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# Banking performance. IFRS and RAS comparative analysis for the Romanian banking system

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**Abstract**

Credit institutions have a key role in the financial system of national economies, of their soundness depends the stability of the financial system as a whole. The financial data provided by banking financial statements offers indicators of significant value regarding the state of economy for a given period of time. Moreover, financial statements are an essential resource of financial information for decision-makers at economy level (population, economic agents etc.) influencing their expectations and behaviour and as a result impacting economic development. The regulatory reporting framework aims at setting certain reporting standards that would ensure a fair presentation of the financial position and performance of credit institutions. These reporting standards are periodically improved as to ensure adaptability to more complex financial instruments, to efficiently identify risks aiming at presenting financial information in a manner that would be easy to process and understand by its users. Romania targets at the normalization and harmonization of its financial reporting standards as to ensure a fair presentation and comparability of the financial position and performance of its credit institutions with financial institutions worldwide in the context of continuously expanding financial markets. The Central Bank of Romania regulates the preparation of individual financial statements under IFRS as of 1 January 2012 as per the agreement concluded in 2009 with the IMF-EU-IFI. This paper studies the impact of transition from RAS (Romanian Accounting Standards) to IFRS (International Financial Reporting Standards) on the financial position and performance of credit institutions. In order to identify the differences we analyzed the financial statements as per 2011 financial year for 5 Romanian banks considering their size in terms of assets. The research involved a comparative analysis and presentation of the major components of banking assets and liabilities emphasizing key findings. One of the major aspects identified relates to determining provisions under the IFRS model. Compliance with the NBR requirements was checked and prudential aspects were outlined.



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## 1. Introduction

In July 2002, the European Union issued Regulation 1606/2002 aiming at an efficient and cost-effective functioning of the capital market, protection of investors and ensuring confidence in financial markets. Companies whose securities were listed on an EU regulated market were required to prepare consolidated financial statements according to the International Financial Reporting Standards starting 2005. This initiative was transposed into national practice through regulation 208/2005 allowing entities to prepare financial statements according to International Financial Reporting Standards starting 2006. Financial institutions had to prepare a set of financial statements as per national accounting standards and a second one in accordance with International Financial Reporting Standards for other users than the state. Starting January 2012 IFRS were fully applicable and financial institutions had to apply these standards on a daily basis when treating and booking every single transaction.

The National Bank of Romania in its capacity as the regulatory and supervisory authority of the Romanian banking system has adopted the IFRS implementation strategy in 2010. One of the main characteristics of this regulation harmonization plan was gradual implementation. The NBR has prepared and sent for public consultation the bills needed to elicit accounting figures reported by banks so that they match the banks' prudential objectives. Financial institutions on their behalf had to prepare and submit to NBR action plans for IFRS implementation and which implementation was closely monitored by the central bank throughout 2011.

Isarescu (2011) states that from the NBR's point of view the IFRS implementation was one of the central bank's area of concerns since relevant and adequate assessments of credit institutions' assets, debts and shareholders' equity are essential prerequisites for the calculation of real prudential indicators.

Another important reason for applying IFRS requirements is ensuring comparability/consistency and transparency across the banking sector, between consolidated versus solo level financial statements between each financial information provided (published FS, financial information for supervision purposes, tax purposes etc.). IFRS implementation was also expected to reduce information asymmetry and thus reduce the cost of capital.

Several challenges that the Central Bank had to address regarding efficient implementation of the IFRS were the update of the regulatory framework (accounting, supervisory reporting etc.), updating the internal accounting/reporting systems by banks, staff training both in banks and supervisors, lack of comparability in data series that needed an agreed set of data to be reported to NBR.

## 2. Literature Review

Several authors studied the difficulties faced by financial institutions from EU countries in applying IFRS and found that the complexity of IFRS and insufficient implementation guidance as the major challenges (Larson & Street, 2004; Hoogendoorn, 2006; Jermakowics & Gornik-Tomaszewski, 2006).

Regarding the expectations of the IFRS impact on the cost of capital studies have been conducted but the conclusions are significantly different. Daske (2006) and Jermakowics & Gornik-Tomaszewski (2006) have concluded that IFRS adoption did not determine a reduction of the cost of capital, while Li (2010) considers that IFRS implementation conducts to a significant decrease in the cost of capital.

In the case of banks the change of the provision computation model was one of the major challenges in the implementation of the IFRS. Gebhardt & Novotny-Farkas (2011) studied the implications of IFRS adoption on the accounting quality of banks in twelve EU countries and concluded that the application of the incurred loss approach results in a delayed recognition of future expected losses.

In 2007 KPMG conducted a survey on 18 of the largest EU banks that were reporting in compliance with IFRS and concluded that the size of the annual statements under IFRS has increased significantly compared to the size of the statements under national accounting principles. In important finding of the conducted study was the treatment of individual versus collective provisions constituted as a result of the impairments tests on loans. Here a significant difference between banks was identified as the percentage of collective provisions ranged from 3% to 87.8%.

Dune et al (2008) studied IFRS implementation in UK, Ireland and Italy and discovered several issues regarding staff training. As certain standards were very technical and required specific skills, financial institutions often contracted external consultants in order to benefit of specific knowledge and skills. One of the main issues to address was adapting information systems with focus on new processes and models to be designed and implemented.

Regarding the impact of the implementation of the IFRS on the Romanian banking system, KPMG has conducted several studies in 2010 and 2011. These were focused on identifying the differences between the requirements of the national accounting regulations and IFRS's and measured the impact on banks' income and equity. Grecu (2011) analysed the challenges of implementing IFRS for the banking sector from the perspective of management and auditors underlining the challenges on the IT system and staff training and emphasizing the importance of the professional judgment, while Ionascu et al (2011) investigated the opinions of the CFOs of the Romanian listed companies regarding IFRS requirements. Bunea et al (2011) investigated the perception of the accounting professionals in Romania regarding a potential implementation of IFRS for SMEs discovering that more than a half of respondents consider that the current regulations do not provide a reasonable level of simplification for SMEs and, consequently, a more simplified reporting system is needed for these entities.

## 3. Research methodology

In order to archive the objective of this study, a sample of five financial institutions from the Romanian banking system were chosen. The selection criteria were banks' size in terms of assets and availability of the financial data. RAS financial statements were compared the reporting according to IFRS in order to identify the differences in value of the assets and liabilities.

Outlining the results, the paper aims at explaining the cause of findings looking at the reported financial figures both under RAS and IFRS. A major area of interest is the treatment of provisions considering assessing impairment and identifying triggering events.

Further the paper looks at the value of loan portfolio, equity and reported result under both reporting requirements and the impact of the use of effective interest rate method, deferred tax and commissions.

One of the important IFRS requirements is the initial recognition and revaluation of assets at fair value. Issues may arise in terms of high volatility of assets and pro-cyclicality and generate concerns in terms of prudential aspects.

## 4. Results

The IFRS requires a specific treatment for provisions. In order to recognize a provision some necessary conditions have to be met. There has to be an objective proof that results from triggering events. The event should result in a negative impact on the value or the moment of future expectable cash-flows (of an asset or portfolio of assets).

According to IFRS a financial institution can establish collective or specific provisions. Collective provisions are established for assets that are not significant considered individually (…but which may have an impact on the expected benefits generated by other assets) or portfolio of assets will similar risk profile, while specific provisions are established for assets of significant individual value for which objective proves of depreciation have been identified.

Key elements in applying the model:

- Identifying those assets or portfolio of assets which have been affected by triggering events;
- Applying the impairment test by comparing its accounting value with its recoverable value;
- Identifying triggering events (observable data that shows that there are reasons to believe that expected cash-flows associated to an asset or portfolio of assets will decrease).

According to NBR regulation no 3/2009, specific provisions for the credit risk are established by applying the following criteria:

- Financial performance (provisions are established progressively as financial performance decreases and from this point of view it can be argued that this model does not account for the appearance of a triggering event, in this case financial difficulty);
- Debt service;
- The initiation of judicial procedures (in which case the loan is classified as loss and the value of the provision is 100% of the value that is not covered by a warrant).

If accounting provisions are less than prudential provisions, then the difference is deducted from Own Funds as a prudential measure for ensuring an adequate capitalization of a financial institution. For the considered sample, there are differences between IFRS and RAS provisions, but they run in both directions. These differences may result from the definition of impairment or consideration of collateral. According to RAS collateral is considered at its market value while IFRS looks at the estimated future cash-flows expected to be generated by the collateral and those are discounted at an effective interest rate. Financial institutions apply uneven practices for identifying triggering events and interest incomes are overestimated before the appearance of a triggering event and underestimated after its occurrence. According to the NBR plan of transition from RAS to IFRS financial institutions had to develop and apply their own internal models for determining provisions that had to be afterwards validated by the supervisory authority. The current financial crisis has shown that applying this model conducts to a late recognition of losses and has a strong cyclic effect. For the considered financial institutions, available-for-sale and held-to-maturity financial instruments have a lower value under IFRS reporting as a result of revaluation and recording at fair value.

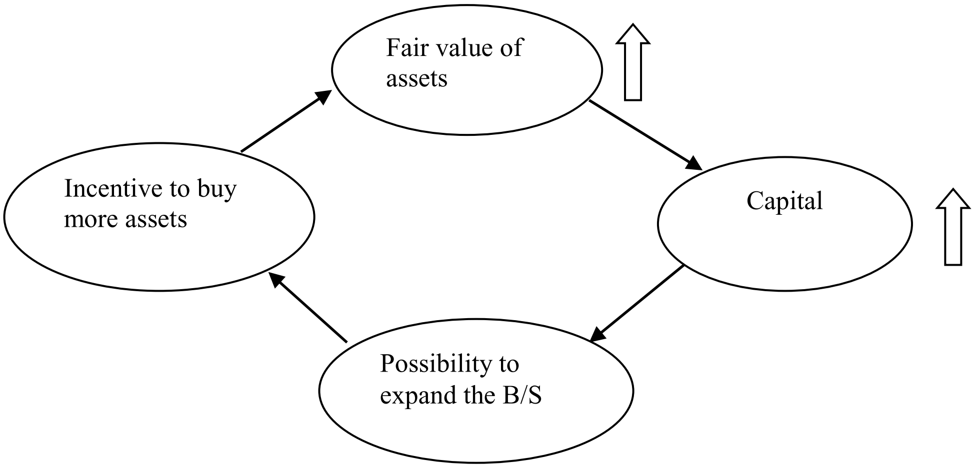


Fig. 1. IFRS pro-cyclicality. Market upturn

As shown in Fig. 1. the use of IFRS fair-value measurement results in pro-cyclicality and high volatility of assets. As a result, a prudential treatment is applied and not all fair-value induced accounting gains are considered regulated capital (permanent resource) as for example available-for-sale gains/losses. In order to assess this issue, Basel III comes with a counter-cyclical buffer that establishes capital increases during booms in order to decrease the possibility of balance sheet expansion and decrease capital requirements during downturns to lower the pressure to contract the balance sheet.

As per analyzed financial statements, the value of the loans portfolios of the financial institutions considered was higher under IFRS reporting requirements than in RAS reporting requirements. One of the causes is the difference in provisioning, an increase or decrease as priory mentioned. The increase in value can be explained by the IFRS requirement to consider the off balance sheet assets, but the main positive difference seems to be generated by the recognition of the receivables and amounts in advance. Looking at the value of a bank's loans portfolio is not only of financial or prudential interest but also of market positioning reason as a financial institution's market share can be accessed from the point of view of the loan portfolio criterion.

The value of equity under RAS reporting requirements is lower as IFRS required a positive adjustment for the inflation until 2003 as it was the case of reporting for a hyperinflationary economy.

The reported result is higher under IFRS requirements mainly due to adjustments to reversing provisions to loans and available-for-sale financial instruments recorded in RAS financial statements, adjustments performed to commissions to loans computed using the effective interest rate method and considering the deferred tax. The effective interest rate method calculates the rate of interest that is necessary to discount the estimated stream of principal and interest cash flows through the expected life of the financial instrument to equal the amount recognized at initial recognition. The rate is applied to the carrying amount at each reporting date to determine the interest expense or revenue for the period. In applying the model it is made use of the fair value at initial recognition, estimated cash-flows, residual value and the expected life of the assets or liability considered.

## 5. Conclusions

Economic and financial developments tending towards internationalization of banking operations in the context of globalization of financial markets have highlighted the importance of financial information, especially in terms of assessing and presenting the results of their activity. Moreover, in the aftermath of the past years' financial crisis, stronger pressures for harmonizing accounting rules worldwide as a basis for the published financial information have emerged.

Under these circumstances, the National Bank of Romania, in its capacity as the regulatory and supervisory authority of the Romanian banking system has steadily sought to harmonize its rules and practices with the best practices in the field so as to increase transparency and ensure comparability of information across the entire banking sector.

Reporting under the IFRS was transposed into the Romanian banking system following a process of transition and stabilization under close supervision of the central bank. As to address issues generated by IFRS application such as late recognition of losses under the IFRS materialized loss provisioning model or pro-cyclical effects generated by fair value recognition and evaluation requirements, the NBR set prudential requirements. If accounting provisions are less than prudential provisions computed under expected loss model, the difference is deducted from own funds and as a result capital adequacy is not affected. As well, not all fair-value induced accounting gains are considered regulated capital.

Given the continuous development of financial markets and expanding banking activity improvements should be performed to the International Financial Reporting Standards framework in order to effectively address the treatment of banking assets and liabilities.

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