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Do Banks in Nigeria Manage Earnings through Loan Loss Provisions?

Ibrahim Labaran Ali (ACA)
Department of Economics and Management Science, Nigerian Defence Academy, Kaduna

Abstrct
The financial reporting scandals that was recorded in Enron, Cadbury Nigeria and some banks like Oceanic bank, International bank and Afribank has prompted researchers and regulators to investigate the incidence of earnings management in Nigeria and abroad.The main objective of this study is to investigate whether banks in Nigeria manage their earnings through the use of loan loss provisions.Data was collected from the fact book of The Nigerian Stock Exchange and published financial statements of 11 banks. The study used a one sample T-Test, Descriptive statistics and pooled linear regression model which was estimated using an ordinary least squares procedure and employing Statistical Package for Social Science Programme to analyse the data collected. The result reveals that earnings management management through the use of loan loss provision is present in Nigeria banks. The study recommends that regulatory agencies responsible for meintaining finanicial reporting quality like the SEC, CBN and FRC should device a means of monitoring financial statements of reporting organisations (banks in particular) quaterly.

Keywords: Audit Committee, Financial Expert, Earnings Management, Banks, Nigeria

1.0 INTRODUCTION

A common feature of the corporate form of business is the separation between ownership and control (Sanda, Minkailu and Garba, 2004). Some of the owners of the businesses lack the time or skills to run the business so they appoint managers and saddle them with the responsibility of directing the business profitably to create value for its owner and other stakeholders.

Due to the fact that owners are usually not involved or present in the running of the business, it will be difficult for them and other interested stakeholders to value the assets and liabilities of the business accurately. Managers on their own part might not be sincere enough to present the true picture of the performance and profitability of the business but are allowed to apply their own discretion to make judgment within the Generally Acceptable Accounting Principle (GAAP) on some accounting related issues like stock valuation, estimating depreciation, amount to be set aside as provision against bad debt and warranty expenses (Bagnoli & Watts, 2005).

Nonetheless, researchers and regulators have raised concerns over the use of these managerial discretions in valuing items on the financial statement. For instance, Levitt (1998) expressed concerns on financial statement manipulation and its effect on resource allocation. He mentioned that management abuse of premature revenue recognition is threatening the credibility of financial statement. These abuses were reportedly practiced by some organisations in the United States (Levitt, 1998).

Consequently, in Nigeria, Kantudu (as cited in Nyor, 2010) in his study found that earnings of some deposit money banks are being smoothed. Subsequently, in 2010 the Central Bank of Nigeria (CBN)Governor lamented that part of the reasons for the banking crisis of 2008 was as a result of financial statement manipulation which is otherwise known as earnings management (Sanusi, 2010).

In the light of the discuss, the main objective of this study is to investigate whether banks in Nigeria manage their earnings through the use of loan loss provisions. As ealier stated, earnings management has been found to be practiced through different method like stock valuation, research and development, loan loss provisioning etc. This study therefore seeks to investigate whether the discresions giving to managers on loan loss provision are used to manage earnings.

The rest of the paper is structured as follows: Section 2 reviews the conceptual and empirical litrature on audit committee financial expert and earnings management. Section 3 discusses the methodology used for the study. In section 4, the result of the data analysed are presented and discussed. Section five concludes the study by making recomendations.

2.0 LITRATURE REVIEW

2.1 Concept of Earnings Management

The literature has not provided a single definition of earnings management as different researchers have viewed earnings management from different perspectives base on which aspect of the financial statement is affected and who benefits from the earnings management. For instance, Mulford and Comiskey (2002) regards earnings management as an inter-period concept where some portion of earnings is moved from one period to the next. Here, earnings management is defined base on the present need and the future activities adjusted to suit the

present exigencies.

Further, most of earnings management practice like all management activities are intended to be for or against a particular stakeholder (note, managers are part of stake holder of the organization). In this regard, Kinney and Trezervet (1997) as cited in Babalyan (2004**)** define earnings management to include classificatory manipulation and selective disclosure. An example of such manipulation is the disclosure of operating loss as extraordinary item. In the light of this definition, managers use the provision in GAAP to practice earnings management since earnings numbers are not affected in situation where the discretion is exercised on classification and disclosure in the income statement.

Considerable portion of earnings management remains within the boundaries of flexibility embedded in accounting standards (this could be the reason why Enron had to hire experts from the Accounting Standard Board to find loop holes in the Accounting standards). This is also one of the reasons why auditors might not easily find a formal ground to query earning management. Also, while some authors place more emphasis on the misleading intent of earnings management, e.g. Healy and Wahlen(1999), others do not agree entirely with the negative definition of earnings management, hence, they try to show theoretically and empirically its opportunistic versus informative nature (Wange, 1994).

Both researchers and practitioners have come to agree that earnings Management is accomplished using the flexibility inherent in accounting standards (Babalyan, 2004). This flexibility mostly is in form of accounting accruals, which represent non-cash revenues and expenses as well as book gains and losses. Accrual process is intended to mitigate the timing and matching problems of cash flows, so that earnings better reflect the firm's performance (Babalyan, 2004).

Banking regulations on the other hand require that banks satisfy some certain capital adequacy requirements that are written in terms of accounting numbers (Healy &Wahlen, 1999). However, studies carried out on earnings management and bank regulatory capital have shown that managers sometimes have strong incentive to match regulatory capital and financial constraints. Biurrun and Rudolf (2010) indicate that more stringent bank regulation are associated with more earnings management and banks manage both capital and earnings using accounting, investment, and financing discretion (Beatty, Chamberlain & Magliolo, 1993).

In addition, since the Basel Accord of 1988 which harmonized minimum capital adequacy regulations and changed the structure of the capital adequacy ratio which by implication made loan loss reserves not part of Tier I capital in the numerator of the capital adequacy ratio? Some researchers have documented evidence that banks still use loan loss provision for capital management (Ahmed, Takeda, Thomas, 1999; Anandarajan, Hasan & McCarthy, 2007).

Researchers have shown that loan loss provision is one of the components of banks' earnings subject to manipulation (Ahmad et al 1999, Beatty et al, 2005). Loan loss provisions are an expense item listed on the income statement reflecting management's current period assessment of the level of future loan losses. Specific provisions are made on the basis of perceived risk of default on specific credit facilities while general provisions are made in recognition of the fact that even performing credit facility harbours some risk of loss no matter how small (CBN Prudential guideline, 2010).

The regulators recognizing the fact that the managers have the first hand information about their debtors and as a result, the prudential guideline and the statement of accounting standard No. 14 left the determination of the time and amount to increase such provision at the discretion of bank managers. More specifically, the Statement of Accounting Standard number 14 noted that 'the precise time at which provisions should be made against risk is a matter of judgment' i.e. each bank should develop a formal procedure for identifying non-performing facilities and evaluating loan losses and a systematic method of making provision for losses. Researchers have found that managers use such timing discretion to smooth earnings and in other situations manage regulatory capital (Ahmad et al 1999, Beatty et al, 2005).

As managers increase loan loss provisions net income decreases, while a decrease in the recording of loan loss provisions increases net income. That is to say, banks regulatory capital, loan loss provisions are sensitive to bank earnings. Taxable net income of a bank can generally be increased by interest income, service revenues, securities gains and losses. It can be reduced by interest expense, operating costs, loan loss provisions, and income tax expense. It will be practically difficult for banks to significantly change interest income or expense, service revenues or operating costs during financial periods or at the year-end since they are non-discretionary.

Hence, the loan loss provision is the only income component that can be revised interim and adjustable at the year-end. This special feature has no doubt makes it a natural choice of bank managers' earnings discretion since investors and regulators can hardly verify the validity of the managers' decision of the loan loss provisions (Beatty et al., 1995; Collins Shackelford & Wahlen, 1995).

Commercial bank regulators view accumulated loan loss provisions, the loan loss allowance account on the balance sheet, as a type of capital that can be used to absorb losses during bad times. If a bank's loan loss allowance balance exceeds its expected loan losses, the bank can absorb more unexpected losses without failing

and imposing losses on the Nigerian Deposit Insurance Corporation (NDIC). Conversely, if a bank's loan loss allowance is less than expected losses, the bank's equity capital will be reduced when and if the expected loan losses materialize. This implies that the bank's capital ratio can overstate its ability to absorb unexpected losses.

Previous researchers, most of whom concentrated on financial institutions in the United States and Europe, concluded that at one stage or another, LLPs were used as a tool for capital management (Collins, Shackelford and Wahlen, 1995; Moyer, 1990), for earnings management (Ahmed, Takeda and Thomas, 1999; Beatty, Chamberlain and Magliolo, 1995; Greenawalt and Sinkey, 1988; among others) and for signalling future intentions to the stock market (Liu, Ryan and Wahlen, 1997).

In summary, loan loss provisions can be used as a worthwhile manipulation tool by bank management to reach their desired results and with low detection risk within short periods since they are highly manipulative with a reasonably low risk of detection. Also, bank managers' judgments and discretion will always be necessary in estimating loan loss provisions in each period. Hence, their judgments cannot be possibly changed or replaced. Guided by SAS No. 14 in Nigeria and SFAS No.5 in the USA, managers can execute judging selecting amount and timing of loan loss provision.

From the perspective of the relationship that exist between the shareholders and managers, and the possibility of managers to engage in earnings management practices; agency theory gives a good theoretical framework of the mechanisms put in place to reduce earnings management practice through the establishment of audit committee. Thus, in the light of agency theory, earnings management will be considered an agency problem.

3.0 Methodology

This study covers 7 years reporting period starting from 2005 to 2011.The population of this study comprises of the 21 banks (deposit money banks) operating in Nigeria as at 31st December, 2011. Base on the fact that it will be difficult to obtain comparable data for the time frame adopted for the study especially from 2007 to 2009 due to the changes in the names of some banks. This study therefore employs a two point filter to drop banks that are thought unsuitable for collecting data for the study. These filters are: (i) scaling the difficulty of the 2005 banking sector consolidation without structural change affecting the name of a bank, and (ii) being quoted and remaining quoted on the Nigerian stock exchange for the last nine years. The filters is applied to ensure the associability and availability of comparable data for the years under review and also to ensure easy accessibility of annual financial statements. Consequently, upon application of these filters, the new population of the study is reduced to 11 banks namely Access Bank Plc., Diamond Bank Plc., Ecobank Nigeria Plc., Fidelity Bank Plc., First Bank Plc., First City Monument Bank Plc., Guaranty Trust Bank Plc.,Starling Bank Plc., Union Bank Plc. United Bank for Africa Plc., and Zenith Bank plc.

This gives a new population of 11 out of old population of 21 banks. This represents 52 % of the old population which is sufficient to obtain a valid and reliable result. Relevant data are selected from the financial report as the study is a census study which makes use of the entire component in the population (i.e. banks).The data used were collected mainly from secondary sources like published financial statements of banks and fact book of The Nigerian Stock Exchange.

Additionaly, Beatty *et al* (2002) model is used in this toestimate discretionary loan loss provisions which empirical studies have found as an item that is used by managers to manage earnings. In other words, we measure earnings management by modeling for discretionary loan loss provision which is acheieved with the modified Beatty *et al* (2002) model as stated thus;

$LOSS_{it} = \alpha_{tr} + \beta_1 LASSET_{it} + \beta_2 \Delta NPL_{it} + \beta_3 LLR_{it} + e_{it}$ …. (Eq 2)

Where:
i = bank holding identifier;
t = year;
LOSS = loan loss provisions as a percentage of total loans;
LASSET = the natural log of total assets;
ΔNPL= change in nonperforming loans (includes loans past due 90 days or more and still accruing interest and loans in nonaccrual status) as a percentage of total loans;
LLR = loan loss allowance as a percentage of total loans;
ε = error term.

The error term or residuals from this regression is the discretionary part of loan loss provision that researchers have found to be used for earnings management (Cornett, *etal*. 2009). Consistent with the model, we expect the loan loss provision to be higher when there is an increase in nonperforming loans and also when the beginning loan loss reserve is high. Hence, we also predict that the coefficients on ΔNPL and LLR will be positive.

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coefficients on ΔNPL and LLR will be positive.

In the prudential guide line issued by the CBN in 2010, the coefficients of $\beta_{4\ to}\ \beta_8$ are regarded as specialized loans and hence, additional guidelines regarding their provision are required and are treated separately. While the coefficient of β_9 is regarded as retail loans (CBN Prudential Guide line 2010, Sec, 12.3). This classification was effected for financial statements prepared for 2010 and beyond. To avoid the problem that will result from missing data for specialised and retail loans for the years 2005 to 2009, this study will consequently modify the model to exclude specialised and retail loans. This modification will not affect the model as according to Beaty et al (2002), their "*model does not make any prediction regarding these loans*". The modified Beaty et al (2002) model is stated thus:

$LOSS_{it} = \alpha_{tr} + \beta_1 LASSET_{it} + \beta_2 \Delta NPL_{it} + \beta_3 LLR_{it} + e_{it}$ …. (Eq 2)

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LLR = loan loss allowance as a percentage of total loans;
ε = error term.

The error term or residuals from these regression is the discresionary part of loan loss provision that is mostly used for earnings management. For the purpose of this study, a higher residuals depicts higher earnings management.

Finally, from the above model (Eq. 2) the study defines earnings management such that higher levels of earnings management increase earnings and a lower level of earnings management will ultimately decreases earnings. In this regard, this study defines earnings management as thus:

$EM_{it} = DLLP_{it}$....... (Eq. 3)

The study predicts that a high level of earnings management will result to underreporting loan loss provisions which can increase reported income while, low levels of EM, which are often negative, suggest that loan loss provisions are over-reported and thus decrease reported income.

Further, to acheive the objective of this study, this study used quantitative methods to analyse the the data collected. The method of data analysis is divided in to three part. The first part is carried out by using a pooled linear regression model estimable by Ordinary Least Squares (OLS) procedure to test for the presence of earnings management using the Beaty et al (2002) model. While the second step will be analysis of the first result using descriptive statistics. Finally, a T-Test is used to test whether result are statisticaly significant to make valid conclusions and recomendations. These are all achieved by and employing the Statistical Package for Social Science (SPSS) statistics program for a total of 77 observations (11 banks × 7 years).

4.0 Results and Findings

The results of these study is analysed in two fold. Firstly residuals from the regression analysis are tested using a one sample T-Test. This is caried out to test the statistically significance of the residuals. The T-Test result is stated thus:

Table 4.1: T-Test Result

One-Sample Test

	Test Value = 0					
					95% Confidence Interval of the Difference	
	t	df	Sig. (2-tailed)	Mean Difference	Lower	Upper
Earnings Management	91.266	76	.000	.56583	.5535	.5782

Source: SPSS output

From the T-Test result of table 4.1, the residuals of earnings management is significant at 1%. This indicate that the result from the subsequent analysis can be relied upon for valid statistical analysis as presented in the descriptive statistics.

TABLE 4.2: Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation	Skewness		Kurtosis	
	Statistic	Statistic	Statistic	Statistic	Statistic	Statistic	Std. Error	Statistic	Std. Error
EM	77	.43	.68	.5658	.05440	-.549	.274	-.051	.541

Source: SPSS output

From table 4.2, the mean for earnings management for the banks is 57% with the highest at 67% and lowest at 43%. The mean of 57% indicates that the practice of earnings managements by banks for the years is relatively strong for the years. The lowest of 43% indicates that there was not a single time during the study period that earnings management was not practiced.

5.0 Conclusion and Recomendation

This study right from the onset seeks to investigate whether banks in Nigeria where managing their earnings through loan loss provisions for the period 2005 to 2011. The study found that earnings management through loan loss provisions are practiced in Nigeria though at a fairly reasonable scale. The scale of the practice could be attributed to the fact that earnings management through loan loss provisioning is quite technical to practice because of the Basel accord and the fact that it has to be undone (i.e the earnings management) in the next quater.

Finally, the study recommends that the regulatory agencies responsible for meintaining finanicial reporting quality like the SEC, CBN FRC should device a means of monitoring financial statements of reporting organisations (banks in particular) quaterly. Further, as it was recommended by SOX in the USA, independent internal monitors of financial reporting i.e audit reporting committee should have an accounting expert.

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