theirview

How to account for extinguished notes

Reduce the central bank's assets which are largely in the form of government securities to the extent of the currency notes extinguished

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An interesting side issue in the controversy over demonetization is how this will have an impact on the Reserve Bank of India (RBI) and the fisc. To the extent of extinguishment of currency, will it constitute a profit for RBI and will the government have access to it? The RBI Act 1934 itself does not specify how this should be treated. It is left to best accounting principles.

POSSIBLE APPROACHES

The first is to say that any note issued by RBI becomes a permanent liability and therefore if some part does not come back to RBI, there is no change in the liabilities and the balance sheet undergoes no change. The second is to argue that to the extent of extinguishment, there is a reduction in the liabilities of RBI and consequently a reserve can be created. A critical question is if RBI can be forced to declare a dividend out of this. It has been argued that this is not a realized gain and therefore should not be treated as a profit for RBI, which comes out of current transactions. There is the contrary view that this can be treated as a profit and government can have a claim on it. The third view is that when there is a reduction in liabilities, RBI can use the existing assets backing to increase the notes in circulation and ease liquidity and therefore there is no question of additional profits. The fourth approach is to reduce RBI assets to the extent of reduction of liabilities due to extinguishment. This means returning to government an equivalent amount of government securities. The result will be a reduction in public debt and the gain to the government is the savings on interest expenditure.

LEGAL PROVISIONS

The legal position relating to transfer of profits is given in Section 47 of the RBI Act, which states that after making provisions for bad and doubtful debts, depreciation in assets, contribution to staff and superannuation fund and for all matters for which provisions are to be made by or under the Act or that are usually provided by bankers, the balance of the profits of the bank is required to be paid to the central government.

Profits of RBI represent the excess of income over expenditure. The major source of income is interest on foreign assets and domestic assets held by it. As per accounting convention, income is recognized on accrual basis. Revaluation gains or losses that are unrealized are taken to various revaluation accounts; such accounts—in the nature of reserve accounts—are maintained separately for revaluation of gold and currency assets, unrealized gains/losses on account of changes in the yields on domestic and foreign securities and revaluation of foreign exchange forward contracts undertaken as part of intervention.

Out of gross income, amounts are set aside on a year-to-year basis in a contingency fund for meeting unexpected and unforeseen contingencies, including depreciation in the value of securities, risks arising out of monetary/exchange rate policy operations, systemic risks and any risk arising on account of the special responsibilities enjoined upon the bank. A committee set up in 1997 (chaired by V. Subrahmanyam) recommended that contingency reserve should be 12% of total assets. Subsequently, another panel (Technical Committee II chaired by Y.H. Malegam) was constituted during 2013-14 to review the level and adequacy of RBI's internal reserves and surplus distribution policy.

Based on the detailed studies, Technical Committee II recommended that since the balances in the contingency reserve are currently in excess of the buffers needed, there was no need to make any further transfers to the contingency reserve for a few years. Accordingly, no transfers have been made to the contingency fund (as it is now called) since 2014. The contingency fund stands at 7.5% of total assets of RBI (as of FY16) reduced from 10.3% in 2011.

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fiscal impact, will have to be kept in mind.

A trivial solution to the problem is that since the currency notes not returned get extinguished only after a notification issued by the government, if no such notification is issued, there will be no change at all. The RBI's liabilities and assets will stay as they are. The profits (the surplus) do not undergo any change. It may be difficult to avoid issuing such a notification and it may not even be legally sustainable. Once a notification is made, there is a reduction in the liabilities of RBI.

In normal commercial enterprises, a reduction in liabilities is generally but not always treated as profit. It is on this analogy some have argued that once the liabilities are extinguished, they go in as profits (reduced by the cost of printing and distribution of new notes and withdrawal of old notes) and could be distributed as dividends to the government. This will be a bonanza to the government.

The macroeconomic implications are clear. Any outflow from RBI has an expansionary effect. If one assumes that government expenditures expand to the full extent of the transfer of surplus, it will be inflationary. If to the extent of the amount of currency extinguished, a reserve is created on the liability side, it will have the same effect as treating the entire amount as surplus.

On the other hand, our suggestion is to use part of the extinguishment of currency notes to add to the Contingency Fund to increase it to at least 10% of total assets, and use the balance to reduce the assets of RBI, which are largely in the form of government securities, to the extent of the currency notes extinguished. This is not only logical but also prudent. The government will gain to the extent of interest income saved by the return of government securities but the reduction in income to RBI will be equivalent and therefore the dividend paid to government will be less. The net result will be no change either for the RBI or government.

BEST TREATMENT

Against this background, the critical question is which of the approaches outlined earlier should be adopted to deal with the extinguished part of the currency in circulation. This is not a pure accountant's problem. Macroeconomic implications, including the

The motivation for demonetization is entirely different. It should not be used as a means to augment the revenue of the government with all the inflationary implications. Prudent accounting and policy must take note of the larger macroeconomic implications.

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