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## Article

# Comments on "Perceptions of Preparers from Romanian Banks Regarding IFRS Application"

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## COMMENTS ON “PERCEPTIONS OF PREPARERS FROM ROMANIAN BANKS REGARDING IFRS APPLICATION”

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1 January 2012 has marked the moment of transition to IFRS as basis of accounting for Romanian credit institutions. As also indicated in the study “Perception of prepares from Romanian banks regarding IFRS application” by Gîrbină, Minu, Bunea and Săcărin, this has been perceived as a positive evolution by the banking sector, and the cost benefit balance has been assessed as positive.

Based on our experience, in addition to, but also supporting some of the results of the study, we would like to point out the following beneficial effects of IFRS application:

- the professional development and significant expansion in the knowledge base of accounting and financial reporting personnel, due to their involvement in the implementation process, working groups organized at the level of Romanian Banking Association and participation in training programs organized within individual institutions or at the sector level. Resulting confidence in own expertise post IFRS implementation is outlined in the study by the lowest mean (2.9 out of 5) and mode (2 out of 5) results returned when asked about the major challenges faced to use IFRS as a reporting system. In our view, should the study have been conducted in 2011 the results might have been different. Yet, as the answers to the question related to the insufficient level of applicable guidance have returned the highest standard deviation (1.449) and mode (4 out of 5), the previous results should be read with caution as they might outline overconfidence in theoretical expertise without sufficient practical application and also knowledge gaps across banks (e.g. small versus large banks).
- streamlining of internal processes (both operational and financial) due to the need to adjust existing or implement IFRS dedicated IT systems;

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- better audit trail for amounts included in the IFRS financial statements, due to an improvement in internal documentation and increase in automation of related processes;
- cleaning up and reconciliation of internal databases;
- a better understanding of IFRS principles by people not involved in accounting/ financial reporting, embedding thus this principles in operation decision making (e.g. product design etc.);
- the positive effect on the Bank's strategic planning process resulting from the existence of a single set of IFRS based numbers (e.g. no need to set objectives and targets under two reporting frameworks). Clear benefits from the preparation of a single set of financial statements are also emphasized by the results of the study, with respondents rating benefits related to the above between agree and strongly agree categories.

While implementation of IFRS as basis of accounting reduced to a great extent the need for parallel reporting, in certain instances different systems and records need to still be maintained, for example:

- calculation of „prudential filters”, i.e. prudential adjustments for loan losses – based on number of days past due and financial performance category in accordance with National Bank of Romania's Regulation no. 11/2011 with regards to the classification of loans and placements and the determination and utilization of prudential value adjustments;
- different measurement models for fixed assets for fiscal purposes (e.g. revaluation model applied for local tax purposes and cost model applied for IFRS purposes) or for group reporting purposes (e.g. revaluation model applied for local tax purposes and IFRS reporting on an individual basis and cost model for group reporting purposes) – so as two or three fixed asset registers are required.

As the study results also show, the question on difficulties and costs stemming from the need to satisfy additional reporting requirements of fiscal and prudential nature has returned the most frequent strongly agree answers.

- different rules applied for consolidated supervision purposes as compared to consolidation requirements of IFRS, leading to inclusion or exclusion of certain group entities into or out of the consolidation area for prudential supervision purposes as compared to financial reporting purposes.

As regards the exercise of transition, we would like to point out several aspects that proved to be most difficult and generated significant debate at the industry level:

- Recognition of interest income for impaired loans: IFRS requires interest income to continue to be recognized for impaired loans using the effective interest rate from impairment calculation applied to the loan balance net of impairment loss allowance; based on this general rule, interest income may be recorded on a gross basis (i.e. by applying the effective interest rate on

the gross loan balance and then correcting the resulting interest revenue to the net level) or directly on a net basis (by applying the effective interest rate directly to the net loan balance). For a better evidence of contractual amounts at each loan level, the National Bank of Romania required application of the gross method for bookkeeping purposes. For IFRS financial reporting purposes, both methods result in the same amounts being reported in the statement of financial position and in the statement of comprehensive income. However, for risk disclosure purposes (IFRS 7 requirement to disclose gross loan balances and related impairment loss allowances) the interest revenue correction may be reported as a decrease in accrued interest or as an additional impairment loss allowance, depending on the risk policy of each individual bank.

- Impact on the foreign exchange position: release of statutory loan loss allowances calculated in accordance with National Bank of Romania's Regulation 3/2009 against reserves down to the level of loan loss allowances calculated in accordance with IAS 39 (significantly lower) for foreign currency (mainly EUR, CHF) denominated loans on 1 January 2012 generated long currency positions for banks, which had to liquidate or to cover these positions in order to avoid profit or loss volatility from fluctuations in exchange rates. The prudential requirement for the open currency position (10% of own funds) had to be aligned to the IFRS figures in order to mitigate this effect.
- Deferred taxes: transition to IFRS as basis of accounting required clarification of fiscal treatment both of amounts arising at transition (especially of adjustments booked in retained earnings on 1 January 2012 for the differences between statutory accounting treatments as per Order 13/2009 and IFRS accounting treatments, as well as of specific IFRS accounting treatments applicable starting with 1 January 2012 onward and not available under the prior accounting standards). The changes brought to the Fiscal Code in certain instances leave room for interpretation and the Ministry of Finance is due to issue an application guide during 2012. However, calculation of deferred taxes as at 31 December 2011 for group reporting purposes as well as for monthly prudential reports to the National Bank of Romania after 1 January 2012 required banks to make assumptions regarding the applicable fiscal treatment where such treatment was not clear. This aspect is also supported by the results of the study with respondents considering that the new prescriptions included in the Fiscal Code are not sufficient to clarify the tax impact of all IFRS treatments, with banks also mentioning that they preferred to take a prudent approach to the topic.

The objective of the Romanian authorities to achieve a transition to IFRS as basis of accounting for Romanian banks neutral from a prudential and tax perspective has been

broadly achieved. The neutral effect on the cost of capital is also due to the fact that investors already had access to IFRS based financial statements for several years. As such, it is unlikely that any reduction in either cost of debt or cost of equity components will occur as a result of the IFRS transition. Moreover, the banking industry is subject to continuous regulatory change, making it difficult to separate effects when analyzing the impact on cost of capital (e.g. for example the new Basel III capital and liquidity standards are expected to increase the cost of capital).

This may explain the findings of the study in this respect that indicate that transition to IFRS as basis of accounting will not lower the cost of capital. More precisely, the question related to the impact of IFRS application on the cost of capital returned the highest standard deviation of all the questions with the mean standing at “undecided”. Perceptions on the potential impact on the cost of capital are thus spread across respondents (mode at both 2 and 4), similar number of replies shared between “disagreeing” and “agreeing” that there is a reduction in the cost of capital from increased quality of financial reporting.