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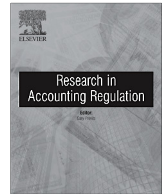

Auditing regulations and bank shareholders' wealth: An international analysis

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ABSTRACT

This paper examines the ability of auditing regulation to protect bank shareholders' wealth during the time of normal growth and during the 2007–2009 global financial crises. The study uses the bank regulation database available at the World Bank website. We select a sample of 2467 banks from 107 countries for the years 1999–2009. We perform multivariate regression analyses and find that while auditing regulations enhance bank equity prices in normal growth periods, there is no evidence that auditing regulations are associated with bank share prices during the period of financial crisis. We observe similar results for both developed and emerging countries and for the common and code law countries. Our results suggest an immediate need to strengthen audit regulations so that investor confidence is more likely to persist during periods of financial downturn.

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Introduction

The financial crisis of 2007–2009, which was sparked by subprime mortgage losses, has caused many banks throughout the world to lose a substantial portion of their equity. The Organization for Economic Cooperation and Development (OECD) points to ineffective banking regulation as a major contributing factor to the crisis (OECD, 2009). Recent articles published in the New York Times suggest a disturbing trend of deterioration in audit quality as the Public Company Accounting Oversight Board (PCAOB) finds more audit deficiencies particularly in the banking industry (Norris, 2012). Specifically, the PCAOB reports audit problems with all the 23 audits of brokers and dealers performed by auditing firms in 2011 to 2012 (PCAOB, 2012). Legislators and regulators around the world have expressed concerns and initiated stringent regulations to prevent the recurrence of a similar catastrophic economic event in the future (Basel III, 2011; Dodd-Frank Act of 2010).

Consistent with these concerns, we examine an important element of the regulatory environment, bank audit regulation, and investigate its effectiveness in protecting shareholder's wealth. First, we investigate whether stricter audit regulations in some countries preserved bank equity during the economic boom of the 1990s and during the financial crisis. Second, we examine the relationship between bank audit regulations and bank stock performance during country-specific financial crises. Third, based on the notion that developed and emerging countries have different economic systems and policies, we test whether the association between audit regulations and bank stock returns varies between those two groups of countries during financial crises. Finally, we evaluate whether the effectiveness of audit regulations varies between common law and code law countries (La Porta, Lopez-de-Silanes, Shleifer, & Vishny 2002b).[2]

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[2] Our underlying premise is that stricter audit regulation is likely to enhance the quality of audit services, which in turn leads to higher quality of audited financial information having greater valuation consequence in the market.

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We use a comprehensive bank regulation database available at the World Bank website (prepared by Barth, Caprio, & Levine 2004). We select a sample of 2467 banks from 107 countries for the years 1999–2009.[3] The results of our multivariate regression analyses show that stringent auditing regulations positively impact bank share prices during the normal time period. We suggest that under stringent auditing standards, bank auditors strive to provide higher-quality audits to meet the mandated level of service quality and force their clients to disclose financial information more accurately and timely. We do not find any evidence that stricter audit regulations influenced bank stock prices during the period of recent financial crisis. A possible explanation is that during the crisis, investors view the audited information as less credible because of losses being observed at other financial institutions. Finally, we find that the countries' legal origin does not have any significant effect on the relationship between bank audit regulations and stock prices. Our main results hold even after controlling for the pricing effect of other regulatory features such as partial ownership stake by the state, restrictions on types of activities that banks can engage in, mandatory loss provisioning requirements, and depositor insurance schemes that could mitigate the bank shareholders' wealth losses during the recent global financial crisis.

The remainder of the paper is organized as follows. In Section 2, we discuss prior studies and identify variables of interest. Section 3 explains the data sources. Section 4 discusses the empirical analyses and findings. Finally, Section 5 concludes the paper.

Prior research on bank regulations and identified variables

Considerable research presents evidence both in favor of and against banking regulations. Barth, Caprio, and Levine (2001) and Pigou (1938) argue that government regulations can mitigate market failures. More stringent bank-related regulations, including stricter monitoring of auditor performance, has the potential to safeguard shareholders' wealth. High restrictions can restrain banks from extending risky loans and increase bank charter value (Gonzalez 2005). Boyd, Chang, and Smith (1998) show that under less restrictive universal banking systems, banks with higher moral hazard have relatively more incentive to engage in riskier activities, which can eventually lead to their downfall. Recently, Beltratti and Stulz (2009) document that banks incorporated in countries with stricter capital requirements performed better during the recent financial crisis.[4] Thus, stricter regulations, including regulations on auditing, are necessary to prevent banks from engaging in excessive risk-taking behavior.

[3] The years 1999–2006 and 2007–2009 constitute the normal time period and the financial crisis period respectively in our analysis.

[4] Benston (2000) outlines nine reasons that could justify bank regulations: making deposit insurance feasible, preventing banks from gaining too much economic power, reducing the cost of bank insolvency, protecting the economy from the effects of bank failures, protecting the payment system, serving popularly elected officials' interests, increasing the Federal Reserve's control over the money supply, suppressing competition, and protecting customers.

Another stream of research produces evidence in support of bank deregulation. Gonzalez (2005) maintains that lower restrictions could provide banks with more opportunities to diversify their operations, which in turn would reduce their risk. Shleifer and Vishny (1998) argue that sometimes the objective of a government to implement regulations is not to protect share markets, but to support selective political constituencies. Government's practice of imposing regulations to support political constituencies is called "grabbing-hand" practice. The grabbing-hand theory suggests that countries with powerful government supervisors, limits on bank activities, and more restrictions to entry would have a higher level of corruption, which would further hurt bank performance or stability. Vennet (1999) asserts that unregulated banks have a relatively higher level of operational efficiency compared to regulated banks. In the context of bank diversification, Eisenbeis and Wall (1984) suggest that unregulated banks could benefit by increasing diversification of their operations, because profits generated from different financial services are not highly correlated. Barth et al. (2001) demonstrate that countries with greater bank-related regulatory restrictions have a higher probability of suffering a major banking crisis. Consistent with this observation, Jayaratne and Strahan (1996) find that in the United States, per capita growth measured in terms of both personal income and state GDP, increased for the states that raised the level of bank deregulation. Furthermore, Demyanyk, Ostergaard, and Sorensen (2007) show that U.S. statewide banking deregulation has a positive impact on personal income insurance, especially in states where small businesses are more prevalent. Finally, Bertrand, Schoar, and Thesmar (2007) document that bank deregulation undertaken by the French government in the mid-1980s was followed by a more efficient allocation of bank loans to firms, increase in market competition, and better allocation of assets and jobs across business enterprises.

The recent financial crisis underscores a nearly complete transformation of business practices in the banking industry that warrants renewed investigation of the effectiveness of banking regulations, including bank audit regulations. Protecting shareholders' wealth becomes a challenging task for the entire banking industry because of the systemic nature of the recent crisis. To investigate this phenomenon, our study focuses on theeffect of bank regulations pertaining to audit, ownership structure, operations and liquidity and capital adequacy on bank stock performance and thus bank shareholders' wealth creation and preservation. Specifically, we use abnormal bank stock returns as the dependent variable that reflects changes in bank shareholders wealth in the capital market in response to differences in auditing and other regulations across countries.

Main independent variable: Auditing regulations

High-quality auditing is expected to improve the credibility and reliability of financial reports. We conjecture that the presence or absence of stringent auditing regulations influences audit quality, which in turn impacts the reliability of audited financial statements and the capital

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