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Auditor reputation and earnings management: International evidence from the banking industry

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A B S T R A C T

We examine the relation between auditor reputation and earnings management in banks using a sample of banks from 29 countries. In particular, we examine the implications of two aspects of auditor reputation, auditor type and auditor industry specialization, for earnings management in banks. We find that both auditor type and auditor industry specialization moderate benchmark-beating (loss-avoidance and just-meeting-or-beating prior year's earnings) behavior in banks. In addition, we find that once auditor type and auditor industry specialization are included in the same tests, only auditor industry specialization has a significant impact on constraining benchmark-beating behavior. In separate tests related to income-increasing abnormal loan loss provisions, we find that both auditor type and auditor expertise constrain income-increasing earnings management. Again, in joint tests, only auditor industry expertise has a significant impact on constraining income-increasing earnings management.

1. Introduction

We examine the effect of auditor reputation on bank earnings management using an international sample of banks. Banks operate in a highly regulated environment in that they are monitored by Central Banks and other regulatory agencies (such as deposit insurance corporations). Consequently, auditor reputation may not be as important in constraining income-increasing earnings management in banks. On the contrary, if our finding establishes a negative association between auditor reputation and income-increasing earnings management, then auditor reputation likely is even more relevant for firms in other industries that are not subject to such direct regulatory scrutiny. To our knowledge no other study has examined how auditor reputation is related to earnings management in the international or the US banking industry.

Our main prediction is that auditor reputation (auditor type and auditor industry specialization) is negatively related to earnings management in banks even after controlling for several previously identified international institutional factors and bank monitoring factors. Evidence of a negative relation between auditor reputation and earnings management may not be surprising for US banks because, in a high-litigation environment such as the US, high-reputation auditors have an incentive to maintain a high level of earnings quality to protect their reputation and legal exposure (Francis and Wang, 2008). Whether such a relation exists across different legal and institutional environments clearly is of interest. We are able to address this issue by analyzing an international sample of banks.

Prior research in banking has examined the relation between international institutional factors and bank monitoring variables and earnings management (Shen and Chih, 2005; Fonseca and González, 2008). Shen and Chih (2005) using earnings benchmark tests document that most banks manage their earnings. They also show that stronger investor protection and greater transparency in accounting disclosure reduce a bank's incentives to manage earnings. Fonseca and González (2008) focus on factors influencing income smoothing through loan loss provisions, the major bank accrual. They find that income smoothing is lower in jurisdictions with greater bank regulation and supervision. Interestingly, neither of these papers addresses the impact of auditing, an important external monitoring mechanism, on earnings management or income smoothing.

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In the auditing literature, Becker et al. (1998) report lower earnings management in industrial firms for clients of Big 5 auditors. Krishnan (2003) finds that firms audited by industry specialists report lower discretionary accruals, a commonly used proxy for earnings management in industrial firms. And, Francis and Wang (2008), using an international sample, report that earnings quality is higher for firms that use Big 4 auditors, but their result holds only for regimes with strong investor protection. A notable deficiency of these studies is that they exclude firms in banking and financial services.

In addition, auditing banks is more complex than auditing industrial firms. In its May 2006 report on large firm Public Company Accounting Oversight Board (PCAOB) inspection deficiency analysis, the American Institute of Certified Public Accountants' (AICPA, 2006) Center for Public Company Audit Firms finds that banks' loan loss allowance ranks number one among the various deficiencies found by inspectors. This indicates that auditing the loan loss allowance and the related loan loss provision are challenging tasks for auditors in general. High-reputation auditors have incentives to provide high-quality audits to avoid jeopardizing their reputation capital. Thus, auditor reputation is potentially important in assessing the adequacy of loan losses and mitigating earnings management incentives of bank managers.

In this study, we extend the research on benefits of auditor reputation to the banking industry. Specifically, we examine two aspects of auditor reputation. First, we investigate the implications of auditor type (Big 5 *vs.* non-Big 5 auditors) for constraining income-increasing earnings management in banks. A large body of empirical research documents that higher audit quality is associated with Big 5 auditors.[1] Relative to non-Big 5 auditors, Big 5 auditors have greater expertise, resources, and more importantly, market-based incentives (e.g., mitigating the risk of litigation and protecting their reputation capital) to constrain the tendency of their audit clients to engage in aggressive reporting. Consequently, we predict that earnings management will be lower for banks audited by Big 5 auditors.

Second, we examine the effect of auditor industry specialization on reducing earnings management in banks. Auditors who are specialists in the banking industry can better assess the adequacy of the loan loss provisions than non-specialist auditors. Prior research documents that auditor industry specialization enhances financial reporting quality and mitigates fraudulent financial reporting (Johnson et al., 1991; Carcello and Nagy, 2004; Krishnan, 2003, 2005). We measure auditor industry specialization/expertise by an auditor's industry market share.[2]

We employ three traditional proxies of earnings management, managing earnings to avoid losses, managing earnings to just-meet-or-beat the prior year's earnings, and an accrual-based proxy (abnormal loan loss provisions), to test the extent of income-increasing earnings management through bank loan loss provisions. By using three different tests (accruals- and non-accruals-based tests), we strengthen the validity and robustness of our results. Our loss-avoidance/just-meeting-or-beating prior year's earnings tests closely resemble the methodology used by Beatty et al. (2002) and Altamuro and Beatty (2010). Our proxy for abnormal loan loss provisions is based on prior banking research on loan loss provisions (Wahlen, 1994; Kanagaretnam et al., 2004).

We use an international bank sample from the *BankScope* database representing 29 countries over the period 1993 to 2006 to test our hypotheses. We find in separate tests that both auditor type and auditor expertise moderate benchmark-beating (loss-avoidance and just-meeting-or-beating prior year's earnings) behavior in banks. However, we find that once auditor type and industry expertise are included in the same tests, only auditor industry expertise has a significant impact on constraining benchmark-beating behavior. In separate tests related to income-increasing abnormal loan loss provisions, we find that both auditor type and auditor expertise constrain income-increasing earnings management. Again, in joint tests, only auditor industry expertise has a significant impact on constraining income-increasing earnings management. Overall we find that audit specialists constrain income-increasing earnings management in banks. Our results are robust to several sensitivity tests including alternate classification of audit specialists, controlling for self-selection, and different bin-widths for benchmark tests.

The rest of this paper is organized as follows. The next section develops the hypotheses. Section 3 explains the empirical models used for tests of earnings management. Section 4 describes the sample selection process. Section 5 discusses the results and Section 6 concludes the study.

2. Hypotheses

Using economic theory, DeAngelo (1981) argues that auditor size is a proxy for auditor reputation and audit quality. She reasons that brand-name auditors (i.e., Big 5 auditors) are better able to detect material misstatements in financial statements and more willing to report what they find than are other auditors (i.e., non-Big 5 auditors). Higher expertise is associated with Big 5 auditors because they not only have more resources but also devote more resources to specialized staff training, peer reviews, and investment in information technology than non-Big 5 auditors (Craswell et al., 1995). Similarly, higher independence is associated with Big 5 auditors because they have higher reputation capital at stake relative to non-Big 5 auditors. Loss of reputation, as Arthur Andersen learned the hard way, could put a Big 5 auditor out of business (Huang and Li, 2009). Litigation risk also motivates Big 5 auditors to remain independent. In the wake of the Enron-Andersen scandal PricewaterhouseCoopers, Deloitte and Touche, and Ernst and Young have resigned from more than 1200 clients to mitigate the risk of litigation (Hindo, 2003). In short, a higher audit quality is associated with the Big 5 auditors.

There is a large body of empirical research that documents that higher audit quality is associated with Big 5 auditors for industrial firms. Teoh and Wong (1993) observe higher earnings response coefficients for clients of Big 5 auditors relative to clients of non-Big 5 auditors, consistent with investors perceiving earnings to be of higher quality when the auditor is a brand-name auditor. Becker et al. (1998) report lower earnings management in industrial firms for clients of Big 5 auditors. Additionally, Basu et al. (2000) find higher levels of financial reporting conservatism (i.e., more timely recognition of bad news) for clients of Big 5 auditors. Although empirical evidence on auditor reputation and audit quality in the banking industry is limited, the economic incentives faced by the Big 5 auditors of banks are similar to those of other industries, i.e., preserving reputation capital and mitigating the risk of litigation.[3] In addition, auditor type may be of higher importance for industries such as banking, where information uncertainty is higher relative to industrial firms due to the greater complexity of banking operations and difficulty of assessing risk on the large portfolio of loans (Autore et al., 2009).

[1] We refer to the high-reputation, brand-name auditors as Big 5 (in fact Big 6, during the period 1993–1997, Big 5 after the merger between Coopers and Lybrand and Price Waterhouse in 1998, and currently Big 4 after the demise of Arthur Andersen in 2002) auditors throughout the paper for simplicity.

[2] In our discussions, we use auditor industry specialization and industry expertise interchangeably.

[3] Kanagaretnam et al. (2009) is an exception. They find a significant, positive association between the discretionary component of LLP and stock returns for banks audited by Big 5 auditors.