

**Political interference in financial reporting in the financial industry:
Evidence from Spain**

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Abstract

This paper provides a theoretical background based on legal and political arguments on ‘rights *versus* public interest’ to explain political interference in accounting. This framework goes beyond the traditional political cost hypothesis. We illustrate it by examining the behavior of the newly elected Spanish Government during the financial crisis, by interfering in bank impairment rules in spite of IFRS being in place. We show how after applying the new rules, the industry impairment trend was completely unrelated with the evolution of delinquency, while linked to Government goals. Thus, they allowed the financial sector bailout and avoided the country rescue. We use a highly political connected entity —Bankia— as a case under study, where the interference might have affected the accounting practices as well. We conclude that non-compliance with the accounting rules to achieve economic aims provides a new angle to analyze political behavior and highlight the potential long-term unintended consequences and implications for the global accounting rules adoption.

Keywords: financial sector, earnings management, political interference, Bankia.

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“There was once a time, not so many years ago, when accounting could be thought of as an essentially nonpolitical subject” (Solomons, 1978, p. 65).

Introduction

The redistributive effects of accounting numbers may create incentives to use accounting as a political tool (Alesina & Tabellini, 2004; Wagenhofer, 2014). In fact, politicians may interfere in accounting by different means and, given the financial stability function that banks fulfill in the economy,¹ the political discussion about accounting in the financial industry requires additional analysis.

Regulatory theory provides support for the hypotheses that politicians might opportunistically use accounting to obtain benefits, and that political connections incentivize reporting lower earnings quality. The notion of “public interest” has an increasingly important role in the standard setting process, and governments might be tempted to use it. However, this notion has not been considered from a conceptual angle that justifies the use of accounting as a political tool. In this paper, we build on existing legal and political theories on the public interest (Raz, 1979; Meyerson, 2007) to analyze the reasons underpinning governmental interference in accounting and its consequences. In particular, we document governmental interference by breaking accounting rules and affecting corporate practices.

We illustrate our theoretical reasoning by examining the behavior of the Spanish Government regarding the financial sector accounting during a very complex period — the financial crisis (which, in Spain, spanned the years 2008-2012)— and focus on a highly politically connected bank —Bankia. Indeed, case studies are a valuable tool to understand complex phenomena and to complement other research approaches (e.g. Wilson & Shailer, 2007; Hilton & O’Brian, 2009; Piekkari, Welch, & Paavilainen, 2009, Jorissen & Otley, 2010), and such evidence provides an opportunity to better understand aspects at a micro level (Healy, 2016). Furthermore, cases that show unusual circumstances allow going a step further and help to obtain valuable insight to generate

¹ Pelger (2016) posits that in the aftermath of the financial crisis the objective of financial stability gained importance due to bank regulators’ concerns, although so far it has not been the aim of accounting standard setters.

new and useful knowledge (Cooper & Morgan, 2008; Dyckman & Zeff, 2014). Thus, this methodology perfectly fits our purpose.

Briefly, the context of our analyses is as follows. By the end of 2011 the Spanish debt crisis had not been solved, and the national elections led to a change from the socialist party (*Partido Socialista Obrero Español* —PSOE) to the conservative party (*Partido Popular* —PP). The newly elected Government faced a dilemma between calling for a bailout for the country, as in Greece and Portugal, with all the austerity measures that this solution might convey; or asking for financial help to rescue the weakest financial entities. The Government finally opted for the latter.

However, according to the accounting figures and the most recent stress test, the situation of the banking industry at that time did not show an urgent capitalization need. Despite the lack of capacity to issue accounting standards for consolidated accounts of entities which were under the International Financial Reporting Standards (IFRS) scope, in the first quarter of 2012 the new Government modified the impairment rules for the financial industry, contradicting IFRS, and provoking a huge aggregated loss in the sector in the 2012 financial statements. In addition, in May the Government commissioned two private entities a stress test of the financial system, which was executed in parallel to the official test carried out by the International Monetary Fund (IMF). By showing a much higher shortfall of regulatory capital than the later, the private tests were used as the argument to obtain the commitment of the European Stability Mechanism (ESM) for a bailout of the financial sector.

Before these severe decisions by the newly ruling Government, in 2010, the previous Government had already taken some actions. In particular, it had fostered the merging of weak entities (saving banks), when the crisis of the Spanish financial institutions became rather obvious. Bankia is an emblematic example of this merger activity. Its emergence at the beginning of 2011 was a political decision, and Bankia was first listed in the stock exchange in July 2011. After the newly elected Government published the aforementioned new impairment rules, in May 2012 the executive chair of Bankia, Mr Rato—a former relevant politician—resigned, and a new executive chair was designated. Under the new management, Bankia restated the 2011 income statement, reporting a loss instead of the profit previously reported. As a consequence of the restatement, the control of the entity was transferred to the Government, as equity in the parent company became negative and its contingent debt securities were transformed into shares. Importantly, this

restatement also provoked a sharp drop in shares prices and a criminal lawsuit for false accounts in the initial public offer (IPO). The application of the new impairment rules to the 2012 financial statements thus caused the collapse of Bankia and subsequently, its rescue by the Government, using the ESM credit. Not surprisingly, over the following years not only in Bankia but also in the aggregate financial system the financial situation reversed. An analysis of Bankia income statements show that the changes in accounting earnings are driven by impairments, whose trend from 2011 to 2015 is unrelated with the trend in delinquency (bad debts), as one would expect under International Accounting Standard (IAS) 39.

Our study sheds new light on the interference of politicians in accounting, providing novel evidence and theory. It shows how a government may interfere in accounting standards and practices to achieve its goals. Our findings suggest that the impairments in the Spanish financial industry followed a big-bath strategy consistent with the political cost hypothesis extended by Jones (1991), but our main contribution lies in basing our reasoning in “the public interest” by “breaking the rules” argument. The assumption that politicians boost their votes by intervening in the economy is not new, but the use of accounting rules to that end provides a new angle.

We also contribute to prior research by highlighting the potential consequences of the “use and abuse” of accounting over information comparability and transparency, as well as in the efficiency of capital markets. We conclude that if the European Union (EU) wishes to achieve further progress in financial reporting and to accrue the benefit of the improvements, it would be necessary to carefully consider political institutions and their incentives, including the enforcement mechanisms, as well as to further engage in the global debate on the future development of IFRS.

The structure of this paper is the following. In the second section, we review the previous literature, which conforms our theoretical background. Section three presents the Spanish regulatory and institutional context in the period under analysis. In section four we refer to the case under study, Bankia. In section five we discuss our findings and their link with the literature. Finally, we provide some reflections and suggest implications.

Theoretical background

Accounting and politicians: Previous literature

The quote that introduces this paper suggests that *there was a time when accounting was not political*; however, it is well accepted nowadays that accounting rules have economic consequences (as coined by Zeff, 1978), which necessarily puts some interest groups at an advantage over others. Stakeholders, governments and politicians also have an interest in the accounting figures. Based on the “self-interest” notion, the accounting literature provides theories and empirical evidence which help to understand their incentives to interfere in accounting. They may exercise such interference through several mechanisms, such as issuing accounting rules, lobbying the accounting standard setters, or even controlling the enforcers; and, in some specific circumstances, interfering in the accounting practices by having a stake in firms.

Regulatory theory provides support for the hypothesis that politicians (not necessarily in power) might use accounting to their own benefit. The models developed by Stigler (1971) and Pelzman (1976) emphasize the exchange relationship in which groups of individuals compete for wealth transfers and offer political support in the form of money or votes. Prior work confirms the view that politicians often use their own preferences in deciding whether to maintain or reform the law, try to please voters to win elections, or simply value short-run economic effects while discounting longer-run consequences (Walsh, 2005).

The literature evidences that besides interfering in accounting rules, politicians affect directly the accounting practices in politically connected firms. Political connections have been documented to incentivize reporting lower earnings quality and transparency (e.g. Chaney, Faccio & Parsley, 2011; Leuz & Oberholzer-Gee, 2006; Bona-Sánchez, Pérez-Alemán & Santana-Martín, 2014). Furthermore, national elections have been shown to promote opportunistic behavior in politically connected firms by managing earnings downwards to avoid political scrutiny, and in that way minimize the costs associated for themselves and their affiliated candidates (Ramanna & Roychowdhury, 2010). Elections affect politically connected firms performance (Fung, Gul, & Radhakrishnan, 2015), and might also promote a big-bath strategy —consisting in a one-time overstatement of charges against income to undervalue net assets, which reduces future expenses and increases future income accordingly. This strategy has been identified in non-routine

executive changes in entities; indeed, the new executives' image improves by showing a better performance when they are in charge (Guan, Wright & Leikam, 2005; Pourciau, 1993).

Regarding enforcement, there is evidence on the more permissive attitude of accounting enforcers and auditors towards income decreasing practices in general (Cano-Rodríguez, 2010) and to avoid litigation risks (Qiang, 2007; García Lara, García Osma, & Peñalva, 2009). But additionally, political connections of entities also affect enforcement attitudes as those entities are documented to be less involved on enforcement actions (Correia, 2014).

The public interest and accounting

Public interest objectives are intended to lie at the heart of the standard setting process (IFRS Foundation, 2012), and the endorsement process in the EU makes an explicit reference to the closely related concept of the “European public good.”² Not surprisingly, the public interest has been commonly used as an argument for lobbying; regarding the banking sector there is some anecdotal evidence of European politicians intervening under the ‘public interest’ notion.³ Despite this increasing preeminence of the public interest in accounting, the notion is abstract and can differ among stakeholders and jurisdictions (Abela & Mora, 2012). Although so far there is no research relating it directly with accounting, in our view, the ‘public interest *versus* non-compliance’ discussion provides an interesting angle to analyze the public interest from an accounting perspective. The issue of the public interest as an argument to overrule the law (more specifically, the legal rights) has been extensively analyzed in the field of law and politics. From a legal perspective, it could be argued that governments might behave with the following code:

² This issue has not received much attention. If anything, the idea was that IFRS should not create competitive disadvantages to European businesses (Walton, 2015; Van Mourick & Walton, 2018). However, recently, European politicians are using it to put pressure on policy-makers. For example, in a report commissioned by the EC entitled *Should IFRS standards be more “European”?* Maystadt (2013, p. 9) suggests that the European public interest should be clarified along the lines of “supporting financial stability and economic development”.

³ It is remarkable the pressure that two French Presidents made to the IASB. Firstly, in 2003 with Jacques Chirac, when banks persuaded him to send a letter to the EC to ask the IASB to modify IAS 32 and 39, Secondly, after the financial crisis, French banks persuaded Nicolas Sarkozy to ask René Ricol, a former President of the International Federation of Accountants (IFAC) to give an opinion about how IFRS place European banks in an unfavourable position in relation with their US counterparts.

“Breaking rules can sometimes be justified where there is a legitimate 'public interest.’”⁴

Based on a case study carried out on the legal/political research context, Meyerson (2007) points out that when there is a controversy between legal rights and public interest, most bills of rights allow for the restriction of the former in the interest of the public. We argue that a similar approach could be applied to explain the non-compliance with accounting rules. Although there are substantial differences between “legal rights” and “accounting rules,” in our view the similarities are significant. When there is a conflict between those rules and governmental goals, and specifically, with the public policy objectives (such as providing for economic well-being), the benefits of breaking accounting rules might be seen by politicians as greater than the costs.⁵

It is commonly understood that the economic well-being of a country should be a matter of public interest. Adopting the simile of rules with rights, to break rules in the name of the public interest some criteria must be taken into account. Hence, based on Meyerson (2007): (i) the objective to achieve must be of sufficient importance to warrant overriding a rule; (ii) the mean chosen must be reasonable and demonstrably justified; and (iii) there must be a proportionality between the expected effects of the measure and the importance of the objective (“legitimate aims”). In testing the proportionality criteria, it should be considered whether the measure is likely to be effective in achieving the government’s purpose, whether there are alternative means to achieve the goal without breaking the rules, and whether the cost of breaking the rule is justified by the public interest benefits.⁶ The government then should apply the so-called “balancing approach”(Aleinikoff, 1987), which states that when two principles come into conflict the satisfaction of one must be at the cost of the other and it then becomes necessary to balance the competing interests; thus, different weight has to be given to the conflicting variables. In other words, a cost-benefit analysis is needed.

⁴ As stated in the Conduct Code of a newspaper, *The Independent*. Available at <http://www.independent.co.uk/service/code-of-conduct-a6184241.html> (accessed 20 December 2017).

⁵ From Charter of Human rights and responsibilities Act 2006 7(2) where we have changed the original word “right” for the word “rule” and “limitation” (of the right) for “infraction” (of the rule).

⁶ These conditions are based on those stated in the European Court of Human Rights to justify a restriction of a right in a democratic society: Chapter of Human rights and Responsibilities act 2006 (Victorian Chapter).

However, there are limitations when applying this balancing approach. Referring to the dispute between legal rights and governmental goals, Meyerson (2007) emphasizes that self-interest and ideology might influence the weight given to the alternatives, and, when determining which of the competing considerations has more weight, it is (wrongly) assumed that there is a homogenous measurement criterion to analyze the consequences, which makes alternative courses of action comparable.

Besides governments, other actors might have a role when a potential decision to break rules is at stake, as for example enforcers or judges. Based on Raz (1979, 1995)'s arguments, we consider two levels of decision making in the conflict between rules (legal rights according to Raz's thesis) and governmental goals. In the first-order reasons, the government uses the balancing approach to give weights to the alternatives and decides what ought to be done based on a balance of reasons. But, some other decisive players might make decisions based on second-order reasons, including what Raz (1979) refers as exclusionary reasons. This happens, for example, when someone does not perform an action according to her first order balance of reasons, as the action is altered by the great weight given to a practical authority's previous decision. Consequently, the second-order reasons lead to refrain from acting according to one's own view of what should be done, which would be more likely the less independent the player is from the practical authority.⁷

Furthermore, one should also keep in mind that governmental goals are not necessarily synonymous to the public interest notion. Under the agency framework the government is an agent that should work in the interests of citizens, the principal, but it may instead attempt to maximize its own utility and act in its own interest.

This theoretical background, which has not been considered before in the accounting field, together with the traditional political costs hypothesis and empirical evidence, provides a framework for analyzing the interference of the Spanish government in the accounting for financial entities. It also helps to understand the accounting decisions made in highly politically-connected banks in extreme circumstances, where Bankia is a most remarkable case.

⁷ Raz (1995) gives the example of a soldier who is ordered to do something by her commander that she thinks is not justified in her own balance of reasons. Being in a second order position would prevent the soldier to consider some relevant considerations that she would otherwise have taken into account, tipping in favor of the action.

Institutional and regulatory context

This section describes the significant events at the institutional and regulatory level that took place in the period under analysis, which are summarized in the Appendix. Figure 1 line A provides a timeline for the general events, and line B provides a timeline of Bankia-related events.

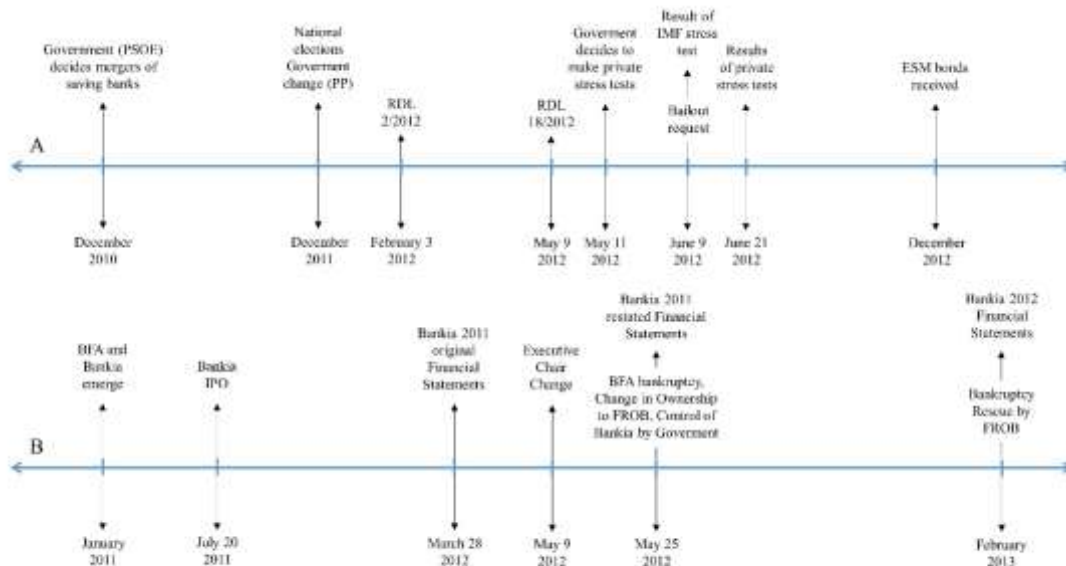


Figure 1: Timeline of the general events (A), and Bankia-related events (B). This figure is not in scale.

The saving banks and the financial crisis

Spanish saving banks (known as *Cajas*) are private institutions owned by foundations and do not issue shares. Originally, they were small, funded only with deposits and retained earnings. Their activity was limited to their geographical regions, and their governance structure was based on representatives of the local stakeholders and regional governments, which had broad powers over them. Between 1997 and 2007 saving banks expanded and became heavily involved in the real estate and construction sectors; to the extent that in 2007 their loans to these sectors exceeded those by banks. For years, the real estate bubble masked serious credit quality problems and a deterioration in leverage and financial margins (Ruiz, Stupariu, & Vilariño, 2016) as well as serious design flaws in the *Cajas* governance structure (Santos, 2014).

During the third quarter of 2008 the Spanish economy suffered a recession, as the General Domestic Product (GDP) contracted for the first time in 15 years. In 2009 the

Government, at that time drawn from the socialist party (PSOE) established the Fund for Orderly Bank Restructuring (*Fondo de Reestructuración Ordenada Bancaria* — FROB) under its direct control, with the purpose of solving bank problems and restructuring financial entities in difficulties. In 2010, when the crisis of the *Cajas* was rather obvious, the Government decided, jointly with the Bank of Spain (Banco de España —BdE) on a series of mergers of these entities. The aim was to increase entity sizes, protect weaker entities and improve efficiency. FROB provided finance to the merged entities by investing in special bonds issued by them. The bonds were subordinated debt ‘contingent to comply’ with equity requirements (what explains their popular name, COCOs), so they would be converted into shares if necessary.⁸ Among those mergers, the one which originated Bankia was the most notable due to its size.

Despite these measures, in the second half of 2011 the debt crisis had not been solved. As in other countries (Greece, Portugal, Ireland, and Cyprus), Spain was unable to repay or refinance its governmental debt or to bail out over-indebted banks under their national supervision.

As mentioned in the introduction, the December 2011 national elections led to a change from the socialist party (PSOE) to the conservative party (PP). The newly elected Government faced a dilemma between calling for a bailout for the whole country or asking for a specific type of financial aid which would allow the recapitalization of banks. This second option was chosen. Notwithstanding this, it should be kept in mind that according to the 2011 accounting earnings, as well as the stress tests performed by the European Banking Authority (EBA)⁹ in the summer of 2011 (referred to December 2010 figures), Spanish banks were “safe” at that time. To understand how the Government got this financial support under those circumstances, next we refer to the regulatory context on loan impairments for the financial industry, as well as the extraordinary intervention of the new Government on those rules.

⁸ From the accounting perspective, this type of bond is a liability, but from the prudential perspective is considered regulatory capital. Consequently, COCOs helped the new entities to comply with minimum capital requirements, as stated in prudential rules.

⁹ The results of the stress test are available at: <http://www.eba.europa.eu/risk-analysis-and-data/eu-wide-stress-testing/2011/results> (accessed 20 December 2017).

Impairments in the Spanish financial industry: Bank of Spain (BdE) versus IFRS

The adoption of IFRS in Europe had a considerable impact on bank accounting. Contrary to pre-IFRS practices in most EU banks, IAS 39 (IASB, 1999) imposed an incurred loss model, which only allows recognizing incurred losses derived from past and present events, and explicitly excludes the recognition of the expected effect of future events. Consequently, the trend of impairments recognized in the income statements should be quite similar to the trend in the macroeconomic variables (such as growth or unemployment) and delinquency, that is, bad debts.

Even though the new EU strategy —as stated in EU Regulation 1606/2002— refers to the consolidated statements of all listed entities, BdE retained the delegated power from the Government to issue accounting standards (*Circulares*, in Spanish) for the financial industry even for consolidated purposes. BdE issued *Circular 4/2004* to “accommodate” the local rules to IFRS, but the resulting rules on loan impairments do not comply with IAS 39. BdE impairment model is based on the rationale that the allowance for impairment and the prudential provision are equivalent. This allowance/provision has two components, “generic” and “specific.”

The generic component is used as a countercyclical mechanism, which is internationally known in the banking jargon as the “Spanish dynamic provision.”¹⁰ It aims to create a buffer during a boom period against future losses, and its main consequence is earnings smoothing through the cycle, which clearly contradicts IAS 39 as some authors and standard setters have argued (Barth & Landsman, 2010; Bushman & Williams, 2012; FASB & IASB, 2009; Hoogervorst, 2012). This countercyclical mechanism worked as expected during the first years of the financial crisis. Thus, although in 2008 the delinquency rate in the Spanish financial industry grew to converge with European figures, and by 2010 the Spanish financial system was in serious trouble (Maudós, 2011), the earnings figures disclosed by the Spanish financial industry covered up their financial difficulties. Consequently, in June 2011, judging by the stability of accounting earnings, the health of the Spanish banking system was better than the average European bank (Carbó & Maudos, 2011), but there were some concerns about the future, as the cushion

¹⁰ BdE was traditionally in charge of monetary and supervisory policies. The euro adoption in 1998 led to a tremendous credit expansion, while BdE had no instruments to react. To deal with the situation BdE introduced the dynamic provisioning system (García-Herrero & Fernández de Lis, 2008).

started to disappear. Had the generic component not been recorded, many entities would have started to report accounting losses earlier.¹¹

The specific component of the impairment allowance, which is estimated using the rules established by BdE, is linked to different types of investments. While some are non-performing loans (clearly bad debts), which are identified (individually or collectively) and have suffered an incurred loss, others are not. These other loans are internally classified as “under-performing” (substandard) or even “performing,” which are loans that do not have financial problems at present. Although most of these loans would not lead to the recognition of an impairment under IAS 39, they do following BdE rules (Oliver Wyman, 2012a). The classification as non-performing, underperforming, and performing, as well as their allowances (provisions), is monitored by BdE, but there is no public information in the annual financial statements about it. Furthermore, the so-called specific allowance under BdE rules has a component which might be easily managed (either by rules or in practice) and is not necessarily linked with incurred losses.

The 2012 Royal Decrees Laws

The political interference of the Government in the accounting standards reached a peak in 2012. With the aim to restructure the “weak” financial sector, the newly elected Government bypassed BdE and issued two Royal Decree Laws (RDL), on February 3 and May 11, which modified the accounting rules to estimate the loan allowance/provision, which should also be applied to consolidated statements. These RDLs required to compute a larger specific allowance by increasing the percentages to be applied to all investments (loans) linked with real state, even if they had not any evidence of being impaired at all, that is performing loans (a loss of 7% of its contractual value was required

¹¹ In April 2009, during a meeting of the International Organization of Securities Commissions (IOSCO) monitoring board, which oversees the IASB trustees, the European Commission internal market commissioner at the time, Charles McCreevy, said he knew that Spanish banks were violating the board’s rules. Thus, he stated: “*They didn’t implement IFRS, and our regulations said from the 1st January 2005 all publicly listed companies had to implement IFRS, ... The Spanish regulator did not do that, and he survived this. His banks have survived this crisis better than anybody else to date. ... The rules did not allow the dynamic provisioning that the Spanish banks did, and the Spanish banking regulator insisted that they still have the dynamic provisioning. And they did so, but I strictly speaking should have taken action against them.*” ... “*Why am I like that? Well, I’m old enough to remember when I was a young student that in my country that I know best, banks weren’t allowed to publish their results in detail... Why? Because we felt if everybody saw the reserves, etc., it would create maybe a run on the banks.*” Available at http://www.iosco.org/monitoring_board/pdf/meeting20090401.pdf (accessed 20 November 2012). Also available at <https://www.bloomberg.com/view/articles/2012-06-14/the-eu-smiled-while-spain-s-banks-cooked-the-books> Jonathan Weil (14 June 2012) (accessed 15 June 2013).

by RDL 2/2012, which was increased to 30% by RDL 18/2012).¹² Moreover, RDLs stated that the impact of this policy change should be considered a “change in estimation” and be recognized in the 2012 net income (or partly delayed to 2013 if there were merger and acquisitions — M&A¹³). This treatment is contrary to IAS 8 (IASB 1978a), as those policy changes should impact equity and not net income¹⁴ (Giner, 2014).

Some figures may help to appreciate that the trend of impairments recognized by Spanish financial entities in their accounting earnings in the period 2006-2015 is inconsistent with the evolution of bad debts. The two lines in Figure 2 illustrate that the delinquency and impairment rates follow different patterns (year 2006 = 100). Although the bad rate grows continuously till 2013, when the delinquency rate was at its maximum,¹⁵ the impairment rate behaves differently. This is specially the case since the beginning of the financial crisis in 2008; the smoothing of impairments due to the Spanish dynamic provision is clearly visible in 2009-2011, while the peak in 2012 captures the huge impairments imposed by the Government through the two RDLs.¹⁶

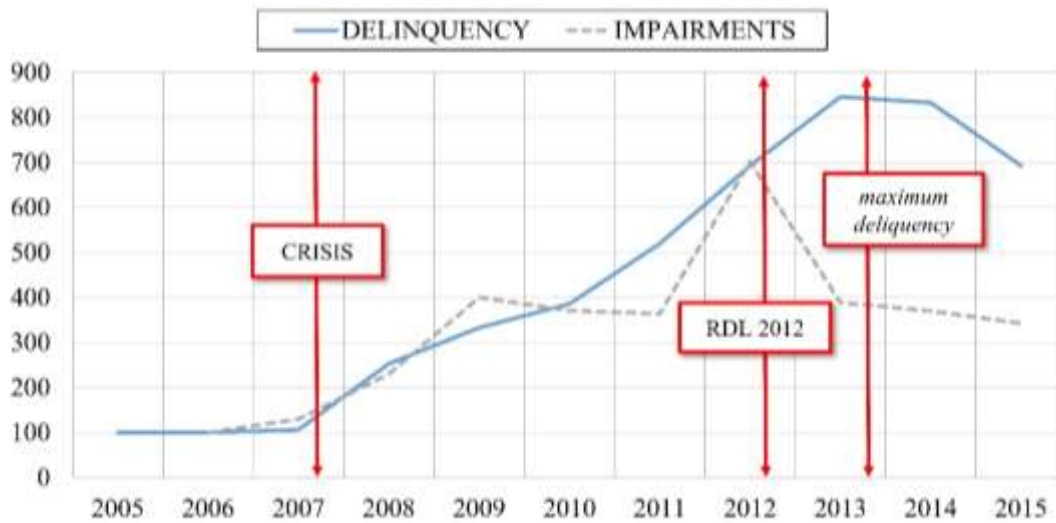
¹² Six years after these events, banks are claiming the Government to delete the RDLs and allow them to reverse the still existing non-incurred losses recognized in the allowances/provisions. Available at: <http://www.expansion.com/empresas/banca/2018/02/18/5a89b08446163f45448b459e.html> (accessed 20 February 2018).

¹³ This is indeed an incentive to promote those transactions, and once again evidences the use of accounting as a political tool.

¹⁴ According to IAS 8 a change in accounting policy due to a rule change by another standard setter other than the IASB will be always considered voluntary (IASB, 1978a, para. 21) and will impact equity of the reporting period when the change in the rule happens.

¹⁵ According to BdE, the delinquency rate was the maximum in the last fifty years (BdE, 2013) <https://www.bde.es/f/webbde/Secciones/Publicaciones/InformesBoletinesRevistas/InformesEstabilidadFinanciera/13/IEF-Noviembre2013.pdf> (accessed 20 December 2017).

¹⁶ The aggregated information in the figures refers to commercial banks and does not include the *Cajas*. Nevertheless, most of them disappeared between 2010 and 2012 due to the mergers, and after that date due to the bankruptcy caused by the application of the RDLs.



Index 100 = 2011

Source: Authors, based on information from AEB which refers to commercial banks and does not include *Cajas*.

Available at: www.aeb.es and the Financial Stability reports issued by the BdE. Available at www.bde.es

Figure 2: Delinquency and impairment trend in commercial banks

As a consequence of the application of the two RDLs, in 2012 there were huge impairments which provoked an aggregate negative net income of €1,653 billion in the commercial bank sector, and subsequently, given the drastic reduction in impairments produced aggregated profits of €9,344 billion in 2013, €11,574 billion in 2014 and €12,647 billion in 2015.¹⁷

Surprisingly, despite the application of the dynamic provisioning and the requirements to record the specific allowance introduced by the two RDLs, financial institutions did *not* receive qualified auditors' reports for non-compliance with IFRS. Furthermore, it seems these practices were also well accepted by the enforcer, the securities and exchange commission (*Comisión Nacional del Mercado de Valores* — CNMV).

Stress tests and bailout of the Spanish financial system

As part of the Financial Sector Assessment Program (FSAP) that the IMF performs regularly,¹⁸ during the first months of 2012 a team led by IMF in cooperation with BdE made an assessment of the Spanish financial sector, which included a stress test. A

¹⁷It excludes the existing saving banks and commercial banks resulting from saving banks mergers. Source www.aebanca.es

¹⁸ At that time, it was performed every 5 years and was mandatory for 25 countries

preliminary brief report was published on April 25 (IMF, 2012a).¹⁹ In May 2012, after issuing the second RDL, the Council of Ministers required an additional stress test to private consulting firms, to be run in parallel to the IMF analysis.²⁰

The purpose of a stress test is to assess the resilience of the financial system under adverse macroeconomic conditions. It requires forecasting portfolio expected losses under various macroeconomic scenarios to be compared with the loss absorption capacity of the banks under examination. To that end, both performing and non-performing loan portfolios are considered. As pointed out by Oliver Wyman (2012a) the stress tests are conducted from an economic—as opposed to an accounting—perspective of the bank. As such, stress tests usually focus on the economic concepts of expected loss and stress loss as opposed to the accounting-based identification of an incurred loss. Expected losses are losses that may reasonably occur over a specified future period which should be specified in the test (usually 2 years). On the contrary, stress (expected) losses refer to future loss levels that might occur if a stressful—albeit unlikely—macro business environment is realized (Oliver Wyman, 2012a).

In June, the final results of both analyses were reported. The IMF analysis concluded that to be able to cover future losses for the analyzed period, and still be able to comply with capital requirements, the financial sector had a regulatory capital shortfall of €10 billion in a base scenario, and €37 billion in a stress scenario (IMF, 2012b). The two consulting firms reported larger figures in both scenarios, between €16 and 26 billion in a base scenario, and €51 to 62 in a stress scenario (Oliver Wyman, 2012a; Roland Berger, 2012).²¹ Given the extreme assumptions about the deterioration in the macroeconomic factors that the private tests introduce, and the fact that they cover a three-year period, 2012 through 2014, as compared to a two-year horizon of the IMF test, the large differences in results are not surprising (Promontory, 2012).

¹⁹ Available at <https://www.imf.org/en/News/Articles/2015/09/28/04/52/mcs042512> (accessed 20 December 2017).

²⁰ According to the information published in the press releases of the Ministry of Economy official website, the Government and BdE agreed the 21st of May 2012 to contract Roland Berger and Oliver Wyman. See: www.mineco.gob.es/yma (accessed 20 December 2017).

²¹ The baseline scenario projects a recession in the first two years and a slight recovery in 2014. The adverse scenario projects a continuing recession over the three-year period. A BdE report comparing the results of the two private entities tests is provided in: https://www.bde.es/f/webbde/GAP/Secciones/SalaPrensa/InformacionInteres/ReestructuracionSectorFinanciero/Ficheros/en/background_proc_eval.pdf (accessed 20 December 2017).

Based on the shortfall of regulatory capital reported in the stress scenario by the private tests, the Spanish Government formally requested financial assistance from the European Financial Stability Facility (EFSF) to support the restructuring and recapitalization of its financial sector; the Eurogroup approved the bailout, granting an amount up to €100 billion to be used if and when necessary. The responsibility for providing the funds was transferred to ESM. The final amount used from this credit was about €40 billion which were received by FROB at the end of 2012 in the form of ESM bonds to be directly invested in the Spanish banks (avoiding to add such amount to the Spanish sovereign debt). A large part of the total amount would be devoted to Bankia as we discuss in detail later.

Bankia case

As explained in the introduction, the special circumstances that surrounded Bankia make this case emblematic, and explain our choice as a case to study: (i) It was “too-big-to fail,” so it survived its collapse through nationalization; (ii) it had political connections with the Government through ownership; and (iii) as in Gabbioneta, Greenwood, Mazzola, and Minoja (2013), due to its involvement in a criminal lawsuit,²² we have had access to additional information from the trial which would not be accessible otherwise.²³ While the lawsuit—and the book value of Bankia equity when emerged—is beyond the scope of this paper, it has provided us with useful material that helps us to understand what happened “behind the scenes” in 2012. Table 1 summarizes the main data sources.

²² The case was presented by *Unión Progreso y Democracia* (UPyD) the only party which had no representative in the seven saving banks that formed Bankia, and consequently in the entity. The suit was against Bankia itself and its parent BFA, as well as their board members (even if they did not formulate the initial financial statements, and those included in the IPO brochure), some managers, the auditor, and even executives of some institutions, in particular from CNMV and BdE. The representatives of BdE and CNMV were excluded by the judge, with the subsequent claim of the accusation to a superior Court. Although the public prosecutor’s office has recently decided not to proceed against anyone for false accounting, contrary to what happens in other countries, in Spain it is not the public prosecutor but a judge who is in charge of the investigation phase, and who decides to proceed with the accusation.

²³ Despite most of the trial documents are available at public domains, should anything not be found, it is available upon request to the authors.

Table 1: Bankia data sources

Data source	Description
Company corporate website	<ul style="list-style-type: none"> - Consolidated interim accounts 2011 - Consolidated Annual Accounts 2011-2015 - Quarter reports 2012
CNMV Official Register	<ul style="list-style-type: none"> - IPO Brochure - Relevant Facts announced by the entity
Trial documents	<ul style="list-style-type: none"> - Transcripts of the hearings - Bank of Spain Supervisors reserved reports (13th April and 11th May 2012) - Draft of the Auditing report to the initial 2011 accounts (before restatement) - Reports from the experts (2 inspectors from the staff of Bank of Spain) designated by the Judge in charge of the trial
Others	<ul style="list-style-type: none"> - News from the newspapers

Creation and debut on the stock exchange

Bankia was the result of a rather complex financial structure. First, in December 2010 a new entity BFA was created to carry out business for seven saving banks, which remained as BFA owners. Second, although BFA received funds from FROB in the form of COCOs, it did not comply with the regulatory capital requirement as established by the Spanish legislation at that time (as stated in RDL 2/2011 the required capital ratio for non-listed entities was 10%, and 8% for listed; BFA ratio was 7.1%). Thus, BFA went for the less demanding option in the legislation and created the subsidiary Bankia to be listed on the stock market. The profitable banking business was concentrated in the subsidiary Bankia, while the parent BFA kept the most toxic assets as well as the subordinated debt (including the COCOs owned by FROB). As mentioned earlier, Figure 1 line B captures the main events that took place in Bankia during the period under study.

The decision to create Bankia was strongly monitored by the Government (the socialist party) through BdE and CNMV.²⁴ BdE approved the strategy of listing Bankia in the stock exchange, making its positive advice public in the CNMV website. At the

²⁴The independence of BdE and CNMV has been questioned by IMF (IMF, 2012a).

same time, CNMV also monitored the entire process. Deloitte, who was the auditor of BFA and Bankia, issued a clean report on the Bankia interim consolidated statements as of March 31 2011, whose figures were included in the IPO brochure. Furthermore, as required by the Spanish law, two independent valuation experts (BDO and International Financial Analysts — AFI) reviewed the asset values. These financial statements, as well as those of the seven saving banks before the merger, received clean auditors' reports (by Deloitte in the two largest *Cajas*, representing 90% of the merger). Subsequently, on July 20 2011 Bankia was trading in the stock exchange.

As with all the other mergers of *Cajas*, BFA emerged using fresh start accounting. Therefore, the assets and liabilities from the previous saving banks (mostly measured at cost) were re-measured at fair value on the business combination date, December 31 2010. Consequently, there was a negative adjustment of €6.4 billion (net of the tax effect) which reduced the aggregate equity of the *Cajas* about 43% (the gross adjustment to loans was close to €6 billion which increased the impairment allowance). Most of these assets and liabilities were transferred to the subsidiary Bankia with effect of 1st January 2011, which was the starting date for accounting purposes.

The Bankia interim consolidated report as of March 31 2011 included in the IPO brochure showed a positive net income of €64 million. After negotiations with institutional investors prior to the official listing, the share price had a discount of 70% on book value. Bankia obtained just €3 billion from the non-controlling investors, but it was enough to comply with capital requirements. BFA, and hence the *Cajas* (whose boards were controlled by local authorities) kept 52.40% and the control of the entity.

A few days after the IPO, the 2011 interim report of Bankia corresponding to the first half of the year (referred to June 30) was announced, showing a consolidated net profit of € 234 million and a clean auditors' report.

The 2011 Annual Financial Statements

The 2011 Bankia statements were originally issued on March 28 2012, showing a consolidated annual profit of €307 million. According to the BdE financial stability reports, the second half of 2011 had not been much different from the first in terms of the trend in delinquency. Consequently, there were no reasons to expect a different impairment pattern in the second half compared to the first. The impairments recognized by Bankia in the 2011 first and second half were similar, as also happened in the other

big financial institutions.²⁵

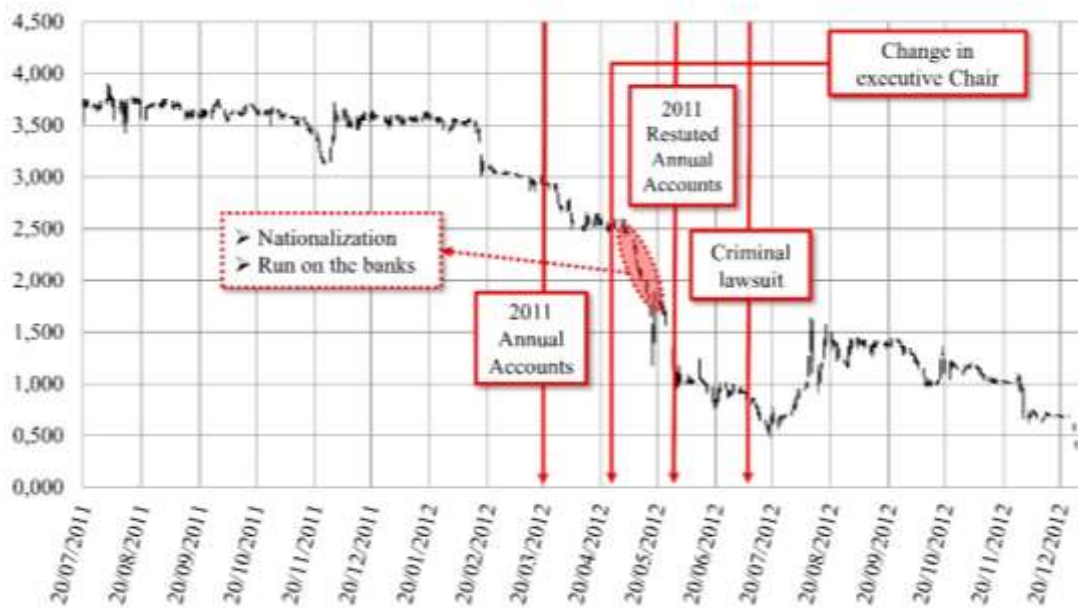
However, as explained earlier, in February 2012 the Government issued the first of the two aforementioned RDLs (RDL 2/2012) and BdE required financial entities to present a report with an estimation of its impact and, if that was the case, their plan to restate the regulatory capital (deadline end of March 2012). BFA, as the parent entity of the group which included Bankia, was obliged to make these calculations and presented a plan. This plan was approved by BdE on April 13.²⁶

Notwithstanding, the 2011 auditors' report of Bankia (and the one of its parent BFA) was no available when the financial statements had to be handed out to the CNMV, the end of April. The media started to make conjectures about the reasons for that breach. Bankia share price dropped dramatically, losing 90% of its value. Subsequently, Bankia's customers withdrew large amounts of deposits,²⁷ which provoked "a bank run" in spite of the Government's calls for calm. On May 9, the second RDL was issued (RDL 18/2012) and Bankia executive chair, Mr. Rato, resigned, and was replaced by a new chair with a high technical profile, Mr. Goirigolzarri, who had been a former CEO of a Bankia competitor (BBVA). Figure 3 displays Bankia share prices until December 2012. As the relative flat line shows, prices were more or less stable until the described events in May 2012.

²⁵ The three other largest banks in Spain, Santander, BBVA and CaixaBank show in their interim and annual consolidated income statement 2011 this similar pattern in the first and second semester 2011, see the corporate webs: www.gruposantander.com, www.bbva.com, ww.lacaixa.com

²⁶ Although conditional on changes in the governance of the parent entity BFA to more professional members and to strengthen its balance sheet. This very same recommendation was given by IMF—in collaboration with BdE—in its preliminary report on the assessment of the financial sector on April 25 2012 (IMF, 2012a).

²⁷ As indicated in the 2012 first and second quarter reports, the loss of about €20 billion deposits from customers in the following days was compensated with BdE deposits. In <http://www.bankia.com/es/accionistas-e-inversores/informacion-economico-financiera/informes-financieros/2012> (accessed 20 December 2017).



Source: Authors, based on information available at www.invertia.com

Figure 3: Bankia market prices

The reasons why the auditor’s report was missing remain unclear. According to the trial documents, on March 27 2012 –one day before the first reporting of the 2011 Bankia Financial Statements showing a profit of €307 million–, the auditor himself presented these statements to the auditing committee of the entity. As stated in the experts’ reports designated by the judge,²⁸ no comments about potential problems neither in the Bankia accounts nor in his report were mentioned by the auditor at that moment. Among the trial documents there is also a draft of a clean audit report referred to the 2011 Bankia consolidated Financial Statements which presumably was received by the entity in April 2012, and a BdE private report dated May 11 2012, which sustains: “*It was not expected*

²⁸ After having analyzed all the minutes and documents of the Bankia auditing committee and board meetings that took place on March 27 and 28 respectively, the experts state: “*It is notable that (the auditor) in the presentation to the Auditing Committee in March 2012 does not mention any potential reclassification of loans from performing to underperforming not even as information pending of reception neither as an aspect to discuss with the managers... In the Board meetings of Bankia on the 28th March 2012 when the 2011 accounts were presented the board members were informed that the auditor would issue the auditing report when the Bank of Spain approved the capitalization plan and he received the pending information from the managers, but there was not any mention to a potential qualified report... The documents we examined indicate that the auditor had finished the auditing work in March 2012 including loans, and only the analysis of some real estate investments was pending to finish the work and issue, predictably, a clean report.*”

by the auditor to issue a qualified report".²⁹ These documents introduce serious doubts about the auditor intention to give a qualified opinion to the 2011 Bankia Financial Statements originally issued in March, but the definitive report was not issued. Furthermore, the auditor did not comply with the legal obligation to send a letter informing about the reasons that explained the lack of report to the auditors' supervisory body, *Instituto de Contabilidad y Auditoría de Cuentas* (ICAC), nor to the public, as required by the Spanish legislation (RD 1517/2011).

It is worth to highlight that ICAC, which depends on the Ministry of Finance, opened an investigation to Deloitte for the auditing work related to the Bankia interim accounts of March 31 2011 (included in the IPO brochure) and those of June 30 2011 —both prepared when the socialist party was in power. This enquiry concluded in 2016 with a monetary sanction against the audit partner of Bankia and the auditing firm due to (i) lack of independence as the firm had participated in the preparation of these accounts, and (ii) not having obtained sufficient evidence. Interestingly, this investigation did not cover the auditing of the annual 2011 Financial Statements of Bankia, in spite of the controversy of the restatement which we discuss below.

The 2011 Restated Financial Statements

On May 25 2012, two weeks after the new Chair designation, the 2011 Bankia Financial Statements were restated adding more than €3 billion of impairment losses, basically 'specific impairments collectively assessed' to the consolidated earnings, while the amounts of non-performing loans reported in the two set of financial statements were the same. Table 2 provides some relevant figures taken from the Bankia consolidated income statements.

²⁹ Although he mentioned concerns regarding the measurement of Bankia shares and deferred tax assets in the parent BFA individual accounts.

Table 2: 2011 Annual Consolidated Income Statement of Bankia: Initial versus restated amounts

(€ millions)

Concept	28 March 2012	25 May 2012 (restated)
Gross Margin	4,098	4,098
Income before impairments and provisions	1,658	1,658
Impairments (net)	(1,135)	(3,373)
Provisions (liabilities)	144	(152)
Other impairments and changes in value	(283)	(2,433)
Tax	(77)	1,330
NET INCOME	307	(2,978)

Source: Bankia 2011 (Restated) Consolidated Financial Statements

The restatement was justified based on the current (May 2012) state of the economy, the new legislation (2012 RDLs), recommendations from the IMF in the preliminary report published on April 25 about improving governance and strengthening the balance sheet of BFA group (IMF, 2012a), as well as “unexpected events” (without specifying which were such events).³⁰ However, according to IAS 8 (IASB, 1978a) and IAS 10 (IASB, 1978b) whatever the unexpected loss provoking event, it should affect the 2011 net income if and only if it had happened during that year, 2011 (equity if it had taken place in previous years). We understand that the 2012 events showing circumstances which happened after the reporting date (the state of the economy in May 2012 or the 2012 RDLs) should not have any impact before 2012.

According to an internal auditing report by the Independent Evaluation Office (IEO) of the IMF (Véron, 2016), the release of the IMF preliminary report which was used as the main argument for that restatement, was controversial as it was published at the Spanish Government’s request, which is unusual practice.³¹

The restatement of the 2011 Bankia Financial Statements brought several immediate consequences. The parent BFA statements were restated as well.³² Although after the

³⁰ Note 1.11 of the 2011 Bankia Financial Statements, in <http://www.bankia.com/recursos/doc/corporativo/20121001/ingles/annual-report-2011.pdf> (accessed 20 December 2017).

³¹ Footnote 78 of the report states that this information is “Based in an interview with IMF Staff”, in http://www.ieso-imf.org/ieso/files/completedevaluations/EAC_BP_16-02_10_Financial_Sector_Aspects%20v3.PDF (accessed 20 December 2017)

³² As stated in BFA 2011 Financial Statements, the adjustment in the individual financial statements was due to the impairment of Bankia shares, whose cost was €12 billion, being the new value 52% of the book

negative adjustments, Bankia equity was still positive (totaling €11.5 billion), and complied with the prudential capital requirements, BFA equity became negative. This entailed the conversion of the COCOs into shares and resulted in FROB becoming the owner of 100% of BFA; as BFA owned 52.4% of Bankia, FROB started to control this entity as well. In other words, as a consequence of the restatement, the control of Bankia through its parent BFA was transferred from the regional authorities (through the saving banks) to the national Government (FROB).

Stress tests and regulatory capital needs

In parallel to the events described, both stress tests, the official IMF and the private tests, were being carried out. As already mentioned, their results were published in June 2012, but do not provide entity-specific results. Regarding the private tests, only the Oliver Wyman (2012a)'s report gives entity details, and states that the BFA group had an estimation of expected losses for the following three years (2012-2014) of €9.8 billion in a base scenario and €23 billion in an adverse scenario (stress losses), which could not be absorbed by existing accumulated provisions/allowances. Considering the capacity to absorb those losses with future profits and existing capital buffers (negative in the case of BFA after the restatement), the regulatory capital shortfall of BFA group for those three years was €13.2 billion in a base scenario and €24.7 billion in an adverse scenario. This last amount was reduced to € 18 billion later on.³³

In summary, in the most likely estimated scenario for the next 3 years (considering a recession in 2012 and 2013 and a small recovery in 2014) the expectation of loan losses accumulated during those 3 years by the BFA group would be around €9.8 billion. This is not what happened in BFA, and specifically, in Bankia, as we explain below.

Impairments in the 2012 Financial Statements, bailout and later on

While at the beginning of 2012 Bankia had positive equity, in 2012 Bankia reported an accounting loss of €19.2 billion which led to its technical bankruptcy, and subsequent rescue by the Government using the ESM bonds. The huge loss was caused by the

value of Bankia equity. Impairments of BFA loans were not adjusted in the restatement. In http://www.bfatenedoradeacciones.com/estaticos/bfa/Informacion_financiera/Informes_anuales/adjuntos/BFA_Informe_Anuar_2011.PDF (accessed 20 December 2017)

³³ According to the Notes in the 2012 Bankia Financial Statements, Bankia. In <http://www.bankia.com/recursos/doc/corporativo/20130312/ingles/cuentas-informe-auditor-ingles.pdf> (accessed 20 December 2017).

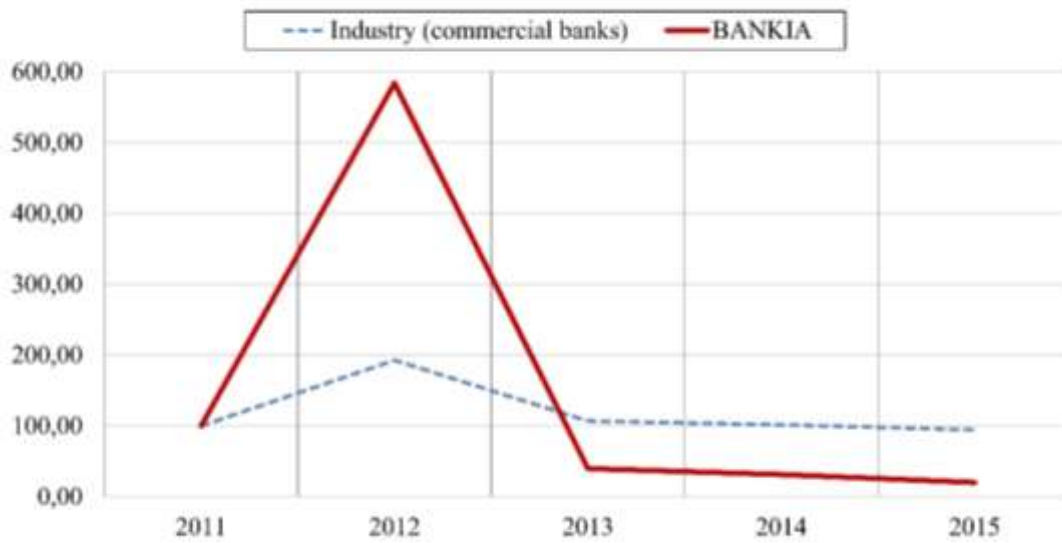
recognition of €18.9 billion impairments (mostly loan impairments), which according to the entity were due to the two RDLs. We think it is useful to compare the impairment losses reported by Bankia with (i) the aggregate impairment losses reported by the industry, and (ii) the expected losses estimated by Oliver Wyman (2012a) for the period 2012-2014.

As Figure 4 displays, commercial banks increased their recognized impairments in 2012 by about 75-100% compared with the previous year,³⁴ mainly due to the application of the two RDLs. However, the increase in Bankia was fivefold³⁵ (i.e. 484%). To have a deeper understanding of Bankia losses, in Figure 5 we compare the trend of non-performing loans with those in the industry. That comparison does not suggest major differences in the trend between Bankia and commercial banks. The enormous difference in the 2012 impairment figures does not appear to be explained by the difference in investments between saving banks (i.e. the founders of Bankia) and commercial banks in prior years, either. As stated by Carbó and Maudós (2011), in 2009 the exposure to real estate risk was 69.3% in savings banks and 53.2% in commercial banks.³⁶ Furthermore, given that when recording the business combination, dated 1st of January 2011, assets were measured at fair value, which implied a reduction in BFA equity of 43%, is even more surprising the huge loss recorded just a year later by Bankia. It should be kept in mind that fair value captures the expected losses which were not recognized in the old *Cajas*, while in commercial banks assets were measured at cost. This difference goes against explaining the larger loss recognized in Bankia vis-à-vis the other banks.

³⁴ For example, BBVA 89%, Santander 68% and Caixabank 71% (although Caixabank was engaged in a business combination, and partially delayed the loss to 2013).

³⁵ It could well have happened that this much more significant impact of the RDLs in Bankia compared with commercial banks not only occurred in Bankia, but in other old *Cajas* as well; AEB excludes *Cajas* as well as banks resulting from their mergers from its analysis. Nevertheless, it is not our purpose to compare Bankia with other *Cajas*, as we are using Bankia as representative of (most of) them.

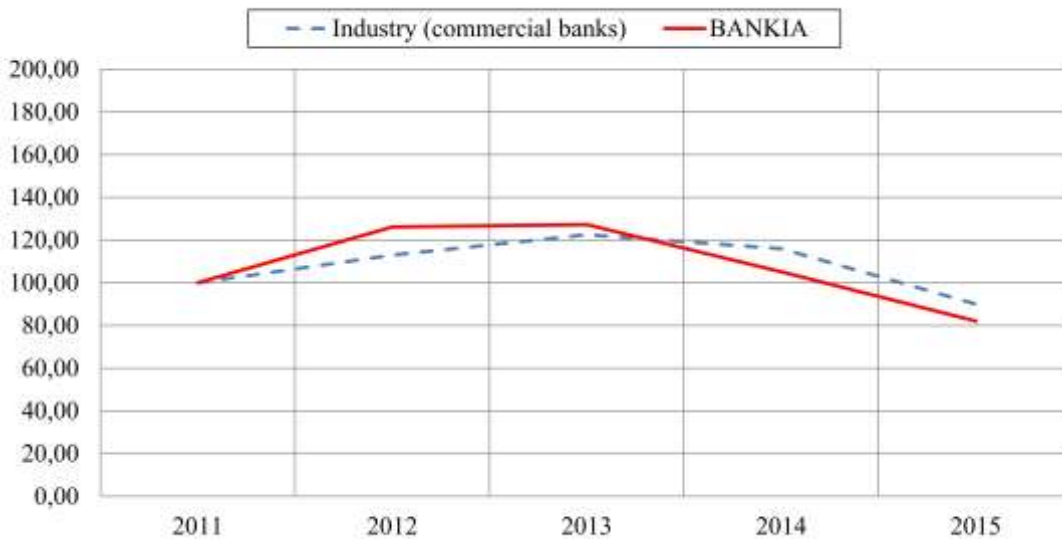
³⁶ According to the 2011 BdE financial stability report, while in 2011 the investment in real estate by saving banks was almost double the investment by commercial banks, those classified as “toxic assets” were slightly more than double in saving banks than in commercial banks.



Index 100 = 2011

Source: Authors, based on Bankia Annual Accounts and information from AEB. Available at: www.aeb.es

Figure 4: Impairments: Industry versus Bankia



Index 100 = 2011

Source: Authors, based on Bankia Annual Accounts and information from AEB. Available at: www.aeb.es

Figure 5: Delinquency: Industry versus Bankia

The comparison of Oliver Wyman (2012a)'s expectations for the most likely scenario in the three-year period (2012-2014) with losses recorded in the 2012 Income Statement of BFA group, which includes Bankia (separate details of Bankia are not reported), is

shocking. The €9.8 billion expectations which should have been allocated to the three years became €18.4 billion of impairments (net of reversals) just in the 2012 BFA income statement,³⁷ almost entirely coming from Bankia. Either the consulting entity was not accurate, neither in the amount nor in the timing of their expectations, or BFA (Bankia) reported excessive losses in 2012.

After the huge loss recorded in 2012, it is not surprising that later impairments were dramatically smaller, so that the trend is below Bankia's competitors, as Figure 4 shows.

To better understand the changes in Bankia accounting earnings along the period 2012-2015, in Table 3 we summarize the details of the components of the net impairment figures in each year under analysis. The information regarding the amount of charges and reversals, as well as the type of allowance (generic and specific), has been hand-collected from the Notes to the Financial Statements. The charges and later reversals of "specific impairments" drive the movements in net income from 2012 to 2015.³⁸

³⁷ As stated in BFA report, in: http://www.bfatenedoradeacciones.com/estaticos/bfa/Informacion_financiera/Informes_anuales/adjuntos/informe_anual_2012_bfa_consolidado.PDF (accessed 20 December 2017).

³⁸ As anecdotal evidence about the doubtful adequacy of the impairments recorded by Bankia in 2012, we refer to the news published in the press about a complaint by a political party (*Izquierda Unida*), who argued its loan had been totally impaired while they had never missed a payment, and there was an additional warranty of a building in Madrid. According to the news, *Izquierda Unida* asked for Bankia to certify they were performing well with all payments, and Bankia did it. Retrieved from: <http://www.elmundo.es/economia/2014/07/16/53c581fc22601dd05b8b4572.html> and <http://www.elmundo.es/economia/2014/07/16/53c6a9e822601d367a8b4588.html> (accessed 20 December 2017).

Table 3: Disaggregation of net loan impairments charged in Bankia's consolidated income statements (2012-2015)

(€ millions)

Impairments	2012	2013	2014	2015
<i>Panel A: Charges in P&L (+)</i>				
Specific	25,521	6,350	3,626	2,777
Other (including generic)	17	19	18	22
Total charges	25,538	6,369	3,644	2,799
<i>Panel B: Reversals in P&L (-)</i>				
Specific	(6,403)	(4,898)	(2,460)	(2,007)
Other (including generic)	(757)	(32)	(29)	(106)
Total reversals	(7,160)	(4,930)	(2,489)	(2,113)
Other adjustments	197	203	(182)	(60)
NET LOAN IMPAIRMENTS (P&L)	18,181	1,236	973	626

Source: Bankia Consolidated Financial Statements (2012-2015)

Table 4: Contractual value of loans, impairments, and net income

Panel A: Doubtful loans and impairments in Bankia group (2011-2015)

(€ millions)

Concept	2011	2012	2013	2014	2015
Non-Performing Loans	14,933	18,838	19,011	15,708	12,252
<i>Net Loan Impairments (P&L)</i>	<i>(3,114)</i>	<i>(18,181)</i>	<i>(1,236)</i>	<i>(973)</i>	<i>(626)</i>

Panel B: 2012-2015 Annual Consolidated Income Statements of Bankia

(€ millions)

Concept	2011	2012	2013	2014	2015
Gross Margin	4,098	4,009	3,630	4,008	3,806
Income before impairments and provisions	1,659	1,717	1,725	2,266	2,148
Other FI impairment (net)	(259)	(750)	(13)	23	43
Loan impairments (net)	(3,114)	(18,181)	(1,236)	(973)	(626)
Provisions (liabilities)	(153)	(1,832)	(180)	(208)	(152)
Others (including tax)	(1,110)	(146)	212	(337)	(353)
NET INCOME	(2,977)	(19,192)	508	771	1,060

In addition, we compare the contractual value of non-performing loans at the end of each reporting period and the impairment amounts charged in net income during 2011-2015. As Table 4 panel A shows the impairment trend does not resemble the evolution of non-performing loans (as it was expected if IAS 39 had been followed). Moreover, as panel B evidences, after 2012 Bankia started to report profits immediately, basically caused by the decrease in impairments charges, while the gross margin and income before impairments remained quite stable.

Discussion of findings

Based on the theoretical background developed in the second section, we argue that the main actors in this case face circumstances which create incentives to manage earnings in the financial industry, in general, and, more particularly, in politically connected entities. We have provided evidence that indicates that the Spanish financial sector suffered large losses in 2012 due to a governmental intervention on the accounting for loan impairments, which was followed by significant reversals in a way that clearly differs from the macroeconomic figures pattern.

The timing of the governmental intervention, right after national elections, and the impact of the accounting changes in a highly politically connected entity are consistent with arguments and evidence on politicians having incentives to use accounting as a political tool (Alesina & Tabellini, 2004; Wagenhofer, 2014). Getting first-order benefits (Jones, 1991), achieving better images about themselves as the big-bath hypothesis predicts (Ramanna & Roychowdhury, 2010), and getting short-run economic effects (Walsh, 2005) are likely reasons for such behavior.

However, the manipulation of the accounting numbers by breaking accounting rules in such a visible way, with the silence of enforcers and the consent of the institutions, makes us suggest a new angle, which we refer to as “the public interest by breaking the rules.” Thus, similar to the political and legal field of research (Meyerson, 2007), we apply it to accounting, and illustrate how the Spanish Government intervention in both accounting rules and corporate practices in the entities under its control, can be explained using the balancing approach (Aleinikoff, 1987).

We should not minimize the fact that the economic situation of the country was critical prior to the Government change of 2011. The newly elected Government had to choose between two alternatives, namely (i) asking for a rescue to the EU, which would have affected the national budget and convey strong austerity measures, or (ii) asking for a bailout for the financial industry addressed to the weakest entities. It is our view that the behavior of the Government appears consistent with the balancing approach, when considering the two alternatives. Given that the consequences of the bailout through the ESM apparently were less costly and the plausible benefits accrued faster, this was the chosen option. Probably the EC was also in favor of this option, as rescuing the whole country could have had an immediate negative impact also in the EU, which explains its immediate agreement to support this alternative. However, according to the 2011 accounting profits and the 2011 EBA stress test (referred to the end of 2010), at the beginning of 2012 the Spanish financial entities did not require such a financial help, at least immediately. If big losses were latent or expected, they should appear gradually in the future.

Under such dilemma one apparently simple mechanism to capitalize banks in the name of the public interest was to break the accounting rules, and to force them to register large losses, as the RDLs did. It was not the first time that Spain had broken the accounting rules in place, as it also happened with the implementation of dynamic provisioning. But the direct intervention of the Government was new. The RDLs issued in 2012 turned profits into losses, changing the situation of the whole system and more dramatically in politically connected entities, particularly when the Government became the owner.

It is remarkable that the compromise from ESM was received by the Government, even before the RDLs were applied to the 2012 financial statements. A stress test that, different to the previous- year test carried by EBA, considered the future impact of the RDLs, and showed a clear shortfall of regulatory capital, would be the perfect argument to ask for the bailout. It seems that the expected result of the stress test being carried out by the IMF was not enough for the Government's purpose. Consequently, private consulting firms were hired to carry out other tests with different assumptions and methodology — more conservative and a longer period of expected accumulated losses (Promontory, 2012)—, as an instrument to justify the requested amount.

Focusing on Bankia, the restatement of the 2011 statements allowed the Government to get control over it. Bankia, even after the restatement still had positive equity and complied with capital requirements, however. But the large losses recorded just in one year, 2012, far exceed the estimation of expected losses which would be allocated in the next three years (2012-2014) under the most likely scenario reported in Oliver Wyman (2012a)'s test and pushed Bankia into bankruptcy. After the rescue by the Spanish Government, the entity started to report profits immediately.

The Government behavior is also consistent with the agency framework in which governments act in the name of the interest of the citizens, but also have their own interests. Although asking for a rescue for the country has a clear cost for the citizens in terms of austerity, this measure has also a cost for the political party in charge of the government. At the same time, the fact that the politically connected entities (i.e. Bankia) recorded such large losses in 2012, completely unrelated with the economics of the entity, as well as with the rest of the industry and the consulting-firms' reports, reinforces the self-interest hypothesis by showing the big-bath pattern. If the amount and allocation of impairment losses would have followed Oliver Wyman (2012a)'s prediction, Bankia would have been still reporting net losses in the following years after the changes in the chair and ownership.

But all these interventions would not have been possible without the complicity of the enforcers of accounting rules. As already mentioned, neither auditors nor the national securities and exchange commission (CNMV) voiced any concerns in relation with the inappropriateness of the application of the RDLs to the consolidated accounts. And focusing on Bankia, even though the justification for the restatement of the 2011 Annual Financial Statements did not comply with IFRS, it also did not provoke any reaction. Neither the 2011 restated financial statements nor the 2012 ones have been questioned or were included in the lawsuit in spite of their apparent lack of economic sense. This practice is consistent with the literature which shows that auditors and enforcers are permissive with decreasing earnings manipulation.

However, breaking the rules requires in our view an additional explanation; it could be that the enforcers' attitude might not be entirely justified by their asymmetric loss function basically due to litigation risks stated in the accounting literature. On the contrary, it might be argued that the silence of enforcers is consistent with the second-order reasons stated by Raz (1986). The compliance costs from a breach of rules could be

perceived differently when they derive from a high-level decision. Applying this reasoning to this case, it could be argued that although the enforcers might consider differently the potential cost of breaking the accounting rules and would have weighted the alternatives in a different way, this might not happen if there is an authority whose decisions are sufficient reasons to act in accordance with them (Raz, 1986). Furthermore, it is assumed that the least independent the enforcers are, the most likely they treat the government as the practical authority whose command is sufficient reason to bias their reasoning, so that considering that its decisions are likely to be more reliable than theirs. Considering that the independence of the institutional enforcer, CNMV, had been questioned by the IMF (2012a), and that the auditors are under the control of the Ministry of Finance, that could have been the case. The existence of a draft clean audit report of the former 2011 Bankia Financial Statements, prepared a few weeks before the change in the Board Chair and the restatement, is consistent with this view.

Conclusions

Along the lines suggested by Arnold (2009), this paper looks beyond the conventional interest group theories of politics and examines the structure of power at the government level. In this study we illustrate how a government can use accounting as a political tool by interfering in the rules and in accounting practices. We explain this behavior using the public interest argument, and the balancing approach, and apply this theoretical background to the Spanish governmental intervention in the accounting for loan provisioning in 2012, in a complex moment in which the financial crisis was hitting the country.

In summary, we show that as a result of the Government intervention, strictly speaking Spain was not hit by a sovereign debt-crisis at that time, as the financial support package received from the ESM was earmarked for a bank recapitalization fund and did not include financial aid for the country itself. Thus, the Government apparently reached its goals that were perceived as in line with the public interest; Spain received an instant financial help, the national budget deficit was not affected by the rescue, the deposits of the population were safe, and the image of the country improved. At the same time, the Government clearly achieved its self-interest goals as the general perception of the population (even that of its political opponents) is that the 2012 RDLs were a positive

measure, and after its application the financial system performance (measured by the accounting earnings) improved. All of this is consistent with the balancing approach applied to the public interest vs breaking the rules dilemma, which has been used in the political and legal context

Nevertheless, as pointed also by Meyerson (2007) when considering the limitations of the balancing approach, the cost of the alternatives might have not been measured in a homogeneous way. The cost of asking for a country rescue could be measured in terms of its effect on the national accounts and would have had an immediate effect. Notwithstanding this, the cost of breaking the accounting rules is not so easy to measure, it is less evident for non-experts, and is not necessarily immediate. Nevertheless, we argue that breaking the accounting rules might have significant costs which were not taken into account at the time. It seems the regulatory risks were not accurately considered when deciding non-compliance (Adams, 1994). In particular, the lack of regulatory sanctions and litigation risks derived from breaking the accounting rules obscure the reputational risks, and might posit serious doubts for investors about the credibility of the Spanish financial system as a whole.

Our study contributes to the accounting literature in several ways. First, by illustrating a case consistent with a new angle of the public interest theory related with accounting. Second, although as it usually happens with case studies, our results cannot be made extensive to other contexts, they should be deeply considered in the debate of the harmonization through IFRS.

This analysis might have implications for policy makers, market regulators, and enforcers. It suggests that interpreting and breaking the agreed common accounting rules in place (IFRS at least in the European case), even if it is justified in exceptional circumstances in the name of the public interest, might seriously endanger the whole system. It could undermine credibility, transparency, comparability and relevance of the information of specific entities, industries and even countries, what might have important negative consequences on global markets and efficient allocations of resources. In other words, all the reasons why the decision of applying a common set of standards was made might be at risk if countries unilaterally contradict them in the name of the so called “public interest”, as its meaning might differ among stakeholders and jurisdictions.

To conclude we just want to point out that if the EU wishes to achieve further progress in financial reporting and to reap the benefit of the improvements, it may make most sense to look at the incentives of those involved in the financial reporting process and at the institutions that surround it. Furthermore, our study can add some contribution to the debate on the future development of IFRS and on the discussion about the convenience of global enforcement mechanisms

APPENDIX: Relevant facts and consequences for the industry and Bankia

DATE	FACTS	INDUSTRY IMPACT	BANKIA (OR BFA) IMPACT
June 27 2009	RDL 9/2009: Bank restructuring	FROB is created to restructure the financial industry	-
December 31 2010	Merger of saving banks (<i>Cajas</i>)	Big banks (old <i>Cajas</i>) controlled by local authorities arise	BFA is created as a merger of 7 saving banks
February 3 2011	RDL 2/2011: New minimum regulatory capital ratios	Higher requirements for non-listed entities	Bankia emerged as BFA subsidiary to be listed
July (mid) 2011	IPOs of new banks (old <i>Cajas</i>)	Comply with the less demanding capital ratios.	Bankia is listed. BFA keeps 52%. Bankia consolidated interim report March 2011 : net income €64. Clean auditing report
July 2011	2010 EBA stress test is reported	All entities (few minor exceptions) pass considering IPOs resources	BFA (including Bankia) passes
August 30 2011	Deadline to issue first semester interim reports	-	Bankia consolidated interim report June 2011: net income €234 Clean auditing report
December 20 2011	National elections	New political party in Government (from PSOE to PP)	
February 3 2012	RDL 2/2012: Bank restructuring (I)	Accounting policy change on impairments with impact in 2012 net income. Contradicts IFRS	BFA group (including Bankia) presents a plan to comply with capital requirements after RDL impact
February 2012	IMF starts periodic assessment of the financial sector	A stress test would be part of this assessment	BFA group is under analysis
March 28 2012	Deadline to elaborate 2011 annual accounts		Bankia issued 2011 Annual Accounts: net income €307
April 13 2012	BdE responds to proposal to deal with RDL 2/2012 requirements	-	BFA plan is approved (subject to governance issues and needs to strength its balance sheet.)

April 19 2012	Deloitte sends Bankia a draft auditing report (BFA draft report is not issued)	-	Clean draft report on 2011 Bankia Annual Accounts (net income €307)
April 25 2012	IMF preliminary report is issued as a request of the Government	Problems of weakest entities are highlighted	The 4 th largest entity (BFA) is pointed out as having problems in the governance structure and needs to strengthen its balance sheet.
April 30 2012	Deadline to send Annual Accounts with auditing report to CNMV register	-	Auditing report of 2011 Bankia Annual Accounts is missing (and BFA's)
May 9 2012	RDL 18/2012: Bank restructuring (II)	Accounting policy change on impairments with additional impact in 2012 net income Contradicts IFRS	-
May 9 2012	BFA and Bankia Chair resigns and a new one is designated	-	-
May 11 2012	Spanish Council of Ministries: Decision to hire private firms for stress tests	IMF and private tests are going to be run in parallel	-
May 25 2012	Bankia (and BFA) 2011 annual accounts restatement	-	BFA shows negative equity. COCOS are converted. FROB (Government) becomes the owner of BFA and controls Bankia Bankia net income (loss) €(2,977) Equity is still positive €11,500 (and complies with capital requirements). Clean auditing report
June 9 2012	IMF report (stress test) is issued	Capital shortfall: €10 billion in a base scenario €37 billion in a stress scenario	Individual results are not published
June 21 2012	Private stress test reports are issued	Capital shortfall: €16 to 26 billion in a base scenario €51 to 62 in a stress scenario	BFA results: €13,2 billion in a base scenario €18 billion in a stress scenario (Expected losses 2012-2014 in a base scenario: €9,800)
June 2012	Official request of bailout to EFSF	EFSF grants till €100 billion	BFA requires around €20 billion (€15 for Bankia)
December 2012	ESM provides the funding, bonds	FROB receives €40 billion	
March 2013	Deadline to elaborate 2012 annual accounts	-	Bankia issues 2012 Annual Accounts: net income (loss) €(19,200). Equity becomes negative, bankruptcy
April 2013	FROB uses the EMS bonds		Bankia is recapitalized

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