INFLUENCE OF FINANCIAL REPORTING STANDARD
APPLICATION UPON THE OUTCOMES OF CREDIT
INSTITUTIONS

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Abstract:
Credit institutions in Romania include: banks, savings and loan banks in the housing field, credit
unions and mortgage loan banks. Since 2012, to all these from the accounting perspective, the International
Financial Reporting Standards have been applied. The present paper shall envisage the main causes that
have led to major banks’ great losses in our country. On one hand, the causes are connected to the
inefficiency of banks’ operation performance and on the other hand to the impact of the transition from
national accounting norms applicable to credit institutions to the International Financial Reporting
Standards. The differences between national and international norms refer to the assessment of financial
instruments at depreciated costs using the actual interest rate, the assessment of financial instruments at
their fair values and the adjustments due to hyperinflation, the assessment of value adjustments and
provisions related to loans etc.

Key words: provisions, impairment adjustments, prudential filters, accounting standards

J.E.L. Classification: G21

1. Introduction
Our country’s accounting regulations referring to credit institutions have undergone major
changes over the time having major effects upon the information issued by means of annual
financial statements. The paper herein aims at an analysis of the legislation path since 1990 up to
the present as well as of how legislative changes have impacted the outcomes shown in annual
financial statements.

2. Content of the Paper
The first steps taken in the banking field were first taken on 1 January 1998 by adopting
specific regulations for the banks operating in the market-economy conditions, four years later
than non-financial enterprises. The accounting regulations applicable to banking entities had their
French inspiration as well as non-financial companies did and they almost succeeded in
introducing some provisions from European accounting standards. In 1997, Order
no.14818/344/1997 of the Ministry of Public Finance and the Governor of the National Bank of
Romania was approved regarding the acknowledgement of banking companies’ account charts
and methodological norms to use the Order issued in Official Gazette no.189/8 August 1997.

Ever since 2001, there has been focus on harmonizing national norms with the
international accounting standards laid down by the International Accounting Standard
Council (IASC, currently IASB).

The first stage aimed at the convergence of national accounting law applicable in the
banking sector with the IAS/IFRS accounting norms by the adoption of banking accounting
norms - accounting regulations in compliance with Directive no. 86/635/CEE of European
Economic Communities (CEE) and with the International Accounting Standards applicable to
credit institutions. Those setting the norms in the field of banking accounting have „adjusted”
Order of the Ministry of Finance no. 94/2001 to the features of credit institutions by taking
certain provisions from the international accounting norms ensuing from Order no. 1982/5

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August 2005 issued by the Ministry of Public Finance and of the Governor of the National Bank of Romania to be found in specialty books under the name "International Accounting Norms according to the NBR: IAS-BNR".

The accounting regulations complying with European Communities Directive (CEE) no. 86/635/CEE and with the International Accounting Standards applicable to credit institutions (IAS-BNR) have been implemented in seven banks and starting in the financial statements of the fiscal year 2003 these regulations have been implemented in all credit institutions. Such regulations underlie the calculation of banking monitoring indicators reported by the NBR (solvency and liquidity).

Two accounting regulations were applied until the financial statements of 2005: IAS – BNR norms and International Financial Reporting Standards: IFRS. International Financial Reporting Standards include: International Financial Reporting Standards (IFRS), International Accounting Standards (IAS), interpretations made by the Interpretation Committee for International Financial Reporting Standards (IIFRIC) or the former Permanent Committee for Standard Interpretation (SIC) adopted by the IASB. Applying these two types of regulations forced the banks to submit two series of financial reports including two different accounting outcomes.

In the year 2008, by Order 13/2008 of the National Bank of Romania, the credit institutions set out as their accounting basis the accounting regulations corresponding to the Deposit Guarantee Fund in the banking sector.

At present, since 2012, Order no. 27/2010 of the NBR has required the application of accounting regulations compliant with International Financial Reporting Standards (IFRS).

As to the classification of financial asset portfolios, there is a significant difference of approaches:

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<th>Table 1. Classification of “Troublesome” Financial Assets</th>
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<td><strong>Method to classify “troublesome” financial assets and their contents</strong></td>
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<tr>
<td>- Past due and doubtful debts</td>
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<td>- Past due debts included all the loans and interests not paid on their due dates, namely at least one day delayed.</td>
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<td>- Doubtful debts included loans and interests in virtue of which banks started juridical procedures against debtors in order to recover their debts.</td>
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<th><strong>Indicators used by the central bank to assess the quality of loan portfolios</strong></th>
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<td>a. Delinquent and doubtful loans granted to the clientele (gross value)/Total loan portfolio associated to the clientele (gross value);</td>
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<tr>
<td>b. Delinquent and doubtful loans granted to the clientele (net value)/Total loan portfolio associated to the clientele (net value). On 31 December 2011, the above–mentioned indicators had the following values: 8.8 % and 2.3%, respectively.</td>
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<tr>
<td>a) impaired receivables of non-banking clientele (gross value)/Total loan portfolio associated to the clientele (gross value);</td>
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<tr>
<td>b) impaired receivables of non-banking clientele (net value)/Total loan portfolio associated to the clientele (net value).</td>
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The different approach when it comes to the portfolio of “troublesome” loans is shown distinctly in terms of how protection instruments against risks have been set.

According to the new regulations compliant with European Directives, the credit institutions had the obligation to prepare provisions for their past due and doubtful debts based on certain coefficients related to the category of debtors. These provisions were most often set out before the losses of value, as a precaution step.

Until 31 December 2011, the specific provisions related to credit risks were calculated prudentially, according to NBR Regulation no.3/2009 regarding the
classification of credits and investment, and the set-up, regulation and use of specific provisions related to credit risks.

At present, according to the accounting regulations compliant with International Financial Reporting Standards, credit institutions enter in their accounting documents only value adjustments related to impaired debts.

On the date of each financial position individual statement, a bank analyzes whether there is any objective hint according to which the financial assets that are not kept at their fair value by profit or loss are impaired. A financial asset or a group of financial assets is impaired and there are impairment losses only if there are objective hints referring to their impairment as a result of one or several events occurring after an asset’s initial recognition ("loss generating event"), and the event or events generating losses have an impact upon the future cash flows of a financial asset or of a group of financial assets that can be estimated credibly. Estimated losses as a result of future events no matter how probable they are cannot be recognized.

Consequently, since 2012 the credit institutions have prepared only value adjustments for their receivables, impaired assets, actually based on events that have already happened. Yet, from this perspective, the National Bank of Romania could not just wait without taking any steps.

In a simple analysis, in 2012 and in the coming years, the credit institutions would have reported much fewer value adjustments by the application of the accounting norms in compliance with International Financial Reporting Standards, as compared to the provisions entered until 31 December 2011 by applying the accounting regulations corresponding to European Directives.

In order to counteract the effect of credit institutions’ undercapitalization, the NBR has adopted NBR Regulation no. 11/6 September 2011 regarding the classification of credits and investment and the set-up and use of value prudential adjustments. The provisions referring to the classification of credits and investment and to the preparation and use of value prudential adjustments introduced by the new regulation have applied since 1 January 2012.

By means of the regulation, the notion "provisions for credit risks" has been replaced by "value prudential adjustments" associated to credits/investment – value adjustments associated to credits/investment generated and entered in extra-accounting documents, being the level by which, if necessary, one should correct the information in the values of credits/investment with the purpose to state the value which shall be taken into account in order to identify the prudential indicators of a lender.

The Regulation helps set the prudential adjustment coefficients associated to each classification category, differentiated for foreign currency loans or indexed at a foreign currency exchange rate and granted to debtors, natural persons, exposed to foreign currency risks and namely for the loans granted to debtors that are not exposed to foreign currency risks.

a. The coefficients of prudential adjustments for the loans granted to the debtors that are not exposed to foreign currency risks: for "monitored" loans – 0.05; for "substandard" loans – 0.2; for "doubtful" loans – 0.5; for "loss" loans – 1.

b. The provision coefficients set for the loans granted to natural persons exposed to foreign currency risks: for "Standard" loans – 0.07; for "monitored" loans”– 0.08; for "substandard" loans – 0.23; for "doubtful" loans – 0.53; for "loss" loans – 1.

The information in loans/investment held by the lenders to a certain debtor rank within a single classification category based on the principle of outranking by contamination, namely by considering the weakest individual classification category.

Under the circumstances of content changes in accounting methodology, especially in terms of setting the impairment adjustments for loans and investment (accounting provisions) and the expansion of fair value use when evaluating the elements shown in financial, statements, it has been pursued that the transition to the IFRS should take place without having a major impact upon prudence indicators.
According to the IFRS, impairment adjustments occur only after the emergence of an event generating losses, whereas the principles of prudential regulations require setting up provisions for expected losses, before an event generating losses occurs, taking account of estimations based on historic background, too.

The prudential pattern of an expected loss ensures the anticipation of future losses by recognizing *ex ante* the effects of the loss generating event in the financial statements as compared to the date of its actual occurrence. Such recognition is reflected by more seriously decreasing a profit as a consequence of expenses related to superior provisions in relation with those that might be reported by the IFRS pattern and additionally ensures the reduction in the volatility of credit institutions’ financial outcomes, thus contributing in financial stability.

In the context of a persistent economic crisis, the goal of the NBR was to avoid the conjectural increase of its own funds exclusively due to a change in the accounting methodology as a result of setting impairment adjustments much lower than the amount of prudential provisions set before the year 2012 by credit institutions and, consequently, the unjustified consideration of prudence indicators.

The goal was accomplished by the NBR’s decision to implement the prudential filters built in order to correct the level of own funds by decreasing them, both with a level of impairment adjustments set by the IFRS and with the provisions set additionally in accordance with a prudential pattern. Prudential filters aim at adjusting the accounting values of own equity so that their recognition in own prudential funds should observe the criteria of permanence, credible evaluation and unconditioned ability to cover losses.

During 1 January – 31 December 2012, in order to lay down certain banking prudence indicators (namely: solvency indicators for credit institutions; large information; information to the people in special relationships with a credit institution; potential changes in the economic values of credit institutions as a result of changes in interest rates) calculated in accordance with own funds minus prudential value adjustments.

The most important filters refer to the positive differences between prudential value adjustments (prudential provisions) and impairment adjustments (IFRS provisions) associated to the Lei loans granted to non-banking clientele for which banks set minimum capital requirements as to loan risks, at individual label according to the standard approach.

In late 2012, there was a positive difference amounting to 9,760 billion Lei of the total prudential value adjustments and the total impairment adjustments as a prudential filter to calculate own funds and banking prudence indicators. As a result, the steps of prudential regulation adopted by the central bank in the context of introducing the new IFRS accounting standards have preserved the level of the solvency indicator.

A positive influence upon a financial outcome by the transition to the IFRS belongs to the expenses related to impairment adjustments associated to financial assets (provisions) reported during the first six months of 2012 according to new standards as they were about 1.5 billion Lei lower than those to be recognized according to prudential approach.

Adopting these prudential filters is highly important to people’s trust in Romania’s banking system by calculating the solvency indicators and equity adequacy indicators. For the calculation of indicators listed, credit institutions shall disclose information on level 1 own funds.

Level 1 own funds include: legal, statutory and other reserves, the positive reported outcome of the earnings of previous fiscal years and interim profit. They are adjusted according to the following prudential filters:

- the fair value differences related to gains and losses not achieved during operations covering treasury cash flows of financial instruments measured at depreciated costs should be excluded from own funds;
- the gains and losses related to debt assessment arising from fair values caused by prior changes in the *rating* of a credit institution should be excluded from own funds by
adjusting, as appropriate, the net result of the latest fiscal year and of the reported outcome for the periods when the rating changes occurred;

- unachieved gains related to the valuation of property investment and fixed assets, resulting from the application of the fair value revaluation model other than those existing on 31 December 2011, should be excluded from level 1 own funds item by item, to be included in basic rate level 2 own funds of 45% of their net value of tax duties, expected on reporting date. Unachieved losses resulting from the application of the fair value revaluation model are not excluded from level 1 own funds;
- differences resulting from the fair value measurement of financial assets available for sale, other than those relating to depreciations;

In 2012, the Romanian banking system had a negative financial outcome due to the continuous growth of provisions volume (due to the depreciation of financial asset quality), the reduction of net interest incomes (due to the decreased interest spread and decrease of loans number granted to the real sector) and to a reduction in yield bonds held by credit institutions.

Restructuring the banks and the expected decrease of spending on provisions related to credit risks creates the potential to improve the financial outcome of 2013, after three years marked by the complete erosion of operating profits.

In late 2012, by centralizing the data of the 40 credit institutions, there were record cumulative losses of 2.12 billion Lei, almost triple as to 2011. In 2008, the system reported its highest payouts in history, with over 4.4 billion Lei.

The year 2012 was the third year in a row for the banking system to have a negative outcome, leading to the greatest increase in losses. It was the consequence of worsening the quality of credit portfolio and also of lowering the balances of loans under the circumstances of new credits going down and of many banks having sold non-performing assets. In 2011, the cumulative losses of banks were 777 million Lei, and in 2010 they were about 516 million.

According to provisional calculations of the central bank, in late last year the level of less preforming loans in the system reached 18.2%, almost 4% higher than the level the previous year.

The consequence of total losses in credit institutions was 2.1 billion Lei, as low profitability of system equity (-5.4%). To maintain an average solvency system at a reasonable level (14.6% in late 2012), the National Bank of Romania placed pressure upon bank shareholders.

With 2.1-billion Lei losses, the profitability of equity system remained negative, a minus of 5.4%. As in previous years, the National Bank of Romania continued to force bank shareholders having negative results to bring additional capital amounts so that the average solvency in the system stood at 14.6% in the end of the year.

3. Conclusions
- Since 2012, credit institutions have been applying accounting regulations in accordance with the International Financial Reporting Standards;
- Provisions for credit risks since 1 January 2012 have no longer been accounted for, being replaced with impairment adjustments of assets depreciation;
- The NBR predicted in 2011 that by replacing provisions by impairment adjustments banks would have been undercapitalized with a much lower amount of projected adjustments (and so it did);
- In order to counteract this shortcoming (namely the formation of much smaller value adjustments), the NBR issued Regulation no.11/6 September 2011 regarding the classification of loans and investment, and the set-up and application of prudential value adjustments by means of which credit institutions are required to constitute their provisions outside accounting documents under prudential filters.
- Many economic analysts on first examination stated that due to the implementation of the International Financial Reporting Standards, credit institutions have suffered in terms of value adjustments which must be established, and hence of profit reduction. On the contrary, by implementing the IFRS, banks have established value adjustments (expenses) lower than the provisions made according to the old regulations. In fact, the negative result of 2012 was due primarily to worsening the quality of credit portfolio and to the decrease of loan balances under the circumstances where attracting new credits went down and many banks sold non-performing asset packages.

References: