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ORGANIZATION OF EQUITY ACCOUNTING IN SECOND-TIER BANKS OF KAZAKHSTAN AND ITS CONTROL

The article shows that the current actual scientific and practical task is to determine the capital adequacy of the second-tier banks. We review the formation, accounting and control over equity of STB in Kazakhstan, as well as the role of the banks' equity in ensuring bank's financial stability. We give an overview and assessment of possible impact of Basel III standards implemented for economic growth and financial stability of the banking system in Kazakhstan.

Keywords: *second-tier banks; accounting; equity capital; registered capital; chart of accounts; IFRS.*

Гульжахан Р. Касимбекова

ОРГАНІЗАЦІЯ БУХГАЛТЕРСЬКОГО ОБЛІКУ ВЛАСНОГО КАПІТАЛУ БАНКІВ ДРУГОГО РІВНЯ І ЙОГО КОНТРОЛЬ В КАЗАХСТАНІ

У статті показано, що актуальним науковим і практичним завданням є визначення достатності власного капіталу банків другого рівня (БДР). Розглянуто порядок формування, облік і контроль власного капіталу БДР РК, а також роль власного капіталу банку в забезпеченні фінансової стійкості банку. Надано огляд та оцінено можливий вплив введення стандартів Базель III на функціонування, економічне зростання і фінансову стабільність банківської системи Республіки Казахстан.

Ключові слова: *банки другого рівня; бухгалтерський облік; власний капітал; статутний капітал; план рахунків; МСФО.*

Табл. 2. Літ. 12.

Гульжахан Р. Касымбекова

ОРГАНИЗАЦИЯ БУХГАЛТЕРСКОГО УЧЕТА СОБСТВЕННОГО КАПИТАЛА БАНКОВ ВТОРОГО УРОВНЯ И ЕГО КОНТРОЛЬ В КАЗАХСТАНЕ

В статье показано, что в настоящее время актуальной научной и практической задачей является определение достаточности собственного капитала банков второго уровня (БВУ). Рассмотрены порядок формирования, учет и контроль собственного капитала БВУ РК, а также роль собственного капитала банка в обеспечении финансовой устойчивости банка. Даны обзор и оценка возможного влияния введения стандартов Базель III на функционирование, экономический рост и финансовую стабильность банковской системы Республики Казахстан.

Ключевые слова: *банки второго уровня; бухгалтерский учет; собственный капитал; уставный капитал; план счетов; МСФО.*

Formulation of the problem. Equity capital is an essential indicator of the banking system reliability, which is intended to ensure successful operation of any bank, its ability to be responsible for its obligations. Along with the borrowed funds equity is the most important source of resources for a second-tier bank.

One of the main causes of financial troubles and failures of banks is poor quality of the formation, accounting and control over its equity capital, the assessment criterion of which is capital adequacy. Banks' capital adequacy is determined not only

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by quantitative parameters, but also by qualitative indicators that mean bank's ability to adequately respond to internal and external risks. In this regard, the clarification of theoretical foundations, the rationale for specific practical recommendations on improving the methodological approaches to the solution of this problem are crucial tasks of scientific research.

Recent research and publications analysis. Issues of accounting and control of equity capital are considered by K.K. Keulimzhayev et al. (2005), G.S. Seitkasimov et al. (2000), E.S. Hendriksen and M.F. Van Breda (1997), S.T. Mirzhakypova (2007) and many other scientists.

Despite substantial research on the issue, the problems of accounting and internal control over equity of second-tier banks are not resolved on both theoretical and practical levels. Thus, the relevance of research and selection of its main directions are based on the lack of theoretical, methodological and practical development of the issues concerning accounting and control over the equity capital of second-tier banks.

The purpose of this study is to reveal the role of bank's equity in ensuring financial stability; to review the formation, accounting and control over the equity capital of second-tier banks in Kazakhstan, as well as to consider the prospects for Basel III International Standards implementation.

Key research findings. The own resources of second-tier banks are formed as a result of passive bank operations. Further, the STBs place their own funds at the market in order to generate income. These are active bank operations.

Equity capital is the base of borrowed resources of second-tier banks. Formation of bank's equity is determined by normative and legislative acts of the Republic of Kazakhstan and has regulative meaning.

As an "element of financial statements the capital is a share in assets of an individual entrepreneur or organization after deducting all liabilities" (Law of the Republic of Kazakhstan, 28.02.2007, #234-III).

International Financial Reporting Standards consider capital as a set of borrowed and equity capitals.

Equity capital of a STB consists of funds and profit from the activities of current operations, created and used by the bank to ensure financial stability, commercial and economic activity. Depending on the quality characteristics, the bank's equity is divided into common equity (core tier I) and added capital (tier II).

Composition of STB's own funds includes the following elements:

- registered capital;
- reserves formed from profits of the previous years and current year;
- share premium as a difference between the market and nominal values;
- additional capital resulting from the revaluation surplus;
- value of property received by the bank from businesses and individuals gratis;
- income of previous years and current year minus the amount of distributed funds for a relevant period, i.e. retained income;
- reserves against the devaluation of investments in securities non subject to classification;
- subordinated debt (Isayev, 2006).

Sources of growth in equity are traditionally divided into internal (profit, revaluation of assets) and external (issue of shares, capital debts (bonds)).

The ratio between these sources is often determined by bank's size and its strategy. Equity capital of banks as financial institutions is their assets after deducting liabilities.

The basic element of equity is registered capital, which is the sum of contributions or deposits originally invested by founders in the course of organization. Formation and changes in registered capital is governed by legislation. Features of accounting for registered capital in different organizations depend on the legal form of a company (Keulimzhayev et al., 2005).

Registered capital is shown in the bank's balance sheet in the amount of stated capital minus uncalled and repurchased shares.

Registered capital in the balance sheet of a second-tier bank is reflected in account 3000 – Registered capital of the bank (Seitkasimov et al., 2000).

Equity capital is the basis of bank resources. There are 3 values of equity:

1. Market value is the value, which a potential investor is ready to pay for the purchase of this bank.
2. Balance value is the amount of capital given in the bank's balance sheet.
3. Regulatory equity is the value calculated by the method of authorized regulatory body. These values can be different in their absolute values (Abishev et al., 2007).

Despite the fact that bank's own funds are usually just a small portion of the total bank's resourses (about 12%), equity performs vital functions necessary for proper functioning and further development of a second-tier bank. STB's equity has the following main functions:

Protective function appears in the event of bank failure, when equity can be used to protect depositors' interests, as well as to eliminate the unforeseen costs and losses. The bank's equity in such a situation enables compensation in the event of bank liquidation, preserving bank's solvency at the expense of reserves established to cover credits, interest and currency risks and for continued operation of this bank, regardless the threat of loss.

Operational function provides that equity is necessary for a bank to obtain a banking license, and borrowed funds are used for active operations of the bank. Bank's capital has to be adequate to the risks taken by it.

Regulating function of bank's capital is related to public interest in the success of second-tier banks. From the point of view of banking regulation and supervision bodies, the most important thing in banking regulation is the availability of sufficient in qualitative and quantitative terms equity to protect both creditors' and depositors' interests and to reduce the likelihood of insolvency.

Thus, the main functions of bank capital show that equity capital is the basis for commercial activity of second-tier banks. The equity capital provides independence and guarantees the financial stability of the bank, at the same time being a source of smoothing the negative effects of numerous risks associated with this bank (Iskakov et al., 2011).

It is known that second-tier banks in Kazakhstan are established as joint stock companies.

Registered capital of joint stock companies is the sum of nominal values of all shares.

Value of registered capital is taken into account in the balance sheet 3001 – in terms of ordinary shares, and in 3025 – in terms of preference shares. The amount of unpaid registered capital is accounted in balance sheet 3002 – for ordinary shares, and 3026 – for preference shares.

Surplus funds are a part of bank's equity formed by deductions from retained income. The use and formation of surplus funds is regulated by the current legislation of the Republic of Kazakhstan and internal documents of banks. Legal requirements to surplus funds of a joint stock company are not less than 15% of its stated registered capital. Surplus funds shall be established to cover various losses of a bank, as well as for the cases of funds shortage to pay dividends to the holders of preference shares. Accounting of formed surplus funds is carried out on the passive balance sheet account 3510 "Surplus funds".

Bank has the ability to make year-end contributions to surplus funds only if it has profit. In accordance with the accounting rules profit is equal to the increase of net assets of a bank at the end of the year as compared to its beginning. Thus, surplus funds of a second-tier bank is an effective bank reserve created by the increase in net assets and is used to cover losses.

Amount of surplus funds for the previous years is shown in account 3599 "Retained net income (uncovered loss)". The account is credited on the amount of previous year on the first business day after final turnovers in the new year. The next distribution of income is performed by decision of shareholders' meeting.

The main source of equity capital for a bank is profits accumulation in the form of various funds or in an undistributed form. This is often the easiest and the least expensive method of capital replenishment, especially for banks whose activities are characterized by a high return rate. At that, property is the net worth of the bank for its owner. At the moment of bank establishment it is equal to the sum of funds invested by the owner. In the process of economic activity it is equal to the sum of initial and additional investments, and accumulated net profit minus owner's withdrawals and net loss, which corresponds to the concept of well-being. According to this theory, property increases due to incomes and reduces due to expenses.

So, net profit as a difference between income and expenses is charged directly to the owner and reflects the growth of well-being by increasing capital. Dividends paid in cash are withdrawal, and the retained profit is a part of total property. At the same time "the interest on loans is the owner's expense, it shall be deducted when calculating the net profit" (Hendriksen and Van Breda, 1997).

In banking, the amount of capital is defined as the sum of common equity and added capital. Under common equity we understand its constant, unchangeable part that can be used to cover real and potential losses. Comparison of domestic and foreign methods of capital adequacy shows that international requirements are not implemented in full by the national regulator. This situation is due to differences in the development level of financial markets, special aspects of functioning of Kazakhstan's banking system. Thus, common equity includes registered capital formed by ordinary shares and non-cumulative shares, share premium and surplus funds; and the core tier I includes paid ordinary shares and preferred non-cumulative undated shares, founders' profit, published (opened) reserves.

It is known that the main function of accounting is to identify and report the results of banking operations. And bank's profit is the increase of capital resulting from banking activities or its complete revenue minus total costs.

In practice, income and expenses are recognized with all basic international accrual principles, care and compliance. They are accrued at the end of a reporting period, if payment will be made in the following periods. All income and expenditure items recognized within a reporting period shall be included in determination of net profit or loss.

In the process of closing income and expenditure accounts special consolidated account 4999 "Income before tax" is used. All accounts of profit and loss statement – income, profit, expenses and losses – are closed on this account. Difference between the totals of credit and debit is the sum of net income or net loss that then shall be transferred to the account 3599 "Retained income (loss)".

Account 4999 "Income before tax" is used for accounting of amounts of bank's income before payment of all taxes and other obligatory payments to the budget. Account's deb it reflects the amounts of expenses at the closing balance sheet accounts of expenditure and amounts written off to the account 3599 "Retained net income (uncovered loss)". After balancing with the account 5999 "Income tax" on account's credit we see the amounts of bank's income.

Profit resulted from banking activities can be used to pay dividends, placed in reserve funds or reinvested to expand banking activities (Mirzhakypova, 2007).

At this stage of economic development as in our country formation of sufficient in terms of volume and quality equity capital by second-tier banks is of particular importance.

One of the main qualitative characteristics of stability, capability and reliability of a second-tier bank and banking system as a whole is banking liquidity. The global financial crisis has forced all banks to pay more attention to liquidity risk management in order to prevent banks failures.

Prudential standards binding for second-tier banks in Kazakhstan are found to be not very effective in reducing the risk of liquidity and capital adequacy. Kazakh banks have fully complied with all prudential standards and had a stock of liquid assets. Despite this, for second-tier banks actual are the problems of poor quality of assets, a large gap between assets and liabilities at amounts and terms, which adversely affect the profitability and stability of these financial institutions. According to experts, second-tier banks should revise their business model, and regulatory authorities should develop new qualitative methods and techniques to reduce banking risks and their assessment (Instruction on normative values..., www.nationalbank.kz).

Basel Committee on Banking Supervision at the Bank for International Settlements has proposed in 2009 the implementation of new standards on banking regulation, known as Basel III, in order to improve the mechanisms of financial regulation.

In should be reminded that this document is the third one concerning the implementation of rules and standards of banking regulation, initiated by the Basel Committee.

Along with the increased demand to the level of core capital the Basel III provides for establishment of special capital buffers that allow correcting bank's own funds to counter the cyclical variations of economic conditions. In order to provide banks with sufficient liquidity in times of crisis and sudden run on banks it is planned to implement the liquidity ratios. According to new regulation principles the Committee introduces even higher requirements to the capital of global system-relevant financial institutions that are able to initiate the spread of risks in financial system.

On the basis of the research made by the Bank for International Settlements and the Bank of England the assessment of the required level of capital adequacy for Kazakh banks was carried out, taking into account specific risks and, accordingly, largely supporting their resistance to systemic risks and possible negative factors. These researches found that the set by Basel III standards minimum capital adequacy ratios do not cover the risks inherent to Kazakh banks. Their calculation results show that capital adequacy to the banks' specific risk can be achieved by setting the requirements above the Basel III, and this is also confirmed by international practice (www.bis.org).

Table 1. **Basel III Standards in terms of capital adequacy of second-tier banks**

Capital structure	Tier I capital		Tier I capital	Tier II capital	Overall level of capital	Conservation buffer	Overall level of capital in view of conservation buffer	Countercyclical buffer	Capital buffer for systemically important banks
	Common equity	Added capital							
Index for Kazakh banks	7	2	9	3	12	3	15	0–3	1
Index set forth by Basel III	4.5	1.5	6	2	8	2.5	10.5	0–0.25	1-2.5

Source: Information on methodology of implementation the Basel III standards in Kazakhstan, www.bis.org.

Thus, the validity of requirements to capital adequacy of Kazakh second-tier banks is the following:

1. *The level of common equity adequacy of domestic banks (Common Equity Tier 1) shall be not less than 7% of the amount of risk assets.* The bank's common equity consists, as a rule, in ordinary shares and profit and surplus funds.

2. The Basel III requirements set the following restrictions to capital structure proportions:

- up to 25% of Tier I capital can consist of instruments that are not shares, which respectively are instruments of the added Tier I capital (Additional Tier 1);
- up to 25% of the overall level of bank's capital can consist of Tier II capital.

Consequently, *Tier I capital should be at least 9% of risk assets, and Tier II capital – not more than 3% of risk assets. Thus, excluding capital buffers, the overall level of bank's capital is 12% of risk assets.*

3. The purpose of conservation buffer is to absorb losses in stressful situations. In this regard, to determine its level the results of stress tests were used. *The volume of conservation buffer for the capital of Kazakh second-tier banks is set at 3% of risk assets.*

4. In addition, the Basel standards provide for establishment a system buffer, the size of which is determined for each bank separately depending on systemic importance of this bank, in the range from 1 to 2.5% of risk assets. Capital buffer for sys-

temically important banks can be determined at the level of 1% of risk assets for the banks recognized as systemically important by the methodology approved by the National Bank of the Republic of Kazakhstan.

5. The capacity of countercyclical capital buffer is directed to smoothing the financial cycle by curbing the excess credit growth during the boom. *The value of countercyclical buffer needed to Kazakh second-tier banks is determined at the level of 3% of risk assets*. According to the analysis the most significant indicator signaling the onset boom is *the ratio of loans to GDP*. The need to accumulate the countercyclical capital buffer may occur when the level of the annual increase of loans reaches 60%, and there is no GDP growth.

In accordance with the Basel III standards full transition should be performed within 6 years, till January 1, 2019. The same term is offered to set for Kazakh second-tier banks also, i.e. from 2013 to 2019.

It should be noted that the compliance schedule and conservation buffer level will be different for systemically important and other banks. For systemically important banks the conservation buffer is set at 2.5 of risk assets from July 1, 2013, since the restriction on income distribution is already in force within the early response measures system. Furthermore, the buffer for systemically-important banks will be implemented from January 1, 2016, when the requirements to conservation buffer for all banks will reach the specified level (3% of risk assets).

Within 3 years (2016—2018) it is planned to gradually increase the requirements to capital.

In order to establish the ability of banks to comply with the proposed requirements and to determine the sequence of implementation the international adequacy standards of Basel III the assessment of the current capital level of Kazakh banks was performed in accordance with the Basel III requirements (based on the information provided by 23 banks as of 01.07.2012).

Basel III sets more stringent requirements to the quality of instruments that will make up the regulatory capital of banks. The criteria are established, with which shall comply the instruments included in the equity capital of second-tier banks. In case of non-compliance with Basel III criteria they are subject to gradual elimination of capital.

Within 5 years (2013—2017) Kazakh second-tier banks shall exclude from capital the instruments that do not meet the Basel III standards, and implement the conservation buffer.

The approximate amount of instruments that do not meet the Basel III criteria currently is about 3.6% of risk assets or 24% of the overall capital level of banks with such instruments in their capital structure.

In general, the required level of additional capitalization of banks is 324 bln KZT (5.08% of risk assets), including additional capitalization of the overall capital level — 143 bln KZT (2.72% of risk assets) and the required capitalization of the conservation buffer — 180 bln KZT (2.83% of risk assets) (Table 2).

According to the Basel III standards, the failure to comply with the requirements for accumulation the required level of conservation buffer does not results in sanctions to a bank, but only imposes restrictions on the use of profit (Information on methodology of implementation..., www.bis.org).

Table 2. **Instruments and amounts of additional capitalization of second-tier banks subject to exclude from capital**

Minimum requirements	Terms of excluding and additional capitalization						
	2013	2014	2015	2016	2017	2018	2019
Amount of exceptions in each year, bln KZT (total: 286 bln KZT)	57.20	57.20	57.20	57.20	57.20	-	-
Amount of exceptions in each year, % of risk assets (total: 3.6% of risk assets)	0.72	0.72	0.72	0.72	0.72	-	-
Required additional capitalization of the overall capital level with progressive total, bln KZT	-	-	-	-	19.81	65.21	143.30
Required additional capitalization of the overall capital level with progressive total, % of risk assets	0.00	0.00	0.00	0.00	0.86	1.99	2.72
Total required additional capitalization, bln KZT	-	-	5.49	44.46	104.75	198.88	323.91
Total required additional capitalization, % of risk assets	0.00	0.00	0.41	1.92	1.99	3.50	5.08

Sourse: Information on methodology of implementation the Basel III standards in Kazakhstan, www.bis.org.

Implementation of Basel III standards provokes a lot of discussions and debates among experts, chairmen of central banks and top managers of companies. They assert that the use of Basel III international standards gives to banks a competitive advantage and will show their resistance to crises. It is possible in case of development and selection by each bank its own economic model to implement the Basel III standards, which should take into account the shortcomings and troubles inherent to these standards (Shanabel, 2011).

It is expected that with the acceptance of international standards the risk of reducing the profitability of second-tier banks will greatly increase through restructuring of accounting balances, exclusion of ineffective capital and increasing liquidity by increasing the minimum value of assets. Also, according to experts, the cost of banking services will increase, and loans volume will be reduced, because projects for financing will have to meet the high credit score. This will lead not only to reduced financial results of the banking system, but also to the growth slowdown, reduction in the number of second-tier banks due to high requirements to capital and liquidity.

Transition to the Basel III has to improve the qualitative composition of equity capital of Kazakh second-tier banks, as well as to give them the opportunity to reach higher competitiveness.

However, today many experts agree that the standards still require significant improvements, and the domestic second-tier banks should choose and change their business models, improve the quality of loan portfolios and perform the restructuring of their balances before implementing international standards. Therefore, the implementation of Basel III standards, in our opinion, could lead to decrease in profitability of banking operations and liquidity loss for domestic second-tier banks. In addition, the amount of capital in Kazakh banks is not so large to meet the international standards, and this can lead to reduction in the number of banks.

Consequently, it makes sense to gradually transfer the domestic STBs to new, fully developed capital adequacy standards. Now for them more actual is the problem of improving the quality of loan portfolios and balance sheets restructuring.

And yet, according to the scientists investigating banking regulation, for second-tier banks under new standards it would be more advantageous to reduce the growth rate of credits than to attract new capital. This, in our view, could cause the increase of already concealments in accounting, and will lead to double-entry bookkeeping in STB, and the existing assets will go behind the balance, especially it is true for large systemically important financial institutions.

Investigating the accounting and control over equity capital in second-tier banks in Kazakhstan we can make the following **conclusions**:

1. Equity capital is a special form of bank resources. Unlike other sources, it has permanent irrevocable character, clear legal basis and functional definition, is the obligatory condition for formation and operation of a bank, i.e. it is an axis supporting the entire activity of a bank from the first day of its existence. Due to its continuity equity capital acts as the "main safe harbor" for depositors and creditors, at the expense of which the significant proportion of bank's assets is funded. In banking practice equity capital is considered as a value within which bank guarantees its liabilities.

2. The important role of the effective organization of accounting and control over bank's equity capital should be noted because it affects bank's ability to fit into complex and dynamic financial market being formed in Kazakhstan, and to use the advantages of the global economic integration.

In this regard, for Kazakhstan second-tier banks the effective exchange of the vast experience in organisation and keeping of accounting and reporting in developed market economies, worked out by decades, is of particular importance. Of course, the solution of fundamental methodological issues of banking accounting and reporting is within the competence of the National Bank of Kazakhstan. Nevertheless, in our opinion, each second-tier bank should follow the new tendencies in methods and techniques of accounting and reporting, control over equity capital, as well as work on the following areas:

- each bank, basing on its specific activities, should develop and choose its economic model of implementing the Basel III standards, taking into account all disadvantages and troubles inherent to these standards;
- in order to save time and avoid mistakes of human factor banks are recommended to use automated control and monitoring systems;
- for second-tier banks to be able to submit to regulating authorities all forms of accounting and reporting they should use a centralized approach to collection and storage of all necessary data. Centralized data storage allows quickly and efficiently management and transmission the data, performing stress tests, accounting and auditing, and also, risk managers are able to manage banking risks more effectively.

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