Financial Reporting, Banking and Financial Crisis: Past, Present and Future

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Introduction

The quality of financial reporting in banks is often cited as a contributory factor in banking crises. There is a broad presumption in favour of greater disclosure in published financial statements, which are now longer and more detailed than ever, with the typical annual report and accounts of major banks several hundred pages long, reflecting the size, complexity and geographical reach of these businesses (Sowerbutts et al., 2013). Tadesse (2006) related the incidence of banking crises in the 1990s to the regulation of disclosures made by banks and characterised arguments over transparency into two categories: 'transparency-stability' and 'transparency-fragility'. Pillar 3 of the Basel II Accord on Capital Adequacy in banking reflects the transparency-stability view: disclosure enhances transparency and improves information flows, thereby contributing to market discipline and financial stability, and leading to the more efficient allocation of resources, with sound banks rewarded and the unsound penalised. In contrast, the transparency-fragility view holds that 'disclosure creates "negative externalities" ' (Tadesse, 2006, p. 34), which include the possibility that disclosure would stimulate runs on banks which faced financial difficulties, and thereby disrupt the banking system as a whole with wider negative economic consequences.

One response to the transparency-fragility view is to curb banking transparency on a temporary basis in times of crisis through suspension of publication of banks' financial statements, as occurred for example in mid-nineteenth century Spain and Italy in 1931-2 (Bernal Lloréns, 2004; James, 1992, p. 611). Another is to block transparency altogether, a situation which prevailed in the United Kingdom for most of the twentieth century. Here the largest banks were firm believers in the merits of 'non-disclosure', a term used in this chapter to describe the techniques these banks adopted to curtail transparency and obscure their 'true' financial position and performance.

This chapter examines the relationship between financial reporting, banking and crisis and comprises three sections and a conclusion. The first section summarizes the evolution of financial reporting in the British banking sector in the twentieth century. Although there were special reasons for the extent and longevity of non-disclosure in banking, similar practices were common in other types of company for as long as legislation allowed. The second section examines fair value accounting (hereafter FVA), sometimes not strictly accurately referred to as 'mark-to-market' (hereafter MTM), which has been a particular focus of controversy in 'our' financial crisis of the early twenty-first century. The third section discusses shortcomings in some other aspects of financial reporting and accounting in banking in the years preceding 'our' crisis. In the inevitable post-crisis reaction, regulators signalled their dissatisfaction with financial reporting and long-held concerns about the quality of audits and concentration in the market for audits of large companies were reignited. This section also examines some of the numerous suggestions for improvement which have been put forward, many of which remain to be implemented.

Financial reporting in British banking[1]

The techniques that contributed to non-disclosure had deep historical roots and arose from the joint-stock banks' origins as private banks and partnerships, most of which had been absorbed in the amalgamation process which by 1920 had produced a concentrated banking sector dominated by the 'Big Five' English commercial, or clearing, banks (Turner, 2014). For governments and the Bank of England this market structure delivered stability and was a convenient policy instrument in an environment in which they could deal with a limited number of significant institutions. For the banks themselves non-disclosure could be regarded as a self-serving device to prevent takeovers and restrict market entry, aside from the stability benefits. The privilege of non-disclosure was part of the implicit regulatory bargain in which the banks accepted the trade-off of special privileges in return for acting as a monetary policy tool, albeit an imperfect one.

'Hidden' (or 'inner' or 'secret') reserves were the main tools of non-disclosure and were usually aggregated with the deposits total in published balance sheets. These reserves were used in 'profits smoothing', in conjunction with opaque accounting policies on the treatment of unrealized profits and losses on investments, fixed asset valuations and depreciation policies, and the determination of write-offs and provisions for bad and doubtful debts. Such practices were used to deliver 'conservative' accounting which reassured depositors and shareholders of the banks' financial soundness and prudent behaviour.

The evidence on the use of hidden reserves by companies generally is unsatisfactory. Their extent and treatment in published accounts varied greatly from industry to industry and company to company (Arnold and Collier, 2007; Arnold and Matthews, 2002; Edwards,

1981; 1989). Accounting historians agree that the general quality of financial reporting deteriorated during and after World War One, due to uncertainties around wartime taxation and difficult postwar economic conditions (Edwards, 1989). Banks appear to have been the most likely users of hidden reserves in the late nineteenth and early twentieth centuries and one of the largest, the Midland, first established a hidden reserve ('contingent fund') in 1866 (Arnold, 1996, pp. 47-49; Holmes and Green, 1986, p. 52). The professionalization of auditing in the nineteenth century appears to have encouraged the general use of hidden reserves, to reinforce conservative accounting and offer protection against the excessive dividend expectations of some shareholders (Maltby, 1999, p. 29). Witnesses to the 1925 Greene company law amendment committee cited the example of banks in support of hidden reserves (Edwards, 1976, p. 292-293).

The Taxation and Financial Relations Committee of the Institute of Chartered Accountants in England and Wales (ICAEW) issued 'Recommendations on Accounting Principles' from 1942 (Zeff, 2009). These recommendations were reflected in the Cohen Committee Report (1945), which provided the basis for the Companies Act 1947 and the consolidating 1948 Act. These required the publication of consolidated accounts for groups of companies and prohibited the existence of hidden reserves, thereby leading to more transparent financial reporting for most companies. These changes reflected a long-term shift in attitudes, with increased importance attached to shareholder interests stimulated by the 1931 Royal Mail Group case, which represented a turning point in financial reporting, other interwar financial scandals, and the wartime experience and acceptance of greater state regulation (Edwards, 1989, pp. 207-210; Maltby, 2000). These Acts granted banks various explicit exemptions: the use of hidden reserves was permitted; profit and loss accounts needed only to show profits

after tax and after transfers to or from hidden reserves; and there was no requirement to disclose asset valuation policies.

The existence and use of hidden reserves by banks was always well-known, but not their extent. The Big Five banks all made significant use of hidden reserves, which they considered entirely normal. Various devices in published accounts and sometimes unambiguous statements to shareholders' meetings signalled conservative accounting. The banks offered paternalistic views on the issue, for example: '... internal reserves are of a somewhat shy disposition and do not like exposing themselves in the public gaze' (Lloyds Bank, 1925, comments by Deputy Chairman). In their written and oral evidence to various official committees the banks heavily emphasized non-disclosure as a foundation for stability and these arguments helped secure their exemptions under the 1947 and 1948 Acts (Cohen Evidence, 1944, questions 4626 and 4728-4743; Committee of London Clearing Bankers, 1960; Minutes of Evidence, 1959, 23 January 1959, pp. 923-924).

Attitudes had started to shift by the beginning of the 1960s. The Jenkins Committee on company law re-examined the issue of non-disclosure and the banks were obliged to articulate more clearly their arguments that disclosure would create negative externalities now that other companies reported on a more transparent basis. Two new arguments emerged in support of non-disclosure. The first was that British banks would be disadvantaged relative to banks in countries which continued to enjoy non-disclosure, notably in continental Europe. The second related to the special concerns of the 'British overseas banks', the British-owned banks with significant international interests, particularly in colonies and ex-colonies. They feared that full disclosure, coupled with the decolonization process, could reveal higher than expected reserves which might expose them to higher taxation, excessive wage claims,

demands that reserves be held in those countries, and even expropriation or nationalization. Alternatively, the disclosure of lower than expected reserves might result in crises of confidence threatening stability.

The Jenkins Committee's report (Board of Trade, 1962) recommended no changes, although many commentators supported a dissenting minority. The election of a Labour government in 1964 gave impetus to moves to fuller disclosure. The bankers reasserted the arguments for non-disclosure in meetings with government in 1966, but the Companies Act 1967 gave the Board of Trade power to withdraw the banks' exemptions and thus force the end of non-disclosure. Two Board of Trade reports confirmed the banks' assertions of volatility in their 'true' profits (Board of Trade, 1965; 1969), but also reinforced the government's view that the large banks used non-disclosure to conceal very strong financial positions, thereby undermining the 'transparency-fragility' argument. Two official reports on banking (Monopolies Commission, 1968; National Board for Prices and Incomes, 1967)) increased the pressure for change by calling for an end to non-disclosure. The Bank of England supported non-disclosure in private comments to the Treasury, but opinion within the Bank was divided (Capie, 2010, pp. 444-447).

Some banks had begun to favour fuller disclosure by the end of the 1960s. They felt that they would prefer to operate in a more competitive environment, having spent much of the period since World War Two subject to various forms of implicit and explicit government control. The laissez-faire regulatory instincts of the Bank of England, which had long resented its own role in implementing these restrictions, pointed in the same direction and led to the *Competition and Credit Control* regime in 1971 (Capie, 2010). A variety of institutions had emerged to meet the unsatisfied demand for bank lending as banks charged interest rates

below market-clearing levels. Bank mergers intensified competition with these institutions but undercut the transparency-fragility argument, with the remaining major banks even more obviously ‘too big to fail’. The control of new share issues by the Capital Issues Committee had forced the banks to wait until 1959 for their first rights issues in decades, with retained profits as their only source of new capital (Billings and Capie, 2007). The banks recognized that more accurate signalling of performance to shareholders would now be necessary in raising additional capital, although there is no evidence of direct pressure for more disclosure from shareholders or the London Stock Exchange.[2]

In the summer of 1969 the major London banks decided collectively to end non-disclosure voluntarily before the supporting legal exemptions were withdrawn. In February 1970 these banks published their ‘true’ results for 1969 based on standardized rules developed on advice from the eminent accountants Ronald Leach and Sir William Lawson. Although the end of the non-disclosure era did not result in fully transparent financial statements for British banks it brought their financial reporting closer to that of other companies, and by 1975 the UK ranked sixth out of 18 countries in an international bank disclosure index (Kahl and Belkaoui, 1981). In 1979 the banks abandoned the most important elements of the Leach-Lawson rules on the treatment of bad debts and profits and losses on investments, which essentially smoothed over a period of five years these important sources of fluctuation in bank performance.

In addition to the practices discussed above, UK banks subjected their cash balances to ‘window-dressing’, the use of short-term transactions to increase the amount of cash shown in their reported financial statements, a signal of the ‘soundness’ of their finances. This practice originated in the second half of the nineteenth century when banks began to publish

balance sheets on a regular basis. Officially it ended among the clearing banks in 1946, but there is evidence of window-dressing in the 1970s by the 'fringe' or secondary banks which developed in the 1960s and early 1970s.[3]

Worries that the kind of practices described above concealed fundamental problems in the sector would have been misplaced. In the period 1920-70 the large banks either smoothed profits over periods of several years rather than consistently overstating them or used higher-than-reported profits to build up their capital positions, despite occasional difficult periods due to bad debts and volatile securities prices (Billings and Capie, 2007; Capie and Billings, 2001). While non-disclosure implied some conflict of interest between depositors and shareholders, in that undisclosed transfers to hidden reserves limited profits available for distribution as dividends, it assisted the long-term survival of banks during periods of difficulty. After the failure of the City of Glasgow Bank in 1878, the British banking system enjoyed remarkable stability (Turner, 2014). Those failures which did occur, for example in the difficult macroeconomic conditions of the late 1920s and early 1930s, would also surely have occurred had financial statements been more transparent. The banks, to their long-term commercial benefit, had earned trust and credibility. The enduring acceptance of non-disclosure suggests that the users of banks' financial statements understood their limitations, believed non-disclosure to be in their individual and collective interests, and generally had faith in bankers' behaviour. Trust prevailed, but depended in part on bankers' willingness to disclose their problems to the Bank of England, as for example Lancashire banks did in the 1920s (Sayers, 1976, p. 249).

From the end of non-disclosure in 1970 until the crisis of the 2000s, deficiencies in financial reporting do not seem to have played a major role in any of the significant failures in British

banking - the secondary banking crisis in 1973-4, and the failures of Johnson Matthey Bankers in 1984, Bank of Credit and Commerce International (BCCI) in 1991, and Barings in 1995. These arose through macroeconomic mismanagement coupled with financial sector liberalization, audit and regulatory failures, frauds of various types, and internal control weaknesses.

This section has focused on financial reporting practices in UK banking. But the ample evidence of these and similar practices elsewhere suggests that the UK is representative of wider international experience, and that the transparency-fragility view also held sway in other countries. Examples include: the use of hidden reserves in banks in Australia (Walker and Whittred, 1983), interwar Canada (Drummond, 1991, p. 249), Germany (Bornemann et al., 2012; Gall et al., 1995, pp. 573-574) and Hong Kong (Leung and Zhao, 2001); window-dressing by the central banks of Austria and France in the interwar period (Aguado, 2001; Blancheton, 2012) and by US banks in the 1970s and 1980s (Allen and Saunders, 1992); and in Japan the recent use of latent revaluation reserves (Sawabe, 2002) and deferred tax accounting (Skinner, 2008) for profits-smoothing and to boost regulatory capital. Future historians will doubtless discover further examples.

Fair value accounting and financial reporting

The financial crisis of the late 2000s tested the stability of individual financial institutions and the financial system as a whole. Crisis also exposed tensions between financial stability and transparency in financial reporting by banks, notably over issues such as FVA, the adequacy

of loan loss provisions, and the timely recognition of losses. This section addresses the first of these issues.

The role of national rules in financial reporting by banks has declined, with requirements heavily dependent on international accounting standards and regulation. The desire to settle on a set of common, comparable and transparent international accounting standards, at least for those large companies which make significant use of financial markets, drove the harmonization of financial reporting based on International Financial Reporting Standards (IFRS) developed by the International Accounting Standards Board (IASB). IFRS were adopted for listed groups in the European Union from 2005, with considerable but incomplete 'convergence' between IFRS and US Generally Agreed Accounting Principles (GAAP). But many have argued that uniform accounting standards are neither desirable or necessary (see, for example, Walker, 2010) and academics and practitioners questioned from an early stage whether IFRS have been implemented and enforced on a comparable basis in different countries (Ball, 2006; Pope and McLeay, 2011; PriceWaterhouseCoopers, 2008; Zeff, 2007).

FVA is particularly relevant to financial institutions because a high proportion of their assets and liabilities are tradable and therefore subject to the FVA provisions in relevant accounting standards. In general terms, under FVA assets and liabilities should be measured at prices set by willing, independent, informed, buyers and sellers in arm's length transactions, or at least approximations of such prices.[4] Advocates of FVA argue that it produces more relevant, consistent and understandable financial information than the main alternative, historical cost accounting. Financial innovation has expanded the range of financial instruments, creating new derivatives and asset-backed securities, for which historical cost values are likely to be irrelevant. This encouraged the shift to FVA as a constraint on managerial discretion in the

use of ‘creative accounting’ techniques, in order to expose more readily the type of unrealistic accounting associated with regulatory forbearance in the US savings and loan industry in the late 1980s and Japanese banking in the 1990s (Jackson and Lodge, 2000, pp. 109, 111; Sawabe, 2002).

The merits of FVA and alternative measurement bases have been debated thoroughly by academics and practitioners (Walton, 2007). Views range from the idealistic (Barlev and Haddad, 2003) to the sceptical on practical or theoretical grounds (Benston, 2008; ICAEW, 2006; Plantin et al., 2007), but pre-crisis evidence broadly suggests that FVA increased the informativeness of financial statements (Landsman, 2007). Both IFRS and US GAAP fall far short of requiring that FVA extend to all the transactions and balances which appear in banks’ financial statements (Laux, 2012) and Georgiou and Jack (2011) argue that the use of ‘mixed measurement’ bases (i.e. some combination of FVA, historical cost or other methods) is the historical norm.[5]

Banks raised numerous objections prior to the implementation of accounting standards which required the use of FVA (Chisnall, 2000; see also the summary by the European Central Bank, 2006, pp. 31-35). They argued that FVA would not serve the interests of a range of stakeholders beyond shareholders (depositors, bond investors, market counterparties and regulators) given the high gearing ratios of banks. Under the Basel approach to determining capital adequacy, FVA would cause capital ratios to become more volatile and therefore minimum regulatory ratios could be violated more frequently. This could damage banks’ credit standing and lead to more conservative lending (to reduce risk-related capital requirements), which in turn would be detrimental to the stability of the financial system and long-term business finance. These arguments appear ironic given the criticisms of banks for

excessive ‘short-termism’ in their lending and securitization activities prior to ‘our’ crisis. Bank regulators were cautious about the use of FVA for measurement purposes in financial statements, but considered disclosure of fair values would provide useful information (Jackson and Lodge, 2000, p. 122). Advocates of FVA argued that greater volatility in the reported profits and capital of financial institutions would simply reflect the economic reality of business cycles and financial markets.

Some bankers, other participants in financial markets and politicians have claimed that FVA created a ‘tipping point’ which exacerbated ‘our’ financial crisis. They argue that in adverse market conditions ‘market prices’ became harder, or impossible, to determine as mutual trust between financial institutions and confidence evaporated. But FVA requirements forced financial institutions to use ‘unrealistic’ values in their financial statements which weakened their reported financial positions. This created a negative feedback loop which drove down asset prices, generated margin calls and led to ‘fire sales’ in the rush for liquidity. These arguments were sufficiently powerful to generate extreme political pressure which forced both the US Financial Accounting Standards Board and the IASB to relax requirements for FVA (Rose, 2009, pp. 627-630).[6] But academic research (summarized by Laux, 2012, and Amel-Zadeh and Meeks, 2013) has largely discredited the charge that FVA or MTM in financial institutions caused or compounded ‘our’ crisis and many academics, practitioners and users of financial statements have defended FVA as representing the ‘best guess’, even in extreme market conditions. But there is also wide acceptance that FVA increased the volatility of reported profits.

A large body of evidence supports the view that companies indulge in ‘earnings management’ to reduce reported volatility and for other purposes (Walker, 2013), which

raises concerns that FVA for financial instruments invites 'creative accounting' in illiquid or incomplete markets, when many 'fair values' are necessarily subjective due to heavy reliance on the use of models and estimates. Discounted cash flow and option pricing models, for example, involve judgmental elements open to potential manipulation, as the collapse of Enron demonstrated before the financial crisis (Benston, 2006; Gwilliam and Jackson, 2008). Accounting standards recognized such problems to some extent, but the combination of complex financial instruments and financial crisis still created formidable problems for preparers and auditors of financial statements, despite attempts by the audit profession and its regulatory bodies to address these in the early stages of the crisis (Humphrey et al., 2009). Allen and Moessner (2012, pp. 143-144) argue that loss of faith in audited financial statements incorporating values derived from regulator-approved models contributed to the crisis, echoing an earlier critique that FVA poses a moral hazard problem by allowing managers to exercize discretion in the use of valuation methods where 'verifiability' is a problem (Watts, 2003).[7]

The argument that FVA introduces undesirable volatility into financial reporting parallels one of the key arguments in favour of non-disclosure. Banks argued that the full disclosure of large fluctuations in investment values and irregular patterns of loan losses disproportionate to profits in any single year could cause depositors and the general public to lose confidence. This argument carried weight when memories of the interwar period were strong and clearly influenced the Cohen Committee's judgement that: '... the interests of the depositors ... outweigh the interests of shareholders' (Cohen Committee Report, 1945, para. 101). Market values of investments were arguably more misleading in the relatively illiquid markets of this earlier period, and such values were anyway irrelevant for assets held for the long-term, echoing modern distinctions between 'trading' (or 'available for sale') and 'investment' (or

'held to maturity') portfolios. In concluding this section, it is interesting to note that the FVA controversy links to the concern expressed by Mark Casson in chapter 2 of this volume that 'business decision-making is based on costly and untrustworthy information', the detrimental effects of which are felt when 'a reputable elite endorses an over-simplified view', a description some would apply to FVA.

Other issues in pre-crisis financial reporting and suggested responses

There have been post-crisis improvements in financial reporting but concerns remain, fuelled by numerous official reports and commentaries by regulators and academics. This section addresses various issues other than FVA.

Andrew Haldane, now Chief Economist at the Bank of England, has argued for '… accounting rules for banks which are crisis-neutral, valuation conventions for all seasons' (Haldane, 2012, p. 263), with no 'return to murky valuation and hidden reserves' (Haldane, 2010, p. 11). This echoes the call of accounting professor Graeme Dean for a conceptual framework of accounting that 'needs to consider the function of accounting in both good (boom) and bad (bust) economic times' (Gebhardt and Dean, 2008, p. 219). 'Confidence accounting' (Harris et al., 2012), which uses distributions of possible values rather than single point-in-time estimates, has attracted broad sympathy. In the UK this approach is already reflected in the 'prudent valuation returns' banks now provided to the Bank of England, although these are not in the public domain. The widespread stress-testing required by bank regulators in the US, European Union and elsewhere to expose shortcomings and over-

optimistic assumptions in banks' financial and regulatory reporting also acknowledges the inadequacy of traditional reporting.

The G20 offered strong post-crisis endorsement of IFRS but progress on enhancing standards has been slow. The IASB's success in promoting the use of IFRS has been offset by its lack of enforcement powers, and with a wide range of interests to satisfy it is slow-moving (Pope and McLeay, 2011). IFRS drew criticism from UK parliamentary enquiries on several grounds such as the link between FVA and management remuneration, and the need for a more prudent alternative for regulatory purposes (House of Lords, 2011; Parliamentary Commission on Banking Standards, 2013).

Many bankers and regulators have argued that crisis was compounded by procyclical accounting requirements which resulted in lower loan loss reserves in good times. The UK's Turner Review proposed the use of non-distributable 'Economic Cycle Reserves' to offset procyclicality while arguing for the need to maintain a commitment to FVA/MTM (Financial Services Authority, 2009). Haldane's 'all-season' accounting rules will eventually arrive in the form of the IASB's new accounting standard, IFRS 9 *Financial Instruments*, which will not come into effect until 1 January 2018, more than 10 years after the first signs of financial crisis. This standard, which will require loan loss provisioning to be based on an 'incurred loss' model rather than the previous 'expected loss model', is expected to reduce accounting procyclicality and result in higher provisions and more detailed disclosures. O'Hanlon (2013), however, casts doubt on the necessity and value of this change, providing evidence from the UK that the pre-crisis IFRS accounting regime for loan loss provisioning was no more procyclical than the national accounting regime which preceded it.

A study of German banks covering the period 1995-2010 (Bornemann et al., 2014) suggests another possibility which combines management discretion in financial reporting with more conservative accounting and some transparency. This study reported that banks using visible 'Reserves for General Banking Risks' had a lower probability of future distress or default, and provided an earnings management tool. Decisions on such reserves, permitted under German rules, are wholly at the discretion of bank management and no explanations are required in the financial statements.

There were inadequacies and inconsistencies in some technical aspects of financial reporting, probably encouraged to some extent by the IASB's view that it is possible to design accounting standards which are not targeted on specific types of business entity and allow management discretion in how they are applied. Pérignon and Smith (2010) and Woods et al. (2008; 2009), for example, demonstrate these deficiencies in investigating risk reporting based around banks' favoured tool for measuring and managing credit and market risks, Value-at-Risk (VaR).[8] More generally, in his examination of US risk reporting, Ryan (2012, p. 312) notes that '[d]isclosure options yield inconsistency across firms and exposures' and that simply increasing the volume of disclosures does not yield useful information.

Numerous ideas for technical improvements have been offered - see, for example, Ryan's (2012) suggestions. Klumpes and Welch (2011) called for greater transparency in reconciling capital ratios reported in IFRS-based financial statements to Basel-based capital adequacy ratios. The Walker Review (2009) proposed a separate risk report to bring together disclosures relating to risk and its management to replace reporting fragmented through the financial statements as a whole and overcome concerns over 'information overload'.

Crisis exposed another aspect of accounting: failures in due diligence, the '… investigation into the affairs of an entity ... prior to its acquisition, flotation, restructuring or other similar transaction' (ICAEW, 1996, p. 1). Royal Bank of Scotland's due diligence on the ABN Amro takeover apparently consisted of 'two lever arch folders and a CD' (Financial Services Authority, 2011, p. 7) and the Co-operative Bank's due diligence in its merger with Britannia Building Society has been criticized as inadequate and incomplete (House of Commons Treasury Committee, 2014). But inadequate due diligence is not confined to banking and is typical in hostile takeovers where access to unpublished information is more limited, and 'there are no codes or standards against which to judge whether due diligence is adequate' (Financial Services Authority, 2011, p. 8).

Finally, crisis has posed many questions over the value and effectiveness of bank audits. Numerous banks in a wide range of countries received 'clean' audit reports but within months failed or required government bail-outs in various forms. Issues raised include auditors' failure to challenge business models (especially in relation to liquidity and going concern issues) and estimates of fair values and provisions against asset impairment, the adequacy of disclosures and auditors' communication with regulatory bodies, and the general lack of auditor scepticism (Humphrey et al., 2009; Parliamentary Commission on Banking Standards, 2013; Sikka, 2009). Some would argue that these questions reflect unrealistic expectations of auditors, particularly in a fast-moving crisis when audit opinions could be rendered irrelevant by rapidly-shifting markets. Were auditors being made scapegoats for the mistakes of bank managements, financial and other regulators, and credit rating agencies, to name but a few? Nevertheless, these perceived shortcomings reignited long-held concerns about the quality of audits and concentration in the market for audits of large companies, which is dominated by the 'Big Four' professional services firms. But no real evidence has

emerged to suggest that auditors allowed their independence to be compromised despite the potential for conflicts of interest in the commercial audit model. Numerous proposals for reforms of the audit market and process have been made at national and international level, the major consequence of which seems likely to be more frequent changes of auditor for major companies.[9]

The accounting profession brought forward its own suggestions to address some of the criticisms of bank audits. In the UK these included: the production of audited Walker-style summary risk statements; the need to provide evidence of key areas of judgement, contentious issues, challenge and debate discussed between auditors, managements and regulators; and the development of a code of practice for the auditor-regulator relationship (ICAEW, 2010; 2012). There is some reinvention here – the Banking Act 1987 provided a framework for communication between auditors and regulators which was used in the BCCI case, raising the question of why this regime had lapsed more recently (Collins et al., 2012).

To conclude this section on a negative note, there is evidence of weaknesses in post-crisis bank audits. The UK's Financial Reporting Council (hereafter FRC), which inspects audits, found that the standard of audits of banks and building societies has been consistently below that of audits of other types of entity for the several years following the crisis. Concerns centred on the audit of loan loss provisions, whereas fair value measurement was a lesser problem in the immediate crisis aftermath (FRC, 2014a, pp. 7, 13). A follow-up report noted improvements (FRC, 2014b). The FRC also announced an investigation into the audits of the Co-operative Bank by KPMG, after that bank's near-collapse and subsequent recapitalization in 2013 (FRC, 2014c).

Conclusion

Increased reliance on financial markets, greater interdependence of financial institutions, and more complex transactions and corporate structures have all contributed to difficult technical accounting challenges which require banks, auditors, regulators and other users of financial statements to make difficult judgements. Crisis has undermined confidence in financial reporting by banks and the credibility of bank audits. But this chapter also suggests that some tensions relating to financial reporting in banking are hard to resolve, with strong elements of continuity in the arguments in different eras and different countries, notwithstanding contrasting economic and regulatory environments.

A common theme running through this chapter is that financial reporting by banks cannot be viewed as an 'objective' representation of 'economic reality'. Banks, as heavily-regulated institutions with high 'political' profiles, wish to manage the political costs they face. More transparent financial reporting exposes them to greater scrutiny, threatening their legitimacy as institutions and bankers' role in managing them. A recurring argument, often skilfully made but arguably self-serving, is the suggestion that more transparent financial reporting can undermine stability, with damaging consequences for the financial sector and the wider economy. Debates about accounting thus reflect economic and political trade-offs as much as the finer technical details of accounting theory and practice. Accounting is a key arena in which bankers have sought, and can be expected to continue to seek, to limit the encroachment of regulation or legislation that substantially increases financial transparency or limits their discretion over the content of financial statements. This tendency is only

accentuated by the integration of accounting numbers into capital adequacy rules and remuneration arrangements.

Where does financial crisis leave financial reporting by banks and their accounting more generally? Neither historical cost accounting nor FVA (particularly in its MTM form) provide a satisfactory basis for measurement in crisis conditions when 'market efficiency' breaks down. In the absence of superior alternatives, the best solution is probably for both sets of measurements to be available. Implementation of the changes suggested in the preceding section should improve the quality of banks' financial reporting. Preparers and auditors of financial statements, and regulators and other users, will exercise more caution, at least for a time. But experience suggests we should not be overly optimistic that future controversies will be avoided. The arguments will continue as to whether banks can be subject to the same financial reporting requirements which apply to all other companies (as standards-setters insist) and whether it is possible for a single financial reporting framework to accommodate the needs of different stakeholder groups in banks.

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[1] See Billings and Capie (2009) for fuller discussion of the issues addressed in this section.

[2] In an inflationary environment, the banks' costs were rising sharply and observers were producing inaccurate, usually too high, estimates of profits prior to the end of non-disclosure (Capie and Billings, 2001, p. 376).

[3] This highlights the problem of how to define a 'bank', which arose again in relation to hedge funds and other 'shadow banks' in 'our' crisis. An answer is needed if banks are to be subject to special accounting and other regulatory requirements.

[4] FVA and MTM are often conflated but are not synonymous. Under the 'fair value hierarchy' of both international and US standards, 'level 1' refers to measurement using quoted prices in active markets for identical assets and liabilities (i.e. strict MTM); 'level 2' to directly or indirectly 'observable' inputs for the asset or liability (for example derived from prices for comparable financial instruments, such as a relevant yield curve); 'level 3' to 'unobservable' inputs (for example entity-specific estimates).

[5] Ma (1982) and Richard (2005) provide pre-twentieth century evidence from the UK, France and Germany on the use of market values in at least some financial reporting. Power (2010) discusses how FVA secured acceptance despite widespread opposition. Some accounting scholars question the legitimacy of FVA in the absence of a coherent conceptual framework for financial reporting (Whittington, 2008).

[6] Such arguments have historical antecedents: in the Great Depression those US banks which held marketable securities rather than illiquid loans were forced to sell those securities, crystallising losses and contributing to bank failures (Friedman and Schwartz, 1963, p. 356).

[7] But agency theory identifies incentives for managers to provide useful and relevant information in the absence of detailed legislation or regulatory requirements (Healy and Palepu, 2001).

[8] The use of VaR in the internal ratings-based approaches to the determination of regulatory capital under Basel II has been heavily criticized (Turner, 2014, pp. 198-199).

[9] Several UK banks have announced changes of auditor: PWC will replace KPMG as HSBC's auditor from the financial year ending 31 December 2015; Ernst and Young will replace KPMG and Deloitte at the Co-operative Bank and RBS respectively from the financial years ending 31 December 2014 and 2016.