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Earnings management and auditor specialization in the post-sox era: An examination of the banking industry

David Gregory DeBoskey [a], Wei Jiang [b,*]

[a] San Diego State University, San Diego, CA 92182-8221, USA
[b] California State University, Fullerton, CA 92834-6848, USA

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ABSTRACT

This study examines the impact of auditor specialization on bank loan loss provisions for a large cross-section of US banks for the period 2002–2006. We find a positive relationship between earning (before provision) and loan loss provision, suggesting that bank managers use LLP to smooth earnings in the post-SOX period. However, this relationship is significantly moderated by audit industry expertise, providing strong evidence that industry specialization constrains income smoothing. In further analysis, we find some evidence that auditor specialization is more effective in reducing potentially incoming-increasing earnings management. Our results hold after controlling for self-selection bias and are robust to alternative measures of industry specialization. Overall, our findings support the conclusion that audit industry expertise plays an effective monitoring role in constraining management's discretionary accounting choices.

1. Introduction

Our study's purpose is to evaluate the role of specialist auditors in constraining earnings management via loan loss provisions in the banking industry. Unlike most other industries, the banking industry is highly regulated and is subject to the scrutiny of various government agencies. Bank financial statements are reviewed by a number of people both internal and external to the bank (e.g., bank management, creditors and owners, banking analysts, and state and federal regulators) (Dahl et al., 1998). Despite extensive regulatory oversight, bank managers have considerable discretion in how they recognize and record the provision for loan losses. The majority of prior studies provide evidence that loan loss provisions are extensively used by bank managers to manipulate reported earnings.[1] Consequently, users of a bank's financial information likely rely on high-quality auditors that can provide crucial oversight in reviewing and attesting to management's estimates, especially material ones such as loan loss provisions. Consistent with this view, a US General Accounting Office (GAO) study (GAO, 1991) states that independent financial audits can improve the reliability of financial statements by verifying whether banks are being truthful in their published financial reports, thereby reducing the public's uncertainty about the banks' financial health.

Auditor industry specialization/expertise represents an important dimension of audit quality. A specialist's knowledge of the industry is developed through extensive auditing experience, specialized staff training, and expensive investments in information technology. Relative to non-specialist auditors, this industry-specific knowledge enables specialist auditors to provide higher quality audit service to the clients by reducing information symmetry through their greater ability to detect material misstatements and constrain management's discretionary behavior. Given that information uncertainty is greater in the banking industry relative to industrial firms due to the more complex nature of bank operations (Autore et al., 2009), auditor specialization may play an even more significant role in mitigating information asymmetry. However, Black (1990b) suggests that compared to federal or state regulators who represent the interest of the deposit insurer, auditors are more likely to know more about the accounting issues but less about the banking industry and current regulatory concerns. The subjectivity involved with valuing banks' loan portfolios is a major

* Corresponding author. Tel.: +1 657 278 8653; fax: +1 657 278 4518.
E-mail addresses: deboskey@mail.sdsu.edu (D.G. DeBoskey), wjiang@fullerton.edu (W. Jiang).

[1] See for example, Collins et al. (1995), Liu and Ryan (1995), Kim and Kross (1998), Beatty et al. (2002), Kanagaretnam et al. (2003), Kanagaretnam et al. (2004), and Fonseca and Gonzales (2008).

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area of concern.[2] Auditors seem to have difficulty measuring amounts of loan losses (Moyer, 1990) and have been forced to reissue their reports because of findings of regulators (Black, 1990a). Hence, it comes down to an empirical question as to whether auditor industry specialization is similarly associated with earnings quality in the banking industry.

We test our hypotheses using a sample of 1249 bank-year observations for the period 2002–2006. This was a period following the implementation of the Sarbanes–Oxley Act of 2002 (SOX) and preceding the recent financial crisis, and it was a period characterized by increasing regulatory scrutiny on auditing practices and the issuance of several new auditing standards. We focus on the post-SOX period for two reasons. First, recent research has found evidence of more conservative management and auditor behavior due to increased regulatory, investor, and media scrutiny and heightened legal liability.[3] Therefore, including data from two distinct sample periods could potentially confound the analysis of the effect of auditor specialization on the financial reporting quality. Second, we believe that by focusing on a more recent period, the findings from this study can be more useful to interested parties, such as regulators and investors. We employ various measures of auditor specialization accepted in the extant literature to conduct our empirical tests. Our results show that US banks continue to smooth accounting earnings via loan loss provisions in the post-SOX period. More importantly, we find strong empirical evidence that auditor industry specialization plays an important role in constraining bank managers' income smoothing behavior. In further analysis, we find that auditor specialization is more effective in reducing income-increasing earnings management. This result is consistent with the notion that auditor industry specialization leads to more conservative estimation of loan loss provisions, probably due to auditors adopting reporting conservatism and focusing more attention on incoming-increasing accruals than incoming-decreasing accruals.

This research is timely and relevant. The recent financial/banking crisis highlights the importance of the auditor's monitoring role in the banking industry. At this important time, investors are increasingly interested in information about the earnings quality of banks and the role of audit specialists in enhancing bank earnings quality. Our research provides valuable insights into whether industry expertise matters and whether it curtails earnings management in the banking industry. To the best of our knowledge, there are a limited number of prior and concurrent studies that examine the relation of income smoothing and audit quality in the banking industry. Kanagaretnam et al. (2009) document a higher market valuation of the discretionary component of loan loss provisions for banks audited by a specialist auditor, consistent with auditor expertise mitigating information asymmetry between bank managers and investors and enhancing the information conveyed by discretionary LLP. A concurrent paper by Kanagaretnam et al. (2010b) is closely related to this study. Using a sample of banks from 29 countries (the US not included), they find that auditor industry specialization moderate benchmark-beating behavior and constrain income-increasing earnings management in banks. Our study differs from theirs in two important ways. First, we focus on US banks drawn from a more recent time period. Second, while their study examines only the income-increasing managerial discretion, we explore the differential role of auditor specialization in mitigating earnings management for different types of discretionary provisioning behavior. Taken together, our results and those of the concurrent research in this area jointly present a fairly cohesive picture of the impact of auditor specialization on the quality of financial reporting. The collective evidence has important implications for financial regulators and others focusing on improved financial regulatory reform. If specialization limits bank managers' ability to manage earnings, then at least regulators and others will have assurance that auditor expertise is important and plays a valuable role in the financial services industry.

We organize the rest of the paper as follows. The next section discusses and develops our hypotheses regarding the impact of industry specialization on earnings management. Section 3 presents the sample selection, research design, variable measures, data, and models employed in testing our hypotheses. Section 4 discusses our results. Section 5 discusses our conclusions and the various limitations of our study.

2. Hypotheses development

Loan loss provisions are generally the largest accrual for most banks.[4] Bank managers use loan loss provisions to reflect expected future losses on their loan portfolios. This process of adjusting banks' loan loss reserves allows bank managers considerable discretion in estimating loan loss provisions. There has been much debate on whether the alleged discretion over the loan loss provision is beneficial or detrimental to sound banking. The SEC and four other banking regulatory agencies stated that "although management's process for determining loan loss allowance is judgmental and results in a range of estimated loss, it must not be used to manipulate earnings or mislead investors" (Federal Reserve Release, November 24, 1998). Recognizing the importance of reported earnings, the Financial Accounting Standards Board issued SFAS No. 114, which provided detailed guidelines for estimation of LLP so that managerial flexibility in manipulating reported earnings could be reduced. The empirical finance and accounting literature has extensively examined income smoothing in the banking industry. The findings of these studies provide conflicting evidence on the use of LLP to manage reported earnings. While some studies support the argument that LLP is extensively used to manipulate reported earnings (Wahlen, 1994; Collins et al., 1995; Liu and Ryan, 1995; Kim and Kross, 1998; Beatty et al., 1995; Kanagaretnam et al., 2003; Kanagaretnam et al., 2004; Fonseca and Gonzales, 2008), other studies do not find any concrete evidence in support of this argument (e.g., Ahmed et al., 1999; Beatty et al., 1995), and a clear winner still has not emerged. What is less clear at this point is whether auditor specialization attenuates income smoothing.

Although all auditors perform the auditing procedures in a similar way for their bank clients, specialist auditors, whose training and experience are largely concentrated in a particular industry, can provide higher-quality audits because their industry-specific knowledge allows them to have a greater ability to detect material misstatements. Experimental research suggests that auditors with industry-specific expertise are more likely to possess a comprehensive understanding of a company's characteristics and enhanced methods for error, both of which can contribute to overall audit effectiveness (Maletta and Wright, 1996). Specialist auditors are also more forthcoming with what they find because they

[2] This is evident by the fact that banks collect substantial amounts of private information regarding its customers, which generally is not made available to the public. This makes it much harder to assess bank managers' subjective assessments of potential loan losses.

[3] For example, Cohen et al. (2008) documents a decline in the accrual-based earning management activity after the passage of SOX. Lobo and Zhou (2006) find evidence that SOX may have altered management's discretionary reporting behavior to make it more conservative. Doyle et al. (2007) finds evidence that auditors are more conservative and apply a lower effective threshold in internal control audits due to increased regulatory, investor and media scrutiny, and heightened legal liability. Myers et al. (2010) find that auditors became more conservative as evidenced by a higher rate of going concern reporting in the post-SOX period.

[4] The mean ratio of loan loss provisions to earnings before provisions and taxes is approximately 11% in our sample.