WRITTEN STATEMENT TO THE COMMITTEE OF INQUIRY

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I am delighted to have this opportunity to assist this Inquiry. I was asked to provide a commentary on the following issues:

- The role of accounting standards in banking crises
- The role of external auditors

In particular, I was asked to discuss the role of auditing, including

- The valuation of loan assets and recognition of impairment to these assets in the financial statements of banks
- The extent to which accounting standards may, or may not have restricted the scope of Directors to reflect expected impairment and losses on loan assets
- The role of auditors in assessing and reporting on the extent of bank capital
- Obligations on Directors and Auditors to disclose important matters in financial statements and other reports
- Corporate Governance: the role of bank boards.

I will seek to address these issues in the remainder of my statement and I would be happy to provide any further detail that the committee requires.

Accounting Standards and Bank Crises

The US FDIC[2] has documented the life cycle of a bank failure[3]:

"In the first stage, there is rapid loan growth; loan concentrations emerge, and lending is aggressive (internal controls in the growth areas are weak, and underwriting standards are lenient). The increased lending may be, but is not always, funded by a volatile lending source. This growth could occur throughout the entire institution or within a specific asset type. If the growth is in a specific asset type, the increase could stem either from growth in concentration in a loan category or from a shift into a new activity, with subsequent growth. If the rapid growth draws the attention of the relevant regulator, management usually points to the excellent earnings and contribution to capital that the growth has provided."

Prior to the Irish banking crisis in 2008, it was widely believed that Irish banks were highly profitable and that they had sufficient 'cushions' to withstand a variety of challenging scenarios. This general belief also

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[1] I am PwC Professor of Accounting at the UCD Smurfit School of Business. My position was created in 1998 as a result of the generosity of PwC in advance of my joining UCD in an open competition. I have no other relationship with PwC nor have I ever had communications with employees or partners of PwC on issues related to Irish Banking.

[2] Federal Deposit Insurance Corporation

[3] FDIC Division of Research and Statistics*, History of the Eighties – Lessons for the Future: An Examination of the Banking Crises of the 1980s and Early 1990s*, December 1997, p.487. I have used the US problems in the 1980's as an example for two reasons: the availability of a substantial literature and the fact that, as in Ireland, real estate lending rather than exotic financial instruments or structures gave rise to the problems.

permitted the dismissal of concerns that were expressed about Irish banks. The belief was based upon accounting reports, particularly income statements and balance sheets.

A balance sheet is a list of assets and claims upon those assets. There are two types of claims – claims by owners (Capital or Equity) and claims by non-owners (Liabilities). Profitability and capital are intertwined since:

Ending Capital = Beginning Capital + Profits + New Capital from Owners – Dividends

By 2009, it was apparent that the capital 'cushions' available to Irish banks were entirely inadequate. Some financial institutions had liabilities that exceeded their assets (i.e. they were insolvent or had negative capital).

This outcome was driven by the both growth *and* the composition of loan portfolios from 2002 to 2007[4]. Exposures to Irish property grew rapidly, but the composition also changed. Rather than being dominated by residential mortgages, commercial loans became almost 50% of the exposure. Not surprisingly, banks appeared exceedingly profitable due to higher margins on these riskier loans.

The risks associated with increased commercial lending are well known and have been well known for many years. In a major review of banking crises in the US, the FDIC concluded:

> *"Commercial real estate markets in particular deserve attention because boom and bust activity in these markets was one of the main causes of losses at both failed and surviving banks[5]"*

The FDIC highlights these risks by stating that (p.138):

> *"even the most well-conceived and soundly underwritten commercial real estate project can become troubled during the periodic overbuilding cycles that characterize these markets. For this reason, historically federal bank regulators have supervised the terms of loans made to commercial real estate ventures and have prohibited federally chartered banks from investing directly in such ventures."*

It also mentions the especial difficulties associated with construction lending (p.139):

> *"Also contributing to the challenges of these investments is the nature of the production process itself when construction lending is involved. Real estate construction projects, and especially large commercial development projects, typically have long gestation periods, and these are superimposed on the traditional cyclicality of the economy and of real estate markets. Thus, the economic prospects for a real estate construction project can change considerably between inception and completion."*

The growth and the change in the composition of loan portfolios at an aggregate level in the Irish banking system is the seismic shift that occurred during 2002-2007. However, the distribution of this shift is also significant. It is clear that these additional risks were not distributed equally across individual banks. Further, a significant proportion of these loans was **concentrated** among a relatively small number of borrowers.

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[4] I use Nyberg to refer to "Misjudging Risk: Causes of the Systemic Banking Crisis in Ireland, Report of the Commission of Investigation into the Banking Sector in Ireland, 2011." Nyberg Figure 2.6 reports that Domestic property lending increased by 3.7X to €168B, however the share of commercial lending expanded from 25% to 46% of this amount. Speculative commercial lending grew by 9.21X from €3.8B to €35B. Nyberg footnote 25: "Speculative C&P lending (a subset of overall C&P lending) is in respect of C&P projects where no construction or rental contract is yet in place."

[5] FDIC, p.24. Figure 3.11 (p.160) demonstrates that the ratio of commercial real estate loans as a % of total real estate loans discriminates successfully between failed and non-failed banks.

Unfortunately, accounting standards were especially unhelpful and served to obscure the underlying nature of both profits and loan portfolios to **external investors and lenders**[6]. International Financial Reporting Standards (IFRS[7]) became effective in 2005[8]. Directors of entities are responsible for preparing financial statements and auditors express their opinion of those statements. Contrary to general expectations, case law determines that an audit is largely concerned with establishing whether the financial statements have been prepared in accordance with accounting standards. For example[9]:

> "In our opinion:
> the Group financial statements give a true and fair view, in accordance with IFRSs as adopted by the EU, of the state of the Group's affairs as at 31 December 2007 and of its profit for the year then ended;
> the parent company financial statements give a true and fair view, in accordance with IFRSs as adopted by the EU as applied in accordance with the provisions of the Companies Acts 1963 to 2006, of the state of the parent company's affairs as at 31 December 2007; and
> the financial statements have been properly prepared in accordance with the Companies Acts 1963 to 2006 and Article 4 of the IAS Regulation."

With respect to bank lending, provisions for loan losses are the most challenging accounting problem. If one had certain knowledge of future losses, it would be straightforward to decrease bank profits to reflect these losses. For example, if a bank engaged in more risky lending, then one would increase the provisions and decrease income (and hence capital). However, certain knowledge is not available and some judgement is necessary in order to establish the provision for loan losses or loan **impairment**.

IAS 39[10] contains the guidance on loan impairment. It is worth quoting the guidance directly so that its limited nature is fully understood. Para. 58 requires an entity to

> "assess at the end of each reporting period whether there is any objective evidence that a financial asset or group of financial assets is impaired."

Para. 59 then states:

> "A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated...Losses expected as a result of future events, no matter how likely, are not recognised."[11]

This is a very conservative definition of impairment since it requires objective evidence that a loss has been **incurred**. As a result, one could argue that impairment accounting is procyclical. In periods of expansion, as a bank expands its loan book, the bank will appear far more profitable since profit measures exclude **expected** loan losses. Nyberg argues (p. iii):

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[6] External investors and many lenders are generally unable to demand additional information. In contrast, bank regulators have additional and more extensive powers to demand information.
[7] Note that IFRS does not contain separate guidance for banks. Rather it involves applying identical 'principles' to both banks and non-financial enterprises.
[8] They apply to the consolidated financial statements of publicly listed European groups.
[9] Excerpt from page 181 of AIB's 2007 Annual Report. This is an example that I chose for convenience.
[10] International Accounting Standard 39 "Financial Instruments: Recognition and Measurement" is the key accounting standard for banking entities as their balance sheets are dominated by financial instruments.
[11] This guidance formed the basis for the Irish Financial Regulator's "Credit Institutions – Regulatory Document – Impairment Provisions for Credit Exposures" (October 2005).

> "From then on, the link between property prices and funding accelerated the downturn and reduced banks' perceived creditworthiness, particularly as international accounting standards had prevented more prudent provisioning for possible future losses during the growth phase of the cycle."

I believe that this conclusion may be too strong. IAS39 became effective in 2005. I reviewed the financial statements of a number of Irish Banks in 2005 and the adjustment arising from this transition was relatively minor. At an aggregate level, this is also supported in Nyberg Figure 2.2. Comparing 2004 and 2005, provisions for loan losses declined from 0.7% of loans to 0.5% of loans. However, nonperforming loans[12] also declined from 0.82% to 0.68% of loans[13]. Further, far from being the handmaiden of International Accounting Standards, there was absolutely nothing to prevent the Financial Regulator from insisting upon additional provisions or enhanced disclosures[14]. Largely, in the period up to 2008, expected credit losses were likely to have been quite low. The key issue was **unexpected** credit losses.

The limitations of impairment accounting are well known and it is widely understood that the process involves extensive judgement[15]. It is also well understood that the income will be overstated during the growth phase and that loans are most likely to perform in the months following origination. Two other aspects of loan accounting are also worth noting:

1. IAS39 requires enterprises to record interest revenue, even when the cash has not been received from a customer. This is of especial relevance to commercial or construction loans where the lending agreements may contain terms that involve an 'accrual; or 'roll-up' of interest. Further, because of interest 'roll-up', it will be easier to conclude that the loan is performing. Interest is also accrued on non-performing and impaired loans under IAS39[16].

2. Upfront loan fees - a bank may require customers to pay upfront fees for certain services – some judgement may be required to determine whether this fee should be booked immediately as revenue or recognised over the life of the loan.

Taken together – impairment, interest accrual and upfront fees – banks will report increasing income during an expansion. This increase will be enhanced by a shift from straightforward residential lending to commercial lending since the latter is likely to be more risky and to involve upfront fees. A further consequence of this shift will be a decrease in the quality of earnings since the upfront fees are one-off items and the non- cash element of interest revenue is likely to be higher.

These accounting issues are well known to informed users of bank financial statements. It is also fair to say that uninformed users may be forgiven for failing to understand that increased bank profits during a growth phase are almost inevitable. However, disclosures to the financial statements are a key part of understanding

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[12] This term is open to many potential interpretations. One definition: "A loan is nonperforming when payments of interest and principal are past due by 90 days or more, or at least 90 days of interest payments have been capitalized, refinanced or delayed by agreement, or payments are less than 90 days overdue, but there are other good reasons to doubt that payments will be made in full" (IMF Statistics Department "The Treatment of Nonperforming Loans" June 2005, p.8).

[13] Data obtained from IMF Country Report No 07/325 – September 2007 – Table 5.

[14] A financial regulator is relatively omnipotent with respect to demands for information, and one would expect that a regulator would seek more granular information from banks and could publish that data in a timely manner. A regulator could also require that certain information must be included in an annual report (e.g. Central Bank "Impairment Provisioning and Disclosure Guidelines" 2011 and 2013). Alternatively, a regulator (e.g. the Spanish Central Bank) could insist upon an alternative provisioning mechanism. In the absence of such requirements, IAS39 could be used as a fig leaf to postpone the recognition of losses.

[15] Indeed, one rationale for the incurred loss model is the minimisation of discretionary provisions.

[16] This may be contrasted with the US. US regulatory practices generally require that accrual should cease once principal or interest is in default for 90 days or more and all previously accrued interest should be reversed (Commercial Bank Examination Manual 2040.1)

the impact of these issues. In my opinion, there was inadequate disclosure concerning the increased risks that were faced by banks. Through the lens of 2002 balance sheets in the sector, users could have concluded that increased profitability was synonymous with increased 'cushions'. Through the lens of 2007 balance sheets, it would have been much easier for a sceptical observer to understand the underlying sources of these profits. If one were seeking a financial reporting failure, it was the absence of detailed requirements to disclose credit risk prior to the 2007 fiscal year when IFRS7 became effective[17]. Prior to IFRS 7, a bank could simply disclose an aggregate amount of loans and receivables[18]. As a result, the only potential disaggregation that was available was by segment for example ROI vs Overseas operations. It was very difficult for outsiders to comprehend the seismic shift that had taken place in bank balance sheets prior to 2008[19].

IFRS7 is not a panacea as the guidance in IFRS7 is 'principles' based. A comparison of the covered banks pre- and post IFRS would reveal a substantial increase in disclosure under IFRS7 but significant cross sectional diversity in the detail of the disclosures that were made[20]. A further difficulty is the use of captions in disclosures that may be misinterpreted by readers - I did not see a bank that used the caption from Nyberg 'Speculative C&P Lending' in its annual report.

In summary, I believe that the real challenge for external users of financial statements was understanding the changing nature of the risks on aggregate bank balance sheets until 2007. Had users fully understood the increased exposure to commercial and speculative lending – and that it was concentrated among a relatively small group of borrowers - it would have been far easier to realise that the quality of profits had declined and that mattresses rather than 'cushions' were required.

Bank Audits

It is also useful to reflect on some features of bank auditing. Directors are responsible for preparing and approving the financial statements. Auditors then issue an opinion of the financial statements. In addition to this statutory requirement[21], there is also additional guidance contained in PN19[22] that addresses a bank auditor's responsibilities to a regulator. The essence of these responsibilities are a requirement to bring matters to the attention of a regulator[23]. However, this relates only to information "of which the auditor has become aware in the ordinary course of performing work undertaken to fulfil the auditors audit

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[17]IFRS 7 "Financial Instruments: Disclosures" became effective for annual periods commencing on or after January 1, 2007. For example, Anglo Irish Bank's financial statements for the year ended September 30, 2008 were its first application of IFRS7. The preliminary financial statements were released in December 2008.

[18] On the other hand, a financial regulator is relatively omnipotent with respect to demands for information, and one would expect that a regulator would seek more granular information from banks and could publish that data in a timely manner. A regulator could also require that certain information must be included in an annual report (e.g. Central Bank "Impairment Provisioning and Disclosure Guidelines" 2011).

[19] Irish Banks that prepared Form 20-F for the US Securities and Exchange Commission included additional credit and loan portfolio disclosure that may not have appeared in their published annual reports.

[20] For example, the granularity of internal ratings and the captions used to categorise loans. Some banks disclosed the percentage of loans extended to their largest customers, while others do not appear to have done so. This diversity also explains the subsequent prescriptive requirements by the Central Bank in 2011 and 2013.

[21] Nyberg p.58 describes this as a 'narrow/limited mandate'.

[22] The Auditing Practices Board - Practice Note 19(I) "The Audit of Banks in the Republic of Ireland" Unless otherwise noted, all references are to the June 2008 Edition.

[23] Assuming that they are relevant to the regulator's function and may be of material significance to the regulator. In addition, an auditor should bring breaches of statutory or regulatory requirements to the attention of a regulator if they are significant.

responsibilities." [24] In addition to these responsibilities, the regulator has the power to request information from the auditor of a bank[25].

Of greatest relevance during 2002-2008 was the reporting of breaches of prudential sector lending limit guidelines. While the regulator did not enforce these limits[26], Nyberg 3.8.3 states:

> "in the majority of cases the auditors did not report regulatory sector lending limit excesses to the FR. Even if all excesses had been reported, it appears unlikely that any action would have been taken by the FR, who was already aware of and not concerned about such excesses."

While I have not had access to the auditors' communications, I note that Nyberg p.vi states "The auditors clearly fulfilled this narrow function according to existing rules and regulations."

In terms of more general auditing considerations, one would also anticipate that some inspection of loan documents should take place[27]. Some of the specific practices might include[28]:

1. Ensuring that lending policies are adhered to
2. Reviewing concentration reports and related-party loan reports
3. Establishing evidence of any collateral assigned to the institution
4. Checking the financial condition of cosignatories and guarantors, examining past experience with the enforcement of guarantees and confirming terms with the guarantor[29]
5. Comparing loan amounts with appraisals
6. Ensuring that construction loans are correctly classified as loans rather than real estate investments
7. For significant construction projects, ensuring that advances are based on progress and on-site inspections to verify collateral and progress
8. Assessing management's loan reviews for impairments. Audit procedures should establish that management have looked beyond the collateral to identify potential borrower weaknesses, that collateral appraisals are adequate[30], that up to date borrower financial information is available. Auditors should also review performance against the original agreement and be alert to biases (e.g. the involvement of a public personality in a venture) (9.18).

In summary, while the published financial statements are prepared in accordance with IFRS, auditors also play a valuable role in assuring the veracity of the loans and receivables on a bank's balance sheet.

Concluding Observations

Between 2002 and 2007 the aggregate loan portfolio of the Irish banking system grew rapidly and exhibited significant concentrations of commercial lending and speculative commercial lending. However, these concentrations varied across banks and there were also significant individual borrower concentrations. Perfect

[24] For a full description of these responsibilities, see PN19, pp. 26-33.
[25] Central Bank Act 1989, Section 47(5).
[26] See Nyberg Figure 4.3
[27] Auditors also examine many other items that could result in a 'material misstatement'.
[28] These practices are based upon the "AICPA Audit and Accounting Guide - Depository and Lending Institutions". This is a US guide and may not reflect domestic Irish practice. However, it is indicative of the verification procedures that might be expected.
[29] Additional guidance is available in 9.105 that addresses guarantees
[30] Note also (9.103) "the auditor may evaluate the security interest in the collateral to determine how the institution knows that it has been perfected by execution and recording of the appropriate legal documents." 9.104 states "there should be documentation that the institution has verified the existence of the collateral. In the absence of such documentation, the auditor should perform these or other collateral verification procedures, especially for significant loans for which collectability is otherwise questionable."

knowledge of loan portfolio risks would have certainly alerted external users to the sources of bank profits and their sustainability. While there was no requirement to report these risks in the published financial statements (especially for financial statements prior to 2007), there were requirements to report capital adequacy, liquidity, impairment, large exposures (concentrations) and sectoral limits to the Financial Regulator. It is an empirical matter as to whether these amounts were correctly reported to the Regulator and to the boards of financial institutions.