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Bank audit practices and loan loss provisioning

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ABSTRACT

I empirically examine the evolution of loan loss accounting across banks that differ categorically by external auditing practice. Using a partial adjustment model, and a sample of 75,505 observations on affiliated banks, 1995–2009, I find evidence of convergence across audit categories in target ratios of provisions for loan losses to nonaccrual loans. This is consistent with a standardized method of accounting for "impaired" loans. I observe less convergence, on the other hand, in target ratios of provisions for loan losses to loans, which appears to accommodate a role for managerial discretion.

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1. Introduction

In 1994, the U.S. General Accounting Office (GAO) sharply criticized loan loss accounting practices in the banking industry. Reserves for loan losses "could not be meaningfully compared" because they were developed using methods that varied greatly regarding the assessment of individual loans, the application of historical loss experience and the inclusion of "supplemental" reserves that "were not clearly linked to losses." The GAO recommended that reserves be directly linked to, and justified by, a comprehensive analysis of "current loss exposure" in the loan portfolio and that the periodic provision for loan losses adjust the reserve balance to the level determined to be necessary.

The Financial Accounting Standards Board (FASB) was thinking along the same lines at that time. The FASB defined a loan as "impaired" when, "based on current information and events," it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement (FASB, 1993). It expected this to resolve, or at least mitigate, the GAO's complaints that banks had established excessive supplemental reserves on the basis of possible future events rather than on the basis of loan-by-loan measurement.

More recently, however, criticism of bank provisioning practice has shifted abruptly, partly in response to the perceived failure of banks, prior to the recent financial crisis, to anticipate losses that were not necessarily identifiable from current loss exposures. The Financial Stability Forum (FSF, 2009) recommended that bankers be given more latitude to exercise "reasonable judgments" in establishing provisions. The U.S. Treasury (2009) similarly recommended that provisioning "incorporate a broader range of available credit information" and be more "forward-looking." The FASB (2011a), in an apparent reversal of its earlier position, concurred, as did, to varying degree, the Basel Committee on Banking Supervision (BCBS, 2011) and the International Accounting Standards Board (IASB, 2011).

These paradoxical observations—provisions for loan losses were too judgmental in 1994 but not judgmental enough by 2009—raise an interesting question concerning the evolution of bank accounting behavior. Have, in fact, the methods used by banks to account for loan losses become comparable, as seen from the perspective of the GAO in 1994, but perhaps inflexible, as seen from the perspective of the FSF and the U.S. Treasury in 2009?

I address this question by analyzing loan loss provisions of banks that vary categorically by external auditing practice. That is, I will determine whether banks which undergo two different types of external audit, or which forego external audit altogether, have moved toward a common standard for establishing provisions. This can be understood as a benchmark against which the evolution of industry-wide accounting behavior can be measured.

I measure provisions relative to, alternatively, nonaccrual loans and total loans. The ratio of provisions to nonaccrual loans is

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intended to reflect potential losses associated with "impairment." The ratio of provisions to loans, on the other hand, is more likely to incorporate potential losses that extend from "the ex ante assessment of future expected losses (Bushman and Williams, 2012)," are "established by management over and above amounts determined by analyses of individual loans and loss history (GAO, 1994)" **or are not individually identifiable** (FASB, 2011a).

My empirical approach uses a partial adjustment model to analyze 75,505 observations, 1995–2009, on affiliated banks with assets less than $500 million. Tests are conducted within seven subsamples of banks that vary by size, loan concentration and capitalization.

Results indicate categorical convergence in target ratios of provisions to nonaccrual loans in six of the seven subsamples and in 20 of 21 possible decompositions (seven subsamples by three audit categories). This may be related to regulatory changes over my sample period intended to improve financial reporting by making similar loans subject to the same requirements for measuring impairment. It is consistent with a preference of accounting standard setters for transparency and comparability (Balla and McKenna, 2009).

Convergence in target ratios of provisions to loans, on the other hand, occurs in three of the seven subsamples and in 14 of 21 decompositions. The greater relative divergence in target ratios of provisions to loans appears to accommodate a role for managerial discretion. The underlying tension reflects the comment of John Dugan, Comptroller of the Currency (OCC), that "savvier institutions that worked hard with the process found ways to document judgmental factors…nevertheless, it is clear to me that a number of banks and their auditors have not been adequately aware of the degree to which judgmental" factors may be used to justify provisions (Dugan, 2009).

The observed evidence of both divergence and convergence appears relevant to the ongoing debate over the extent to which provisions should anticipate future credit losses rather than observable loss events (FASB, 2011b). It constitutes an attempt to "more fully understand and quantify" the "distortions" embedded in provisioning behavior upon which future regulatory change depends (Balla and McKenna, 2009).

The remainder of the paper is organized as follows. Section 2 presents the methodology, with particular attention devoted to the decomposition of auditing categories. Section 3 discusses the sample from perspectives of time, audit category, loan specialization and capitalization. Section 4 presents results and Section 5 concludes.

2. Methodology

My focus on external audit as a means of categorization follows prior research analyzing relationships between auditing and the recognition of loan loss provisions (Dahl et al., 1998; Gunther and Moore, 2003; Kanagaretnam et al., 2009; DeBoskey and Jiang, 2012). It also follows the FSF (2009), which explicitly lists "auditor practices" as a determinant of "diversity" in loan loss provisioning. Diversity may reflect the "complexity of accounting standards themselves, extensive complex judgments in applying the standards and a lack of specificity in auditing standards (BCBS, 2008)."

In the U.S., bank financial statements are examined by regulatory agencies. One set of financial statements, required for all banks, on a bank-specific basis, is the quarterly Report of Condition and Income. External audits of these statements are required for banks with assets of more than $500 million. Smaller banks are exempt from this requirement, although they may choose to be audited voluntarily.

An audit constitutes "the most comprehensive level of auditing work performed for the bank by independent external auditors." The following levels are reported: (1) independent audit of the bank conducted in accordance with generally accepted auditing standards by a certified public accounting firm which submits a report on the bank; (2) independent audit of the bank's parent holding company conducted in accordance with generally accepted auditing standards by a certified public accounting firm which submits a report on the consolidated holding company (but not on the bank separately); (3) attestation on bank management's assertion on the effectiveness of the bank's internal control over financial reporting by a certified public accounting firm; (4) director's examination of the bank conducted in accordance with generally accepted auditing standards by a certified public accounting firm; (5) director's examination of the bank performed by other external auditors; (6) review of the bank's financial statements by external auditors; (7) compilation of the bank's financial statements by external auditors; (8) other audit procedures; and (9) no external audit work.

From these nine possible categories, I isolate three: (1) external audit of a bank conducted at the bank level; (2) external audit of a bank conducted at the holding company level; and (3) no external audit. The aggregation of categories as "unaudited" was predicated on the relatively few numbers of observations within some of these categories and the apparently modest functional distinctions between them.

2.1. The empirical model

In distinguishing among these categories, a regression specification must permit each bank's target loan loss provisions to vary over time and must recognize that deviations from the target are not necessarily offset quickly. The ability of banks to reverse deviations from targets, if they occur, depends upon adjustment costs (see, among others, Flannery and Rangan, 2006). With zero adjustment costs, banks should never deviate from optimality, while with infinite adjustment costs, no movement toward a target should be observed.

Provisions have been previously analyzed with respect to auditing by Dahl et al. (1998), Gunther and Moore (2003), Kanagaretnam et al. (2009) and DeBoskey and Jiang (2012). These papers are part of a much wider literature that has been pursued from perspectives of both finance and accounting (see Bushman and Williams, 2012).

Provisions play a central role in accounting for asset quality problems in the banking industry and are "critical" to understanding financial condition (GAO, 1994). They are an expense item that reduces a bank's net income while increasing its reserves (allowance for loan losses). The Manual of Examination Policies of the Federal Deposit Insurance Corp. (FDIC) states that "the total amount for each reporting period credited to the reserve for loan losses should be the amount management determines is necessary to ensure continued adequacy of the reserve."

Attempting to measure categorical differences in how banks establish provisions during a transitional period is problematic. For instance, comparing mean levels of provisions at a point in time, or even over several years, is likely to be misleading due to the fact that banks are adapting to changing conditions for loss recognition. In this regard, the OCC (1998) identifies effects on loss recognition that are associated with changes in: lending policies and procedures; national and local economic and business conditions; the volume and severity of past due, nonaccrual and other classified loans; the nature and volume of the loan portfolio; the experience, ability and depth of lending management and staff; the quality of the bank's loan review system; concentrations of

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