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The federal deposit insurance corporation improvement act, bank internal controls and financial reporting quality

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ABSTRACT

Altamuro and Beatty (2009) examine financial reporting quality before and after the Federal Deposit Insurance Corporation Improvement Act (FDICIA). They document increases in the validity of the loan-loss provision, earnings persistence, predictability of future cash flows and reductions in benchmark-beating for banks complying with FDIC's internal control regulations relative to non-complying banks. Our discussion focuses on Altamuro and Beatty's interpretation of the results, specifically that the internal control provision of FDICIA improved financial reporting quality. In this paper, we provide a brief overview of FDICIA in an attempt to assess the importance of FDIC's internal control regulations. We then review the findings of other studies on internal control regulations with the goal of evaluating what new insights we gain from Altamuro and Beatty. Next, we report new evidence relating to the sub-groups driving the changes in financial reporting quality surrounding the FDICIA. Finally, we discuss the results in the context of the current financial crisis and suggest avenues for future research.

1. Introduction

The Federal Deposit Insurance Corporation Improvement Act (FDICIA) was enacted in 1991 in response to the savings and loan crisis of the late 1980s. FDICIA was intended to recapitalize the Bank Insurance Fund of the FDIC and reform the bank regulatory system (Mishkin, 1997). Section 36 of FDICIA, "Early Identification of Needed Improvements in Financial Management" requires that affected banks establish an independent audit committee, perform an annual independent audit and carry out an assessment of the effectiveness of internal controls over financial reporting and compliance with designated laws and regulations.[1] The intent of Section 36 was to facilitate the early identification of problems in the financial management of insured depository institutions.

Altamuro and Beatty (2009, hereafter AB) use Section 36 of FDICIA and the exemption of banks with assets less than $500 million from Section 36 to examine how the internal control regulations of FDICIA affect financial reporting. Specifically, AB examine attributes of financial reporting quality before and after the enactment of FDICIA by comparing banks with assets of less than $500 million, which were unaffected by Section 36, to those with assets greater than $500 million, which were affected by Section 36. Their results document increases in the validity of the loan-loss provision,

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[1] Initially the asset threshold for complying banks was set at $500 million in assets and, in 2005, it was raised to $1 billion in assets.

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earnings persistence, the predictability of future cash flows and reductions in benchmark-beating for banks required to comply with FDICIA's internal control regulations relative to non-complying banks.

AB examine an important issue in financial reporting, internal control regulations, drawing on a unique and interesting non-SOX setting. Our discussion focuses primarily on the interpretation of the evidence presented by AB. In particular, we focus on whether or not their findings can be attributed to internal control regulations. Our discussion proceeds as follows: we first provide a brief overview of FDICIA in an attempt to assess the role that internal control regulations play in FDICIA. We then review the findings of other internal control regulation studies. Next, we offer new evidence examining the robustness of AB's findings. Specifically, we find that the sub-groups of banks driving AB's results vary across the loan charge-off and earnings persistence tests, potentially calling into question the consistency of their results. Finally, we discuss the results in the context of the current financial crisis and some avenues for future research.

2. FDICIA and internal control regulations

Like many regulations, FDICIA was formulated out of a crisis, specifically the savings and loan crisis of the late 1980s and early 1990s. The banking crisis resulted in approximately 1150 failed banks and the inclusion of 1500 other banks on FDIC's problem bank list by the end of 1990 (Benston and Kaufman, 1997). Out of this crisis came new regulations in the form of FDICIA, much of which was targeted at recapitalizing the Bank Insurance Fund and reforming deposit insurance through features like risk-based deposit insurance. FDICIA also reformed bank supervision and regulations through stricter reporting requirements, such as the disclosure of the fair market values of bank assets. FDICIA increased the supervision of banks by requiring annual on-site examinations of banks and interventions into banks that fail to meet their capital requirements.

AB consider one specific section of FDICIA, Section 36, "Early Identification of Needed Improvements in Financial Management" in their study. The title of Section 36 summarizes very well the intent of the regulation. Section 36 was intended to mitigate information asymmetries between banks and their stakeholders by improving the quality and oversight of financial reporting. Section 36 requires affected banks to establish an independent audit committee, perform an annual independent audit and perform an assessment of the effectiveness of internal control over financial reporting and compliance with designated laws and regulations. Section 36 includes an exemption for smaller banks, which the FDIC defined as those with assets less than $500 million. However, prior to the enactment of Section 36, most banks with assets greater than $500 million had engaged independent auditors to perform annual audits and the Foreign Corrupt Practices Act of 1977 required companies to have internal controls over financial reporting. Overall, Section 36 and the increased scrutiny placed on banks following the savings and loan crisis undoubtedly increased bank monitoring and oversight.

AB use the Section 36 exemption to develop a control sample, but before we can assess the validity of this control sample, we need to understand the factors contributing to this exemption. Similar to the debate around Sections 302 and 404 of SOX, regulators, firms and other interested parties were concerned about the cost that the regulation imposed on smaller firms. Regulators took these concerns into account by exempting smaller firms from only Section 36. While economies of scale were definitely a consideration in this exemption, the exemption itself is potentially related to the somewhat unique role that bank regulators perform. We contend that the primary role of bank regulators is to oversee the banking system, to insure that the system as a whole continues to function and both depositors and creditors continue to have confidence in the system. One piece of evidence consistent with this contention is the "too big to fail" provision in FDICIA and other bank regulations. With respect to the banking system, a relatively small number of large banks control the majority of the assets in the system. Thus, the exemption of smaller banks might also reflect regulators' views of the smaller banks' importance to the system and could potentially indicate that other parts of FDICIA, such as provisions for increased supervision, would be applied differently to larger banks than to smaller banks.

The importance of large banks to the banking system and regulators' concerns with the system as a whole potentially cloud the interpretation of AB's results in that their results may be attributable to the differing application of FDICIA in general to big and small banks rather than to the explicit exemption of Section 36 of small banks. While AB do note in their fourth footnote that "Our study focuses on the comprehensive effects of the regulation," they interpret their results in the context of internal control regulations rather than the "comprehensive effects of regulation." The vastness of the FDICIA, the crisis and the subsequent recovery of the banking system resulted in multiple moving parts. While this is true for almost every empirical study, it is particularly relevant in this setting, since there were ex-ante factors that may have led to the reforms as a whole, not just Section 36, affecting banks differently based on their size.

3. What we know about internal controls and financial reporting

The recent literature on internal controls examining the SOX era documents several features important for assessing the results reported by AB. Ashbaugh-Skaife et al. (2007) and Doyle et al. (2007b) provide evidence that firms first disclosing internal control deficiencies (ICD) likely exhibited these control problems before the first disclosure. The results reported in these studies indicate that observable firm characteristics predict the incidence of ICDs. Specifically, Ashbaugh-Skaife et al. (2007) and Doyle et al. (2007b) find that firms with complex operations, recent changes in their organization structures, more accounting risk exposure and fewer resources are more likely to report ICDs.