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SPI Project: The Impact on the Banking Regulations of the IFRS Implementation

http://www.spi-albania.eu/en/2008-program/the-impact-on-the-banking-regulation-of-the-ifrs-implementation/

Project information

PUBLIC-PRIVATE FINANCIAL SECTOR MODERNIZATION MATRIX					
Italian Banking Association CRITERIA	**European Central Bank CRITERIA**				
	Asymmetric information reduction	*Completeness of the market*	*Increased opportunities to engage in financial transactions*	*Reduced transaction costs*	*Increased competition*
Business development					
Industry competitiveness	X				
Industry reputation					

Short description of the context: In May 2008, the Ministry of Finances issued a decree that made obligatory the application of International Accounting Standards and International Financial Reporting Standards since January 1st 2008. Banks, as business entities, have to start with the application and implementation of the new standards.
In order to facilitate the transition process, Bank of Albania, as the banking system supervisory authority, has to adjust the banking regulative framework and align it with the new international accounting and reporting standards.

Stakeholder proposing the project: Bank of Albania

Other Stakeholders involved (sponsors): AAB and Banking community, Financial Supervision Authority, National Council of Accountants and Auditing Companies.

Project objectives:
General: Improving competitiveness and transparency of the market
Specific: Uniform reporting
Operational:

1. To interpret the Order of the Ministry of Finance on the timing of the full application of IFRS standards.
2. To assess the impact of IFRS implementation in banking regulatory framework by preparing a list / identifying the affected laws, bylaws, regulations and guidelines.
3. To assess the main areas of impact and the general sense of the changes to be brought to the regulations.

Description of the project contribution toward financial modernization:
By reaching the project's objectives, BoA would identify more accurately the main areas of impact and the general need for change on the banking regulations as consequence of IFRS implementation. Consequently, the existing regulatory framework would be adopted to reflect the new international accounting and reporting standards and would address with more efficacy all users needs.

Project Working Group:
Bank of Albania (Project Owner & Project Manager)
Banka Popullore (Deputy Project Manager)
Raiffeisen Bank (member)
First Investment Bank (member)
Banka Kombetare Tregtare (member)
Emporiki Bank (member)
Alpha Bank (member)
International Commercial Bank (member)
Intesa SanPaolo (member)
ProCredit Bank (member)
National Accounting Council (member)
FSA (member)
KPMG (member)
Deloitte (member)
PWC (member)

PWG meetings:
1st meeting – July 3, 2008; Output: Project ToRs; Note on the Albanian Statutory Framework; Note on European Experience in Implementing IFRS; Note on IFRS implementation on banking regulations; The implementation of IFRS 1 - Time adoption, in Albania.
2nd meeting –July 29, 2008; Output: Note of the European Experience (sent to NAC); Main findings of the banking survey on banks' readiness to implement IFRS; Inventory of banking regulations, preliminary categorization according to the depth of impact.
3rd meeting – September 22, 2008; Output: Inventory of banking regulations, final categorization according to the depth of impact; Main changes introduced by IFRS – 1 slot of regulations (deeply affected).
4th meeting – October 29, 2008: Output: Main changes introduced by IFRS – second slot of regulations; Consultations document.

Contributions:
PWG members: participation in PWG meetings and discussions; answers to the questionnaire on banks' readiness to implement IFRS; feedback on regulations categorization and on changes introduced by IFRS on individual regulations; reconciliation tables; participation in the discussions with NAC; MoF and Tax Authorities.
SPI Secretariat: draft Project ToRs; Note on the Albanian Statutory Framework; Note on European Experience in Implementing IFRS; Note of IFRS implementation on banking regulations; The implementation of IFRS 1 - Time adoption, in Albania; Note of the European Experience (sent to NAC); Draft questionnaire on bank's readiness to implement IFRS; Main findings of the banking survey on bank's readiness to implement IFRS; Inventory of banking regulations, categorization according to the depth of impact; collection and aggregation of individual PWG contributions; daft the consultation document and participation in the discussions with NAC; MoF and Tax Authorities.
Other contributions: AAB support for running the bank survey.

Other Supportive Activities:
June Meeting with the leader of the ROSC Team
July Meeting with NAC; NAC interpretation of the Minister of Finance decree on the adoption of IFRS
October Meeting with the Deputy Minister of Finance and representatives from Tax Authorities

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1. Summary of PWG analysis

Bank of Albania is the supervisory authority of the banking system. One of the mechanisms used by Bank of Albania in carrying out its supervisory function is through continuously building and improving the regulative supervisory framework, in accordance to the best international principles and to the domestic developments.

The mandatory adoption of IAS/IFRS by the financial institutions in Albania is an important step towards the evolution of global standards of accounting and is expected to ensure higher quality and comparability with the European and other developed countries.

On the other side, the adoption of the international standards raised the emergency to Bank of Albania to adapt the banking regulatory framework and aligned it with these developments in the domestic accounting platform. The Scoping of Problem document, presented in Annex 7, describes the context and the need for regulatory changes in order to fully implement IFRS in the banking industry.

The objectives of this project were achieved mainly through brainstorming and PWG discussions. The adaptation of the current banking regulative framework to the IFRS standards, preserving the prudential principles, required the harmonization of the Central Bank's perspective with the one of the commercial banks.

Objective 1 of the project - strategy followed by the PWG

Annex 3 details on the need of bringing clarifications to IFRS implementation time and procedures. In accordance with law no. 9228, dated 29.04.2004 "For Accounting and Financial Reporting", Chapter IV, the National Accounting Council is the authority responsible to interpret and generalize the problems evidence from practice regarding accounting standards (article 19.ç). In order to prompt for the issuance of a interpretation to the Decision of the Ministry of Finance on the timing of the full application of IFRS standards by NAC, the PWG and SPI Secretariat run a banking survey on banks' readiness to implement IFRS. In addition PMT and SPI Secretariat met with the Deputy Chairman of NAC's board. Annex 6 (point 1 and 2) presents details of the consultation process, including statistics and summary findings of the banking survey.

Objective 2 and Objective 3 of the project - strategy followed by the PWG –

In order to assess the impact of IFRS implementation in banking regulatory framework, SPI Secretariat prepared the comprehensive list of banking regulations. Project Management Team made a preliminary division of these regulations in three categories, having as references the priority of change and depth of impact. PWG members presented their comments and suggestions on the categorization. All contributions were discussed and PWG agreed on the final categorization.

In addition, PMT and SPI Secretariat met with the Deputy Minister of Finance and representatives from the General Directorate of Taxation (please see details on the respective discussions in Annex 6.3)

2. PWG Policy Recommendations

The Project Working Group Members, based on the professional and practical experience in reporting under IFRS for their respective parents, the documents prepared by SPI Secretariat on Albanian experience (Annex 4), the main findings of the banking survey (Annex 6.1), the International experience on IFRS implementation in Europe and changes (Annex 5) have discussed and agreed on a categorization of the regulations, with reference on the amending priority and on depth of impact, giving the sense of change.

PWG recommends that BoA:

- Issues *immediate* amendments to the following list of banking regulations:

	Regulation – Highly impacted	**Main areas of impact**
1	Regulation "On credit risk administration"[1]	− Loan loss provisioning policy; − Methodology on problem loans interest calculation
2	Regulation "On the amount and fill in the "initial minimal capital" on allowed activities for banks and foreign branches";	Treatment of capital BoA requires the revaluation of the capital with the current / spot exchange rate, while in IFRS the capital is recorded with historical value. Treatment of earnings – taking in consideration the loan loss provision according BOA regulation
3	Regulation "On foreign open positions";	Treatment of in and out-of-balance-sheet items and of the capital when they expressed in foreign currencies
4	Directive "On the interest rate risk administration"	Treatment of in and out-of-balance-sheet items
5	Bank Accounting Manual	Changes in the accounting charts Preconception of the Accounting Manual as a Methodology for preparing the reporting forms to BOA (SRU)

Annex 1 presents the detailed PWG comments and suggestions on the sense of changes to be brought to the above mentioned regulations.

- Issues amendments for the following banking regulations:

	Regulation – Moderately impacted	**Main areas of impact**
1	Regulation " On capital adequacy"	Treatment of capital – prudential standards vs. accounting standards
2	Regulation "On market risk"	
3	Directive " On banks' regulatory capital "	
4	Regulation "On administrating banks' large risk exposures"	Treatment of financial assets
5	Regulation "On consolidated supervision"	Adjustment of definitions
6	Regulation "On external audit"	Adjustment of definitions
7	Directive "On foreign exchange risk"	Treatment of financial assets and revaluations

[1] The methodology of loan provisioning is highly impacted by IFRS implementation, but as clearly stated during the PWG meetings, BoA intends not to make any change in the regulation "On administration of the credit risk", for the time being. Banks have to calculate provisions using both IFRS and BoA regulations.

8	Directive "On Deposit certificates"	Redefinition of accounting references

Annex 2 presents the detailed PWG comments and suggestions on the sense of changes to be brought to the above mentioned regulations.

- Does not amend the following banking regulations:

	Other regulations, not impacted
1	Regulation "On Credit Bureau in the Republic of Albania"
2	Regulation "On the use of information and communication technology on the subjects licensed by Bank of Albania"
3	Regulation "On anti- money laundering"
4	Directive "On bank's custody and liquidation"
5	Directive "On foreign exchange reports"
6	Directive "On the procedures for extracting the report on borrowers and on the revision of the information stored on the Credit Register"
7	Regulation "On risk administration in the foreign bank branches activities"
8	Regulation "On bank's investments on commercial companies' capital"
9	Regulation "On foreign exchange activity"
10	Regulation "On internal control systems of banks and foreign branches"
11	Regulation "On administrators of banks and foreign branches"
12	Directive "On bank's liquidities"
13	Manual on the corrective actions toward banks and foreign branches in the Republic of Albania

PWG recommends that BoA follows the below **action plan** for the issuing the amendments in order to harmonize the banking framework with the IFRS platform, adjusted by the necessary prudential concerns:

I. ***First phase***:

- Revises and sets the principles on the treatment of the chart of accounts and on the reporting scheme for regulatory purposes – this includes detailed guidance on preparation and presentation of the schedules required for the purpose of meeting the Bank of Albania regulatory requirements;
- Starts the procedures for a detailed revision and adaptation of the first group of regulations – highly impacted by IFRS implementation.

II. ***Second phase***

- Embodies in regulations the identified changes;
- Starts the procedures for a detailed revision and adaptation of the second group of regulations –moderately impacted by IFRS implementation.

Other PWG considerations

In article 4/3 of the Law No. 9228, "On Accounting and Financial Reporting (Accounting Law)", dated 29.04.2004, requires that listed companies, banks and other financial institutions and large unlisted companies prepare their legal individual and consolidated financial statements (article 9) according IFRS. The Minister of Finances, based on the legal provisions and the availability of the standards in Albanian, authorized the application of IFRS in 2008 for the financial statements. By

these means, all the companies, as defined by the law, can apply IFRS instead of the Albanian National Accounting standards to present their financial statements in 2008. These comprehensive changes in accounting standards will have a deep impact on banks and will result in substantial changes in the accounting information used to calculate their regulatory ratios.

PWG appreciates that Bank of Albania will make all the necessary adjustment in the banking regulatory framework to reflect the new accounting platform. Anyhow, being the banking Supervisory Authority, it is expected that the prudential objectives with regard to financial stability will prevail to any other action.

3. Proposed SPI Committee decision

SPI Committee endorses PWG recommendations for further presentation to the Bank of Albania for facilitating the drafting by the Supervision Department of the new specific regulations.

Annexes

Annex 1

Main Areas of Impact: Regulations with High Priority

Regulations with High Priority

1. Regulation on Credit Risk Administration

Purpose of this regulation is the administration of credit risk to minimize potential losses from loans and other similar assets sensible to interest rates fluctuations.

- Substantial differences in loan provisioning policy

Under the current framework, loans are classified in 5 categories – standard loans, special attention loan, substandard loans, doubtful loans and lost loans (art.7). Among many characteristics, the days past due serve as the pivotal characteristic that rules the classification of the loan during its maturation process. To cover for potential losses from default, the bank has to create allowances, provisions, weighting periodically its expenses, respectively to the category the provisions are 1%, 5%, 20%, 50% and 100% (art.15).

Under IFRS, in accordance with IAS 39 the loan portfolio should be registered at amortized cost and subject to impairment measurement if there is an objective evidence of impairment as result of events that occurred after initial recognition of the asset and that loss event (or events) has an impact on the estimated future cash flows of the loan portfolio (financial asset) that can be reliably estimated.

The bank first has to assess whether exist objective evidence of impairment on individual or collective financial assets[2].

- If for an individually assessed asset is determined that no objective evidence of impairment exists the asset is included in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment.
- If for an individually assessed asset is determined that an impairment loss is or continues to be recognized the asset is not included in a collective assessment of impairment.

To make sound assessments on objective evidence of impairment of given financial assets requires experience in credit judgment, sound estimate techniques and comprehensive information data set systems with historical information on financial assets and groups.

- Different treatment of the calculated interest on problematic loans

Under the current framework, the calculated interests of the substandard, doubtful and loss loans are not recorded on books, in order not to burden the financial statements with interests that have a low possibility of recovery (art.13).

Under IFRS, in accordance with IAS 39 – AG 39, when an financial asset is removed as result of a lost from devaluation, the revenues from the interests are recognized, using the interest rate that is used to discount future cash flows of the monetary assets

[2] The assessment is done individually or collectively based on their significance.

in order to measure the devaluation lost.

2. Regulation "On the amount and fill in the "initial minimal capital" on allowed activities for banks and foreign branches"

Under the current framework, if the minimal paid in capital is in foreign currency, the bank has to revaluate the capital with the current / spot exchange rate, creating a "revaluation difference" (art.4.2.1)

Under IFRS, in accordance with IASX, capital is considered as "non-monetary" item and consequently is recorded in books with historical value. The capital is converted with the exchange rate in the date of transaction, eliminating the need to record revaluation differences.

The selected approach to convert the capital, in addition to the minimal paid in capital, affects the regulatory capital and consequently the capital adequacy ratio.

The profits calculated according to IFRS differs from the amount of profits calculated according BoA's requirements (general IFRS earning > statutory earnings). The discrepancy will be reflected in the "dividend policy".

- According to IFRS's calculations the bank might have a substantial level of profit to distribute dividends and to preserve a satisfactory level of the capital requirements; but
- According to statutory accounting calculations the bank might not have enough profits as to distribute and to preserve capital requirements.
- The extreme case: According to IFRS standards the bank is in profits and according to BoA standards the bank is in loss

3. Regulation on Foreign Open Position

The purpose of this regulation is the definition of rules for the measurement of the foreign open position for banks. These rules aim to limit banks' losses from foreign currency transactions and precious metals.

Under the current framework, banks have the power to interpret regarding the out-of-balance-sheet items expressed in foreign currencies. It has to be specified which items has to be included in the process of valuating the foreign open position and it has to be specified as well the methodology (statutory or IFRS) to be used to calculate the underlying items.

4. Regulation on Interest rate risk administration

The purpose of this Guideline is to provide recommendations regarding risk management, which risk derives from bank's position in securities, financial instruments trading portfolio, and interest rate fluctuations, as well as to evaluate bank's adequacy and effectiveness in the management of interest rate risk.

The same rationale as for the regulation on Foreign open position lies behind the regulation on Interest rate risk, regulation on Market risk and directive on Risks for foreign exchange.

The European experience with Interest rate risk management

The new international standards, as they apply to overall interest rate risk management in the banking sector, and IAS 393 in particular, initially gave rise to fears that sweeping changes would be required in the implementation procedures for asset-liability management (ALM) if no alterations were made to adjust the new principles to the context of macro-hedge accounting. Then, the application of IAS 37 on Provisions, Contingent Liabilities and Contingent Assets led to the calculation of a provision to cover the risk of the exercise of options embedded in home savings schemes.

Adoption of IAS 39 with the transitional carve-out solution.

The discussions preceding the European Commission's adoption of IAS 39 on 19 November 2004 focused on ALM. The most difficult aspects were the following ones:

– The impossibility of hedging a net position or dynamic management of hedged items and hedging instruments;

– The risk of instruments being disqualified from hedge accounting in the event of a shortfall in the hedge or the associated underlyings;

– Recognition of sight deposits, when the IASB deems that the fair value is equal to the nominal value, whereas, with regard to balance sheet management, such deposits obey runoff rules that ought to reflect their statistical stability.

IAS 39 was finally adopted on 19 November 2004, after major adjustments. The European Commission adopted only part of IAS 39 after carving out some of its provisions.

The carve-out concerns the following macro-hedge accounting principles:

– Looser requirements for hedge effectiveness to avoid disqualification in the event of a shortfall in the hedge or the underlyings;

– Lifting the ban on including sight deposits in hedged items.

This means that the version that was ultimately approved by the European Commission has had, in practice, only a limited impact on overall interest rate risk management.

Annex 2

Main Areas of Impact: Regulations with Medium Priority

Regulations with Medium Priority

1. Regulation "On capital adequacy"
The purpose of this regulation is to calculate the ratio – Capital Adequacy Ratio, between the regulative capital and the risk weighted off-balance sheet items; and to set a minimum threshold of this ratio – The Minimum Capital Adequacy Ratio.

In the nominator, the regulative capital is calculated in accordance to the Directive "On banks' regulatory capital".
In the denominator are included the sums of the weighted items of selected balance sheet items, off balance sheet items that represent the contracts of the financial instruments, related with the interest rate and the exchange rate and other off balance sheet items.

2. Regulation "On market risk"
The purpose of this regulation is the calculation of the Regulatory Capital to cover market risks. Market risk shall mean the risk of loss for on- and off- balance sheet positions as a result of changes in prices of financial markets. It involves analysis of position risk for:
1. the interest rate on fixed-income securities;
2. the market value of variable-income securities;
3. settlement of payment with the counterparty;
4. the surpass of limits on significant risks;
5. the foreign exchange.

Regulatory Bank Capital to cover market risks is:
1.1. Residual Base Capital
1.2. Residual Additional Capital
1.3. Capital Surplus

3. Directive on "On banks' regulatory capital"
The purpose of this Guideline is to define the calculation method of Regulatory Capital of banks in order to cover credit risk.
Regulatory Bank Capital to cover credit risk is composed of **core capital** and **supplementary capital**.

IFRS introduce new accounting principles that have an impact on the measurement and nature of the items used to compute prudential capital. In order to net out the effect introduced by IFRS is require the use of prudential filters. Specifically, the widespread use of fair value and the accounting options available under IFRS seem to be in contradiction with the objectives of prudential supervision in some cases.

IAS 39 deals with the recognition and measurement of financial instruments. The standard is based on a mixed model that combines fair value for trading portfolios and cost for the other portfolios, but with an extended use of fair value.

In some cases, more extensive use of fair value may increase income and own funds volatility. If the volatility is economically justified and provides a true reflection of the institution's financial situation, it can actually play a positive role from the prudential point of view as it might provide a better tool to the assess the scale of risk exposure for the bank, the shareholders and the supervisors. This means that fair value is often a helpful accounting tool, as long as it is measured prudently.

On the other hand, generally the measurement of non-trading assets and liabilities[3] at their presumed fair value relies primarily on internal valuation models and these valuations measurements can be unreliable and vary greatly from one entity to the next. They can be economically unrealistic, since it is practically impossible to carry out actual transactions on the basis of the valuations made in this way. The real economic nature of the volatility of the values shown in the accounts is uncertain and deceptive. The volatility created by the expanded use of fair value does not reflect the underlying economic reality of intermediation transactions and is not material, given the duration of the transactions, it is actually just "accounting" volatility and detrimental to a true representation of credit institutions' financial situation, profitability and risk exposure.

Some of the provisions of IFRS would give rise to income and equity volatility that appears to be artificial from the outset. For example, the accounting treatment of hedged future transactions or future cash flows obviously gives rise to artificial equity volatility, because variations in the fair value of the hedging transactions have a direct impact on equity, without taking into consideration the opposite variations in the fair value of the hedged transactions or cash flows.

Committee of European Banking Supervisors (CEBS) has assessed the potential impact of the new international accounting standards on the prudential ratios calculated on a consolidated basis and has made the following proposals on the use of prudential filters in the context of the IFRS:

1. To apply the following adjustments and prudential filters on own funds of institutions:

- Institutions shall not include in own funds the fair value reserves related togains and losses on cash flow hedges, other than cash flow hedges on available for sale assets where the treatment should be consistent with that of the reserve created for the relevant assets.
- Institutions shall not include in own funds the consequences (gains and losses) resulting from valuing liabilities at fair value that are due to changes in their own credit standing. CEBS is aware that the Fair Value Option is not, under the EU carved out version, currently available on liabilities.

2. As a general principle, no filter should apply to impairment losses which, therefore, should flow through original own funds.

3. For the revaluation reserves on available-for-sale assets the following filters shall apply:

- for equities, unrealised losses should be deducted after tax from original own funds and unrealised gains should only partially be included in additional own funds before tax. Partially means that at least the tax effect should be taken into account;
- for loans and receivables, included in the available-for-sale category, the unrealized gains and losses, apart from those related to impairment, are neutralised in own funds after tax;

[3] As non-trading assets and liabilities are rarely, actively traded on markets and usually managed over the medium to long term.

- for the other available-for-sale assets, two methods can be applied, either that applied to equities or that applied to loans and receivables.

4. To keep the current prudential classification or definition of :
   - Debt and equity, as CEBS is of the opinion that issued financial instruments can be included in own funds if they respect the criteria of the directive on own funds regardless of the accounting classification and for the amount which would exist if no separation between liabilities and equity had been made. Competent authorities should also have the possibility to exclude from regulatory capital some instruments booked in equity or to classify these instruments as hybrid original own funds or additional own funds.
   - The trading book, as CEBS considers that the accounting classification of items as trading should not be carried through to prudential regulation.

On the treatment of revaluation reserves arising from fair valuing investment property or property plant and equipment, CEBS encourages national competent authorities to apply the following treatment:

- unrealised losses should be deducted after tax from original own funds;
- cumulative unrealised gains should only partially be included in additional own funds before tax. Partially means that at least the tax effect should be taken into account;
- additionally national competent authorities are encouraged to consider the need for transferring unrealised gains, if any, resulting from the first time application of the cost method to properties from original own funds to additional own funds.

4. Regulation "On administrating banks' large risk exposures"

The purpose of this regulation is to define rules and criteria on calculating, supervising and reporting the large exposures of the bank toward a client or a group of clients related among them or with the bank, in order to administer the risk generate from a concentrated exposure.

The exposure toward a client or a group of clients related among them or with the bank is considered large when its value is equal or larger than 10 per cent of the regulatory capital.

Current methodology:
From the calculated exposure is deducted the value of defined collateral.

The calculations on exposure are based on the definitions of the law "On banks in the Republic of Albania", article 62, and refer to the amounts in the balance sheet or commitments of-balance sheet of all the relations of the bank or branch with a third person(s) or related parties.

In the calculations:
- Selected security investments with 0% risk are deducted;

[4] According to article 15.a in the law "On accounting and financial statements", states that financial reports are prepared and presented in the Albanian language and the values are expressed in the national monetary unit. In addition, article 8.3 in the same law states that economic entities may record their economic transactions and balances in foreign currencies and convert them in the Albanian currency, according the respective accounting standard.

- Selected security investments with low risk are weighted with 20%;
- Selected security investments with medium risk are weighted with 50%;

The items employed by this methodology (balance sheet items, off-balance sheet items and security investments) are recorded on accounting books based on the accounting principles in power.
In IFRS, according to IAS 39, the categorization of financial statements, initial recognition and subsequent measurement differs from the previous accounting standards. These divergences might imply differences in the categorization and financial effect with relation to the large exposure measurement.

In addition the large exposures rules might need to be reviewed to take into consideration the future revision Capital Requirement Directive and also the interrelationship between the measurement of these exposures in Pillar I and the Pillar II rules on concentration of risk

5. Regulation "On consolidated supervision"
The purpose of the consolidated supervision is to assess the position to risk(s) not only of the activities of the company, but the activity of its subsidiaries and significant interests, as well
Consolidated supervision consists of:

1. Consolidated accounting.
2. Quantity supervision.
3. Quality supervision.

Adjustment in accordance to IFRS

- Adjustment of the definition of "the branch".
- Adjustment of the definition of "participation".
- In the function of "Consolidated accounting" should be introduced the notion of "Uniform application of accounting policies".

6. Regulation "On external audit"
In this regulation are defined:
• The criteria and procedures on the approval of authorized chartered auditors being appointed from banks;
• The scope of activity; form and content of both audit and auditing' reports of banks of the authorized chartered auditors.

For the purpose of this regulation, "the auditing performed by the authorized chartered auditor" includes:
a- the auditing of basic financial statements, that thereafter will be called "financial statements", which are prepared by the bank in accordance with "International Accounting Standards (IASs), except otherwise defined in the Law "On accounting" and in the "Bank Accounting Manual". The basic financial statements are prepared to be published for general use;
b- the assessment of financial statements of particular character prepared by the bank in accordance with the Bank of Albania by-laws;
c- the assessment of sufficiency, quality and implementation of the bank by-laws and procedures.

The adoption of IFRS from banks and the alignment of the banking regulations with the new accounting standards will require a new specification of the auditing that will be performed by the authorized chartered auditor.

7. Directive "On foreign exchange risk"

This directive presents the concept of the risks that steam from foreign exchange open positions and how to administer these risks.

According to IAS 21 the foreign currency is any currency other than the functional currency[4] of an entity. The functional currency is the currency of the primary economic environment in which an entity operates. Foreign currency transactions can arise when an entity (a) buys or sells goods or services whose price is denominated in a foreign currency; (b) borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency; or (c) otherwise acquires or disposes of assets, or incurs or settles liabilities denominated in a foreign currency

a. Divergences in initial and subsequent measurement

According to the current framework, the position in Lek (functional currency) for every currency is calculated by using the respective exchange rate in the reporting date (in the end of the month)

According to IFRS for the initial recognition the foreign currency transactions are recorded on initial recognition in the functional currency at the transaction rate (the spot exchange rate at the date of the transaction) between the entity's functional currency and the foreign currency. An average exchange rate may be used for all transactions occurring during a period of say a week or a month, if exchange rates do not fluctuate significantly. However, if exchange rates fluctuate significantly, the use of average rates is inappropriate

Subsequent measurement of the financial instruments- IFRS.

Financial instruments can be monetary or non-monetary and may be carried at fair value, cost or amortised cost. Where a financial instrument is denominated in a foreign currency, it is initially recognised at fair value in the foreign currency and translated into the functional currency at the spot rate. The fair value of the financial instrument is usually the same as the fair value of the consideration given in the case of an asset, or received in the case of a liability.

The foreign currency amount of financial instruments carried at amortised cost or cost is translated into the functional currency using either the closing rate (if it is a monetary item) or the historical rate (if it is a non-monetary item) for subsequent measurement. Financial instruments carried at fair value are translated to the functional currency using the closing spot rate.

b. Divergences in the treatment of gains/loses as result of evaluation

According to the current framework, foreign currency revaluation is done with the spot exchange rate of the previous day, as calculated by BoA. Gains or loses from the revaluation are recorded as revenues or expenses in the profit and loss account (chapter IV).

According to IFRS the entire change in the carrying amount of a non-monetary

available-for-sale financial asset, including the effect of changes in foreign currency rates, is reported in equity at the balance sheet date.

A change in the carrying amount of monetary available-for-sale financial assets on subsequent measurement is analysed between the foreign exchange component and the fair value movement. The foreign exchange component is recognised in profit or loss and the fair value movement is recognised in equity.

The entire change in the carrying amount of financial instruments measured at fair value through profit or loss, including the effect of changes in foreign currency rates, is recognised in profit or loss within fair value differences on subsequent measurement.

Notions related to the monetary unit

Identification of the functional currency

The functional currency is the currency of the primary economic environment in which the entity operates. The primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash. An entity's management considers the following factors in determining its functional currency:

a. The currency that dominates the determination of the sales prices; and

b. The currency that most influences operating costs.

The currency that dominates the determination of sales prices will normally be the currency in which the sales prices for goods and services are denominated and settled. It will also normally be the currency of the country whose competitive forces and regulations have the greatest impact on sales prices. The currency that most influences operating costs will often be the currency in which such costs are denominated and settled. The emphasis is, however, on the currency of the economy that determines the pricing of transactions, as opposed to the currency in which transactions are denominated, if these are different.

Factors other than the dominant currency for sales prices and operating costs are also considered when identifying the functional currency. The currency in which an entity's finances are denominated are also considered. The focus is on the currency in which funds from financing activities are generated and the currency in which receipts from operating activities are retained. Financing activities include issuing debt and equity instruments.

Additional factors are considered in determining the functional currency of a foreign operation and whether its functional currency is the same as that of the reporting entity. These include considerations of the autonomy of a foreign operation from the reporting entity and the level of transactions between the two. Consideration is also given to whether the foreign operation generates sufficient cash flows to meet its cash needs and whether the cash flows of the foreign operation directly affect those of the reporting entity.

When the above indicators are mixed and the functional currency is not obvious management uses its judgement to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions. Management gives priority to the currency most affecting sales prices and operating costs before considering the currency most relevant to the financing of an entity and the degree of autonomy and independence. The latter factors are designed to provide additional supporting evidence in determining an entity's functional currency

Presentation currency

An entity may present its financial statements in any currency (or currencies). IAS 21R prescribes a specific methodology for translating from the functional currency to the presentation currency, where the functional currency is not hyperinflationary [IAS21R.39]:

a. Assets and liabilities are translated at the closing rate at each balance sheet date for each period presented

b. Income and expenses are translated at the exchange rates existing at the dates of the transactions. The average rates may be used if the exchange rate does not fluctuate significantly;

c. All resulting exchange differences are recognised as a separate component in equity

An entity whose functional currency is the currency of a hyperinflationary economy restates its financial information in accordance with IAS 29. The following procedures are followed for the translation of the financial information from the functional currency to the presentation currency:

a) Assets, liabilities, income and expenses are translated at the closing rate at the current balance sheet date;

b) When the presentation currency is non-hyperinflationary, comparative amounts shall be those that were presented as current year amounts in the relevant prior year financial statements; and

c) When the presentation currency is hyperinflationary, comparative amounts are translated at the closing rate at the date of the current balance sheet date.

8. Directive "On Deposit Certificates"

The first chapter of the directive defines the features of the Deposit of Certificates. The second chapter deals with the accounting of these instruments.

The adoption of IFRS will require:

a) The redefinition of the used accounting charts;

b) The initial recognitions; and

c) The subsequent measurement.

Annex 3

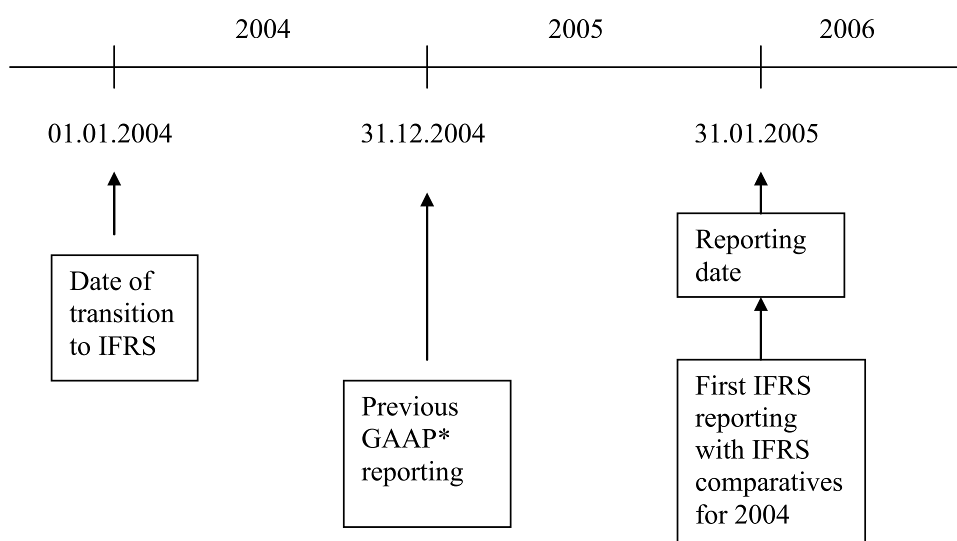
Objective 1 of the project: To interpret the Order of the Ministry of Finance on the timing of the full application of IFRS standards

In May 2008, the Minister of Finance issued a decree No. 55, dates 05.05.2008, "On the announcement and the compulsory implementation of the International Accounting and Financial Reporting Standards IAS/IFRS translated in the Albanian Language". According to the decree the application of IAS/IFRS becomes compulsory from January 1, 2008 (art.2). This decree enters in power immediately and extends its effects from January 1, 2008.

IFRS 1 deals with the first-time adoption of IAS / IFRS
The general principle in IFRS 1 requires a first-time adopter to apply the version of IFRS effective at the reporting date retrospectively and therefore the first IFRS financial statements are presented as if the entity has always presented financial statements in accordance with IFRS.

The date of transition to IFRS is defined as the "beginning of the earliest period for which an entity presents full comparative information under IFRS in its first IFRS financial statements". According to IFRS 1, entities have to prepare financial statements and restate retrospectively the opening balance sheet, the first period for which full comparative financial statements are presented. The opening IFRS balance sheet does not need to be published as part of the IFRS financial statements rather it will be used as a basis for the preparation of those financial statements.

Opening Balance Sheet approach (dates are for illustrative purposes)



GAAP – Generally Accepted Accounting Standards – local accounting standards

Application of IAS/IFRS in Albania

Based on the decree of the Minister of Finance, the interpretation provided by NAC and on the PWG discussions, the application of IFRS in Albania will follow the following procedures:

1. First IFRS financial statements for a period beginning on or after **1 January 2008**.

2. An entity that adopts IFRSs for the first time in its annual financial statements for the year ended 31 December 2008 has to undertake the following:
• Selects its accounting policies based on IFRS in force at 31 December 2008.
• Prepares at least 2007 and 2006 financial statements and restate retrospectively the opening balance sheet (first period for which full comparative financial statements are presented) by applying the IFRSs in force at 31 December 2008:

- since IAS 1 requires at least one year of comparative prior period financial information, the opening balance sheet will be 1 January 2007 if not earlier; and
- if a 31 December 2008 adopter reports selected financial data (but not full financial statements) on an IFRS basis for periods prior to 2007, in addition to full financial statements for 2006 and 2007, that does not change the fact that its opening IFRS balance sheet is as of 1 January 2007.

Annex 4

The Albanian experience in implementing IFRS

I. Statutory framework

II. Banking regulations framework.

III. Main changes identified by the users (banks) brought by IFRS implementation in the financial statements

I. Statutory framework

- The legal identity of all entities in Albania is established in the Law No. 7850, dated 29.711994, The Civil Procedure Code of the Republic of Albania (CPC). In CPC are identified the nature of commercial entities as private legal persons. It further outlines the liabilities of legal persons, the creation and content of obligations, and the legal foundations of the agency (management versus owners) relationship.

- The formation and regulation of the business entities is governed by the Law No. 7638, dated 19.11.1992, For the Commercial Companies. The regulatory framework in this regard is completed by sector specific laws, regulations and guidelines.

- The formation, regulation and the activity of banks is governed by the Law No. 9662, dated 18.12.2006 On Banks in the Republic of Albania.

With regard to accounting and auditing, the law regulates the function of:

  - (art. 38) *Audit Committee*, which is responsible for: (a) controlling and supervising the application of accounting procedures and internal audit, including those set by BoA; (c) proposes the authorized / external auditor; (e) approves public financial reports and declarations.
  - (art. 47) *Financial reports and accounting standards*, have to follow the form and substance of the Law on Accounting and the International Accounting Standards.
  - (art. 48) *External audit*, which is selected by the assembly of the shareholders and approved by BoA, performs the statutory audit of bank's financial statements. The statutory audit should apply the accounting and financial standards set in the Law of Accounting and by IFRS.

- The accounting standards and reporting, for the economic entities for profit located in the territory of the Republic of Albania are governed by the Law No. 9228, dated 29.04.2004, For Accounting and Financial Reporting (Accounting Law), in power since January 1st, 2006. In the law (article 4/3) is required that listed companies (none actually), banks and other financial institutions and large unlisted companies (not defined) to prepare their legal individual and consolidated financial statements according to IFRS (art. 9).

- The Accounting Law is complemented by the General Accounting Plan – Council of Ministers Decree No. 783, dated 22.11.2006, On the Accounting Standards and Regulations. The new Accounting Plan entered in force with the Law in Accounting and will have legal power until December 31st, 2007 (article 3).

- In May 2008, the Minister of Finance issued a decree No. 55, dates 05.05.2008, On the announcement and the compulsory implementation of the International Accounting and Financial Reporting Standards IAS/IFRS translated in the Albanian Language. IAS/IFRS become compulsory from January 1, 2008 (art.2).

- In April 2008 was translated the whole set of International Accounting Standards, International Reporting Standards and the commentary (summary) translated in Albanian by the English company IMCL.

II. Banking regulations framework.

Bank of Albania is the supervisory authority for the subjects licensed by it. According to the Law no. 8269, dated 23.12.1997 "On Bank of Albania", Bank of Albania has the exclusive authority to approve the commencement of the activity for banks through licenses and to supervise the activity of the licensed entities. Bank of Albania has the right to issue by-laws; decrees, regulation, guidelines and orders, to fulfill its mission as supervisory authority. BOA issues general and prudent regulations and guidelines for banks. All these create the supervisory regulatory framework for subjects licensed by BoA. The regulative framework is in line with "The Core Principles for an Effective Supervision" and all other guidelines issued by the Basel Committee on banking supervision.

Table 1. Inventory of Banking Supervision Framework

Laws
Law "On Banks", revised in 2006
Regulations
Regulation "On administering bank's large exposure risks"
Regulation "On internal control systems of banks and foreign branches"
Regulation "On Credit Bureau in the Republic of Albania"
Regulation "On risk administration in the foreign bank branches activities"
Regulation "On the use of information and communication technology on the subjects licensed by BoA".
Regulation on the Consolidated supervision.
Regulation "On anti- money laundering"
Regulation "On administrators of banks and foreign branches"
Regulation "On Credit risk administration"
Regulation "On foreign exchange activity"
Regulation "On statutory auditor / external authorized auditors"
Regulation "On bank's investments on commercial companies' capital"
Regulation "On market risk"
Regulation "On capital adequacy"
Regulation "On foreign exchanges' open position"
Regulation "On the amount and fill in the "initial minimal capital" on allowed activities for banks and foreign branches".
Directives
Directive "On foreign exchange reports"
Directive "On bank's custody and liquidation"
Directive "On Deposit Certificates'"
Directive "On interest rate risk administration"
Directive "On bank's liquidation"
Methodical directive "On foreign exchange risks"
Directive "On banks' regulatory capital"
Directive "On the procedures for extracting the report on borrowers and on the revision of the information stored on the Credit Register"
Manuals
Manual on the corrective actions toward banks and foreign branches in the Republic of Albania.
Bank Accounting Manual

Issued in 1999, with the support of Ernst and Young

III. Main changes identified by the users (banks) brought by IFRS implementation in the financial statements

BALANCE SHEET
ASSETS
Amortized cost of loan portfolio, to be adjusted according to the effective interest rate method (IAS 39). Adoption of effective interest rate method for acknowledging of income also impact on interest income and commission income.
Loan loss impairments. Regulatory requirements on loan loss provisions significantly diverge from the IAS / IFRS requirements.
Fair value measurement of financial instruments under IFRS 39.
Amortization expense. Bank accounting manual prescribes some rates of amortization for different categories of assets. This does not seem to converge with IAS / IFRS requirements.
LIABILITIES & EQUITY
Revaluation of the capital held in currencies different from ALL has to be included in P&L instead of Balance sheet as it is actually reported.
PROFIT AND LOSS
Income from FX operations and accounting treatment of foreign currency denominated equity. While the existing standards allow the usage of some "Translation reserve account" to account for the differences between historical cost of equity and current value, under IFRS such variation has to go through P&L.
Deferred tax asset / liability. This derives from the above listed adjustments.
Expenses for the reconstruction of the branches which are not property of the bank should not be amortized any more based on the life of the rent contract but have to be included directly in the P&L.
Start up cost expenses will not be amortized but will go directly to P&L. (Adjustment of start – up costs capitalized on Intangible Assets and reclassification in P&L account.)
Reclassification in P& L account of the amount of inventories in use, held according to old standards in Other Assets.
RECLASSIFICATIONS
Adjustment related the reclassification of statistical provisions of loans from liabilities to contra – assets accounts.
Reclassification of Statutory Reserve with Central Bank.
Reclassification of Difference from Capital Revaluation in to P&L account (the capital should be held with historical cost).

Source: Survey "On Banks' readiness to implement IFRS", SPI Albania, July 2008.

Annex 5

International experience in implementing IFRS

A. European Experience with IAS/IFRS implementation
B. Some of the Main Changes Brought In Europe by Implementing IFRS

A. European Experience with IAS/IFRS implementation

I. Implementation of IFRS in Europe: Record of the Main Legislation Process
II. IFRS Application Some Countries

The Lisbon Summit of the European Council in 2000 established the necessity of a unique set of accounting standards in the EU, for those consolidated groups listed in a stock market from year 2005 onwards, with the goal of promoting the creation of a European integrated capital market. The standards chosen were those issued by the IASB (International Accounting Standard Board): the International Financial Reporting Standards (IFRS, known until 2002 as International Accounting Standards – IAS) and some interpretations related with them (IFRI – International Financial Reporting Interpretation - or SIC in their former acronym).

The adoption of IFRS means a breaking point with the accounting rules and principles of each Member State, as well as a first step into an effective harmonization throughout the EU.

I. Implementation of IFRS in Europe: Record of the Main Legislation Process

In 1995, the Communication "Accounting Harmonisation: a new strategy vis-à-vis international harmonisation" **proposed that the member states allow the Global Players to use IFRS**, as long as these standards were in conformity with the Accounting Directives and their implementation in the European countries. As shown in the summary table, some European countries adopted this proposal (namely, Austria, Belgium and Germany). It was accepted that Accounting Directives would be amended to eliminate conflicts -if any- with IFRS.

In February 2001, **the proposal for a Regulation of the European Parliament and of the Council on the application of International Financial Reporting Standards**, introduced the requirement for all EU listed corporations to produce their consolidated accounts in conformity with the IFRS, at the latest in 2005, and proposed the **setting up** of an **Accounting Regulatory Committee (ARC)** mandated by the Commission, at the political level, and the **European Financial Reporting Advisory Group (EFRAG),** a private group of European experts in accountancy to act as a liaison between the EU and IASB5.

In **July 2002**, the European Council approved the EU regulation. Companies listed in Europe have to establish their consolidated accounts in accordance with IFRS by 2005. Postponement until 2007 was granted to companies that use another reporting system, due to quotation on a non-European stock market, and to companies that only quote fixed-interest rate securities. The Regulation set a deadline to decide on the applicability of the IFRS: 31 December 2002.

On **1st January 2005**, the IFRS regulation came into force, moving over 8.000 listed European companies to IFRS. First financial statements presented according to IFRS were those for the first quarter of year 2005. 17. IFRS 2 was endorsed by the European Commission in **February 2005**. This standard is included in the stable platform, that is to say, standards to be applied by European listed groups when presenting their financial statements.

II. IFRS Application Some Countries

As mentioned above, the fact that there are no conflicts between European Directives and IFRS does not necessarily mean that there are no conflicts with the national laws of the European countries. Some European countries have decided to introduce in their national legislation the accounting options accepted by IFRS, which are available in the Accounting Directives, but which have not yet been implemented in the country (for instance, Spain is rewriting its national accountancy laws and, in addition, individual and consolidated accounts of financial institutions and also individual accounts of listed corporations must include from 2005 an IFRS reconciliation statement). Adopting this solution is very difficult in those countries with a close link between accounting and taxation (Germany and France, for example), and, consequently, it is rather difficult to adopt IFRS as the basis for the individual accounts. To sum up, for the individual accounts of all countries presented, there is no obligation to use IFRS directly.

a. Austria

The Austrian Commercial Code was amended in 1999 and allows all Austrian groups, whether listed or not, to use international standards instead of Austrian financial standards, if they comply with the EU Directives.
According to the regulations of the European parliament capital-market oriented companies are compelled to establish their consolidated accounts under IFRS with the beginning of the financial year 2005 as far as they are listed at a stock exchange within the European Union. Non capitalmarket oriented enterprises will still have a choice to establish their consolidated accounts under IFRS. The individual accounts of not capital-market oriented and capital-market oriented enterprises have to be established only under the Austrian commercial code.
As it stands only for information it will be allowed to establish the individual accounts under IFRS. This IFRS accounting will have no discharging effect because of the dependence between the Austrian commercial code and the Austrian tax law.

Those enterprises that are capital-market oriented will haven to create three different sets of annual accounts:

- tax accounts (tax law),
- individual accounts (Austrian commercial code),
- consolidated accounts (IFRS).

b. Belgium

Belgium's accounting framework is based on the Commercial Code of May 1999 and it’s implementing royal decree of 30 January 2001, while consolidated accounts are based on a particular royal decree of March 1990. The authorities set up the accounting regulation after taking into consideration the opinion of the ASC (Accounting Standard Commission). The main differences between Belgian legislation and IFRS are chiefly based on the prudence principle and on the existence of a tax burden that heavily influences Belgian rules, since Belgian financial statements are the main basis for corporate tax returns. **Global players are allowed to use IFRS (not subject to authorisation) or US GAAP (only until 2007 and subject to authorisation from the Ministry of Economy) to prepare consolidated accounts** (also including medium-sized companies to be listed on the EASDAQ). This is called the "Global Player Policy". 282 out of 886 companies used non- Belgian standards when preparing consolidated accounts (database on consolidated accounts filed with the NBB for the year 2005). Of these 282 companies, 166 used IFRS.

On the 9th of February 2005, a Royal Decree was published to regulate the use of IFRS in **consolidated** accounts:
Quoted companies:

- compulsory application of IFRS as from the 1st of January 2005, by virtue of the direct effect of the European IFRS Regulation

- postpone the application of IFRS until 2007 for companies that use another reporting system, due to quotation on a non-European stock market, and for companies that only quote fixed-interest rate securities

Unquoted companies:

- possibility to apply IFRS on a voluntary basis for accounting periods starting on or after 31st of December 2003

Regarding the **statutory** financial statements, the Belgian Accounting Standards Committee proposed four years ago to proceed to a practical adjustment of the current Belgian accounting law to the IFRS standards. To study this issue, three working groups have been established that concentrate on the following topics: tax law, company law and SMEs.

c. France

In April 1998, the CRC (Accounting Regulation Committee) was created with legal authority to approve new accounting standards. In practice, **only French standards are allowed12**. In 1999 a new methodology on consolidation was passed by the CRC in order to reconcile, to a certain extent, French GAAP with IFRS. Significant differences still remain (intangible assets, goodwill, business combinations, fair value and optional adjustments). In June 2003, the National Accounting Body (CNC) has restated its preference as regards the faculty given to each member states to adopt IFRS for individual accounts. At the latest in 2004, the French Parliament has followed CNC's preferences.

CNC's preferences:

Consolidated accounts	Listed groups	IFRS compulsory from 01.01.2005 onwards with postponement until 2007 for companies that only quote fixed-interest rate securities (approximately 970 groups concerned)
	Unlisted groups	Option given to the groups to adopt IFRS in 2005. Progressive convergence of national GAAP towards IFRS (approximately 8,000 groups concerned)
Individual accounts		**Option not allowed.** **Progressive convergence of national GAAP towards IFRS** with simplifications for SME

From 2005 listed companies must apply IFRS for their consolidated accounts (postponement until 2007 for companies that only quote fixed-interest rate securities), while unlisted groups have the option to adopt IFRS or national GAAP. Adaptation of regulation CRC 99-02 relating to consolidated accounts was completed in November 2005: new rules came into effect from 1st January 2006.

As regard individual accounts, the wish of the National Accounting Body (CNC) is a progressive endorsement of IFRS through a selective approach. **National rules have already evolved with the partial adoption of four IFRS, namely IAS 16, 36, 37 and 38.** Besides, **changes in tax regulation** seem to have preserved so far the link between accounting and tax.

The CNC worked on the impact of IFRS related to taxation, SMEs, and law issues. Reports were published in 2005 and 2006. About the SMEs project of the IASB, the CNC has analyzed the discussion paper, during regular meetings, focussing on four topics:

- consolidation

- financial instruments

- recognition of assets and liabilities
- presentation of financial statements

At least a new organization of the National Accounting Body (CNC) has been studied to increase its resources so as to improve its functioning and its influence in the decisions process.

d. Germany

In 1998 the law has been changed and from this year on it has been possible to draw up consolidated accounts under IFRS or US GAAP only, provided that the German company is listed on the German Stock Exchange. This regulation was valid until 2004. At the same time, the German Federal Ministry of Justice founded a Committee to represent Germany in international standard setting committees and to develop new standards for consolidated accounts based on the German Commercial Code**.**
Currently, a discussion takes place in Germany on the future of individual accounts, especially for these enterprises which are capital-market oriented and have to prepare the consolidated accounts according to IFRS from 2005 on. They prefer the idea of moving towards one commercial code for individual as well as for consolidated accounts.

On the other side, there are a lot of German enterprises which are not capital-market oriented and hence they are not very interested in changing their accounts towards IFRS or even adapting the German Commercial Code in small steps with IFRS-rules.

Another problem is the close relationship of German tax laws and the Commercial Code. There is a lot of conformity between them which enables German enterprises to create only one unified annual accounts. As IFRS can not be used as the basis for German taxes, a liberalization of the individual accounts towards IFRS would make it necessary that the German government establishes independent tax rules.

With the fiscal year 2005 the consolidated accounts of capital-market oriented German enterprises must be established under IFRS rules. Non capital-market oriented enterprises have a choice to establish their consolidated accounts under IFRS or German Commercial Code. Individual accounts of not capital-market oriented and capital-market oriented enterprises have to be established under the German commercial code. Only for information it is allowed to establish additional individual accounts under IFRS, which can be published in the federal gazette instead of the one based on the Commercial Code. This IFRS accounting will have no discharging effect because of the dependence between the German commercial code and the German tax law as well as capital maintenance rules. So far, no individual accounts under IFRS were published in the federal gazette.

A debate about the need to internationalize financial statements for small and medium-sized enterprises is currently taking place in Germany. The positions of the opponents are:

- it is very expensive to switch from German GAAP to IFRS rules with high employee training expenses and large investments in data processing systems,
- IFRS rules are frequently amended,
- many of the IFRS rules are very complex, some even being too complex for big corporations,
- IFRS rules are more comprehensive than the rules of the German commercial code.

The standpoint of the supporters is:

- it is not good to have two accounting classifications,

- banks and rating agencies want to have one system of accounts for their financial statements analyses, and that will probably be IFRS,
- many German small and medium-sized enterprises have a lot of international customers, IFRS financial statements fit their needs,
- some small and medium-sized enterprises look for investors or new owners, therefore it is better to have international accounts,
- some small and medium-sized enterprises are subsidiaries and they need to draw up financial statements based on IFRS in order to be consolidated. Therefore, costs should be reduced for these enterprises.

The publication of the Exposure Draft "IFRS for SMEs" gave this discussion a new direction. More or less all interested parties in accounting do not see this draft standard as appropriate for SMEs in Germany.

B. Some of the Main Changes Brought In Europe by Implementing IFRS

I. **Alternative Accounting Treatments in IFRS.**
II. **Asset Valuation Under IFRS.**
III. **Accounting versus Prudential Principles**

I. Alternative Accounting Treatments in IFRS.

There are no major conflicts between European Directives and IFRS. One of the areas of greatest conflict in the process of adoption of IFRS relates to those accounting treatments which give the option of choosing between two alternatives. This is perhaps still the most controversial aspect of IFRS, although the IASB worked in 2003 to reduce these alternatives, since it gives a margin of discretion to preparers of financial statements when preparing their accounts, with the danger that entails.

The accounting treatments which envisage alternatives are the following:

- Calculation of the **cost of inventory** using the FIFO or weighted average cost formulas, IAS 2.
- **Identification of geographical or business segments** as primary segments of the entity, in the presentation of financial information by segment, IAS 14[5].
- **Subsequent measurement of property, plant and equipment** at cost or at revalued amount, IAS 16.
- Accounting for non-monetary **government grants** received at the fair value of the assets received or at nominal value, IAS 20.
- Consideration of **government grants** relating to assets as reducing the value of the asset or as deferred income (on the liabilities side), IAS 20.
- Treatment of **grants relating to income** as other income or as deductions from the related expense, IAS 20.
- According to the revised IAS 23, **interest costs** must be compulsory accounted for as part of the cost of the relevant asset in case certain conditions are met. Those not meeting these requirements shall be treated as an expense.
- Recognition of an interest in a **jointly controlled entity** (joint venture) in consolidated
- Financial statements using proportionate consolidation or the equity method (alternative treatment), IAS 31[6].

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[5] IFRS 8, not yet endorsed by EU, removes this option by allowing reporting entities to freely define their segments.
[6] The exposure draft ED9 - Joint arrangements, issued in September 2007, removes this option by only allowing the equity method.

- **Subsequent measurement of intangible assets** at cost or at revalued amount, IAS 38.
- **Subsequent measurement of investment property** at cost or fair value, IAS 40.

In addition to these alternative accounting treatments, IFRS also envisage different options for the **presentation of the financial statements**. Income statement can be defined by function or by nature (IAS 1), the cash flow statement may be presented using the direct, the indirect, or the alternative indirect model (IAS 7), and the statement of changes in equity can be prepared on an aggregate basis or highlighting solely the profits and losses not recognised in the current period's results[7] (IAS 1). These alternatives even exist for the balance sheet, since IAS 1 allows the items to be presented according to their function within the operations of the enterprise (distinguishing the current from the non-current) or else according to their liquidity, though this last criterion should be rarely used, only when the current-non current is less reliable.

II. Asset Valuation Under IFRS

The table below discloses the different methods of valuation of the main asset items allowed by IFRS.

Type of asset	IAS	Method 1	Method 2
Inventories 2	2	The lower of cost and net realizable value	--
Property, plant and equipment	16	Acquisition cost, less accumulated depreciation	Revalued amount, less subsequent accumulated depreciation and impairment
Leases • Lessee	17	The lower the fair value of the asset and the present value of the minimum lease payment	--
• Lessor		Receivable at an amount equal to the net investment in the lease	--
Financial assets[8]			
Loans and receivables	39	Amortized cost (those with a fixed maturity) or cost	---
Held-to-maturity investment	39	Amortized cost (those with a fixed maturity) or cost	---
Available-for-sale financial assets	39	Fair value	If fair value cannot be estimated (unlikely to happen), at cost
Financial assets held for trading	39	Fair value	If fair value cannot be estimated (unlikely to happen), at cost
Investment property	40	Fair value	Acquisition cost, less accumulated depreciation and impairment losses
Biological assets	41	Fair value, less estimated point-of-sale costs	If fair value cannot be estimated (unlikely to happen), at acquisition cost,

[7] The revised IAS 1 issued in September 2007 modifies the set of financial statements to be disclosed, including a statement of other recognised income and expenses for those recognised directly in equity as well as the statement of changes in equity.

[8] IAS 39 also allows valuation of every financial asset (with some restrictions) at fair value, with fair value changes through income statement.

			less accumulated depreciation and impairment losses

III. Accounting versus Prudential Principles

The long-term objective of banking supervision is to ensure protection for depositors, to contribute to the smooth running of the banking system and to maintain financial stability. These factors imply that banking supervisors take a more prudent approach than that of accounting rules and conventions, particularly with regard to the measurement of regulatory capital.

Prudential supervisors have identified the exact characteristics required for items to qualify as regulatory capital. Such items must be:
– permanent (resilience);
– readily available for absorbing losses;
– reliable and indisputable when their amounts are concerned.

IFRS introduce new accounting principles that have an impact on the measurement and nature of the items used to compute prudential capital.

For example, due to IFRS application permanence requirement could result in excluding from regulatory capital profit and loss items or equity items that are especially sensitive to volatile economic data, such as the unrealised gains that are measured on the basis of market data or internal models. Similarly, some of the items recognised in equity are sure to be offset in the fairly short term by scheduled symmetrical transactions, such as unrealised hedging losses and gains on future cash flows or future operations, as well as equity components in compound debt instruments which will be offset by future interest expense representing an effective interest rate in excess of the coupon rate. These particular items seem to lack the permanence required to qualify as regulatory capital.

Unrealised gains recognised in equity on the basis of simple estimates may not meet the requirement of being immediately available to cover losses. This is the case for unrealised gains computed on financial instruments not traded on markets that are liquid enough or deep enough to absorb the sudden sale of a large quantity of assets, or when the assets in question are being managed on a long-term basis.

In addition, some valuation methods rely on internal models that incorporate assumptions that are specific to each company. The results cannot always be compared with market benchmarks, which makes it difficult to detect and remedy assessment errors and weakens comparability between companies. The reliability and indisputable nature of the amounts could thus be jeopardised, meaning that items measured in this way cannot be included in regulatory capital.
These uncertainties about the availability and the reliability of the amounts to be recognised as regulatory capital could warrant a haircut before being included and/or classified as additional regulatory capital rather than original regulatory capital.

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Annex 6

Consultation with Stakeholders

Consultation process

6.1. Consultations with banking community on Bank's readiness to implement IFRS

In order to assess the readiness of the banking system to implementing IFRS, SPI Albania with the support of Albanian Association of Banks – AAB, undertook a market survey. SPI Secretariat, in collaboration with the Project Working Group Members, prepared a questionnaire with two objectives:

1. To identify the number of Banks who have no prior experience in applying IFRS.
2. To assess the readiness of the Banks in implementing IFRS.

The questionnaire was delivered to all the banks in the banks operating in the system.

Summary of Consultation Process Statistics

Total members of AAB (no.):	**16 banks**
Market Share (100%):	**100%**
Total respondent banks (no.):	**11 banks**
Respondent ratio:	**68.8%**
Market share of the respondent banks:	
(reference indicator: total assets)	**67.6%**
Size of the respondent banks:	**small, medium, large**

Summary of the findings of the consultations with banking community on Bank's readiness to implement IFRS

1. Respondent banks represent a large share of the banking market, therefore the results of the survey may be considered as relevant. To a large extent, the findings of this survey can be generalized to the entire banking system[9].

2. The survey confirms that the largest part of the banking system is applying international financial reporting standards. Out of the 11 respondent banks only three banks have not applied IFRS yet, and one of them is under the implementation process.

3. The adjustment of human resources and IT systems to the requirements of IFRS implementation would need 3 to 6 months for HR and 7-12 month for IT in case the reports are to be produced automatically.

4. Regarding the main changes brought by IFRS, banks have identified different treatment of loan loss impairment, amortization of expenses, treatment of the income form various activities (FX, fees and commissions etc.), deferred tax asset / liability, reclassification of statistical provisions of loans from liabilities to contra – assets accounts, revaluation of the capital held in currencies different from ALL, fair asset value etc.

[9] The respondent banks cover all types of operational and ownership structures.

6.2. Consultations with the National Accounting Council

In order to acquire a clear understanding of the consequences of the decree of the Minister of Finances in the application and usage of the international standards by the eligible commercial entities a group representing the SPI Albania Project in IFRS met with deputy chairman of the Board of the National Accounting Council – NAC and a specialist on the council. The representatives of the project made a request[10] to the NAC to interpret the decree of the Minister of Finance on the adoption of IAS/IFRS in Albania.
SPI Secretariat sent to NAC for information a Note on The European experience in implementing IFRS and the Findings of the survey on Bank's readiness to implement IFRS.

The meeting preceded the NAC's board meeting in which the request for interpretation was discussed and prepared.

Summary of the interpretation provided by NAC

- NAC has not the legal right to modify the time limits defined in the law.

- Although the translation of IAS/IFRS in the Albanian language ended on May 2008, the users of the standards may apply the original published version, in English, which is the only version approved. The translated version serves only as support and to facilitate the implementation in domestic countries.
- All the entities defined in the law "On accounting and financial statements" as eligible to apply IFRS, should take all the necessary means for a correct application. The time period from 2004 when first was notified in the law the application of IFRS until 2008 is considered as sufficient for preparatory work.

6.3. Consultations with the Ministry of Finance and General Directory of Taxes

SPI Secretariat and the Project Management Team for the impact of IFRS implementation, met with the Deputy Minister of Finance and two representatives of the General Directory of Taxes. The objective of the meeting was to discuss the changes in tax reporting introduced by IFRS implementation.

Summary of the meeting with the Ministry of Finance and General Directory of Taxes

The PM of the SPI project presented the concerns raised by banks during the project working group (PWG) meetings related to the financial reports for the Tax Authorities. Actually, according to the article 25 on the law "On tax on income", no. 8438, dated 28.12.1998, to determine the taxable profits for banks and insurance companies are used the known technical provisions created (for banks) in accordance to the rules set by Bank of Albania in this regard.

Banks are concerned with the divergences that will arise as result of the different methodologies of calculating these technical provisions (loan loss provisions) by Bank of Albania (BoA) and by IFRS – the accounting standards in power since January 1st, 2008.

[10] A formal request for interpretation to NAC was sent as well by the Supervision Department, Bank of Albania.

Bank of Albania's methodology in calculating the loan loss provisions is based on prudential principles, while IFRS methodology is based on accounting principles - the evidence of impairment of the financial assets. Due to the difference in principles, the provisions and consequently the calculated taxable profit are different.

The representatives from the tax authorities stated that they are preparing a draft law proposal with scope to harmonize the tax procedures (tax on income) with the new accounting standards i.e. IFRS.

In addition, they stated that the link with BoA regarding the technical provisions most probably will continue to exist, but in a modified version. One possible alternative is to follow the methodology applied for the depreciation of assets. Banks will calculate the provisions in compliance with BoA's standards and as a next step they will have to correct these calculations in accordance to IFRS.

Another important area treated in the draft proposal will be related to financial active / passive items. According to the representative of the tax office, the devaluation/evaluation of these items (fair value valuation) will not be recognized as respective expense / revenue.

Annex 7

Scoping the problem

7.1 Problem identification

7.1.1 Background information

In May 2008, the Albanian Ministry of Finance issued a decree making obligatory the application of International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) since January 1st 2008. Banks, as business entities, have to start with the application and implementation of the new standards.

In order to facilitate the transition process, Bank of Albania, as the banking system supervisory authority, has to adjust the banking regulatory framework and align it with the new accounting and reporting standards.

IFRS are considered a "principles-based" set of standards in that they establish broad rules as well as dictating specific treatments.

International Financial Reporting Standards comprise:

- *International Financial Reporting Standards (IFRS)* - standards issued after 2001
- *International Accounting Standards (IAS)* - standards issued before 2001
- *Interpretations originated from the International Financial Reporting Interpretations Committee (IFRIC)*-**issued after 2001**
- *Standing Interpretations Committee (SIC)* - issued before 2001

There is also a *Framework for the Preparation and Presentation of Financial Statements* which describes some of the principles underlying IFRS.

The framework states that the objective of financial statements is to provide information about the financial position, performance and changes in the financial position of an entity that is useful to a wide range of users in making economic decisions.
The underlying assumptions used in IFRS are:

- ***Accrual basis*** - the effect of transactions and other events are recognized when they occur, not as cash is received or paid;
- ***Going concern*** - the financial statements are prepared on the basis that an entity is a going concern and will continue in operation for the foreseeable future.

The Framework describes the qualitative characteristics of financial statements as being

- Understandable,
- Relevant,
- Reliable, ***and***
- Comparable.

IFRS are used in many parts of the world, including the European Union, Hong Kong, Australia, Pakistan, India, GCC countries, Russia, South Africa, Singapore and Turkey. As of March 28, 2008, about 75 countries require the use of IFRS, or some form of modified IFRS.
All listed EU companies (including banks and insurance companies) have been required to use IFRS since 2005.

7.1.1.1 Analysis of the market

General market: Banking and insurance market
Specific segment: Banking market

4.1.1.2 Legal framework

Statutory framework

- Law No. 7850, dated 29.711994, “The Civil Procedure Code of the Republic of Albania (CPC)”;
- Law No. 7638, dated 19.11.1992, “For the Commercial Companies”;
- Law No. 9662, dated 18.12.2006 “On Banks in the Republic of Albania”;
- Law No. 9228, dated 29.04.2004 “For Accounting and Financial Reporting (Accounting Law)”;
- Council of Ministers Decree No. 783, dated 22.11.2006, “On the Accounting Standards and Regulations, General Accounting Plan”;
- Minister of Finance decree No. 55, dates 05.05.2008 “On the announcement and the compulsory implementation of the International Accounting and Financial Reporting Standards IAS/IFRS”;
- The complete set of IAS/IFRS standards, translated in Albanian;
- Law No. 8560, dated 22.12.1999 “On tax procedures in the Republic of Albania”;
- Law No. 8438, dated 28.12.1998 “On tax on income”.

7.1.1.3 Stakeholders - Institutional framework

- **Bank of Albania.** Bank of Albania is the supervisory authority for the subjects licensed by it. According to the Law no. 8269, dated 23.12.1997 “On

Bank of Albania", Bank of Albania has the exclusive authority to approve the commencement of the activity for banks through licenses and to supervise the activity of the licensed entities. Bank of Albania has the right to issue by-laws; decrees, regulation, guidelines and orders, to fulfill its mission as supervisory authority. BOA issues general and prudent regulations and guidelines for banks. All these create the supervisory regulatory framework for subjects licensed by BoA.

- **Commercial banks.** The Albanian banking system consists of 16 commercial banks having as main area of activity lending to individuals and companies. Regarding the ownership structure, as in December 2007, only one of the banks has private Albanian capital.
- **National Council of Accountants.** NAC is professional, public, independent institution. NAC's main objectives are the continuous improvement of the accounting legal framework, the development of the accounting system, the establishment of the national accounting standards and the enhancement of application of the international accounting standards.

- **Ministry of Finance**
- **Auditing Companies**
- **Tax office**
- **Consumers**

7.2 Market/regulatory failure analysis (nature and evidence)

According to art. 72 law "On banks", the supervision function of BoA, among others, is based on: The regulative framework; and The financial analysis of the data periodically reported by the banks.

The current banking regulatory framework and the periodical reports are based on national accounting standards and principles. The application of new international principles and standards in accounting requires that the Regulatory Authority adapts the banking regulatory framework accordingly. The identified regulatory failure is in this case "Regulation wrongly prescribed for the market".

7.3 Policy Goal(s) threatened by the failure

The regulatory failure described above generates uncertainty and confusion among the market participants, delays innovations and integration with the international markets.

Furthermore, according to the Law "On banks" art. 73.3, the balance sheet and financial reports of banks are prepared in accordance to the Law "On accounting and financial statements" and to the international accounting standards. Despite BoA's powers to define format, type, methodology and content of the financial reports (Law "On Banks", art. 47.4 On financial reports), BoA has also the legal obligation to accept, recognize and use the financial information generated by the international accounting standards, adjusted with the prudential concerns.

In addition, the financial stability policy goal could also be affected in case BoA cannot fulfill properly its supervisory functions.

General Objectives:

- To improve the competitiveness of the economy;
- To integrate and harmonize the domestic economic structure to the global, more developed economic structures.

Specific objectives:
- To facilitate the access in the international markets;
- To adequately supervise the banking activity in order to ensure the banking system stability.

Operational:
- To provide a sound banking activity in full agreement with and pursuant to the respective legal and regulative framework, with a view to preventing the financial crisis and protecting the depositors;
- To continuously build and improve the regulative supervisory framework, in accordance to the best international principles and market developments.

7.4 "Do nothing" option

7.4.1 Possible medium-term (max 2 years) self – corrective market actions (e.g. mechanisms through which the "Do Nothing" option would address the market/regulatory failure).

The non-revision of all banking regulations with the international accounting principles would make banks to maintain two evidences of their activity: one based on national accounting standards, in order to comply with banking regulatory provisions, and one based on international standards, in order to comply with the general legal requirements. This situation would involve additional costs for banks and confusion among the market participants.

7.4.2. Impact of the "Do Nothing" option to the various stakeholders

- Regulated firms / Banks:
  - Additional costs on human capital generated by double reporting (NAS and IFRS).

- Consumers:
  - Non informed consumers might be confused.

- Authorities:
  - There are no additional costs.

7.5 Alternative policy option(s)

7.5.1 Broad description of the regulatory or self-regulatory action(s) needed to remedy the market or regulatory failure and hence achieve the policy goal(s)

The banking regulations must not be conflicting with the general legal provisions, therefore the discrepancies between the general and the specific regulations have to be corrected in order to allow BoA to **supervise the banking activity** and to ensure

the banking system stability.
7.5.2 Possible operational regulatory or self-regulatory actions to achieve the policy goal - to identify the regulations affected by the change in the general legal provisions. - to perform a banking survey in order to assess banks' readiness to implement IFRS. - to set up the implementation process of the regulatory changes.
7.5.3 General description of various Options Option 1: To modify the specifics of banking regulations, and Option 2: To issue a general decree stating that references to national accounting standards are replaced with references to IFRS.
7.5.3.1 Detailed description of Option 1: To modify the all affected banking regulations in order to correctly reflect all the changes brought by IFRS implementation. In order to get the package of banking regulations to be amended, PWG will browse through all banking regulatory framework and will prepare a list of all the regulations related to the regulation and supervision of the banking activity. The list will be analyzed and regulations will be arranged according to 3 categories: regulations that need important changes, regulations that require slight changes and regulations not affected by IFRS implementation. For the heavily impacted regulations, specific changes will be indicated, while for the less affected only the general sense of the changes. The banking survey will indicate banks' readiness to implement IFRS or, in other words, the time needed for full implementation of IFRS provisions, to be used as indication for BoA regulatory further actions.
7.5.3.2 Detailed description of Option 2 To issue a provisional regulation that will state that all the references to the national standards will be replaced with the international standards, having as legal ground the Decree on IFRS. The PWG will set up an implementation timeline for the regulatory changes.

Summary Problem Scoping			
Auction procedures under foreclosure for immovable collateral			
Market failure			
Asymmetric information	Market power	Positive externalities	Negative externalities
(Existing) Regulatory failure			
Regulation wrongly prescribed for the market	Regulations succeeded in addressing the failure; a different market failure	Regulation made it worse	Regulation so far has failed to work; maybe in due course

	(e.g. side effect)		
X			

Annex 8

SPI Albania Methodology

The EU Better Regulation Approach	
Steps	**Purpose**
Scoping of problem	
1. Problem identification	To understand if a market/regulatory failure creates the case for regulatory intervention.
2. Definition of policy objectives	To identify the effects of the market /regulatory failure to the regulatory objectives.
3. Development of "do nothing option"	To identify and state the status quo.
4. Alternative policy options	To identify and state alternative policies (among them the "market solution").
Analysis of impact	
5. Costs to users	To identify and state the costs borne by consumers
6. Benefits to users	To identify and state the benefits yielded by consumers
7. Costs to regulated firms and regulator	To identify and state the costs borne by regulator and regulated firms
8. Benefits to regulated firms and regulator	To identify and state the benefits yielded by regulator and regulated firms
9. Data Questionnaire	To collect market structure data to perform a quantitative cost and benefit analysis
Consultations	
10. Policy Document	To learn market participant opinions on various policy options
Conclusion	
11. Final Recommendations	Final report to decision-makers, based on Cost Benefit Analysis and market feedback