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## **VALUATION OF OUTSTANDING LOANS AND THE FINANCIAL RESULT OF A BANK**

**Summary:** In the last twenty years – which are characterized by rapid development of capital and financial markets as well as by rapid growth of the economies of many countries – there is an increased demand for complete, timely, comparable and reliable information about financial standing and financial results of business entities. This article explores the impact of credit valuation methods on a bank's financial result.

**Keywords:** valuation, loans, financial result, historical cost, amortized cost.

### **Introduction**

Commercial banks are important units in any economy, due to their active participation as an intermediary among entities in need of funds for their activities, and those who invest free cash. In carrying out its business a bank has to ensure fair, reliable, accurate and timely inclusion of receivables in accounting books, from the point of view of its information needs and the risk that results from these activities. However, the accounting policy gives it a variety of valuation options [Kaczmarek, 2008, p. 12]. The problem of valuation is one of the most important issues in accounting and is the subject of this discussion. This article aims at presenting selected issues relating to valuation of outstanding loans and their impact on a bank's earnings. In the view of IFRS disclosure requirements one should pay attention to the importance of clarity and transparency of information disclosed to a wide range of users. The research methods adopted in this article are based on the study of literature, review of legislation and reasoning.

## 1. Valuation principles used in preparation of financial statements

Valuation is a process aimed at establishing amounts of money, in which the components of financial statements are to be included and reported on the balance sheet and a profit and loss statement [*Międzynarodowe Standardy Sprawozdawczości...*, 2011, p. 77-78].

The valuation principles applied in varying degrees and different combinations used in financial statements include :

- 1) the historical cost principle,
- 2) the current cost principle,
- 3) the principle of sale price (realization),
- 4) the principle of present value.

The historical cost principle says that assets are recognized at acquisition date in the value equal to the monetary amount paid for them, or the fair value of non-monetary payment made in order acquire them [Emerling, 2012, p. 35].

The current cost principle (current purchase price) says that the assets are valued at a value equal to the amount that would be payable in case of acquiring the same or equivalent component at the present time. Another principle is that of the sale price (realization). According to it assets are valued at a value equal to the amount of money possible to obtain at the present time as a result of assets sale in a regular, scheduled transaction.

The principle of present value, also used in preparation of financial statements, says that assets are valued at discounted present value of future net cash flows which an item will develop in a course of commercial activity. The ability to choose among certain categories of prices and use of different valuation methods of outstanding loans provides a commercial bank with a framework to conduct its own accounting policies, and thus gives a possibility to influence its financial result.

Initial valuation is based on historical cost. Historical cost can be defined as the total amount of cash assets, or its equivalent, an entity has to pay for acquisition of assets in a way to be able to control them to obtain future economic benefits [Turyna, 2003, p. 74-75].

The need for review of outstanding loans is due to reliability and accuracy of the true picture of the commercial bank's financial situation disclosed in its financial statement. The main significance here has the valuation of its present value.

## 2. Economic categories used in valuation of outstanding loans

The existing accounting law uses different price categories in the valuation process, which include: purchase price, acquisition price, fair value, market value, adjusted acquisition price, amount payable and the corrective position associated with these economic categories – permanent loss of value.

The **purchase price** is a component of acquisition price corresponding to the amount due the seller equal to the product of quantity and unit value of the purchased assets or benefits.

The **acquisition price** [Ustawa o rachunkowości, 2013, art. 28] is a broader category, which includes the actual purchase price of a new or used asset component due to the seller, reduced by the deductible tax on goods and services and excise tax, discounts, rebates and other similar reductions and recoverable items and increased by public-legal burden in the case of imports, and costs directly related to the purchase and adaptation of an asset item to a condition for use or marketing, including transportation costs, as well as loading, unloading, storage or marketing costs.

In the case of credit claims it is the level of cost – at fair value given or received. This amount includes transaction costs, unless they are unimportant, but then they are charged to the bank .

The **fair value** is understood as the amount for which an asset item could be exchanged and a liability settled, on terms of a market transaction between well informed, but not interconnected parties. In the absence of a market value, as the equivalent of fair value the following items can be recognized [Stoga, 2002, p. 2-3]:

- expert valuation,
- adjusted historical prices (costs),
- current market prices for similar asset items,
- reports from market analysts,
- discounted cash flows based on market interest rates.

The **adjusted acquisition price** (amortized cost) – is the purchase price at which a financial asset or financial liability was first introduced to the account books (initial value), reduced by the repayment of the nominal value (base capital), adjusted respectively by a cumulative amount of the discounted difference between the initial value of a component and its value at maturity, calculated using the effective interest rate, and also reduced by write-downs.

The effective interest rate is the internal rate of return of an asset item or a financial liability for a given period. Upon calculation of the cumulative amount of a discount on financial assets and liabilities using the effective interest rate, all fees paid or received by the parties to the contract are taken into account.

However the **amortized cost** of a financial asset is the amount at which an asset or financial liability is valued at the initial recognition, less the repayment of the capital and increased or decreased by the redemption of any differences between the initial value and the value at maturity and reduced by allowances in virtue of specific provisions, loss of value or inability to collect.

An important category in terms of the amount due is also the **repayable amount**. This is an economic category used in the valuation balance sheet receivables (Uor, art. 28). The amount payable includes: the nominal value of receivables at creation date, any accrued interest, if its calculation was stipulated in the agreement between the parties, the potential amount of debt indexation set out in a non-monetary measure, pursuant to the provisions of the contract, any currency exchange differences on receivables denominated in foreign currencies.

A possibility to choose among certain categories of prices and the use of different valuation principles the outstanding loans, provides a commercial bank with its own framework of balance policies, thus providing a possibility to influence the financial result.

### 3. Valuation methods of outstanding loans applied in commercial banks

Bank receivables are accounted for in accounting books at the date of the transaction, i.e. when it becomes a party in such transaction of a given financial instrument (IAS 39 & 43-70).

**Initial valuation of receivables**, which are a component of financial assets, is carried out at acquisition price (fair value paid or payable), whereat the transaction costs are included in the initial value of all assets, unless they are immaterial. For the valuation purposes at a later date (i.e. the balance valuation), IAS 39 and the regulation introduced a division of assets into four categories, which are presented in the following table.

**Table 1.** Classification of financial assets

Categories of assets according to IAS 39	Categories of assets according to regulation
1) financial assets at fair value through profit, 2) investments held to maturity, 3) loans and receivables, 4) financial assets available for sale	1) financial assets held for trading, 2) financial assets held to maturity, 3) loans and advances and other receivables originated by the bank, 4) financial assets available for sale.

Source: Own study based on IAS 39 and the Minister of Finance Regulation of 10 December 2001 on specific accounting rules for banks.

Balance sheet valuation of credit claims is carried out by different rules. The main significance has valuation at present value. Receivables are measured at present value, meaning the value of discounted future cash flows being a measure of anticipated economic benefits. This method is also used as an impairment test for outstanding loans.

Valuation of receivables at the **balance sheet date** depends on the initial classification of the asset item.

IAS 39 states that financial assets, including asset type derivative instruments, should be measured at fair value, without deducting transaction costs that an entity may incur on sale or disposal by any other means. There are exceptions from this rule which include valuation of loans and receivables as well as investments held to maturity. They should be measured at an **amortised acquisition price using the effective interest method** [Wielgórska-Leszczyńska, 2005, p. 28-30]. An exception is also investing in financial instruments that are not quoted on an active market and whose fair value can not be reliably determined. They are valued at amortized cost.

One should bear in mind that the preparation of financial statements requires the management and the board to make subjective judgments, estimates and assumptions that affect the accounting principles used, the presented amounts of assets and liabilities and revenues and expenses. The estimates may depend on the judgment of management [*Międzynarodowe Standardy...*, 2009].

In the case of assets denominated in foreign currency, the amortized cost should be calculated based on the amount of foreign currency using the effective interest rate, and then the calculated amount converted into Polish zlotys in accordance with the provisions of the Act or IAS.

It should be noted that IFRS 7 also requires disclosure of the fair value of all assets and liabilities on the balance sheet and those not included there, unless such disclosure is not possible for practical reasons.

In addition, all financial assets, excluding those priced on fair value based on a financial result, are assessed in terms of loss of value according to IAS 39 & 58-70.

**Permanent loss of value** occurs when there is a high probability that an asset controlled by a commercial bank will not bring economic benefits in the future. Then the bank is obliged to a write-down in such a way that it will bring the component value to fair value established in another way. Specific provisions are the write-down which updates the value of outstanding loans.

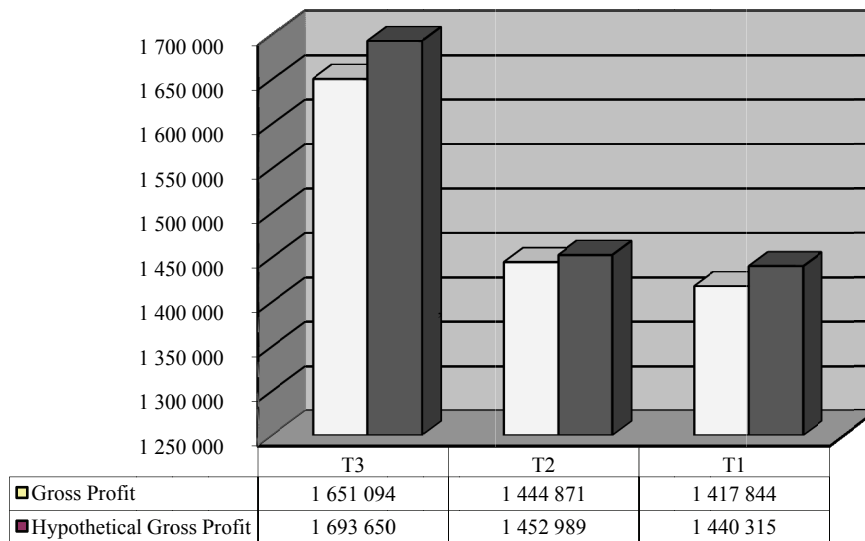
#### 4. The effect of different valuation methods on the level of earnings

The analysis of a profit and loss statement of an examined bank reveals that reserves constituted a significant financial burden. In comparison with the burden resulting from establishing reserves for ordinary loans and OLEM loans, the provisions burden in virtue of doubtful loans was in the analyzed period much higher.

To illustrate this impact, financial statements of a bank were analyzed with the exclusion of established reserves for standard receivables and those under observation. These reserves were excluded because the bank's management could decide that from these receivables it does not create provisions based on IAS/IFRS. These are receivables with relation to which you cannot talk about arrears yet.

By analyzing the resulting hypothetical profit and loss statement in the position that the bank made no provisions for ordinary and OLEM it can be said that the provisions have the greatest impact on gross profit. This impact is illustrated by Fig. 1.

In the given hypothetical situation one can observe a significant increase in gross profit as a result of reducing the amount of created provisions. Besides the direct visible impact of no provisions for individual economic items contained in the reports, it is very important that the image of the company can be generally distorted due to the creation of provisions.



**Fig.1.** The influence of applied provisions policy on earnings

Source: Own adaptation based on bank data.

The lack of provisions may give a misleading impression of a bank's financial strength. This illustrates the increase in profits in a hypothetical example. A bank showing lower provisions can convince the recipient of information about the strength of the bank and lower risk. All of these conclusions, data and indicators will refer to misrepresentation of economic figures, and above all to the artificially inflated profits. Since the companies, including banks do not operate in isolation from their environment; accounting decisions are often influenced by other people or entities. An approval of unethical behaviours in accounting leading to adulteration of reports results in creation of information that can not be considered as a foundation for long-term investment decisions and do not serve the safety of business transactions [Maruszewska, 2010, p. 24] .

## Conclusion

Presented issues certainly don't exhaust the problem. It is clear from the above discussion that the problem of valuating credit receivables is very complex.

From a theoretical as well as practical point of view, any change in the principles of valuation and recognition of outstanding loans in the accounting books, may cause changes in the bank's financial position and profit. The analysis and simulations carried out at work confirm the argument that the use different valuation methods affects the bank's financial results, but may also depend on estimates of the bank's board and management and their balance policy.

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#### **WYCENA NALEŻNOŚCI KREDYTOWYCH A WYNIK FINANSOWY BANKU**

**Streszczenie:** W ciągu ostatnich dwudziestu lat, które charakteryzowały się szybkim rozwojem rynków kapitałowych i finansowych, a także szybkim wzrostem gospodarek wielu krajów, zwiększa się zapotrzebowanie na pełne i aktualne, porównywalne i wiarygodne informacje o sytuacji finansowej i wynikach finansowych podmiotów gospodarczych. Ten artykuł bada wpływ metod wyceny należności kredytowych na wynik finansowy banku.

**Słowa kluczowe:** wycena, kredyty, wynik finansowy, koszt, sprawozdanie finansowe.