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Regulation and disclosure about financial instruments:

Evidence on financial reporting in the Portuguese banking sector

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TITLE

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ABSTRACT

Financial instruments, and the underlying accounting regulation and reporting disclosure in the financial statements of banks, have been subject to great uncertainties and major changes. This paper aims at analyzing the impacts of the new regulation about financial instruments and to assess their current disclosure in the annual reports in the Portuguese banking sector. The sample consists of fourteen banks in the different sectors. This research reveals that IFRS 9 will turn the accounting of financial instruments more transparent and easy to compare among banks and that currently disclosure are related to the characteristics of banks and the economic cycle.

Keywords: Financial Instruments, IAS/IFRS, Financial Reporting, Portuguese Banks

1. INTRODUCTION

The financial sector, and particularly the banking sector, has been in the center of attention during the current financial crisis started in 2008, with financial instruments used, and the respective reporting in the financial statements of banks, being a matter of great uncertainties. In this context, the financial instruments' accounting regulation and required disclosure in financial reporting has been subject to major changes.

The accounting system used in the Portuguese banking sector is the *Normas de Contabilidade Ajustadas* (Adjusted Accounting Standards – NCA), which are the *Normas Internacionais de Contabilidade* (International Accounting Standards – NIC) with some exemptions[1] issued by the Bank of Portugal (BoP). In its turn, the NIC are the Portuguese adaptations of the International Accounting Standards (IAS) issued by the International Accounting Standards Board[2] (IASB). The NCA are the application in the financial statements of the International Financial Reporting Standards (IFRS). Since 2005, Portuguese companies listed on regulated markets[3] have to prepare their consolidated financial statements according to IAS/IFRS as established by the EC Regulation No. 1606/2002[4].

The IASB developed specific legislation about financial instruments to enable a more clean view of the financial statements and annual reports regarding the accounting principles and risk exposures of the entities. *'IAS 1 – Presentation of Financial*

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[1] Exceptions by Bank of Portugal are in the following areas: (i) valuation and provisioning of loans; (ii) employee benefits; and (iii) valuation of fixed assets.

[2] The International Accounting Standards Board (IASB) is the standard setting body which is responsible for the development and publication of the International Financial Reporting Standards (IFRS). Before, the International Accounting Standards Committee (IASC) issued International Accounting Standards (IAS), which are under a process of review.

[3] The United States of America (USA) has not yet adopted the IAS/IFRS. The General Accepted Accounting Principles in USA (US GAAP) for public and private companies, as well as for non-profit organizations are established by the Financial Accounting Standards Board (FASB) that issued the Statement of Financial Accounting Standards (SFAS).

[4] Regulation (EC) No 1606/2002 of the European Parliament and of the Council of July, 19th 2002 on the application of international accounting standards.

Statements' sets out overall requirements for the presentation of financial statements. '*IAS 32 – Financial Instruments: Presentation'* establishes principles for the presentation of financial instruments. '*IAS 39 – Financial Instruments: Recognition and Measurement'* requires the principles for recognizing and measuring financial assets and financial liabilities. '*IFRS 7 – Financial Instruments: Disclosures'* requires entities to provide disclosures in their financial statements and notes that enable users to evaluate the significance of financial instruments for the entity and the nature and extent of risks arising from financial instruments, and how the entity manages those risks. It is generally accepted that one of the causes for the current financial crisis was the lack of knowledge, or even the lack of transparency regarding the concepts of financial instruments, in both clients and banks, as the presentation of these instruments in the financial reporting of the banks do not transmit to the market a true and fair view of the risks that institutions were subject to.

Following the increasing attention in the financial reporting of banks and their incurred losses, the IASB issued[5] *'IFRS 9 – Financial Instruments'* that will reformulate the accounting treatment and the disclosure of the financial instruments, with effective date on January 1st, 2015[6], however earlier application is permitted since 2010.

The purpose of this paper is to analyze the impacts of the implementation of the new regulation about financial instruments and to assess their current disclosure in the annual reports of banks in the Portuguese banking system.

This paper is organized as follows. Section 2 provides the key concepts and summarizes the legal framework. Section 3 reviews prior empirical research. Section 4 outlines the

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[5] On November 12th, 2009, the IASB issued '*IFRS 9 - Financial Instruments*', covering classification and measurement of financial assets.

[6] On August 4th, 2011, the IASB issued an Exposure Draft (ED) proposing to postpone for two years the mandatory effective date of the new financial instrument standard, IFRS 9, from January 1st, 2013 to January 1st, 2015.

research questions and methodology and Section 5 discusses the results, their possible causes and provides recommendations. Finally, Section 6 summarizes the main conclusions and limitations and present suggestions for future research.

2. KEY CONCEPTS AND LEGAL FRAMEWORK

This section introduces the key concepts associated to the banking sector and its related financial instruments and financial reporting and summarizes the legal framework.

2.1. Key concepts

The banking activity in Portugal is regulated by the '*Regime Geral das Instituições de Crédito e Sociedades Financeiras*' (Legal Framework of Credit Institutions and Financial Companies - RGICSF)[7]. According to the RGICSF, a bank is a Credit Institution[8] that is a company "whose business is to receive deposits or other repayable funds in order to apply them on their own by granting credit"[9]. However, despite this general framework, banks present specific characteristics given their operational area and type of business. Currently, the main types of banks in the financial system worldwide are Retail banks, whose business is essentially related to collect deposits and concede loans to individual clients and enterprises; Private banks, which mainly provide wealth management services to wealthy costumers; Investment banks, whose business is essentially linked to the financial markets; and Consumer credit banks, which provide loans to finance the purchase of goods and services.

Therefore, according to their business type, banks can operate a defined set of activities that are provided in Article no. 4 of the RGICSF. In accordance with this article, among

[7] Regime Geral das Instituições de Crédito e Sociedades Financeiras, was approved by Decree-Law No. 298/92, of 31 December and amended several times, being the last amendments by Decree-Law No. 88/2011of 20 July, No. 119/2011 of 26 December, No. 31-A/2012 of 10 February and No. 242/2012 of 7 November.

[8] Article No.3 of the RGICSF.

[9] Article No.2 of the RGICSF.

other activities defined, it stands out to perform “transactions, on their own or customers, on money market instruments and foreign exchange, forwards, options and operations over foreign exchange, interest rate, commodities and securities”. This project focuses in this type of transactions.

Accounting treatment and financial reporting of financial instruments are regulated by IAS 32, IAS 39 and IFRS 7. **Table 1** presents the accounting standards that regulate the financial instruments and their coverage.

According to the IAS 32, a financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity (IAS 32, Paragraph 11). In its turn, a financial asset is any asset that is: cash; a contractual right to receive cash or another financial asset, a contractual right to exchange financial assets under conditions that are potentially favorable or a contract that may be settled in the entity's own equity instruments, while a financial liability is any liability to deliver cash or another financial asset, or to exchange financial instruments with another entity under conditions that are potentially unfavorable; or a contract that will or may be settled in the entity’s own equity instruments (IAS 32, Paragraph 11). Still in accordance with IAS 32, an equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities (IAS 32, Paragraph 11).

Finally, according to IAS 39, a derivative is a financial instrument whose value depends on variations of an interest rate and foreign exchange rate; the financial instrument price; the commodity price; index of prices or rates, credit rating or credit index; or other variable. (IAS 39, Paragraph 9).

Following their investment strategy, through the combination of the financial instruments mentioned above, banks prepare their financial reporting. In accordance to IAS 1, the financial statements shall present fairly the financial position, financial performance and cash flows of an entity and requires the faithful representation of the effects of transactions. It is stated that a complete set of financial statements comprises (i) a statement of financial position (balance sheet); (ii) a statement of comprehensive income (or an income statement and a statement of other comprehensive income - OCI); (iii) a statement of changes in equity; (iv) a statement of cash flows; and (v) notes, comprising a summary of significant accounting policies and other explanatory notes (IAS 1, Paragraph 10).

Presented the key conceptual aspects to the interpretation of the topic of this paper, it will be stated the Legal Framework in the Portuguese banking sector in the next section.

Table 1 – *Regulation of financial instruments.*

IAS / IFRS	Coverage
IAS 32 – Financial Instruments: Presentation	Principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities
IAS 39 – Financial Instruments: Recognition and Measurement	Principles for recognising and measuring financial assets and financial liabilities
IFRS 7 – Financial Instruments: Disclosures	Principles for disclosing information about financial instruments

2.2. Legal Framework

Accounting regulation

The financial instruments' accounting regulation and required disclosure in financial reporting has been subject to major changes since the implementation of IAS/IFRS and more steeply following the financial crisis started in 2008. Current accounting treatment for the recognition and measurement of financial instruments is stated in IAS 39. Following the financial crisis, with the aim to improve transparency and the fair view of the accounting treatment and disclosure of financial instruments, IASB issued the new IFRS 9 that will replace the current IAS 39. This section will present the current accounting principles and the changes predicted in IFRS 9.

In accordance with IAS 39, the classification of financial assets should be done between four categories, while two categories are defined for the classification of financial liabilities (IAS 39, Paragraph 9). **Table 2** presents the categories predicted in IAS 39 and its condition for classification.

Table 2 – *Conditions for classification of financial assets and financial liabilities (IAS 39)*

Classification	Condition for classification
Financial asset/liabilities at fair value through profit or loss (FVTPL):	-
- Held for trading	(i) Purpose of selling or repurchasing it in the near term; (ii) Evidence of a recent actual pattern of short-term profit-taking; or (iii) Derivative
- Fair value through profit or loss	(i) It eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise; (ii) A group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis.
Loans and receivables	Non-derivative financial assets with fixed or determinable payments that are not quoted in an active market.
Held-to-maturity (HTM)	Non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity.
Available-for-sale (AFS)	Non-derivative financial assets that are designated as available for sale or are not classified as (a) loans and receivables, (b) held-to-maturity investments or (c) financial assets at fair value through profit or loss.
Other financial liabilities at amortized cost	Non-derivative financial liabilities that are not classified as financial liabilities at fair value through profit or loss

The entity shall recognize the financial asset and financial liability when, and only when, the entity becomes a party of the contractual provisions of the instrument. In its initial recognition, the entity shall recognize the financial instrument at its fair value (FV)[10]. The reclassification between categories is also allowed, in specific conditions, by IAS 39. The reclassification can happen to avoid impacts of specific categories due

[10] Plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

the particular conditions of the markets (e.g. avoid effects in Equity reclassifying AFS instruments). To make transparent to users any reclassification, since it is not expected to have regular reclassifications of financial instruments, banks should disclose the reason for doing it (IFRS 7, Paragraph 12).

For subsequent measures (see **Appendix 1**), the financial assets shall be measured at its fair value, except the following categories: (i) Loans and receivables; and (ii) HTM investments, which shall be measured at amortized cost using the effective interest method. The subsequent measurement of the financial liabilities shall be at the amortized cost using the effective interest method, except for financial liabilities at FVTPL, including derivatives, which shall be measured at fair value. **Table 3** summarizes the definitions related to recognition and measurement in IAS 39.

Table 3 – *Definitions related to recognition and measurement (IAS 39, Paragraph 9).*

Item	Description
Amortized cost	Amount at which the financial asset or financial liability is measured at initial recognition: (i) minus principal repayments; (ii) minus any reduction for impairment; (iii) plus or minus the cumulative amortization using the effective interest method of any difference between that initial amount and the maturity amount.
Effective interest method	Method of calculating the amortised cost and of allocating the interest income or interest expense over the relevant period.
Effective interest rate	The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument.
Fair value	Amount for which an asset could be exchanged or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

The recognition of gains and losses arising from a change in the fair value[11] of a financial asset or financial liability, which is not part of a hedging relationship, depends on its classification. **Table 4** presents the different recognition of gains and losses arising from changes in fair value according to IAS 39 for the different categories.

[11] For the financial assets and financial liabilities carried out at amortized cost, a gain or loss is recognized in profit or loss when it is derecognised or impaired, and through the amortization process.

Table 4 – *Recognition of gains and losses according to IAS 39*

Classification of	Categories	Changes of balance
Financial assets	Financial asset at fair value through profit or loss	Profit & Loss (P&L)
	Available-for-sale	Equity[12]
Financial liabilities	Financial liabilities at fair value through profit or loss	Profit & Loss

Related to the adjustment of the value of financial assets and financial liabilities, are the events after the reporting period. According to *'IAS 10 – Events after the Reporting Period'*, these are events that occur between the balance sheet date and the date when the financial statements are authorized for issue (IAS 10, Paragraph 3). It is also defined two types of events: (i) Adjusting events: Events that provide evidence of conditions that existed at the balance sheet date, which lead to adjustments of the financial assets and financial liabilities; and (ii) Non-adjusting events: Those that are indicative of conditions that arose after the balance sheet date, which should only be disclosed in the notes, if the impacts are material.

The classification of the financial assets and financial liabilities has an important role. There is the recent example of the haircut of the Greek Government Bonds in 2012[13]. Since the nominal amount of these securities had suffered a haircut around 50%, the entities that classified those securities in a category measured at the amortized cost booked an impairment of that amount in its Profit & Loss accounts. The banks that classified the securities in AFS had severely impacts in their Equity. Firstly, with the decrease in the FV of those securities and then with the impairment booked[14].

As it can be seen in the current requirements, in particular the classification of the financial assets and liabilities (with impacts in the remaining components), there is an

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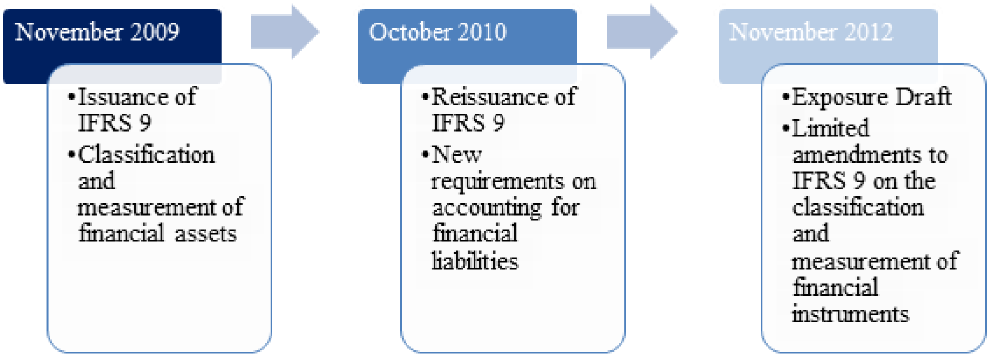
[12] Through the 'statement of changes in equity' in available-for-sale financial asset, except for impairment losses and foreign exchange gains and losses, until the financial asset is derecognized, at which time the cumulative gain or loss previously recognized in equity shall be recognized in profit or loss.

[13] Eurogroup statement on Greece on February 21st, 2012.

[14] This situation led to the need for banks to raise their equity from the shareholders.

underlying degree of subjectivity. Namely, financial assets classified in AFS are those that do not fit in the remaining categories, being the requirements for those categories in itself subjective. Therefore, the IASB has decided to replace IAS 39 over a period of time with the issuance gradually of the new IFRS 9. **Fig.1** presents the milestones of the IFRS 9 issuance.

Fig.1 – *Milestones of the IFRS 9 issuance*



IASB is adding to the standard as it completes the various phases of its project on financial instruments to complete the full replacement of IAS 39 and applies IFRS 9 to annual periods beginning on or after January 1st, 2015.

In accordance with IFRS 9, financial assets shall be classified, instead of the four categories in IAS 39, between three categories: (i) Fair value through other comprehensive income; (ii) Fair value through profit or loss; and (iii) Amortized Cost. Regarding the classification of financial liabilities, IASB decided to retain almost all of the existing requirements from IAS 39. **Table 5** compares IFRS 9 with the current IAS 39 regarding the classification of financial assets and financial liabilities.

Regarding the gains and losses with financial instruments (see **Appendix 2**), IFRS 9 defines that changes in FV should be recognized in (i) OCI for financial assets at FVTOCI; and (ii) in P&L for financial assets at FVTPL. Regarding the financial liabilities, changes in FV should be recognized in (i) P&L for Held for trading; and (ii) in OCI for changes in the FV attributable to changes in the liability's credit risk with the remaining amount of change in FV being recognized in P&L for FVTPL category. For the financial assets and financial liabilities classified at amortized cost, the amortization process continues to be recognized in P&L.

Table 5 – *Comparison of IAS 39 and IFRS 9 regarding classification requirements*

<table>
<tr><th>Classification of</th><th>IAS 39</th><th>IFRS 9</th></tr>
<tr><td rowspan="4">Financial assets</td><td>Financial asset at fair value through profit or loss
- Held for trading
- Fair value through profit or loss</td><td>Fair value through other comprehensive income (FVTOCI)</td></tr>
<tr><td>Loans and receivables</td><td>Fair value through profit or loss (FVTPL)</td></tr>
<tr><td>Held-to-maturity</td><td rowspan="2">Amortized cost</td></tr>
<tr><td>Available-for-sale</td></tr>
<tr><td rowspan="2">Financial liabilities</td><td>Financial liabilities at fair value through profit or loss
- Held for trading
- Fair value through profit or loss</td><td>Financial liabilities at fair value through profit or loss
- Held for trading
- Fair value through profit or loss</td></tr>
<tr><td>Other financial liabilities at amortized cost</td><td>Amortized cost</td></tr>
</table>

Following the description above, it is clear that the classification of financial assets and liabilities, the initial and subsequent measurement and gains and losses booked under IFRS 9 will be clearer and without subjectivity.

Financial Reporting – Disclosure

After the exposure in the last section of the accounting principles underlying the financial statements of the banks in Portugal, this section describes the normative that guides the transition of that financial information to the financial reporting, IFRS 7.

The disclosure requirements prescribed by IFRS 7 are based in information regarding the financial instruments that banks should present in their annual report. It is defined the information, compulsory and just recommended, to be disclosed in the financial statements (e.g. Balance sheet and Income statement) and under the notes whose presentation is important to enable users of the financial statements to evaluate the significance of financial instruments for financial position and performance and the degree of risk that the entity is subject to.

3. LITERATURE REVIEW

This section reviews the existing literature on reporting financial instruments. Studies under review were grouped according to two criteria: firstly, literature refers to studies regarding the accounting treatment of financial instruments; and secondly, studies concerning financial reporting analysis. Gebhardt and Farkas (2011) examine the implications of mandatory IFRS adoption on the accounting quality of banks in European Union (EU) countries. They conclude that, consistent with the notion that financial reporting outcome are not only shaped by accounting standards, the IFRS adoption effect is significantly less pronounced in stricter supervisory regimes and in countries with more dispersed ownership of banks. Chalmers (2001), Chalmers and Godfrey (2000), Blankley *et al*. (2000), Roulstone (1999) and Mahoney and Kawamura (1995) conclude that there are high levels of non-compliance among Australian companies and problems of understanding, comparability and consistency with derivative disclosure. Edwards Jr. and Eller (1995) and Edwards Jr. and Eller (1996) analyze the top ten US dealer bank's annual reports after SFAS 119[15] had become effective. They conclude that the deepness of both the qualitative and quantitative disclosures improved. Additionally, the same authors conclude about changes in the disclosure requirements with SFAS 119 and that the increase of transparency introduced is evident. Woods and Marginson (2004) analyze the implementation of FRS 13[16] in the UK, and conclude that the information disclosed lacks usefulness due to the generic nature of qualitative disclosures, the lack of detail and comparability of qualitative disclosures and the difficulty of combining qualitative and quantitative disclosures.

[15] SFAS 119: Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments, issued by the Financial Accounting Standards Board (FASB), 1994.
[16] FRS 13: Derivatives and other Financial Instruments: Disclosures, issued by the UK Accounting Standards Board, 1998.

Lopes and Rodrigues (2007) analyses accounting for financial instruments of STOXX 50 companies and compare them to the requirements of IAS 32 and IAS 39, before IFRS are mandatory in the EU. They conclude that the majority of companies disclose the fair value amounts and methods of calculation but the information is neither clear nor objective, preventing the fair value information from being relevant and useful. They also show doubts about the degree of compliance and the usefulness of the information. Linsley and Shrives (2006) analyses the annual reports of UK non-financial listed companies and provide evidence of a positive relationship between firm's size and the quality of disclosure. Lopes and Rodrigues (2004) analyze the annual reports of Portuguese listed companies to compare accounting practices for financial instruments and compliance with IAS 32 and IAS 39 and conclude that companies are not fulfilling the requirements of these standards. Lopes and Rodrigues (2006) analyze the determinants of disclosure level in the accounting for financial instruments of Portuguese listed companies. They conclude that the degree of disclosure is significantly related to size, type of auditor, listing status and to the economic sector.

It is clear that the impacts of the implementation of new accounting standards and the disclosure in the financial reporting of companies were always subject of deep analysis and that the interest in the financial instruments in the banking sector and their disclosure in the annual reports has been rising. Prior literature focuses in the application of the current accounting standards, namely IAS 32 and IAS 39, in a wide range of companies, including in Portugal. However, there is a lack of analysis of the accounting standards in the banking sector, including their different sectors of activity, namely in Portugal. This lack of studies is also evident regarding the implementation of the new accounting standard IFRS 9. So, is in line with this conclusion that this project emerges, being to the best of our knowledge the first research to study the impacts of the implementation of IFRS 9 and the current disclosure of financial instruments in the banking sector in Portugal.

4. RESEARCH QUESTIONS AND METHODOLOGY

This section states the research questions to be answered, discusses methodological issues and presents a characterization of the banks in the sample.

4.1. Research Questions

This project is an explanatory study which aims at providing evidence about the current financial reporting regarding the financial instruments in the Portuguese banking sector. To do so, classification, recognition, measurement and disclosure variables are analyzed and that relationship with company-specific characteristics to disclosure practices in Portugal are discussed. The main question to be answered is the following:

> *How do Portuguese banks disclose information about financial instruments within their annual report?*

After characterizing the banks in the sample, regarding the size, the public-private status, being listed or non-listed and the sector of activity, five questions are addressed:

> RQ1: *What disclosures methods about financial instruments are banks doing?*
>
> RQ2: *Are disclosures methods about financial instruments related to the characteristics of the bank?*
>
> RQ3: *Did reclassification of the financial instruments categories happen since 2008, when the impacts of the crisis started to be more severe?*
>
> RQ4: *Do events after the reporting period notes exist in the banks' annual report during this period of constant events affecting the value of financial instruments?*
>
> RQ5: *Do banks follow the accounting standards regarding the terminology related to financial instruments in the annual reports?*

For a better understanding of the results obtained, some associations were made concerning the characteristics of the banks, namely the public-private status, being listed-non-listed and the sector of activity on one side, and the characteristics of the reporting about financial instruments, namely the disclosure type of the notes presented, the note regarding the events after the reporting period and the terminology used in the annual report.

4.2. Sample and data

Data is collected from the annual reports obtained in the official website of the Banks[17]. The reports analyzed pertain to years 2008 until 2011 (last available) to obtain the impacts of the current financial crisis in the banks' financial statements, e.g. events after the reporting period and reclassification between categories.

Regarding the exclusive use in this project of information presented in the annual reports, namely in the balance sheet, income statement and notes related to financial instruments, literature recognize the shortcoming associated to research based on that, e.g. Zeghal and Ahmed (1990), since banks can disclose information on other channels[18]. However, literature also supports the idea that the standard format of the annual reports facilitates comparison among different banks, Aljifri and Hussainey, (2007). Besides, the annual report is still pointed as the main form of corporate communication, Marston and Shrives (1991), it provides information with high degree of credibility, Unerman (2000), and is widely distributed by listed companies, Adams, Coutts and Harte (1995).

Currently, the banks' annual reports present a consolidated report of the all financial

[17] Caixa Económica Montepio Geral is included in our sample due the relevance in the Portuguese banking sector. This situation was also considered in the Special Inspection Program (SIP) carried out by Bank of Portugal regarding the assessment of the credit portfolios and the validation of the credit risk capital requirements of the eight largest national banking groups where it was included the Caixa Económica Montepio Geral. The Special Inspection Program results and the background of the inspection is available in the Press release by Bank of Portugal on December 16th, 2012.

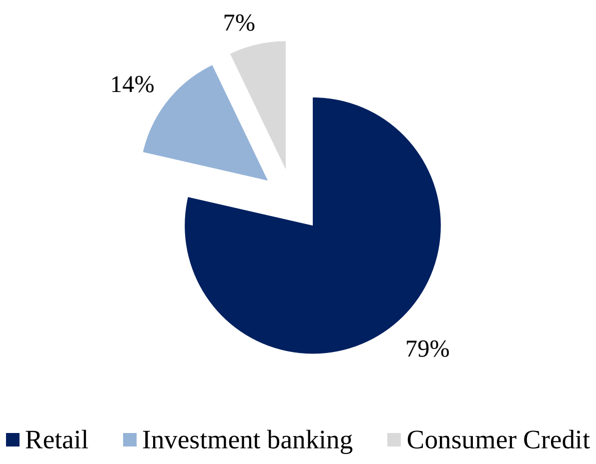
[18] Namely disclosures made through mass media vehicles such as magazine, radio and television advertisements and company brochures.

group and an individual report of the entity. The analysis was based on the individual report to capture the information of the financial instruments of each bank and not from the entire group as a whole. As stated in **Section 1**, banks only have to prepare their consolidated financial statements according to IAS/IFRS, so it was observed in the note regarding the basis of presentation that individual financial statements were prepared according to NCA.

The initial sample for the analysis, which was randomly selected, comprised 15 banks (see **Appendix 3**), out of 35 authorized by Bank of Portugal[19], covering the various sectors of activity in the Portuguese banking sector (retail, investment banking, consumer credit). One bank has been excluded from the initial sample, because it is a group of small banks, which individually have a small dimension, and just present a consolidated report. The final sample is then composed by 14 banks. **Appendix 3** shows the composition of the sample, regarding the public-private status, being a listed or non-listed bank, the sector of activity and the External Auditor in 2011.

Regarding the sector of activity (**Fig.2**), eleven banks (79%) are retail banks, whereas two (14%) are investment banks; only one bank (7%) is a consumer credit bank.

Fig.2 - Sector of activity



The majority of the banks in the sample are private banks (twelve banks, 86%), while a small minority are public banks (two banks, 14%). Regarding the fact of being listed, the majority (ten banks, 71%) is non-listed (see **Table 6**).

[19] Information regarding February 2012, the most updated version available by Bank of Portugal.

Table 6 – *Typology of banks*

	Listed	Non-listed	Total
Public	0 (0%)	2 (14%)	2 (14%)
Private	4 (29%)	8 (57%)	12 (86%)
Total	4 (29%)	10 (71%)	14 (100%)

The three largest banks regarding the total assets are *Caixa Geral de Depósitos* (CGD with over €108,800 millions), *Banco Comercial Portugês* (BCP with over €97,700 millions) and *Banco Espírito Santo* (BES with over €74,000 millions). The average size of the banks in the sample is €31,000 millions of total assets. Regarding the net income of the year, the opposite occurred in 2011, in the sense that the largest banks regarding total assets have the worst results. The three banks with highest net income in 2011 are *Montepio* with €33 millions, *Santander Totta* with €22 millions and *Banco Popular* with €13 millions. On its turn, the three banks[20] with the lowest net income are BCP with - €470 millions, CGD with - €316 millions and *Banco Português de Investimento* (BPI) with - €216 millions.

5. RESULTS

This section presents the answers to the research questions presented in Section 4. It is also announced possible causes for the results obtained.

Disclosure method (RQ1)

Regarding the general disclosure of financial instruments in the notes of the annual report, IFRS 7 does not provide a mandatory approach of presentation. For each category of financial instrument, banks present the information in narrative, in a table with their composition (e.g. internal issuers-external issuers), or disclosure that table and more detailed information (e.g. decomposition by maturities). **Table 7** presents a

[20] BES which is the bank with the third highest bank in total assets has the fourth worst net income in 2011 with a €133 million loss.

summary of the disclosure method adopted by banks in the sample[21] for the presentation of financial instruments. It is observed that there is not, excluding for the AFS category, a defined pattern in the disclosure method used. One reason for this different approach is the materiality of the different categories of financial instrument. The category AFS presents the highest average in terms of materiality[22] (17.64%) and is simultaneously the category where all banks in the sample presents a table with composition with detailed table. It can be argued that, as stated in **Section 2.2**, since this category has impacts directly in Equity, and so with direct connection with the Shareholders, the information required by the users of the financial statements is higher. In its turn, the two banks that present the narrative method in the notes do it regarding the category of financial assets at FVTPL, which is the category with the smallest individual materiality in the sample: *Montepio* (0.01%) and *Santander Totta* (0.18%).

Table 7 – *Disclosure method of financial instruments*

	Category	Narrative	Table with composition	Table with composition + Detail tables	Total
Financial assets	Held for trading	0 (0%)	3 (23%)	10 (77%)	**13** (100%)
	FVTPL	2 (20%)	3 (30%)	5 (50%)	**10** (100%)
	AFS	0 (0%)	0 (0%)	13 (100%)	**13** (100%)
	HTM	0 (0%)	1 (17%)	5 (83%)	**6** (100%)
Financial liabilities	Held for trading	0 (0%)	6 (46%)	7 (54%)	**13** (100%)
	FVTPL	0 (0%)	2 (67%)	1 (33%)	**3** (100%)

Characteristics of the banks (RQ2)

Related to the type of disclosure presented (i.e. Narrative; table with composition; or table with composition and detailed tables), three characteristics were associated, namely being listed, the public-private status, and the sector of activity (Retail,

[21] The different total of banks for the various categories of financial assets and financial liabilities and for the total of the sample (14 banks) is related to the fact that some banks do not have those specific financial instruments.
[22] Materiality considered is computed as: Materiality = (Amount of each category / Total Assets or Total Liabilities).

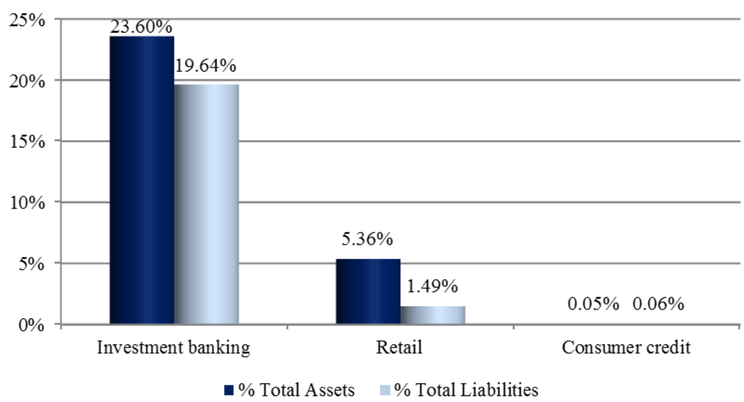
investment banking or consumer credit), to verify possible correlations. It is observed that listed banks present more detailed information than non-listed banks. All listed Banks present a table with composition of the category and detailed tables. The only two exceptions are BPI and *Banif* in the financial liabilities – held for trading category, since it is completely immaterial in terms of total assets, BPI (0.99%) and *Banif* (0.05%). This result is in line with the defined in **Section 1** that listed banks have to prepare their consolidated[23] financial statements according to IAS/IFRS since 2005 and are subject of more information requirements. Regarding the public-private status, there are a positive relationship between being public and the disclosure detail in the notes. CGD and *Caixa – Banco de Investimento* (*CaixaBI*), the two public banks in the sample, present, similar to listed banks, table of composition more detailed tables for 100% of the categories of financial instruments. It is possible to conclude that the public status of these two banks, with the environment around them due this position, contribute to an increase in the information disclosed in the annual report. In its turn, private banks have not a defined pattern in the disclosure method used varying from bank to bank. Finally, concerning the sector of activity, the only positive relationship observed is the fact of being an investment bank. The two investment banks in the sample, *Banco de Investimento Global* (BIG) and *CaixaBI*, present a table of composition more detailed tables for 100% of the categories of financial instruments. For the retail and consumer credit banks there is not a defined pattern of disclosure type. In this way, it can be concluded that the degree of disclosure is positively related to the listing status and to the economic sector as suggested by Lopes and Rodrigues (2006).

[23] Since banks have to prepare the disclosure information according to IAS/IFRS to the consolidated report, the information about financial instruments is also provided in the individual report, used in this project.

This result is in line with the stated in **Section 2.1** about the banks' business type. Being the financial markets the center of its activities, the average weight of financial instruments in the total assets and total liabilities is expected to be higher in investment banks (**Fig.3**).

Reclassification of the financial instruments (RQ3)

Fig. 3 - Weight of financial instruments



Six banks (43%) reclassified financial instruments since 2008, when the impacts of the financial crisis started to be more severe. To make transparent to users any reclassifications, since it is not expected to have regular reclassifications of financial instruments, banks should disclose the reason for doing it, as described in **Section 2.2**. From the six banks, only BIG does not present a reason for the reclassification. The remaining five banks (38%) argued the turbulence of the financial markets started with the financial crisis in 2008 as the reason for the reclassification. **Table 8** presents the reclassification done by category of financial instrument in each year by bank. This permission for reclassifications, that leads the banks to do it in the various categories and in the different years, as shows **Table 8**, can bring comparability problems. This situation arises because the reclassification between categories is only disclosed in the notes and it is not reflected in financial statements. Therefore, the ability of users of the financial statements to take appropriate decisions can be affected.

Table 8 – *Reclassification of financial instruments*

Bank	Reclassification	
	Year	Categories
BCP	2010	AFS to HTM; Trading to AFS; Trading to HTM
BIG	2008	AFS to HTM
BES	2008	AFS to HTM
BPI	2008	Trading to AFS
CaixaBI	2008	Trading to AFS
CGD	2008; 2010	Trading to AFS

Events after the reporting period (RQ4)

No banks disclosed the events after the reporting period note regarding financial instruments in the annual report since 2008, with particular relevance in 2011 due the February 2012 'Eurogroup statement on Greece' that modified the value of the Greek Government Bonds. One reason for this can be the fact that seven banks (78%[24]) delayed the approval of their annual accounts, and the underlying authorization for issue, by about one month comparing 2008 and 2011 accounts. This situation is particularly clear for BCP that usually approved annual accounts in the beginning of February (e.g. February, 1st in 2011) while the approval by the Board of the 2011 financial statements were in April 23th, 2012. This delay gives to the banks the possibility to take into account the open events, with possible impacts in the financial instruments, and book them in the current reporting period. In addition, it would be recommended that the banks disclose the date of approval of the financial statements by the board in the annual report. This situation is important for comparative issues and to inform the users of the financial statements the cut-off point for the post-balance sheet period.

Terminology issues (RQ5)

Even though all banks name the AFS, HTM and financial liabilities held for trading

[24] To calculate this percentage, it was taken into consideration the fact that five banks did not disclose the date of the approval of financial statements in the annual report (so the basis was 9 banks instead of 14).

categories as the terminology described in IAS 39, the names used for the remaining categories varies compared to the official terminology presented in the accounting standard. **Table 9** presents a summary of the terminology in the balance sheet adopted by banks in the sample, along with frequency of use. It is observed that there are deviations from the standard terminology. Regarding the category of financial assets held for trading, only one bank (7%), BPI, presents a different terminology, since it joints that category with financial assets at FVTPL. Although, in the underlying note, BPI presents the total balance of those two categories and then disclose the individual balance. Regarding the financial assets and liabilities at FVTPL, no banks present the official terminology in IAS 39. One reason for this is the fact that, according to the Regulatory Instruction No. 18/2005 of BoP[25] on the reporting of financial statements and other accounting elements of institutions adopting NIC and NCA, the name predicted in the NCA's balance sheet format does not correspond to the official terminology of IAS 39, which is the base of those standards. So, even though eight banks (80%), regarding financial assets at FVTPL, and one bank (50%), concerning financial liabilities at FVTPL, use the terminology predicted by the Regulatory Instruction of BoP, it is a deviation from the official accounting standards.

Table 9 – *Differences in terminology*

	Item	Frequency by item	Percentage by item
	Financial liabilities		
Held for Trading	**Standard terminology** *Passivos financeiros detidos para negociação*	12	100%
	Non standard terminology	-	0%
FVTPL	**Standard terminology** *Passivos financeiros pelo justo valor através dos lucros ou prejuízos*	-	0%
	Non standard terminology *Outros passivos financeiros ao justo valor através de resultados (NCA)*	1	50%
	Outros passivos financeiros ao justo valor via resultados	1	50%

[25] Regulatory Instruction No.18/2005 of Bank of Portugal, amended by Regulatory Instruction No.34/2005, Regulatory Instruction No.9/2006 and Regulatory Instruction No.28/2009.

(continued)

Table 9 – *Differences in terminology (continued)*

	Item	Frequency by item	Percentage by item
	Financial assets		
Held for Trading	**Standard terminology** *Ativos financeiros detidos para negociação*	13	93%
	Non standard terminology *Activos financeiros detidos para negociação e ao justo valor através de resultados*	1	7%
FVTPL	**Standard terminology** *Ativos financeiros pelo justo valor através dos lucros ou prejuízos*	-	0%
	Non standard terminology *Outros ativos financeiros ao justo valor através de resultados (NCA)*	8	80%
	Outros ativos financeiros ao justo valor via resultados	1	10%
	Ativos financeiros detidos para negociação e ao justo valor através de resultados	1	10%
AFS	**Standard terminology** *Activos financeiros disponíveis para venda*	13	100%
	Non standard terminology	-	0%
HTM	**Standard terminology** *Investimentos detidos até à maturidade*	6	100%
	Non standard terminology	-	0%

Considering the above, it would be recommended a harmonization of the terminologies used in financial instruments at FVTPL, similar to the remaining categories.

6. CONCLUSION

The purpose of this project was to analyze the impacts in accounting principles and reporting requirements of the new regulation about financial instruments and to assess their current disclosure in the annual reports of banks in the Portuguese banking sector. It is clear the increase attention on the subject of the financial instruments used in the banking sector, and their respective accounting regulation and required reporting in the financial statements of banks. However, there is a lack of information about the current accounting environment of the Portuguese banking system and, consequently, the impacts of future regulation.

The review of legal framework, financial reporting of the banks, previous literature and technical documentation regarding this topic helped to develop the research questions to be answered. The results obtained were important once it was clarified the changes that will occur in the near future with the new regulation concerning financial instruments as well as it was presented the different reporting disclosure among the banks analyzed.

Being the first research about the changes of the accounting regulation regarding financial instruments and their current reporting disclosure in the Portuguese banking sector, this project contributes in three main areas. Firstly, it establishes a starting point for the study of these themes in the Portuguese banking sector. Second, it contributes to regulators, banks and users of financial statements to understand the continuous changes of the current accounting standards that are in progress. Finally, it complements the existing literature, providing further evidence from the disclosure practices in the Portuguese banking sector.

Hence, future research on the topic can add more banks, different periods of analysis, compare the financial reporting disclosure regarding financial instruments in banks operating in Portugal with banks in the United States of America, where the General Accepted Accounting Standards (i.e. US GAAP) are different. Moreover, it could be analyzed the impacts of the new accounting regulation in further variables that were not analyzed in this project, namely the derivatives accounting, the accounting and disclosure of the gains and losses with the financial instruments and the accounting for loans to costumers and its provisioning.

Overall, this project contributes to new perspectives on the so specific accounting system and financial reporting on the banking sector, in particular regarding the financial instruments used, and how to analyze the annual reports of banks. Besides, it is hoped that it provides a meaningful base for understanding the evolution regarding accounting principles and financial reporting that is being prepared.

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8. APPENDIXES

Appendix 1 – IAS 39 measurement

Classification of	Category	Measurement
Financial assets	Financial asset at fair value through profit or loss	Fair value
	Loans and receivables	Amortized cost
	Held-to-maturity	Amortized cost
	Available-for-sale	Fair value
Financial liabilities	Financial liabilities at fair value through profit or loss	Fair value
	Other financial liabilities at amortized cost	Amortized cost

Appendix 2 – IFRS 9 gains and losses

Classification of	Category	Measurement
Financial assets	Fair value through other comprehensive income (FVTOCI)	Equity (OCI)
	Fair value through profit or loss (FVTPL)	Profit & Loss
Financial liabilities	Financial liabilities at fair value through profit or loss	-
	- Held for trading	Profit & Loss
	- Fair value through profit or loss	Profit & Loss *

* With changes in FV attributable to changes in the credit risk to be recognized in OCI

Appendix 3 – Initial and final sample

	Banks	Public - Private	Listed - Non-Listed	Sector of activity	External auditor in 2011	Included in the Final Sample
1	*Banco Bilbao Vizcaya Argentaria* (BBVA) *Portugal*	Private	Non-Listed	Retail	Deloitte	Yes
2	*Banco Comercial Português* (BCP)	Private	Listed	Retail	KPMG	Yes
3	*Banco de Investimento Global* (BIG)	Private	Non-Listed	Investment bank	KPMG	Yes
4	*Banco Espírito Santo* (BES)	Private	Listed	Retail	KPMG	Yes
5	*Banif - Banco Internacional do Funchal*	Private	Listed	Retail	E&Y	Yes
6	*Banco Popular Portugal*	Private	Non-Listed	Retail	PwC	Yes
7	*Banco Português de Investimento* (BPI)	Private	Listed	Retail	Deloitte	Yes
8	*Banco Angolano de Investimentos* (BAI) *Europa*	Private	Non-Listed	Retail	PwC	Yes
9	*Caixa - Banco de Investimento (CaixaBI)*	Public	Non-Listed	Investment bank	Deloitte	Yes
10	*Caixa Económica Montepio Geral*	Private	Non-Listed	Retail	KPMG	Yes
11	*Caixa Geral de Depósito* (CGD)	Public	Non-Listed	Retail	Deloitte	Yes
12	*Banco BIC Português*	Private	Non-Listed	Retail	Deloitte	Yes
13	*Santander Consumer Finance*	Private	Non-Listed	Consumer credit	Deloitte	Yes
14	*Santander Totta*	Private	Non-Listed	Retail	Deloitte	Yes
15	*Sistema Integrado do Crédito Agrícola Mútuo* (SICAM)	-	-	-	-	No