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IMPACT OF CURRENT FINANCIAL CRISIS ON DISCLOSURES ON FINANCIAL INSTRUMENTS

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Abstract

Many specialists consider that financial instruments such as credit derivatives are, among other factors, to be blamed for the current financial crisis. This financial engineering, called credit derivatives, long praised as a great way of diffusing risks for banks, encouraged many financial institutions to take higher risks on loans than they should have. Their huge success took everybody, including their creators, by surprise. In just a few years, the credit derivatives market reached a staggering $60 trillion contracts and, unfortunately, multiplied the complexity and opaqueness of the financial world. That is why some people considered that the massive use of these instruments played an important role in creating the financial crisis. Paradoxically, some specialists did not accuse the irresponsible use of sophisticated derivatives of having generated the crisis but the accounting rules applicable for these instruments and the reporting rules issued by the American and international standard-setters. Although it is true that accounting for financial instruments has been a controversial subject for bankers, insurers, standard-setters and practitioners for quite a while, placing the blame on it for the current crisis is a little too much. The complex features of some of these instruments, the non-regulated markets many of them are transacted on and the difficulties in establishing their fair value have been good reasons for strong debates about the accuracy and adequacy of the accounting standards during the last years. But the disputes have never been as virulent as they became as the crisis started. Many people have accused financial reporting endorsed by Financial Accounting Standards Board (FASB) or International Accounting Standards Board (IASB) of not disclosing enough information on financial instruments, on the valuation methods used or the risks associated with them. Hence the investors could not correctly assess the risks and made bad decisions. The policymakers, some investor groups and other interested parties called for improved transparency and enhanced accounting guidance on fair value and financial instruments. The aforementioned standard-setters responded by amending some of the old rules and by issuing further guidance. This paper aims at analyzing the disclosure rules on financial instruments before and during the crisis by studying the financial reports published by some major financial companies.

Keywords: financial instruments, fair value, financial statements, financial risks, financial crisis.
JEL classification: G01, G15, G32, P34

1. INTRODUCTION

Without any doubt, the present financial crisis has changed the world and the way businesses are conducted. After the initial shock sent around the entire financial system by the collapse of some gigantic American financial corporations, many voices were heard and many assumptions were made about the causes of the crisis. The majority of specialists [1] noted that bad bank lending, unrealistic expectations that the world economy would continue to grow indefinitely, poor risk management policies coupled with pure greed and the ineffectiveness of the regulatory system played a significant role in the current crisis.

Many people agreed that one of the causes of these events was the *inappropriate use of complex exotic financial instruments*, poorly understood even by their creators. "The best and the brightest at top investment banks expended great energy designing ludicrously complex financial products which you need a Nobel Prize in physics to understand" [16]. Unfortunately, the consequence was an increased opacity of the financial system and reporting that eventually led to disaster.

Because of the wide perception that there is a strong connection between the crisis and certain types of financial instruments, the *accounting standards* for such instruments have been subject to a thorough scrutiny. The standards were highly incriminated because of the *fair value accounting*, extremely criticized for requiring that financial institutions take in enormous losses in connection with illiquid financial instruments, making a bad situation worse. By imposing the valuation of financial assets at their current market value, fair value accounting forced companies to write-down asset values, destroying equity and threatening banks' lending ability [2].

Some voices [17] considered that the villain of the crisis was not necessarily fair value accounting but the *financial reporting* that lacked transparency and comparability due to the application of inappropriate accounting standards on disclosures. They argued that financial reporting should have provided a more timely and clear image of the risks involved by the use of some sophisticated financial products (e.g. mortgage-backed obligations). These critics blamed the crisis on the failure of companies to provide a complete and accurate depiction of their financial standings reflected in deficient disclosures of asset and liability values or risks on their balance-sheets.

Debates on the importance of transparent financial reporting have been going on for a while. In the context of the internationalization of business and globalization of financial markets, the pleas for a real harmonized reporting framework that should offer guidance for preparing financial statements to reveal open, complete, unambiguous and timely information are not surprising. The solution seems to be the use of a single set of accounting standards all over the world.

After long disputes and controversies this set appears to be the one issued by IASB. But its adoption does not shelter standard-setters, accountants, auditors, financial statements preparers and users from difficulties in applying and analyzing the accounting information. Business structures and transactions nowadays are so complex that accounting standards and financial reporting, which reflect them, cannot be otherwise but complicated.

Still, the adoption of IAS/IFRS in many countries all over the world (including the European Union) was a big step toward reducing diversity in financial reporting practices, improving investors' confidence in markets and ending the Tower of Babel in accounting and disclosures rules. The only important country refusing to adopt IAS/IFRS and still holding onto its national standards (US GAAP) is USA. Although the American standard-setter

(FASB) and the international one (IASB) have been working on a project to converge their rules toward a global unique standard for quite a while, the road ahead seems quite long. But the financial crisis has accelerated the process and has attracted more proponents of the idea that IAS/IFRS should be adopted by the American companies as soon as possible. A big step toward the goal of achieving real globalization of financial reporting was taken in 2007 when Securities Exchange Commission (SEC) decided to eliminate the US GAAP reconciliation requirement for foreign private issuers of financial statements prepared in accordance with IAS/IFRS.

Although there is still a long road ahead till the achievement of a real harmonized framework for financial reporting, the crisis has shown us there is a stringent need to simplify the rules to allow management to better explain their business performances and to enable users to identify, understand and correctly analyze the information.

2. IFRS 7 AND SFAS 157 BEFORE AND DURING THE CRISIS

In terms of disclosures related to financial instruments, the last few years have meant an infusion of new and controversial rules from both the international standard-setter (IASB) and the American one (FASB).

The IASB, in an attempt to simplify and enhance the disclosures on financial instruments, replaced the requirements from IAS 32 "Financial instruments: presentation and disclosure" and IAS 30 "Disclosures in the financial statements of banks and similar financial institutions" with a new standard, *IFRS 7 "Financial instruments: disclosure"*, issued in 2005 and becoming effective in 2007. By doing this, the IASB put all the financial instruments disclosure in one standard.

IFRS 7 has the primary objective of providing risk and financial instruments disclosures that enable users to evaluate the significance of financial instruments to an entity's financial position and performance. Unlike IAS 30 that applied only to banks and other financial institutions, IFRS 7 addresses all entities reporting in accordance with IFRS, regardless of the extent of the entity's use of financial instruments and its exposure to risks. Of course, the disclosure are to be expected to be more detailed for financial institutions which are the most exposed to the risks deriving from financial instruments.

The standard does not only replace some of the disclosures required in IAS 32 and IAS 30, but also adds new disclosures, such as:

- requirements to provide quantitative data of the exposures to the relevant financial risks;
- preparation of a market risk sensitivity analysis for each type of market risk;
- disclosures of the carrying amounts of financial assets and liabilities under the IAS 39 classifications;
- disclosures of the hedge ineffectiveness.

All the disclosures in IFRS 7 are grouped in two categories:

- information about the significance of financial instruments (in the balance-sheet, income statement and equity);
- information on the nature and extent of risks arising from financial instruments (qualitative and quantitative disclosures on credit risk, liquidity risk and market risk).

Specialists [5] argue that the most challenging aspects of the standard are the market risk sensitivity analysis and the quantitative disclosures because they require the development of and/or investment in additional systems and processes. But another great challenge is to find the balance between disclosing too much or too little because the standard contains just minimum requirements. It depends on the management to provide sufficient information about their policies for monitoring, measuring and managing risks so the investors understand and properly assess them.

"The financial crisis has shown that a clear understanding of how entities determine the fair value of financial instruments, particularly when only limited information is available, is crucial to maintaining confidence in the financial markets" (David Tweedie, chairman of the IASB on the release of the latest amendments to IFRS 7). That is why the IASB tried to improve financial instruments disclosures and issued an amendment to the standard in early March 2009 as a response to the crisis and to the demands made for enhanced financial reporting by the G20 in November 2008. These amendments bring IFRS more closely in line with the US standards (namely FAS 157) by introducing (only for disclosure purposes) a three-level hierarchy for fair value (in May 2009 IASB issued an exposure draft on fair value measurement consistent with US GAAP, addressing the valuation matter, including in markets that become inactive). They also clarify the existing requirements for the disclosures on liquidity risk. The new rules apply for annual periods on or after 1 January 2009.

Considering that many specialists called the current crisis a "liquidity crisis" and that fair value accounting was one of the most debated causes of the crisis, the aforementioned amendments seem to enhance disclosures exactly where it was needed, respectively for the most sensitive aspects of financial instruments accounting. The annual reports for 2009 will tell us if this really happens.

Another amendment published in October 2008 arises from the modifications made to IAS 39 "Financial instruments: recognition and measurement" that allow reclassification out of "available-for-sale" and "fair-value-through-profit-and-loss" categories. These reclassifications trigger extensive disclosures requirements that affect IFRS 7.

In the USA, the rules on financial instruments disclosures are contained mostly in *FAS 107 „Disclosures about fair value of financial instruments" and FAS 133 „Accounting for derivative instruments and hedging activities"* (repetedly amended during the last years, the lastest modifications being made through FAS 161 „Disclosures about derivative instruments and hedging activities", issued in 2008). But starting with 2007, these rules are combined with the information disclosed under another accounting pronouncement: *FAS 157 „Fair value measurement"*, issued in 2006. Statement 157 establishes a single definition of fair value and a framework for measuring fair value in US GAAP, and also expands disclosures about fair value measurements. According to this standard, the assets are labeled in one of the three categories depending on their relative liquidity:

- Level 1 includes the most liquid assets whose value stems from a quoted price in an active market;
- Level 2 includes assets valued using observable market data other than a quoted market price;
- Level 3 includes the hardest-to-value assets whose fair value can be determined only through unobservable inputs and prices that are based on internal models and estimates.

Precisely the 3rd level has raised the most critics during the crisis because it massively relies on subjective information that might reflect distressed or forced transactions. Critics have argued against the compulsory use of a market value for a transaction or a financial asset/liability for which there is no liquid market. In response to the critics (some of the opponents asked for the suspension of fair value accounting during crises), the American standard-setter issued further guidance on determining fair value of financial assets when their market is not active (FSP FAS 157-3) and when the volume and level of activity have significantly decreased (FSP FAS 157-4). Moreover, FASB increased the frequency of disclosures about fair value by requiring disclosures for interim reporting periods of publicly traded companies (FSP FAS 107-1).

3. DISCLOSURES ON FINANCIAL INSTRUMENTS DURING THE FIRST YEAR OF THE CRISIS

The year 2007, the one in which most financial institutions implemented IFRS 7 or FAS 157 for the first time (depending on the set of accounting standards they used), was one that marked the beginning of the current crisis: the credit crisis. So, the first year of adoption coincided with the start of the credit market turmoil and the severe volatility of the most advanced financial markets. That is why the analysis of the disclosures on financial instruments and fair value presented by financial institutions (especially banks) was a very interesting and challenging task for many specialists.

The first impression after examining some of the annual reports published by both European and American banks was that the volume of disclosure significantly increased in 2007 [15]. Probably, the increase was caused not only by the implementation of the new standards, but also by the beginning of the credit crisis that was reflected in every single annual report, more or less detailed.

The information on financial instruments, fair value and financial risks was scattered all over the annual reports which made it more difficult to be found and compared. The IFRS generally do not prescribe the format of annual reports (the same happens with IFRS 7), so banks could locate the mandatory information in different sections of their financial reports, but most of it was located in the explanatory notes.

Some of the *positive consequences* arising from the application of IFRS 7 and FAS 157 are [23, 6, 16, 20]:

- the aforementioned standards heavily rely on the principle-based approach which means greater flexibility for the preparers of the financial statements to provide the information they consider important to their users. This liberty makes banks act more actively and more responsible;
- the volume of disclosures on fair value increased significantly, most financial institutions providing proper information on the valuation methodologies, on the inputs used in the techniques applied, on the proportion of financial assets and liabilities measured with valuation techniques using significant unobservable data compared to the total assets/liabilities carried at fair value;
- the quantitative disclosures for all financial instruments classified according to the fair value hierarchy provided useful information and it was notable that some banks reporting in accordance with IFRS voluntarily offered information on level 1, 2 and 3 of the fair value valuation methods in FAS 157. Moreover, the banks reporting under US GAAP gave more useful information on fair value that enabled users to understand the impact of the valuation techniques, the criteria selection for the unobservable parameters and the movements from one level to another across the hierarchy attributable to the changing market conditions;

- the more transparent disclosures on the governance and control frameworks of the valuation process led to more reliable fair values. Also, the changes in the fair value presented by instrument type whether they were reported into the income statement or equity were more insightful;
- the credit risk and the liquidity risks were more disclosed than previously and also their impact over the valuations was better emphasized. Improvement could be noticed about the total credit exposure and the analysis of the age of financial assets that are past due but not impaired. Some banks voluntarily presented information on the liquidity of their financial assets although IFRS 7 requires these disclosures only for financial liabilities;
- when presenting the market risk, most banks provided detailed information on value-at-risk (VaR), which was one of the most used tools in managing market risk;
- all banks that carried on sub-prime activities provided disclosures on their exposure and quantifications of their impairment losses on the sub-prime markets.

But there is also a great deal of *shortcomings* even after the implementation of the new standards [23, 6, 16, 20]:

- the increased volume of information does not necessarily mean a better information or a more useful one, because sometimes the banks did nothing else but complied with the letter of the standards and applied only the minimum requirements. Unfortunately, many times the additional quantitative and qualitative information was not properly explained, so the result was not a better transparency;
- many banks did not change disclosures in certain areas (especially the ones not affected by the credit crisis) and in some situations the old rules from the superseded IAS 30 were applied;
- there were areas in which certain terms that required the use of professional judgement were not explained which made the information less meaningful and comparable (e.g. active market, observable inputs);
- certain information were provided at the level of total financial instruments when a depiction at class level would have been more useful;
- some information was nothing but a reproduction of the standards' provisions and was not sufficiently explained or grounded (e.g. not any commentary was made on the difference between the fair value and the carrying amount of loans as a result of the credit crisis, not any explanation was given on the reason for electing the fair value option for certain types of financial instruments, the valuation techniques used were not linked to the inputs selected etc.);
- as regards the impact of the market conditions, the banks did not disclose whether the credit crisis changed the valuation techniques and the inputs or assumptions used or not. They also did not provide separate information on whether the losses due to the credit crisis were realized or unrealized;
- although IFRS 7 puts a great deal of emphasis on the description of risk management, it is not a bank-specific standard so it contains only minimum disclosures of the financial risks. Even though the standard allowed the preparers to present the information "through the eyes of the management", many banks did not take the opportunity to properly explain their vision on monitoring and managing risks, but complied with the minimum requirements;

- the most problematic areas regarding the credit risk were the description of the fair value of the collateral, the presentation of the renegotiated assets or the incorporation of the credit risk into the valuation process;
- the liquidity risk which was significant during a liquidity crisis was not properly disclosed, the maturity analysis presented not being explained, nor the eventual changes of the risk management policies due to the modification of the market conditions;
- the market risk was disclosed through the sensitivity analysis which varied widely in format and details making the information less comparable.

We have to mention that all these shortcomings could be explained in two ways: on one hand, some banks did nothing to improve their disclosures with explanations and interpretations of the used data, being content with only applying the letter of the standards, not their spirit. On the other hand, some of the standards requirements could be enhanced because they were not suited to the real conditions that financial institutions had faced. That is why some information was simply not disclosed or was adapted, which resulted in big differences of presentation.

Even though the application of IFRS 7 was intended to harmonize the disclosures on financial instruments and to increase transparency of the risk management presentation, there is still a big diversity in its application which inhabits comparability. The nature and the extent of disclosures still varied widely.

Considering that 2007 was the first year of adoption for both standards and the beginning of the financial crisis, an improvement of the disclosures is expected in the next years as banks become more accustomed with the requirements, as they learn valuable lessons from the crisis and as standards are enhanced by their creators.

4. DISCLOSURES ON FINANCIAL INSTRUMENTS DURING THE SECOND YEAR OF THE CRISIS

The financial market turmoil started in 2007, accelerated in 2008 (especially during the second half of the year) and turned into a global financial crisis. The downturn from the housing markets, where prices continued to decline, spread to other classes of assets and affected a wide range of financial institutions (especially banks). The results consisted in significant losses, massive write-downs and increased impairments that altered banks' capital ratios and liquidity.

The functioning of many credit markets was severely influenced, especially during the fourth quarter of the year, when all banks reported losses. The year 2008 meant a significant change of the landscape of world banking sector: there was a constant tide of acquisitions, mergers, and reorganizations, the stronger banks swallowing the weaker ones, while others were nationalized.

In the context of the massive losses and the significant drop of investors' confidence in markets, governments and central banks took unprecedented actions during 2008: some financial institutions were left to collapse, filing for bankruptcy, while others were placed under administration. Authorities decided to inject liquidity into the markets (the famous $700 billion Troubled Assets Relief Program – TARP), to raise basic deposit insurance coverage or to augment existing lending facilities, all to ensure the financial stability. Many banks were provided with the necessary capital from the governments which helped them raise the capital needed after the huge losses and write-downs.

Naturally, all these circumstances made the publication of banks' financial reporting, frequently under scrutiny as one of the causes of the crisis, a significant event for specialists. The annual reports for 2008 were expected to explain what went wrong on the credit markets and to provide useful information for the prevention of other crises in the future.

The expectations were probably too high because financial reporting did not change significantly from the previous year. That means that most of the comments we made for 2007 are valid for 2008 too. The volume of disclosures increased both as a consequence of the additional information required by the standard-setter (FASB or IASB) and as a result of the pressure coming from supervisory bodies (such as the Financial Stability Forum, the Committee of European Banks Supervisors, the Institute of International Finance, the Basel Committee or the Securities Exchange Commission) to reflect specific information not required by the accounting standards. Another explanation for the increase in the volume of disclosures could be the significant number of acquisitions and reorganizations that took place during 2008.

As expected, the financial crisis was commented in every annual report, not in a separate section of the report, but in various notes (e.g. the segment reporting or the risk report). These comments were an integral part of the annual report, being treated as any other regular event in the markets (could this mean that the current situation is something normal that we should get used to?).

Besides the positive aspects identified for the previous year, we would like to add some other things [23, 14, 15]:

- the additional information that most banks voluntarily offered because of the new regulatory and legal requirements or the recommendation made by different supervisory bodies was welcome;
- the disclosure of maximum credit exposure or credit rating structure of financial assets (using mainly internal ratings) was provided in a clear manner by most banks;
- the impact of the financial crisis on banks' exposures was better grounded in 2008 with quantitative and qualitative information;
- the disclosures on capital and on the preparers' methods of managing and measuring liquidity were more useful than in 2007.

But the shortcomings are still there because [23, 14, 15]:

- the increased disclosures did not enhance transparency. The annual reports are still very complex and difficult to understand and mostly they do not explain the reasons behind certain choices or data;
- the most problematic areas remained the risk management policies, because information was provided in the same format and with the same details as last year. Which means that the disclosures were still very different and therefore less comparable;
- the additional disclosures were provided in very different ways which significantly reduced their usefulness and comparability;
- the banks that presented credit ratings based on internal ratings did not offer a mapping of internal to external ratings or a reconciliation between these ratings and the associated probability of default.

- in the context of a severe liquidity crisis, not many banks presented disclosures on liquidity ratios.

5. CONCLUSIONS

The regulations on financial instruments disclosures have undergone many changes and a significant improvement during the last few years. The information provided by financial institutions on the matter is less various. But...

The complexity of the disclosures is still very high. This has a special meaning during this period of crisis when the investors' confidence in the financial system should be raised through transparent and easily understandable information. For this to be achieved, the preparers of the financial statements should not be satisfied with just complying to the standards requirements, but should refine their disclosures and provide more accurate explanations for the judgments or estimates used in their reports. Also, efforts need to be made by the standard-setters which, after prior consultation to all the parties involved, should still improve the disclosure requirements to be suited to the real conditions of the markets.

While it is true that simple, transparent and neutral information reduces uncertainty and promotes stability, let us not forget that complexity can be diminished only till the extent of the complexity of the business structures and transactions. So, the efforts need to be made also by regulators, supervisors and other authorities to achieve a better framework for financial reporting that would suit everybody's best interests.

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