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Agency problems, accounting slack, and banks' response to proposed reporting of loan fair values ☆

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A B S T R A C T

We investigate the determinants of bank representatives' responses to the United States Financial Accounting Standard Board's 2010 Exposure Draft that proposes fair value measurement for most financial instruments. Over 85% of the 2971 comment letters were received from bank representatives, with most bank-affiliated letters addressing—and opposing—one issue: fair value measurement of loans. The Exposure Draft proposes that companies report both fair value and amortized cost measures for loans; thus, the proposal should result in increased levels of loan-related information and improved financial reporting transparency. We investigate three reasons for bank representatives' resistance. First, fair value measurement should result in less accounting slack than the current incurred-loss model for loan impairments; therefore, we propose that representatives from banks that historically utilized that slack will resist fair value measurement for loans. Second, we propose that agency problems are an important motivating factor because bank representatives reaping more private benefits from their franchises have less incentive to support increases in financial reporting transparency. Third, we test whether the most common reasons for opposition included in the comment letters are associated with negative letter writing. Our analyses support the first two determinants of bank representatives' resistance to the Exposure Draft. Specifically, accounting slack and lower demand for accounting transparency are strongly associated with resistance to the standard. However, we find that stated reasons for resistance are not associated with letter writing. Specifically, representatives at firms with difficult to value loans and firms that mostly hold loans to maturity are no more likely to resist the standard than others. The narrow scope of bank representatives' comments and our empirical findings suggest that bankers' responses to the Exposure Draft may be more driven by concerns over reduced availability of accounting slack and accompanying *de facto* regulatory forbearance than by the conceptual arguments they offer. Our results have implications for standard setters, who must navigate special interests as they attempt to promulgate high quality accounting standards, and for users of financial statements who must consider how political forces shape generally accepted accounting principles.

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Introduction

In May 2010, the United States (US) Financial Accounting Standards Board (FASB) issued an Exposure Draft (ED) that proposes greatly expanding fair value recognition for most financial instruments, including long-term receivables, such as bank loans (FASB, 2010). Responses received by the FASB during the ED's comment period were overwhelmingly negative and particularly concentrated within the banking industry; specifically, the FASB received 2971 comment letters in response to the ED, with over 85% from bank representatives and banking trade organizations. Through the end of 2011, this is one of the highest comment-letter volumes in response to any single FASB-issued public-comment discussion document. Because of the large volume of negative letters received from bank representatives, the FASB withdrew the proposal in January 2011 (Rapoport, 2011). This study seeks to understand the factors systematically associated with bank representatives' decisions to submit comment letters.

The choice to submit an accounting-standards-related comment letter (and the specific issues discussed in the letter) should be a function of the perceived economic consequences of the proposed accounting changes (Watts & Zimmerman, 1978). Despite the many changes proposed in the ED, the vast majority of letters submitted by commercial-bank representatives addressed *only one issue*: opposition to the proposed reporting of loans at fair value.[1] Given the large, uniform, and narrowly focused response that was concentrated in the banking industry, this suggests that responding bank representatives perceived an economic threat from the FASB's ED and its proposal to change current accounting for loans.

Under current US generally accepted accounting principles (GAAP), companies report loans at amortized cost, adjusted for loan impairments determined via an incurred-loss measurement model. Standard setters, regulators and practitioners note substantial disagreement about factors that bank managers should consider in determining loan-loss provisions under this model (Dugan, 2009; FASB, 2009). In addition, empirical research suggests that banks use discretion available in loan loss reporting to opportunistically manage income (e.g., Liu & Ryan, 2006) and capital (e.g., Beatty & Liao, 2011), and that this discretion reduces transparency and diminishes the ability of outsiders and regulators to monitor banks' risk-taking behavior (Bushman & Williams, 2012). Taken together, the practitioners' criticisms and empirical research findings suggest that the incurred-loss model for loans is a source of accounting slack available to bank managers.

The accounting proposed in the ED should result in a greater amount of relevant information about loans because the ED requires loans to be reported at fair value while retaining much of the information currently reported for loans.[2] Specifically, the ED requires (1) that amortized cost information for loans be presented on the face of the statement of financial position (parenthetically, and reconciled to fair value) (FASB, 2010, para. 86), and (2) that estimated credit losses be charged against net income with any remaining change in the fair value of loans (i.e., that is not related to counterparty credit quality) recognized in other comprehensive income (i.e., outside of reported net income) (FASB, 2010, para. 91).[3] Because only estimated credit losses will be recognized in net income, and because currently recognized amortized-cost information will continue to be prominently displayed on the face of the balance sheet, the proposed changes should increase the amount of loan-related information available to outside investors and creditors while retaining key measurement principles embedded in current accounting standards.[4] However, the changes should also reduce the amount of accounting slack available to bank managers and improve the transparency of banks' loan reporting because loans will be recognized at fair value, which, by construction, should reflect more timely recognition of expected future losses and market-related opportunity costs (Financial Crisis Advisory Group, 2009, p. 7).

Given the proposal's potential informational benefits, we investigate why representatives from more than 1000 unique commercial banks submitted comment letters resisting *only* the loan-related provisions of the ED, while the vast majority of commercial bank representatives did not submit letters. We investigate three significant sources of incentives for resistance to the proposed fair value measurement of loans. First, because fair value measurement of loans will likely reduce the accounting slack available to bank managers (i.e., when compared to the current incurred-loss model), representatives from banks that have a history of exploiting the slack available under current GAAP will have higher incentives to resist a change to fair

[1] The FASB's ED proposes a comprehensive set of changes related to fair value recognition for most financial instruments (including liabilities), equity method accounting, derivatives, and hedging. The ED also proposes that companies continue to report balance sheet and income statement metrics using amortized-cost basis-measurement. Reflecting its wide-ranging scope, the ED contains 214-pages and requests that comment letters potentially address 71 separate questions (i.e., 36 questions for all respondents, 13 questions for preparers and auditors, 22 questions for users).

[2] Although current US GAAP requires banks to provide disclosure of loan fair values in the notes to the financial statements (i.e. FASB Accounting Standards Codification (ASC) 825-10-55-3), many small- and medium-sized US banks avail themselves of the "practicability exception" that allows them to disclose loan value amounts based on simplified cash flow models (i.e. FASB ASC 825-10-50-16 through -19). These reported values often capture measurement attributes other than fair value (e.g., entry price). As noted by Tschirhart, O'Brien, Moise, and Yang (2007), these valuation methodologies need to be substantially modified to arrive at measurements that meet the definition of fair value.

[3] Thus, the ED cannot be characterized as a "fair value versus historical cost" proposal because it retains amortized cost measurement on the face of the financial statements, while complementing that information with reconciliation between amortized cost and fair value bases. For these reasons our analysis cannot address whether either amortized cost measurement or fair value measurement provides better information in the absence of the other. Instead, in this study we propose that financial statement recognition of accounts measured at fair value with supplemental prominent display of amortized cost information can improve transparency by revealing additional information that is not apparent in financial statements measured solely under amortized cost.

[4] Any effect of the ED on net income would necessarily derive from differences between managers' estimates of incurred losses and expected losses arising from non-collection of contractual cash flows. The incurred loss model impounds less information, and is arguably less conservative than the expected loss model. These terms are discussed in more detail in the next section.