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Effects of international institutional factors on earnings quality of banks

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ABSTRACT

We examine the relation between legal, extra-legal and political institutional factors and earnings quality of banks across countries. We predict that earnings quality is higher in countries with legal, extra-legal and political systems that reduce the consumption of private control benefits by insiders and afford outside investors greater protection. Using a sample of banks from 35 countries during the pre-crisis period from 1993 to 2006, we find that all five measures of earnings quality studied are higher in countries with stronger legal, extra-legal and political institutional structures. We also find that banks in countries with stronger institutions are less likely to report losses, have lower loan loss provisions, and higher balance sheet strength during the 2007–2009 crisis period. Our findings highlight the implications of country level institutional factors for financial reporting quality and are relevant to bank regulators who are considering additional regulations on bank financial reporting.

1. Introduction

We investigate whether differences in country-wide legal, extra-legal and political institutions explain cross-country differences in earnings quality of banks. We examine earnings quality from two perspectives: an information perspective and an opportunistic earnings management perspective. The information perspective indicates that earnings quality increases as managers report less noisy or more accurate earnings, or take reporting actions that reveal information about banks' future earnings and cash flows. By contrast, earnings quality decreases if managers act opportunistically and take actions that disguise the true underlying economic performance of the bank in an effort to enhance their own welfare at the expense of investors. We examine the implications of differences in international institutional factors on earnings persistence, predictability of future cash flows, future loan write-offs, earnings benchmark-beating behavior, and income-increasing abnormal loan loss provisions (LLP).

Recent research shows that the reporting environment is shaped by country-specific institutional structures including legal and judicial systems, product-market competition, press coverage, tax compliance and political economy (Ball et al., 2000, 2003; Bushman et al., 2004; Gul, 2006). Another stream of research documents the role of legal, extra-legal and political institutions in reducing the consumption of private control benefits by insiders (LaPorta et al., 1998; Dyck and Zingales, 2004; Haw et al., 2004). The potential for private control benefits provides incentive to insiders to distort financial reports, thus decreasing their credibility (Leuz et al., 2003). Strong institutional structures constrain the consumption of private control benefits and improve the credibility of financial statements.

Prior research on the relation between international institutional factors and earnings quality excludes firms in banking and financial services (e.g., Ball et al., 2000; Leuz et al., 2003). Given the importance to national and global economies of this highly leveraged sector of the economy, that firms in this sector are very different from industrial firms, and the recent concern with the quality of reported earnings following the meltdown in this sector, a study of factors affecting earnings quality in the banking industry clearly is warranted. In an attempt to better understand differences in earnings quality of banks, we provide empirical evidence on the relation between several dimensions of earnings quality of banks and cross-country differences in legal, extra-legal, and political institutional structures.

In addition to the important role banks play in the economy of a country, studying attributes of earnings quality of banks has at least two important advantages. First, focusing on a single, relatively homogeneous industry facilitates control over other

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determinants of cross-sectional differences in properties of earnings and increases the reliability of the inferences from our empirical analyses. Furthermore, focusing on a single accrual (loan loss provisions) facilitates a better separation into its nondiscretionary and discretionary components, thus permitting a more accurate assessment of earnings quality.

Second, banking was a profitable industry until 2007. It ranked second in profitability after pharmaceuticals among *Fortune 500* firms in the U.S. in 2001 (Public Citizen, 2002) and third in return on revenues in 2005 (CNNMoney.com). These high levels of profitability provide opportunities and incentives for managers to earn quasi-rents from distorting earnings. Overall, these reasons indicate that focusing on the banking industry provides an appealing context for examining the relation between international institutional factors and earnings quality.

Prior banking literature documents that managers use their discretion in financial reporting for efficiency reasons such as signaling private information (Wahlen, 1994; Kanagaretnam et al., 2004), risk management (Bushman and Williams, 2012), reducing perceived risk (Wahlen, 1994; Kanagaretnam et al., 2004) and external financing (Kanagaretnam et al., 2003), or for opportunistic reasons such as bench-mark meeting or beating (Beatty et al., 2002), income-increasing accruals (Kanagaretnam et al., 2010) and job security concerns (Kanagaretnam et al., 2003). In related research, Fonseca and González, 2008 show that bank income-smoothing depends on investor protection, disclosure, regulatory supervision, financial structure, and financial development. Our research differs from Fonseca and González, 2008 in several important ways. First, Fonseca and González, 2008 use income-smoothing to measure earnings management. Because income-smoothing could proxy for both earnings management conducted for opportunistic as well as for efficiency reasons, the underlying motivation for the earnings management studied in Fonseca and González, 2008 is unclear. Unlike Fonseca and González, 2008, we use measures of earnings quality such as bench-mark beating and income-increasing abnormal loan loss provisions that specifically reflect opportunistic earnings management and measures such as earnings persistence, predictability of future cash flows, and future loan write-offs that specifically reflect the information enhancing role of earnings.[1]

Second, while Fonseca and González, 2008 consider only "hard" investor protection measures (e.g., anti-director rights and legal enforcement), we employ softer dimensions such as competition between banks and news coverage. Additionally, we study the role of political institutions, an important factor not considered in prior literature. We explicitly control for the institutional variables studied in Fonseca and González, 2008 in all our tests, to ensure that we isolate the incremental effects on earnings quality of the institutional variables we focus on.

Third, Fonseca and González, 2008 sample period spans 1995–2002, whereas ours spans both the period before the recent financial crisis (i.e., 1993–2006) as well as the crisis period (i.e., 2007–2009). Thus, we are able to provide evidence on the effects of institutional characteristics on earnings quality in the pre-crisis period, as well as on selected accounting outcomes (i.e., losses, large loan loss provisions, and capital adequacy) in the crisis period.

We hypothesize that banks in countries with stronger legal, extra-legal and political institutions will exhibit higher earnings quality. We use earnings persistence, cash flow predictability, the ability of current period's loan loss provisions to predict next period's loan charge-offs, the extent of earnings management to just-meet-or-beat prior year's earnings, and the extent of income-increasing earnings management through abnormal loan loss provisions as measures of earnings quality. We use a principal component derived from the rule of law index, the efficiency of the judicial system (LaPorta et al., 1998), and the law and order index (Economic Freedom of the World Annual Report, 2005) to proxy for the legal environment. We proxy extra-legal institutional structures by a principal component derived from the competition between banks, newspaper circulation, and tax compliance (Dyck and Zingales, 2004). For political involvement of the government in business, we use a principal component extracted from risk of expropriation, state ownership, and cost of starting a business (Bushman et al., 2004).

Although primarily exploratory in nature, we also examine the effects of institutional structures on earnings quality of banks during the financial crisis (i.e., the period 2007–2009). We examine three related measures of earnings quality in the crisis period – probability of having a loss, probability of having a large LLP, and probability of having low capital. We choose these three measures because the probability of having a loss is related to the level of earnings and timely loss recognition, the probability of having a large LLP is related to earnings management through LLP, and the probability of having low capital is related to balance sheet weakness.

We use an international bank sample from the *BankScope* database representing 35 countries for the 1993–2006 pre-crisis period to test our hypotheses.[2] Our results indicate that country-wide legal, extra-legal and political institutions have strong association with all our measures of earnings quality. In particular, we document that international institutional factors greatly increase the information value of bank earnings. Earnings persistence, cash flow predictability, and the ability of current period's loan loss provisions to predict next period's loan charge-offs are all enhanced by strong legal, extra-legal and political institutions. Furthermore, our results show that international institutional factors constrain opportunistic earnings management by managers of banks. We find that higher quality legal, extra-legal and political systems reduce earnings management to just-meet-or-beat prior year's earnings and reduce income increasing abnormal loan loss provisions. For the crisis period analysis (i.e., for the period 2007–2009), our preliminary evidence shows that banks in strong legal and political institutional environments exhibit lower probability of incurring a loss, lower probability of reporting a large LLP, and lower probability of having low capital. The results are weaker for the extra-legal institutional environment.

Our results contribute to the literature in several ways. First, our results extend prior research on the effects of international institutional factors to the banking industry. Our study identifies international institutional characteristics that are associated with relatively higher quality of earnings in banks around the world. In particular, we provide evidence on the relations between country-specific institutional structures and past practices related to loan write-offs and income-increasing managerial discretion in the estimation of loan loss provisions. Second, we employ a broader test of earnings quality that spans both the information perspective and opportunistic earnings management perspective. Third, our research design mitigates error in measuring managerial discretion by focusing on a single industry.

Our study is timely and relevant given the recent banking crisis that has placed particular emphasis on earnings quality of banks,

[1] Leuz et al. (2003) hypothesize and find that earnings management is lower in environments where investor protection is high because strong protection limits insiders' ability to acquire private control benefits, which reduces their incentives to mask firm performance. Their evidence primarily supports stronger investor protection curtailing opportunistic earnings management for industrial firms.

[2] Researchers generally agree that the financial crisis started in the latter half of 2007 (Ryan, 2008; Erkens et al., 2012). This is consistent with NBER, which indicates that the banking crisis started in the third quarter of 2007.