COLLEGE OF BUSINESS
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Predicting Accounting Misstatements Within The Banking Industry

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Overview and Method

- Our goal is to analyze the characteristics of financial institutions that are likely to misstate their financial statements and develop a model to predict future misstatements within the industry.
- Using the Audit Analytics database of the SEC, we examine a list of more than 1000 banking firms that historically disclose their financial misstatements in 10K, 10Q or 8K reports.
- Based on our analysis of most frequently misstated accounts, we develop the prediction model.

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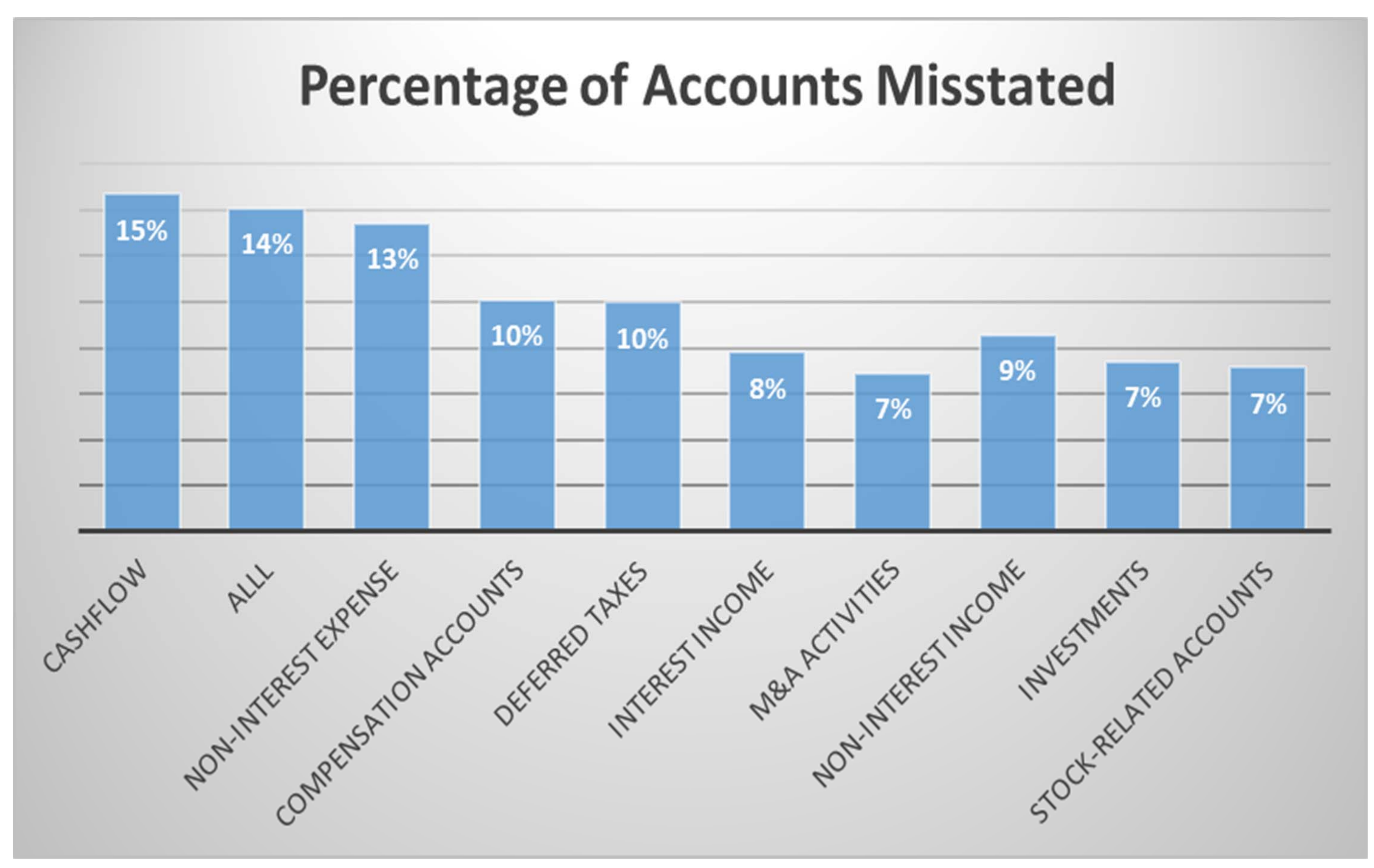
Analysis and Explanation

Our analysis reveals that:

- The most restated accounts are those that involve individual judgements and estimates. Specifically, estimating loan loss expense at the end of the year, the asset value after a merger or whether to classify a loan activity as an operating or investing cash flow are more subject to judgements from corporate accountants, which means they are also at higher misstatement risk.
- Failure to fully understand and comply with US GAAP is also an issue causing the firms to restate their financials. SFAS 123R (Share-Based Payment) and SFAS 133 (Derivative Instruments), for example, are two of those that pose high risks of financial errors.

Preliminary Results

Banks' business model is different from those in non-bank industries; therefore, the accounts they set up to record accounting activities are also different from other industries. The chart partially sums up our preliminary findings:



Impact and Future Steps

The analysis lays the foundation for building our prediction model of misstatements in the financial industry. The model will:

- Raise internal controllers' awareness about potential financial risks within their firms.
- Provide auditors with more accurate information regarding the financial risks of potential clients.
- Enhance monitoring effectiveness on financial institutions for regulators such as the SEC and Federal Reserve.

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