Chapter - 10

Conclusion

Indian economy is growing rapidly. The globalized business activity exposes business entities to greater risks. The growing complex needs to manage these risks are met through derivatives. Derivatives now-a-days have become an essential tool in managing the risks.

In India, corporate companies follow the Indian GAAP (Generally Accepted Accounting Principles) which are in line with IFRS issued by the Institute of Chartered Accountants of India (ICAI). Indian Accounting Standard AS-30 contains the comprehensive guidelines for derivatives accounting. For Indian banks it is the RBI which issues separate guidelines for derivative accounting. Under the guidelines issue by RBI, derivative transactions for trading purpose are marked-to-market while, those meant for hedging are accounted on accrual basis. These entirely diversified accounting treatments and their information, limits the quality of financial information hindering the usefulness of financial statements to its users.

Also the concept of derivatives is unfamiliar among retail investors even after more than ten years of its introduction as a hedging tool against risk faced by corporations in India. They have strong believes in the myths and misconceptions of Derivatives (Pasha, 2013). The past derivative related financial disasters have made the stakeholders more conscious about the business firm’s usage of derivatives.

To adequately evaluate the financial position and performance of a financial institution the stakeholders need accurate information about its business management and corporate governance practices. Such information aids in understanding the
business operations of banks and indirectly assists in practicing market discipline through better corporate governance mechanisms exhibiting enhanced quality and level of disclosures. The economic well being of a large number of stakeholders depends on the health of the banking system. The health of the banking system depends on the execution and appropriate regulatory practices and supervision. In turn, the regulators and supervisors act on behalf of wide range of stakeholders. The financial soundness of a well regulated and supervised financial system depends in the fundamental objective of good corporate governance practices of such institution (Purvey, 2009).

The analysis of the quantitative and qualitative derivative accounting guidelines by Bank for International Settlements (BIS) and Reserve Bank of India show that there is a gap in the quantitative and qualitative derivative accounting guidelines provided by RBI when compared to the guidelines provided by BIS. Quantitative derivative accounting information relating to major risk associated with the use of derivatives like market risk, credit risk, liquidity risk and information related to earnings from derivative trading activities show a major gap. In case of qualitative derivative accounting information, a major gap is found for the information types like market risk, credit risk and liquidity risk. The study has made suggestion for the inclusion of the information items with major gaps in the present derivative accounting guidelines so that the information provided by the bank annual reports can be enhanced to meet the requirement of international best practices.

The survey of the users of derivative accounting information in the annual reports of banks show that majority of respondents consider derivative accounting information important for taking informed decisions and in assessing the use of derivatives and its exposures to banks. The survey respondents consider bank annual
reports as the most important source of derivative accounting information while quarterly reports are ranked as the second most important source of derivative accounting information. Most of the quantitative and qualitative derivatives accounting information items were ranked important by the respondents hence, it is considered that the annual reports of banks should provide sufficient quantitative and qualitative derivative accounting information. The user’s comments for the two open ended questions related to the perception and improvements needed for the present derivative accounting information, show that the present derivative accounting information in the annual reports could be more useful if they provide;

- Increased explanation of the purpose for which derivatives are used and the associated risks involved.
- Derivative disclosures that is more simple and understandable.
- Education to the users to understand the usefulness of the information disclosed.
- Enhanced market risk disclosures associated with derivative activities.
- Awareness about the risks and rewards associated with the usage of derivatives by banks to the users.
- Derivative related information that is comparable at national and international level.

The results of the survey and user’s comments show that there is an information gap in the information provided by banks through annual reports.

The analysis of annual reports of twenty banks for five years shows that, there is room for improvement in a number of areas. It is noticed that the banks show good level of compliance with quantitative derivative accounting information than
qualitative derivative accounting information. It is said that quantitative information might be misleading (Susan, 1994) and incomplete without proper supporting qualitative derivative accounting information, hence Indian banks should give more attention toward complying with supportive qualitative derivative accounting information. Banks lack in complying with quantitative derivative accounting information like information related to collateral required while entering into swap agreements, notional principal of exchange traded interest rate derivatives, valuation of outstanding contracts, risks involved in use of derivatives for non-trading purpose, recognition of income, premiums and discounts. For these quantitative derivatives accounting information types the banks show less than 75% level of compliance. The reason for reduced compliance scores is due to incomplete information provided by banks for many of the quantitative derivative accounting information types. In case of qualitative derivative accounting information, generally most of the qualitative derivatives accounting information have low compliance scores and are generic in nature. Hence, banks have to provide proper, accurate and enhanced quantitative and qualitative derivative accounting information in their annual reports to the regression results show that quantitative derivative accounting information are positively and insignificantly influenced by the size and ownership of banks, while negatively and significantly influenced by the age of the banks i.e., as the age of the banks increases the quantitative derivative accounting information among banks decreases. In case of qualitative derivative accounting information are positively and significantly affected by the size and ownership of banks, and negatively and significantly affected by the age of the banks i.e., as the size and private ownership of banks increases banks tend to provide more qualitative derivative accounting information and as the age of the
bank increases the qualitative derivative accounting information provided by bank decreases and vice versa.

The banks show consistency in providing both quantitative and qualitative derivative accounting information over the period of study. The results of regression show that, size of banks as measured by market capitalization, age as measured by number of years in business and ownership of banks are all significant determinants of the level of compliance with the overall derivative accounting information among Indian banks. While size and ownership show positive beta values as they are directly related and age of banks shows a negative beta values as age is inversely related to derivative accounting information among banks.

The findings of the empirical study on the level of compliance with derivative accounting information among Indian banks are varied and conflicting. In case of quantitative derivative accounting information most of the banks have shown higher level of compliance while few of them have shown lower compliance scores but in case of qualitative derivative accounting information most of the banks have shown lower compliance scores while few of them have shown higher compliance scores. Variations in the level of compliance with the required derivative accounting information have been observed among large and small size banks, old and new age banks and among public and private sector banks.

Adequate steps should be taken by the regulatory authorities to ensure full compliance with derivative accounting guidelines by banks. Increase in the compliance and quality of derivative accounting information by banks would help the users of such information to take informed decisions and help the evaluations of the bank’s progress and performance. The interest of the wide range of users of derivative
accounting information can be protected with effective compliance enforcement programs. Regulators like RBI should strongly encourage enhanced disclosures by banks and reward such institutions for showing good market discipline. The quality of derivative accounting information can be enhanced if the standard setters focus on the users of these information at the time of framing standards. A compliance assessment committee could be formed that represents the wider user group of annual reports to assess the efficiency of banks in meeting the required reporting regulations and give their recommendations. This would ensure and restore the confidence in the traditional means of communication between banks and its stakeholders.

The increased growth of derivative activities is an advantageous issue, as it gives opportunities to transfer different types of market risk. At the same time institutions using derivatives should be conscious about the serious effects of the rapid growth of derivatives.

Regulators and standard setters in India like ICAI and RBI need to frame better financial reporting requirements reflecting the risks and rewards associated with derivative activities. The principle intention of derivative accounting information requirements is to enable the users of these reports to evaluate the risks (lack of skill to understand treasury, price risk and inadequate operational controls) and rewards (more profits and lesser impact on a firm’s cash flows due to financial market volatility) (Chalmers & Godfrey, 2004).

The present derivative accounting information requirements are very minimal and limited in nature at the same time, banks show insufficient derivative accounting information in their annual reports. This may lead to increased fear of the risks associated with derivative activities by banks.