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FINANCIAL REPORTING: PERFORMANCE AND FAIR VALUE
THE CASE OF THE EUROPEAN BANKING SECTOR

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Abstract

Regarding financial reporting, information about performances is one of the preferred items banking institutions are referring to. Therefore, quantitative and qualitative performance indicators are a significant part of annual reports. Reporting about performances raises some other issues: valuation at cost or at fair value, registration versus disclosure.

In the case of the banking industry, the accounting information disclosed is all the more important as this sector is highly regulated. The regulation is based on management and structure ratios whose intended effects are the prevention of bank failures, as informational asymmetry between depositors, banks and borrowers can cause economic panics.

Within the framework of international accounting standards, fair value is more and more referred to as a mean of valuation in the process of determining the economic income. Furthermore, the international accounting regulation institutions tend to promote comparable performance indicators while maintaining the quality of the disclosures about segments of an enterprise. Nevertheless, except the standards dealing with earnings per share and segment reporting, of all the present standards of the IASB, none is specifying the contents and the form of the information about performances. The adoption of IAS 32 and IAS 39 by the banking institutions which decided to use in advance the IAS framework from January 1st 2001 shows the growing importance of fair value in financial statements.

The information strategy aimed at the investors which is developed by a lot of European banking institutions consists in the disclosure of voluntary information such as the determination of the income by the way of fair value.

The purpose of this paper is the presentation of the characteristics of this voluntary information. Studying a sample of nineteen European banking institutions, we

developed an exploratory research. This research is based on a contents analysis of the voluntary information disclosed (frequency tests). The most representative factors of the informational structure are settled by means of a factor analysis.

INTRODUCTION

Report about performances raises two sets of issues: first, the selection of a valuation method (at cost or at fair value), and second, registration *versus* disclosure.

In the banking industry, these issues are all the more important as the sector is highly regulated and the regulation is based on management and structure ratios whose intended effects are the prevention of bank failures.

In this paper, we are first exposing the contextual analysis regarding to the accounting valuation methods. Safety and soundness regulations and accounting valuation in the banking sector. Conceptual framework and valuation methods.

Then, we are presenting the results of our study concerning the structure of the information disclosed by the 19 european banks of our sample.

1. CONTEXTUAL ANALYSIS

1.1. SAFETY AND SOUNDNESS REGULATIONS AND ACCOUNTING VALUATION IN THE BANKING SECTOR

As intermediaries between depositors and borrowers, banks fill an important place in information economy. They limitates the problems which can be derived from informational asymmetry. Banks equities play a great part in the safety device they have to comply with.

1.1.1. Intermediation, informational asymmetry and delegated monitoring

Banks are unable to foresee the day when depositors will make withdrawals. At the opposite, depositors have no real means of determining the financial stability of these institutions. This stability depends on the quality of the borrowers.

In case of panic and random withdrawals from depositors, banks will be unable to give them the cash they are waiting for. Most of the assets of banks consist of loans. Banks take short-term deposits and transform these funds in longer term loans. This can involve problems of liquidity. Depositors delegate to the banks the control of the borrowers. As they have regular and long term relations with borrowers, banks can be more efficient than the market in the reduction of informational asymmetry (Aglietta

et Moutot, 1993). Because they are in possession of informations on borrowing firms everyday life, they hold an advantage in the distribution of credits (Fama, 1985). Furthermore, when granting loans, delegated monitoring is a good way of avoiding the duplication of investigation costs and free rider problems which can be the consequences of the emissions of debts on the market (Dewatripont and Tirole, 1993, p.51).

According to Diamond and Dybvig (1983), the banks are not sure borrowers can meet their obligations and have no idea of what will be the attitude of depositors concerning withdrawals. That is the reason why deposit insurance could be a good way of preventing banks failures.

1.1.2. Systemic risk, moral hazard and usefulness of equities

Bank failures are likely to generate a vicious circle : no more confidence in the economic system, difficulties in borrowing funds from banks, failures in other economic sectors. This is the systemic risk (de Boissieu, 1996, Dietsch and Pagès, 1993). Contagion is the major component of systemic risk. According to Benston and Kaufman (1995), depositors who run for their deposits are acting this way for very precise reasons, especially categories of borrowers to which their banks granted loans or areas in which their banks are present.

Another point of informational asymmetry concerns the relation between stockholders, depositors and managers. The formers are less informed than the managers. They have great difficulties in estimating the real level of risk of banks. Furthermore, depositors and stockholders do not have the same vision of their interests. The less financially involved the stockholders are (and the more the depositors are), the more risky the investments the former choose will be. To prevent this moral hazard situation, the level of banks'equities has to be high.

1.1.3. The safety and soundness regulation

In reaction to panics and crises, an important safety and soundness regulation has been set during the twentieth century. At its beginnings, it was liquidity orientated. It was important to be able to meet one's obligation. The level of current assets had to meet the one of current liabilities. Solvency concerns have been added to these monetary questions. In 1988, the Governors of the central banks of the G10 countries

which are members of the Basle Committee agreed upon the necessity of defining solvency criteria. So, the Cooke ratio was born. It expresses own funds as a proportion of risk-adjusted assets and off-balance sheet transactions. In case it could be of no efficience, most of the countries dispose of deposit insurance systems. As central banks can act as lenders of last resort, it is very important to differenciate the problems of liquidity from solvency ones. Otherwise, bad banks would continue to stay in life.

As accounting data support the safety and soundness regulation system, the valuation methods play an important part in its efficiency.

1.1.4. The accounting choices and the concern of meeting regulation requirements

Solvency requirements are likely to influence the accounting choices of banks. They will prefer those which enable them to display higher solvency ratios. To lessen the denominator, banks will resort to off-balance sheet operations (reduction of assets). Concerning the numerator, they will try to maximize the income in lessening as much as possible the amount of allowances for doubtful acccounts and risk provisions.

In the case of the banking sector, the interconnected use of historical cost and the resort to the concept of intention / purpose accounting is likely to facilitate the smoothing of losses and, by this way, to preserve the solvency ratio. This is creative accounting. If we refer to financial innovations, some of them have been designed as a mean of getting out of the requirements of prudential control (OECD, 1987).

The necessity to fit safety and soundness regulation, in which the solvency ratio plays an important part, contributes to explain the specific place of income smoothing in banking industry.

1.2. CONCEPTUAL FRAMEWORKS AND VALUATION METHODS

1.2.1. The IASB in favour of fair value

✓ **Conceptual definition**

The IASB defines fair value in IAS 32 « Financial Instruments : Disclosures and Presentation ». This is the amount at which an asset could be exchanged, or a liability settled, in a current transaction between informed and willing parties (paragraph 5). The disclosure requirements of IAS 32 has been supplemented by IAS 39. According to IAS 39, « Financial Instruments : Recognition and Measurement » (1998), all financial assets and financial liabilities are recognised on the balance sheet. They are initially measured at cost, which is the fair value of whatever was paid or received to acquire the financial asset or liability. Subsequent to initial recognition, most of financial assets are remeasured at fair value. That is not the case for loans originated by the enterprise and not held for trading. They are measured at amortised cost, less reductions for impairment or uncollectibility. The enterprise do not need to demonstrate an intent to hold originated loans and receivables to maturity. The standard requires that an impairment loss be recognised for a financial asset whose recoverable amount is less than carrying amount.

✓ **Main qualities attributed to fair value**

<u>Predictability</u>

"Fair value" enables one to make a better prediction of future cash flows insofar as it integrates these future financial flows by construction. "Fair value" favours the objectives of investors in the divulgency of accounting information. The use of the "fair value" method applied to all of the accounts makes the financial statements clearer than financial statements that use "fair value" only for financial instruments.

<u>Its consistency with an active management of financial risks :</u>

The majority of the enterprises manage their interest rate and price risks, even for instruments that cannot be sold like swaps. This management is carried out by reference to current rates and values and not by comparison to historic values. The historic cost can "inhibit" management.

Total accounting of value :

By applying historic cost, everything that is not a cost is not entered in the accounts. This principle involves not entering certain financial instruments in the accounts for particular derivatives which, by definition, do not usually generate financial flows at the origin. Since the users of the accounts do not see them, they cannot take them into account to evaluate future cash flows. This absence from the financial statements disappears with the appearance of "fair value".

An accounting of the whole performance :

Fair value is not based on the existence of a transaction. In other words, only transactions are entered in the accounts in the historic cost model. "Fair value" enables one to evaluate the company's decision to retain, for example, one or more financial instruments.

Neutrality :

Since "fair value" is determined by reference to external data, either directly by using market values, or in the absence of an active market by reference to a model based on parameters taken from external data, it appears as a "neutral" value, in other words not influenced by the enterprise itself.

1.2.2. The determination of a fair value

The valuation method to determinate fair value founded on a market value or a model value.

- ✓ **To refer to Market**

IAS 32 (§ 81) explains that « when a financial instrument is traded in an active and liquide market, its quoted market price provides the best evidence of fair value »

According to Barth and Landsman (1995), when the market is perfect – liquide, active and organized – the fair value is equal to the market value.

IAS 39 (§ 96) specifies that « situations in which fair value is reliably measurable include (a) financial instrument for which there is a published price quotation in an active public securities market for that instrument ; (b) a debt instrument that has been rated by an independant rating agency and whose cash flows can be reasonably estimated, and (c) a financial instrument for which there is an appropriate valuation

model and for which the data inputs to that model can be measured reliably because the data come from active markets »

✓ **To refer to Model**

Only the values resulting from active markets (listed, liquid, organised…) can claim the qualities of objectivity and neutrality. The large majority of financial instruments issued, negotiated, or used by credit institutions in particular, are not listed and do not have an organised or assimilated market. Their valuation therefore depends on internal models, that we are not qualified to criticise, but which are recognised by the banks themselves as including estimated parameters, to the best of their knowledge but with degrees of uncertainty such that they incorporate adjustment variables for risk of model, risk of liquidity, risk of volatility… All random variables which mean that it is not possible to qualify the valuation as neutral even if an internal or external valuer subsequently considers this calculation, that this value is reasonable, acceptable… but he will not be telling the truth in the exact sense.

It is therefore possible to assert that "fair value" encloses varied methodologies and models giving "fair value" a random nature. Accepting that the standard setters are sincere in the determination of "fair value", this "fair value" retains an extremely relative reliability. And in any case, it is not always objective, or always neutral.

1.2.3. The fair value impact on performance measurement

The extensive application of "fair value" to all of the assets and liabilities of the balance sheet has two major correlated consequences:

- the abandonment of the realisation criterion; and
- the loss of the foundation of transactions for the profit and loss account.

These two consequences concern the profit and loss account.

These issues are current ones but not new ones. Edwards and Bell (1961) developed a theory of measurement of business income. They distinguished the result from the operations from the holding gains and losses.

Valuation at “fair value” is based on a concept in accordance with which an asset is transferred and a liability paid permanently. It is a case of recording a virtual result “in continuum” since there is no real transaction, the market provides information on what could have taken place in terms of a “round trip”. It is no longer necessary to record the realisation of an operation to validate its “actual” cost in the accounts since the market monitors the prices of assets exchanged on the market (and, in the absence of a market, techniques giving a value equivalent to what the market would give are used).

The disappearance of the realisation criterion involves the abandonment of the historic cost principle and also the principle of prudence, insofar as unrealised gains are automatically taken into account (since unrealised losses, in principle, have to be included in the historic cost model).

Currently, the interest margin is a key indicator for many credit establishments. It has its place in the net banking income and is the subject of detailed analyses.

What is the significance of the interest margin when financial instruments bearing interest are valued at fair value? The net amount of interest (*prorata temporis* revenues on the instrument issued, a loan, for example, less the cost of its refinancing) was until now recorded in the profit and loss account of the establishment that granted the loan to its client; in the future, since the loan and the financing debt will be valued between the beginning and end of the financial year at their fair value, the result for the period will correspond to the difference between the fair values of the instruments concerned, whatever the amount of the interest received and receivable and paid and payable for the period. It is clear therefore that the presentation of the profit and loss account must be radically changed; there is no longer any logical reason to maintain the interest there, even if, moreover, it is the only significant and useful information for the bank (and its client).

There is no need to extrapolate a great deal to realise that the profit and loss account could under these conditions be limited to several lines: one to enter the net variations (positive or negative) of the fair values of all instruments between the beginning and end of the financial year, one (or more) for overheads, one for allocations to provisions.

2. EXPLORATORY RESEARCH

We studied the contents and the structure of the financial information published by nineteen European banks concerning fair value. First we identified the set of accounting principles the banks of our samples are refering to (Appendix 1). Then we selected 14 items or variables related to fair value, valuation methods, factors likely to induce changes in fair value and recognition: financial instruments and derivatives, fair value, market value, replacement value, use value, present value, cash-flow, interest risk, currency risk, sensitivity, value at risk, hedge, comprehensive income and unrealised gains and losses (Appendix 2).

Our study is based on the information related to these items that the banks of our sample published in their annual reports for the years 2000 and 2001.

First, we collected the information the following way : anytime one word, group of words or sentence in relation to one item or variable is present in the report of one of the bank of the sample, we add the corresponding number to the value of this variable.

Second, the content analysis of these variables has been developped through an analysis in principal components for each year (Appendix 3).

According to the Kaiser criteria (eigenvalue >1), we selected four factors for 2000 and four factors for 2001.

For 2000, the factors are the following:

Factor 1 : What the fair value accounting is dealing with
Financial instruments and derivatives, **cash-flow**, **hedge** (and **fair value)**

Factor 2 : The reasons why there are changes in fair value and the way the accounting model is taking them in account
Interest risk, sensitivity, value at risk, replacement value, comprehensive income and fair value

Factor 3 : The informations which are likely to make up for the inability of the accounting model to recognised the information in fair value
Unrealised gains and losses, market value and **currency risk**.

Factor 4 : The opposition between fair value accounting in its financial aspect (present value) and intention / purpose accounting (use value).

For 2001, the factors are the following:

Factor 1 : What the fair value accounting is dealing with
Cash-flow, **fair value and hedge**

Factor 2 : The informations which are likely to make up for the inability of the accounting model to recognised the information in fair value
Replacement value**, currency risk** and **unrealised gains and losses**.

Factor 3 : The informations linked to the measurement of market risk
Market value and value at risk

Factor 4 : Reporting on use value
Use value

Regarding the years 2000 and 2001, the common factors of the structure of the accounting information supply are the following:

Factor 1: Cash-flow, hedge (and fair value)

Factor 2: Unrealised gains and losses and currency risk.

Banks are publishing informations about derivatives and financial instruments. They are supplying two sets of informations: the first set of correlated informations on hedge and cash-flow, the second one on currency risk and unrealised gains and losses.

Globally, disclosures are hedge orientated and mainly dealing with the market currency risk and the derivatives performance. But disclosures is not limited to currency risk as hedge includes informations on and interest rate risk as well.

When banks are reporting on unrealised unrecognised gains and losses, in fact they are contributing to offer fair value informations. When realised, the unrealised gains and losses will become cash-flows.

Regarding our sample, we see that in 2000 and 2001 only four and seven banks are respectively presenting financial statements refering to International Accounting Standards. It is very interesting to notice that the information supply is centered on derivatives instruments valuation and accounting. This is the main subject IAS 39 is dealing with. As we said on contextual analysis, the implementation of IAS 39 is raising conceptual difficulties. Maybe financial institutions anticipates the implementation of IAS 39 concerning derivatives instruments and market risk.

CONCLUSION

TOWARD A NEW FINANCIAL PERFORMANCE REPORTING

In a fair value accounting model, the measure of the performance of the company over a period will include both the realised and unrealised results, these results being determined either on a market assessment basis or on internal estimations. At this level of measurement, it will become more and more difficult to distinguish the part of the performance deriving from the sanction of the quality of the company's management from the part deriving from the trends of the markets and their effects on the value of the assets and liabilities, independent of any effective transaction.

In such a context, the annual (or intermediate) financial report should evolve; the profit and loss account will lose all or part of its interest in favour of a performance statement (but which performance), the balance sheet will retain its significance as an

inventory value with the cash flow statement. This one should become the main working document worthy of interest. Indeed, it is thanks to this statement and this statement only that a third party will be able to assess how the announced performance is actually represented in the cash flow of the company and how this has been generated and used.

Since 2001, companies who apply IAS must disclose the performance in fair value. Our study describes a structural disclosure hedge orientated and mainly dealing with the market currency risk and the derivatives performance.

Its implications on the significance of financial statements in their current and traditional presentation have not been analysed or, at least exploited. Consequently, if they are used without being substantially redrafted, they will lose all significance, interest and usefulness which may have a result opposite to the one sought for. On the other hand, it has not proved itself as a model for the initial and subsequent valuations of the company's assets and liabilities (financial and/or non financial). As a matter of fact, the volatility arising in the measurement of the performance of the company (over a financial year or a shorter period) and in its equity capital is not the kind of thing which will help to promote a faithful representation of economic reality.

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APPENDIX 1 : BANKS' GAAP

	National GAAP		IAS		US GAAP		Reconciliation board	
	2001	**2000**	**2001**	**2000**	**2001**	**2000**	**2001**	**2000**
Bénélux								
ABN AMRO	X			X				
DEXIA	X	X					X	
ING	X			X			X	
Germany								
COMMERZBANK			X	X				
DEUTSCHE BANK				X	X		X	
DRESDNER BANK			X	X				
HYPOVEREINSBANK			X	X				
Great Britain								
BARCLAYS	X	X				X	X	X
HSBC	X	X						X
ROYAL BANK OF SCOTLAND	X	X					X	
France								
BNP PARIBAS	X	X						
CREDIT AGRICOLE	X	X						
CREDIT LYONNAIS	X	X						
SOCIETE GENERALE	X	X						
CAISSE D'EPARGNE	X	X						
Italia								
SAN PAOLO IMI	X	X						
Spain								
BBVA	X	X						
Swiss								
UBS			X	X			X	X
Credit Suisse	X	X						
TOTAL	**14**	**12**	**4**	**7**	**1**	**1**	**6**	**3**

APPENDIX 2: VARIABLES RELATED TO FAIR VALUE

Financial instruments and derivatives	
	Financial instrument Derivative Option (except option plans) Swap (Swapped) Swaption Forward Future Cap Floor Collar
Fair value	
	Fair value Fair valued
Market value	
	Market value Current market value Mark to market (Marked to market) Mark to market value Marking to market Market price Mid-market prices Quoted market prices Market valuation
Replacement value	
	Replacement value Replacement cost
Use value	
Present value	
	Present value Net present value Discounted present value
Cash flow	
	Cash-flow Discounted (discounting) cash-flow Future cash-flow Expected future cash-flow (Risk) discount rate Market rate (calculated at) Loan's effective interest rate (discounted at the) Rates currently offered by At appropriate rates Quoted market rates Current settlement rates

Interest risk	
	Interest rate risk Interest rate exposure Currency risk Exchange rate risk Foreign exchange rate risk Foreign exchange risk Foreign exchange exposure Exchange rate exposure Currency risk exposure Foreign currency exposure Currency exposure
Sensitivity	
	Sensitivity (if no detail provided in the reports) Interest rate sensitivity (of loans) Interest rate sensitivity (of earnings) Interest sensitivity gap
Value at risk	
	Value at risk Stress test Worst case Model risk Hypothesis
Hedge	
	Hedge (To) hedge Hedged Hedging Hedge accounting
Comprehensive income	
Unrealised gains and losses	
	Holding gains Unrealised (unrealized) gains Holding losses Unrealised (unrealized) losses

APPENDIX 3 : COMPONENTS ANALYSIS

2000

Rotated Factor Matrix

	Factor 1	Factor 2	Factor 3	Factor 4
Hedge	,907	-6,851E-02	,237	-6,896E-02
Cash-flow	,894	9,737E-02	-1,228E-04	-5,128E-02
Financial instruments & derivatives	,834	,250	,207	-1,896E-02
Replacement value	,131	,870	,150	-6,008E-02
Value at risk	9,878E-03	,835	6,777E-02	,214
Interest risk	,137	,742	,207	-,399
Unrealised gains and losses	3,766E-02	,296	,879	4,489E-02
Currency risk	,410	4,226E-02	,832	-,144
Present value	-6,568E-02	-1,043E-02	-3,208E-02	,955

Rotation Methodology : Varimax with Kaiser normative.

2001

Rotated Factor Matrix

	Factor 1	Factor 2	Factor 3	Factor 4
Cash-flow	0,933	-0,170	0,199	-8,995E-02
Fair value	0,887	-0,215	0,269	0,119
Hedge	0,840	3,822E-02	0,346	0,214
Replacement value	0,808	0,236	-0,174	-0,294
Currency risk	0,120	0,920	-0,152	9,968E-02
Unrealised gains and losses	-0,252	0,868	0,238	-0,100
Market value	9,086E-02	0,160	0,820	-0,241
Value at Risk	0,304	-0,126	0,794	0,137
Use value	-1,531E-02	2,662E-02	-7,984E-02	0,951

Rotation Methodology : Varimax with Kaiser normative.