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# **PROBLEMS OF HARMONIZATION OF THE PRINCIPLES OF IMPAIRMENT LOSSES ON LOANS AND ADVANCES OF THE BANK IN THE IAS AND NATIONAL REGULATIONS**

## **Introduction**

From the first of January 2005, the companies whose securities are publicly traded, operating in Poland (including banks) are subject to reporting under International Financial Reporting Standards /International Accounting Standards (IFRS/IAS) – the preparation of the financial statements must be used EU regulations, or standards and directives, but only in matters not based on in-country standards. These banks in accordance with the provisions of IAS 39 are required to establish impairment losses on receivables, and in accordance with the provisions of the Financial Supervision Authority – write-downs for impairment of receivables (a slight lack of precision in terminology).

However, for the remaining banks are the most important domestic legislation – Regulation of the Minister of Finance on the creation of provisions for risks associated with the activities of banks, under which are required to create provisions for loans and advances. Systems and the creation of write-downs in the form of specific provisions under the Act on accounting and impairment losses in accordance with IAS (the FSA), are different. The purpose of this article is to present some problems of harmonization of development of impairment in the regulation of national and International Accounting Standards as well as the regulations resulting from the resolutions of the Polish Financial Supervision Authority.

## 1. The cause and nature to make write-downs of receivables to banks

The creation of impairment charges in the banks due to the existence of credit risk. Credit risk occurs when „(...) the borrower does not pay within the deadline falling capital repayments together with the agreed interest, and possibly other charges”<sup>1</sup>. There is always some risk of not getting at all or do not get on the scheduled date of loan installments and interest due. Credit risk is the risk incurred by the bank losses due to defaults by the borrower of its obligations. It's not a risk at the same time appearing in the credit decision-making, but the risk occurring after the grant of the loan<sup>2</sup>.

The need for updating the value of debts accumulated losses due to accounting principle of prudence and the principle of matching revenues and expenses. In accordance with the principle of prudence impairment should take into account any events for credit claims, even those that are disclosed only in the period between the balance sheet date and the actual date of closure<sup>3</sup>. The principle of matching revenues and expenses requires that both the formation of receivables, as well as in the risk of the total or partial non-recovery, are recognized in the same period<sup>4</sup>.

As a result of financial statements in accordance with the precautionary principle, regardless of the amount of the reserve account should be taken of known individual risk, threatening the loss and the effects of other events. This principle of prudence in banks is almost done, inter alia, by updating the value of loans and advances. Rules on the valuation of loans and advances and the creation of write-downs of receivables includes the national regulation laying down specific rules on bank accounting<sup>5</sup> and regulation on the creation of provisions for risks associated with the activities of banks<sup>6</sup>. Polish law provide that loans and other debts of the bank, which are not classified as held for trading, are measured at the balance sheet at amortized cost using the effective interest

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<sup>1</sup> Z. Zawadzka: *Ryzyko bankowe. Ryzyko stopy procentowej i ryzyko walutowe*. Poltext, Warszawa 1995, s. 10.

<sup>2</sup> Por. I. Emerling: *Działalność kredytowa banku komercyjnego*. MARINA, Wrocław 2008, s. 129-131.

<sup>3</sup> Ustawa o rachunkowości z dnia 29 września 1994 r. (Dz. U. 2009. Nr 152, poz. 1223 z późn. zm.), art. 7.

<sup>4</sup> Por. Ibid., art. 6.

<sup>5</sup> Rozporządzenie Ministra Finansów z 1 października 2010r. w sprawie szczególnych zasad rachunkowości banków (Dz. U. 2010. Nr 191, poz. 1279 z późn. zm.).

<sup>6</sup> Rozporządzenie Ministra Finansów z dnia 16 grudnia 2008 r. w sprawie zasad tworzenia rezerw na ryzyko związane z działalnością banków (Dz. U. 2008. Nr 235, poz. 1589 z późn. zm.).

method, and what is very important – taking into consideration the provisions of the rules creation of provisions for risks associated with the activities of banks<sup>7</sup>. Rules on the valuation of loans and advances and the creation of write-downs of receivables includes the number of solutions of international standards IAS/IFRS, ie International Accounting Standard 39 Financial Instruments: Recognition and Measurement<sup>8</sup>, IFRS 7 Financial Instruments: Disclosures and IFRS 9 Financial Instruments<sup>9</sup>. According to the provisions of IFRS 9, financial assets (including loans and advances) are valued on the balance sheet at amortized cost using the effective interest method or at fair value. The amortized cost of a financial asset or financial liability is the amount at which the financial asset or financial liability is measured at initial recognition, less principal repayments and plus or minus a fixed using the effective interest rate cumulative amortization of any difference between the initial value and value at maturity, and less any deductions (directly or through reserve account) for impairment or uncollectible. In terms of making allowances for impairment of banks applying International Accounting Standards should make use of the provisions of the Recommendation R<sup>10</sup> Polish Financial Supervision Authority on the principles for the identification of balance sheet credit exposures that have lost value, the determination of impairment losses balance sheet credit exposures and provisions for off-balance sheet credit exposures and resolutions Polish Financial Supervision Authority No 76 of 2010 on the scope and the detailed rules for determining capital requirements against particular risks<sup>11</sup>.

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<sup>7</sup> Por. Rozporządzenie Ministra Finansów z 1 października 2010 r. w sprawie szczególnych zasad rachunkowości banków..., op. cit., § 36 ust.1 pkt. 2.

<sup>8</sup> Por. MSR nr 39 Instrumenty finansowe – ujmowanie i wycena. W: Rozporządzenie Komisji (WE) Nr 1126/2008 z dnia 3 listopada 2008 r. przyjmujące określone międzynarodowe standardy rachunkowości zgodnie z rozporządzeniem (WE) nr 1606/2002 Parlamentu Europejskiego i Rady (Dz.Urz. Unii Europejskiej nr L 320/1 z 29.11.2008); MSSF.SKwP, Warszawa 2011.

<sup>9</sup> MSSF nr 7 Instrumenty finansowe: ujawnianie informacji i MSSF nr 9 Instrumenty finansowe. W: MSSF. Wyd. SKwP, Warszawa 2011.

<sup>10</sup> Rekomendacja R Komisji Nadzoru Finansowego dotycząca zasad identyfikacji bilansowych ekspozycji kredytowych, które utraciły wartość, wyznaczania odpisów aktualizujących z tytułu utraty wartości bilansowych ekspozycji kredytowych oraz rezerw na pozabilansowe ekspozycje kredytowe – Załącznik do uchwały nr 151/2011 Komisji Nadzoru Finansowego z dnia 7 czerwca 2011 r.

<sup>11</sup> Uchwała Komisji Nadzoru Finansowego nr 76 z 2010 roku w sprawie zakresu i szczegółowych zasad wyznaczania wymogów kapitałowych z tytułu poszczególnych rodzajów ryzyka. Dz.Urz. KNF 2010, nr 2, poz. 11 z późn. zm.

## 2. Principles for impairment losses on loans and advances in national regulations

According to national legislation – Regulation of the Minister of Finance of 16 December 2008 on the creation of provisions for risks related to banking operations – loans and advances to banks to make provisions. Provisioning concept is misleading, since they are not in the literal sense reserves are not recognized in the balance sheet on the liabilities side, but reduce the carrying amount of loans and advances. The banks correspond to the concept of provisioning write-downs of loans and advances, as evidenced by the balance sheet date applicable law, that provision defines as „obligations that timing or amount is uncertain”<sup>12</sup> and prescribe the form of receivables write-downs as the precautionary principle, which expresses taking into account the reduction in the value of the receivables, for which there is doubt as to whether they will be expected inflow of economic benefits to the entity<sup>13</sup>. The same definition also includes provisions of IAS 37 Provisions, Contingent Liabilities and Contingent Assets reserves while explicitly that „(...) in some countries, the term reserve is also used to refer to such items as depreciation, impairment loss of assets or decrease in the value of bad debts. These items as adjustments to the carrying amounts of assets are not subject to Standard No. 37”<sup>14</sup>.

This inconsistency in terminology arises from the fact that the term reserves for receivables occurred primarily in the Accounting Act of 1994, but the amendment in 2000, it replaced the term impairment charges<sup>15</sup>. Further implementing regulations for the law is not unified accounting of the facts, however, § 2, point 11 of the Regulation of the Minister of Finance on special accounting principles for banks provides a definition of the special reserve a copy – write-off balancing the effects of the bank's business risk created in accordance with the provisions of the Regulation of the Minister of Finance on the creation of provisions for risks associated with the activities of banks<sup>16</sup>.

<sup>12</sup> Ustawa o rachunkowości z dnia 29 września 1994r. o rachunkowości z dnia 29 września 1994 r..., op. cit., art. 3 ust. 1 pkt. 21.

<sup>13</sup> Por. Ibid., art. 35b.

<sup>14</sup> Por. A. Wszelaki: *Definicja rezerw w ustawie o rachunkowości i MSR-ach*. „Prawo Przedsiębiorcy” 2004, nr 49.

<sup>15</sup> A. Wszelaki: *Ewidencja księgowa rezerw*. „Prawo Przedsiębiorcy” 2005, nr 2; ustawa o rachunkowości z dnia 29 września 1994 r..., op. cit.

<sup>16</sup> Por. Rozporządzenie Ministra Finansów z dnia 1 października 2010 r. w sprawie szczególnych zasad rachunkowości banków..., op. cit.

In Polish law, the basis for the provisioning of credit receivables without regard to specific provisions, but including anticipated in connection with the restructuring of the debt, the amount of the redemption of the credit claim. The banks make provisions for risks associated with their activities, known as specific provisions for credit exposures are classified to the category of „normal” (in terms of credit exposure arising from loans and retail loans), the category of „under observation” and a risk group („substandard”, „doubtful” and „lost”)<sup>17</sup>. The amount of provisions created can be determined in accordance with Regulation according to the procedure: universal or individual<sup>18</sup> and thus is related to the adopted by each bank loan receivables classification system. Financial Supervision Authority may, at the request of the bank, to allow a different classification of the outstanding loans based on internal ratings systems and methods for estimating the expected loss models, called credit risk. The size of the provision created is correlated with the risk group, which is assigned to a particular credit claim (in the national regulations – 1,5% for normal duties in the group of retail loans and receivables under observation, 20% for loans below standard, 50% for receivables doubtful and 100% for claims lost). The basis for provisioning against the risk of credit exposures, qualified as a „under observation” or „a risk group”, can be reduced by the value of the security law. From an accounting point of view, this option allows the banks to create a provisioning at a lower rate or not creating them at all, but the tax law treats this issue rigorously – is a significant discrepancy tax law and the balance sheet, for example, the type and amount of collateral taken as the basis for legal reduction target reserve<sup>19</sup>.

Polish Financial Supervision Authority may, at the request of the bank to allow for the creation of provisions at a different rate based on credit risk models, but the valuation of balance sheet credit exposures resulting from the application of the risk model adopted should be in accordance with the valuation resulting from the application of International Accounting Standards<sup>20</sup>.

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<sup>17</sup> Por. Rozporządzenie Ministra Finansów z dnia 16 grudnia 2008 r. w sprawie zasad tworzenia rezerw na ryzyko związane z działalnością banków..., op. cit., § 2 ust. 1, pkt. 1.

<sup>18</sup> Por. T. Orzeszko: *Rezerwy na ryzyko kredytowe jako przedmiot norm rachunkowości bankowej*. W: *Standardy rachunkowości wobec wyzwań współczesnej gospodarki*. Red. Z. Messner. Tom II. Wydawnictwo Akademii Ekonomicznej, Katowice 2006, s. 348.

<sup>19</sup> A. Wszelaki: *Wykorzystanie rezerw celowych w podejmowaniu decyzji zarządczych w bankach*. W: *Zintegrowany system pomiarów dokonań w rachunkowości*. Red. H. Buk i A. Kostur. Wydawnictwo Akademii Ekonomicznej, Katowice 2009.

<sup>20</sup> Por. Rozporządzenie Ministra Finansów z dnia 16 grudnia 2008 r. w sprawie zasad tworzenia rezerw na ryzyko związane z działalnością banków..., op. cit., § 10.

### 3. Principles for impairment losses on receivables in banks in the IAS and FSA regulations

In accordance with International Accounting Standards on loans and write-offs should be created for impairment and write-offs estimating procedure in general regulate the International Accounting Standard No. 39, and has a detailed Recommendation R Polish Financial Supervision Authority. R Recommendation is addressed to banks operating in Poland, and preparing financial statements in accordance with IAS/IFRS and its objective is to identify banks using IAS/IFRS best practices in the identification of balance sheet loans and advances that have lost value, determine the amount of impairment losses balance sheet credit exposures and provisions for off-balance sheet credit exposures in the credit risk management policy.

It should be noted that the procedure for estimating impairment losses on loans and advances looks different than in the case of Polish banks using the right balance. There are also problems of harmonization of accounting rules and tax laws, as all banks for bank reporting, as well as defining the base, must comply with the national laws relating to specific provisions relating to the classification into risk categories (in accordance with the Regulation of 2008). In accordance with International Accounting Standard No. 39 outstanding loans divided only on risk and not at risk of losing value, without isolating additional subcategories<sup>21</sup> and creates the impairment loss. Loss on impairment arises when the recoverable amount in repayment of the debtor or of collateral is less than the carrying amount of the credit claim, the „no Losses expected as a result of future events, no matter how likely”, but only losses<sup>22</sup>.

„An impairment loss is the excess of the carrying amount of the loan exceeds its recoverable amount”<sup>23</sup>, and if there is objective evidence of impairment at the time the copy is made. There are indications of impairment as a result of one or more events that occurred after the credit claim and this event must have an impact on the estimated cash flows reliably measured. IAS 39 requires the bank to determine at each reporting date whether there is objective evidence that an impairment loss of an asset or group of assets measured at amortized cost<sup>24</sup>. Each bank applying IAS should evaluate all their loans and the risk for impair-

<sup>21</sup> Por. M. Iwanicz-Drozdowska: *Zarządzanie finansowe bankiem*. Polskie Wydawnictwo Ekonomiczne, Warszawa 2010, s. 44.

<sup>22</sup> MSR 39..., op. cit., § 59.

<sup>23</sup> E. Popowska, W. Wąsowski: *Rachunkowość bankowa po zmianach*. Difin, Warszawa 2008, s. 191.

<sup>24</sup> Por. Ibid.; MSR nr 39..., op. cit., § 58.

ment, and not only those of low credit quality<sup>25</sup>. It should be noted that despite the scale of the difficulties of this problem, a general model for calculating impairment of loans and advances has not been presented in international standards. IAS 39, however, shows that it is possible to use statistical or mathematical models or use your credit history database.

In accordance with Recommendation R FSA in relation to the identification and designation of impairment write-downs on loans and bank balance should have:

1. Defined by objective evidence (evidence) indicating impairment of balance sheet loans and advances.
2. Description of identification of balance sheet loans and advances that have lost value and determine the amount of impairment losses on an individual.
3. Description of identification of balance sheet credit exposures that have lost value, and determining the amount of write-downs in terms of a group.
4. A description of the rules and how to obtain data where the bank uses the observations made by other institutions by identifying, for example, the frequency of data collection.
5. Information on the period for which historical data collected on the level of losses and ultimately write-downs.
6. Information in terms of the adjustments, including the reasons for these adjustments and their calculation.

Banks create two types of impairment losses.

1. The impairment loss recognized (called impairment) – the bank already has objective evidence of one or more loss events.
2. The unrecognized loss of value (called IBNR-Incurred, but not reported losses) – the lack of objective evidence of impairment makes allowances for losses incurred but not included are based on statistical data from previous periods<sup>26</sup>.

The assessment of the impairment of credit claim can be made:

1. Individually by future cash flows – in practice reserved for claims of significant value or which can not be attributed to any of the existing portfolio.
2. Total – by the portfolio – for different groups of loan receivables that are not considered by the bank individually significant. Portfolio method involves grouping claims in uniform in credit risk portfolios, and the principle is the convergence of risk factors and the reliability and stability of the results<sup>27</sup>.

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<sup>25</sup> Por. MSR nr 39..., op. cit., OS.85.

<sup>26</sup> M. Iwanicz-Drozdowska: Op. cit., s. 44.

<sup>27</sup> Por. MSR 39..., op. cit., § 64.

Assessment for the identification of exposures that have lost value and the calculation of the impairment should be carried out by the bank at least once a quarter. However, in the case of a new significant information for the period between reviews, the bank should immediately assess the impairment of the credit claim or group of loans and advances<sup>28</sup>.

To estimate the loss due to the impairment must be determined in the future expected payments of principal and interest, and if predicted that credit debt security will be repaid, then the calculation of the present value of the loan should include in addition to discounted future cash flows arising from the contract also include discounting the influence from the sale of collateral. Bank absolutely should consider in valuing only the collateral that can be used to repay the loan valued. So you can see a clear convergence in IAS, Recommendation R FSA and Polish regulations on the use of security legislation to establish the basis for the creation of an impairment loss.

In the creation of write-offs due to impairment plays a vital role the institution of the Polish Financial Supervision Authority, as it may allow the creation of write-downs for impairment at a different rate based on credit risk models that comply with International Accounting Standards<sup>29</sup>. In view of the fact that international standards do not specifically formulate such models, banks can use the so-called method of internal ratings – use records relating to the internal ratings systems and methods for estimating the expected loss, hereinafter referred to as credit risk models<sup>30</sup>.

Proposing a method of internal ratings regulations refer to the provisions of the New Basel Capital Accord of the Basel Committee on Banking Supervision (BASEL 2), which was adopted in Poland and currently in force in the form of Resolution No. 76/2010 of the Polish Financial Supervision Authority on the scope and detailed procedures for determining requirements capital for particular types of risk<sup>31</sup>. Pay attention to the fundamental difference between the IAS and the provisions of resolution No. 76/2010 concerning the time to assess impairment. According to international standards, assessment is made as of the balance sheet date and future losses are not taken into account, while the provisions of the Resolution No. 76/2010 require the support of the assessment of risk in forecasting future periods and estimating future losses<sup>32</sup>. This discrepancy can be

<sup>28</sup> Por. Rekomendacja R KNF..., op. cit., s. 16.

<sup>29</sup> Por. Rozporządzenie Ministra Finansów z dnia 16 grudnia 2008 r. w sprawie zasad tworzenia rezerw na ryzyko związane z działalnością banków..., op. cit., § 10.

<sup>30</sup> Por. Ibid. § 2 ust. 5.

<sup>31</sup> Uchwała nr 76/2010 Komisji Nadzoru Finansowego z dnia 10 marca 2010 r..., op. cit.

<sup>32</sup> Por. G. Kurek: *Prezentacja – MSR/MSSF a BASEL II – Podobieństwa i różnice na gruncie działalności bankowej*. „Bank” 2010, nr 6.

explained by the fact that the IAS / IFRS does not define any credit risk measurement models<sup>33</sup>, so banks use internal rating model for the creation of write-downs for impairment. The legislature should approach banks method of internal ratings, because it contains many points in common between the IAS and Basel II: A shared historical database, unified credit portfolios and use in calculations the same parameters for estimating losses<sup>34</sup>. Internal ratings method is described in detail in Annex 5 to the Resolution No. 76/2010 of the Polish Financial Supervision Authority, but you can only use it appropriately, because in this form it is used only for calculating capital requirements for credit risk. The resolution uses the concepts of the expected loss and the default, rather than international standards used in the concepts of loss suffered and impairment. In accordance with the resolution defaulted bank FSA has to do when:

- finds that the debtor does not repay in full its obligations without taking debt collection activities,
- the debtor is in arrears with payment of substantial debt for longer than 90 days<sup>35</sup>.

To calculate the impairment losses of receivables in method of internal ratings method is necessary to set values for the following parameters:

- PD – probability of default
- LGD – loss given default
- EAD – exposure at default<sup>36</sup>,

which, however, do not define and implement International Accounting Standards. Banks, therefore, to use the internal ratings-based method for determining impairment losses, on their own need to modify the definitions of these parameters in the application to the FSA for the use of such a method.

Risk parameter PD (probability of default) in the Basel II methodology specifying the probability of repayment of the loan may be used to calculate the losses suffered due to losses and unrecognized (IBNR), after adjusting for loss identification period<sup>37</sup>. Estimated Bank values for loan receivables PD “classes obligor or by the pool on the basis of long-term average annual default rates”<sup>38</sup>, the “length of the observation period used shall be at least five years”<sup>39</sup> for each data source, internal or external. “Obligor grade mean a risk category within the

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<sup>33</sup> Por. Ibid.

<sup>34</sup> Por. Ibid.

<sup>35</sup> Por. Uchwała nr 76/2010 Komisji Nadzoru Finansowego..., op. cit., § 171 Załącznik nr 5.

<sup>36</sup> Por. Ibid., § 13 ust. 3 Załącznik nr 5.

<sup>37</sup> G. Kurek: Op. cit.

<sup>38</sup> Ibid., § 191 i § 198 Załącznik nr 5.

<sup>39</sup> Ibid., § 197 ust. 1 i § 203 ust. 1 Załącznik nr 5.

obligor rating scale which is part of the rating system”<sup>40</sup>. The assignment of the debtor to the appropriate class of debtors is already in the award of credit. When creating such a system should take into account the bank “for both the debtor risk and transaction risk”<sup>41</sup>. The obligor rating scale should consist of “at least 7 classes defaulted obligors and one for debtors who do not comply with obligations”<sup>42</sup>. Such a recommendation is formulated FSA only for receivables from businesses, institutions, governments and central banks, and in the case of retail receivables minimum number of classes has not been determined, but the number should allow adequate diversification of credit risk<sup>43</sup>.

Risk parameter LGD (loss given default) in the Basel II methodology for determining the average economic loss to the identified risk loans within the same category of risk, can be used to measure the loss of homogeneous portfolios, both in terms of IBNR, as well as for receivables impaired, after adjusting for the length of the observation period, and the costs of decommissioning security. The parameter value is estimated LGD “by grade or pool”<sup>44</sup>, based on historical data from at least the last 5 years. Calculated as the weighted average of the period of losses actually incurred in the class / pool. Facility grade means a risk category within the scale of the instruments forming part of the rating system<sup>45</sup>. The higher the quality of the collateral accepted by the bank, the lower the value of the parameter takes the LGD.

EAD (exposure at default) in the Basel II methodology, specifying the the value of receivables at the date of reporting discontinued operations, can be used to calculate the exposure after taking into account the adjustment calculation method, instead of the expected commitment to the respect of taxes should be used in the actual engagement.

Giving credit rating, the credit of the credit claim to a particular grade or pool, it has a direct impact on the provision set up (losses) and is calculated according to the formula:  $impairment\ loss = (1 - (1 - PD)^{M/12}) \times LGD \times EAD$ .

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<sup>40</sup> Ibid., § 130 Załącznik nr 5.

<sup>41</sup> Ibid., § 128 i § 136 Załącznik nr 5.

<sup>42</sup> Ibid., § 129 Załącznik nr 5.

<sup>43</sup> Ibid., § 137 Załącznik nr 5.

<sup>44</sup> Ibid., § 205 Załącznik nr 5.

<sup>45</sup> Ibid., § 133 Załącznik nr 5.

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LOSSES ON LOANS AND ADVANCES OF THE BANK IN THE IAS  
AND NATIONAL REGULATIONS**

**Summary**

Making impairment losses on loans and advances is difficult and multifaceted issue. The difficulty in making impairment loss of receivables credit appears at the beginning, because it is the difference in terminology – national standards dictate create provisions for loans and advances, and the International Accounting Standards require to create impairment loss of receivables following an impairment test previously values. Each bank applying IAS should evaluate all their loans and the risk for impairment, IAS, however, do not offer a model for calculating impairment of loans and advances. In the creation of impairment losses on loans and advances of the institution plays a huge role Polish Financial Supervision Authority, as it may allow the creation of copies at a different rate based on the credit risk model in accordance with the provisions of International Accounting Standards. In view of the fact that international accounting standards do not specifically formulate these models, banks can use the so-called method of internal ratings, formulated by Resolution No. 10/2010 in the wake of the FSA provisions of the New Basel Capital Accord of the Basel Committee on Banking Supervision (BASEL 2).

There are also problems of harmonization of accounting rules and tax laws, as all banks for bank reporting, as well as defining the base, must comply with the provisions of Polish law – Regulation of the Minister of Finance in 2008.