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CREDIT IMPAIREMENT LOSS IN NATIONAL AND INTERNATIONAL ACCOUNTING STANDARDS

Introduction

Value has always been a basic category in accounting. It is particularly gaining in significance now as the balance sheet approach is becoming more important than the incopme approach. Practically, it means that economic entities attach more significance to correct measurement and presentation of the components of a balance sheet than to the components of the profit and loss account. The article deals with the valuation of assets and, particularly, with their impairment loss. However, the analysis will focus on loans granted by banks, which are a specific type of assets. Such approach is justified by the fact that the regulations concerning the credit impairment losses recognized by financial statements differ significantly as regards Polish and international accounting standards.

The article is going to present the measurement methods of impairment losses of these assets depending on the type of regulations accepted by banks in the development of their financial statements. The aim of the article is to show the discrepancies between the national and international regulations as regards credit impairment losses. The objective of the author is to prove that the international accounting standards are more liberal than the national ones. Moreover, as illustrated by a selected bank, the article presents to what degree the change of the accounting standards may influence the financial statements.

1. The concept of value

The concept of value is a key issue in the theory of economy. Thus, it is natural that many scholars have expressed their opinions on the concept and the factors that create it. According to the Dictionary of Polish Language value defines *how much something is worth in the material sense*. It is the feature of an object which can be expressed by money or other means of payment[1]. Value is also understood as a feature or set of features typical for a particular

[1] *Słownik języka polskiego*, PWN, Warszawa 1981, p. 660

individual or thing that are decisive as regards their quality. It may also be perceived as the importance or significance of somebody or something. In that context one can speak of emotional, passing, permanent or medical values. Thus, value is a feature of both human beings and objects. It itself is something precious, good, positive and desirable.

A.Karmańska says that value may be a subjective or objective assessment. That depends on the fact whether the object in question is engaged in business or non-business operations. In the latter case, the estimation of the value is subjective as it depends on the preferences of a person making the assessment and on the cultural environment in which he/she is functioning. In the first case, when the object under assessment operates in business, the situation is different; the object has a particular economic role that should result in economic benefits to a person who is entitled to them. As a result, the value of the object can be expressed by the value of measurable benefits that it can generate in business[2]. Due to the subject matter of the article, the author will concentrate only on the business approach to value.

The notion of value appeared in economy fairly early as, according to L.Hostyński, it was probably used first by St Thomas Aquinas (1225-1274) in his considerations on just exchange. In that kind of exchange, it is of key importance to determine correctly the values of goods being exchanged in order to define a fair price.

Valuation became a key issue not only when determining the price of goods but also in accounting. The balance-sheet approach, which places emphasis on the theories of value and is in line with the contemporary reorientation as regards regulations, is more important than the income approach (which is dominated by the concept of the preservation of capital). Consequently, the resources that are evaluated in a reliable way play a dominating role rather than the revenues and costs which derive from the value changes of the resources that result from economic decisions.[3]

When determining the economic value of assets for the requirements of balance sheets, the issue of the impairment losses of the assets appears. That is particularly important in the case of loans granted by banks.

[2] Df. A. Karmańska, *Wartość ekonomiczna w systemie informacyjnym rachunkowości finansowej*, Difin, Warszawa 2009, pp. 137-138

[3] Based on A. Karmańska., *Wartość ekonomiczna w systemie informacyjnym rachunkowości finansowej*, Difin, Warszawa 2009, p. 168

2. Accounting principles applicable to banks operating in Poland

The banks that operate in Poland can be divided into two groups: the ones that follow national accounting regulations and the banks that base their financial statements regarding accounting on International Accounting Standards and International Financial Standards (IAS/IFRS).

The national regulations include: the act on accounting and the regulations of the Minister of Finance on: the detailed principles of bank accounting, the model structure of bank accounts, the creation of provisions for risk associated with bank activities as well as the regulations on the detailed principles regarding the recognition, valuation, disclosure and presentation methods of financial instruments.

Pursuant to article 55 item 5 of the Act on accounting[4], the obligation to apply IAS/IFRS is applicable to banks that develop consolidated financial statements. Thus, it can be assumed that Polish regulations concerning bank accounting regard only smaller banks, particularly co-operative banks[5].

Another group of regulations is constituted by IAS/IFRS. Unfortunately, there is no single and individual standard at present that would refer only to bank accounting. The related issues are dispersed in various standards, which makes it difficult to get acquainted with them.

Moreover - as regards the impairment loss of assets related to credit exposures - in 2006 the Financial Supervision Authority issued Recommendation R on the principles for the identification of balance sheet credit exposures that have been impaired, the determination of the write-downs due to impairment losses of balance sheet credit exposures and the reserves for off-balance sheet credit exposures. The recommendation is directed to banks that operate in Poland but develop their financial statements in line with IAS/IFRS.

[4]Act of 29th of September 1994 on accounting , consolidated text , Jpurnal of Laws of 2002, No. 76, item 694 as amended

[5] S. Hońko, P. Mućko, *Informacje o utracie wartości ekspozycji kredytowych w sprawozdaniach finansowych banków notowanych na Giełdzie Papierów Wartościowych w Warszawie*, Zarządzanie i Finanse, Journal of Management and Finance Vol. 12, No. 2/2014, pp. 206-207

3. Impairment losses of assets

Generally, the valuation of the assets to be presented in a balance sheet should follow the value that was accounted by an entity (it can be the price of the purchase, acquisition, the cost of production or other values depending on the circumstances in which a particular asset was acquired). The value in question must not exceed the future economic benefits that can be achieved. Otherwise, i.e. when the component value that can be reclaimed is lower than its book value, it is revaluated downwards, which is equivalent to the write-down that takes into consideration the component's impairment. In other words, if the value of the future economic benefits is lower than the book value of a given asset, it is considered that the component lost its ability to bring economic benefits to an entity (completely or partially) and, consequently, it is necessary to conduct the impairment of its balance sheet value. Thus, the impairment of asset value should be understood as a high probability confirmed in the course of the revaluation procedure that either a significant part or the total of an asset component managed by an entity will not bring future net economic benefits that would be adequate to at least its book value on the day of the balance sheet valuation.[6]

The principle presented above applies also to credits granted by banks. From the point of view of financial statements developed by banks, credits constitute a substantial component of the assets and banks must determine to what extent it is necessary to conduct the write-down of their value. In banking such impairments are usually referred to as specific provisions.

The issue of value impairment is dealt by both national and international regulations. However, certain discrepancies occur between them.

4. Credit value impairment by Polish regulations

The issue of credit impairment losses concerning banks that develop financial statements along Polish standards was determined in detail by the Regulation of the Ministry of Finance on provisioning for risks related to bank's activity[7]. Pursuant to the regulation, banks are obliged to classify credit expositions in one out of five categories: standard, watch, substandard,

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[6] A. Karmańska., *Wartość ekonomiczna w systemie informacyjnym rachunkowości finansowej*, Difin, Warszawa 2009, p.184

[7] See Regulations of Ministry of Finance on provisioning for risks related to bank's activity. Journal of Laws 2008, No.235, item 1589

doubtful and loss, while – with reference to credits and retail loans – banks apply only two risk categories: standard and loss. The classification of these categories is based on two independent criteria:

- timely repayment,
- economic and financial condition of the borrower.

Detailed criteria of classification for particular credit exposure categories are given in table 1.

Table 1. Classification criteria for particular categories (without retail credits and exposures to the State Treasury)

Credit exposure category	Criterion - timely repayment	Criterion - economic and financial condition
Standard	Delay in repayment of capital or interests – less than one month	No anxiety
Watch	Delay in repayment of capital or interests – between 1-3 months	Particular attention is required due to the risk related to the region, state, sector, customer group , product group
Substandard	Delay in repayment of capital or interests – between 3-6 months	Economic and financial situation may endanger timely repayment of credits
Doubtful	Delay in repayment of capital or interests–between 6 - 12 months	Economic and financial situation is deteriorating, and particularly when the impairments affect substantially the capital (net assets)
Loss	Delay in repayment of capital or interests – over 12 months	Economic and financial situation has deteriorated irreversibly which makes credit repayment impossible, or other criteria such as the bankruptcy of a borrower, the commencement of credit enforcement proceedings, the credit is judicially questioned by the borrower

Source: Author's research based on the Regulations of Ministry of Finance on provisioning for risks related to bank's activity. (Journal of Laws 2008, No.235, item 1589)

Polish regulations consider credit impairment as the probability that the credit will not be repaid by borrowers. The degree of such probability is determined by the above credit categories: the worse the classification, the higher probability of credit non-repayment, while the amount of the write-down due to the impairment is determined by the above mentioned regulation, which obliges the banks to establish specific provisions of a defined value (see table 2). In fact, the provisions are the credit impairment losses. They are updated as regards their value and terminated the latest on the last day of the last month of a quarter when credit exposure review and classification were conducted[8].

[8] Z. Miętki, *Rachunkowość bankowa*, Wyd. Wyższej szkoły Bankowej w Poznaniu, Poznań 2007, p. 100

Table 2. The amount of provisions (write-downs due to permanent impairment loss) established depending on credit exposure category

Credit exposure category	**Provisions in relation to the provisions base (for other than retail credit)**	**Provisions in relation to provisions base for retail credits**
Standard	0%	1,5%
Watch	1,5%	Not applicable
Substandard	20%	Not applicable
Doubtful	50%	Not applicable
Loss	100%	100%

Source: Author's research based on the Regulations of Ministry of Finance on provisioning for risks related to bank's activity. (Journal of Laws 2008, No.235, item 1589)

The base of the provisions is constituted by credit exposure less securities accepted by banks in line with the regulation.

It can be admitted that the principles that are imposed on banks by Polish regulations as regards specific provisions are clear, transparent and – which is the most important – cohesive. Certain doubts may be raised by the lack of clear criteria concerning the classification of credit exposures for particular risk categories from the point of view of the borrower's economic and financial situation. There are – among others – statements that the economic and financial situation may endanger a timely repayment of a credit or that it has deteriorated to the degree that the repayment is irreversibly impossible. Practically, such general statements do not specify the moment when risk category should be changed. Even banks themselves frequently do not provide precise explanations and leave the assessment of the situation to their employees.

5. Credit value impairment by international regulations

The IAS/IFRS principles regarding the correction of credit exposures are definitely less precise than the Polish regulations. Moreover, they do not include a detailed credit classification[9] as it is in the case of the Polish provisions. What is more, they lack a standard that would solely refer to banking. The regulations regarding credits can be found in several standards, e.g. in IAS 39 – *Financial standards: recognition and measurement*, IAS 37 – *Provisions, contingent liabilities and contingent assets*, and IFRS 7 – *Financial instruments: disclosures*. The guidelines on credit issues and credit impairment are also included in Recommendation R issued by the Polish Financial Supervision Authority in 2006. The

[9] S. Hońko, P. Mućko, *Informacje o utracie wartości ekspozycji kredytowych w sprawozdaniach finansowych banków notowanych na Giełdzie Papierów Wartościowych w Warszawie*, Zarządzanie i Finanse, Journal of Management and Finance Vol. 12, No. 2/2014, pp. 207-208

recommendation is directed to the banks that apply IAS/IFRS. However, it is only a recommendation and banks only may apply it but are not obliged to do it.

According to the recommendation, a board is responsible for credit risk management and for the development, implementation and functioning of the system that manages that kind of risk. The procedures include issues that concern the recognition of the impairment of balance sheet credit exposures and the provisions on off-balance sheet credit exposures.

However, when analyzing Recommendation R, it is difficult to find such detailed criteria as the ones that are included in the Minister of Finance Regulation on provisioning for risks related to bank's activity

There are some common elements in the additional information of banks that develop financial statements in line with IAS/IFRS. That concerns provisions that result from particular standards and coincide with Recommendation R.

Generally, banks divide credits into exposures:

- which are assessed individually and their impairment is recognized,
- which are assessed in groups whose impairment is recognized
- whose impairment is not recognized.

According to IAS 39, a component or a group of financial assets is impaired if there is an objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. Such objective events that cause the impairment may include[10]:

- substantial problems of a borrower,
- failure to repay or delays in the repayment of the interests or the credit,
- high probability of bankruptcy or of other financial reorganization of the borrower.

There are two stages in the measurement of the credit exposure impairment. In the first stage there is the estimation of credits that are individually significant due to a substantial amount of the credit. After the impairment has been recognized, an adequate write-down is created as the result of the credit impairment. In the case when there are no objective reasons

[10] See IAS 39 paragraph 59 , Financial instruments: recognition and measurement, International Accounting Standards Board, London 2011

for an impairment for a particular exposure, the exposure is classified to a group of similar characteristics and is subject to a collective estimation of impairment (as a second stage).

In the cases when no impairment was recognized for a given exposure, banks calculate write-downs for incurred but not reported losses (IBNR) which reflect the level of credit impairment that occurred due to an impairment event and which have not been identified by the bank till the balance sheet date. The level of the loss is determined on the basis of historical data concerning the impairments of assets with similar characteristics.

The final decision on the determination of the write-down depends on the experience of the bank management which is based on the impairment history of credits with a similar risk[11]. It follows IAS 39 paragraph 62, which states that in the cases when data indispensible to estimate the amount of an impairment loss are limited, the entity should use its experienced judgment to estimate it.

The amount of the impairment write-down and IBNR is the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition). [IAS 39, paragraph 63] The amount of the loss is to be recognized in the profit and loss account.

[11] S. Hońko, P. Mućko, *Informacje o utracie wartości ekspozycji kredytowych w sprawozdaniach finansowych banków notowanych na Giełdzie Papierów Wartościowych w Warszawie*, Zarządzanie i Finanse, Journal of Management and Finance Vol. 12, No. 2/2014, p. 209

6. Differences between national and international guidelines regarding credit impairment losses of banks

It is noticeable that there are basic differences in the impairment losses measurement systems as determined by the national and international regulations. According to the national guidelines, the measurement of the impairment is closely related to the category to which a particular credit exposure has been assigned, and that depends on the financial situation of the borrower and the timely repayment of the capital and interest installments. The regulation of the Ministry of Finance defines precisely the amount of write-downs (i.e. of the specific provision) with the consideration of the classification, Moreover, the principles of credit exposure classification have been clearly determined, although it is a fact that they are fairly general as regards the financial and economic condition of a borrower, which has been mentioned before. Nevertheless, it is obvious, that the principles of the impairment loss estimation have been defined in a top-down process and the banks are somehow restricted in their operations.

IAS/IFRS, however, do not provide detailed guidelines as regards asset impairment loss. This is partly due to the fact that the basic IAS 39, which concerns financial instruments, their measurement and the impairment, does not only regard only banks but also other business entities. That is why it includes only general statements (it does not even include a division of credits by categories as it is the case in the Polish regulations). As a result, banks are more independent in the determination of the amount of write-downs as they can use their practical experience and judgment.

It should be remembered that irrespectively of regulations the write-downs constitute a cost in the profit and loss account. Thus, it should be expected that the banks that apply more general ad less rigorous international accounting standards will tend to understate the amount of credit impairment losses in order to recognize higher profits.

7. The description of the research and results

The aim of the research was to check to what degree the change of accounting principles influences the amount of write-downs related to credit impairment losses. Is it true, as it was implied before, that banks will be eager to understate the amount of specific provisions?

Bank Pekao S.A., whose data are available on the website, was selected for the research. The bank's financial statements were analyzed and the results were compared.

According to the information provided by the bank, the 31st December 2005 was the reporting date when the bank was obliged to develop its first annual IAS-based financial statement. Thus, the day of the opening balance sheet of the earliest of the presented periods i.e. 1st January 2004 was the day when the bank adopted IAS/IFRS

The data analysis was divided into two parts. The first one concerned a 5-year period when the bank still applied national regulations, i.e. the 1st January 1999 – the 31st December 2003 , and the second one concerned financial information from the1st January 2004 to the 31st December 2008, which is the period when IAS/IFRS were applied. 5-year periods were selected to enable the comparison. The second period ends on the 31st December due to the fact that afterwards the crisis was becoming more visible and it affected the bank's financial statements.

In order to conduct a comparative analysis of the two periods, the share ratio of credits in the balance sheet total and the share of specific provisions for a given year in the value of credits were calculated. Then, their values were averaged to reduce the impact of single event in a given year. The results are presented in table 3.

Table 3. Average share of selected ratios for Pekao S.A. bank in 199-2008

	1 January 1999 – 31 December 2003	**1 January 2004 – 31 December 2008**
Average share of credits in balance sheet total	55.20%	58.03%
Average share of specific provisions generated in a given year to credit value	4.88%	3.06%

Source: Author's research based on the financial statements of the Pekao S.A. bank that were available on http://www.pekao.com.pl/informacje_dla_inwestorow/informacje_finansowe/Raporty_roczne (accessed: 15.05.2015)

Table 3 clearly shows that the average share of credits in the balance sheet total is lower in the period when national guidelines were applied. That is due to the fact that the amount of write-downs, i.e. of the specific provisions, was higher, which is confirmed by the calculation of the average share of provisions in the credit value. Although the differences of the share indexes are insignificant (a few percentage points), it should be borne in mind that they may be of significance if the balance sheet total is over 100 billion zlotys. Thus, the hypothesis that banks implementing IAS/IFRS use less restrictive regulations and generate lower write-downs has been confirmed.

However, it should be emphasized that there are problems regarding the comparison of balance sheet data even in the case of one bank. Standards have change and, consequently, the layout of the statement is different. For example, before 2004 the bank recognized precise amounts of specific provisions by particular credit categories. At present, the amount of impairment write-downs is given jointly, and sometimes even together with the impairment of other assets. As a result, the generation of comparable data is increasingly more difficult.

Conclusion

The analysis of the regulations showed that there are significant discrepancies as regards the generation of credit write-downs. International standards are less detailed and allow banks for individual estimations that are based on historical data. On the other hand, the Polish regulations determine precisely the principles of classification of particular credits and the amount of reserves.

In the view of the above, one can expect lower write-downs when international standards are implemented. The research cofirmed this assumption. The selected bank, after accepting the international standards, started generating lower credit impairment write-downs. That does not mean that other banks behaved similarly. Thus, further research and calculations are necessary.

Moreover, there were problems regarding the acquisition of precise information concerning the amount of specific provisions for particular years, which may lead to the conclusion that international standards provide the banks – and not only the banks – with more freedom when developing financial statements.

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Summary

The article deals with the issue of impairment of loans granted by banks. The national and international standards regarding the issue are discussed and the differences between the regulations are presented. A research showed that international standards are less restrictive than the Polish regulations and allow the creation of lower impairment losses.