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"The Objective of our Project is to Analyze the Characteristics of Banks that are Likely to Restate Their Financial Statements and Develop a Model to Help Outsiders Predict Accounting Misstatements of the Banking Industry"

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Project Summary and Significance

The objective of our project is to analyze the characteristics of banks that are likely to restate their financial statements and develop a model to help outsiders predict accounting misstatements in the banking industry. After the financial crisis, a large number of banks were caught for engaging in massive accounting fraud, e.g. Lehman Brothers, Citigroup, New Century Financial Corp. Those banks employed various types of accounting manipulations to disguise their actual performance. Cohen et al. (2014) shows that banks which engaged in earnings management prior to 2007 are more likely to have stock price crashes in the financial crisis period, suggesting that earnings management impedes the flow of information about banks' performance and lead to increased tail risk. Hence, accounting manipulation plays an important role in facilitating the banking crisis, and understanding the type of banks that are more likely to commit financial misreporting is of great value to capital market participants.

There has been an extensive amount of research studying the determinants of financial misreporting in the non-financial industry. Beneish (1999) builds a model that consists of eight variables to identify potential manipulating firms—the Beneish M-score. Dechow et al. (2011), building on the Beneish (1999), use a more comprehensive data to study the characteristics of firms that committed accounting misstatements. They focus on a group of financial and non-financial variables that are indicative of accounting manipulations and develop a model, the F-score, to detect firms that have misstated their financial statements. Despite that we already have a considerable amount of knowledge about how to identify potential financial misreporting in non-financial firms, very little work has been done as to what causes financial institutions to manage their financial numbers and how we can best predict accounting misstatements in banks.

The prediction of accounting misstatements in financial institutions can be very different from that in non-financial firms. Due to the uniqueness of banks' operation, those accounts that are frequently manipulated by managers in non-financial firms, e.g. accounts receivables, inventory, do not really exist in banks. Thus, the way banks manipulate their accounting numbers is different from non-financial firms. Given the substantial costs associated with accounting restatements and a large number of restatements in banks within recent years, a careful analysis of the variables that could be indicative of accounting manipulations is of great value to investors and other market participants. By developing a prediction model to anticipate potential accounting manipulations in banks, our research project will make a significant contribute to market investors, financial analysts, auditors and regulators. Our prediction model can help investors make better decisions in capital allocation, help analysts to provide more accurate forecasting, help auditors to avoid costly litigation and also help regulators to enhance the effectiveness of monitoring.

Student Prerequisites

Students with accounting and finance or economics background are preferred. A minimum GPA of 3 is expected.

Student Duties

The students will do initial collection and analysis on banks' accounting misstatements disclosed on 8-K reports through SEC (Security and Exchange Commission)'s EDGAR database. Through this process, the students will learn financial transactions and recording in banks and how managers in banks manipulate accounting numbers/or conduct potential fraud. The financial reporting in banking industry is not taught by any course in the business school. Participating in this project provides an opportunity for students to understand the financial accounting knowledge for banking industry.

Mentor Supervision and Interaction

Students will meet with their mentor once a week to report their current work completed and plan for the next steps.