The Case of AIB and ICI 1985–1993: The Measurement and Disclosure of a Liability

Derry Cotter*

ABSTRACT

In 1983, Allied Irish Banks plc (AIB) acquired the Insurance Corporation of Ireland (ICI). Shortly afterwards, ICI got into difficulty and sought a substantial injection of funds, which AIB was not in a position to provide. ICI was effectively bankrupt, and in March 1985 the Irish Government agreed to purchase the ailing subsidiary for a nominal sum. The Government's intervention was perceived as preventing a financial crisis in the entire banking sector.

Analysis of AIB's accounting treatment provides evidence of a classic case of earnings management. In both 1986 and 1992, AIB failed to provide for the full cost of support arrangements provided to the Government and Central Bank, after the State's purchase of ICI. Following a change in accounting policy, these costs were recognised in full in AIB's financial statements for the year ended 31 December 1993. This change of policy coincided with the settlement of a legal claim with the auditors of ICI. The bank's dividend policy is identified as a key driver of its earnings management strategy, as is the pressure that may have been exerted by AIB's large institutional shareholders.

Key Words: Earnings management; economic consequences; big-bath accounting; dividend policy

INTRODUCTION

Following the purchase of 25 per cent of the Insurance Corporation of Ireland (ICI) in 1981, Allied Irish Banks (AIB) acquired its entire share capital in 1983. The acquisition gave the bank an immediate foothold in the general insurance and life assurance markets. Shortly afterwards, ICI got into difficulty and sought a substantial injection of funds from its parent company. AIB was unable to provide the necessary capital, however, and it fell to the government of the day to come to the rescue. In 1985, AIB wrote off the entire cost of

* Department of Accounting, Finance and Information Systems, University College Cork

its investment in ICI, and two sets of support arrangements were agreed in 1985 and 1992, each of which committed AIB to incurring annual costs for a substantial number of years.

The reason for ICI's collapse is an interesting issue in its own right, and the circumstances are outlined briefly below. The focus in this paper, however, is primarily on the accounting treatment employed by AIB in respect of the support arrangements entered into with the Government and Central Bank. This treatment is analysed in detail, firstly to establish that AIB employed an earnings management strategy in accounting for its ICI-related support arrangements. The validity of that strategy is evaluated in the context of the accounting rules in force at the time. Using an approach that employs positive accounting theory, the paper then seeks to establish the reasons why AIB chose not to recognise the full cost of its support arrangements at the time they were put in place.

The paper begins by setting out the research design. This is followed by a chronological summary of events surrounding the collapse of ICI. Details of the measurement and disclosure provided in AIB's financial statements are then outlined, covering the period 1985–1993. This treatment is subjected to critical analysis, employing, in particular, the empirical findings on earnings management and dividend policy in the academic literature. The paper concludes by considering the implications of the accounting information provided by AIB during the period 1985–1993.

RESEARCH DESIGN

This paper uses a case study approach to conduct a longitudinal analysis of a single event. The collapse of the Insurance Corporation of Ireland in 1985 resulted in ICI's parent company, AIB, having to seek major government financial support. The paper uses public document sources, in particular published financial statements, to analyse the accounting treatment employed by AIB in respect of the significant losses it incurred following the collapse of ICI. The findings are linked to a theoretical framework, provided primarily by the earnings management, economic consequences and dividend policy literature. In this context, the objective of the research design is to interpret and explain the reasons for the accounting treatment employed by AIB during the period 1985–1993.

It is readily acknowledged that a disadvantage of the case study technique is that the findings may not have general application. It is hoped, nonetheless, to provide a useful and valuable insight into the accounting practices of one of Ireland's most important financial services companies, and the implications of those practices from a policy-making perspective.

THE COLLAPSE AND RESCUE OF ICI – A CHRONOLOGICAL SUMMARY

On 15 March 1985, a Friday evening, both the Ministers of Finance, and Industry and Commerce, together with senior civil servants, held a press conference to announce that the Irish Government had agreed to acquire ICI from AIB for a nominal sum. ICI was Ireland's largest general insurance company at the time, with a turnover of IR£380 million and 800 employees. The insurance company was effectively bankrupt, as William McCann, a partner in Craig Gardner, had been appointed administrator by order of the High Court on that day.

The announcement had been well timed, as the Dublin capital markets had just closed before the St Patrick's public holiday weekend. The Dublin Stock Exchange was not scheduled to open until Tuesday 19 March. News of the collapse of this insurance company, a wholly owned subsidiary of Ireland's second largest banking group, sent shock waves through Dublin's financial community. As one senior banker commented ruefully, 'That rocks the whole system' (*Irish Times*, 1985: 5).

A chronological summary of events is outlined below.

The Making of a Crisis

ICI, which was established in 1935, traded initially in the fire and accident business. In 1946 it moved into marine insurance, and in 1971 the Government appointed it as the sole agent for managing the export credit insurance scheme for Irish exporters. In 1973, it successfully entered the life assurance market. Subsequently, ICI's London office expanded into general insurance underwriting, which had become the fastest growing segment of its overall business by the early 1980s. ICI, which was quoted on the Dublin Stock Exchange, had reported a steady growth in its profits and dividends up to 1983. In 1981, AIB had subscribed IR£10.2 million for new ICI capital, which gave it 25 per cent of the enlarged equity. Subsequently, in July 1983, AIB made an offer for the remaining 75 per cent of ICI's quoted equity. Acceptance of the offer was recommended by the board of directors of ICI and it was successful. The total cost of the investment was IR£86 million.

Not long after its acquisition of ICI, AIB was faced with a request to inject further capital, following the discovery that ICI was operating at a level which was below its minimum statutory reserve ratio. ICI's perilous state at that time was explained by the fact that it had failed both to properly assess the underwriting risks of its reinsurance business, and to maintain an adequate level of reserves. ICI's London office was at the centre of its difficulties, having attained the unenviable reputation as the place where UK brokers went when they had an uninsurable risk. Consequently, ICI (and therefore its parent company, AIB) became responsible for the underwriting of colossal risks, including potential losses on oil rigs, racehorses, satellite systems and even American baseball teams (*Irish Independent*, 1999: 32). With AIB unable to provide the necessary capital required by ICI, it was feared that up to one-quarter of all businesses in the Republic would have to close temporarily, as their liability insurance would become invalid. Additionally, the collapse of AIB could also affect other banks, due to AIB having to recall its inter-bank loans, thus depriving the entire banking sector of essential liquidity.

Following the acquisition of ICI by Icarom (a new specially created company owned by the State), AIB wrote off its carrying value of ICI of IR£90 million as an 'extraordinary item' on the face of its consolidated profit and loss account for the year ended 31 March 1985. In brief, AIB reported a net loss of IR£35 million compared to a net profit of IR£50 million in 1984.

Initial estimates suggested a total loss of IR£61 million by ICI for 1984, though some commentators forecasted that losses might exceed IR£100 million (*Irish Times*, 1985: 5). The final losses reported by Mr McCann, in fact, accumulated to almost IR£300 million. AIB reported that it would be making a claim for recovery of its losses for a sum in excess of IR£100 million from the auditors of ICI, Ernst & Whinney.

A statement from the administrator, by way of an advertisement in the national newspapers the following week, stated that:

> My function is to take over the management of the company's business, which will be carried on as with a view to placing it on a sound commercial and financial footing. In particular, I wish to emphasise that the insurance cover provided under all policies remains in force; the terms and conditions of all such policies remain unchanged (McCann, 1985).

After some years and considerable reorganisation, the administrator was able to identify that significant segments of ICI's business were profitable and had a good future. The business was restructured, with the loss-making elements closed down and hived off as a separate operation to cater for outstanding claims, which would take some years to finalise. The majority of the business was sold to a French–Irish consortium.

The First Set of Support Arrangements

At the outset, AIB provided an undertaking to give the Government a loan of IR£50 million at a subsidised interest rate of 4 per cent below the market rate. It was estimated that this would cost AIB about IR£2 million annually (McCann, 1985). Subsequently, AIB reported to its shareholders that the final settlement with the Government was that it and the banking industry would pay an annual levy to support the administration of ICI. It would also deposit IR£70 million with the Central Bank for up to fifteen years, at a reduced rate of interest, which would represent an annual subsidy of IR£3.5 million. This, together with the banking industry levy, would cost AIB IR£5.5 million annually.

The chairman of AIB commented that:

> The basis of the agreement with the Central Bank of Ireland (in which the Minister for Finance concurred) is that AIB will not be required to contribute further to the funding of the administration (AIB, 1986: 9).

The Renegotiated ICI Administration Support Package of 1992

In late 1992, following a review of the total losses of ICI, and the potential future liabilities of the administration, the Irish Government sought additional financial support from AIB. In December 1992 it was agreed that AIB would contribute, by way of interest subsidy, IR£8.8 million per annum for twenty years from 1993 (AIB, 1992: 51).

The chairman of AIB commented that:

> The decision to participate in the agreement, while a difficult one for your Board, has brought finality to that aspect of an unhappy event in the Group's history (AIB, 1992: 4).

However, there was some silver lining for AIB, arising from the legal action against Ernst & Whinney. In October 1993, the case was settled just prior to a High Court hearing. The auditors offered a total of US$110 million, without admission of liability. It was agreed that the settlement proceeds would be split equally between AIB and the administrator of Icarom. AIB's share was IR£38.9 million.

In AIB's 1993 Annual Report, its chairman referred to the ICI affair and AIB's financial commitments:

> With the finalisation of the legal action related to our investment in Icarom, and the likelihood of implementation of a new financial reporting standard, the Group has made provision for its future commitments related to the funding of Icarom. These provisions have been shown as exceptional items in the Consolidated Profit and Loss Account, together with the settlement proceeds from the legal action and certain related costs. The net cost of the exceptional items is IR£96.7m before taxation. There will be an ongoing benefit to future years' profits from the recognition in 1993 of all future funding costs; this will amount to approximately IR£7m per annum in 1994 and 1995 (AIB, 1993: 3–5).

ACCOUNTING MEASUREMENT AND DISCLOSURE ISSUES

The accounting treatment employed by AIB in respect of the sale of ICI, and the related liabilities arising, must be evaluated by reference to the accounting standards in force at that time.

Initial Record of Sale of ICI

In its 1985 financial statements, the investment in ICI was written off by AIB as an extraordinary item. The IR£90 million written off comprised the cost of the investment of IR£86 million, and ICI's post-acquisition retained profit of IR£4 million. Statement of Standard Accounting Practice (SSAP) 6, *Extraordinary Items and Prior Year Adjustments*, defined extraordinary items as:

> … those items which derive from events or transactions outside the ordinary activities of the business and which are both material and expected not to recur frequently or regularly … (Accounting Standards Steering Committee, 1974).

The treatment of the ICI write-off as an extraordinary item would seem to be consistent with this definition. The write-off of IR£90 million was certainly 'material' in view of the fact that the profit from ordinary activities for that year amounted to IR£54.8 million. Clearly, it was also unlikely to recur.

The notes in the financial statements for the year ended 31 March 1985 also provided evidence of a contingent gain:

> A claim for the recovery of these amounts and consequential losses amounting in aggregate to a sum in excess of IR£100m has been made, and if not satisfied out of court will be the subject of litigation.

The disclosure of a contingent gain in this way presumably satisfied the requirement of SSAP 18, *Accounting for Contingencies*, which did not allow contingent gains to be accrued, but permitted their disclosure if it was probable that the gain would be realised.

Support Arrangements Entered into by AIB in Respect of ICI

AIB's financial statements for the year ended 31 March 1986 disclosed (based on an agreement of 4 October 1985) that an amount of IR£70 million had been placed on deposit with the Central Bank at a discounted interest rate. This represented a subsidy of IR£3.5 million per annum. Additionally, AIB agreed to contribute IR£2 million per annum as part of a banking industry contribution to the funding arrangement. These funding arrangements were expected to last for up to fifteen years.

In December 1992 AIB agreed to contribute, by way of interest subsidy, a further IR£8.8 million per annum for twenty years.

From a review of the financial statements during the period 1986–1992, it seems that it was not clearly indicated how either set of commitments was being accounted for. In fact, the basis on which they were recorded did not become fully apparent until the accounting policy was changed in the 1993 financial statements. It was then disclosed that the ongoing commitments had been accounted for on an annual basis in the financial statements over the period 1985–1992.

The fundamental concept of prudence, as outlined in SSAP 2, *Disclosure of Accounting Policies*, required that:

> … provision is made for all known liabilities (expenses and losses) whether the amount of these is known with certainty or is a best estimate in the light of the information available (Accounting Standards Steering Committee, 1971: para 14(d)).

In view of this requirement, it could be argued that the financial statements, for the year ended 31 March 1986, should have provided for the quantifiable and verifiable capital value of the annual subsidies to which AIB was contractually committed at that time. On the same basis, a provision would have been required at 31 December 1992, in respect of the capital value of the additional annual interest subsidy of IR£8.8 million, agreed in December 1992.

An alternative view could be that the financial commitments were a prerequisite in ensuring the support of the Irish Government during the crisis. In this respect the financial commitments could be linked to future benefits, whereby AIB was effectively underwriting a significant amount of the financial fallout associated with the insolvency of ICI. This view might be considered to be consistent with the accruals concept of SSAP 2, which required that costs and expenses be matched with related benefits.

One is still faced with a residual problem, however, as SSAP 2 required that '… where the accruals concept is inconsistent with the prudence concept …, the latter prevails' (Accounting Standards Steering Committee, 1971: para 14(b)).

If one were to hold that the prudence concept was not applied correctly, then it would seem that there was a consequent disclosure omission. This follows from the statement in SSAP 2 that:

> In the absence of a clear statement to the contrary, there is a presumption that the four fundamental concepts have been observed (Accounting Standards Steering Committee, 1971: para 17).

AIB's financial statements during the period 1985–1992 made no reference to a failure to apply the four fundamental concepts of accounting, of which prudence was one. In the absence of such a disclosure, users of those financial statements are entitled to have assumed that AIB's financial support for ICI's losses was accounted for in accordance with the prudence concept. If so, they would have erroneously assumed that the capital amount of all losses had been provided in full.

Settlement of Legal Action and Change in Accounting Policy

As outlined previously, in October 1993 an out-of-court settlement was agreed in respect of the action against Ernst & Whinney. AIB's share of this settlement was IR£38.9 million. In its 1993 financial statements, AIB changed its accounting policy in respect of its support arrangements provided to the Government and Central Bank. The new policy saw the present value of these future commitments being written off in their entirety as an exceptional item in the 1993 financial statements.

Table 1 shows the components which comprise the exceptional loss of IR£96.7 million.

Table 1: Exceptional Loss, Year Ended 31 December 1993

	IR£ (millions)
Balance of commitments under the 1985 agreement on a present value basis	(34.0)
Additional commitments under the 1992 agreement on a present value basis	(99.5)
AIB's share of out-of-court settlement of legal action	38.9
Legal and other related costs	(2.1)
Total	*96.7*

This treatment, as acknowledged in the 1993 financial statements, was inconsistent with Financial Reporting Standard (FRS) 3, *Reporting Financial Performance*, which required that a change in accounting policy be accounted for by adjusting the financial statements of previous years. One must assume that the departure from FRS 3, in respect of the change in accounting policy, had the full support of AIB's auditors, who made no reference to it in their audit report.

Discounting

The manner in which AIB's future financial commitments were discounted to present value in the 1993 financial statements is also deserving of further consideration. The discount rate chosen was derived from the '… weighted average of the yield to maturity of Irish government securities maturing on the same dates as the future commitments' (AIB, 1993: 27). This appears to have been a reasonable approach in identifying an appropriate discount rate.

It is arguable, however, if discounting was a commonly employed technique at that time. Although it is now widely used, the use of discounting in 1993 appears to have been ground-breaking in the context of accounting policies used by Irish PLCs. The general position relating to the accounting treatment of liabilities at that time is perhaps best reflected in SSAP 24, *Accounting for Pension Costs*, which stated that, 'Financial statements … normally include items at their face value without discounting them' (Accounting Standards Committee, 1988: para 40).

ANALYSIS OF THE ACCOUNTING TREATMENT EMPLOYED BY AIB

Earnings Management

Earnings management can be defined as the active manipulation of accounting results for the purpose of creating an altered impression of business performance (Mulford and Comiskey, 1996). The term '*discretionary accruals*' has been used as a proxy for earnings management behaviour (Healy, 1985). The other component of accruals is *non-discretionary accruals*, which are the expected level of accruals in a firm if there is no manipulation. The relationship is expressed in Equation (1):

$$TAC_t = NDAC_t + DAC_t \tag{1}$$

where TAC_t = Total accruals in year t;
$NDAC_t$ = Non-discretionary accruals in year t; and
DAC_t = Discretionary accruals in year t.

Financial statements are prepared using accrual accounting. Accrual accounting depicts the effects of transactions in the periods in which those transactions occur, even if the resulting cash receipts and payments occur in a different period. This concept can be applied to the 1985 support arrangements provided by AIB in respect of ICI. Under these arrangements, AIB agreed to contribute IR£5.5 million annually to the Central Bank for up to fifteen years. In its financial statements for the year ended 31 March 1986, AIB appears only to have charged the cash loss suffered during that year (i.e. IR£5.5 million) as an expense. However, this ignored the fact that the support arrangements would cost AIB up to a further IR£77 million (i.e. IR£5.5 million x 14 years on an undiscounted basis). In the context of Equation (1) above, the accounting treatment adopted by AIB in its financial statements of the year ended 31 March 1986 is represented as follows:

$$TAC_t \text{ (i.e. IR£Nil)} = NDAC_t \text{ (i.e. IR£77M)} + DAC_t \text{ (i.e. -IR£77M)} \quad (2)$$

This can be interpreted as follows: In accordance with the prudence concept, the amount that should have been provided as a liability in AIB's financial statements at 31 March 1986, relating to its ICI support arrangements, was IR£77 million (i.e. $NDAC_t$). The amount *actually* provided by AIB as a liability at that date, however, was IR£Nil (i.e. TAC_t). The reason for this discrepancy was that no provision was made on 31 March 1986 in respect of an event that had already occurred (i.e. the support arrangements agreed in 1985), but which would only result in AIB incurring a cash cost (i.e. IR£5.5 million per annum) in periods after that date. There was therefore a negative discretionary accrual of IR£77 million at 31 March 1986.

The use of discretionary accruals essentially has the effect of transferring earnings from one period to another. As a consequence of not recognising the full cost of the 1986 support arrangements, AIB's earnings were increased in the year ended 31 March 1986. Similarly, the capital cost of the support arrangements under the 1992 agreement was not provided for in AIB's financial statements for the nine months ended 31 December 1992. Ultimately, the full cost of AIB's support arrangements was charged as an expense in its financial statements in the year ended 31 December 1993, following the settlement, in October 1993, of the action against ICI's auditors.

AIB's accounting treatment of its ICI-related support arrangements is consistent with the results of DeFond and Park (1997), which suggest that when current earnings are 'poor' and expected future earnings are 'good', managers 'borrow' earnings from the future for use in the current period.

Economic Consequences

As outlined above, in accounting for its ICI-related support arrangements, AIB applied an earnings management strategy in its financial statements during the period 1986–1992. It is important to consider the reasons why this strategy was employed, as a key objective of accounting theory is to explain and predict phenomena such as accounting practices employed by the management of a firm (Watts and Zimmerman, 1986). This concept is known as positive accounting theory, and it is regarded as being important because it can provide decision makers, such as regulators, with predictions of and explanations for the consequences of their decisions.

There is a significant body of empirical evidence showing that financial reporting rules have economic consequences. Zeff (1978: 56) defines economic consequences as '… the impact of accounting reports on the decision-making behaviour of business, government, unions, investors and creditors'. The investment tax credit controversy in the United States (US) in the early 1960s provided an early example of the economic consequences of financial reporting rules. This related to a 7 per cent investment tax credit, equivalent to a cash refund for most tax-paying corporations, introduced by the administration of President John F. Kennedy (Previts and Flesher, 1994). The Accounting Principles Board (APB) voted to require that the investment tax credit be deferred for accounting purposes, rather than be taken immediately into income (Zeff, 2003). Although this ruling had no effect on the timing or amount of the cash benefit from the tax credit, it met with widespread opposition, on the basis that delaying its recognition in the financial statements would lessen its beneficial impact on the economy. In 1963, the Securities and Exchange Commission overruled the APB, and allowed the investment credit to be either deferred or included immediately in income.

Hope and Gray (1982) have documented the effect that Exposure Draft 14, on research and development, would have had on the British aerospace industry, had it been implemented as an accounting standard by the Accounting Standards Steering Committee in 1975. More recently, some commentators, including John McCain, the Republican candidate for the US presidency in 2008, blamed accounting's market value rules for contributing to and worsening the global financial crisis (Cotter, 2012: 392). In 2010, accounting rules were also blamed for the continuing decline in the number of defined benefit pension schemes offered by employers (*Pensions Insight*, 2010).

As outlined in the previous section, AIB employed an earnings management strategy to avoid including the full cost of the ICI support arrangements in its financial statements for the year ended 31 March 1986. So as to understand its reasons for adopting this strategy, we need to consider the potential economic consequences for AIB. Watts and Zimmerman (1978) maintain that management is influenced by the size hypothesis, the debt/equity hypothesis and the bonus plan hypothesis:

- The size hypothesis predicts that management of very large firms will want to decrease their profits in order to avoid unwanted government intervention in its pricing and other structures.
- The debt/equity hypothesis maintains that firms with a high debt/equity level will be likely to use accounting policies that increase profits.
- The bonus plan hypothesis predicts that when management's bonuses are profit related, they will use accounting policies to increase their firm's profit.

It is unlikely that any of Watts and Zimmerman's (1978) hypotheses were significant factors in AIB's decision not to record the full cost of its ICI support arrangements in its financial statements for the year ended 31 March 1986. The size hypothesis does not apply, as AIB did not attempt to reduce its profits in that period. Nor is the debt/equity hypothesis applicable, as AIB was not highly geared at that time. It is not known whether management bonuses were dependent on profits, but at a time of crisis they were unlikely to have been a key factor in determining the bank's accounting policies.

Naser (1993) reports that auditing practitioners and management have cited the following reasons for the use of creative accounting practices:

- To meet limits on borrowing and gearing
- A desire to reduce taxation
- A desire to control dividends
- Pressure from big institutional investors

As stated above, once the State had taken over ICI's liabilities, borrowing and gearing limits do not appear to have been a factor for AIB at that time. Neither would taxation concerns have been a deterrent, as recognising the full cost of the support arrangements as an expense in the 1986 financial statements would certainly not have increased AIB's tax charge in that year.

As regards dividends, despite reporting a net loss of IR£35 million in its financial statements for the year ended 31 March 1985, AIB maintained its dividend at the same level as the previous year. This was understandable, in view of the importance to a firm of maintaining a stable dividend policy (Lintner, 1956). Dividends are also regarded as having information content and are frequently used as a mechanism to signal a firm's future earnings growth (Woolridge, 1982). Clearly, at a time of difficulty, AIB was intent on signalling its financial strength to the market.

Had AIB immediately expensed the full cost of its October 1985 support arrangements, its profit after tax for the year ended 31 March 1986 of IR£54.6 million would have become a loss of IR£22.4 million. On the assumption that balance sheet retained earnings are a reasonable proxy for distributable profits, AIB would still have been able to pay its 1986 dividend, by drawing on accumulated profits from previous years. Accumulated profits would have been significantly reduced, however, leaving the bank with a smaller earnings cushion to protect its dividend payments in 1987 and beyond.

AIB's decision to pay a dividend in 1985, following the collapse of ICI, attracted widespread public criticism. This is evident from the record of Dáil debates at the time: 'There has been a good deal of criticism about the statements coming from AIB that they will continue to pay dividends' (O'Keeffe, 1985: 6). Full provision of AIB's support arrangements, in its financial statements of the year ended 31 March 1986, would have resulted in two years of consecutive losses. In that scenario, a decision to continue to pay a dividend in 1986 is likely to have led to a renewed public backlash, amid criticism that, although AIB was incurring losses, shareholders were continuing to prosper at the State's expense.

Naser (1993) also raises the issue of pressure from big institutional investors as a factor that may induce firms to engage in creative accounting practices. In 2000, the bulk of AIB shares were held by institutional investors, which included pension funds and assurance companies. In fact, 65 per cent of the bank's shares were held in share holdings of more than 100,000 shares (Department of Finance/Central Bank Working Group, 2000). It is difficult to imagine that a charge of IR£77 million against its profits of the year ended 31 March 1986 would not have brought increased pressure to bear on the board of AIB. In this regard, some of the bank's institutional shareholders, such as pension funds, would have been particularly concerned about AIB's ability to maintain and increase its dividend payments.

Fudenberg and Tirole (1995) suggest that concern about job security creates an incentive for managers to shift future earnings into the current period when current performance is 'poor'. Should the board of AIB have been subjected to this type of pressure from the bank's institutional shareholders, following the collapse of ICI, the decision to defer recognising the cost of its support arrangements is consistent with the findings of Fudenberg and Tirole (1995).

Big-Bath Accounting

In its financial statements for the year ended 31 December 1993, AIB changed its accounting policy in respect of its ongoing ICI support arrangements. In that year, the present value of commitments totalling IR£133.5 million was written off as an exceptional loss. AIB's share of the legal settlement amounted to IR£38.9 million and this was offset against the exceptional loss of IR£133.5 million. This treatment is indicative of 'big-bath accounting', which involves large profit-reducing write-offs, or income-decreasing discretionary accruals. Weberman (1986), citing David Hawkins of Harvard Business School, states that firms usually record such write-offs several years after the events have taken place, which brings into question the validity of earlier financial statements. In AIB's case the exceptional loss in its 1993 financial statements results from the decision not to provide for its ICI commitments at the time the support arrangements were agreed in 1985 and 1992.

When the first tranche of AIB's support arrangements was put in place in October 1985, the bank had commitments totalling IR£77 million. At that time, AIB had also announced that it would be making a claim for recovery of its losses for a sum in excess of IR£100 million from ICI's auditors. Under the accounting rules of SSAP 2, *Disclosure of Accounting Policies*, the legal claim was regarded as a contingent asset, which could not be recorded in the financial statements until such time as it became virtually certain. In effect, therefore, it seems that AIB was deferring the full recognition of its ICI-related commitments during the period 1986–1992, in the expectation that these could be offset against a legal award in a later period.

Walsh et al. (1991) maintain that big-bath practices may have their roots in psychology. In this context, they are perceived as having a cleansing effect, freeing a firm from the shackles of whatever bad fortune has befallen it in the past. It is very much the case of a new broom sweeping clean, a public purging of costly misjudgements that can now be definitively consigned to history. Furthermore, as future earnings will no longer be diluted by the ongoing write-off of past costs, management can take increased credit for their firm's improving fortunes.

CONCLUSION

This paper provides evidence for the assertion that obfuscation has been practised in the Irish banking sector as far back as 1985. This contention is supported by the manner in which AIB's ill-fated investment in the Insurance Corporation of Ireland was recorded in the bank's financial statements. In particular, losses incurred by AIB, relating to future interest subsidy commitments provided to the Government and Central Bank, were recognised on an annual basis, rather than being provided for in full at the time that they became a contractual obligation.

Certain factors were influential in determining the accounting policy employed by AIB. In common with most publicly listed companies, AIB had a policy of increasing, or at least maintaining, its annual dividend year on year. In fact, AIB would continue to employ this strategy several years later, declaring an increase of 13 per cent in its dividend, following the revelations in 2002 that rogue trader John Rusnak had covered up losses of $691 million at Allfirst, AIB's Baltimore-based subsidiary. As outlined previously, however, had AIB recorded the full cost of its ICI-related support arrangements in 1986, it would have seriously eroded the bank's accumulated profits. Had AIB then gone on to incur a third consecutive significant loss in 1987, it may have been in danger of having to reduce its dividend to shareholders. Given that companies generally employ dividends as a signal of their financial strength and capacity for earnings growth, this is likely to have had an adverse effect on AIB's share price, and therefore also to have led to an increase in its cost of equity capital.

Annual recognition of the cost of AIB's support arrangements is also likely to have reduced the pressure coming from the bank's clientele of institutional shareholders. This pressure would almost certainly have intensified in the event that shareholders' dividends were under threat. Therefore, the earnings management strategy employed by AIB served to enhance the job security prospects of senior personnel within the bank.

The analysis indicates that, at a time of organisational crisis, AIB initially sought to minimise losses in its financial statements. In effect, during the period 1986–1992, this involved offsetting a contingent asset (i.e. the pending claim against ICI's auditors), against AIB's liabilities relating to the support arrangements agreed with the Government and Central Bank. Ultimately, AIB recognised the liability and the asset in 1993, following a settlement of its legal claim. The bank's accounting treatment provides an illustration of how, at a time of organisational crisis, truth can be a process. In 1993, having delivered eight years of sustained growth and stability, it was clearly far less damaging for AIB to record the full extent of the ICI-related losses in its financial statements at that time.

This paper presents historical evidence of the failure of an Irish bank to record the full amount of its liabilities in the mid-1980s and early 1990s. These liabilities, which related to the collapse of ICI, triggered a financial crisis that resulted in the bailout of AIB by the Irish Government in 1985. A second banking crisis, which occurred two decades later, forced the Government to announce a bank guarantee scheme in September 2008. Unlike the previous AIB bailout, however, this time the scale of the banks' losses would exceed even the resources of the State.

ACKNOWLEDGEMENTS

This paper is partly based on joint research conducted with the late Edward Cahill, who was formerly professor of accounting in University College Cork.

The author sincerely thanks the editors and anonymous reviewers for their valuable feedback on a previous version of this paper.

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