

**Agency Problems, Accounting Slack and Banks' Response to Proposed Reporting of Loan
Fair Values ***

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Abstract

We investigate the determinants of banks' responses to the United States Financial Accounting Standard Board's 2010 Exposure Draft that proposes fair value measurement for most financial instruments. Over 85 percent of the 2,971 comment letters were received from banks, with most bank-affiliated letters addressing—and rejecting—one issue: fair value measurement of loans. Interestingly, banks' resistance to fair value measurement occurred despite the fact that the Exposure Draft explicitly proposed continued reporting of amortized cost information on the face of the financial statements. By proposing that companies report both fair value and amortized cost measures for loans, the Exposure Draft should result in increased levels of loan-related information and improve financial reporting transparency. We propose that agency problems are an important motivating factor for responding banks because banks reaping more private benefits have less incentive to increase financial reporting transparency. Consistent with weak monitoring and risk-shifting on the part of responding banks, we find that our non-accounting-based proxies for contemporaneous agency problems are associated with a higher propensity for banks to submit comment letters. In addition, consistent with banks valuing slack available in current generally accepted accounting principles, we find that banks historically and opportunistically using loan-related accounting discretion are more likely to submit negative comment letters. The narrow scope of banks' comments and our empirical findings suggest that banks' 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 offered. 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.

Keywords: Lobbying, Financial Accounting Standards Board, fair value, loans

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1. 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 2,971 comment letters in response to the ED, with over 85 percent from banks, 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 banks, the FASB withdrew the proposal in January 2011 (Rapoport, 2011). This study seeks to understand the factors that led to these consequences.

A company's choice to submit a 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 and 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

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, and 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 runs 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).

responding banks 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 and credit losses determined via an incurred-loss measurement model. Under this model, potential loan losses are supposed to be recognized only when a loss is deemed "probable" based on past conditions and events that exist as of the financial statement date. Standard setters, regulators and practitioners note substantial disagreement about factors that bank managers should consider in determining loan-loss provisions (Dugan, 2009; FASB, 2009). In addition, empirical research documents significant variation in banks' application of the incurred loss model for loan losses (Beatty and Liao, 2011; Nichols, Wahlen and Wieland, 2009). Empirical studies also suggest that banks use discretion available in loan loss reporting opportunistically to manage income (e.g., Liu and Ryan, 2005) and capital (e.g., Beatty and Liao, 2011), and that this discretion reduces transparency and diminishes the ability of outsiders and regulators to monitor banks' risk-taking behavior (Bushman and Williams, 2012). Taken together, the observations of practitioners and empirical research findings suggest that the wide variation in application of, and the diminished financial reporting transparency related to, the incurred-loss model for loans is a form 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. 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).² 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.³ 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 more than 1,000 unique commercial banks submitted comment letters resisting *only* the loan-related provisions of the ED, while the vast majority of commercial banks remained silent. We propose that agency problems are an important motivating factor for responding banks because the incentives for transparent reporting are decreasing in agency problems (Jensen and Meckling, 1976); thus, banks reaping more private benefits have incentive to resist increases in financial reporting transparency. In conducting our tests, we consider two types of proxies for agency problems: (1) contemporaneous non-accounting-based proxies and (2) historical accounting-

² 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. In addition, our empirical 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.

³ 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.

based proxies. Our non-accounting-based proxies include arrangements with third parties that indicate lower levels of outside monitoring that should be contemporaneously associated with agency problems. Our accounting-based proxies capture the relative extent to which banks historically use the accounting slack available under the current incurred-loss model of accounting for loan impairments. We predict that, after controlling for banks' usual capital- and risk-based incentives, banks exhibiting weaker contemporaneous outside monitoring and greater historical use of the slack available in the current accounting for loan losses have greater incentive to resist the changes proposed in the ED.

We use logistic regression analysis to test the agency-related determinants of differential bank comment-letter writing. We collect all 2,971 comment letters submitted to the FASB in response to the ED, read each of the letters, and identify those written by commercial-bank representatives. We identify 2,472 financial-institution-affiliated letters, which, after adjusting for non-commercial-bank submissions (e.g., credit unions and savings and loans) and multiple submissions per firm, represents 1,047 unique commercial banks. Because the majority of banks are not publicly traded, we collect financial data, information on purchased excess government-sponsored insurance, audit status and information about enforcement orders from regulatory filings and disclosures.

Our results suggest that banks' documented resistance to the loan-accounting provisions in the ED is associated with greater agency problems in the responding banks. Specifically, with respect to our contemporaneous non-accounting-based proxies, the likelihood of banks submitting negative comment letters is (1) increasing in banks' demand for excess insurance purchased through the Federal Deposit Insurance Corporation's (FDIC's) temporary Transaction Account Guarantee Program (TAGP) or Debt Guarantee Program (DGP), (2) decreasing in the level of outside (nonguaranteed) debt, and (3) decreasing in banks' choice to obtain full financial

statement audits. With respect to our accounting-based proxies, our results also suggest that the likelihood of banks submitting negative comment letters and resisting the loan-accounting provisions in the ED is associated with banks' historical use of the accounting slack available through the incurred-loss method of accounting for loan losses. Our results are consistent with findings that firms will incur real costs to maintain accounting slack around debt covenants (e.g., Beatty, Ramesh and Weber, 2002).

Our results should be considered in the context of due process for accounting-standards setting and for legislating financial regulation. Our study suggests that banks writing negative comment letters have agency-related motives to resist accounting standards that result in the reporting of additional information and increased transparency. As one would expect, these motives and patterns of financial-reporting behavior are not mentioned in the comment letters. Instead, the negative letters submitted by responding banks cite conceptual reasons for resisting the proposal to report additional information related to loans (e.g., insufficient precision for fair value measurements, and irrelevancy). These conceptual concerns deserve serious consideration, and we attempt to control for these factors in our analyses by assessing whether those banks with more difficult to value loans and those banks not using fair values for internal decision-making are more likely to oppose fair value measurement and reporting for loans. We find no evidence that these factors are associated with an increased propensity to lobby against fair value accounting. These findings suggest that accounting standards setters and financial regulators should consider the potential motives of those responding to rule-making proposals when evaluating the conceptual merits of respondents' arguments.

Our study also contributes to the debate over the relation between regulatory accounting and general-purpose financial reporting. US federal law requires banking regulators either to accept financial information prepared in conformity with GAAP or on a basis of accounting that

is “no less stringent” than GAAP. Prior research suggests that this legally mandated conformity between US GAAP and US regulatory accounting principles (RAP) causes bank managers to make accounting choices to avoid noncompliance with regulatory covenants. Regulatory-compliance-motivated accounting choices may reduce the transparency of financial information for outside investors, and banks incur real economic costs to manage accounting numbers to meet regulatory bright lines (e.g., Hodder, Kohlbeck and McNally, 2002). Despite these findings, in recent years US Congressional Representatives have proposed direct oversight of the FASB by banking regulators (Johnson, 2009), and the AICPA (2008) has proposed increased coordination between banking regulators and the International Accounting Standards Board (IASB).

With respect to the 2010 ED, regulatory concerns appear to be an important determinant of the response by commercial banks because of (1) the heavy concentration of letter writing by *nonpublic* commercial banks and (2) the lower proportion of negative letters written by companies in non-bank industries that have heavy concentrations of financial instruments (e.g., the insurance industry). Beatty, Ke, and Petroni (2002) argue that private US banks have less incentive to manage reported GAAP earnings to beat benchmarks because ownership concentrations among manager-shareholders reduce agency costs of equity and also reduce shareholder reliance on general-purpose financial statements. Many of the banks responding to the ED are nonpublic, do not have outside creditors, are not required to issue general purpose financial statements, and are not required to obtain a financial statement audit. Therefore, private banks’ resistance to elimination of accounting slack is likely driven by the reliance of US government regulators on US GAAP financial statements. Our finding that banks resist incremental slack-reducing transparency complements the findings of other studies (e.g., Hodder et al., 2002) to suggest that the marriage of RAP and GAAP can lead to value-decreasing

behavior by banks and can decrease the effectiveness of regulatory oversight (Bushman and Williams, 2012).

Prior research has examined factors related to firms' reporting incentives and their decisions to lobby for or against various accounting standards (e.g., Watts and Zimmerman, 1978). These studies usually are based on the assumed effects that a proposed rule will have on the primary financial statements of public corporations. In particular, studies predict increases in lobbying behavior when proposed standards are anticipated to reduce the level of income (e.g., expensing the fair value of stock options decreases reported net income, as in Dechow, Hutton and Sloan, (1996)) and/or increase the volatility of reported income (e.g., including foreign exchange translation adjustments in net income increases net income volatility, as in Kelley, (1985)). Our investigation extends these studies by including a large sample of public and private companies, and by analyzing lobbying in the context of agency problems within a regulated industry. Thus, our study is related to Hochberg, Sapienza and Vissing-Jorgensen (2009), who show that US public companies with greater agency problems lobbied more intensely against Sarbanes-Oxley Act of 2002. Our study is distinct from Hochberg et al. (2009) because we address the intersection of agency problems, financial reporting standards, and regulatory accounting, while they address the intersection of agency problems and internal control regulations.

We organize the paper as follows: In Section 2, we discuss current and proposed accounting for loans; in Section 3, we describe our hypotheses and agency proxies; and in Section 4, we describe our sample and research design. In Section 5, we discuss our research findings and we provide concluding remarks in Section 6.

2. Current and Proposed Accounting for Loans

2.1 Accounting Slack Inherent in Current GAAP for Loan Losses

Current US GAAP for loan losses is based on an incurred loss model of accounting for counterparty credit risk. Losses are recognized when probable, based on past events and economic conditions existing as of the reporting date. Even in the absence of subjectivity, incurred losses differ from losses embedded in expected values because expected values take into account unbiased expectations about future economic conditions that would give rise to future incurred losses. Moreover, unlike continuous measurement of losses via expected values, the incurred loss method in current US GAAP results in recognition of losses only when the probability of loss exceeds the “probable” threshold. For these reasons, unbiased loss provisions recognized using the incurred loss method will generally result in cumulative loan loss provisions that are less than cumulative expected losses reflected in unbiased expected values or unbiased fair values.

However, there appears to be widespread variation in application of the incurred loss method (Dugan, 2009; FASB, 2009). At one extreme, required reliance on objective evidence of impairment leads some to argue that losses should not be recognized until loans become delinquent or otherwise default. At the other extreme, risk-averse regulatory field auditors and conservative managers may cause a bank’s loan loss allowance to converge to or exceed the manager’s unbiased estimates of expected losses. This divergence causes great variability in the extent to which loan loss provisions recognized under current GAAP are associated with nonperforming loans and realized losses in subsequent periods (e.g., Beatty and Liao, 2011; Nichols et al., 2009; Bushman and Williams, 2011).

In addition to non-strategically divergent implementation of the existing standard, slack associated with the incurred loss model is used actively to manage both earnings and capital

(Moyer, 1990; Collins, Shackelford, and Wahlen, 1995; Beatty, Chamberlain and Magliolo, 1995).⁴ Although research generally is mixed on the consequences of earnings management, with some studies suggesting earnings management is value-increasing, evidence on loan-loss-provision-related earnings and capital management in the banking industry suggests negative consequences. For example, Bushman and Williams (2012) find that using the loan loss provision to smooth earnings reduces transparency and makes more difficult the efficient monitoring and market discipline that restrain losses due to agency problems. In addition, Beatty and Liao (2011) document cross-sectional differences in the timeliness of loan loss provisions after controlling for incentives for earnings and capital management, and find that banks delaying loss recognition suffer from an incremental decrease in lending capacity during economic downturns. This occurs because delayed recognition means that losses are more likely to be recognized when the loans subsequently exhibit weakness. The regulatory capital erosion resulting from accelerating charge-offs is difficult and expensive to remediate in the down economy when most capital providers are de-levering and reducing risk.

Taken as a whole, prior research suggests that the incurred loss model of loan-loss recognition under current GAAP is an important source of accounting slack available to bank managers and that the use of such slack can be socially and economically detrimental.

2.2 *FASB's 2010 Financial Instruments Exposure Draft*

In May 2010, the FASB issued an ED for a Proposed Accounting Standards Update titled, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (FASB, 2010). This proposal includes a comprehensive set of changes related to classification and measurement of financial instruments, impairment of

⁴ Apparent upward discretion in recognizing loan losses may signal that management is aggressively working out existing problem loans (Liu, Ryan, and Wahlen, 1995); however, electing to more timely recognize losses may actually convey bad news about losses on defaulting loans (Liu and Ryan, 1995).

financial instruments and hedge accounting. Of the many changes proposed in the ED, the most controversial—at least according to banks—is the FASB’s proposal that most financial instruments, including loans, be measured and reported on the balance sheet at fair value.⁵ Under current US GAAP, unless an instrument-by-instrument election is made under the fair value option (FASB ASC 825-10), companies generally measure and report loans at amortized cost, adjusted for loan losses determined under an incurred-loss measurement approach.

While the ED proposes that most financial instruments should be carried at fair value with the periodic change in fair value reported in net income (FV-NI), the ED does allow for a subset of debt instruments held as assets (i.e., loans) to have a portion of the change in fair value recognized in other comprehensive income (FV-OCI). Specifically, consistent with credit-risk-related income effects for estimated loan losses under current GAAP, the ED proposes that credit-related impairment of loan value should be recognized as a component of net income in the period in which credit-related decline in loan value occurs. The ED proposes that any remaining change in the fair value of loans during the reporting period should be recorded as a component of other comprehensive income.⁶ Thus, under the ED, the total effect on comprehensive income equals the holding gains and losses related to the change in fair value of loans.⁷

Based on responses from banks, the most significant effect of the ED’s proposed accounting is that loans—the single most significant class of assets on commercial banks’

⁵ The comment period for the ED ended on September 30, 2010. The FASB announced, in January 2011, that it would not consider measuring and reporting loans at fair value as part of the final financial instruments standard. As of June 2012, the FASB has not issued a revised proposal related to the financial instruments project.

⁶ Although not the focus of this paper, the ED proposes that the credit-related losses (i.e., the FV-NI component of the total change in fair value) should be measured using an approach that includes some consideration of expected value. The letters submitted by commercial banks did not comment on these potential minor modifications in measurement.

⁷ According to the ED, the non-credit-risk change in value for a debt instrument can qualify for FV-OCI treatment if (1) it includes contractual terms specifying the payment of substantially all of the principal and interest to the creditor/investor and (2) if the entity’s business strategy for the instrument is to collect (or pay) the contractual cash flows rather than to sell (settle) the financial asset (liability) with a another party.

balance sheets—will no longer be carried at amortized cost, adjusted for “incurred losses” related to credit risk.⁸ Instead, these assets will be recognized in the balance sheet 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). Even if loan fair values include significant measurement error, the ED should result in a net increase in relevant loan-related information because the ED mandates continuing financial statement reporting of important amortized-cost amounts. Specifically, the ED requires (1) that amortized cost be presented parenthetically (and reconciled to fair value) on the face of the statement of financial position, and (2) that estimated credit losses be charged against net income.

An interesting feature of the response to the ED is the high proportion and absolute number of comment letters received from privately held banks. In general, private companies do not submit high volumes of comment letters in response to FASB standard-setting proposals because, unlike public companies, they are not statutorily required to publicly issue general-purpose GAAP financial statements. In the next section, we describe regulatory factors that likely caused private banks to submit an unusually high number of comment letters about the ED.

2.3 *Why GAAP Matters for Bank Regulation*

In response to perceived deficiencies in US bank regulation highlighted by the S&L crisis, the passage of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) ushered in an era of more stringent standards and decreased regulatory discretion. Prior to FDICIA, regulators could engage in case-by-case forbearance; for example, by allowing an undercapitalized bank to continue to operate while attempting to raise capital. In addition, regulators had discretion to exercise “wholesale” forbearance by selectively relaxing accounting

⁸ Untabulated descriptive statistics reveal that, as a percentage of total assets, loans for our median sample bank equal 66 percent of total assets, with the first quartile equal to 54 percent of total assets.

principles to indirectly ease capital standards. However, discretionary forbearance was perceived to increase the cost of bank failures, causing Congress to act to curtail regulatory discretion (Edwards, 2011).⁹

FDICIA attempted to limit regulatory discretion and case-by-case forbearance by adopting an objective capital-ratio based system of prompt corrective action (PCA). As reported bank capital ratios decline, FDICIA prescribes mandatory intervention. To forestall wholesale forbearance, FDICIA also placed limits on regulators' ability to selectively override accounting principles. As a result, United States federal law (i.e., Title 12, Chapter 16 §1831n(a)(2)(A) and (B)) now mandates that regulatory accounting principles must be based on GAAP or a basis of accounting that is "no less stringent" than GAAP (i.e., "RAP-GAAP conformity").¹⁰

The divergent views on regulatory forbearance versus timely intervention, together with FDICIA's *de facto* RAP-GAAP conformity, have placed unprecedented pressure on financial accounting standard setters to respond to regulatory concerns and political pressure surrounding the effects of accounting standards on reported bank capital ratios. Cognizant that regulatory objectives concerning safety and soundness may diverge from the SEC's joint objectives of investor protection, enhanced transparency and relevancy of financial reporting for outside capital providers, the SEC has resisted the notion that the content of general purpose financial statements should be dictated by regulatory concerns (Johnson, 2009). This position was expressed by SEC Chief Accountant James Kroeker, in testimony to Congress on March 25, 2009:

⁹ For example, regulators allowed certain losses to be deferred as assets and amortized instead of immediately recognized in income. As well, certain liabilities were classified as contra assets, and certain liabilities were classified as capital.

¹⁰ FDICIA reduced, but did not eliminate, regulatory discretion to modify GAAP. For example, regulators chose to exclude unrealized gains and losses on Available for Sale (AFS) securities from regulatory capital. AFS accounting was initially promulgated in Statement of Financial Accounting Standards (SFAS) No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, and is currently included in Topic 320 of the FASB's Accounting Standards Codification. It is unclear how excluding losses recognized under GAAP meets the stringency criterion.

“In sum, while financial reporting may serve as a starting point for other users, such as banking regulators, it should continue to be developed by the FASB to primarily satisfy the needs of private sector investors and other users that may not have the ability to otherwise obtain information in a format specific for their own use”¹¹

The Financial Crisis Advisory Group (2009) also noted that general-purpose financial reporting and “prudential regulation” have different reporting objectives. Despite concerns about divergent regulatory and investor objectives, the United States banking industry continues to press for oversight over the financial accounting standard setting process (ABA, 2009), and the AICPA has proposed that bank regulators should be included in an International Accounting Standards Board Monitoring Group (AICPA, 2008).

2.4 RAP-GAAP Conformity and Regulatory Slack

Within the banking industry, RAP-GAAP conformity has caused accounting flexibility to become a source of regulatory slack. For example, Hodder et al., (2002) document that, as a direct result of RAP-GAAP conformity, banks’ initial accounting classification choices for investment securities largely were driven by concerns about potential effects on regulatory capital. Amortized cost accounting for investment securities allows firms to manage capital and earnings by strategically timing the recognition of gains and losses (e.g. Barth, Beaver, and Wolfson, 1990), with publicly held banks more likely than privately held banks to manage earnings through securities gains and losses (Beatty and Harris, 1999). Hodder et al. (2002) show that when regulators relaxed RAP-GAAP conformity by excluding from regulatory capital

¹¹ Testimony Concerning Exploring the Balance Between Increased Credit Availability and Prudent Lending Standards by James L. Kroeker, Acting Chief Accountant U.S. Securities and Exchange Commission Before the House Committee on Financial Services on March 25, 2009.

unrealized gains and losses on securities classified as AFS, banks responded by reclassifying the majority of their investment securities from Held to Maturity (HTM) to AFS.¹²

Interestingly, banks' ultimate choice to recognize the majority of their investment portfolios at fair value contrasts markedly with the industry's near unanimous opposition to fair value recognition of investment securities that was expressed in comment letters on the FASB's exposure draft of SFAS 115. Banks comprised the majority of respondents to the SFAS 115 exposure draft, and despite bankers' subsequent, almost-universal, adoption of fair value accounting for investment securities, 96% of bank comment letters voiced opposition to fair value accounting for investment securities purportedly on conceptual grounds (Schultz and Hollister, 2003). These two studies provide indirect evidence (1) that banks lobbied to retain amortized cost accounting for investment securities because amortized cost accounting provides a source of regulatory slack, and (2) that banks' stated reasons for opposing fair value accounting did not convey this fact. When regulators provided regulatory slack by excluding from regulatory capital unrealized gains and losses recognized under GAAP, banks relaxed their opposition to fair value accounting for investment securities under GAAP.

The continuing influence of RAP-GAAP conformity on banks' stated positions against fair value accounting is suggested by the disproportionately large industry response to the fair value provisions of the 2010 ED, with many letters coming from banks that are not required to issue general purpose financial statements (e.g. privately held banks). Banking regulators also opposed the ED, expressing concerns about the proposal's effect on "financial intermediation and stability," implying that regulators would be unwilling, or perhaps politically unable, to carve out the ED's effect on capital as they had done with SFAS 115 (comment letter from the

¹² The Treasury Department issued final rule excluding unrealized gains and losses on AFS from regulatory capital on November 24, 1994, stating, "although the OCC and other Federal regulatory agencies attempt to conform to GAAP when formulating regulatory policy, it is not always appropriate. When formulating GAAP, the accounting policy makers do not focus on the unique capital adequacy requirements of banks," which were noted to include managing reported volatility (Federal Register Volume 59, Number 226, Doc No: 94-29110).

Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, and Office of Thrift Supervision, 2010).¹³ During the third quarter of 2009, troubled bank resolutions caused the FDIC insurance fund balance to become negative, and the FDIC in November of 2009 approved a plan to recapitalize the fund by requiring all insured institutions to prepay insurance assessments through 2012 (Dash, 2009). Caught between unaffordable insolvencies that might be revealed by fair value accounting and demands for tighter regulation and compliance with FDICIA, bank regulators had a number of incentives to convince standard setters to relax proposed accounting rules. Delaying loss recognition would provide additional time to recapitalize the insurance fund and would avoid the need for politically costly explicit regulatory forbearance at a time when public sentiment was critical of bank bailouts.

3.0 Hypothesis and Agency Proxies

While US RAP-GAAP conformity can explain the heavy concentration of public and private banks responding to the ED (compared to other industries), it does not unconditionally explain why representatives from 1,047 unique commercial banks submitted comment letters while the vast majority of commercial banks did not formally respond to the ED. US RAP-GAAP conformity also does not explain why most responding banks commented on *only one issue* related to one class of assets (i.e., fair value recognition of loans) in an ED that spanned 214 pages and that requested responses to 71 separate questions. As we describe in the previous section, current US GAAP for loans and related impairments includes significant opportunities for managers to use accounting slack. By retaining important elements of the current amortized-

¹³ Regulators' unwillingness to expand disclosure in the middle of the credit crisis might be explained by political incentives. As Kane (1989) notes, "(t)he subtlest and quantitatively most important form of assistance a guarantor can give consists of turning a blind or nearly blind eye to a debtor's economic insolvency..." If Kane's (1989) observation that "[a]uthorities show a propensity to keep themselves underinformed that suggests an intention of maintaining a deniability option" remains true today, then the environment surrounding the credit crisis creates a unique opportunity to examine regulators' demand for financial accounting slack.

cost system while also requiring fair value recognition for loans, the FASB's ED should increase the amount and quality of relevant information about loans, while also improving accounting transparency for loans—by far, the single biggest class of assets on banks' balance sheets.

We propose that agency problems are an important motivating factor for responding banks because incentives for transparent reporting are decreasing in agency problems (Jensen and Meckling, 1976). This means that banks obtaining more private benefits have less incentive to provide additional information or to improve financial reporting transparency. Further, in the banking industry, regulator-imposed RAP-GAAP conformity creates *de facto* regulatory forbearance that is derived from accounting slack. The ED's proposed increase in reported relevant loan-related information and the likely improvement of accounting transparency potentially constrains managers' ability to opportunistically intervene in the timing of loss recognition. Although banks' demand for decreased financial reporting transparency and increased accounting slack is unobservable, these factors should be positively related to banks' agency problems. Therefore, we propose that banks' propensity to lobby against the ED is positively related to banks' observable choices that are indicators of agency problems. This leads to the following alternative-form hypothesis:

H1: Banks with agency problems are more likely to lobby standard setters against fair value measurement of loans.

In conducting our tests, we consider two types of proxies for agency problems: (1) contemporaneous non-accounting-based proxies and (2) historical accounting-based proxies. We discuss each of these types of proxies in the following paragraphs.

3.1 Contemporaneous Non-Accounting-Based Proxies for Agency Problems

Our non-accounting-based proxies include arrangements with third parties that suggest lower levels of outside monitoring that should be contemporaneously associated with agency problems. Our first contemporaneous non-accounting-based proxy is whether banks participated in a supplemental deposit insurance and debt guarantee program offered by the FDIC beginning in 2008. In general, deposit insurance is intended to insulate depositors from potential consequences of banks' excessive risk taking; however, an unintended consequence is that deposit insurance exacerbates agency problems by removing depositors' incentives to provide the monitoring and discipline typically imposed on firms by external creditors (Merton, 1977; Gorton and Rosen, 1995). By reducing monitoring and price discipline, deposit insurance relaxes constraints on the risk-shifting incentives of bank managers and shareholders. Thus, the value of deposit insurance is essentially equivalent to the private benefits of operating without outside creditor discipline (Forssbäck, 2011).

When government-sponsored insurance is provided for banks' liabilities, total agency costs decline because depositors do not demand a risk premium, and existing agency problems become less expensive (Forssbäck, 2011). Further, bank regulators generally do not have incentives to provide the level of monitoring provided by private creditors. For example, Kane (1989) documents a pattern of systematic information suppression among state bank regulators preceding the S&L crisis of the early 1990s. He suggests that principal-agent problems make government-based deposit insurers slow to recognize the extent to which banks' risk shifting threatens the solvency of the funds they administer. Further, according to Kane (1989), information suppression provides plausible deniability for regulators whose short horizons allow problems to be passed off to successors.

Notwithstanding the moral hazard problems potentially exacerbated by traditionally available government-sponsored insurance, in 2008 the FDIC offered optional, supplemental deposit insurance and debt guarantees as part of the government's response to the 2008 global financial crisis.¹⁴ Banks' choice to purchase additional deposit insurance and debt guarantees suggests potential agency problems because the private benefits expected to obtain from the incremental reduction in creditor discipline were greater than the flat-rate (i.e., not adjusted for bank-specific risk) premium paid for such insurance and guarantees. Thus, we expect a positive relation between banks' choices to purchase supplemental insurance through the TAGP and DGP programs, and banks' likelihood of submitting negative comment letters.

Our second contemporaneous non-accounting-based proxy for agency problems is whether banks have long-term uninsured outside creditors. Private creditors provide important monitoring functions that reduce the incidence of risk-shifting, and the price discipline of unguaranteed debt constrains the private benefits extracted by self-interested managers (Jensen and Meckling, 1976). Because banks with outside creditors have greater incentives to reduce agency costs by providing transparent financial information, we expect a negative relation between the existence of outside uninsured creditors and banks' likelihood of submitting negative comment letters.

Our third contemporaneous non-accounting-based proxy for agency problems is whether banks elect to engage an independent auditor to attest that its general purpose financial

¹⁴ The Transaction Account Guarantee Program (TAGP) and the Debt Guarantee Program (DGP) were enacted on October 13, 2008 as part of the FDIC's Temporary Liquidity Guarantee Program in response to the 2008 global financial crisis. The TAGP provides full guarantee, above the existing deposit insurance limit, by the FDIC for funds held at FDIC-insured depository institutions in noninterest-bearing transaction accounts. TAGP coverage became effective on October 14, 2008 and, after three extensions, continued through December 31, 2010. Presently, the Deposit Insurance Provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act provides similar transaction account insurance and is scheduled to lapse on December 31, 2012. The DGP guarantees all newly-issued senior unsecured debt issued by participating entities between October 14, 2008 and June 30, 2009, with the guarantees ending on or before June 30, 2012. On March 17, 2009, the FDIC Board of Directors voted to extend the deadline for issuance of guaranteed debt from June 30, 2009, to October 31, 2009, and to extend the expiration date of the guarantee to the earlier of maturity of the debt or December 31, 2012 (i.e., extended from June 30, 2012).

statements are prepared in accordance with GAAP. Firms distributing audited GAAP financial statements make a commitment to more transparent disclosure, and by engaging an auditor, have constrained their own discretion. Part 363 of the FDIC's regulations requires banks with more than \$500 million of assets at the beginning of a fiscal year to obtain a financial statement and internal control audit by an independent auditor; thus, for banks with less than \$500 million in assets, independent financial statement audits are optional. Given the large number of small, private banks responding to the ED, we anticipate significant variation in banks' choices to obtain (or forego) full financial statement audits. Because outside auditors provide an important monitoring function, we expect a negative relation between banks' choices to obtain full financial statement audits and banks' likelihood of submitting negative comment letters.

3.2 *Historical Accounting-Based Proxies for Agency Problems*

Our accounting-based proxies for agency problems capture the relative extent to which banks historically used the accounting slack available under the current incurred-loss model of accounting for loan impairments. By construction, these are more backward looking measures of agency problems when compared to the previously discussed non-accounting-based proxies. Thus, they provide an *ex post* information-based complement to our contemporaneous measures.

We examine four separate measures of accounting discretion that are consistent with banks' use of slack in the provision for loan losses: (1) a measure of loan-loss timeliness based on Beatty and Liao (2011), (2) a measure of loan-loss conservatism consistent with Watts (2003), (3) a signed measure of loan-loss discretion computed as the residual from the cross sectional regression of the provision on current and future levels of nonperforming assets, and (4) a measure of smoothed income realizations. Given its extensive use in the accounting literature, we consider the loan-loss timeliness measure to be our primary proxy for the historical use of loan-related accounting slack. We expect a positive relation between banks' historical use of the

slack available in the current (nontransparent) accounting for loan losses and banks' likelihood of submitting negative comment letters. Because construction of these proxies relies heavily on financial data, we describe the exact specifications of each of these measures in the next section.

4. Sample and research design

4.1 Sample selection

Our primary sample consists of all commercial banks with necessary financial data in the periods covered by our tests. To calculate time series measures of timeliness we collect quarterly data spanning 2001Q1 through 2011Q4. Our sample includes private and publicly held banks. We collect financial statement data from publicly available regulatory filings. Our sample includes 5,289 unique banks.

From the FASB's web site (www.fasb.org), we individually collect all 2,971 comment letters submitted in response to the ED. We classify all letters as either supporting the ED or not supporting the ED. We also identify letters that explicitly mention fair value accounting for loans. For each of the comment letters, we first collect any identifying information provided by the letter writer, including name, state, and company affiliation. For letters not providing any company affiliation, we collect implicit company affiliation by cross-referencing the letter-writer name, email address domain, street address, and phone number to company profiles. If the letter writer is a documented affiliate of a company (e.g. officer, director, or employee) and takes an industry-related position on the issues, we attribute company affiliation to the letter writer for statistical purposes. In order to avoid double-counting of entities, we do not include bank holding companies in our sample together with their consolidated subsidiaries. Consistent with this convention, letters written by personnel of single-bank holding companies are attributed to the subsidiary bank.

To provide summary statistics, we first classify comment letters by affiliation and position with respect to fair value. In deriving affiliation, we attribute letters to preparers, users, or others based on identifying information included with the correspondence. We use the following classification hierarchy to resolve contradictory identifying information: (1) letterhead, (2) identifiable officer or director of firm, (3) identifiable phone number or mailing address of firm, (4) email domain of a firm, and (5) self-reference provided in the text of the correspondence.

Figure 1 provides an example of a letter with contradictory identifying information. Although the writer self-identifies as a “bank investor” in the text and as an “investor” in the signature line, we classify the letter as company-originated because the writer is the known Chief Executive Officer of a publicly-traded bank. Correspondingly, we classify the industry as “Financial Firm.”

4.2 *Contemporaneous Non-Accounting-Based Proxies for Agency Problems and the Likelihood of Banks Submitting a Negative Comment Letters*

To test the hypothesis that banks with greater agency problems are more likely to lobby the FASB against the ED’s fair value proposal for loans, we estimate the following model based on contemporaneous non-accounting-based proxies for agency problems:

$$\Pr(\text{Letter})_t = \alpha + \beta_1 \text{CAPITAL}_t + \beta_2 \text{ENFORCEMENT}_t + \beta_3 \text{SMALL}_t + \beta_4 \text{SIZE}_t + \beta_5 \text{DEP_INS}_t + \beta_6 \text{CREDITOR}_t + \beta_7 \text{AUDITED}_t + \varepsilon_t \quad (1)$$

where

| | |
|--------------------|---|
| <i>CAPITAL</i> | Tier 1 regulatory capital as of December 31, 2009 divided by average assets over the year ended December 31, 2009 |
| <i>ENFORCEMENT</i> | Indicator variable equal to 1 if the bank was under an active enforcement order in the 5 years preceding the beginning of the comment period, and 0 otherwise |
| <i>SMALL</i> | Indicator variable set to 1 if AVG_ASSETS (i.e., average daily balance of total assets for the year ended December 31, 2009 reported on the bank’s |

| | |
|-----------------|--|
| | call report) is less than or equal to \$10 billion, and 0 otherwise |
| <i>SIZE</i> | Natural log of average assets computed over the year ended December 31, 2009 |
| <i>DEP_INS</i> | An indicator variable equal to 1 if the company elected to purchase additional insurance through the FDIC's TAGP or DGP during 2008 and 2009. |
| <i>CREDITOR</i> | Indicator variable equal to 1 if the firm has outstanding uninsured long-term debt, and 0 otherwise |
| <i>AUDITED</i> | Indicator variable equal to 1 if the firm engages an independent auditor to conduct an audit of financial statements prepared in conformity with GAAP, and 0 otherwise |

All continuous variables are winsorized at the top and bottom 1%. We estimate three proxies for agency problems in banks. *DEP_INS*, is based on banks' decisions to participate in TAGP or DGP during 2008 and 2009. Qualifying entities under the TAGP and DGP include all FDIC-insured depository institutions, all U.S. bank holding companies, and most U.S. savings and loan holding companies. Eligible banks could make an irrevocable decision to opt out of either the TAGP or DGP, or both. A decision by one member of a banking group to opt-out was irrevocable and binding on all other group members. The cost of the TAGP program entails a 10 basis point annual rate surcharge applied to noninterest-bearing transaction deposit amounts more than \$250,000. The assessment rate on DGP is between 50 and 100 basis points of guaranteed debt. We obtain banks' participation information from SNL, Inc.

We set *CREDITOR* equal to 1 if the bank has long-term uninsured debt and 0 otherwise. Because banks with outside creditors have greater incentives to reduce agency costs by providing transparent financial information, we expect a negative coefficient on *CREDITOR*. For similar reasons, we include an indicator variable for *AUDITED*, which is equal to 1 if the firm elects to engage an independent auditor to attest that its general purpose financial statements are prepared in accordance with GAAP. Firms distributing audited GAAP financial statements have made a

commitment to more transparent disclosure, and by engaging an auditor have constrained their own discretion. We expect a negative coefficient on AUDITED.

We include several control variables shown by prior research to be associated with firms' propensity to lobby. Dhaliwal (1982) proposes that capital structure will influence the choice to lobby. Specifically, if a proposed accounting standard is expected to decrease capital levels or increase capital volatility, then capital levels should be negatively related to the choice to lobby against the standard. This is particularly true in the banking industry because regulators impose minimum capital standards. For these reasons we expect a negative sign on CAPITAL.

An implicit assumption underlying banks' fervent resistance to proposed fair value standards is that RAP-GAAP conformity has caused accounting slack to become an important source of regulatory slack that equates to forbearance for troubled banks with opaque financial conditions. If this is true, then those banks not eligible for forbearance should be less likely to lobby for accounting slack. Specifically, banks identified by regulators as troubled are given very little slack and are subjected to enhanced monitoring, additional reporting, and the imposition of higher minimum capital levels. For these banks, regulatory constraints are already binding to the point where accounting slack is likely to be much less valuable. We provide an example of a regulatory enforcement order in Figure 2. To incorporate the effects of active enforcement, we include an indicator variable, ENFORCEMENT, which is equal to 1 if the firm the firm has been subject to regulatory order in the five years preceding the beginning of the comment period, and zero otherwise. We predict a negative sign on ENFORCEMENT.

Two factors lead us to believe that an unusually high proportion of small banks will respond to the ED. First, RAP-GAAP conformity causes even the smallest banks to be subject to the ED's mandated fair value measurement of loans in their regulatory filings, and loans are—by far—the single largest class of assets on commercial banks' balance sheets. Second, the

American Bankers Association (ABA) and state banking associations mounted an intense lobbying campaign targeted specifically at smaller regional and community banks (Ciesielski, 2010b, p. 1). As part of this campaign, these associations made available resources that facilitated comment letter submission by less-sophisticated banks. To control for this, we includes SMALL, which is equal to 1 if AVG_ASSETS (i.e., average daily balance of total assets for the year ended December 31, 2009 reported on the bank’s call report) is less than or equal to \$10 billion, and 0 otherwise. We predict a positive sign on SMALL. By separately controlling for small banks, we are able to also control for bank size within the small versus large partition of banks. To accomplish this we also include SIZE, which is the natural log of average assets computed over the year ended December 31, 2009. After controlling for SMALL in the regression equation, we expect larger banks within each of the small and large partitions to submit comment letters. Therefore, we predict a positive sign on SIZE.¹⁵

Although we expect the control variables in equation (1) to capture non-agency-related factors that are associated with the likelihood that banks submit negative comment letters, bank representatives could have submitted comment letters based on beliefs they hold about the potential effects of the proposed standard. For example, banks might have incentive to oppose fair value measurement for loans if loan quality is poor, if loan fair values are difficult to measure, or if banks business practices dictate that loans are always held to maturity.¹⁶

Therefore, we also estimate equation (2) to control for these supplemental bank-specific factors.

$$\Pr(\text{Letter})_t = \alpha + \beta_1 \text{CAPITAL}_t + \beta_2 \text{ENFORCEMENT}_t + \beta_3 \text{SMALL}_t + \beta_4 \text{SIZE}_t +$$

¹⁵ Size has been used in prior research as a proxy for political costs (Watts and Zimmerman, 1978) because theory suggests that large firms are more likely to lobby for income-decreasing accounting standards that reduce political visibility. On the other hand, scale economies are likely important both for the probability of engaging in lobbying activity and for the potential gains from influence (Hill, Kelly, Lockhart and Van Ness, 2011). Given the relative large number of small commercial banks that submitted comment letters, these theoretical relations do not appear to apply in the present setting. The results of our analyses are qualitatively similar (i.e., coefficient direction, magnitude and significance levels for agency-related independent variables) if we omit SMALL, SIZE or both variables from our specification.

¹⁶ These last two factors were specifically mentioned in a significant number of comment letters submitted by banks.

$$\beta_5 DEP_INS_t + \beta_6 CREDITOR_t + \beta_7 AUDITED_t + \beta_8 NPA_PCT_t + \beta_9 COMM_RBC_t + \beta_{10} SOLD_t + \varepsilon_t \quad (2)$$

where CAPITAL, ENFORCEMENT, SMALL, SIZE, DEP_INS, CREDITOR and AUDITED have the same definitions as in equation (1), and where

| | |
|-----------------|--|
| <i>NPA_PCT</i> | Average nonperforming assets divided by the average balance in loans computed over the year ended December 31, 2009 |
| <i>COMM_RBC</i> | Total commercial and industrial loans (including real estate) divided by risk-based capital at December 31, 2009 |
| <i>SOLD</i> | Indicator variable equal to 1 if the firm sold any of its loans during the two years ending December 31, 2009, and 0 otherwise |

For banks that hold relatively higher concentrations of loans with lower credit quality, a move from current GAAP to the ED's fair value measurement for loans will likely lead to significant recorded losses for the troubled loans. Thus, banks might be more likely to resist the proposed move to fair value measurement and reporting if they believe that fair value measurement would more immediately recognize embedded losses on low quality loans. To control for the potential effects of banks' loan quality on the likelihood that they submit negative comment letters, we include NPA_PCT, which is the average balance of nonperforming assets divided by the average balance in loans computed over the year ended December 31, 2009.

The remaining two control variables in Equation (2) are based on reasons provided in banks' comment letters. First, bank representatives expressed concern over measurement of hard-to-value loans. Specifically, they noted that a move from current GAAP to the ED's fair value measurement for loans could cause banks with higher concentrations of harder-to-value assets to incur significant direct and indirect costs in the preparation of periodic financial statements and regulatory reports. For example, bank representatives suggested that commercial and industrial loans are more difficult to value than residential real-estate loans. To control for variation in the relative difficulty of valuing loans across banks, we include COMM_RBC,

which is equal to total commercial and industrial loans (including real estate) divided by risk-based capital at December 31, 2009.

A second and even more ubiquitous justification included in bank representatives' negative comment letters is that the respondents' banks do not use fair values for internal decision-making because, they asserted, fair values are irrelevant to managers and investors. To control for this stated belief, we identify at least one context in which fair values are clearly relevant to loans: the decision to sell certain loans in the portfolio. We argue that banks making informed judgments to sell subsets of loans (i.e., for purposes that include liquidity and the management of credit risk and interest rate risk) must understand values, liquidity risks, and market risks inherent loan assets.¹⁷ In contrast, representatives from banks not engaging in loan sales might be motivated to submit negative comment letters because *they believe* fair value measurement is inappropriate for their business models. To control for banks' historical propensity to sell loans, we include SOLD, which is an indicator variable equal to 1 if the firm sold any of its loans during the two years ending December 31, 2009, and 0 otherwise.

4.3 *Historical Accounting-Based Proxies for Agency Problems and the Likelihood of Banks Submitting a Negative Comment Letters*

To test the hypothesis that banks with greater agency problems are more likely to lobby the FASB against the ED's fair value proposal for loans, we also estimate the following model based on historical accounting-based proxies for agency problems related to loan-loss accounting:

$$\Pr(\text{Letter})_t = \alpha + \beta_1 \text{CAPITAL}_t + \beta_2 \text{ENFORCEMENT}_t + \beta_3 \text{SMALL}_t + \beta_4 \text{SIZE}_t + \beta_j \text{LLSLACK}_t + \varepsilon \quad (3)$$

where CAPITAL, ENFORCEMENT, SMALL, SIZE, DEP_INS, CREDITOR and AUDITED have the same definitions as in equation (1), and where

¹⁷ Even if banks only sell subsets of loan assets, all loan assets are eligible for sale. For example, active markets exist for loan participations, even when loans are large or contain unique terms.

LLSLACK The extent to which bank historically utilized slack available in current GAAP for loan losses

All continuous variables are winsorized at the top and bottom 1%. We expect CAPITAL, ENFORCEMENT, SMALL and SIZE to have similar effects as in our tests of contemporaneous non-accounting-based proxies for agency problems. LLSLACK represents banks' historical use of slack available in current GAAP for loan losses, and represents an accounting-based manifestation of agency problems in banks. We construct four different proxies for LLSLACK. Our primary measure, TIMELINESS, is consistent with the measure of loan-loss recognition timeliness in Beatty and Liao (2011) and is measured as the increase in explanatory power of future non-performing assets over past non-performing assets. Greater timeliness is not equivalent to conservatism because timeliness is symmetric and captures the extent to which the current provision captures both positive and negative future changes in non-performing assets. For example, a provision would be timely if future expected decreases in nonperforming loans were recognized as a reduction in the current provision; however, the timely recognition of expected future decreases in nonperforming assets would probably not be considered conservative. We detail the estimation procedures for TIMELINESS in the Appendix. Because we require at least 5 degrees of freedom in the firm-specific estimation, TIMELINESS, cannot be computed for all firms in the sample in 2009.

Our second proxy for LLSLACK is LLCONSERV, which is based on the relative size of the allowance for loan losses controlling for non-performing assets. This is consistent with Watts' (2003) notion of conservatism, which he describes as an intentional downward bias in reporting the value of net assets. We compute LLCONSERV as the residual from a regression of ALLOWANCE/LOANS on non-performing assets (NPA) as of December 31, 2009. Higher (lower) values of LLCONSERV indicate that banks are using accounting slack to report

relatively higher (lower) loan-loss allowances, which means they are reporting relatively lower (higher) net asset balances for loans after controlling for the amount of problem assets.

For our third proxy for LLSLACK, we calculate LLACCRUAL as the (signed) firm-specific residuals from a cross-sectional estimation of equation (A-2) (specified in the Appendix) over the period 2010Q1 through 2011Q3. We structure this firm-specific time series measure to reflect short-term earnings management, which is distinct from our measure of TIMELINESS. LLACCRUAL is estimated in cross-section, and captures the residual short-term discretion in the provision after controlling for the variables that influence TIMELINESS. Firms with more negative (positive) realizations of LLACCRUAL relatively underprovided (overprovided) for expected future losses.

Our last proxy, STD_ROA, is consistent with Bushman and Williams' (2012) finding that banks' use of loan loss discretion to report smooth earnings reduces transparency and hinders the ability of outsiders to monitor. We calculate STD_ROA as the standard deviation of quarterly net income divided by average assets for the quarter, computed over the period 2001-2011.

We view the four proxies for LLSLACK as representing complementary dimensions of banks' use of slack in loan loss accounting. Therefore, we also analyze the simultaneous effects of all of our LLSLACK proxies. In addition, the four historical proxies for LLSLACK should be incrementally predictive even when considering the contemporaneous non-accounting-based proxies for banks' agency problems. Therefore, we also estimate equation (4), which includes all variables included in equation (2) along with all four of our LLSLACK proxies.

$$\begin{aligned} \text{Pr}(\text{Letter})_{i,t} = & \alpha + \beta_1 \text{CAPITAL}_t + \beta_2 \text{ENFORCEMENT}_t + \\ & \beta_3 \text{SMALL}_t + \beta_4 \text{SIZE}_t + \beta_j \text{LLSLACK}_t + \beta_9 \text{DEP}_{INS}_t + \beta_{10} \text{CREDITOR}_t + \\ & \beta_{11} \text{AUDITED}_t + \beta_{12} \text{NPA_PCT}_t + \beta_{13} \text{COMM_RBC}_t + \beta_{14} \text{SOLD}_t + \varepsilon \end{aligned} \quad (4)$$

5. Results

Panel A of Table 1 presents descriptive statistics for the 2,971 comment letters obtained from the FASB. Consistent with prior literature, we find that preparers are much more likely to lobby standard setters than users, with preparers accounting for 91.7% of all letters compared to 5.3% of letters attributable to individual investors and investment advisors (Sutton, 1984; Weetman, Davie and Collins, 1996; Tutticci, Dunstan and Holmes, 1994; Ryan, Dunstan and Stanley, 2000).¹⁸ Financial statement users (e.g., current and prospective investors) may be reluctant to invest in accounting-standards-related lobbying because the cost of disclosure is borne by the disclosing parties (i.e., it is only indirectly shared by current investors), and the resulting benefits of enhanced disclosure becomes a public good (Olson, 1965; Sutton, 1984).

Financial firms, which include banks, credit unions, specialty finance, and insurance companies, prepared the vast majority of comment letters, accounting for 2,525 (i.e., 85 percent) out of 2,971 separate pieces of correspondence. The content of the correspondence addresses a variety of concerns, including fair value measurement, hedging, convergence with IFRS, and the equity method of accounting. However, the vast majority of responses was submitted by commercial banks and only addresses the expansion of fair value accounting for loans. For purposes of analysis, we focus on comments addressing fair value measurement and code the comments as “Positive,” “Negative,” or “Mixed.”¹⁹

Panel A of Figure 1 provides an example of a comment letter which we coded “Negative” with respect to fair value. Panel B provides an example of a “Positive” response. Responses that were neither clearly “Positive” nor “Negative” were coded “Mixed.” Our coding reveals that financial firms are almost uniformly negative about fair value (99.8%), while non-financial firms

¹⁸ Our tabulation may understate the number of users, because some user groups, including Financial Executives International surveyed their members and conveyed the tabulated results in a single letter. Extrapolation of survey results to letter counts would have resulted greater user participation and a much higher ratio of favorable responses to the ED.

¹⁹ Responses were coded twice by independent research assistants. There were no cases of disagreement.

are also negative, but significantly less so (77.3%, X^2 $p = 0.000$). Not unexpectedly, those classified as users are significantly less negative about fair value than preparers (X^2 $p = 0.000$). Because no commercial banks took a favorable position with respect to fair value, we treat the entire commercial bank sample as “Negative” for the remaining analyses.

Panel B of Table 1 provides a reconciliation of the number of letters to the final unique firm sample used for the remaining statistical analyses. Non-financial firms accounted for 446 letters. Many financial firms were represented multiple times, leading to deletion of 828 pieces of correspondence to arrive at our unique firm sample. The maximum number of letters sent by individuals associated with a single firm was 46 (untabulated). Credit unions, savings banks, specialty finance, and commercial banks missing necessary quarterly data items account for another 650 pieces of correspondence. The final sample comprises 1,047 unique commercial banks.

Table 2 provides distributional and descriptive statistics for regression variables. Except as otherwise noted, regression variables are measured as of December 31, 2009. Statistical comparisons reported in Panel A of Table 2 suggest that lobbying banks differ from non-lobbying banks on several dimensions.²⁰ The average value of CAPITAL of non-lobbying banks is significantly higher than that of lobbying banks (10.16% compared to 9.78%; $p < 0.01$). A smaller percentage of banks with open ENFORCEMENT actions in the 5 years preceding the comment period choose to lobby (32.5% compared to 37.6%; $p < 0.01$), consistent with these banks (1) reaping lower benefits from accounting slack and (2) having decreased desire for visibility given the extreme level of regulatory scrutiny accompanying ENFORCEMENT. Because banks under enforcement orders are also financially weak, the negative coefficient on

²⁰ Panel A of Table 2 reports two-sample pooled t-test significance levels with Satterthwaite approximations of degrees of freedom in cases of unequal sample variance. For variables measured on a ratio scale, we report Savage two-sample nonparametric significance levels. Indicator variables are only tested using nonparametric X^2 test statistics.

ENFORCEMENT suggests that lobbying behavior is complex, and is not explainable by levels of income or capital alone. Accounting slack is likely to be most beneficial for those banks with low capital, excepting those under ENFORCEMENT, where increased scrutiny may limit the ability to use accounting slack.

The size distribution AVG_ASSETS is highly skewed for both groups, as suggested by the fact that medians are much smaller than the means. The mean value of AVG_ASSETS for non-lobbying firms is larger than lobbying firms (average assets of \$1.479 billion compared to \$0.344 billion); however, the median values do not statistically differ. Given the skewed distribution, we use the natural log of average assets in our regressions to capture SIZE. We find that the mean value for SIZE is significantly larger for lobbying firms (12.046) than that of non-lobbying firms (11.936) ($p < 0.05$), but the medians are, again, not statistically different. Interestingly, we include the variable SMALL because, compared to companies' responses to other FASB proposals, an unusually large number of small, private banks submitted comment letters. However, the proportion of small banks submitting comment letters appears to represent the overall proportion of small banks in the entire sample because the difference in SMALL between lobbying (93.9%) and non-lobbying banks (92.9%) is not statistically different.

Turning to our non-accounting-based measures of agency problems, banks receiving additional deposit insurance are more likely to lobby against fair value (85.4% compared to 81.2%; $p < 0.01$). In addition, banks choosing to provide audited financial statements prepared in accordance with GAAP appear to be less likely to submit comment letters, with 45.2% of lobbying banks purchasing financial statement audits, compared to 48.2% of non-lobbying banks ($p < .10$). In contrast, the simple univariate comparisons of the CREDITOR reveal that lobbying and non-lobbying banks are not statistically different. Taken together, our three non-accounting-

based measures of agency problems suggest that banks lobbying against the ED have agency-related incentives for lower-transparency financial reporting.

Related to our accounting-based proxies for agency problems, we find that the average R^2 corresponding to the firm-specific estimation of Equation (A-2) is significantly lower for lobbying firms (0.298) than for non-lobbying firms (0.322), suggesting that lobbying banks' provisions are more likely to deviate from amounts predicted by past and forward-looking explanatory variables ($p < 0.01$). TIMELINESS, measured as the change in R^2 between Equations A-2 and A-1, is larger for non-lobbying firms (0.113 compared to 0.103; $p < 0.01$), consistent with non-lobbying firms' provisions incorporating more timely forward-looking information in the years preceding the comment period. We find that, in absolute terms, lobbying firms have significantly lower allowances for loan losses as a percentage of loans (0.016 compared to 0.018, $p < 0.01$). LLCONSERV, measured as the residual from a regression of the allowance for loan losses on non-performing assets, is significantly lower for lobbying firms (-0.127 compared to 0.031, $p < 0.01$) suggesting that non-lobbying (lobbying) firms are more likely to use accounting slack to report lower (higher) net asset values. The average signed discretionary loan loss accrual (LLACCRUAL) in the quarter ending March 31, 2010 is significantly more negative for lobbying firms than for non-lobbying firms (-0.045 compared to 0.010, $p < 0.01$). This suggests that income-decreasing earnings management immediately preceding the comment period was associated with an increased propensity to lobby. The standard deviation of return on assets (STD_ROA) is smaller among firms that lobby (0.287 compared to 0.331; $p < 0.01$), suggesting that firms accustomed to smoothing earnings are more likely to oppose fair value accounting for loans. Taken together, it appears that the FASB's proposal for loan losses would likely mitigate an important source of accounting discretion that facilitates smoothing in banks lobbying against the ED.

Finally, Panel A of Table 2 reveals an interesting pattern in our proxies for possible non-agency-based incentives to oppose the FASB's fair value proposal. First, counter to the argument that banks with higher levels of nonperforming assets will be more concerned with a move to fair value measurement, the relative proportion of nonperforming assets is higher in non-lobbying banks than in banks opposing the ED (0.024 compared to 0.021, $p < 0.01$). Next, there appears to be no statistical difference in the relative proportions of hard to value commercial and industrial loans. Finally, banks opposing the ED actually had higher relative amounts of loans sold in the period leading to the issuance of the FASB's ED (0.105 versus 0.085, $p < 0.10$). Thus, two-thirds of these potential non-agency-related proxies display an opposite pattern from the claims made in banks' comment letters, with the remaining proxy showing no reliable difference between letter-writers and non-letter-writers.

Panel B of Table 2 indicates that the four measures of accounting slack are positively correlated, although not perfectly. For example, the correlation between STD_ROA and LLACCRUAL is 0.24, and the correlation between STD_ROA and TIMELINESS is 0.08. Panel B of Table 2 also reveals significant correlations among other explanatory variables. For example, banks under ENFORCEMENT within the previous five years appear to have higher provision quality, consistent with increased regulatory scrutiny having a dampening effect on the use of accounting slack. Specifically, banks under ENFORCEMENT are more likely to have conservative allowances for loan losses (correlation coefficient 0.14 with LLCONSERV), more TIMELY with provisions (correlation coefficient 0.10), and less likely to smooth earnings (correlation coefficient 0.25 with STD_ROA).

Table 3 presents statistics from our estimations of Equations (1) and (2), with DEP_INS, CREDITOR and AUDITED serving as non-accounting-based proxies for banks' contemporaneous agency problems. Overall, the model explanatory power is significant for

Equations (1) (log-likelihood of 53.72, $p < 0.001$) and (2) (log-likelihood of 69.63, $p < 0.001$), and the significance levels are consistent with results of other studies seeking to explain firms' lobbying choices (e.g. Dechow et al. 1996).

In Equation (1), we focus on determinants of lobbying that are indicative of contemporaneous agency problems in banks. Consistent with predictions of agency theory, we find that DEP_INS is positively and significantly associated with firms' propensity to lobby ($\beta_5 = 0.122$, $X^2 = 4.88$, $p < 0.05$), while the coefficients on CREDITOR ($\beta_6 = -0.247$, $X^2 = 3.44$, $p < 0.05$) and AUDITED ($\beta_7 = -0.105$, $X^2 = 6.30$, $p < 0.05$) are both negatively and significantly associated with firms' propensity to lobby. In addition, we find that ENFORCEMENT and CAPITAL are significantly negatively associated with lobbying ($\beta_2 = -0.166$, $X^2 = 14.97$, $p < 0.01$ and $\beta_1 = -0.012$, $X^2 = 4.60$, $p < 0.05$ respectively). Untabulated analyses of marginal effects indicate the DEP_INS (ENFORCEMENT) increase (decrease) the probability of lobbying by 9.3% (11.7%).²¹

The results for DEP_INS, CREDITOR and AUDITED suggest that demand for accounting slack is associated with agency problems in banks, after controlling for CAPITAL, ENFORCEMENT, and other factors. The results for these variables are also consistent with the significance of regulatory factors in banks' decisions to lobby against fair value accounting for loans. Low CAPITAL levels immediately preceding the comment period influenced firms to lobby for accounting slack that would be beneficial in maintaining compliance with minimum regulatory capital standards, while the presence of ENFORCEMENT dampened banks' propensity to lobby, consistent with bankers perceiving lower benefits of accounting slack when regulatory scrutiny is high. The significantly positive coefficient on SMALL ($\beta_3 = 0.299$, $X^2 = 8.14$, $p < 0.01$) confirms our observation that a disproportionately large number of small banks

²¹ Marginal significance is computed by setting all continuous variables to median values and all dichotomous variables to 0.

responded to the FASB's ED, while the positive and significant coefficient on SIZE ($\beta_4 = 0.100$, $X^2 = 20.25$, $p < 0.01$) is consistent with notion that after controlling for SMALL (and other factors), the larger banks within the small/large partition have a greater propensity to lobby after controlling for other factors.²²

In Equation (2), we supplement our primary analysis of contemporaneous proxies for agency-problem by also introducing non-agency factors that plausibly could have caused banks' to write negative comment letters. Specifically, banks might have incentive to oppose fair value measurement for loans if loan quality is poor, if loan fair values are difficult to measure, or if banks business practices dictate that loans are always held to maturity. Interestingly, when we include these factors in our contemporaneous agency-problem analysis, our agency-related variables remain significant in the predicted direction while each of the additional non-agency controls yield results that are opposite of the signs predicted by the lay theories expressed in banks' comment letters. In particular, banks with higher levels of nonperforming assets and higher levels of hard-to-value commercial and business loans were less likely to submit negative comment letters ($\beta_8 = -1.593$, $X^2 = 5.87$, $p < 0.05$ and $\beta_9 = -0.020$, $X^2 = 2.72$, $p < 0.10$ respectively), while banks that sell loans were more likely to submit negative comment letters ($\beta_{10} = 0.211$, $X^2 = 5.76$, $p < 0.05$). Taken together, the results reported in Table 3 suggest that contemporaneous non-accounting-based proxies for agency problems are robust determinants of banks' choices to submit comment letters critical of the FASB's ED.

Table 4 presents statistics from our estimations of Equations (3) (i.e., columns (I) through (V)) and (4) (i.e., column (VI)), with TIMELINESS, LLCONSERV, LLACCRUAL, and

²² Consistent with Beatty, Ke, and Petroni (2002) we also consider whether a firm is publicly traded or private and find that publicly traded firms are less likely to lobby against the ED. Inferences are unchanged by inclusion of PUBLIC. However, AUDIT, becomes insignificant. AUDIT is correlated with PUBLIC because all public firms must be audited. When the sample is restricted to private firms, AUDIT is significantly negative, and all inferences remain unchanged.

STD_ROA serving as historical accounting-based proxies for banks' agency problems. Overall, the model explanatory power is significant for all specifications of Equations (1) (all log-likelihood ratios > 46.442 , $p < 0.001$) and (2) (log-likelihood of 91.59, $p < 0.001$) and consistent with prior research on the determinants of lobbying behavior.

Results reported in columns (I) through (IV) reveal that each of our four historical accounting-based proxies for banks' agency problems are associated with firms' propensities to lobby against fair value accounting for loans. In particular, TIMELINESS ($\beta_5 = -0.506$, $X^2 = 7.50$, $p < 0.01$), LLCONSERV ($\beta_6 = -0.058$, $X^2 = 8.11$, $p < 0.01$), LLACCRUAL ($\beta_7 = -0.093$, $X^2 = 7.24$, $p < 0.01$), and STD_ROA ($\beta_8 = -0.286$, $X^2 = 14.44$, $p < 0.01$) is each negatively associated with the decision to lobby, with each model-wide significance level at $p < 0.001$. An untabulated analysis of marginal significance shows that increasing each measure of LLSLACK by one on standard deviation results in an increased probability of lobbying that ranges from 6.8% (LLCONSERV) to 1.8% (LLACCRUAL).

Across all four models, the coefficients on control variables are significant in the predicted directions and are consistent with those resulting from estimation of Equations (1) and (2). In particular, higher CAPITAL and ENFORCEMENT are negatively associated with firms' propensity to lobby. SMALL is consistently positively related to banks' likelihood of lobbying propensity, while the positive and significant coefficient on SIZE suggests that the larger banks within the small/large partition have a greater propensity to lobby.

In column (V), we simultaneously include in the regression all four accounting-based proxies for agency problems to further explore the incremental contribution of each. We find that TIMELINESS ($\beta_5 = -0.452$, $X^2 = 5.94$, $p < 0.05$), LLCONSERV ($\beta_6 = -0.054$, $X^2 = 6.78$, $p < 0.01$) and STD_ROA ($\beta_8 = -0.283$, $X^2 = 8.70$, $p < 0.01$) each retain their significance, while LLACCRUAL becomes insignificant. This suggests that LLACCRUAL is subsumed by more

structural measures of accounting slack that are measured cumulatively or over a longer horizon. Our control variables retain their predicted signs and significance in this specification. Overall, our estimation of Equation (3) suggests that our four proxies for LLSLACK represent complementary dimensions of banks' use of slack in loan loss accounting, and establishes that firms' historical use of accounting slack plays a significant role in banks' choice to lobby against fair value measurement of loans.

In column (VI), we report the results of estimating regression equation (4), which simultaneously includes all four historical accounting-based proxies for agency problems, along with the contemporaneous non-accounting based proxies and the three potential non-agency-related determinants of banks lobbying. We find that TIMELINESS ($\beta_5 = -0.449$, $X^2 = 5.83$, $p < 0.05$), LLCONSERV ($\beta_6 = -0.060$, $X^2 = 7.79$, $p < 0.01$) and STD_ROA ($\beta_8 = -0.176$, $X^2 = 3.43$, $p < 0.10$) each retain their significance, while LLACCRUAL remains insignificant. Our three contemporaneous non-accounting-based proxies for agency problems also continue to predict banks' propensity to lobby against the ED, with DEP_INS ($\beta_9 = 0.150$, $X^2 = 7.20$, $p < 0.01$), CREDITOR ($\beta_{10} = -0.262$, $X^2 = 3.80$, $p < 0.05$) and AUDITED ($\beta_{11} = -0.084$, $X^2 = 3.92$, $p < 0.05$) all retaining their predicted directional significance in the presence of the historical accounting-based proxies for agency problems. Finally, our *ad hoc* proxies for the non-agency-related predictors of banks' resistance (i.e., based on the content of banks' comment letters) mostly lose their statistical significance in the fully augmented model. Of these additional proposed explanatory variables, only SOLD retains its significance ($\beta_{114} = 0.204$, $X^2 = 5.34$, $p < 0.05$) in a direction opposite of the claims made by bank representatives in their comment letters (i.e., banks were more likely to oppose the ED if they previously sold loans). Taken together, the results reported in Table 4 suggest that banks' historical use of accounting slack available under the incurred-loss model for loan losses is an important determinant of banks' lobbying against

the FASB's ED, even in the presence of contemporaneous non-accounting-based proxies for agency problems.

6. Summary and Conclusions

In 2010, the ABA and state banking associations engaged in an intensive campaign to convince member banks to lobby the FASB against the ED's proposal to measure and report loans at fair value (Ciesielski, 2010b, p. 1). Despite the fact that the Financial Accounting Foundation (FAF) states that "it would not be appropriate to establish a standard based solely on a canvass of the constituents" (FAF, 1977, p. 19), it appears that the FASB decided to scuttle fair value recognition for loans because of the "overwhelmingly negative reaction to its proposal from companies and investors" (Rapoport, 2011). In this study, we seek to understand why representatives from 1,047 unique public and private commercial banks submitted comment letters opposing the FASB's proposal, while the vast majority of commercial banks chose to remain silent.

Using a sample of 5,289 commercial banks, we provide evidence suggesting that banks' objections to the ED were motivated less by general conceptual concerns and more by bank-specific agency problems. In our investigation of contemporaneous non-accounting-based proxies for agency problems, we find that banks submitting comment letters opposing the loan-reporting provisions of the ED were (1) more likely to elect to participate in the new optional, supplemental, unlimited deposit insurance and debt guarantee programs offered by the FDIC, (2) less likely to have nonguaranteed outside creditors and (3) less likely to obtain financial statement audits of their non-regulatory, GAAP financial statements. These results are consistent with bank managers and shareholders affiliated with lobbying banks benefitting from the lower agency costs that accompany government guarantees of indebtedness and the lower levels of external monitoring that otherwise would be provided by unguaranteed debt holders and by

auditors. Given that the demand for transparent information is increasing in agency costs, banks obtaining more (unobservable) private benefits from these contemporaneous non-accounting-based sources of agency problems are more likely to resist a movement to more transparent accounting standards.

In our investigation of historical accounting-based proxies, we find that banks lobbying the FASB against fair value measurement and reporting for loans are also more likely use the accounting slack inherent in the incurred loss model for accounting for loan losses. The fact that the ED retains amortized cost reporting on the face of the financial statements, and also requires the credit-loss component of fair value changes to be estimated and charged against net income, suggests that financial statement users and regulators will have more information under the proposal. Our finding that banks historically using accounting slack are more likely to oppose the ED suggests that the FASB's fair value proposal is perceived to decrease available accounting slack related to loans.

Our results are also inconsistent with banks' arguments that their opposition to fair value measurement is driven primarily by concerns about costs, decreased transparency, measurement difficulty, or a mismatch with their existing business model. Similarly sized banks using accounting slack to delay the recognition of loan losses are unlikely to face systematically higher implementation costs than those not using such slack. Further, banks using accounting slack (1) to manage earnings, (2) to less-timely recognize anticipated non-performing assets, and (3) to present relatively higher net asset balances than banks with similar asset quality, are also unlikely to be concerned with potentially diminished transparency. We find no evidence that banks with more-difficult-to-value loans are more likely to lobby against fair value measurement, and our results suggest that banks that use loan fair values for internal decision-making are actually more likely to lobby against fair value measurement.

Conceptually, fair value recognition should increase transparency (Linsmeier, 2011). For example, Blankespoor, Linsmeier, Petroni and Shakespeare (2011) find that fair value measurement of financial instruments better describes banks' credit risk. For public banks disclosing fair values annually, Barth, Beaver and Landsman (1996) find that loan fair values are value-relevant. Further, Hodder, Hopkins and Wahlen (2006) suggest that income volatility measured under full fair value accounting is significantly more informative about banks' risks—and better reflects the risk priced in banks share prices and expected returns—than volatility measured under the current U.S. reporting system. Moreover, as compared to disclosure, financial statement recognition may increase the precision of fair value estimates, leading to higher financial statement quality (Libby, Nelson, and Hunton, 2006). One objection to fair values is that their use may increase measurement discretion. Given that the ED proposes retaining financial-statement recognition of currently required amortized-cost-based information, bank managers may perceive the system of fair value measurement included in the ED as discretion-reducing.

Our findings contribute to the continuing debates related to fair value measurement of financial instruments, the incurred-loss model for loan losses, RAP-GAAP conformity and the impact of regulators on the promulgation of general-purpose financial accountings standards. Our results should also be considered in the context of due process for setting accounting standards and for legislating financial regulation. Our analysis reveals (1) that a nontrivial number of individuals identified as investors were, in reality, bank-affiliated individuals who concealed their affiliation, (2) that the negative comment letters were concentrated among banks, and (3) that the banks submitting letters had higher levels of potential agency problems and systematically utilized the accounting slack available in current GAAP for loan losses. To the extent comment letter submissions continue to be part of regulatory and accounting-standard-

setting due process, regulators and standard setters may wish to consider ways to effectively identify all letter writers and to explicitly consider the incentives of all participants in the rule making process.

Activism on the part of the ABA and various state banking associations made negligible the cost of writing comment letters. Electronic letter templates were provided to members with drag-and-drop “talking points” that could be used to auto-generate letters for those members not wishing to read the ED or formulate their own responses. Given the increasing sophistication of automatic internet-based letter-writing applications, we believe the then-unprecedented number of letters received in response to the ED will become commonplace, creating increased need to accurately identify—and understand the incentives of—comment letter writers.²³

²³ For example, through its January 14, 2012 comment deadline, the FAF received 7,368 comment letters in response to its *Request for Comment: Plan to Establish the Private Company Standards Improvement Council* (2011). Of these letters, the FAF staff identified 7,069 as virtually identical. These identical letters were generated with the assistance of the automatic internet-based letter-writing application available at <https://apps.aicpa.org/pcf/>. The internet-based letter writing programs sponsored by the American Bankers Association and state banking associations (in response to the ED) were more difficult to detect because they allowed sentences to be included in letters in unique orders and allowed letter writers to insert supplemental information.

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FIGURE 1
Examples of Fair Value Related Letters

Panel A: Negative Fair Value Letter with Bank Affiliation Concealed

| | |
|--|---|
| | <small>1810-100 Comment Letter No. 62</small> |
| <h2 style="margin: 0;">C. Steven Sjogren</h2> | |
| June 17, 2010 | 2853 Soland Drive Rockford, IL 61114 |
| Mr. Russell Golden Technical Director Financial Accounting Standards Board 301 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116 | |
| File Reference: No. 1810-100 <i>Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities</i> | |
| Dear Mr. Golden: | |
| <p>Thank you for the opportunity to comment on the exposure draft <i>Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities</i> ("proposal"). As a bank investor, of utmost importance to me regarding the banks in which I own stock is their financial position, and transparent financial reporting is key in order for me to make investment decisions. With this in mind, I am writing to express my deep concerns and opposition to the portion of the proposal that requires all financial instruments to be marked to market. From a bank investor's perspective, this will cloud transparency rather than improve it, and put into question the most critical element of bank financial statements: bank capital.</p> | |
| <p>In your proposal, banks must record loans on the balance sheet at their market value. In all my meetings with bank management regarding financial results, market values of loans are never discussed. The reason for this is that investors are interested in how loans perform, not how the market views loan performance. Although I understand the rationale for providing banks with the ability to provide more robust loan loss reserves, I believe the focus on mark to market is not relevant for loans that are not being sold. Additionally, with individualized payment terms, collateralization, and guarantee structures, the vast majority of commercial bank loans have no reliable market in which they could be sold, further calling into question the reliability of using fair value as the basis for financial statements. Even if there were active markets, fair value is not the appropriate measurement for these loans since it does not represent the cash the bank will receive.</p> | |
| <p>I understand that a loan's intrinsic value may change because of current interest rates or because of problems the borrower may have. But if there is a problem in repayment, the banks' typical process is to work the problem out with the borrower rather than sell the loan. So, even if it were easy to find a market value, that market value is irrelevant, since the bank would not sell the loan. As a result of your proposal, bank capital will be affected by market swings that cannot reasonably be expected to ever be realized by the bank.</p> | |
| <p>Another serious concern I have is whether, because the proposal to mark loans to market does not reflect a bank's business model, requiring them to do so could result in a need for banks to change</p> | |

Panel A (continued)

1810-100
Comment Letter No. 62

their business models. As an investor, my desire to hold equity securities generally declines as volatility increases. Because I do not view this as "true" volatility, I will be in a quandary about the true reported financial position under the proposal. Some investors will likely put pressure on banks to reduce the volatility, and, in many cases, this may result in shifting toward an investment banking model rather than a traditional banking model, or result in limiting products to those that are sheltered from market volatility. This, to me, seems to be an illogical and unintended result, and a situation where the accounting should not be driving the business model.

Additionally, I am very concerned about the costs and resources that will need to be dedicated to produce and audit such data. We have learned from the recent financial crisis that markets are sometimes illiquid and sometimes irrational. Because banks do not use fair values in managing their cash flows, I anticipate that this could require banks to hire more staff and/or consultants to assist with estimating fair values and to pay significantly higher audit fees. In the end, investors will be paying consultants and auditors significant sums to make estimates that my fellow shareholders and I will do nothing with.

With this in mind, I recommend you to drop your proposal to mark loans to market, as, from my perspective as an investor, it does not improve financial reporting.

Thank you for considering my views. Please feel free to contact me if you would like to discuss my concerns.

Sincerely,



C. Steven Sjogren, Investor

Panel B: Positive Fair Value Letter

1810-100
Comment Letter No. 121

From: [A G](#)
To: [Director - FASB](#)
Subject: Mark-to-Market Acct.
Date: Thursday, July 08, 2010 2:15:00 PM

Dear FASB,

I am an investor, and I am writing to applaud your efforts to enforce mark-to-market acct on banks.

I am IN FAVOR of mark-to-market accounting.

While I realize that this may produce volatility in a bank's balance sheet, I believe it is far more useful to investors to have this kind of valuation that to have the banks subjectively put they own price on illiquid assets.

Thank you,
Alberto Gross

FIGURE 2
Example of Regulatory Enforcement

#2008-012

AGREEMENT BY AND BETWEEN
Millennium Bank, National Association
Reston, Virginia
and
The Comptroller of the Currency

Millennium Bank, National Association, Reston, Virginia ("Bank") and the Comptroller of the Currency of the United States of America ("Comptroller") wish to protect the interests of the depositors, other customers, and shareholders of the Bank, and, toward that end, wish the Bank to operate safely and soundly and in accordance with all applicable laws, rules and regulations.

The Comptroller, through his National Bank Examiner, has examined the Bank and his findings are contained in the Report of Examination ("ROE") for the examination commenced on July 23, 2007.

In consideration of the above premises, it is agreed, between the Bank, by and through its duly elected and acting Board of Directors ("Board"), and the Comptroller, through his authorized representative, that the Bank shall operate at all times in compliance with the articles of this Agreement.

Article I
JURISDICTION

(1) This Agreement shall be construed to be a "written agreement entered into with the agency" within the meaning of 12 U.S.C. § 1818(b)(1).

(2) This Agreement shall be construed to be a "written agreement between such depository institution and such agency" within the meaning of 12 U.S.C. § 1818(e)(1) and 12 U.S.C. § 1818(i)(2).

On January 24, 2008, Millennium Bank, National Association (The Bank) entered into a formal written agreement (regulatory enforcement order) with the Office of the Comptroller of the Currency (OCC) pursuant to prompt corrective action initiatives. Among other provisions, the regulatory enforcement order requires the bank to (1) Appoint an independent compliance committee comprised of board members to meet at least monthly, (2) maintain higher minimum capital levels to be considered "adequately capitalized," (3) develop and implement, subject to OCC approval, a three-year program to

increase capital that include detailed analyses of assets, liabilities, earnings, and off-balance sheet activities, (4) develop and implement a written strategic plan establishing objectives for the Bank's overall risk profile, earnings performance, growth, balance sheet mix, liability structure, product line development, and market segments, (5) develop comprehensive budgets, including projected balance sheets and year-end income statements, including sufficient detail to provide for a meaningful tracking mechanism, and (6) develop detailed contingency plans in the event of a negative variance in budgetary projections. The Bank is required to provide the OCC with copies of all plans and budgets and must notify the OCC within 60 days of intent to deviate from previously filed plans.

TABLE 1
Descriptive Statistics Comment Letters

Panel A: Comment Letters by Affiliation and Overall Letter Position

| Affiliation Subgroup | Number | Overall Percent | Positive | Negative | Mixed | Subgroup Percent Negative |
|------------------------------|--------|--------------------|----------|----------|-------|---------------------------------|
| Preparers: | | | | | | |
| Financial Firms | 2,525 | 85.0% | 0 | 2,521 | 4 | 99.8% |
| Bank Trade Assoc. | 50 | 1.7% | 0 | 50 | 0 | 100.0% |
| Other Firms | 150 | 5.0% | 7 | 116 | 27 | 77.3% |
| Total Preparers | 2,725 | 91.7% | 7 | 2,687 | 31 | 98.6% |
| Users: | | | | | | |
| Investors/Advisors | 131 | 4.4% | 12 | 114 | 5 | 87.0% |
| Other/Individuals | 27 | 0.9% | 3 | 18 | 6 | 66.7% |
| Total Users | 158 | 5.3% | 15 | 132 | 11 | 83.5% |
| Other: | | | | | | |
| Public Accountants | 35 | 1.2% | 0 | 33 | 2 | 94.3% |
| Regulators | 18 | 0.6% | 0 | 15 | 3 | 83.3% |
| Other | 35 | 1.2% | 3 | 24 | 8 | 68.6% |
| Total Other | 88 | 3.0% | 3 | 72 | 13 | 81.8% |
| Overall Total | 2,971 | 100.0% | 25 | 2,891 | 55 | |
| Overall Total Percent | | | 0.8% | 97.3% | 1.9% | |

Panel B: Reconciliation of Total Comment Letters to Sample of Commercial Banks Submitting Letters

| | Number |
|---|--------|
| Total Letters | 2,971 |
| Non-Financial Firms | 446 |
| Duplicate Letters from Individual Firms | 828 |
| Potential Financial Firm Sample | 1,697 |
| Missing Required Data Fields | 650 |
| Final Sample | 1,047 |

Table 1 reports descriptive statistics for all 2,971 comment letters received by the Financial Accounting Standards Board (FASB) in response to its Exposure Draft titled, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (FASB, 2010). Panel A categorizes the comment letters according to their source. Preparer-submitted letters are categorized according to whether they were submitted by a financial-firm representative, bank trade association or a preparer that falls outside of these two categories. User-submitted letters are categorized

according to whether they were submitted by investors or investment advisors, or individuals and others. The last major category, Other, is comprised of submissions from public accountants, regulators, and individuals and organizations that fall outside of these two categories. Panel A also categorizes the letters according to the overall fair-value-related position communicated in the letter: Positive, Negative, or Mixed. Responses that were neither clearly Positive nor clearly Negative were coded Mixed. Panel B provides a reconciliation of the total number of letters received by the FASB to the final unique firm sample used in our statistical analyses of commercial banks. Non-financial firms accounted for 446 letters. Banks represented multiple times led to the deletion of 828 pieces of correspondence. Financial firms missing data are comprised primarily of non-commercial bank financial firms, including credit unions, insurance companies and specialty financial firms, leading to the deletion of another 650 pieces of correspondence. The final sample comprises 1,047 unique commercial banks.

TABLE 2
Distributional and Descriptive Statistics for Lobbying and Non-Lobbying Banks

Panel A: Distributional Statistics

| | LOBBYING BANKS (n=1,047) | | | | NON-LOBBYING BANKS (n=4,242) | | | | <i>t</i> test | Nonpara- metric |
|-------------------------------|--------------------------|--------|--------|--------|------------------------------|--------|--------|--------|------------------|--------------------|
| | Mean | Q1 | Median | Q3 | Mean | Q1 | Median | Q3 | | |
| CAPITAL | 9.780 | 8.260 | 9.160 | 10.700 | 10.167 | 8.140 | 9.300 | 11.220 | *** | ### |
| ENFORCEMENT | 0.325 | | | | 0.376 | | | | + | ### |
| AVG_ASSETS | 0.344 | 0.080 | 0.163 | 0.333 | 1.477 | 0.064 | 0.131 | 0.283 | *** | |
| SMALL | 0.939 | | | | 0.929 | | | | + | |
| SIZE | 12.046 | 11.291 | 11.999 | 12.717 | 11.936 | 11.069 | 11.782 | 12.553 | ** | |
| DEP_INS | 0.854 | | | | 0.817 | | | | + | ### |
| CREDITOR | 0.023 | | | | 0.031 | | | | + | |
| AUDITED | 0.452 | | | | 0.482 | | | | + | # |
| R ² Equation (A-2) | 0.298 | 0.150 | 0.258 | 0.413 | 0.322 | 0.160 | 0.279 | 0.451 | *** | ### |
| TIMELINESS | 0.103 | 0.030 | 0.069 | 0.138 | 0.113 | 0.033 | 0.078 | 0.156 | *** | ### |
| ALLOW/LOANS | 0.016 | 0.012 | 0.015 | 0.019 | 0.018 | 0.012 | 0.015 | 0.021 | *** | ## |
| LLCONSERV | -0.127 | -0.526 | -0.214 | 0.225 | 0.031 | -0.569 | -0.202 | 0.325 | *** | ### |
| LLACCRUAL | -0.045 | -0.285 | -0.196 | -0.003 | 0.010 | -0.290 | -0.187 | 0.033 | *** | ### |
| STD_ROA | 0.287 | 0.114 | 0.182 | 0.380 | 0.330 | 0.125 | 0.222 | 0.469 | *** | ### |
| NPA_PCT | 0.021 | 0.004 | 0.012 | 0.026 | 0.024 | 0.003 | 0.012 | 0.029 | *** | ## |
| COMM_RBC | 3.351 | 1.907 | 3.205 | 4.515 | 3.359 | 1.652 | 3.085 | 4.742 | | |
| SOLD | 0.105 | | | | 0.085 | | | | + | ## |

Panel B: Correlations (Pearson upper, Spearman lower)

| | <A> | | <C> | <D> | <E> | <F> | <G> | <H> | <I> | <J> | <K> | <L> | <M> | <N> | <O> | <P> | <Q> | <R> |
|-----------------------------------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|
| <A> LETTER | 1.00 | -0.04*** | -0.04*** | -0.02 | 0.02 | 0.03*** | 0.04*** | -0.02 | -0.02* | -0.05*** | -0.04*** | -0.06*** | -0.03*** | -0.03*** | -0.06*** | -0.03*** | 0.00 | 0.03** |
| CAPITAL | -0.02 | 1.00 | -0.16*** | -0.02 | 0.07*** | -0.21*** | -0.13*** | -0.07*** | 0.01 | -0.01 | -0.02 | 0.05*** | 0.16*** | 0.02 | 0.02* | -0.12*** | -0.40*** | -0.10*** |
| <C> ENFORCEMENT | -0.04### | -0.21### | 1.00 | 0.04*** | -0.14*** | 0.21*** | 0.08*** | 0.10*** | 0.08*** | 0.09*** | 0.05*** | 0.24*** | 0.09*** | 0.13*** | 0.21*** | 0.25*** | 0.29*** | 0.12*** |
| <D> AVG_ASSETS | 0.06### | -0.28### | 0.20### | 1.00 | -0.15*** | 0.23*** | 0.01 | 0.20*** | 0.04*** | 0.05*** | 0.00 | 0.07*** | 0.02 | 0.01 | 0.00 | 0.01 | -0.02 | 0.12*** |
| <E> SMALL | 0.02 | 0.12### | -0.14### | -0.44### | 1.00 | -0.64*** | -0.08*** | -0.33*** | -0.19*** | -0.10*** | 0.04*** | -0.13*** | -0.01 | -0.13*** | -0.15*** | -0.16*** | -0.13*** | -0.61*** |
| <F> SIZE | 0.06### | -0.28### | 0.20### | 1.00 | -0.44 | 1.00 | 0.21*** | 0.34*** | 0.31*** | 0.15*** | 0.00 | 0.15*** | 0.02 | 0.20*** | 0.17*** | 0.24*** | 0.38*** | 0.54*** |
| <G> DEP_INS | 0.04### | -0.14### | 0.08### | 0.22### | -0.08### | 0.22### | 1.00 | 0.05*** | 0.10*** | 0.10*** | 0.03** | 0.08*** | 0.00 | 0.05*** | 0.12*** | 0.10*** | 0.24*** | 0.09*** |
| <H> CREDITOR | -0.02 | -0.13### | 0.10### | 0.22### | -0.33### | 0.22### | 0.05### | 1.00 | 0.11*** | 0.07*** | 0.00 | 0.05*** | 0.00 | 0.05*** | 0.05*** | 0.03** | 0.09*** | 0.23*** |
| <I> AUDITED | -0.02# | -0.01 | 0.08### | 0.30### | -0.19### | 0.30### | 0.10### | 0.11### | 1.00 | 0.15*** | -0.01 | 0.10*** | 0.03** | 0.09*** | 0.19*** | 0.10*** | 0.20*** | 0.15*** |
| <J> R ² Equation (A-2) | -0.04### | -0.05### | 0.11### | 0.14### | -0.09### | 0.14### | 0.11### | 0.07### | 0.14### | 1.00 | 0.44*** | 0.16*** | 0.06*** | 0.09*** | 0.26*** | 0.08*** | 0.25*** | 0.08*** |
| <K> TIMELINESS | -0.04### | -0.06### | 0.10### | 0.04### | 0.03### | 0.04### | 0.05### | 0.00 | -0.01 | 0.44### | 1.00 | 0.05*** | 0.02* | 0.03** | 0.04*** | 0.01 | 0.07*** | -0.04*** |
| <L> ALLOW/LOANS | -0.04### | -0.05### | 0.24### | 0.16### | -0.13### | 0.16### | 0.10### | 0.05### | 0.09### | 0.19### | 0.10### | 1.00 | 0.42*** | 0.17*** | 0.35*** | 0.35*** | 0.23*** | 0.12*** |
| <M> LLCONSERV | -0.01 | 0.02 | 0.14### | 0.05### | -0.04### | 0.05### | 0.06### | 0.02# | 0.04### | 0.17### | 0.09### | 0.62### | 1.00 | 0.05*** | 0.06*** | -0.03** | 0.03* | 0.01 |
| <N> LLACCRUAL | -0.02 | 0.02 | 0.10### | 0.28### | -0.14### | 0.28### | 0.07### | 0.07### | 0.11### | 0.12### | 0.04### | 0.14### | 0.11### | 1.00 | 0.45*** | 0.41*** | 0.17*** | 0.11*** |
| <O> STD_ROA | -0.07### | -0.08### | 0.25### | 0.11### | -0.09### | 0.11### | 0.14### | 0.06### | 0.18### | 0.34### | 0.08### | 0.38### | 0.16### | 0.24### | 1.00 | 0.56*** | 0.35*** | 0.08*** |
| <P> NPA_PCT | -0.01 | -0.21### | 0.31### | 0.32### | -0.15### | 0.32### | 0.14### | 0.06### | 0.08### | 0.13### | 0.13### | 0.39### | 0.10### | 0.25### | 0.38### | 1.00 | 0.30*** | 0.15*** |
| <Q> COMM_RBC | 0.02 | -0.47### | 0.27### | 0.50### | -0.15### | 0.50### | 0.26### | 0.10### | 0.21### | 0.27### | 0.11### | 0.23### | 0.12### | 0.20### | 0.40### | 0.36### | 1.00 | 0.16*** |
| <R> SOLD | 0.03### | -0.14### | 0.12### | 0.43### | -0.61### | 0.43### | 0.09### | 0.23### | 0.15### | 0.08### | -0.02 | 0.15### | 0.06### | 0.14### | 0.06### | 0.17### | 0.19### | 1.00 |

Table 2 reports distributional statistics and correlation statistics for our final sample. The final sample includes 5,289 banks. Lobbying banks include 1,047 unique banks from which the Financial Accounting Standards Board received comment letters in response to their Exposure Draft (ED) titled, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (FASB, 2010). Non-Lobbying Banks included 4,242 banks from which the FASB did not receive comment letters in response to the ED, and for which we are able to obtain necessary financial data. Panel A reports distributional statistics. LETTER is an indicator variable equal to 1 if the bank submitted a comment letter in response to the ED (i.e., left half of Panel A), and 0 otherwise (i.e., right half of Panel A); CAPITAL is Tier 1 regulatory capital as of December 31, 2009 divided by average assets over the year ended December 31, 2009, ENFORCEMENT is an indicator variable equal to 1 if the bank was under an active enforcement order in the 5 years preceding the beginning of the comment period, and 0 otherwise; AVG_ASSETS is the average daily balance of total assets for the year ended December 31, 2009 reported on the bank's call report; SMALL is a an indicator variable set to 1 if AVG_ASSETS is less than or equal to \$10 billion, and 0 otherwise; SIZE is the natural log of

AVG_ASSETS ; DEP_INS is an indicator variable equal to 1 if the firm elected to participate in the Transaction Account Guarantee Program or the Debt Guarantee Program when these programs were offered by the Federal Deposit Insurance Corporation, and 0 otherwise; CREDITOR is an indicator variable equal to 1 if the firm has outstanding non-deposit long term debt on December 31, 2009, and 0 otherwise; AUDITED is an indicator variable equal to 1 if the firm engages an independent auditor and 0 otherwise. R^2 Equation (A-2) is the adjusted R^2 from the firm-specific estimation of Equation (A-2) over the period 2001 through 2011.

$$PROVISION_t = \alpha + \beta_1 \Delta NPA_{t-1} + \beta_2 IBP_t + \beta_3 CAPITAL_t + \beta_4 \Delta NPA_t + \beta_5 \Delta NPA_{t+1} + \beta_6 \Delta NPA_{t+2} + \varepsilon_t \quad (A-2)$$

where, PROVISION is the provision for loan losses in period t divided by average loans during the period, ΔNPA is the change in non-performing assets during the period divided by average loans, and IBP is income before loan loss provision divided by average assets.

Firms with error degrees of freedom less than 5 are eliminated from the sample. Results are robust to including these firms. TIMELINESS is the firm-specific difference in adjusted R^2 from estimating Equation (A-2) compared to that derived from estimating Equation (A-1).

$$PROVISION_t = \alpha + \beta_1 \Delta NPA_{t-1} + \beta_2 IBP_t + \beta_3 CAPITAL_t + \varepsilon_t \quad (A-1)$$

ALLOWANCE/LOANS is the ratio of the allowance for loan losses divided by loans at December 31, 2009; LLCONSERV is the residual from a regression of ALLOWANCE/LOANS on non-performing assets (NPA) as of December 31, 2009 times 100; LLACCRUAL is the signed residual from estimating equation (A-2) in cross-section over the first quarter preceding the comment period (March 31, 2010) times 100; STD_ROA is the standard deviation of quarterly net income divided by average assets for the quarter times 100, computed over the period 2001-2011; NPA_PCT is the average nonperforming assets divided by the average balance in loans computed over the year ended December 31, 2009; COMM_RBC is total commercial and industrial loans (including real estate) divided by risk-based capital at December 31, 2009; SOLD is an indicator variable equal to 1 if the firm sold any of its loans during the two years ending December 31, 2009, and 0 otherwise.

The t-test column reports two-sample pooled t-test significance levels with Satterthwaite approximations of degrees of freedom in cases of unequal sample variance. ***, **, and * denote parametric statistical significance at the 1%, 5%, and 10% (two-tail) levels, respectively. For variables measured on a ratio scale, we report Savage two-sample nonparametric significance levels. Indicator variables are denoted “+” in the t-test significance column, and are only tested using nonparametric X^2 test statistics (i.e., we do not report parametric significance levels for indicator variables). ###, ##, and # denote nonparametric statistical significance at the 1%, 5%, and 10% (two-tail) levels, respectively.

Panel B reports correlation statistics for all 5,289 sample banks, with Pearson correlation coefficients presented in the upper diagonal and Spearman correlation coefficients presented in the lower diagonal. ***, **, and * denote parametric statistical significance at the 1%, 5%, and 10% (two-tail) levels, respectively. ###, ##, and # denote nonparametric statistical significance at the 1%, 5%, and 10% (two-tail) levels, respectively.

TABLE 3
Logistic Regressions of Banks' Probability of Lobbying on Banks' Non-Accounting-Based Proxies for Agency Problems

| | Pred. Sign | Equation (1) | | | Equation (2) | | |
|--------------------------|---------------|--------------|----------|-----|--------------|----------|-----|
| | | Coeff | χ^2 | | Coeff | χ^2 | |
| Intercept | ? | -2.195 | 41.41 | *** | -2.281 | 43.88 | *** |
| CAPITAL _t | - | -0.012 | 4.60 | ** | -0.016 | 6.85 | *** |
| ENFORCEMENT _t | - | -0.166 | 14.97 | *** | -0.131 | 8.71 | *** |
| SMALL _t | + | 0.299 | 8.14 | *** | 0.425 | 13.37 | *** |
| SIZE _t | + | 0.100 | 20.25 | *** | 0.105 | 19.62 | *** |
| DEP_INS _t | + | 0.122 | 4.88 | ** | 0.139 | 6.17 | *** |
| CREDITOR _t | - | -0.247 | 3.44 | ** | -0.269 | 4.03 | ** |
| AUDITED _t | - | -0.105 | 6.30 | ** | -0.093 | 4.88 | ** |
| NPA_PCT _t | ? | | | | -1.593 | 5.87 | ** |
| COMM_RBC _t | ? | | | | -0.020 | 2.72 | * |
| SOLD _t | ? | | | | 0.211 | 5.76 | ** |
| Model Log-likelihood | | | 53.72 | | | 69.63 | |
| DF | | | 7 | | | 10 | |
| p-value | | | <0.001 | | | <0.001 | |

Table 3 reports the results of the following probabilistic regression equations:

$$\Pr(\text{Letter})_t = \alpha + \beta_1 \text{CAPITAL}_t + \beta_2 \text{ENFORCEMENT}_t + \beta_3 \text{SMALL}_t + \beta_4 \text{SIZE}_t + \beta_5 \text{DEP_INS}_t + \beta_6 \text{CREDITOR}_t + \beta_7 \text{AUDITED}_t + \varepsilon_t \quad (1)$$

$$\Pr(\text{Letter})_t = \alpha + \beta_1 \text{CAPITAL}_t + \beta_2 \text{ENFORCEMENT}_t + \beta_3 \text{SMALL}_t + \beta_4 \text{SIZE}_t + \beta_5 \text{DEP_INS}_t + \beta_6 \text{CREDITOR}_t + \beta_7 \text{AUDITED}_t + \beta_8 \text{NPA_PCT}_t + \beta_9 \text{COMM_RBC}_t + \beta_{10} \text{SOLD}_t + \varepsilon_t \quad (2)$$

The sample includes 5,289 bank observations. Lobbying banks include 1,047 unique banks from which the Financial Accounting Standards Board (FASB) received comment letters in response to their Exposure Draft (ED) titled, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (FASB, 2010). Non-Lobbying Banks included 4,242 banks from which the FASB did not receive comment letters in response to the ED, and for which we are able to obtain necessary financial data. CAPITAL is Tier 1 regulatory capital as of 12/31/2009 divided by average assets computed over the year ended 12/31/2009, ENFORCEMENT is an indicator variable equal to 1 if the bank was under an active enforcement order in the 5 years preceding the beginning of the comment period and zero otherwise; AVG_ASSETS is the average daily balance of total assets for the year ended December 31, 2009 reported on the bank's call report; SMALL is an indicator variable set to 1 if AVG_ASSETS is less than or equal to \$10 billion, and 0 otherwise; SIZE is the natural log of

AVG_ASSETS; DEP_INS is an indicator variable equal to 1 if the bank elected to participate in the Transaction Account Guarantee Program or the Debt Guarantee Program when these programs were offered by the Federal Deposit Insurance Corporation, and 0 otherwise; CREDITOR is an indicator variable equal to 1 if the firm has outstanding non-deposit long term debt and 0 otherwise; AUDITED is an indicator variable equal to 1 if the firm engages an independent auditor and 0 otherwise; NPA_PCT is the average nonperforming assets divided by the average balance in loans computed over the year ended December 31, 2009; COMM_RBC is total commercial and industrial loans (including real estate) divided by risk-based capital at December 31, 2009; SOLD is an indicator variable equal to 1 if the firm sold any of its loans during the two years ending December 31, 2009, and 0 otherwise. ***, **, and * denote parametric statistical significance at the 1%, 5%, and 10% (two-tail) levels, respectively.

TABLE 4

Logistic Regressions of Banks' Probability of Lobbying on Banks' Accounting-Based and Non-Accounting-Based Proxies for Agency Problems

| | Pred Sign | (I) | | (II) | | (III) | | (IV) | | (V) | | (VI) | |
|--------------------------|--------------|--------|-----------|--------|-----------|--------|-----------|--------|-----------|--------|-----------|--------|-----------|
| | | Coeff | χ^2 |
| Intercept | | -1.980 | 34.88 *** | -2.037 | 36.56 *** | -2.124 | 39.37 *** | -2.007 | 35.69 *** | -2.064 | 31.52 *** | -2.253 | 41.03 *** |
| CAPITAL _t | | -0.014 | 6.50 *** | -0.012 | 4.60 ** | -0.013 | 5.40 ** | -0.013 | 5.11 ** | -0.011 | 3.39 * | -0.011 | 2.71 ** |
| ENFORCEMENT _t | | -0.161 | 3.97 *** | -0.150 | 12.01 *** | -0.156 | 13.18 *** | -0.136 | 9.73 *** | -0.115 | 6.79 *** | -0.106 | 5.56 ** |
| SMALL _t | | 0.350 | 11.34 *** | 0.336 | 10.47 *** | 0.336 | 10.41 *** | 0.318 | 9.33 *** | 0.335 | 10.28 *** | 0.410 | 12.20 *** |
| SIZE _t | | 0.088 | 17.80 *** | 0.087 | 17.67 *** | 0.096 | 20.47 *** | 0.094 | 20.03 *** | 0.098 | 21.22 *** | 0.101 | 17.32 *** |
| TIMELINESS _t | | -0.506 | 7.50 *** | | | | | | | -0.452 | 5.94 ** | -0.449 | 5.83 ** |
| LLCONSERV _t | | | | -0.058 | 8.11 *** | | | | | -0.054 | 6.78 *** | -0.060 | 7.79 *** |
| LLACCRUAL _t | | | | | | -0.093 | 7.24 *** | | | -0.040 | 1.10 | -0.035 | 0.80 |
| STD_ROA _t | | | | | | | | -0.286 | 14.44 *** | -0.239 | 8.70 *** | -0.176 | 3.43 * |
| DEP_INS _t | | | | | | | | | | | | 0.150 | 7.20 *** |
| CREDITOR _t | | | | | | | | | | | | -0.262 | 3.80 ** |
| AUDITED _t | | | | | | | | | | | | -0.084 | 3.92 ** |
| NPA_PCT _t | | | | | | | | | | | | -0.832 | 1.15 |
| COMM_RBC _t | | | | | | | | | | | | -0.006 | 0.26 |
| SOLD _t | | | | | | | | | | | | 0.204 | 5.34 ** |
| Model Log-likelihood | | 46.44 | | 47.95 | | 46.90 | | 54.25 | | 68.95 | | 91.59 | |
| DF | | 6 | | 6 | | 6 | | 6 | | 9 | | 15 | |
| p-value | | <0.001 | | <0.001 | | <0.001 | | <0.001 | | <0.001 | | <0.001 | |

Columns (I) through (V) of Table 4 report the results of the following probabilistic regression equation:

$$\Pr(\text{Letter})_{i,t} = \alpha + \beta_1 \text{CAPITAL}_t + \beta_2 \text{ENFORCEMENT}_t + \beta_3 \text{SMALL}_t + \beta_4 \text{SIZE}_t + \beta_j \text{LLSLACK}_t + \varepsilon \quad (3)$$

Column (VI) of Table 4 reports the results of the following probabilistic regression equation:

$$\Pr(\text{Letter})_{i,t} = \alpha + \beta_1 \text{CAPITAL}_t + \beta_2 \text{ENFORCEMENT}_t + \beta_3 \text{SMALL}_t + \beta_4 \text{SIZE}_t + \beta_5 \text{LLSLACK}_t + \beta_6 \text{DEP}_{INS}_t + \beta_7 \text{CREDITOR}_t + \beta_8 \text{AUDITED}_t + \beta_9 \text{NPA_PCT}_t + \beta_{10} \text{COMM_RBC}_t + \beta_{11} \text{SOLD}_t + \varepsilon_t \quad (4)$$

The sample includes 5,289 bank observations. Lobbying banks include 1,047 unique banks from which the Financial Accounting Standards Board (FASB) received comment letters in response to their Exposure Draft (ED) titled, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (FASB, 2010). Non-Lobbying Banks included 4,242 banks from which the FASB did not receive comment letters in response to the ED, and for which we are able to obtain necessary financial data. CAPITAL is Tier 1 regulatory capital as of December 31, 2009 divided by average assets over the year ended December 31, 2009, ENFORCEMENT is an indicator variable equal to 1 if the bank was under an active enforcement order in the 5 years preceding the beginning of the comment period, and 0 otherwise; AVG_ASSETS is the average daily balance of total assets for the year ended December 31, 2009 reported on the bank's call report; SMALL is an indicator variable set to 1 if AVG_ASSETS is less than or equal to \$10 billion, and 0 otherwise; SIZE is the natural log of AVG_ASSETS; DEP_INS is an indicator variable equal to 1 if the firm elected to participate in the Transaction Account Guarantee Program or the Debt Guarantee Program when these programs were offered by the Federal Deposit Insurance Corporation, and 0 otherwise; CREDITOR is an indicator variable equal to 1 if the firm has outstanding non-deposit long term debt on December 31, 2009, and 0 otherwise; AUDITED is an indicator variable equal to 1 if the firm engages an independent auditor and 0 otherwise. R² Equation (A-2) is the adjusted R² from the firm-specific estimation of Equation (A-2) over the period 2001 through 2011.

$$\text{PROVISION}_t = \alpha + \beta_1 \Delta \text{NPA}_{t-1} + \beta_2 \text{IBP}_t + \beta_3 \text{CAPITAL}_t + \beta_4 \Delta \text{NPA}_t + \beta_5 \Delta \text{NPA}_{t+1} + \beta_6 \Delta \text{NPA}_{t+2} + \varepsilon_t \quad (\text{A-2})$$

where, PROVISION is the provision for loan losses in period t divided by average loans during the period, ΔNPA is the change in non-performing assets during the period divided by average loans, and IBP is income before loan loss provision divided by average assets.

Firms with error degrees of freedom less than 5 are eliminated from the sample. Results are robust to including these firms. TIMELINESS is the firm-specific difference in adjusted R² from estimating Equation (A-2) compared to that derived from estimating Equation (A-1).

$$\text{PROVISION}_t = \alpha + \beta_1 \Delta \text{NPA}_{t-1} + \beta_2 \text{IBP}_t + \beta_3 \text{CAPITAL}_t + \varepsilon_t \quad (\text{A-1})$$

ALLOWANCE/LOANS is the ratio of the allowance for loan losses divided by loans at December 31, 2009; LLCONSERV is the residual from a regression of ALLOWANCE/LOANS on non-performing assets (NPA) as of December 31, 2009; LLACCRUAL is the signed residual from estimating equation (A-2) in cross-section over the first quarter preceding the comment period (March 31, 2010); STD_ROA is the standard deviation of quarterly net income divided by average assets for the quarter, computed over the period 2001-2011; NPA_PCT is the average nonperforming assets divided by the average balance in loans computed over the year ended December 31, 2009; COMM_RBC is total commercial and industrial loans (including real estate) divided by risk-based capital at December 31, 2009; SOLD is an indicator variable equal to 1 if the firm sold any of its loans during the two years

ending December 31, 2009, and 0 otherwise. ***, **, and * denote parametric statistical significance at the 1%, 5%, and 10% (two-tail) levels, respectively.

APPENDIX
Construction of TIMELINESS and LLACCRUAL Variables

Two of our proxies for LLSLACK are derived from regression equations that estimate the extent to which the loan loss provision captures the expected future losses from nonperforming loans. Our first proxy, TIMELINESS, is based on analyses in Beatty and Liao (2011) and Nichols et al. (2009), and is measured as the improvement in explanatory power of a model explaining the loan loss provision when the model includes current and future period changes in nonperforming assets. The logic behind this measure is that more timely banks recognize loan losses contemporaneously or in advance of loans becoming nonperforming, whereas less timely banks use the discretion available in current GAAP for loan losses to delay recognition of losses from problem loans. The specific equations are expressed as follows:

$$PROVISION_t = \alpha + \beta_1 \Delta NPA_{t-1} + \beta_2 IBP_t + \beta_3 CAPITAL_t + \varepsilon_t \quad (A-1)$$

$$PROVISION_t = \alpha + \beta_1 \Delta NPA_{t-1} + \beta_2 IBP_t + \beta_3 CAPITAL_t + \beta_4 \Delta NPA_t + \beta_5 \Delta NPA_{t+1} + \beta_6 \Delta NPA_{t+2} + \varepsilon_t \quad (A-2)$$

where:

| | |
|------------------|--|
| <i>PROVISION</i> | Provision for loan losses in period t divided by average loans during the period |
| <i>ΔNPA</i> | The change in non-performing assets during the period divided by average loans |
| <i>IBP</i> | Income before loan loss provision divided by average assets |
| <i>CAPITAL</i> | Tier 1 risk-adjusted capital ratio at the beginning of the quarter divided by average assets |

We estimate these models using quarterly data from 2001 through 2011. For banks with more timely loss recognition, future ΔNPA , current ΔNPA , *IBP*, and *CAPITAL* will explain proportionately more of the current period provision than the model with only current ΔNPA , *IBP*, and *CAPITAL*. Our proxy, TIMELINESS, is equal to the difference in the adjusted R^2 s for equation (A-2) and (A-1). Consistent with Beatty and Liao (2011), we rely on the regression analyses to provide R^2 s as proxies for loan loss timeliness (i.e., we do not interpret the coefficients in the regression); however, we report the results of these regression analyses in the following table under the heading Estimation (I).

Table A-1

| | Estimation (I) | | | | | | Estimation (II) | | |
|--------------------|---|--------|-----|---------------|--------|-----|----------------------------|--------|-----|
| | Pooled time series estimation 2001-2010 | | | | | | Cross-sectional estimation | | |
| | Equation (2a) | | | Equation (2b) | | | 2010Q3 | | |
| | Coeff | t-stat | | Coeff | t-stat | | Coeff | t-stat | |
| Intercept | 0.001 | 41.66 | *** | 0.001 | 38.94 | *** | 0.008 | 30.41 | *** |
| ΔNPA_{t-1} | 0.042 | 54.84 | *** | 0.046 | 58.95 | *** | 0.013 | 2.06 | *** |
| IBP_t | 0.227 | 205.86 | *** | 0.227 | 206.46 | *** | -0.065 | -18.26 | *** |
| CAPITAL | -0.000 | 0.87 | | 0.000 | 1.01 | | -0.011 | -5.44 | *** |
| ΔNPA_t | | | | 0.027 | 34.47 | *** | 0.003 | 0.37 | |
| ΔNPA_{t+1} | | | | 0.014 | 17.75 | *** | -0.033 | -4.48 | *** |
| ΔNPA_{t+2} | | | | 0.008 | 10.63 | *** | -0.035 | -5.00 | *** |
| N | <hr/> | | | <hr/> | | | <hr/> | | |
| | R2= 0.153 | | | R2= 0.168 | | | R2 = 0.075 | | |

Because TIMELINESS is based on the differences in R^2 , it is unsigned. We also construct a signed proxy, LLACCRUAL, for the discretion used by managers via loan loss accounting under current GAAP. To estimate LLACCRUAL, we compute firm-specific residuals from a cross-sectional estimation of equation (A-2) over the period 2010Q1 through 2010Q3. Although we do not interpret the parameter estimates from this regression, we report the results of this analysis under Estimation (II) in Table A-1. Banks with more negative (positive) residuals reported loan loss provisions in 2010 Q1 that were understated (overstated) considering the change in nonperforming assets during the contemporaneous quarter and the two succeeding quarters.