TANZANIA STATEMENT OF ACCOUNTING GUIDELINE NO.7 AND THE CENTRAL BANK'S SUPERVISORY ROLE.

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Abstract

It is in the interest of the Bank Customers, particularly depositors, Central Bank, public and Government that the Bank and of course other financial institutions should continue to exist in providing its services for an enforceable future. The role played by financial institutions is also crucial to justify the need for stable financial system.

This factor is manifested through various mechanisms established by the Central Banks and the Government to ensure that there is sustainable and efficient banking system in the daily running of activities by all interested parties The National Board of Accountants and Auditors (NBAA) on the other hand, has its main role being to monitor the development of the accounting profession in the country. Over and above this primary role, NBAA plays the role of safeguarding individuals (investors and even depositors) through constant monitoring of their (NBAA) members practice as well as issuance of accounting pronouncements to guide in daily accounting practice which in the end, is expected to achieve the above goal. The release of TSAG 7 on the Information to be disclosed in the Financial Statements of Banks and similar Financial Institutions is one of several Guidelines issued to meet that particular end.

This article discusses the TSAG 7 and its impact towards Central Bank's role as a supervisor of all Financial Institutions.

INTRODUCTION

Banks plays an intermediation role in the financial system by channeling resources among individuals having different requirements. Banks also play a key role in the economic activities, that is, creating money and administration of payment meachnisms, and as such a sustainable and efficient institution ought to be in place for this and many other roles to be efficiently achieved.[1]

The primary pre-requisite for a financial institution to exist is its ability to command the confidence of the depositors. This is so crucial as the entire financial intermediation starts from the deposits held by the banks. In absence of this confidence, financial intermediation will not take place as banks will not have funds to channel to borrowers. To build the confidence, banks are regulated.The regulation is done by the Central Bank. Regulation is an overseeing of the bank activities, specifically to address the solvency and the viability of financial institution. This role is complemented by some other documents and bodies which regulate and issue guidelines to their profession. These include National Board of Accountants & Auditors (NBAA) the Capital Markets & Securities Authority (CMSA). The combination of these guidelines and the Central Bank circulars reinforces the supervisory role of the Central Bank.

This paper addresses the above issues. Part one will briefly deal with the financial intermediation and the role of banks. Part two will detail the supervisory role and approaches

by the Central Bank. Part III deals with the TSAG 7[2] on the information to be disclosed by Banks and similar financial Institutions. Part IV deals with the TSAG 7 as a reinforcement of Central Bank's supervisory role and the last part will be the conclusion.

FINANCIAL INTERMEDIATION

Financial Intermediation is a process of channeling funds from individuals who have an excess funds to those without through an intermediary, a bank. Fry (1995) defines financial intermediation as the activity of obtaining funds from lenders[3] to pass on to borrowers.

These funds must be accumulated by a financial intermediary from many individuals before being channeled to the borrowers. Shang (1990) argues that "Financial intermediation helps the process of savings and investment in the economy because financial institutions reduce the risk of capital loss by savers, reduce transaction costs and provide the investor with funding in quantities and repayment schedules convenient to them.

Financial Institutions mobilize resources through accepting deposits from individuals and then channeling these resources into investible activities to the borrowers. Accepting deposit is the creation of a financial liability by the bank while extending credit is the creation of an asset by the same bank.[4]

This activity need to be done efficiently. The efficiency is achieved through the existence of an efficient system as well as a good number of intermediaries to effect the creation of the assets and liabilities. A competitive financial environment provides mechanism of improving the provision of financial services.

The current reforms taking place in Tanzania are means to achieve this objective. Financial Intermediation need to be sufficiently equipped by the intermediaries as well as the market interplay for the determination of appropriate interest rates. This factor assists in the efficient provision of financial services. The existence of private financial intermediaries proliferate the institutions availabe as well as enhancing the competion, good governance and eventuall efficiency in terms of timely provision of services, variety of products, choice of provider of service and the availability of different method of delivering financial products to customers. These qualities enhances the provision of financial services by promoting both deposits as well as advancements. It is these functions that are needed in order for the financial system, and indeed financial intermediation, to take place.

REGULATION OF FINANCIAL INTERMEDIARIES

Financial Intermediation is regulated by the Central Bank. This regulation is important for the following reasons[5]

1) Monetary policy
2) Credit allocation
3) Competition
4) Prudential Regulation

1. Monetary Policy

The need to regulate banks becomes necessary due to bank ability to create money. Banks operates on a law of large numbers where small depositors keep their money and the Bank channels this money to their borrowers. In lending, banks use a fraction of the deposits to lend to many people. As such, banks are in a position to create more assets by using same liabilities (deposits). There is a need to control and supervise the credit creation so as to minimize chances of bank failure resulting from excessive risks assumed by a financial intermediary. The risks involved include the inability of banks to honour deposit demands, the failure of borrowers to honour terms and potential losses to banks from non-performing loans.[7]

2. Credit Allocation

Regulation of banks restricts excessive credit allocation to borrowers as this may result in a

group of borrowers. The central bank will direct the allocation so as to spread the risk among many borrowers. Credit ceilings are set by the Central Banks to prevent individuat banks to concentrate on a single customer which may result in substantial losses should that customer fail to honour obligations attached to the advance.

3. Competition and Innovation

In a competitive financial environment, regulation becomes important to ensure fair play among all banks in the financial system. All intermediaries will be innovating new products to diversify from the traditional banking products. This is so as the margin will tend to narrow due to competition in the market.

Central Banks regulates the innovation to ensure the quality of the products and the safety of the depositors money. Regulation also restricts cartels in banking operation which is not competitively productive.

4. Prudential Regulation

The safety of depositors' savings is a crucial issue in the efficient bank operations. Depositors need to be assured to the safety of their deposits for them to continue holding their savings with the bank. This is one of the factors which create the confidence of the Institution and in deed the entire financial system. Prudential regulation attempts to ensure that there is no "Bank run" by all depositors to demand their money at once as Financial intermediary will not be able to honour their withdrawal demand.[7] Inyangete (1993) provides that prudential controls require financial Institutions to satisfy capital adequacy requirements, diversify their risks, adopt generally accepted accounting policies, engage professionally suitable managers, report their true financial position and be subject to effective supervision.[8]

Banks also provide a payment mechanism. This service need to be monitored in order for the payments to be made efficiently. Shang (1990) emphasized that banks must command the confidence of the society when public savings and operators of the payment mechanism can be done for and on behalf of customers with no loss and at a low cost.

This confidence is rather fragile because banks are vulnerable to collapse because of high gearing, mismatch of maturates between assets and liabilities, lack of transparency and the settlement risk.

Failure by counterparts to settle their claims may lead the bank into problems and hence the threat of the banks liquidity.

Approaches to Bank Supervision

There are basically four approaches towards bank supervision. These are :

1) Information disclosure
2) Self - regulation through -internal auditors
   - -external auditors
   - -Board Audit Committee
3) Government bank examination (implicit guarantee of deposits)
4) Deposit guarantee scheme (explicit guarantee of deposits).

This paper deals with the first approach, the Information disclosure only.

Information Disclosure

Banks, as any other entity is duty bound to disclose as much as possible the information on their condition and operations. This requirement is as per NBAA Act, Institutional Act[9] and th Companies Act. The disclosure is further reinforced by the Banking and Financial Institutions' Act No.12 of 1991 as well as the Bank of Tanzania Act. of 1995[10] Traditionally, the information disclosure has been effected through a set of audited accounts.

In the case of financial Institutions, the information disclosure is also a mandatory to the bank supervisors (the Central Bank). The information disclosed to bank supervisors is detailed and may not fit the requirements of a

public.

Some statistics, over and above the normal audited accounts are required for bank examination purposes. These will include daily foreign exchange positions, overnight clearing, weekly and monthly deposits, loan growth and quarterly and annual financial statements.

These statistics are then analyzed and compared with the similar institutions to asses the growth and determine early warming signals for an appropriate action by the Central Bank. Public disclosure is supported by the opinion of auditors. In some cases, and in particular, banking businesses, auditors are statutority required to communicate with the Central Bank necessary information that will strengthen the Central Bank's supervision role.[11]

TSAG 7

The TSAG 7[12] deals with the information which needs to be disclosed in the Financial Statements of Banks and Similar Financial Statements.

The main objectives of TSAG 7 are:-

a) To address the significant interests in the financial conditions of Banks and similar Institutions as regards their solvency, liquidity and degree of risk attached to their businesses due to their position in the economy.
b) To harmonise banks' financial reporting. Banks' operations are quite different from other entities. This difference applies to their accounting and reporting requirements as well. These factors warrants a separate standard for these Institutions in order to facilitate effective reporting and consequently performance evaluation.

Banks are specifically required by TSAG 7 to disclose accounting policies in respect of the following:-

a) Valuation of Investment and dealing securities
b) Distinction between those transactions and other events that result in the recognition of assets and liabilities of the balance sheet and those transactions and other events presently not recognized as assets and liabilities but which give rise to contingencies and commitments.
c) Recognition of the principal types of revenue
d) The basis for determination of losses of loans and advances and for writing of bad loans and advances.
e) The basis for determination of charges for general banking risks and the accounting treatment of such charges.
f) All other matters generally required by BFI Act of 1991.[13]

Income Statement

In a nut shell, the Income Statement of the bank ought to disclose sources of revenue like interest, fees for services, commissions and dealing results. These sources must be disclosed separately to facilitate assessment of their efficiency and overall contribution to the Bank revenue. The expenses must also be disclosed separately. These include interest, commissions paid losses on advances, general administrative expenses and any other charges incurred by banks.

As far as possible, banks should avoid offsetting similar charges, that is, offsetting interest income and expense and similar charges should be avoided as this limits the extent to which performance can be evaluated.

Balance Sheet

TSAG 7 recommends grouping of assets and liabilities by their nature to approximate order of their liquidity. The Guideline, further, emphasize the need to report assets and liabilities without offsetting them with their respective reduction, unless there is a legal right to offset such assets or liabilities. This is again meant to enhance the usefulness of the balance sheet disclosures, and permitting effective comparison for evaluation as well as supervision purposes.

The Guideline specifies separate disclosure of the following:-

a) Balances with the Central Bank
b) Other money market placements
c) Placements with other banks
d) Deposits from other banks
e) Other money market deposits
f) Other deposits.

Dealing in securities should be specifically disclosed as securities are marketable securities that are held on a short term basis.[13] Investments, on the other hand are held on a long-term basis in anticipation of a capital gain, hence they are likely to be held to maturity.

Cashflow Statement

Banks' cashflow statement will be presented as per requirements of the Tanzania Statement of Accounting Guideline No. 8 issued by the National Board of Accountants and Auditors (NBAA).

Contingencies and Off-Balance Sheet Items

These may be significant and in most cases, Banks' contingencies and Off-Balance Sheet Items are substantially larger than other commercial enterprises. Because of the significance of the amount involved, these should be disclosed separately. Contingencies and Off-Balance sheet items include:-

1) Letters of credit saving as financial guarantees for loans and securities.
2) Short-term self-liquidating trade-related contingencies arising from the movement of goods, such as documentary credits where the underlying shipment is used as security.
3) Interest and foreign exchange related items to include swaps, options and futures.

Maturities of Assets, Liabilities and Off-Balance Sheet Items

These should be disclosed according to their maturity based on the remaining period at the balance sheet date. The disclosure may need to be supported by additional information on the likelihood of assets and liabilities maturities within the remaining period, usually through notes to financial statements, or management reports on bank performance.

Concentration of Assets & Liabilities

Banks are required to disclose on how they have determined bad loans and advances and their respective write-offs. This disclosure must show the changes in the provision and any amounts previously written - off recovered. The disclosure should be separately done to assist performance assessment. Banks should also show the total amounts of loans and advances on which interest is not being accrued and the basis used in determining these amounts.

Any amounts charged in respect of losses on loans and advances in addition to those losses that have been specifically identified or potential losses which experience indicates are present in the loan portfolio should be accounted for as an appropriation of retained earnings. Any credits resulting from the reduction of such charges should be accounted for as an increase in retained earnings.

Assets Pledged as Security

This together with the total amount of secured liabilities must be clearly disclosed.

TSAG 7 and the Bank Supervision

Bank supervision is a continuous process of monitoring banking activities. It takes two forms, the regulators or off-site monitoring process and a bank examination process.

This process is implemented by the Bank of Tanzania through its directory of Bank Supervision which conducts on site examination of the banking operations to ensure that they adhered to the directives issued by BOT. In addition to that, BOT requires all banks to furnish periodic reports of the compliance to the regulators as from time to time. The recent amendment of the Bank of Tanzania Act of 1995 requires the BOT to ensure that Banks publish their Balance sheet and Income statements to the newspapers of a general circulation in Tanzania at an interval to be determined by BOT.

The practice adopted is to produce these financial Statements on a quarterly basis so as to inform the public on the financial condition of

the bank over the said period.[14] TSAG 7 requires that Banks disclose in their financial statements the items of mentioned therein with the objective of permitting informed judgment by various users of the financial statements. Ideally, financial statements are the end product of an accounting system and as such the requirement focuses more on this end product. Mhagama (1995)[15] cited this as the deficiency as banking supervision is a continuous process while TSAG 7 is only effective on the financial statements which comes at the end of the year.

This deficiency is however, overcome by the BOT Act 1995 which requires that Banks produce quarterly interim reports. TSAG 7 applies to these reports as well. So far, all banks which have produced their interim reports have clearly complied to the requirements of TSAG 7.[16] These interim reports forms part of the continuous reporting mechanism not only to the BOT but also to the shareholders and to the general public. The spirit behind is to provide early information to the market so as to facilitate judgment as to the efficiency of the bank. This, however, should not be taken as a substitute to the normal reports required by the Central Bank for supervision purposes.

The interim reports are unaudited reports. They may fall short of what the public would have expected from them. For these reports to be objective, they ought to have been subjected to senating by a third party. This deficiency is partly taken careoff by the attesting to the accuracy and correctness of reports as made by the management of the banks as required by BOT Act 1995.

Despite this deficiency, the disclosure of this information raises the concern of the interested parties and may spark off the required knowledge of what they were expecting from a given bank. It is, however, expected that such disclosures will in the end capture the essential requirements in the end of year financial statements which are submitted to the external auditors for verification purposes. The fear of getting qualified audit report makes the bank management to be alert and ensure compliance to TSAG 7 and the rest of other requirements. This is a control mechanism by itself and it reinforces the Central Bank supervision role by ensuring the integrity and completeness of the accounting report. TSAG 7 is specific to financial institutions. There was no harmony in reporting results. This is not a conducive environment for competition as well as performance appraisal.

It was even worse for supervision purposes as no bench mark could be developed to facilitate the appraisal of a bank on a common denominator. TSAG 7 provides the basis for uniform reporting by all banks. This facilitate the supervision work of the BOT through getting adequate disclosures by all banks, and secondly uniform reporting environment which may be used in developing a benchmark for examination purposes as well as effective comparison of banks as regards liquidity, credit limits, foreign currency exposure and capital adequacy requirements. The breakdown of different sources of income and the different areas of expenses provides a basis for evaluating the extent to which a financial institution depends on a given source and the item of expenditure. It can be seen clearly what items constitutes the largest source and use of funds and an assessment of the future can be predicted on the basis of this information.

An analysis can also be made of the level of risks, particularly foreign exchange risks which a bank exposes themselves to upon observation of the contingencies and off-balance sheet items. Banks carries a significant amount of contingencies,and the level taken must be according to the BOT guidelines which tends to restrict the extent by an individual bank

Conclusion

It is widely accepted that Bank Supervision reinforces the confidence of the public in the financial system. The role of ensuring that the public is confident with the financial system rests with the Central Bank. This role is effected through continuous monitoring of banks activities achieved by site visits and the feedback reports supplied by individual banks to the Central Bank.

One of the key issue in bank supervision is the information disclosure.The disclosure is normally effected through published financial statements. The disclosure has been enhanced by the BOT Act of 1995 which requires more frequent disclosure by banks than the traditional year end disclosures. These need to be harmonized in order to eliminate potential conflicts among them.

TSAG 7 has been very instrumental in the supervision of banks as it has created a basis for uniform disclosure requirements as a necessary input towards effective regulation. It is expected that the TSAG 7 will provide a significant input towards effective bank supervision.

It is a step towards the right direction, that is, effective supervision and hence stable and sustainable financial system.

NOTES

1. Other functions of the bank includes discounting Bills, cheque facilities, financing & facilitating foreign trad, trustee services and dealings in securities market. These requires an efficient system in order to be run on acceptable standards.
2. TSAG 7 is the Tanzania Statement of Accounting Guideline No. 7 issued by the National Board of Accountings and Auditors (NBAA). This guideline became operational on 1/1/96.
3. Lenders in this case are the bank depositors.
4. These are the opposite that is depositors regard their deposits as assets while borrowers regards the amount borrowed as liabilities. Banks reagards deposits as liabilities and advances as assets. The advances are made from the deposits held by banks.
5. Ian Giddy cited the above as the main reasons for the Bank Supervision in World Bank publication "Bank Supervision: Principles & Practice of Bank Supervision proceeding of workshop - 1990
6. Other risks of a bank include liquidity risks, financial risks, project risks, interest rate risks, exchange rate risks and management risks.
7. When there is a bank run, banks are likely to collapse as cash resources will not be available. Unless there is strong lender of last resource facility from the Central Bank, the collapse is inevitable. No single bank, however large it may be, can honour ALL depositors withdrawal demand at once.
8. C. G. Inyangete - Paper on Financial Regulation, Intermediation capital market structures and Development presented at African capital market conference August. 1993.
9. The Institutional Acts applies to the Banks which are 100% owned by the Government. These include NBC, TIB, Karadha and in the past CRDB. The latter is now covered by the CRDB Act 1996 which made the bank private.
10. Section 47 subsection 3 of the Bank of Tanzania (BOT) Act of 1995 requires all financial institutions to publish financial statements in newspapers of general circulation at a frequency to be determined by BOT. The interval adopted is every after three months.
11. The auditing practice prohibits auditors to communicate the information regarding their clients to other parties. However, banks may be excluded from this provision due to their role in the economy. This requirement was emphasized with the collapse of the Bank of Commerce & Credit International (BCCI) in 1992 in the Bingham report which suggested among other things, the need for bank auditors to communicate to the Central Bank any information considered necessary for the effective supervision of banks. This suggestion has already been implemented by the Bank of England (UK Central Bank).
12. The TSAG 7 became operational on 1st January, 1996.
13. BFI Act of 1991 means Banking & Financial Institutions Act of 1991 which laid down the current financial reforms in Tanzania.
14. Inyangete (1995) argues that a decision has to be made whether banks should do both banking and securities business and hence Central Bank regulates both. This distinction is important as securities trading is relatively risky, hence increasing bank risks. Tanzanian approach is that of separating securities from banking business. CMSA will regulate capital market operations while BOT will regulate banking operations. Regulating emerging securities

markets, Financial Intermediation capital market trading systems" paper presented in Nov 1995.

[15] BOT Act 1995 section 4. An observation of all banks indicates the highest level of compliance to this directive.

[16] A. M. Beno Mhagama: Financial sector deregulation: Financial Information disclosure a discussion paper presented to the 9th conference of Financial Institutions - October, 1995.

[17] Trust Bank for instance produced their interim report for the quarter to 30/9/96. This report shows among other things contingencies as regards foreign Letters of credit and detailed sources of revenue and expenditures. These are as per TSAG 7. Other banks which have done the same include Standard Chartered, Stanbic, Diamond Trust, Savings & Finance, CRDB, TIB and Karadha Co. Ltd. (Sources: Daily News; Guardian; Business Times).

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