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The relation between auditor reputation, earnings and capital management in the banking sector: An international investigation

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ABSTRACT

In this study we examine two types of manipulation: earnings and capital management (or capital adequacy management) in banks, using an international sample of banks from four countries (USA, UK, Germany and France), which in couples belong in common financial systems (two common – law countries and two code – law countries). In specific, we examine the implications of two aspects of auditor reputation, auditor type and auditor industry specialization, for earnings management via the manipulation of the earnings benchmark. We prove that different aspects of auditor reputation per financial system restrict the motivation of managers for earnings manipulation. Furthermore, we examine the levels of the earnings and capital management in banks by separating our research period in the pre – Basle II regime and the post – Basle II regime. We prove that in the post – Basle II period the banks per financial system limit earnings and capital adequacy management. Moreover, we examine the effects of auditor reputation both in earnings and capital management by using the same model taking into account the financial crisis of 2008 with the results of this (expanded) research to be highly interesting for each financial system.

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1. Introduction

The recent financial crisis has highlighted the main issue of the risk-taking behavior of banks at a global level (Bernanke, 1983; Calomiris and Mason, 2003a,b). Regulators tried to mitigate that phenomenon by putting stricter and more effective capital adequacy standards (Chalermchatvichien et al., 2014). The stricter regulations provide a great deal of debate among policy makers, regulators and financial economists (Lagoarde-Segot, 2016). In particular, the opponents of restrictive regulation put forward the argument that self-regulation through effective corporate governance mechanisms and market

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discipline should lead to a moderation of risk-taking practices by financial institutions. According to Vauhkonen (2011), the current financial crisis brings into focus the need for greater transparency and market discipline. The purpose of this study is to analyze the impact of auditor reputation on earnings quality and capital adequacy ratios in the periods before and after the financial crisis and in the pre and post – Basle II periods.

In this paper we examine earnings and capital management through loan loss provisions in the banking sector. In the first part of our study we examine whether or not auditor reputation reduces earnings management via an earnings benchmark, while in the second part we examine if the sample banks manipulate simultaneously with their earnings and capital adequacy ratios violating or not the provision of the Basel Committee (Basle I & II). In the last part of our analysis we investigate whether auditor reputation affects, not only the extent of earnings but also the extent of capital management. We use an international sample banks from the USA, UK, Germany and France for the period 2005–2012. The selection of these countries was based on the nature of their financial systems which in couples is common (two common – law countries and two code – law countries). The USA and UK are common – law countries and France and Germany are code – law countries. According to Ball et al. (2000) common – law countries are characterized by active stock markets, a diverse base of investors, strong investor protection and corporate governance mechanisms and high litigation risks, and are shareholder – oriented. However, code – law countries are characterized by less active stock markets, low litigation risks, and are lender – oriented and call for less public disclosure. Coppens and Peek (2005) and Daske et al. (2006) show that discrepancies in earnings reporting are more evident in code – law countries, implying that earnings management would be more pronounced in code – law countries. A major research question according to Iatridis (2012) is whether being audited by a Big 4 auditor increases earnings quality and conservatism regardless of the respective national institutional differences. In contrast, it would be expected that audit firms that operate in strict regulatory environments improve the quality of financial reporting irrespective if they are big or not (see Maijoor and Vanstraelen, 2006).

In the first part of our study we investigate the effect of auditor reputation on earnings management. Auditor reputation consists of two components: 1) auditor type (Big 4[1] vs. non – Big 4 auditors). A large number of studies emphasize that higher audit quality associated with the Big 4 auditors. Relative to non – Big 4 auditors, Big 4 auditors have greater experience, resources and more importantly, market – based incentives (e.g. mitigating the risk of litigation and protecting their reputation capital) to reduce the tendency of their clients to apply earnings management techniques (Jenkins et al., 2007). In conclusion, we predict that manipulation on earnings will be lower for the banks that audited by Big 4 auditors. 2) auditor industry specialization. We examine if auditors experts in the banking industry can constrain earnings management. Auditors who are experts in the banking sector can better assess the adequacy of the loan loss provision in comparison with auditors without expertise in the banking industry. Prior research concluded that auditor industry specialization improve financial reporting quality and mitigates fraudulent financial (Johnson et al., 1991; Carcello and Nagy, 2004; Krishnan, 2003, 2005). We calculate auditor industry expertise by an auditor's industry market share.

Banks operate in a strict regulatory framework that monitored by the Central Banks and by the provision of the Basel Committee. Thus, auditor reputation may not be so important in limiting earnings management in banks. Conversely, if our results determine a negative association between auditor reputation and earnings management, then this reputation is likely to affect firms that does not belong in the financial sector and so does not strictly governed by regulatory frameworks (Kanagaretnam et al., 2010).

In our analysis we use two approaches for earnings management:

- The extent of earnings management to avoid a loss.
- The extent of earnings management to just meet – or beat the prior year's earnings (Beatty et al., 1995; Altamuro and Beatty, 2010; Kanagaretnam et al., 2010).

We find in separate tests per financial system that different approach of auditor reputation moderate benchmark – beating[2] behavior in banks. When we examine simultaneously earnings and capital management, we conclude that there is greater manipulation in earnings than in the capital adequacy ratios through LLPs. In the post – Basle II period and mainly in the post – crisis period the results reversed concerning with earnings and capital adequacy management in the banks of our sample. The rest of this study is organized as follows:

In the first section we refer to the literature review about auditor reputation, earnings and capital management in industrial firms and financial institutions. In the second section we develop the hypotheses. In Section 4, we refer to the measurements of earnings and capital management and we explain the empirical models used for the tests. In Section 5 we describe the sample data collection. In Section 6 we present the empirical results of our research. In Section 7 we refer to the conclusions of our study.

[1] We refer on Deloitte, PricewaterhouseCoopers, Ernst & Young and KPMG.
[2] Loss – avoidance and just – meeting or – beating prior year's earnings.

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