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THE APPLICABILITY OF THE PRUDENCE PRINCIPLE TO BANK COMPANIES IN THE VISION OF IAS 37

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The general accounting principles are presented in section 7 of annex to OMFP 3055/2009 (as amended and supplemented). Thus, the effects of transactions and other events are recognized when the transactions and the events occur and are recorded in the accounts and reported in the financial statements of the periods involved. In this paper we propose to deal with specific aspects regarding the application of the general accounting principles to the banking companies with particular reference to the principle of prudence, which will be combined with the current provisions of IAS 37 and the issues regarding the identification and the management of the banking risks.

Keywords: words corporations, IAS 37, risk, GAP, the principle of prudence

JEL Code: M41

1. Introduction

In the literature we find numerous approaches to the concept of banking risk.

The economic literature defines risk as the probability that the real future profitability will be less than the expected profitability. (1) Risk can be defined as an uncertain but likely event. Once produced, its harmful effects are difficult to eliminate . Risk occurs in the process of the political, economic, social and human activity as well as in the relationship between man and nature. (2)

In her paper on "The Management of the Banking Risk", Luminita Roxin states that "when defining the risk and its management, most authors focus on the classic function of the banks, that of reducing the financial risks by dividing them. From this perspective, the work deals mostly with the issue of unforeseen losses of the banking assets, losses caused by market, credit or liquidity risks." (3)

2. Classification of risks

Risks can be classified according to the following criteria: (4)

1. Depending on the market that determines the appearance of the risk, there are Risks caused by the product market or Risks arising from the capital market. Of the risks arising from the product market, mention should be made of : the credit risk, the strategy risk, the risk caused by the regulations of the bank , the operational risk, the commodity risk, the human resources risk, the legal risk and the risk concerning the products.

2. According to the banking activity principle , there can be pure risks which occur as a result of the current activity or there can be speculative and lucrative risks.

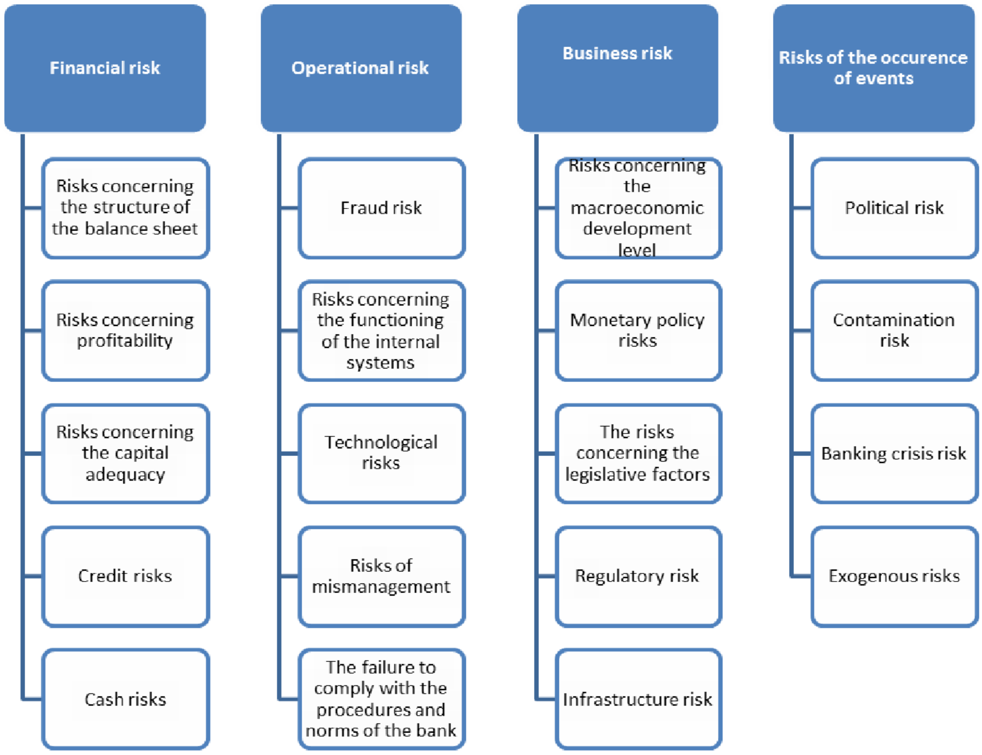
Another classification is given by the Bank for International Settlements (5) as follows:

Risk classification according to the Bank for international settlements

Source own Adaptation after the Bank for international settlements ' Risk management Guidelines for Derivates "Basel Committee on Banking Supervision, Basel, 1994

Bank risk spectrum is shown synthetically in the following figure:

Bank risk Spectrum



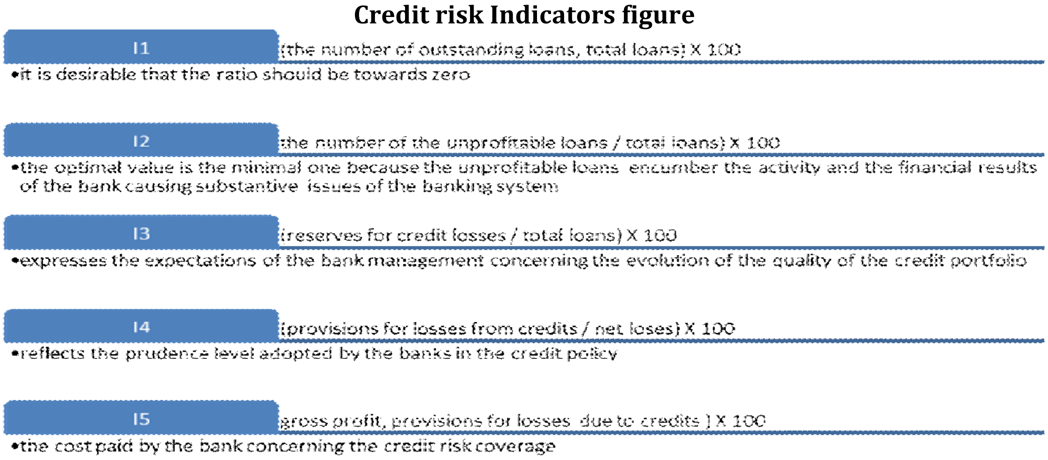
Source Adaptation source H van Greuning, Sonja Brajovic Bratanovic "Analyzing and Managing Banking Risk", Irecsson Publishing House, Bucharest, 2004, p. 12

2. Credit risk indicators

The Bank must have effective systems of reviewing and reporting to inform upper management of the Bank about the way the lending policies are implemented because the quality and the characteristics of the credit portfolio of a bank reflect the position on the market, the demand for a Bank, its business and risk strategies, as well as its capacity to grant loans.

In order to do an accurate analysis of the way in which the quality of the credit portfolio evolves in time, and its impact on the profitability, of the capital adequacy and of the customers' confidence in the bank, banks take into account the following categories of indicators for estimating the credit risk.

Credit risk Indicators figure



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3. Risk management methods

The methods of managing the risk of the interest rate (7) include the measuring of the GAP at different maturity dates, dynamic measurement of the GAP and, on the basis of some estimates of reinvestment and rates ,the measurement of the duration for the Bank's assets. The appeal to these more advanced techniques is due to the fact that the traditional way of measuring the interest rate risk (as the difference or the ratio between the assets and the liabilities sensitive to interest rates) poses a series of problems caused by the difficulty in selecting the maturity to be used as a criterion for the sensitivity as well as , by the fact that the reinvestment or the modification of the rates may rapidly affect the sensitivity of the interest.

Based on the information provided by the GAP method, the interest net income is protected by reducing its volatility, both through direct adjustment of the assets or liabilities sensitive to interest rates and by means of some instruments of the capital market.

In order to properly manage the interest rate risk, it is necessary to identify the factors affecting the net income from interest, such as: the variation of the level of the interest rates, the change in the relationship between the active and the passive interest, the changes in the volume of the assets and liabilities.

The GAP method is used to protect the net income from interest against the modifications of the interest rates or to speculatively alternate the size of the GAP in an attempt to increase the net income from interest and consists in determining the discrepancy between the assets and liabilities with variable interest in the Bank's portfolio.

G.A.P. = ASD-PSD

where ASD-interest sensitive assets;

PSD-interest-sensitive liabilities.

Besides the methods dealing with the management of the GAP in the banking practice field, it is also common practice to use the simulations method which involves the elaboration of a comprehensive model of a bank's balance sheet.

The aim of the simulation is to measure how the sensitivity of the net income from interest, the gains and the capital change, when some key variables are modified. The simulation involves the parametrical modelling of all the assets and liabilities of the Bank in order to determine their evolutionary scenarios by observing any inconsistency with the behavioural pattern in relation to the projections of the interest rates. Compared to the other techniques dealing with the management of the risk of the interest rate , the simulation method , however, involves the existence of higher requirements which allow the access to a great deal of information in real time.

Also, in the event of bad market conditions, banks must evaluate their vulnerability by assuming models of interest rates and by taking into account the result of the assessments made when they adopted the policies and set the limits concerning the risk of the interest rate.

"The stress test" is taken according to the characteristics of risk of each bank and its aim is to provide information about the situations of extreme vulnerability for the bank. It also involves taking into account some abrupt changes in the general level of the interest rate and the potential modifications of the volatility and/or liquidity on all markets on which the bank operates.

4. General Accounting Principles Applied in the case of banking

The accounting principles are conceptual elements according to which accounting rules are elaborated , starting with the accounting postulates. At the same time, they support an accurate accounting of the transactions and other events, as well as a faithful representation of the financial position and performance of the Bank through the documents of synthesis. Also, the accounting principles are considered reference points by the auditors, in their audit activity in the annual accounts. As far as the banks are concerned a series of specific situations regarding the application of the general accounting principles can occur.

1. The prudence principle

According to this principle, it is not allowed to overvalue the assets and the revenue or to undervalue the liabilities and the expenditure, taking into account the depreciation, risks and the possible losses stemming from the activity done the current or the previous financial year. Those who elaborate financial statements have to deal with uncertainties which are inevitably related to events and circumstances, such as the collection of questionable debts, the duration of the probable use of the machinery and equipment and the number of the possible complaints about the products under warranty. Such uncertainties are recognized both by their nature and value and, by the use of prudence in preparing financial statements. Prudence means taking some precautions when it comes to making judgements about the estimates required under conditions of uncertainty, so that the assets and the income won't be overvalued and the debts and the expenditure shall not be undervalued.

2. The principle of the independence of the financial year

Involves the delineation of income and expenditure related to the Bank's activity as they are operational and, they have to be registered according to the results they refer to. The result of the financial year shall include, according to this principle, all the income and the expenses relating to this financial year, as they are engaged and not the takings or the payments.. Thus, the interest rates are recorded as results on the basis of the source interest and from the technical point of view , this aim is achieved by using debts accounts and accruals or regulatory accounts.

Difficulties arise when the expenses are assigned to more financial years.. In such a situation, the question that arises is how much of the expenditure represents the current annual income. The sum of money which has to be paid out of the expenditure is called "expenses" while the sum of money which hasn't reached the maturity yet is called "assets". If a part of the expenditure may not be connected with future revenues, they constitute a loss. (8)

3. The lack of compensation principle

According to this principle, the assets and liabilities must be evaluated and recorded in the accounts separately, since the assets column in the balance sheet can not compensate for the liabilities position. The same idea applies to the income and expenditure in the results account.

The unbalanced principle is stipulated by IAS 1 but it does not exist as such in the Fourth Directive of the European Union. The directive stipulates (7.31.1. e) that: "the elements in the assets column and those in the liabilities column must be valued separately '. It is interesting to notice that both the Order 403/1999 and the subsequent one, namely the Order 94/2001 included in the sphere of the explicit accounting principles both the lack of compensation principle and the separate evaluation one, although the concept of liabilities is not accepted by the international accounting standards. The preferred terms are equities and debts.

4. Nominalism or the historical cost Principle

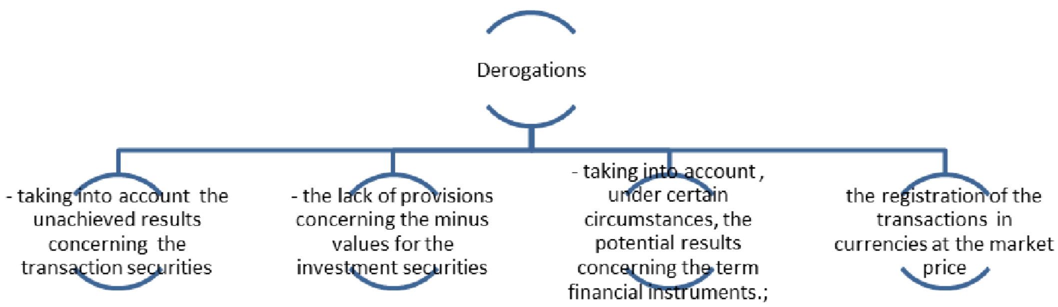
This principle posits that the historical cost at which the assets or the liabilities have been recorded in the patrimony and in the accounts must be maintained.. This principle entails derogations in respect of operations with estimates, foreign currency, securities transactions and financial instruments, since they are subject to periodic evaluation at market prices-or at the exchange rate or at the quotation recorded on the stock market.

The value of the banks ' accounting record was represented by the historical cost, i.e. the value recorded in the accounts at the time of obtaining the goods , the debts or at the time of contracting a debt. This is a verifiable value, recorded in the document certifying the right of ownership of the assets, the debts or the bonds Because historical cost is a value that comes from the past, since the purchase of the assets and liabilities of an entity and because it is a verifiable value,it is regarded as an objective cost. In addition, the use of a value that comes from the past, from the date of the transaction, the accounting value, so cost is a value associated with the principle of continuity.

5. The applicability of the principle of prudence on banking companies

At the level of banking firms there are derogations from the principle of prudence regarding market operations, when they are valued at market prices (see figure below)

Derogations from the principle of conservatism



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Thus in order for a security to be recorded as a transaction must meet the three conditions simultaneously:

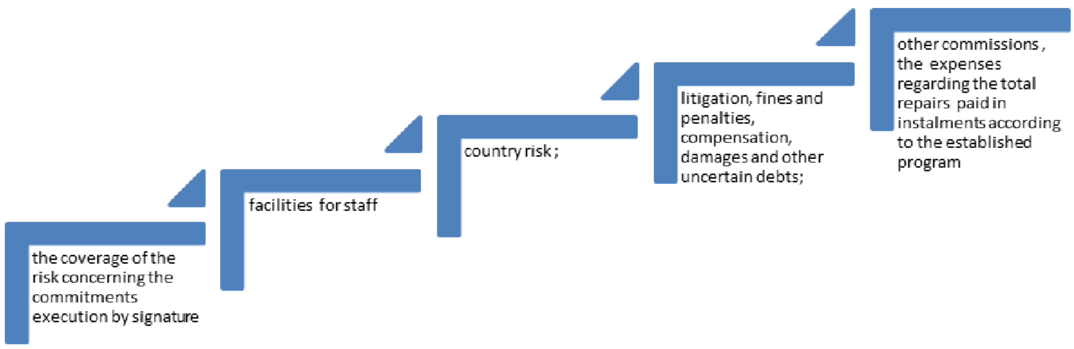
1. the intention is to realize in trading as soon as possible, before maturity, typically in less than 6 months;
2. titles to be marketable at any time on a liquid market;
3. the market price of the securities to be accessible to third parties.

"Violation" of the principle of prudence consists of revaluation of transaction on the basis of scholarship and enrollment rate favorable difference directly into the accounts of revenue, without income to be realised.

Investment Securities are fixed-income securities which were purchased with the intention of holding them in principle until maturity. In the category of investment securities include bonds, the effects of public and other fixed-income securities. Expenditure on acquisition of investment securities are highlighted in the appropriate expense accounts and are not included in the value of securities entered into heritage.

Periodically, investment securities should be valued at market prices, in which case the differences are not recorded in the accounts, and for unfavourable differences, there is, as a rule, provisions as happens in the case of securities placement. It may constitute provisions for depreciation for depreciation of investment securities, in the event of possible sales of investment securities before maturity, or if the risk of bankruptcy of the issuer. Probable losses will be recorded on account of expenditure with provisions for liabilities and charges are being thus provisions for liabilities and charges. The provision is, as a rule, at the end of the financial year in respect of those assets or liabilities whose realisation or payment is uncertain, or for expenses which become due in later periods, such as those highlighted in the following figure:

Expenses become due in later periods



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5. Issues relating to linking with IAS 37

IAS 37 Provisions, Contingent Liabilities and Contingent Assets outlines the accounting for provisions (liabilities of uncertain timing or amount), together with contingent assets (possible assets) and contingent liabilities (obligations and present possible obligations that are not probable or not reliably measurable). Provisions has measured at the best estimate (including risks and uncertainties) of the expenditure required to settle the present obligation, and reflects the present value of the expenditures required to settle the obligation where the time value of money is material.

IAS 37 was issued in September 1998 and is operative for periods beginning on or after 1 July 1999

The objective of IAS 37 is to ensure that appropriate recognition criteria and measurement bases has applied to provisions, contingent liabilities and contingent assets and that sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount. The key principle established by the Standard is that a provision should be recognised only when there is a liability i.e. a present obligation resulting from past events. The Standard thus aims to ensure that only genuine obligations has dealt with in the financial statements-planned future expenditure, even where authorised by the board of directors or equivalent governing body, is excluded from recognition.

Recognition of a provision

An entity must recognise a provision if, and only if: [IAS 37.14]

- a present obligation (legal or constructive) has arisen as a result of a past event (the obligating event),

- payment is probable (' more likely than not '), and
- the amount can be estimated reliably.

An obligating event is an event that creates a legal or constructive obligation and, therefore, results in an entity having no realistic alternative but to settle the obligation. [IAS 37.10]

A constructive obligation arises if past practice creates a valid expectation on the part of a third party, for example, a retail store that has a long-standing policy of allowing customers to return merchandise within, say, a 30-day period. [IAS 37.10]

A possible obligation (a contingent liability) is disclosed but not accrued. However, disclosure is not required if payment is remote. [IAS 37.86]

In rare cases, for example in the lawsuit, it may not be clear whether an entity has a present obligation. In those cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the balance sheet date. A provision should be recognised for that present obligation if the other recognition criteria described above has met. If it is more likely than not that no present obligation exists, the entity should disclose a contingent liability, unless the possibility of an outflow of resources is remote. [IAS 37.15]

Measurement of provisions

The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date, that is, the amount that an entity would rationally pay to settle the obligation at the balance sheet date or to transfer it to a third party. [IAS 37.36] This means:

- Provisions for one-off events (restructuring, environmental clean-up, the settlement of a lawsuit) has measured at the most likely amount. [IAS 37.40]
- Provisions for large populations of events (Attn, customer refunds) are measured at a probability-weighted expected value. [IAS 37.39]
- Both measurements at discounted present value using a pre-tax discount rate that reflects tax the current market assessments of the time value of money and the risks specific to the liability. [IAS 37.45 and 37.47]

In reaching its best estimate, the entity should take into account the risks and uncertainties that surround the underlying events. [IAS 37.42]

If some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised as a separate asset, and not as a reduction of the required provision, when, and only when, it is virtually certain that reimbursement will be received if the entity settles the obligation. The amount recognised should not exceed the amount of the provision. [IAS 37.53]

In measuring a provision consider future events as follows:

- forecast reasonable changes in applying existing technology [IAS 37.49]
- ignore possible gains on sale of assets [IAS 37.51]
- consider changes in the legislation only if virtually certain to be enacted [IAS 37.50]

Remeasurement of provisions [IAS 37.59]

- Review and adjust provisions at each balance sheet date
- If an outflow no longer probable, provision is reversed.

Use of provisions

Provisions should only be used for the purpose for which they were originally recognised. They should be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources will be required to settle the obligation, the provision should be reversed. [IAS 37.61]

Contingent liabilities

Since there is common ground as regards liabilities that are uncertain, IAS 37 also deals with contingencies. It requires that entities should not recognise contingent liabilities-but should disclose them, unless the possibility of an outflow of economic resources is remote. [IAS 37.86]

Contingent assets

Contingent assets should not be recognised-but should be disclosed where an arterial inflow of economic benefits is probable. When the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate. [IAS 37.31: 23]

Disclosures

Reconciliation for each class of provision: [IAS 37.84]

- opening balance
- additions

- used (amounts charged against the provision)
- unused amounts reversed
- unwinding of the discount, or changes in discount rates
- closing balance

The prior year reconciliation is not required. [IAS 37.84]
For each class of provision, a brief description of: [IAS 37.85]

- nature
- timing
- uncertainties
- assumptions
- reimbursement, if any

6. Conclusion

General accounting principles are set out in section 7 of annex to OMFP 3055/2009. The application of banking companies, the most important are the principle of prudence, the principle of the independence of the financial year, no-netting principle, nominalism or the historical cost principle.

At the level of banking firms there are derogations from the principle of prudence regarding market operations, when they are valued at market prices.

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