# ACCOUNTING OF BANKS AND CERTAIN FINANCIAL INSTITUTIONS FROM THE YEAR 2003

## *PART I*

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***The new decree of the Ministry of Finance of the Slovak Republic dated November 13, 2002 stipulating the details of accounting procedures and the framework chart of accounts for banks, branches of foreign banks, the National Bank of Slovakia, the Deposits Protection Fund, securities dealers, branches of foreign securities dealers, the Investments Guarantee Fund, asset management companies, branches of foreign asset management companies and mutual funds, has been developed in accordance with § 4(2) of Act No. 431/2002 Z.z. on Accounting with effect from January 1, 2003. The purpose of this decree was to provide for harmonisation with the new Accounting Act no. 431/2002 Z.z., which took force on January 1, 2003, as well as to reduce the cost of accounting and auditing, since International Accounting Standards (IAS) have been applied in the greatest possible extent, whereby the custom bridge between Slovak accounting legislation and International Accounting Standards should be removed, even if the IAS have not yet been applied in the full scope.***

The changes in the procedures for accounting of banks and certain financial institutions concern several areas. We shall provide information about the most relevant changes in a series of three consecutive papers.

### Basic Definitions

Certain basic definitions have been adopted in the accounting procedures. They chiefly concern the definition of a financial instrument, a financial asset, a financial liability, an equity instrument, etc.

**Financial assets are understood to be:**
- cash, i.e. funds represented by a currency in circulation and other funds payable on demand;
- the right to acquire cash or another financial asset of another entity arising from a contract;
- the right of converting financial instruments arising from a contract and under the conditions thereof;
- an equity instrument of another entity.

**Financial liabilities are understood to be:**
- obligations to settle in cash with another entity arising from a contract;
- obligations to exchange financial instruments arising from a contract under the conditions of this contract.

**A financial instrument** is understood to be any legal relationship giving rise to a financial asset for one of the contracting parties and a financial liability or an equity instrument for the other contracting party.

**An equity instrument** is understood to be a residual share in an entity's assets on the deduction of all of its liabilities, such as a share, a participation, an equity certificate.

### Framework Chart of Accounts

A framework chart of accounts does not contain the numbering of ledger accounts, it contains only the recommended ledger accounts. Accounting entities shall set up ledger accounts in accounts groups of the framework chart of accounts. They will compile the accounting entity's chart of accounts on the basis of these in accordance with the provisions of §13 of the Accounting Act. If accounting entities set up and designate ledger accounts numerically, with account names added according to their specific conditions and needs within the defined accounts groups, they must establish a correspondence through references between the accounts and the chart of accounts and their numbering therein.

### Date of an Accounting Event

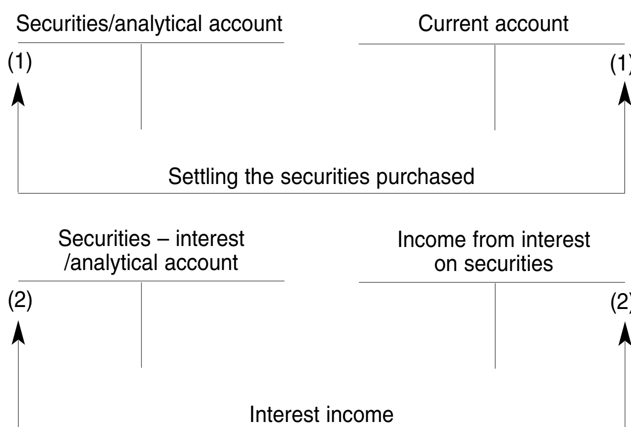
In making an accounting entry under IAS 39, either the date of settling a deal (the settlement date) or the day of concluding a deal (the trade date) may be applied. Financial institutions have chosen to use the settlement date. This means that accounting events consisting of purchases and sales of financial assets with a standard delivery term (spot transactions) are carried on off-balance sheet accounts from the day of concluding a deal to the day of its settlement. On the settle-

ment date an off-balance sheet entry is cancelled and the settlement is entered in the balance sheet.

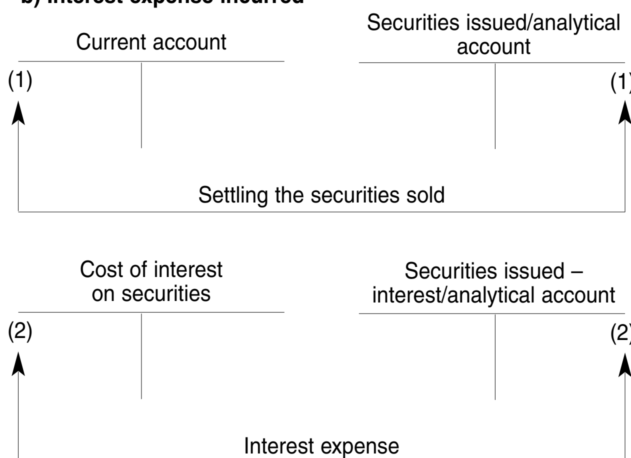
## Interest Income Earned and Interest Expense Incurred

Under the new accounting procedures, the interest income and expense earned/incurred in relation to assets and liabilities are recorded together with these assets and liabilities. The interest earned/incurred is a part of the accounts groups used to account for the respective assets and liabilities. This means that the interest expense incurred and income earned is no longer entered in the accruals accounts.

**a) Interest income earned**




**b) Interest expense incurred**




Interest income or interest expense is calculated according to the effective interest method for any financial assets and liabilities valued at an accrued amount.

A linear method may be used for:

- securities held for trading;
- securities held for sale;
- obligations from securities held for trading;
- securities held to maturity with a remaining maturity period on the settlement date of bought securities less than one year;
- securities procured in primary issues not held for trading with a remaining maturity period on the settlement date of less than one year;
- issued short-term securities;
- accounting of interest income from receivables and interest expense on payables, namely the periods between individual payments, if these are less than one year.

In these exemptions from the effective interest method there is practically no difference between the linear method and the effective interest method.

## Participations in the Share Capital of Business Entities

For the purposes of accounting procedures, participations in the share capital of business entities are understood to be:

- equity securities and investments in companies with a controlling influence, if the accounting entity holds an interest of more than 50% in the share capital or voting rights of a business entity;
- equity securities and investments in companies with a significant influence, if the accounting entity holds an interest of at least 20% and not more than 50% in the share capital or voting rights of a business entity.

The Accounting Act stipulates two methods for valuing participations in the share capital of business entities. An accounting entity may decide whether it will value the participations at acquisition cost or using the equity method.

Under the equity method equity securities and investments in business entities with a controlling or significant influence are valued at cost on their acquisition. Goodwill included in the acquisition cost is transferred to the respective intangible asset account of the accounts group 47. When valuation is done using the equity method, the data from the closing accounts of a subsidiary or an affiliate is applied. The valuation of an equity security and an investment is:

- reduced by dividends received in the amount not reduced for income tax, and/or other proceeds from distribution received;
- increased by the share in the profits or decreased by the share in the losses of a subsidiary or an affiliate; corresponding accounting entries are made in the accounts Share in Profits or Losses from Investment at the equivalence of the accounts group 76 or 66.

When doing a valuation using the equity method, dividends received, or other proceeds from distribution received are credited to incomes in the account Incomes from a Share in Profits from Investment at equivalence of the accounts group 76, with a corresponding

entry in the accounts of the group 12 or 13, or the account Deferred Income of the accounts group 35; at the same time the valuation of equity securities and investments is reduced by the value corresponding to the dividends received, or other proceeds from distribution received, with a corresponding entry made to the debit of the account Income from the Share in the Profits from Investment within the accounts group 76.

The valuation of an equity security and investment is reduced or increased by the respective share of changes in the equity capital of a subsidiary or an affiliate that has not been included in the subsidiary's or affiliate's profit and loss statement, for example due to changes arising from exchange rate differences entered in the balance sheet. Differences arising from such a valuation of equity securities and investments are charged to costs or incomes in the accounts Share in Profits or Losses from Investment within the accounts groups 76 or 66.

The amount by which the profit from the valuation of equity securities and investments at equivalence, included by an accounting entity into the profit and loss statements in the account Incomes from the Share in the Profits from Investment at equivalence of the accounts group 76, exceeds dividends received or other proceeds from distribution received, shall be transferred to the reserve fund when the profits are distributed. The value of an equity security and investment equals zero, if the share of an accounting entity in the losses of a subsidiary or an affiliate equals or exceeds the valuation of the equity security and the investment given in the accounting entity's books.

It may be expected that at the present time accounting entities will not apply the equity method in valuation, but will value their interests in the share capital of business entities at acquisition cost, including provisions created, if any.

**Provisions.** – Provisions amounting to the difference by which the valuation of a participation in the books exceeds the rate of an accounting entity's interest in the business entity's equity shall be created for equity securities and investments in business entities with a controlling or significant influence not valued through the equity method and for other participations. The rate of the accounting entity's interest in the business entity's equity shall not be applied in the following cases:
- the accounting entity is subject to composition;
- a bankruptcy petition has been granted in respect of the accounting entity's assets;
- a bankruptcy petition has been rejected on the grounds of the accounting entity's insufficient assets;
- bankruptcy proceedings has been cancelled because of the accounting entity's assets being not sufficient to cover the cost of bankruptcy proceedings.

Provisions in such cases are created to the amount of the valuation of equity securities and investments or other participations stated in the books.

## Accounting for Exchange Rate Differences

Assets and liabilities denominated in a foreign currency shall be converted by an accounting entity to the Slovak currency at the rate announced by the National Bank of Slovakia as at the date of the accounting event, as at the date of financial statements or as at another date, if so stipulated by other separate legislation (such as the Banking Act). Under IAS 21, exchange rate differences arising as a rule from the daily revaluation of foreign currency assets and liabilities are charged to cost or income accounts, except for the following exchange rate differences arising from:
- net investment associated with foreign currency equity securities and investments in business entities with a controlling influence and foreign currency equity securities and investments in business entities with a significant influence that are charged to the account Revaluation Differences from the Conversion of Net Investment Associated with Equity Securities and Investments of the accounts group 56. Exchange rate differences in the event of a reduction in these equity securities and investments are charged to the account Cost of Transferring Equity Securities and Investments of the accounts group 66 or the account Incomes from the Transfer of Equity Securities and Investments of the accounts group 76, where a net investment in a business entity is the share of a reporting accounting entity in the business entity's equity, net investment associated with equity securities and investments are long-term receivables and payables that form a part of the net investment in a subsidiary or an affiliate, their settlement is not planned, nor is it likely to occur in the foreseeable future, and in essence represent an increase or a decrease in the interest in the subsidiary or affiliate;
- foreign currency financial liabilities by which an accounting entity hedges against foreign exchange risk ensuing from net investment in foreign currency equity securities and investments in business entities with a controlling influence and in foreign currency equity securities and investments in business entities with a significant influence that are charged to the account Valuation Differences from the Conversion of Net Investment Associated with Equity Securities and Investments in the accounts group 56. Exchange rate differences in the event of a reduction of such net investment in equity securities and investments are charged to the account Cost of Transferring Equity Securities and Investments of the accounts group 66 or to the account Incomes from the Transfer of Equity Securities and Investments of the accounts group 76;

- a foreign currency financial asset or liability by which an accounting entity hedges against a foreign exchange risk arising from contracts not entered in balance sheet accounts and that are binding on both parties and contain contractual terms and conditions including the setting of an amount, price, delivery date, sanctions for a failure to observe the terms and conditions. Exchange rate differences are charged to the account Valuation Differences from Conversion of Hedging Derivatives of the accounts group 56 up until the moment when they become a part of the valuation of balance sheet assets or balance sheet liabilities arising under a contract;
- a foreign currency financial asset or liability by which an accounting entity hedges against a foreign exchange risk ensuing from an expected future deal which is not yet contractually concluded, but is likely to be performed. These are charged to the account Valuation Differences from Conversion of Hedging Derivatives of the accounts group 56 up until the moment when they become a part of the valuation of balance-sheet assets or liabilities arising from the expected future deal. If the expected future deal is not carried out, the exchange rate differences will be charged to the costs or incomes by their reposting from the account Valuation Differences from Conversion of Hedging Derivatives of the accounts group 56 to the account Cost of Foreign Exchange Operations of the accounts group 61 or the account Incomes from Foreign Exchange Operations of the accounts group 71;
- foreign currency equity securities and investments in business entities with a controlling influence and foreign currency equity securities and investments in business entities with a significant influence valued through the equity method. Exchange rate differences are recorded together with other changes due to valuation through the equity method.

Exchange rate differences arising from the conversion of foreign currency receivables and payables due to spot operations on off-balance-sheet accounts of the accounts group 94, where as a rule a deal is settled within two days, become a part of the accounting entity's profit or loss and are charged to the account Cost of Foreign Exchange Operations of the accounts group 61 or the account Incomes from Foreign Exchange Operations of the accounts group 71 with a corresponding entry made in the account Exchange Rate Difference Redistribution of the accounts group 35.

## Provisions

Accounting procedures not only contain general principles for creating provisions, but also specific principles for creating provisions on securities and participations in the event that these are not valued at fair value. Specific principles for the classification of claims on loans and the creation of provisions on such receivables for banks are stipulated by Decree of the NBS No. 7/2002 on the classification of assets and liabilities of banks and branches of foreign banks, the adjustment of their valuation, the creation and cancellation of reserves and reports related thereto.

**Provisions are created in respect of:**

- receivables from financial activities, such as loans made, deposits made, payments due on guarantees, letters of credit, factoring and other financial activities;
- receivables from activities other than those financial, such as trade receivables, advances paid;
- securities held to maturity and securities procured in primary issues and not held for trading;
- other participations in business entities other than joint-stock companies, such as participations in a limited liability company that do not fulfil the characteristics of participation in business entities with a controlling or significant influence;
- tangible and intangible assets.

**Provisions are not created in respect of:**

- an increase in the value of assets above the amount stated in the books;
- liabilities;
- assets valued at fair value or through the equity method;
- assets underlying a hedging derivative, if the value hedged is the same or greater than the asset valuation stated in the books.

In creating provisions in respect of assets it is also possible to take into account security on these in the form of a financial asset received as part of a reversed REPO (a collateral received), guarantee, loan derivative, provided that an accounting entity:

- can satisfy itself from the security in the event of a debtor's default, for example by realising a guarantee or selling a collateral;
- is able to satisfy itself within an adequate time following a debtor's default such as overdue interest, fee or principal payments;
- recognises a security at no more than its currently realisable value upon the deduction of the cost of its selling, only at the amount not used to secure other assets or third-party assets, if these have a priority right to satisfaction over the accounting entity, and at no more than the valuation of secured assets stated in the books.

Provisions on foreign currency asset accounts are recorded in the Slovak currency and in a foreign currency. Exchange rate differences from the revaluation of provisions in foreign currency are treated in the same way as exchange rate differences from the revaluation of foreign currency assets and liabilities to which they relate.

### Reserves

Under the Accounting Act, reserves are defined as payables with indeterminate time specification or amount.

Under the Act No. 368/1999 Z.z. on Reserves and Provisions, in order to ascertain the taxable income base, reserves may also be raised on receivables from the lending business of banks with a contractual maturity of more than 1 year that are reasonably believed to be satisfied to the amount of their principal, on receivables from the lending business of banks giving rise to standard claims subject to qualification and on guarantees provided, as well as for the repair of tangible assets.

Reserves as per Slovak legislation are not in accordance with IAS 37.

Reserves are charged in the Slovak currency and in a foreign currency in which the performance can be made. If reserves are also recorded in a foreign currency, exchange rate differences are treated in the same way as exchange rate differences arising from other liabilities.

In its internal regulations an accounting entity shall determine the purpose, the method for the creation and application of reserves. Provisions may not be created for the same purpose and in the same amount as the reserves raised.

### Accounting for Income Tax

Income tax due is to be debited from the account Income Tax Due of the accounts group 68 and credited to the account Clearing with the State Budget of the accounts group 34.

Deferred income tax is charged to the account Deferred Income Tax of the accounts group 68 and is calculated on the basis of temporary differences between the tax base of assets or liabilities and its book value reported in the balance sheet.

Temporary differences are:

- taxable incomes ascertained in determining a taxable income base (tax losses) of future periods, where the book value of assets or liabilities is claimed or paid, result in a deferred tax liability, for example where the book value of tangible assets taking into account depreciation for accounting purposes is greater than the value of these assets for taxation purposes;
- deductible items ascertained in determining the taxable income base (tax deductibles) of future periods, where the book value of assets or liabilities is claimed or paid, result in a deferred tax receivable, for example where the book value of receivables taking into account provisions is lower than the value of these receivables on taking into account provisions recognised for taxation purposes.

Deferred tax liabilities are understood to be amounts of income tax to be settled in future periods due to taxable temporary differences. Deferred tax receivables are understood to be amounts of income tax claimed in future periods on the grounds of:

- deductible temporary differences;
- unapplied tax losses that have been carried over;
- unapplied tax deductibles that have been carried over.

A deferred tax liability arising from deductible temporary differences is charged to the subledger account Deferred Tax Liability to the account Clearing with the State Budget of the accounts group 34 only if it is likely that a taxable income base against which it will be possible to apply the deductible temporary differences is achievable, if there exist sufficient taxable temporary differences relating to the same tax administrators and to a taxed entity to which an amount is expected to be returned

- in the same period in which deductible temporary differences are expected to be returned;
- over periods in which a tax loss ensuing from a deferred tax receivable may be retrospectively applied or carried over to other periods.

On fulfilling these conditions, a deferred tax receivable is awarded in the period in which the deductible temporary differences have arisen.

As at the date of compiling financial statements, an accounting entity shall review the book value of a deferred tax receivable and in the event that it is unlikely that the taxable income base that will be achieved will be sufficient to enable the application of a portion or the whole of the deferred tax receivable, the book value of the deferred tax receivable will be reduced. The reduction is made in the extent in which it is probable that the sufficient taxable base will not be achievable.

A deferred tax receivable arising from unapplied tax losses or unapplied tax deductibles that have been carried over is charged in the extent in which it is likely that it will be possible to cover unapplied tax losses and unapplied tax deductibles by the future taxable base.

In calculating a deferred tax receivable and liability, income tax rates are applied that are known to be applicable over the period in which a deferred tax receivable will be performed or a deferred tax liability settled. When there is a change in the tax rate, the deferred tax receivables and liabilities calculated will be recalculated at a rate applicable under the Income Tax Act over the period in which a deferred tax receivable will be performed or a deferred tax liability settled.

Neither deferred tax receivables, nor deferred tax liabilities are discounted.

No deferred tax is charged in the event of temporary differences arising from the valuation of goodwill.

***To be continued by Accounting for Securities in the next issue.***