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Bank accounting and bank value: harmonising (d)effects of a common accounting culture?

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Abstract

Purpose – This paper aims to draw on the potential behavioural implications of the new (economic) measurement attributes initiated recently by the International Accounting Standard Board (IASB) in their efforts to reflect more relevant, "true" underlying economic values as opposed to historical.

Design/methodology/approach – Owing to lack of readily observable market prices (market values) for loans (retail and commercial operations) for statistical testing and initial conservatism on the part of banks for a survey to be conducted, 15 interviews were employed (from October 2005 to November 2006) with major bankers (CEOs and CFOs of major banks) and standard setters. The paper analyses the perceived benefits and costs associated with the application of two diametrically opposite measurement methodologies for banks. These can also have important implications for the "perceived" value/measurement profile of a bank – as argued in the concluding section – for bankers and their regulators, on the one hand, and accounting standard setters and investors, on the other.

Findings – The propositions constitute a significant departure from current accounting practices in that all financial assets and liabilities should uniformly be recognised and reported under a universally accepted "economistic" measurement framework.

Originality/value – The paper captures perceptions and attitudes as to the future "behavioural" direction of banks and provides a balanced argument between the rigours of historical cost accounting and fair value accounting.

Keywords Accounting, Standards, Financial services

Paper type Research paper

1. Introduction

The rapid growth of the financial sector in the past 20 years owing to the greater sophistication and an ever increasing degree of interaction among financial markets has unambiguously led to a heightened degree of interconnectedness among investors, standard setters, banks and regulatory authorities through tighter information provision. This is coupled with rapid financial innovation, increasing volatility and unprecedented cases of accounting fraud, which eventually led to the demise of global conglomerates. These developments have further uncovered some dysfunctional aspects of the processing and communication elements of financial reporting necessary for sound value/risk management, transparency and market discipline.

According to Enron's Internal Risk Management Manual (2002):

> Reported earnings follow the rules and principles of accounting. The results do not always create measures consistent with underlying economics. However, corporate management's

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> performance is generally measured by accounting income, not underlying economics. Risk management strategies are therefore directed at accounting rather than economic performance.

The above statement – one out of many – in conjunction with the associated scandal(s) explicitly induces readers to question themselves as to which is the most reliable basis for measuring company value. Not only does it question the merits of traditional HC accounting, but it also makes explicitly obvious why International Accounting Standard setters have moved towards adopting fair value accounting (and ideally full fair value accounting, hereafter FFVA[1]) as the single, universally accepted basis of asset measurement and financial reporting. This reflects an effort to minimise the manipulation of accounts, increase transparency and comparability and, to some extent, restore the damaged reputation, integrity and trust of the wider investing community in accounting standards.

Specifically, in the case of banks, the current mixed accounting model followed (whole book approach[2]) (Jackson and Lodge, 2000) inevitably creates distortions of value:

- partly due to the nature of the assets/liabilities employed by companies (i.e. the increasing degree of complexity of financial instruments);
- partly due to the nature of their operations;
- partly due to the different prioritisation of the characteristics attached to financial information by accounting standard setters and stock exchange commissions on the one hand and bankers and their regulators on the other; and
- partly due to the system characteristics in which companies operate.

Hence, the combined efforts of International Accounting Standard Board (IASB) and FASB to also provide for convergence between US and European standards (i.e. a universally accepted accounting framework). For example, the specific operational characteristics of the system under which banks function (i.e. credit-based vs market-based systems) make it even more difficult for a uniform agreement to be reached among the related parties and gives rise to our interest in the reaction between operators in a market-driven system (UK) and their counterparts in a credit-driven system (Greece). Our motivation, therefore, is enhanced to endeavour to examine the views of professionals belonging in two "contrasting systems".

All internationally active, listed companies have had to prepare and report their results under International Financial Reporting Standards (hereafter IFRS) since January 2005. The latest proposed amendment came from the Financial Accounting Standard Board's Exposure Draft deliberations (The Fair Value Option), which came to co-advocate IASB's Standard 39-Fair Value Option (IASB 39, 2004). In the latter, companies can opt for FFVA for all financial instruments and liabilities. Specifically, the proposed standard states:

> This proposed statement would create a fair value option under which an entity may irrevocably elect fair value as the initial and subsequent measurement attribute for any financial asset or liability on a contract-by-contract basis, with changes in fair value recognised in earnings as those changes occur (Para. 2, FASB, ED, Jan. 2006).

Full compliance with this proposition for European institutions (if they opt for it) has started since 1 January 2006. For the US counterpart banks, if they elect such an option, full compliance was expected from 15 December 2006.

It is well established that the fair value measurement attribute is not new. During the last decade, the financial accounts of banks shifted from being based entirely on historical cost basis attribute into a mixed model of historical cost accounting (HCA) and market value approach (MVA), in an effort to reflect the changing role of banks and their operations in the financial sector and their effect on the economic cycles (Wall and Koch, 2000). The innovation is reflected in the refined proposals of accounting standard setters for the introduction of newer elements of FVA for financial instruments in the banking books of banks.

These elements range from proposed redefinitions of what constitutes an asset/liability that qualifies for FVA measurement to full pragmatic – and most importantly impartial and objective recognition – of FV gains/losses in the face of the accounts. These have caused a heated debate between the parties (and the systems) involved and they reflect their different perspectives, which can have a profound effect on the banking and financial industry in general.

The clashing perspectives of bankers and their regulators, on the one hand, and accounting standard setters on the other revolve around the question: "what constitutes pragmatic value and how should it be measured?"

The focal point of the debate for bankers and regulators is that the transactions of banks and the subsequent "goods produced" – both retail and commercial – are fundamentally different from most other economic transactions in (the following respects) the nature of banking transactions (Llewellyn, 2005): principal-agent relationships are involved and transactions are relationship-based rather than contractually based since credence goods[3] call for values spread over long periods of time. Thus, a relationship is created between buyer and seller, which leads to:

- *Incomplete contracts.* Where the future outcome of a transaction is uncertain since future behaviour cannot be anticipated and where post-contract behaviour of both buyer and seller is paramount.
- *Frequency of banking transactions.* Loans in the banking books of commercial banks are either not traded/held to maturity or being thinly traded and thus, agents have either no indication of intrinsic values in the former case or very little experience on which to base objective valuations in the latter.

Fair value, as advocated by accounting standard setters, can be summarized in the definition as laid down in FASB, which states:

> The amount at which an asset (liability) could be bought (incurred) or sold (settled) in a current transaction between two willing parties, that is, other than in a forced or liquidation sale[4] (FAS133, par. 540, p. 243).

"Fair value" as defined above, is paramount when financial contracts are created and when assets/liabilities are bought/sold. The *Oxford's Complete Dictionary* defines fair as: just, equitable, impartial, unprejudiced, even-handed, honest and trustworthy.

Within a banking context and for the purposes of this paper, we can also summarise valuation fairness as: "An independent, objective valuation of the company and its assets/liabilities – whether upwards or downwards – free from bias or error".

An important question, however, that needs to be asked is whether addressing "fairness" in valuations within the banking context falls solely within the remit of accounting bodies and standard setters without paying attention to the type of companies and their output and the context/system in which they operate. Furthermore, even if it is accepted that the definition of "fair value" falls within the collective remit of standard setters, bankers and their regulators, then whose interpretation of fairness and best practice must prevail? The standard setters' views as professionals on the cutting edge of measurement techniques and the associated regulations, the regulators as the guardians of the financial services or the bankers as the practitioners on the cutting edge of the profession?

Before accounting harmonisation can be implemented, a common communication platform must exist between standard setters, bankers and their regulators. Therefore, a fundamental prerequisite is the convergence of their perspectives and the harmonisation of views between the providers/preparers and users of financial information. Attention should also be paid to the system under which banks operate, while for investment decision purposes, financial information must be both relevant and reliable.

In order to get an insight into the rigours of both approaches and how these might be applied and potentially affect behaviour, interviews were conducted with major bankers and accounting standard setters in Greece and the UK for reasons elaborated on in Section 3. The next section continues to present the research methodology utilised in this study.

2. Methodology

Owing to the reticence within the banking sector to provide access for research purposes and lack of tested hard data, a qualitative research rationale became the critical methodology of choice for the research design in this project. This was the main reason for altering the initial objective of our study to measure behaviour into the examination of leading bank officers' perceptions about the change over accounting standards, which are likely to affect behaviour. This is potentially more so in differing economic settings – credit vs market based systems – (Zysman, 1983) and explains our motive to also examine behavioural aspects of banks in Greece. Thus, an inductive approach was adopted as this study sought not only to describe but also to identify future behavioural aspects emerging from the potential impact of such change (Silverman, 2005).

It sought to investigate the following objective in the context of the proposed changes: as much as financial information is processed, prepared, and communicated under accounting authorities' guidance, it is effectively sustained when it serves a wide array of interrelated parties; if not, lobbying or "notorious" behaviour may be observed which may subsequently render such implementation non-pragmatic. The following were the main research questions around which interview questions were structured to be answered by interviewees:

- Which are the key forces and financial dynamics that underlie this proposed shift and initiation of new accounting standards with regard to measurement and disclosure?
- What implications do bankers' specific mindsets and pre-conceived assumptions carry for compliance with the proposed accounting shift?

- To what extent do the above direct the interplay among accounting standard setters, bankers and their regulators?

2.1 Data collection

The procedure adopted was to begin with a set of in-depth semi-structured "elite" (Gillham, 2003) interviews with CFOs and CEOs of major commercial and investment banks, both in Greece and the UK, who were identified as the gatekeepers to inside information for guiding data generation:

> Although they may be remote from some aspects of what you are researching, they are likely to have a particularly comprehensive grasp of the wider context and to be privy to information that is withheld from others (Gillham, 2003, p. 81).

The particular sample of banks was selected for their central role in being captured in the middle of the debate between accounting standard setters and regulators, as detailed in the previous sections. Semi-structured interviews gave us the opportunity to use some latitude in order to ask further questions on what could be seen as a "significant reply" (Bryman and Bell, 2003).

Furthermore, they were an effective tool for establishing rapport and engagement with the interviewees. Indeed, this created the potential for a "snowballing effect" (further interviews were achieved). Open-ended questions were used in in-depth interviews (13 one-to-one interviews with chief banking officers), which were later transcribed and anonymised. The interviews had an average duration of one hour and generated answers to the research questions, as detailed above.

Moreover, two highly experienced certified accountants – members of the Accounting Standards Boards in UK and Greece – were interviewed on the same themes for purposes of triangulation. Owing to the banks' particular nature of being highly regulated organisations within the economy and their interaction with national and international regulators, specific questions were asked to gain a basic understanding of relationships among accountants, banks and their regulators and detect any potential friction areas relating to the research questions as presented above.

2.2 Data analysis

Interviews were analysed utilising qualitative content analysis methods, whereby a series of themes and sub-themes was developed, which were then written up as annotated "summaries" (Gillham, 2003). Our own pre-understanding gathered through literature review and secondary research was utilised for selecting the indicators and their explicit value of evidence from the data, as well as discovering connections between individual and seemingly separate issues that are linked, for example through being indicators of the same construct. The next section presents the findings which emerged through the analytic process.

3. Empirical evidence on commercial and investment banks' responses to changing accounting standards

In order to ascertain the desirability and interest of accounting standard setters, banks and their regulators in the new measurement technology, the next section will present findings from all fifteen in-depth interviews in order to provide a sharper focus on the nature of tensions emerging among them. Commercial and investment banks provided some mixed responses regarding the issues in question. This, in essence, reflects the

nature of operations involved in each setting despite the fact that the types of assets/liabilities employed in their operations exhibit a high degree of commonality. Some common issues remain at the core of the debate and are presented below.

3.1 Valuation relevance, reliability and bias

3.1.1 Trading book operations. All participants – accountants, investment and commercial bankers – agreed on the appropriateness of using fair (market) values for trading book instruments as the most reliable and relevant measurement attribute. The three quotes following are summative of the collective opinions of all the participants involved.

Excerpt 1:

> If you are holding – let's say a gilt – in your trading book, then you have to effectively admit that you are prepared to sell or buy it, in which case, FV is completely appropriate for the trading book (Banker 1, Commercial Bank).

Excerpt 2:

> Yes, it is an accounting issue... market values. I can assure you though any changes have to do with the banking book. It doesn't concern our trading book. Nothing has changed in that respect. We follow the same practices as before (Banker 1 Commercial Bank B, Greece).

The above can further be verified with a quote given from an investment banker when he was asked about trading book positions.

Excerpt 3:

> Yes, everything we have we count it as being trading book. Trading book is great because what you effectively say is everything is liquid, everything can be sold (Banker 1, Investment Bank).

This, in turn, corroborates that ready-made, reliable market prices that take into account risk-return trade-offs exist in deep, active markets for such assets and liabilities. Consequently, they are indisputably recognised as the most relevant and reliable information platform for investment decision and evaluation purposes and they are also consistent with regulators demands for sound risk management.

The rest of the paper and the analysis following is based on perceptions of what characteristics constitute useful financial information both for investment and capital management purposes for the banking book part of banking operations.

3.1.2 Banking book operations and asset measurement. Participants (notably commercial banks) were mostly concerned with measurements applied to particular financial assets and liabilities in the banking books of banks and this has some implications also about the nature of banking operations and management of assets and liabilities further analysed below. The core of the objection seems to stem for the fact that FV measurements become highly questionable when:

- Markets for trading particular assets are inactive and preparers of financial statements must either "mark-to-model" or use their own estimates and assumptions regarding the valuation of the assets/liabilities in question.
- Some form of market exists but such assets and liabilities are thinly traded.

And thus "inside" valuation deviates from market value assignments for reasons exposed in Section 1 above (i.e. characteristics of banking products). As it can be

argued, the above leaves some room for flexibility and subjective judgments on the managers' part in measuring (estimating) fair values. As such, the concept of neutrality becomes a key issue because entity-specific inputs become highly critical for assigning values to assets and liabilities.

Under such a setting and based on the above, since defining economic value may be equally susceptible to bank-specific inputs, certain qualitative characteristics of financial reporting might be jeopardised or "traded-off" for some others. This raises important implications for the reliability (faithful representation), consistency of valuations (and thus verifiability) as well as for the timeliness and comparability among institutions of such measurements, as will shortly be demonstrated below.

Our first point of call was how the officers, both commercial and investment bankers, interpreted the concept of FVA measurement and its appropriateness. This could provide us with an objective view of their respective approaches as far as the pitfalls and attractions of the contrasting accounting bases are concerned. From that, the concepts of relevance and reliability could be assigned differing dimensions of meaning. When asked what their opinions were about how they interpreted FVA and its functionality, mixed responses emerged.

Excerpt 4:

> . . . It has as many flaws as the current cost accounting has and as HCA has as well. I don't think it improves things significantly. I've never been a believer that everybody fits in the same prescriptive (emphasis added) standards. And when it comes to banks the use of FVA can change significantly by economic data coming out either just before or just after an accounting period. It makes capital management far more difficult to having FV moving up or down just because something happened in the world that affects FV (Banker 2, Commercial Bank).

The above is a statement that questions the operationalisation of the proposed measurement attribute on the basis of the way bank value is looked at. Most importantly, it challenges the uniformity aspect of the treatment of assets and liabilities and the underlying informational content of such a measurement for regulatory purposes as well.

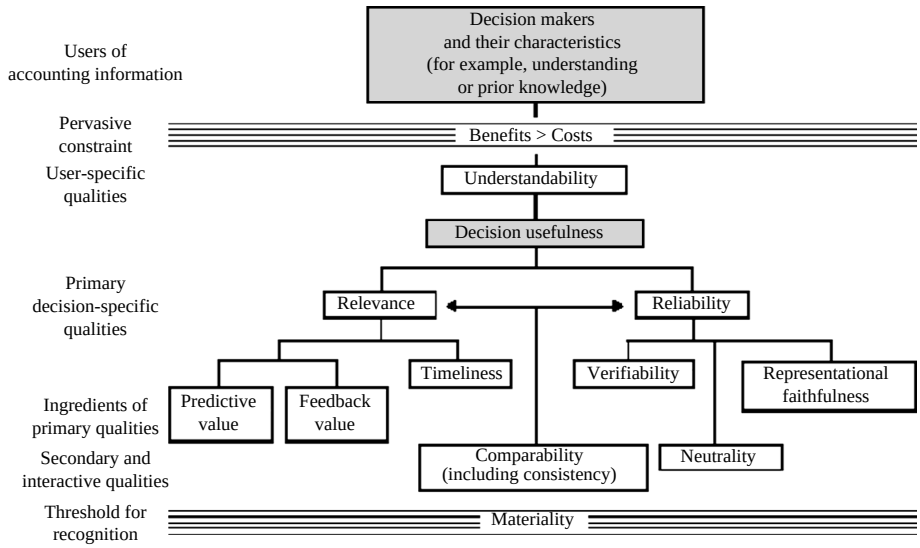
Interestingly, the FASB in its Concepts Statement (2005), ranks comparability of the accounts under the tier of secondary qualitative characteristics (Figure 1). Whether this enables investors to choose between alternative investments – in the context of banking – and whether the investing community will really make use of such estimates is indeed uncertain.

Excerpt 5:

> . . . suppose that we do it (i.e. apply FVA) for our loans and we adjust values for changes in current market conditions and someone else with similar projects doesn't. Then you'll have extreme variations. You don't have to be only externally consistent but also internally (Banker 3, Commercial Bank).

Excerpt 6:

> The more flexibility you allow, the more risk there is to achieving comparability. Again, if you are to use judgement, then the principle should be a formulate approach to be considered consistently over time and across companies (Banker 4, Commercial Bank).



Source: FASB (2005)

Figure 1.

While this was the broad consensus among commercial bankers, some investment bankers insisted on operationalising Full FVA spanning the whole of the banking operations.

Excerpt 7:

> We do our best to FV loans. Fair Valuing a loan takes into account two things: one is the interest rate and the other is the credit rating… now publicly available there's a lot of credit information about publicly traded companies. What HCA doesn't tell you is the *real* (emphasis added) volatility that actually gets through the banks' books (Banker 2, Investment Bank)

The above response explicitly acknowledges that HCA cannot be forward looking since essentially, there is a time lag in risk recognition and thus the portraying of real risks inherent and consequently the associated valuations are suspect of reliability. Such observations however, need to be interpreted in the context in which they take place.

This further led us to question the reasons for such perseverance and what are the fundamental grounds for the dichotomous opinions over measurement appropriateness between investment and commercial banks. Specifically, it was asked whether long or short positions in relation to loans had a bearing on measurement decisions.

Excerpt 8:

> Well, that's what banks always say; they are holding to maturity… but if the bank was to stop trading you would sell of those assets and ultimately when you sell them off you get a certain amount, you won't get the amount recorded in the books. You have say the high yield side and you can actually see that they will be trading in some cases at 70c/dollar… now if the high yield is at 70c/dollar and their loans are still in the banking book for 100… you would think there's something wrong there… we do (Banker 3, Investment Bank).

Investment bankers due to the position taken in employing their assets and the nature of operations involved are mostly interested in interest-rate movements which can alternately impair or enhance a financial institution's net worth or income. This is more so if Balance sheets are not fully hedged against such movements. Recent experiences, most notably in USA (Fannie Mae, Freddie Mac) during 2002-2003 can demonstrate positive accounting profits even when interest rate fluctuations render such profits economically negative or alternatively hide high-economic profits by over-reserving. The temptation to manage earnings is felt to be stronger when management is linked to contractual incentives' payments. In that sense, regulators and customers are more likely to encounter hidden losses than hidden reserves.

From this point of view, the following were generated.

First, although commercial banks have traditionally not been shy about taking on risks, based on the above statement, it is implied that they tend to overstate value. If this is indeed the case, then this has important implications both for:

(1) the reliability and relevance; and

(2) prudence instilled in the banks' measurement techniques directly supporting the standard setters move towards FFVA and uniform measurement of company value.

Second, it also implicitly challenges the stance that regulators take against such shortcomings. Financial stability is key among regulators. A collapse of a financial conglomerate emanating from misleading information can trigger systemic implications. More so in a credit-driven system where authorities might not turn a "blind-eye" for reasons exposed in Section 5 below.

There also seem to be some signs of tension between investment and commercial banks regarding capital management and investment issues; while investment banks in terms of capital treatment have to bear higher capital charges, commercial banks can "disguise" their capital management intentions as "banking book" assets/liabilities. These carry lower capital charges from a regulatory standpoint. However, when commercial bankers where asked about the forthcoming properties of FVA, they were once again sceptic as to the usefulness of such an approach.

Excerpt 9:

> Fair values are no more precise a measure of profitability than HCA or Current Cost Accounting. The amount of volatility increases and because the amount and timing of volatility increases it means that companies and shareholders are taking on additional risk. Particularly shareholders from one year to another. Say for example, there was a shift in economic data worldwide just before the end of the financial year. You would then see a deterioration of profits and that year's shareholders would actually see a fall in profits and dividends whereas in the beginning of next year as things correct themselves and assuming some shareholders changed they would benefit from excess profits. This is not a good way of rewarding shareholders because you expect them to be long-term shareholders. (Banker 3, Commercial Bank)

Commenting on the above, it is widely accepted, that bank loan portfolios are designed on a long-term, strategic basis and interest rate changes have a bearing on credit decisions but they are managed separately and are not connected to performance measurement of the underlying credit transactions (interest income gained). This statement though seems to imply that short-term interest rate fluctuations can

potentially create an unfounded sense of instability and that shareholders are unaware of the fundamental difference between realised/unrealised profits.

True, markets can be unstable. It is also true that companies are affected by such instability yet if banks are to be measured at FV they are still subject to discretion: measures of bonds and shares are easy to determine; in the case of banks, assessing the fair values of loans or mortgages for example is still subject to interpretation since two "contractually same" mortgages can be economically different to the bank (entity-specific, relationship banking, value in use).

Lastly, as argued above, in the context of banking, short-term fluctuations and short-term forecasts should not in principle affect the behaviour of banks regarding their long-term credit policy. A question regarding the effects of such fluctuations on credit policy generated the following answers.

Excerpt 10:

> I'll tell you something... it's been eight months now that we have been expecting declines in the general level of interest rates. Nothing happened. We now move to the opposite direction. Next some said we expect stability, others were talking even about increases: *buy fixed not variable rates*. We are still waiting to see what happens. So, nothing is certain following this rationale. It shouldn't affect pricing and risk measurement since it is short-term. Secondly, it should apply to everybody and have the same effects for everybody. Obviously, it has not and thus we had the shocks and accounting scandals that percolated through the system (Banker 2, Commercial Bank Greece).

Excerpt 11:

> The valuation of a banking book for two banks that do exactly the same things is basically as objective as to plan a future scenario better. This discussion about FVA for the banking books of banks is linked with scenario planning. You can probably use some flexibility or some kind of elasticity and then banks are obviously tempted to report good results, isn't this the case? By using too many assumptions or different assumptions each time then there's lack of consistency. I mean it will make the results that banks report even more grey because you know... bank accounting is already complicated (Banker 4, Commercial Bank).

Such quotes pose serious question marks for the reliability and consistency of valuations and whether users can potentially obtain a better indication of financial health is arbitrary. In order to try and get a better insight as to where the "superiority" of HCA lies when compared to FVA we specifically asked about judgment decisions between the two approaches.

Excerpt 12:

> Commercial banks as I said before hold loans to maturity and this coupled with illiquidity means that active markets do not exist for loans and thus it is very hard to value reliably originated loans. You know we cannot really either add value or write down loans especially when there is lack of documented reliable evidence to document it... unless of course, that documentation method can classify it from one category to another, which comes close to what FVA is really; portraying the fair values of portfolios which can be very widely determined (Banker 5, Commercial Bank).

Excerpt 13:

> If we buy a gilt or originate a loan which, we intend to hold to maturity why should we have it move up or down through the P&L? Especially, when the economic reality to us is that we know what the income stream is, we know what the capital that we are going to get at the

> end is. Why should we not reflect that in the P&L account as opposed to some artificial Fair Value? (Banker 6, Commercial Bank)

The above quotes are a clear display of preference for stability over volatility, verifiable versus judgmental measurements. An interesting aspect of this is that it pays more attention in looking at the distribution of volatility over time. Whether HCA or FVA is applied, assuming the positions of commercial banks with regard to the banking book remain unchanged, the cumulative profits at maturity will be the same. The big difference comes from the distribution of volatility through time. Furthermore, with regard to claims about the increased volatility introduced by adopting FVA as evidenced particularly from excerpts 7, 9, 12 and 13 above, there are arguments both in favour and against operationalizing such a framework.

Spreads, as risks indicators can be so apart, failing to communicate reliably for an asset's value, especially in the case of banks where interest and credit risk become entwined. True, "white volatility" translated in this context as observable interest rate risk that has a real and immediate effect on bank value is indeed relevant, should be reflected and have a bearing on investment decisions but equally the same goes for credit risk, if not more so; "black volatility" can also be introduced via estimation error or managerial expropriation. In that respect, relevance is no more important than reliability.

When asked about the desired features of bank accounting bankers responded.

Excerpt 14:

> Conservatism. Accounting principles with respect to regulated businesses like us should be conservative aiming for predictability and stability versus short-term earnings swings (Banker 7, Commercial Bank)

Excerpt 15:

> In my opinion conservatism is an important feature of accounting conventions. I come from the old school of accounting. I was involved with the stock exchange – during its peak – as well for three years and I was still conservative in my approach. In our industry being too spread out in upturns it's not so bad but in downturns is altogether a different thing; you are running the risks of capital seizure (Banker 3, Commercial Bank, Greece).

Open interpretations of conservatism imply different measurement estimates of assets and liabilities. One is the deliberate underestimation of assets and overestimation of liabilities in order to provide debtholders and regulators with sufficient (hidden) cushions during a downside. Another one is the setting of higher materiality thresholds in recognising gains and losses (realised vs unrealised changes). While these appear satisfactory for regulators and debtholders they are not for accounting standard setters, shareholders and stock exchanges particularly with regard to loan values and the corresponding loan-loss allowances for reasons exposed in the next section.

3.2 Substance, form and transparency

Regarding the valuation of loans, bankers and indeed other users are interested in the economic values of such instruments; however, the valuation approach as argued above, differs considerably. It will be argued that for the controversy over the setting/measurement of such amounts no method is superior over the other.

It is also very interesting that within this context and with the introduction of IASB 37, 1999 and IAS 39 accounting standard setters, regulators, conventional[5] and investment bankers seem to approach the same issue (i.e. loans and the setting of loan-loss allowances) from a different angle. It will inevitably have implications for harmonisation and implementation purposes.

This is due to the disagreement over value measurement, the methodology utilised over the setting of loan-loss allowances and the associated provisions. Owing to the uniqueness of loans and their underlying characteristics this value is the present value of the interest and capital payments discounted at the effective interest rate the bank expects to receive from borrowers collectively. This amount disclosed in the accounts is as expected not accurate since banks cannot perfectly predict which loans will default and by how much. Accounting standard setters argue that such value will usually be less than the promised amount just for the reason stated above.

That is not to say that accountants imply that banks tend to overvalue loans; it is more to do with the inherent bias built in the estimations whether upwards or downwards. This can have detrimental investor effects by either buying overpriced stocks or selling underpriced stocks. It is explicit though, that the potential for intentionally biased estimates is what causes the biggest worry (Benston and Wall, 2005). Bankers and regulators on the other hand are concerned with unreal volatility and capital safeguarding which can potentially have detrimental effects for bank viability and financial stability, respectively. Neither is superior but in the context of banking one might be preferable over the other.

In principle, when loans are recognised at their economic values (fair values) there should be no allowance for bad debts. FVA is forward looking since as stated before it requires the revaluation of an asset whenever there are changes in interest rate levels and any changes in risk (at any point in time within the holding period) are reflected in the change of the value of the asset. When asked about "vanishing" loan-loss allowances in the face of the accounts with the in introduction of FVA standard setters and bankers replied, respectively:

> Yes... impairment becomes part of the FV measurement rather than provisioning as something separate. I think it would become just one element... the changes in Fair Value. It might still be an important element that needs to be measured separately and reported separately... unless you can distinguish between changes in FV from changes in interest rate and general market interest rate changes that result to changes in the additional spread that you charge for a particular loan due to its particular credit risk (Accounting standard setter 1).

Yes that would be my understanding as well... you would see an end of the general provisions and a more scientific approach in a way to the same principle though (Banker 5 Commercial Bank).

For originated loans there are a number of valuation challenges that are there to FV credit risk and other types of risks. If you were to do FV for a loan then every risk is there; interest rate risk, credit risk, sector risk as part of the credit risk or not, maybe foreign currency risk... all of this needs to be factored into the model. To FV interest rate risk, there are a number of models that do quite well but to FV credit risk is much more challenging. When loans become impaired, we do discount the expected cash flows, so the amount charged on the reserves we record you could say it is a proxy for FV. Incurred loss makes a wonderful concept but in practice is very difficult to incorporate (Banker 7, Commercial Bank).

In effect, any losses are written-off against the income within the year in which they are incurred (i.e. they are specifically placed with the particular loan(s) in default). Then if market expectations change (i.e. increase in interest rates, increase in credit default probability) and this leads to a further decrease in value then the decrease is a top-up to the loan-loss expense specifically identified. Loans will be carried at their market value from one year to the next. From a conceptual standpoint, it seems sensible to account for "incurred" losses once agreement is reached that the object of financial reporting is direct decision usefulness, accounting for events that took place within a financial year and limit income "massaging". The interest charged should cover both "types" of losses; interest and credit losses, realised and unrealised.

Commercial bankers though disagreed with such an approach:

> A loan of £100,000 with interest rates going up effectively signals that its value is reduced in the balance sheet. So you FV that loan down but with swaps you mitigate this. You can however still lose money on the loan just because someone is not willing to pay. No... even if the loan is marked-to-market this has nothing to do with provisions. It has absolutely nothing to do with the fact that a loan is going into default or with the fact that a borrower is strong enough to pay.

Just because you moved a loan in FV it doesn't mean that you are going to lose money on it either. Fair Values and provisioning do not go hand-in-hand (Banker 6, Commercial Bank).

FV measurements though seem not to take into account prudence since they treat unrealised gains and losses similarly. They do not distinguish between different types of risks and what that essentially mean is that they incorporate risk types that are not directly linked to the counterparty. Even if proxies for Fair Values were used (i.e. spreads) are at best imprecise and are susceptible to factors again not linked to the counterparty in question.

So in terms of "superiority" neither method is bias-proof since both depend on subjective measurements. Yet, in a qualitative characteristics context a dynamic capital buffer (that takes into account the recognition of losses) seems more acceptable on the bases of reliability and prudence. When bankers and accounting regulators were asked about the potential grounds for manipulating income based on current cost accounting practices/HCA we were given the following responses:

> It's true either way. History though has shown that for banks this is not probably the case (Banker 7, Commercial Bank).

> Yeah... I have heard that argument as well. My counter argument to that would be that if you want to look back at banks' history, say in 1988, their level of provisions was nearly zero. Then the crush comes and how did the banks absorbed massive losses? They increase their charges to the customers. The spread back then was 180 basis points and overnight was 240 basis points. So what they did was to charge all their customers that they were left for the losses that had been incurred on people who defaulted. That's the long-term impact of not providing sufficiently through the cycle (Banker 1, Commercial Bank).

> A lot of banks have used general reserves... certainly in the 70's. They used those general reserves more often as well to smooth profits... not completely but they certainly did... if you look at IAS 39 you do not have general reserves going forward (Investment Banker 1).

> Well, there is the temptation to do that… and banks have been very keen to smooth their earnings… so investors feel confident they will get a constant growth rate… rather something big this year and very low next year, even if the total over 5 years is best… (Accounting standard setter 2).

It is however, difficult to operationalise and document, largely due to the fact that the vagueness in the proposed accounting standards as currently defined makes it difficult to establish concrete proofs of events that triggered specific losses. IAS 37 states that for a loss to occur this must be based on past events without specifying the timing of such events or which event is admissible that an advance by a borrower has occurred.

It could be literally everything; when the factory closed down, when there has been a shift in pricing, a bankruptcy of a subsidiary. Equally, there is still quite some latitude in "eventing" the causes of loss, identifying what has actually happened and what type of loss confirmation period banks need to utilise for such an accounting treatment.

Furthermore, it could be argued it makes things even easier for income manipulation purposes since such latitude allows for even wider margins of supporting documentation. IASB's accounting guidance as currently set provides even more grounds for biasing estimates and consequently undermining in a way the FV treatment.

On that ground, regulators have quite rightly established a common approach and specific guidelines for loan-loss accounting – the so-called dynamic provisioning or over-the-life provisioning for the expected losses – not only for financial stability and systemic risk prevention but also for more consistency and comparability in the loan accounting approach within the banking context. It would be sensible for such an accounting "stable" to be agreed among accountants, regulators, bankers and even stock exchanges on the grounds that is information which, is more obtainable, more reliable in terms of its statistical precision and admittedly more conservative as well.

Despite the fact that such a system (as stated by accounting authorities) primarily stems from a principles-based approach, highly prescriptive standards (for example the highly strict rules for meeting hedge effectiveness criteria, strict technical adherence to the incurred loss model, etc.) place a threat on the "substance over form" concept. The latter was advocated by accounting standard setters over the years and by many is regarded as a necessary accounting quality that can potentially safeguard against the kinds of fraud that took place during the pre-Enron era. This further means, that it can potentially have a neutering effect on the "true and fair view" maxim as well. Increasingly, companies adopting IFRSs in their opening accounts' statement declare: "the accounts give a true and fair view, in accordance with IFRSs adopted for use in the E.U.".

First, one could ponder on whether this statement has traces of similarity with the one presented above in the introductory part (page 1) or at least ask whether there is some backfiring potential. Second, such a statement need not be displayed if standards are indeed principles-based and most importantly it reloads the burden of responsibility to accountants again. Third, this can potentially turn to an expensive compliance exercise that will try to over-ride conflicting national accounting standards rather than reflecting the real substance of transactions involved. Fourth, as a result of point three above, the auditing liability for attesting to "bad accounting"/"true and fair view" is further diminished shifting the burden once again to both accountants and even more to regulators and puts a strain on verifiability. As a banker explicitly stated:

I believe that banks should be allowed to use dynamic reserves or any type of conservative accounting for managing the portfolio on a lifetime basis. My personal

view is that this is a management issue; we should be allowed to do that and hold reserves to that level. I do not think that the standard setters should be able to dictate that. This is what they effectively do (Banker 5, Commercial Bank).

One way forward would be to include enhanced disclosures of distinction between "incurred" and "expected" losses and show the reserve split for financial reporting purposes for general purpose users since that is already happening for regulatory capital purposes.

So far, with reference to FVA, the accounting standard setter's point of view comes close to "one-size-fits-all" approach. One significant obstacle in our opinion for harmonisation and convergence of accounting standards is that not only do standard setters not distinguish between different types of companies but also attention is paid neither to the way banks deploy their assets nor to the system in which banks operate. These can have further important harmonisation implications as the purposes of financial reporting differ considerably in such environments. It is this to which we turn our attention now.

4. System type and regulatory policy implications

While increased transparency and risk management practices are at the centre of the proposed accounting changes, emphasis should be placed also on the types of banks, the nature of the operations involved (i.e. long or short positions) and the way their assets are deployed in achieving the desired returns with regard to the system in which they operate. However, the move to FFVA is bound not to distinguish among the above characteristics. When asked about distinctions made between companies, accounting standard setters replied:

> Well... no. It is not what type of company you are but what type of assets and liabilities you have... therefore... the same types of assets and liabilities should be measured the same way whether you are a bank, an investment bank or an insurer... and that is happening under IASB (Accounting standard setter 1).

Under the IASB's doctrines only if FFVA is applied, transparency and comparability of accounts are efficient since the market's voice is heard and according to classic finance theory same assets should bear the same cost (price) for holding (selling) them. This might not hold true when strong government intervention is present or when banks operate in a strong creditor-oriented system. The introduction of IASs will potentially pose many challenges for such systems which are credit-based. According to Nobes (1998) differences in the financial reporting emerge through the different purposes of national financial systems.

In the case of Greece, banks follow a mixture of the French-German accounting system with a very small capital market. That is, the system under which they operate, is strongly credit-based, with banks being the dominant financiers, what Zysman (1983) called "weak-equity outsider system". As such, the demand for public disclosure is much more limited when compared to strong, market-based systems (i.e. UK and USA), where prices are established in strong, competitive markets and thus the pressure for systematised, timely information is of paramount importance. To that, it should be added that government intervention co-exists with the Bank of Greece consulting with the government for fiscal and monetary policy issues.

The new, IAS 37 (impairment and provisioning) and IAS 39 will pose major challenges for adaptability, comparability and convergence since it can potentially

transform the way the financial sector conducts its business, especially in strong, creditor-oriented systems.

When bankers in Greece were asked about the potential implications of compliance with IAS 37 and IAS 39 guidance for measurement, disclosure and provisioning and their effects on credit policy their replies can be seen as critical against such prescriptive standards:

> Oh... I feel very strongly about that... in our country banks are the steam-machines of the economy... especially when we don't have strong companies and strong markets we have to have strong banks at least... it doesn't matter whether we are supported by political parties, government or other "public" say bearers. When financing is needed mostly banks have to be strong so as to be able to support any kind of lending asked, from risky corporate loans to potential problem lending. So... yes, to some extent we should (emphasis added) receive favourable treatment (Banker 3, Commercial Bank, Greece).

> I believe it is very rational to incorporate the idea that from the moment you grant loans to individuals or companies a percentage of it should be considered bad debt, lost or defaulted. You don't know who exactly but you can estimate the amount. I believe that dynamic provisions ensure safety and liquidity. The pricing also here in Greece is more or less "flat" except in sluggish periods in which instead of say selling 100 loans we decide to sell 150 cheaper loans to help the economy. So by nature we are restricted as to "individual pricing". Dynamic reserves help you establish the dynamic viability so as to be able and stop the downfall before it actually happens (Banker 2, Commercial Bank, Greece).

The main scepticism around IAS 37 and IAS 39 for such types of banks and their respective systems stems from the fact that once the notion of "strong equity markets" is stricken out of the equation, market discipline is substituted by "official discipline" which selectively chooses what to regulate and what not to. A characteristic example is that the Greek equity market is dominated by investors unwilling to lend to private companies. Banks on the other hand, as the main source of funds, can still influence firms' behaviour by threatening to withhold the services that only they can provide sufficiently (Emre Ergunor, 2003) as insiders and most of the time as part of a management lever. When asked about the degree of market discipline that could be potentially exerted on banks we were literally cut-off:

> ... In Greece? There is not a chance that authorities will ever allow a bank to go bust... I can give you thousands of reasons... banks in Greece are the mirror of the economy (Banker 1, Commercial Bank, Greece).

This, in turn, is seen as lending support to notions such as "social conscience of the economy" that can be also translated simply as, protectionism. Sovereigns, thus, can effectively rule out "chunks" of the international legislature whenever such standards either distort their own national standards or do not serve the "local conduct code of business". To that we can also superimpose the role of banks as the kind of institutions that smooth intertemporal shocks (Freixas and Tsomocos, 2003), especially in the case of weak-equity systems where bank stability has an all important role to play.

While HCA has been argued to posses adverse microsystemic properties[6] for the assessment of an entity's truthful income and position representation (income smoothing, hidden reserves), it can equally be argued that FFVA will have perverse effects in the macro-level context, particularly for credit-based systems (for example,

countries like Greece, Germany, France, Italy) through its effects percolating through cumulative pro-cyclicality.

As argued above, FFVA measurements will drive ever increasing results during boom times when asset prices are increasing since according to economic theory, economic agents will underestimate risks (or irrationally ignore them). This can, in the short-term, be creating expectations reflected through for example a short-term bias by investors demanding higher, increased dividend payouts on "might never be" realised profits.

This approach has two undesirable attractions: firstly, it does not instil the desired degree of prudence in the system, which in principle, should to the very least not recognise unrealised changes and secondly, does not appreciate the role of reserves built in the system earlier for the efficiency and stability of the financial system. In the case of weak-equity systems, the danger of a main bank collapsing is significantly higher for systemic stability.

Even in strong, market-based systems, there can potentially be "subsidisation issues" emanating from the IAS doctrines around provisioning and the strict adherence to the proposal based on "incurred loss models". An important aspect of such proposition is that it comes very close to linking profitability with segregated customers/companies, whereas commercial banks manage on an aggregate portfolio basis. Assets like loans are non-negotiable as a result of their non-marketability and consequently a "reasonable level of opacity" is owed to firm-specific aspects since they provide deposits and loans on a matched basis so as to be able to service sufficient liquidity to different components of the financial industry in downturns. This further means that such an approach endangers the role of banks as liquidity and maturity conduits stemming from their unique feature as fulfillers of informational asymmetry gaps.

FFVA advocates the stop or liquidation value of the business by treating every asset and liability as being "spot" liquid. In the case of banks, it will not reflect their hold-to-maturity attitude and thus long-term loans would appear to be the most costly and volatile to hold. The potential trade-off can be a shift to a defending position by being overly worried in extending credit especially for high-risk industries both in good times and even more in bad times, shifting to short-term loan contracts or shifting the risk – and accordingly pricing – to customers:

> We prefer to charge our customers 2 basis points per year for provisioning charges rather than waiting for nine years charging nothing and then in the tenth year charge all our customers (emphasis added) 25 basis points to recover specific losses. Now, it seems a fairer approach to wait until some people have lost money and then you charge all of your customers the amount of the people that have lost. It doesn't appear to us to seem fair that (Banker 4, Commercial Bank).

The above quote not only poses some vital questions over the desirability of FFVA at least for the banking books of banks. It portrays the different stance between accountants and bankers and their regulators over fairness perceptions. This comes to reinforce the point made in Sections 2 and 4.2 above that FVA has different attractions and dangers for accounting standard setters as opposed to regulators and bankers. It also reinforces the regulatory stance that: "the probability of losses exists from the moment a loan is granted, but will come apparent ex-post with the emergence of default problems" (Caruana, 2002).

In addition, by definition a stop-value assessment cannot be taking into consideration the going-concern concept. That is: long-term fundamentals, long-term

relationships or long-term investment needs. Hence, the Basle Committee's efforts to support dynamic provisioning for hardwiring the credit culture of banks and shielding banks and systems collectively, early for adverse economic shocks instead of supporting an incurred loss model put forward by standard setters.

In a recent statement after deliberations with the EU Committee, IASB and the EU Committee agreed to the introduction of IAS with the exception of two "carve outs" relating to the Fair Value Application on the banking books of banks relating to hedging and impairment measurements. This was after the Basle Committee's and the EU's concerns over the use of the FV Option. This debate is far from over. The above it is just intended as a short-term solution, since IASB has signalled their intentions to continue working on the application of a single set of high quality, uniform standards. Interestingly, France has declared that they will not require IAS and Germany will permit but not require their companies to follow IAS while they have completely opted out of the FV Option supporting that it does not work for their respective systems. Greece while endorsing it will not follow the FV option as well.

5. Conclusions

For most part of the debate, the disagreement revolves around different perceptions of value measurement and prudence/conservatism in accounting and their desired degree of application and appropriateness. In addition, such disagreements could be examined in light of the system that financial institutions operate. This provides for another platform on which the argument can be developed.

In strong, open capital markets where, transactions can be observed in an arm's length the preparation of financial information and its disclosure are especially important. This is not so much the case in settings which, are based on long-term relationships and designed to keep information tightly constructed around the providers and users of funds as insiders (Allen and Gale, 2000). This goes for banks both in market and credit-based systems. In any case, the constituent parts of information provision bear both the characteristics of public good and proprietary information (Borio and Tsatsaronis, 2005a, b). Such elements are almost by definition most restraining in the banking sector than anywhere else[7].

This is exacerbated in markets in which financial institutions must also act as the disciplinerers of other institutions through their ability to develop and monitor long-term contractual relationships and their ability to also capitalise on such information sets.

Since, banks specialise in the collection and evaluation of private information, the disclosure of information considered proprietary for strategic purposes (i.e. strategic portfolio allocations – long and short positions) can potentially be detrimental to a bank's future ability to generate profits (Jordan *et al.*, 2000). On the other hand, non-financials' success or failure is dependent on patents with financial accounting information communicating the results of such competitive positioning. One can immediately spot the difference between these two types of companies and how a uniform approach in financial reporting can potentially affect the competitive advantage of one type over the other more severely.

In addition, to the satisfaction of standard setters and stock exchanges additional fair valuation techniques (estimates) could be disclosed not in the notes to the accounts but parenthetically along the cost values of corresponding items (e.g. loans) so as to substitute for recognition and also incorporate other users' interests on such

specific information. Lastly, some have argued that historic cost accounting reflects an emphasis on providing reliable financial information, even if the information is not the most relevant to the problem facing the decision maker (Benston and Wall, 2005). Relevance though should again be addressed in the context in which is applied. This means that account should be taken of the intentions of banks to either sell or hold. If banks are prepared to sell then indeed FVA provides timely information, relevant to the investment decision in question. If the intention though is to realise an investment to maturity then by applying FV measurements it is not transparent how a change in value is derived, how this relates to the contracted cash flows and most importantly how this can influence the decision to hold to maturity.

Designing a channel from which information will flow with accuracy, timeliness and reliability does not come without some trade offs. For example, over the issue of the use of HCA and FVA and their informational content, today's accounting standard setters, managers and regulators have somewhat different prioritisation. This can be reflected on stressing the importance of relevance in the first case and accuracy and immediate verifiability of the accounts in the second case. Depending on the user of such information "less immediate verifiability" but reliability might be preferred over accuracy and objectivity.

Notes

1. Fair Value Accounting includes but is not limited to market value accounting. It can also incorporate values that are marked-to-model in the absence of observable, reliable, ready-made market prices (i.e. values that are based on some version of the Pr. Value model).
2. We restrict our approach to banks due to their importance fort systemic implications and financial stability in general. The same concerns could be raised, though, for the stability of other sectors such as insurance.
3. "Subsequent goods": credence goods, those goods for which quality can be ascertained at a cost, after the purchase with some time lapse involved and for which in some cases it does not lend support to notions of "objective evaluations".
4. This statement, though, does not seem to take into account the going concern concept since it actually bases the setting of prices as exit values. An almost identical statement can be found in IASB's standards.
5. Conventional: the normal banking business of underwriting loans.
6. Microsystemic: micro level, firm level.
7. We would argue that it is even more vital for banks that operate in small credit-based economies characterised by the dominance of 3-4 big players whose success mainly lies with protecting management accounts rather than say patents.

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