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Accounting research in banking – A review

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1. Why carry out accounting research in the banking industry?

1.1. Why focus on the banking industry?

The banking industry is critically important to national and global economies. Banks are vital to the operation of a country's domestic economy in their role as depository institutions and lenders to both corporations and individuals. For example, Fields et al. (2004) estimate that banks represent over twenty percent of the total public equity market capitalization in the United States.

Compared to industrial firms, firms in the banking industry have a number of distinct characteristics that suggest interesting topics for research. First, banks have an unusually high degree of leverage relative to other firms, with the leverage ratio in the banking sector reported to be as high as 90%. Employing an analytical model, DeAngelo and Stulz (2015) demonstrate why it is optimal for banks to be highly leveraged. In their model, high bank leverage is not the result of moral hazard, taxes or any of the other leverage-related distortions outlined in Modigliani and Miller (1958). In an idealized setting without any such distortions, the only motive for a bank to issue debt is the value generated by servicing the demand for socially valuable safe/liquid claims.

Second, banks have a different governance structure from non-financial firms. Kroszner and Strahan (2001) find that banks in the 1992 Forbes 500 had larger boards and a lower fraction of insiders than non-financial firms. Adams (2011) also reports bank boards to be larger and more independent than the boards of non-financial firms in the Riskmetrics database of S&P 1500 firms from 1996 to 2007. However, recent proposals to improve bank governance, such as that made by Walker (2009), suggest that bank governance structures are ineffective because of their differences from those of non-financial firms. The current bank governance regime is also blamed for being responsible in large part for the subprime mortgage crisis (Adams and Mehran, 2011).

Third, banks operate with a higher degree of information uncertainty than other firms. Bank operations and products are complex, rendering it difficult to assess risks of large and diverse portfolios of loans or other financial instruments (Autore et al., 2009). Given these complexities, it is difficult to fully understand all the relevant information when communicating about a bank's future prospects.

Finally, banks are highly regulated. In the United States, they are subject to the scrutiny of the Federal Deposit Insurance Corporation (FDIC), Federal Reserve Board and other government agencies. Regulation restricts banks' activities and imposes other conditions. For example, banks have to maintain minimum levels

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of capital, and they were not allowed to engage in the issuance of securities until the late-1990s. Moreover, governments in some countries provide deposit insurance and guarantees, which change the way banks think about risk, an important issue during the recent financial crisis. The highly regulated nature of the industry renders banks relatively homogeneous compared with industrial firms, both in terms of their operating activities and accounting practices. Focusing on a single, relatively homogeneous industry with relatively homogeneous accounting practices facilitates control over other determinants of cross-sectional differences, thus increasing the reliability of inferences from empirical analysis. Hence, focusing on the banking industry allows researchers to avoid many of the problems that arise when dealing with industrial firms.

1.2. Accounting research in the banking industry

The financial crisis of 2007–2009 sparked a surge in accounting and finance research on the banking industry. Conducting accounting research on this industry has many advantages.

First, the banking industry is a good setting for investigating earnings management. Banking was a profitable industry until 2007, and became highly profitable once again after the financial crisis. For example, in 2001, the industry ranked second in profitability after pharmaceuticals among Fortune 500 firms in the United States (Public Citizen, 2002) and ranked third in returns on revenue in 2005 (CNNMoney.com). These high levels of profitability provide opportunities and incentives for managers to earn quasi-rents by distorting earnings. Moreover, the complexity of banking operations and the high level of information asymmetry increase the need for the communication of private information, and thus also expand opportunities for earnings management.

Second, as the banking industry is highly regulated, there are several regulations that affect banks' financial reporting, auditing, internal control, etc. In 1991, the FDIC Improvement Act (FDICIA) imposed new auditing, corporate reporting and governance requirements on depository institutions with assets exceeding US $500 million (this threshold was raised to $1 billion in 2005) and on their auditors (Murphy, 2004). More specifically, the FDICIA requires bank management to evaluate the bank's internal controls over financial reporting, and auditors to attest to and report on the effectiveness of those controls. Such requirements, particularly in the wake of the financial crisis, raise many interesting and important accounting-related research questions. For example, Jin et al. (2011) examine whether and how accounting and audit properties predicted impending bank failures and trouble during the crisis.

Finally, the exogenous shock to the system caused by the 2008–2009 financial crisis has created considerable interest in conducting research on the banking industry. For example, the crisis provides an ideal setting in which to test the implications of discretionary reporting choices for risk-taking and financial stability. Moreover, as with any empirical research, data constitute the foundation and the banking industry offers a large body of detailed information for public and private banks that is readily available to researchers.

2. What have we learned from recent accounting research in banking?

2.1. Use of reporting discretion

The majority of accounting research in the banking arena focuses on how bank managers use their reporting discretion. Bank managers have flexibility when preparing financial statements. Therefore, how they use that flexibility, and particularly whether they manipulate financial reporting, is deserving of study.

Unlike studies on the use of reporting discretion in by non-banking firms, research in the banking sector generally focuses on a single accrual, loan loss provision (LLP) or loan loss allowance (LLA). LLP (LLA) is by far the largest and most important accrual for banks. In normal times, the median ratio of LLP to earnings before LLP ranges between 15% and 20%, according to most studies, and the median ratio of LLA to stockholders' equity is around 10%. Bank managers estimate LLP to reflect changes in expected future loan losses, a process that allows them wide latitude for discretion in LLP estimation (Kanagaretnam et al., 2003). Moreover, the degree of discretion depends on the type of loan. For example, homogeneous loans typically provide management with less flexibility in estimating LLP than do heterogeneous loans. Bank managers' use of discretion in estimating LLP has received considerable attention from the U.S. Securities and Exchange