

BACKGROUND

Bank of Spain Circular 4/2004 came into effect on 1 January 2004. This Circular changed the accounting regime of Credit Institutions and brought it into line with the new accounting environment deriving from the European Union's adoption of International Financial Reporting Standards, in accordance with Regulation 1606/2002 of the European Parliament and Council of 19 July 2002.

IMPACT OF NEW ACCOUNTING LEGISLATION ON THE FINANCIAL SECTOR

For Spanish entities, the most significant change brought about by the new accounting policies contained in Circular 4/2002 and IFRS is the prevalence of **fair presentation over prudence**. Under accounting legislation previously in force in Spain (contained, in the case of credit institutions, in Bank of Spain Circular 4/91), prudence was the guiding principle.

The main impacts deriving from the application of new accounting legislation on the financial institution sector are as follows (see paragraph 6.6 of the annual accounts for more detailed information):



- **Consolidation:** The obligation to consolidate extends to all companies which form part of the same economic group including companies which were previously excluded by reason of activity. Similarly, the concept of “significant influence” is reinforced, meaning that a company can be classified as an associate and consolidated under the application of the equity method.
- **Financial instruments:** The new Circular lays down new criteria for recognising, classifying and measuring financial instruments, basically differentiating four categories. In two of them, financial instruments are measured at fair value and differentiated depending on whether changes in value are recorded directly in the income statement (trading portfolio and other assets at fair value through the income statement) or are transitionally recorded in an equity account until the financial instrument is written off the balance sheet (available-for-sale financial asset portfolio). The other two categories (held-to-maturity investment portfolio and loans and discounts) are measured at amortised cost through the application of the effective interest method.
- **Operations with derivatives:** All derivatives should be included in the balance sheet (they were previously recorded in memorandum accounts) and measured at fair value, which should normally agree with market value. Changes in value are generally recorded in the income statement.
- **Doubtful risks and bad debts:** The new Circular establishes a new provision for inherent losses which replaces the previous general and statistical provisions. In order to calculate this provision, a mechanism is established which takes into account the development of credit over the year and the specific appropriations made during the year, setting maximum and minimum provision levels.
- **Financial fees:** The Circular defines these fees as those fees that form an integral part of the return on a financial transaction, which should be recorded in the income statement over the term of the transaction. It mainly affects loan and credit origination fees. These fees were previously carried in the income statement at the time of collection, generally at inception.



ADAPTATION IN CAIXA GALICIA

In 2005 the Caixa Galicia Group completed the studies and work started up and carried out in 2003 and 2004 in order to adapt to new accounting legislation. The adaptation plan entailed a major effort (i) on an organisation level, through the formation of a multidisciplinary committee to study, plan and start up the implementation of the new accounting legislation; ii) on an IT level, that called for far-reaching changes to most of the

Entity's applications and the development of new tools and ii) on a communications level, in order to ensure that all areas of the Entity directly or indirectly affected had an understanding of the new standards.

The process described ended with the issue for 2005 and 2004 (for comparative purposes), within the timeperiods established by applicable legislation, of financial statements which were fully compliant with international accounting standards and Bank of Spain Circular 4/2004.