The predictive ability of loan loss provisions in banks — Effects of accounting standards, enforcement and incentives

Jan Marton[*], Emmeli Runesson

School of Business, Economics and Law, University of Gothenburg, P.O. Box 610, SE 405 30 Gothenburg, Sweden

A B S T R A C T

In this study we compare the predictive ability of loan loss provisions with respect to actual losses under IFRS and local GAAP. The 'incurred loss model' of IAS 39 is a model that requires a relatively low level of judgment by preparers compared to alternative models that exist under local GAAP. We find that loan loss provisions in IFRS bank years predict future credit losses to a lesser extent than in local GAAP bank years, consistent with the incurred loss model reducing the timeliness of provisions. We also examine the interaction of standards with enforcement of financial reporting and with preparer incentives. In testing the role of enforcement from, e.g., banking supervisory authorities, we find that the benefits of local GAAP are largely limited to high-enforcement settings. Local GAAP also performs relatively better than IFRS in large and in profitable banks. This has implications for the IASB and the FASB as they prescribe the adoption of the more judgment-based expected loss model in IFRS 9 and the corresponding US GAAP standard (ASC topic 326), as well as for supervisory authorities that will enforce these standards.

© 2016 Elsevier Ltd. All rights reserved.

1. Introduction

In this study we investigate credit loss accounting for a sample of banks in the European Union (EU) and Switzerland. The banks follow either International Financial Reporting Standards (IFRS) or local Generally Accepted Accounting Principles (GAAP). Although it is claimed that IFRS require more preparer judgment than most local GAAP in many accounting areas, we focus on an area where the opposite is true. International Accounting Standard (IAS) 39 *Financial Instruments: Recognition and Measurement* (IASC, 1998) requires an incurred loss model for estimating credit losses. Under this approach, an objectively verifiable so-called 'loss event' must have occurred for specific loan loss provisions (LLP) to be made. This may be contrasted with (pre-existing) local standards in many countries, which allow or require banks to make general loan loss provisions. This means that local standards are often more forward-looking and allow greater discretion (see Gebhardt & Novotny-Farkas, 2011). In other words, although accounting for credit losses is innately uncertain (IFRS 9, BC 5.85 [IASB, 2014]), the implementation of standards can exhibit more or less subjectivity. In this study we compare the ability of LLP to predict actual losses under IFRS and local GAAP.

Credit loss accounting has received attention in the wake of the financial crisis in 2007 and onwards. Following criticism of the incurred loss model, both the International Accounting Standards Board (IASB) and the Financial Accounting Standards

---

  * Corresponding author.
   E-mail addresses: jan.marton@gu.se (J. Marton), emmeli.runesson@gu.se (E. Runesson).

Board (FASB) are in the process of introducing more judgment-based standards in accounting for credit losses. In the amended version of IFRS 9 *Financial Instruments* (IASB, 2014) issued in July 2014, the IASB prescribes an expected loss model, which is based more on management estimates than the incurred loss model required in IAS 39. A similar but not identical model is prescribed by the FASB[1] in its accounting standards update on financial instruments and credit losses (FASB, 2016). The IASB timetable suggests that IFRS 9 will be mandatory from 2018, and the EU is currently discussing endorsement of the standard. The FASB standard will be mandatory from 2020.

Much research in financial reporting has been concerned with the quality of accounting standards and the quality of financial statements produced in accordance with the standards. An important consideration is the level of judgment allowed in the preparation of financial statements. A purported benefit of allowing judgment in the application of accounting standards is that it gives management the opportunity to provide private information to financial statement users. However, judgment also enables preparers to manage earnings when they have strong incentives to do so (Ball, 2006). The effect of incentives on reported loan loss provisions has been studied by Kanagaretnam, Lobo, and Yang (2004). Meanwhile, stricter enforcement can mitigate the effect of incentives as shown by Beck and Narayanamoorthy (2013). Therefore, accounting standards that allow more judgment are assumed to work better with stricter enforcement. The importance of enforcement in explaining variations in international financial reporting quality has been shown generally by Ball, Kothari, and Robin (2000) and, for banking specifically, by Fonseca and González (2008) and Bouvatier, Lepetit, and Strobel (2014).

Credit losses in banks play a central role in the evaluation of risks and stability in banks and thus have substantial economic significance. As noted, for example, by Ahmed, Takeda, and Thomas (1999) and Gebhardt and Novotny-Farkas (2011), credit losses are often the primary reason behind bank failures. Because economic effects in banking potentially have a direct impact on states, there is systematic enforcement in most countries to protect the states' interests. In the evaluation of accounting standards that involve different levels of judgment, it is therefore important to consider the interaction of standards with incentives and enforcement. Because the reporting of credit losses involves judgment and these losses have economic significance, it is useful to look at the combined effect of standards, enforcement and incentives for this area.

We use a sample consisting of 628 European listed and unlisted banks for the 2000–2010 period. We compare banks that have adopted IFRS and the incurred loss model with banks that use local GAAP, which often allow more judgment-based models. There exists a favorable research setting in that the change from local GAAP to IFRS occurs at different points in time in the EU[2], enabling us to separate the effects of accounting standards from other factors. Additionally, varying degrees of enforcement for banks in the EU enable us to examine the interaction effects between accounting standards and enforcement. Overall, we hypothesize and find that high-judgment accounting standards produce higher predictive ability of LLP with respect to actual losses. We interpret this finding as a sign of higher reporting quality and argue that it is directly related to the ability of management to convey private information through the use of judgment. The results are robust to the exclusion of voluntary IFRS adopters, indicating that these adopters do not drive the results. We also study two factors that are believed to interact with the effect of accounting standards: the level of enforcement which the banks are subject to and preparers' reporting incentives. We hypothesize and find that the effect of differences in accounting standards is stronger in strict enforcement settings. In other words, IFRS perform worse, while local GAAP perform better, in stricter enforcement settings. With weak enforcement, the difference in the predictive ability of LLP between the standards is small. We also hypothesize and find that bank-specific factors linked to incentive structures (size and operating profitability) interact with accounting standards in determining the predictive ability of LLP. More specifically, local GAAP perform better than IFRS but only in comparatively large or profitable banks, i.e. in banks that do not have incentives to understate credit losses. There is no difference in predictive ability between the standards in small or less profitable banks. These findings are consistent with incentives having a negative effect in a high judgment setting (local GAAP) while having less of an effect in a low-judgment setting (IFRS). In summary, our findings support the existence of interaction effects between accounting standards, enforcement and incentives.

We contribute to the literature on effects of changes in accounting standards for loan loss provisions in Europe. Primarily, two prior studies have looked at effects of IFRS implementation on accounting for credit losses in banks. Gebhardt and Novotny-Farkas (2011) study smoothing and conditional conservatism for a sample of listed European banks. They find conflicting evidence with respect to the benefits of IFRS, which may be attributed to their chosen earnings quality measures. We extend their work by looking instead at the *predictive ability* of loan loss provisions. Using a model similar to ours, O'Hanlon (2013) focuses on the predictive ability of LLP; however, the sample is limited to UK banks. We add to the findings in these studies by making a distinction between high- and low-judgment standards, with variations cross-sectionally and over time. We highlight the potential impact of country-variant enforcement and bank-level incentives in this setting.

The rest of the paper is structured as follows. Different accounting treatments of credit losses are discussed in Section 2. Hypotheses are presented in Section 3, followed by a description of the variables and statistical models in Section 4. The sample is described in Section 5, with results presented in Section 6. Finally, a concluding discussion is provided in Section 7.

---

[1] The FASB uses the term 'Current expected credit loss model' (CECL).

[2] Because we have a sample of both listed and non-listed banks there is no requirement for all banks to have implemented IFRS in 2005 in accordance with the EU IAS regulation, which applies only to consolidated reports for listed firms.