CHAPTER 1

INTRODUCTION

CHAPTER I

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(A) BACKGROUND ANALYSIS

1.1 COST ACCOUNTING IN A BANK:

1.1.1 MEANING:

Cost Accounting in a bank enterprise, as of any other business enterprise may be defined after Kohler's more general definition, as the art of " Classification, recording, allocation, summarisation and reporting of current and prospective costs, or after wheldon's, as the classifying, recording, and appropriate allocation of expenditure for the determination of the costs of products or services. Or after Batty's as "the classification, collectioin, and analysis of costs". The ascertainment of costs of jobs, products, processes cost centers, and other divisons of a business, etc.

The Bank Management Institute of U.S.A. define all these, for commercial banking purposes, in the following way:

i) Using the more significant terms (stated in parentheses) costing can be described as,

The accumulation of costs (Cost) in some relevent and convenient from (cost center) and

ii) Regarding Cost:

For business purposes, cost is a general term for a measured amount of value purposefully released or to be released in the acquisition or creation of economic resources, either tangible or intangible.

iii) Regarding 'Costing Object', it is:

The specifically identified economic resource or function, organizational unit, activity, service, etc. for which cost is bearing determined.

iv) Regarding 'Allocation', it is:

The process of transforming cost data to a costing object according to benefits received or other logical measures of use.

v) Regarding Cost Center:

The same is: An intermediate cost accumulation that facilities the transference of cost to a costing object.

Cost accounting in a banking enterprise is necessary because an exhaustive knowledge of individual costs in a bank is essential for its intelligent and efficient measurement.

1.2 CONVENTIONAL COST ACCOUNTING: MERITS & DEMERITS:

Traditionally speaking, bank cost accounting has relied to a very great extent, upon apportionment and allocation of expense accounts on the general ledger of banks, first to the various organizational units (departments, divisions, sections), and then only to their various fune-using (i.e. lending and investing) functions, or their various fund-suppling, (i.e. deposits and capital-fund) functions.

The emphasis may, in this conventional approach, be on either of the following two:

i) ultimate profitability of lending and investing functions of individual banks, and

ii) profitability of deposits and capital functions of individual banks-taking into account their return on investment, net of their cost.

Thus in this conventional approach, all expenses of individual banks are distributed and apportioned to organizational units of banks and then only to bank functions or descrete services where per item costs can be calculated by comparing cost, thus determined with the number of items processed.

However, several inadequacies and defects can be indicated in this "Conventional" cost accounting of the bank firm, two of which may be considered to be quite serious. They are given below:

i) The distribution or apportionment of overhead costs as well as that of the supervisory or administrative salary expenses, in a bank firm, happens to be too complex and difficult cost accounting process, to be capable of being tackled by the described methods and techniques of the said "Conventional" approach successfully.

The more highly a bank is broken into organizational units the more readily can a major portion of its income and expenses be objectively distributed to clear-cut organizational units and functions. However, for the smaller banks, and even for the medium-sized benks which may be considered smaller by any international comparision, for example, only a few participate actively in nearly all of the bank's operations, making precise cost distribution virtually impossible.

ii) The second major critique of the "Conventional" approaches is that the statistical and other information relating to costs within banks which are arrived at through the tools and techniques and procedures discribed above, may not be, and is usually not comparable as between two or more banks - especially because of their purely operating costs being combined with their administrative costs, and that too on the basis of estimates made individually, arbitrily and subjectively by each of the banking firms.

General Flow Chart of Expense for a typical commercial bank is shown on the next page in figure 1.1.

Figure 1.1: Conventional Cost Accounting of the Bank Firms:

General Flow Chart of Expense For A Typical Bank Firm.

Expense Accounts.	Departments.	Functions Directly Affected.	Item Costs.
Advertising	Bond-Coupon Collection,	Loaning ------>	Commercial Loans. Mortgage Loans Installment Loans.
Contributions	Cashier Department.		
Depreciation	Commercial Tellers,		Government and other securities.
Directors' Fees	Drafts & official Cheques.	Security Investments->	
Subscriptions	General Book-keeping		Account maintenance Deposits
Examinations		Commercial Deposits->	Transit Cheques. Clearing House Cheques Currency & Coin.
Insurance & Bonds	Loaning Department: (include credit note Teller & Collateral expense)		
Interest Expense			
Legal		Time Deposits ---->	Account Maintainance Deposit withdrawals.
Light & Water			
Occupancy (Rent)	Proof Department,	Other Deposit.	
		Non-Deposit.	
Postage and Stationery	Purchasing & Stock-room.	Service Functions: Safe Deposit ----->	Box Maintenance Box Enterance, Storage.
Repairs-Equipments			
Taxes	Safe Deposit,		
Telephone & Telegraph	Savings, Security Investments	Bank Drafts & Official Cheques,	
Travel & Entertainment.	Expenses temporarily not distributed.	Bond-coupon-collection	
		Other.	

Source: The Association for Bank Audit Control and operation, U.S.A., - Bank Cost Manual, as quoted on P.7 of "Basic Approach to Cost Accounting in Commercial Banking Industry" published by I.C.W.A. of India. (1979).

It is the operating efficiency of the systems and practices of Bank Firms in terms of their Costs - the pure or direct costs of performing each operation within the bank - which requires to be isolated, accounted for, compared and controlled by the internal bank management, as also to be looked into by regulatory authorities extraneous to the banking industry, with the help of Cost & Management accounting techniques, and with the object of improving upon such efficiency, thus raising the productivity of individual banks as well as of the industry as a whole.

1.3 FUNCTIONAL COST ACCOUNTING:

The Functional Cost Accounting (FCA) is essentially a standardised cost accounting procedure and programme, especially valuable to the smaller banks with insufficient resources and personnel to develop any cost accounting system of their own. But, bigger banks can also make use of FCA. Thus, the banks are proveded with the basic framework and necessary materials - works - sheets, schedules and detailed instructions (manuals) - and the participating banks generate and make available their cost stastics.

The FCA visualise the operation of a bank in terms of its servicing as well as the fund-suppling and the fund-using functions: banks' demand deposits, time deposits, non-deposit, liabilities and capital, consisting of the sources of funds; and cash and due from banks, investments and loans (instalment, real estate, and commercial and agricultural) are the uses of funds. In addition there are four miscellaneous Departments that nither use nor supply funds - the computer service, strust, safe deposit and non banking departments. The list of a typical banks' functions contains the following:

1. Demand Deposits;
2. Time Deposits;
3. Non - Deposit Funds; (capital plus other liabilities)
4. Investments;
5. Real Estate Mortgage Loans;
6. Instalment Loans;
7. Credit Card Loans;
8. Commercial, Agriculturel and other loans;
9. Safe Deposit Department;
10. Trust Department;
11. Computer Service Department;
12. Non - Banking Departments.

The Functional Cost Analysis of banks has two primary objects in view. First, it is designed to present an itemised list of the various current income and expense items they relate to the major bank functions. And, also comparative figures for groups of other bank firms are provided by FCA to aid in the analysis of an individual bank's efficiency and performance.

The FCA's basic approach is to break the operatrions of a bank down into these broad "Product" streams or categories to which the bank's incomes and expenses are allocated. These allocations constitute the most important part of the entire FCA prodedure and largely determine the degree of validity and usefulness of the resulting information.

An adequate cost accounting method distinguishes direct costs of making and servicing specific, discrete bank functions from the administrative and overhead costs of a bank that apply to the whole banking operations. Direct costs are those that are clearly assignable to a given banking function, and such costs usually vary in a fairly systematic manner, and directly, with the volume of activity in the function.

On the other hand, indirect costs of banking are incurred for services which are essential to the operation of each and every such functions. However, casual responsibility for them is embedded in the overall operation of the bank, and the distinction between direct and indirect costs in banking is that, as a general rule. And only direct costs are affected to any appreciable degree by the variation in the volume of activity or organisation of any single bank function.

In the FCA, the cost of bank's deposits consists of the interest which the bank in turn pays to its time and savings depositors and the cost of the services discharged in connection with the deposits over and above its service charges. The cost of making and servicing loans and investments are deducted from the income received thereon. The other costs which cannot be directly related to processing assets or deposits the hard core of overhead and administrative costs - are distributed to both the asset and the deposit operations of banks in proporation to processing or direct operational costs.

The Basic "Functional" Cost Equation of a Bank Firm.

INCOME	-	EXPENSES	- "COST OF MONEY"	=	PROFITS
FROM:		Salaries/	Cost of acquiring		
Loans		Wages	and processing:		
Investments		Postage	Demand Deposits		
Other Function		Advertising	Time Deposits		
		Other exp.	Other Deposits.		

A few key terms of FCA are provided below:

i) Pool of Funds:-

For the purpose of Functional Cost Analysis, we assume that all of the liabilities of a participating bank flolw into a common pool from which they are distributed or opportioned to the various assets. There is no earmarking of specific types of loans or investments.

ii) Cost of Money:-

One of the most Crucial figures in the FCA report, the cost of money for a participating bank is simply the average net cost of acquiring and processing its libilities. It is calculated by dividing the total expenses of its deposit and capital function's (net income) by the total valume of funds generated by these functions.

iii) Net Portfolio Yield:-

This figure is the mirror image of cost of money on the asset side of the balance sheet of the bank. It is calculated by dividing the total income of its loans and investment functions by the sum of fund invested.

iv) Functional Net Earnings:-

The above two figures allow the net earnings for each function in the operating bank. On the libility side the FCA programme multiplies the bank firm's net portfolio yield the volume of funds provided by each function, with the result listed as an income item labelled "Portfolio Income".

Thus, the net result of all this calculation is to allow the participating bank to examine each function in the bank independently of the others.

1.4 COST ACCOUNTING IN COMMERCIAL BANK IN INDIA:

Virtually, nothing has as yet been done in the area of bank cost accounting in India, and guidelines provided in the official documents are extremely sketchy and faulty. A survey of the existing information on costs in banking industry by The Banking Commission, 1972, of the Government of India, revealed that, apart from the annual publication by the Reserve Bank (Statistical Tables Relating to Banks in India.) of the data on the earnings, expense, profits and allocation of profits of schedule commercial banks, there was hardly any information regarding industrywise applicability of the subject.

In particular, it was found that barring modest attempts by a very few commercial banks, cost accounting has not made any progress in the banking industry in India. Moreover, the statistics published by the Reserve Bank of India so long have not been suitable for the purpose in view. Again, the Banking Commission, 1972, as also its study group on Banking Costs, earlier reported very little on the development of methods of cost analysis or accounting abroad and in India, although they made attempts at collecting bank cost and earnings data as part of their banking cost exercises.

On the conceptual plane, the Report of the Banking Commission, 1972, suggested the following measures of Bank "Output":

i) Output in terms of some non-monetary variable like the number of vouchers handled, the number of drafts issued/paid, etc. and

ii) Output in monetary terms eg. outstanding various types of Deposits and Advances, the total amounts of drafts, issued etc,

On the other hand regarding methodology of bank cost accounting, the Report Suggestged four following steps:

First: the activities in a commercial bank firm are classified and related to particular services, and units for measuring the different output of the various services are then specified,

Second: the work "input" for the various commercial banking services is obtained by asking the branches to report the time devoted by the bank firm's employees to the various operations necessary in rendering the services,

Third: the unit cost's are obtained by dividing 'input' by the corresponding outputs, and the unit costs are then loaded with costs at the Head Office and expenses of a general nature, through, suitable reallocation; and

Fourth: the average costs of each of the bank services are worked out for the average bank branch with the view to enabling inter bank and interbranch comparison.

All these have been suggested to scrutiny and comments. The 'output' measures suggested are not realistic enough from the poing of view of cost analysis or accounting. The physical measure of output, infact, represents operations or activities directly connected with effort or cost, and not-output-the end product of the bank. And the monetary measure is wrong one on the ground that it is not the monotery valume of Deposits or loans that determines operating costs in banking.

1.5 COST ACCOUNTING IN AN URBAN CO-OPERATIVE BANK:

Cost accounting in an urban co-operative bank like Youth Development Co-operative Bank Ltd., Kolhapur (henceforth called the Youth Bank) does not exist. There is no cost accounting system in any of the urban co-operative banks in India. The Researcher, however, wanted to undertake this study with a view to see the potential for a cost accounting system being installed in an urban co-operative bank. The management of the Youth Development Co-operative Bank was found to be enlightened and co-operative in this respect and this was the precise reason for undertaking this study.

1.6 SCOPE AND OBJECTIVES OF THE STUDY:

Scope of the study extends to the cost accounting system in an urban bank. This study is undertaken with special reference to the Youth Bank.

OBJECTIVES:

The study was undertaken with the following objectives:

i) To allocate the expenses to the various departments and compute the costs of each such department,

ii) To suggest measures, if any, on installation of a cost accounting system in the Youth Bank.

1.7 METHODS OF DATA COLLECTION:

Data to be collected for the above purpose relate the Youth Bank and those data are available from the annual reports and other accounts registers and books. Three years' data - of the years' 1986-87, 1987-88, and 1988-89, have been thus collected. Departments were classified into operating and non-operating departments. Deposits (all types), borrowings, lending and recovery were identify as the main operating departments. General Administration, Chairman and Board of Directors, Managers and Chief Executive Officer, Investments, etc., were classified into the non-operating departments.

Major expense items were then considered for the allocation to the various ooperating as well as non-operating departments. It was important at this stage to decide the basis on which the apportionment was to be made. The Manager and Chief Executive Officer was consulted in this matter. He was firstly briefed as to what was to be done and the reasons for the same. He ~~was~~ also suggested a basis of allocation which was based on the Researcher's observation and the cost accounting principles. Thus the various basis were decided for the various items of the Bank expenses. As Building Fund could not be treated as an expense, it was excluded for the purpose of allocation. After decision on the basis of allocation, the expenses were allocated and the functional annual cost for various departments were calculated for three years of the study.

1.8 CHAPTER SCHEME:

The dissertation is prepared and divided into the following chapters:

Chapter No.	Title	Contents
1.	Introduction	(A) Background Analysis (B) Methodology.
2.	Theoretical Background.	Cost Accounting in a Bank Salient features of the system.
3.	Profile of the Youth Bank.	Historical background & progress of the Bank. Also the organization structure of the Bank.
4.	Data Presentation and Analysis.	Presentation of functional annual cost statements for three years and the analysis.
5.	Summary and Conclusion.	Summary and conclusions of the study.

1.9 LIMITATIONS OF THE STUDY:

The major limitation was that a cost accounting system is non-existent in the Youth Bank. The management was found to be willing to install a cost accounting system it found beneficial. Second limitation was in respect of the size of the bank. The bank was a small bank from the view point of deposits and number of employees. As on 30th June, 1989, the Bank had deposits worth Rs.4.42 Crores and 23 employees only.

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