approval in all worthwhile matters, including cases of granting of loans, he thinks it is not his personal responsibility to recover loans.

B.2.14 Rural borrower

Agricultural and rural credit lending programs are undertaken by GOB mostly in isolation and many different credit lines are opened, quite frequently, in the same command area under leadership of different banks. This probably happens because aid/grant agreements are negotiated and annual development program budgets are allocated that way. But one can imagine predicament of a rural farmer who has to go to different banks for his different credit requirements at different times of year each time wading through unnecessary bureaucracy and paper work (of which he is totally uncapable and also has to pay for services obtained) and corruption. He gets frustrated in the process and turns to informal local credit sources to meet his needs where he has no paperwork requirements to meet, gets his credit rightaway and avoids corruption but all this at the cost of exhorbitant interest rates.

The lone borrower or farmer. is never eyed by the banking and credit machinery as an individual with his own credit needs for an entire year but always as part of some particular farming program. His total profile is never prepared catering to all his needs (productive or domestic/personal) for a year which accounts for his channelling of credit obtained to unproductive uses eventually leading to loan nonrecovery.

B.3 Income Tax Laws and Practices

B.3.1 Provisions for bad loans are not allowed for income tax purpose and therefore these, when made in accounts, suffer tax at 60%. Even bad loans, when written off in accounts, are not normally allowed as deduction at first level of assessment. These are, in many cases, allowed after cumbersome and time-consuming tax litigation and appeals to higher tax authorities.

In 1984 income tax laws were amended to allow a provision for bad and doubtful debts made by banks for overdue agricultural or rural loans upto a maximum of 1½% of such total overdue loans. Provisions, if any, made in accounts in excess of 1½% similarly suffer tax at 60%.

These are very serious deterrants and act as disincentive for banks to provide for bad and doubtful loans.

B.3.2 A summarized list follows of above and some income tax provisions and their practical application which offer very serious resistance to growth of deposits, promotional activities, correct accounting and reporting practices.

		Reference to Income Tax Ordinance 1984
(a)	Writeoffs of bad loans (bad debts) routinely disallowed at first level of assessment; mostly allowed after appeals and litigation	As per practice observed, although allowed under section 29(1)(xv)
(b)	Provision for bad loans (bad debts) not allowed as a deductible expense item	Does not appear in list of business deductible expenses under section 29(1)

		Reference to Income Tax Ordinance 1984
(c)	Provision for bad loans (bad debts) allowed to banks on overdue agricultural or rural loans upto 1½% only of their overdue rural loan portfolio	Section 29(1)(xviii)
(d)	Banks are required to furnish particulars of depositholders receiving interest, in excess of Taka 15,000, during a year (this has proved to shy away existing and prospective depositors)	Section 109
(e)	All interest earnings on deposits paid to deposit-holders are tax exempt upto Taka 15,000 only in a year	Section 44(2) sixth schedule (part A) clause 10(1)
(f)	Amounts placed in fixed deposit accounts by individuals do not qualify for deduction as investment allowance (this allowance is permitted in case of purchase of GOB securities, life insurance policies, etc)	Section 44(2), sixth schedule (part B), clauses 10(1,4,5 and 6)
(g)	Accumulations of staff provident fund are not allowed to be kept in banks (such accumulations are allowed to be invested in GOB securities, etc)	Section 2(6), first schedule (part A), clause 3(e) read with section 20 of Trusts Act 1882

		Reference to Income Tax Ordinance 1984
(h)	A bank's interest earning from its investment in GOB securities and corporate shares and debentures is taxed on receipt basis (irrespective of what is shown in accounts as accrued income) whereas its interest earning from loan portfolios is taxed on accrual basis	Section 22 read with erstwhile Central Board of Revenue Circular No. 15 of 1954
(i)	Tax rebate at the rate of 10% of annual profits (subject, however, to ceiling of paidup capital) is allowed for amounts transferred to special reserve fund by specialized financial institutions or development finance institutions (DFIs) only for augmenting their equity base but commercial banks are not given this facility.	Section 29(1)(v)

B.4 Accounting, financial and operational disclosure in annual financial statements

Banks are required to publish their financial statements once a year duly audited by professional and independent chartered accountants. Preparation of financial statements is guided by formats prescribed by and embodied in Banking Companies Ordinance 1962. These formats are shown, in somewhat abridged versions, in Appendix 2 to this report. Study of formats will certainly reveal that these -

- have become very outdated by now (for one, these were designed back in 1962)
- offer very little disclosure to readers
- are not even sufficient for purposes of income tax department.

There is another bottleneck in way of adequate accounting disclosure for banks (specifically for those which are in denationalized/private sector and whose shares are quoted on Dhaka Stock Exchange Ltd). Corporate entities quoted on Exchange are exposed to significant disclosure in their published financial statements by Securities & Exchange Rules of 1971 framed under Securities & Exchange Ordinance of 1969 but these Rules have clearly exempt banks and insurance companies from disclosure requirements. Therefore, banks legally fulfil their obligations by adhering to requirements of formats laid down in Banking Companies Ordinance 1962.

General realization in financial, banking and professional circles of inadequacy of disclosure of published financial statements is there but since relevant formats are statutorily prescribed there is very little one can do about it unless the guiding statute is amended.

B.5 Management Information System - MIS(Reporting)

There is a frightening number of management reports generated at branch level. Their number, however, varies from branch to branch and from bank to bank. Head offices also generate many reports. A good guess about their number could be around 200. Reports are prepared with varying frequency - daily, weekly, monthly, quarterly, bi-annually and annually. They are distributed differently - to principal office, zonal office, head office, BDB, MOF, GOB, etc having no rationalized distribution channel.

Reports going to head office are instantly distributed to concerned departments/sections of head office where these are handled and then filed. Attempts to obtain copies of all reports at any office, due to this reason, often ended in failures. Owing to this reason, no head office has so far been able to establish a central data bank where all information and reports are available and which could then generate reports by exception for corrective steps by top layers of management in time.

Demands made by these reports are often very elaborate and the most interesting part of the scenario is that books and records, specially at branch level, are not designed in a fashion which would conveniently yield figures and data to be fed into reports. Compulsorily, therefore, branch staff have to quite frequently dig into elementary records like vouchers, etc in order to prepare reports. An example could be classification of loan amounts into important elements like principal, interest, penal interest, service charge, other charges, overdues, etc. Reporting of these elements is desired, quite rightly, by all concerned but loan ledgers do not appear to have been provided with columns for recording these elements. This necessitates consulting subsidiary records for report preparation.

Once reports reach their destination, no feedback is generated for education or training of offices preparing them.

B.6 Auditing

B.6.1 Types of audit

Branches/offices are subjected to audits/inspection by -

- BDB inspectors
- bank's own inspectors/internal auditors
- members of office of Comptroller and Auditor General, GOB
- chartered accountants.

B.6.2 BDB inspectors

BDB inspectors mainly visit branches for purpose of classification of loans in terms of requirements of BCD Circular 17 of 1975 (updated by 41 of 1985) of BDB. BDB inspection has not been found to be adequate and while their inspectors do not audit/inspect all branches of any bank, their reports on branches covered are often very late.

B.6.3 Internal auditors

Banks' internal auditing/inspection systems leave much to be desired. Auditors are half or quarter trained, there is no standardized auditing guidelines or audit programs used in audit, there is no auditing manual in use and there are no instructions on how to write audit reports for management. As a result, internal auditors mostly restrict their checking to expenditure vouchers on staff salaries, travelling allowances and medical expenses and expenditures on stationery, transport maintenance, etc which make these reports of very little auditing value.

B.6.4 GOB auditors

Members of office of Comptroller and Auditor General, GOB conduct what is termed as commercial audits. These audits never yield any results as these remain bogged down with unnecessary scrutinization of establishment and administrative expenditures.

B.6.5 External auditors

Audits conducted by external/professional auditors (chartered accountants), by far, meet requisite standards and internationally accepted auditing essentials and guidelines but these audits face two very serious handicaps.

- Since external auditors have to certify annual accounts soon after year end they somewhat work under time constraints and therefore their audit is limited to head office and big branches and offices necessitated by maximum possible coverage of transactions in financial terms for forming and expressing a professional opinion on annual accounts. As nature of audit demands coverage of big branches, small and rural branches have to be most reluctantly dropped altogether.

- External audit compensation/fee is deplorably low compared to costs involved in doing a quality work by employing experienced professional personnel for required span of time. This is a matter of concern and very often external auditors find it extremely difficult to perform all the time maintaining professional standards demanded by audit of banks which deal with huge public money.

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B.7 Performance Evaluation

B.7.1 At present budgets are prepared for each branch which includes budget lines like deposits, loans, income, expenditures (capital and revenue), etc only. These budget lines are so brief in nature that no purposeful analysis of branch operation or performance is possible. Activity or performance budgeting and monitoring systems have not yet been really introduced at branch level.

B.7.2 Employees are promoted and their compensation refixed based on number of years put in and not really based on periodic evaluation of their performance.

B.7.3 Quite frequently a tendency has been noticed with branch managers to deliberately inflate branch profits because calculation of their incentive bonus entitlements is based on bank's total profits. In order to discourage this BDB has issued guidelines vide its Circular letter No. BCD(C)613/10-46 dated 26 December 1985 (Appendix 3) whereby bonus is to be paid on the basis of actual recovery of loans and not on profits arrived at following accrual basis of income accounting. This will necessitate arriving at total cash recovery for entire bank in a year. This can be very easily done by inserting a "received in cash" column in recovery portion (credit side) of loan ledgers.

SECTION C : RECOMMENDATIONS

Reference to Observation (Section B)

C.1 Accounting systems

Although banks are justified in making provision in accounts strictly in terms of BCD Circular 41 of 1985, yet overall position of provision should be studied in a broader and more realistic perspective as banks are financial institutions dealing with public money and they should be financially conservative in their total approach. The matter therefore necessitates reconsideration and banks should create provision based on their own latest assessment of all loan accounts of all branches. in which opinion of branch managers should play the most dominating role-reports of BDB loan inspectors providing guidance only. B.1.1 B.1.2 B.1.3

C.2 Accounting procedures and banking practices

C.2.1 Criteria of ageing and preparing breakdowns of loans for various accounting, reporting and banking purposes should be standardized. B.2.1

C.2.2 Mode of adjustment of loan recoveries against various elements of loans should be determined and fixed for application. B.2.2

C.2.3 Branches must be made self accounting units through incorporation of all accrued expenses including a share of their head office overhead. B.2.3

C.2.4 Detail accounting steps involved in flow of data from vouchers to drawing up of trial balance need to be made uniform between branches as well as banks. B.2.4

Reference to Observations (Section B)

C.2.5	Format of weekly trial balance (statement of affairs) should be made uniform with accommodation of previous period figures for comparison purposes. Ledger forms should be identical.	B.2.5
C.2.6	Minimum amount of mechanization should be introduced at all branches for sake of speed and efficiency.	B.2.6
C.2.7	All circulars, instructions, etc should be properly filed and indexed. Steps should be taken to thoroughly streamline overall filing and indexing systems in order to improve the working atmosphere and increase efficiency. Manuals in use must be kept updated. Branch log book should be re-introduced.	B.2.8 B.2.9 B.2.10 B.2.11
C.2.8	Storage and security arrangements for preservation of records and valuables should be greatly improved.	B.2.12
C.2.9	Branch manager must be made more independent, aggressive and businesslike. He must be given more authority and necessary facilities with equally demanding responsibility. He should be in a position to independently assess a loan applicant, give him loan and take all necessary steps to recover loan including, wherever called for, taking wilful defaulter to doors of justice with absolutely no interference - social, political or otherwise from any quarter. He should be judged by his performance, given incentive and rewarded for good work and penalized for negligence and bad performance.	B.2.13

Reference to Observations (Section B)

C.2.10 **Rural farmer should be viewed in a total perspective. His entire annual credit needs** should be taken into consideration by providing him one-stop service as has been visualized for city-based industrialists. He should be given a Borrower Credit Card which will help him in getting B.2.14
all his credit needs met at one bank branch that he chooses to be the most convenient for him. Introduction of this card will also help in avoiding the possibility of his getting credit from more than one bank or even more than one branch.

C.3 Income tax laws and practices

C.3.1 Writeoffs and specific provisions made by banks, as per their own appraisal, against all uncollectible loans should be allowed as deduction in order to encourage adequate provision in accounts. On the other hand, in order to discourage borrowers from B.3.1
not paying back their loans at all, tax statutes B.3.2(a)
should be suitably amended to tax such delinquent B.3.2(b)
borrowers for amount of bad debt writeoff or B.3.2(c)
provision allowed as tax deduction to banks-thereby equalizing effect on internal tax mobilization of GOB.

C.3.2 Banks should be made exampt from submitting particulars of recipients of interest on deposits. This will go a very long way in augmenting and mobilizing bank deposits. In 1985 national budget an announcement was made for withholding taxes from interest paid on fixed deposit accounts. This created such a scare in the minds of depositholders(even after repeated assurances from GOB that their names will not be disclosed to taxing authorities) that there was virtually a run on banks for withdrawal of funds and closure of fixed deposit accounts and eventually MOF was compelled to totally withdraw that announcement forthwith.

Reference to Observations (Section B)

C.3.3 **Ceiling of tax free annual interest earning on bank deposits should be increased from existing Taka 15,000 to Taka 50,000. Alternatively, these could be taxed at a concessional rate. This will boost deposit mobilization greatly.** B.3.2(e)

C.3.4 Amounts invested by individuals in fixed deposit accounts should be treated at par with GOB securities and life insurance policies for purpose of deduction as investment allowance paving the way for deposit mobilization. B.3.2(f)

C.3.5 Accumulations of staff provident fund should be allowed to be invested in term deposits with banks. This measure, too, will bring considerable amount of funds into national banking channels. B.3.2(g)

C.3.6 Taxing a bank's income from its investment in GOB securities and corporate shares and debentures and from interest on loan portfolios should receive identical tax assessment treatment and the second should be, like the first, taxed on receipt basis. (This could be an alternative to allowing writeoffs of and provisions made in accounts against uncollectible bad loans. B.3.2(h)

C.3.7 In order to allow banks to augment their equity base which, in turn, will ensure their financial soundness, non-DFIs should also be, like DFIs, given a tax rebate of 10% (subject, ofcourse, to same DFI ceiling of paidup capital) of annual profits for transfer to a special reserve fund. B.3.2(i)

C.4 Accounting, financial and operational disclosure in annual financial statements

C.4.1 It is high time formats of financial statements are changed/amended, to the extent feasible and in phases, in line with internationally accepted principles of accounting and disclosure requi..d by International Accounting Standards (IAS's) published from time to time by I..ernational Accounting Standards Committee(IASC). IAS's should be uniformly adopted by all banks at national level since Institute of Chartered Accountants of Bangladesh, which regulates the profession of accounting, auditing and reporting in the country, became a member of IASC back in 1977. B.4

C.4.2 Since banks deal with public money, investors have every right to know about their financial dealings and position and therefore there is no reason why banks (irrespective of being in public or private sector) should remain outside the ambit of compulsory disclosure under Securities & Exchange Rules of 1971. The Rules should therefore be amended to include banks also. B.4

C.5 Management information system - MIS (Reporting)

C.5.1 Number of reports should be drastically reduced through a process of consolidation, simplification and integration of existing multifarious reports. Data bank at head office of each bank should be established. An executive summary of reports should be prepared by each branch/office highlighting strategic performance areas. Reporting channels (both for their timing frequency and for distribution) need rationalization. B.5

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C.5.2 Based on collectability, standardized guidelines should be issued by BDB for classification and ageing of loan portfolios.

C.5.3 Depositholders should be categorised into various professions/strata of society in order to measure potentially untapped pockets of deposits in command area of each branch.

C.5.4 Programwise segregation of deposits and lending should be done at each branch to evaluate viability, popularity and effectiveness of various economic programs of GOB. Consideration may be given to possibility of programwise accounting by alloting cost and income centres to each GOB program. Necessary changes may be made in accounting systems and procedures to accommodate these requirements under the direction of BDB at national level.

C.6 Auditing

C.6.1 BDB inspectors should be properly trained to adopt modern auditing practices and techniques of loan evaluation. Steps should be taken to ensure submission of their reports on time. B.6.2

C.6.2 Internal audit department must be upgraded. Qualified personnel should be appointed and trained in modern bank auditing techniques. Their entire approach and outlook towards auditing are to be changed so that external auditors can rely on internal audit work. B.6.3

C.6.3 Audits conducted by office of Comptroller and Auditor General, GOB should be discontinued for banks. B.6.4

		Reference to Observations (Section B)
C.6.4	Audits conducted by external auditors should be done in close cooperation with internal auditors (provided standard and quality of internal auditors' work is sufficiently raised) in a way that external auditors can rely on the work of internal auditors thereby avoiding unnecessary duplication of work.	B.6.5
C.6.5	All branches of a bank should be, by rotation each year, covered by external audit in way that total coverage is complete, say, within a span of 4-5 years.	B.6.5
C.6.6	Appointment of external auditors should be left to discretion of banks themselves and the matter should not be decided by GOB (as in case of nationalized banks).	B.6.5
C.6.7	External audit compensation/fee should be fixed on commercial considerations following recommendations of Institute of Chartered Accountants of Bangladesh.	B.6.5

C.7 Performance evaluation

C.7.1	Budgeting system at branch level should be improved to help management in monitoring and decision making.	B.7.1
C.7.2	Employee compensation should be reviewed and refixed based on performance and not on length of employment.	B.7.2
C.7.3	Incentive bonus should be tied to recovery of loans at branches as already decided by GOB. Implementation of this policy should be strictly and forthwith done.	B.7.3

C.8 Training

Foregoing recommendations should be implemented in phases by dividing these into short term and long term steps. Short term steps should be completed in 2 years' time while long term steps should be executed in 4 years. Accordingly, staff at all concerned levels should be trained in phases so that implementation does not face any bottlenecks. Alongwith training there has to be an ongoing program of staff evaluation and repeat training.

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APPENDICES

BANKING CONTROL DEPARTMENT
BANGLADESH BANK
HEAD OFFICE
DHAKA

NO. BCD CIRCULAR NO. 41 Dated: The 24th December 1985

All Scheduled Banks
in Bangladesh.

Dear Sirs,

APPLICATION OF INTEREST ON CLASSIFIED LOANS AND ADVANCES AND MAKING PROVISIONS THEREFOR

In supersession of the instructions contained in BCD Circular No. 17 of 1975 and No. 17 of 1976 and incorporating the guide-lines given in BCD Circular No. 37 of 1985, the following instructions are issued with regard to the application of interest in classified advances and making provision there-against for necessary action by the banks :

2. Provision against classified advances :

(a) No provision need be made against advances classified as 'Sub-Standard' by the Bangladesh Bank inspectors. But provision should be made against advances classified as 'doubtful' and 'loss' by the Bangladesh Bank inspectors at the following scale in respect of both public and private sectors :

(i)	Doubtful	50% of the total amount remaining classified in this category.
(ii)	Loss	100% of the total amount remaining classified in this category.

(b) Provision at the scale mentioned at para 2(a) above should be made in the same accounting year in which the inspection report from Bangladesh Bank is received. It cannot be deferred to subsequent accounting years.

(c) It has also been decided that banks should raise the minimum level of provision to 4% of their total outstanding loan port-folio by the accounting year 1989 of the following scale beginning from the accounting year 1985

(i) 2% of the outstanding loan at the end of 1985.
(ii) At the rate of 0.5% of total outstanding loan in each subsequent year upto the accounting year 1989.

(d) From the accounting year 1990, provision should be made at the prescribed scale against classified advances or at 4% of total loan port-folio which ever is higher.

(e) Provision made against bad and doubtful debts should be deducted by the banks from their total outstanding loans and advances and only the resultant balance should be shown in all their returns to be submitted to Bangladesh Bank so as to reflect a realistic position of their assets and liabilities. Such provisions should also not be shown as reserves in the returns to be submitted to Bangladesh Bank as in the case of Balance Sheet.

3. <u>Application of interest on classified advances :</u>

(i) In the case of advances classified as 'doubtful' or 'loss' interest should neither be debited to the concerned loan account nor credited to the Interest Account/Interest Suspense Account by banks right from the date of classification of the relative advances. But separate records of such interest should be kept by the banks so that the same may be claimed from the concerned borrowers as and when required. Such interest may be taken into income account of the bank as and when actually realised.

(ii) In case of advances classified as 'substandard' interest accrued may however be credited to interest account for the first two years from the date of classification of the relative advances. Interest on such advances thereafter should neither be credited to interest account/ interest suspense account nor debited to the concerned loan account as in the case of advances classified as doubtful and loss if the relative advances remain stuck up without any repayment during the first two years from the date of classification.

4. The above instructions regarding provision and application of interest will also be applicable to advances considered as 'sub-standard', 'doubtful' or 'bad' by the bank itself.

5. The external auditors of the banks should ensure that verification of all stuck-up account has been carried out by inspection team of Bangladesh Bank/Commercial Banks' own inspection team.

6. The above instructions will come into force with immediate effect.

7. Banks are, therefore, advised to circularise the above instructions to their branches in Bangladesh immediately and ensure meticulous compliance of the same.

Please acknowledge receipt.

Yours faithfully,

MOHD. BUZRUCH MEHER
Deputy General Manager
Phone: 281944

Formats prescribed in the Banking Companies Ordinance 1962

Balance Sheet (Form A)

Capital and Liabilities

Capital
- Authorised
- Issued, subscribed and paidup

Reserve fund and other reserves
- Statutory reserve
- Special reserve
- General reserve

Deposits and other accounts
- Fixed deposits
- Savings bank deposits
- Current accounts, contingency accounts, etc

(1) Borrowings from other banking companies, agents, etc

Bills payable

(1) Bills for collection being bills receivable, as per contra

Other liabilities

Acceptances, endorsements and other obligations, as per contra

Profit and loss

Contingent Liabilities

(1) Figures separately reported for within and outside the country

(2) Some more informative particulars, apart from the 4 classifications, are included in the published balance sheet

Total : Taka

Property and Assets

Cash

(1) Balance with other banks

Money at call and short notice

Investments (at cost)

Advances (less provision made to the satisfaction of auditors)

(1) Loans, cash credits, overdrafts, etc

(1) Bills discounted and purchased

(2) Classification of advances

Debts considered good to the extent of -
- full coverage of security
- debtors' personal security only
- personal liabilities of one or more parties in addition to personal security of debtors

Debts considered doubtful but not provided for

(1) Bills receivable being bills for collection, as per contra

Constituents' liabilities for acceptances, endorsements and other obligations, as per contra

Premises less depreciation

Furniture and fixture less depreciation

Other assets

Non-banking assets

Profit and loss

Total:Taka

Profit and Loss Account (Form B)

Expenditure

Interest paid on deposits, borrowings, etc

Salaries, allowances and provident fund
- To chief executive
- To others

Directors' fees and allowances

Rent, taxes, insurance, lighting, etc

Law charges

Postage, telegrams and stamps

Auditors' fees

Depreciation on and repairs to bank's property

Stationery, printing, advertisement, etc

Loss from sale of non-banking assets

Other expenditure

Balance of profit

Total : Taka

Income

Income (less provisions made during the year)

Interest and discount

Commission, exchange and brokerage

Rent

Net profit on sale of investment and other assets

Net profit on revaluation of investments and other assets

Income from non-banking assets

Other receipts

Loss (if any)

Total : Taka

/ Appendix 3 /

BANKING CONTROL DEPARTMENT
BANGLADESH BANK
HEAD OFFICE
DHAKA

Circular Letter No. BCD(C)613/10-46 Dated 26-12-85

Sonali/Janata/Agrani/Rupali bank
Head Office
Dhaka

Dear Sirs,

PAYMENT OF INCENTIVE BONUS TO THE EMPLOYEES OF NCBS.

In view of ECNEC'S decision that bonus be paid on the basis of actual recovery and not on accrual basis, the following arrangements have been suggested by the Ministry of Finance in this regard.

i) NCBs should strictly follow the orders of the Bangladesh Bank with respect to classification of loans and to make adequate provision for bad and doubtful debts;

ii) Auditors would be asked to submit confidential reports to the Ministry of Finance whether these instructions regarding classification of advances and making provisions thereagainst are being adequately followed by NCBs;

iii) Bangladesh Bank will at random inspect 10(ten) representative branches of each of the NCBs to make assessment of classification of loans and provisions for bad and doubtful debts. Bangladesh Bank will complete the inspection by March every year ;

iv) Proportion of bad and doubtful debts in relation to the total loan as found from above exercise would be applied for the bank as a whole for estimating provisions for bad and doubtful debts before calculating bonus;

v) While doing the inspection as mentioned in sub-para(iii) above, Bangladesh Bank will also examine recovery in actual and accrual terms for few branches and recommend weightage between the two types of incomes that comes to approximate the results found by making actual classification/ provision as per sub-para(iii) above.

Yours faithfully,

(A.H. TAWFIQUE AHMED)
DEPUTY GENERAL MANAGER
PHONE: 230898