Thoughts on financial accounting and the banking industry

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A B S T R A C T
I provide big picture comments on the review of the banking literature in accounting by Beatty and Liao (2014). Beatty and Liao (2014) does a service to the accounting field by providing an intelligent, well organized and accessible point of entry to banking research in accounting. I complement Beatty and Liao by presenting my observations on the role of financial accounting in banking, focusing my discussion on real effects of accounting policy choices on individual bank risk taking and codependence of risk among banks. I also offer ideas on future research directions.

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1. Introduction

The primary functions of the financial system of a country include production of information about investment opportunities and allocation of capital; monitoring investments and exerting corporate governance after finance is provided; facilitating the trading, diversification, and management of risks; mobilizing and pooling savings; and organizing trade in goods, services, and securities. How well a financial system operates to efficiently allocate capital to the most promising investment opportunities can powerfully influence economic prosperity (e.g., Levine, 2005, Merton and Bodie, 1995). The financial system that delivers these functions is comprised of an ever evolving configuration of financial institutions, securities markets, securities laws and enforcement budgets, information intermediaries, financial regulation, and relations between political and financial institutions. As the recent financial crisis has made clear, the banking system is a central element of a country’s financial infrastructure which is vulnerable to catastrophic systemic events.

Banks, like business firms in other industries, must attract outside funding in competitive capital markets, face competition in product and labor markets, and deal with corporate governance issues deriving from managerial self-interest and asymmetric information. However, in other respects banks are special and introduce additional considerations that are unique to the financial sector. Relative to non-financial firms, banks’ balance sheets reflect significantly higher leverage. Debt commonly comprises around ninety percent of a bank’s capital structure, and the existence of deposit insurance and government backed financial safety nets can significantly reduce incentives for depositors and other creditors to monitor banks’ risk-taking behavior (Acharya et al., 2014). Further, it is often asserted that banks are inherently more opaque than non-financial firms (Morgan, 2002; Flannery et al., 2004, 2013). This inherent lack of transparency is presumed to derive

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1 See Calimorités and Haber (2014) on role of politics in the determination of banking systems’ performance.

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from the fact assets on banks’ balance sheets reflect investment decisions based on private information about borrowers and projects that is not available to those outside the bank (e.g., Diamond, 1984; Boyd and Prescott, 1986). Trading activities may also make banks relatively more opaque as complex trading portfolios embed risks that are hard to assess and verify, and trading positions and related risk profiles can be quickly altered in real time (Morgan, 2002; Laeven, 2013). High leverage combined with subsidized deposit insurance, government guarantees and bank opacity engenders incentives and opportunities for banks to engage in risk taking that is excessive from a society’s point of view (Jensen and Meckling, 1976; Macey and O’Hara, 2003).

Further, the role of banks as efficient allocators of scarce capital to the economy and as important providers of liquidity make bank balance sheets special as well. Consider the balance sheet of a bank or the aggregate balance sheet of the entire banking system. Distinct from most other industries, the balance sheet itself represents the productive output of the banking business. The asset side represents the supply of bank financing to the real economy and is the product of private information collection, delegated monitoring activities and capital allocation decisions. While it is common to view the right hand side of the balance sheet solely in terms of capital structure, for banks debt is a factor of production, and in some cases it is itself a key output which is used as money, whether demand deposits, sale and repurchase agreements, other forms of short-term debt (Gorton, 2013), and off-balance sheet items such as lines of credit and loan commitments (Kashyap et al., 2002). The balance bank sheet can also be conceptualized as a transmission mechanism that broadcasts economic shocks and monetary policies to the wider economy (e.g., Kashyap and Stein, 2000). To the extent that the balance sheets of many banks are simultaneously vulnerable to the same downside risk exposures, negative economic shocks can cause banks to co-move and amplify shocks across the entire economy (Adrian and Brunnermeier, 2011; Acharya et al., 2010).

However, the true bank balance sheet is itself unobservable. What we actually observe is the accounting balance sheet which is a quantitative depiction of a bank’s economic reality constructed via application of managerial judgment and discretion to existing accounting rules. While this is true for firms in any industry, the centrality of banks in the financial system and the potential for bank failures to impose negative externalities on the entire economy raise a number of issues unique to banking. Given that regulators and investors make decisions based on what is observable, financial accounting exerts a potentially significant influence on outcomes in the banking sector. The recent financial crisis focused a spotlight on the importance of the accounting rules governing fair values of assets and liabilities, asset securitizations, derivatives, repos and loan loss provisioning. The recognition by regulators that accounting rules can fundamentally impact bank stability is reflected in proposals issued by the Financial Stability Forum (2009) and the US Treasury (2009) strongly recommending that both the FASB and IASB re-evaluate fair value accounting, accounting for loan losses, and hedge accounting, among others issues. It is also important to note that there is tension created by the fact that the objectives of accounting standard setting differ from those of bank regulation. General purpose financial reporting is concerned with providing information to those outside the firm to support a wide range of decision contexts and contractual arrangements. In contrast, prudential bank regulation seeks to limit the frequency and cost of bank failures, and to protect the financial system as a whole by limiting the frequency and cost of systemic crises (e.g., Wall and Koch, 2000; Roche, 2005).

Given the central role played by banks’ real and accounting balance sheets, the exposure of economies to systemic risk in the banking sector, and the complexities of bank regulation and governance, banks have been the focus of vast academic and policy literatures which have been growing at a dramatic pace in the aftermath of the recent financial crisis. This literature spans a number of academic fields encompassing large bodies of theory and empirical research, and within and across country research designs. The demand by economists and policy makers for powerful, insightful accounting research in banking has probably never been higher than it is right now. However, the sheer volume, scope and complexity of this literature present a significant entry barrier to PhD students and other researchers interested in pursuing banking research.

In this regard, the paper by Beatty and Liao (2014) (BL) does a service to the accounting field by providing an intelligent, well organized and accessible point of entry to banking research in accounting. The paper critically discusses and synthesizes fundamental results from thirty years of accounting research in banking. How does a review paper create intellectual value? First and foremost, a good review paper organizes the literature into a coherent framework which delineates the distinct lines of inquiry that have been pursued and provides the reader a strong sense of the boundaries between what is known and yet unknown. BL organize the literature into three buckets: (1) valuation and risk relevance of bank accounting information; (2) the use of accounting discretion to manage earnings and reported regulatory capital; and (3) the effect of accounting on banks’ economic behaviors. I think this organization of the literature works well and that each section provides the reader a good sense of the state of the literature.  

2 Opacity is not unique to the banking industry. For example, R&D-intensive industries where the development of new products requires substantial investments with long gestation periods and highly uncertain outcomes are also often viewed as opaque. What is special about banks is the combination of high leverage with relatively opaque assets.

3 For example, FASB (2010, paragraph OB2) states “The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity.”

4 The monograph by Ryan (2011), focused on financial reporting for financial instruments, provides an alternative organization of the accounting literature in banking, organizing his discussion into four categories: (1) banks’ loan loss accruals, (2) fair value versus amortized cost accounting measurement bases, (3) balance sheet presentation of risk-concentrated financial instruments such as derivatives and retained residual securities in securitizations, and (4) risk disclosures.
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