DO BANKS IN NIGERIA MANAGE EARNINGS THROUGH LOAN LOSS PROVISIONS?

Ibrahim Labaran Ali, ACA
Department of Economics and Management Science,
Nigerian Defence Academy, Kaduna.
08036805096
ibrahimlabaranali@gmail.com

Abstract
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 maintaining financial reporting quality like the SEC, CBN and FRC should device a means of monitoring financial statements of reporting organisations (banks in particular) quarterly.

Key Words: Audit Committee, Financial Expert, Earnings Management, Banks, Nigeria

1. 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 earlier 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 literature 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. Review of Related Literature
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.

This raises two questions. First, who or which of the stakeholder is targeted in earnings management? This question is relevant in defining what earnings management actually is, because a mere classification of operating loss as extraordinary item might change the perception of a potential investor and also might save managers from getting ‘the boot’ from shareholder.

Secondly, it raises the question of which part of the financial statement is affected for a manipulation to be regarded as earnings management? This is because the general perception of earnings leads one to the income statement (profit and loss account), while other researchers like Stolowy and Breton (2000) generalize the term as account manipulation since it is not just the income statement that is affected but also, balance sheet, cash flow and notes to the account are also potential targets for such manipulation. An example of such manipulation is when the sales
of asset or varying research and development expenditure are used to manage earnings. Also, revaluation of fixed asset (permitted by IAS 16) could be intentionally carried out to manipulate the balance sheet. A renowned example was the case of Enron and its off-balance sheet liabilities (Wikipedia, 2012).

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).

In the opportunistic earnings management, managers seek to mislead investors by pursuing their (i.e. the managers own) interest. The literature on this type of earnings management originated from Healy (1985) who finds that managers use accruals to strategically manipulate bonus income. She explains that stockholders lose when earnings management result in abnormal private gains for managers. This could be in form of an increased in compensation to managers (Healy, 1985).

Informative earnings management on the other hand is aimed at enhancing value maximization. It was first put forward by Holthausen and Heftwich (as cited in Beneish, 2001). Here, managerial discretion is a means for managers to reveal to investors their private expectation about the firm’s future cash flows. Stockholders gain when earnings management is used to signal manager’s private information, as noted by Healy and Palepu (1993) or to reduce political cost (Watts & Zimmerman, 1986).

Like most previous studies on earnings management, this study regards the definition of Healy and Wahlen as the most comprehensive definition of earnings management as it captured clearly the fact that earnings management involves the manipulation of financial statement by managers in order to achieve some personal gain which might be at the detriment of other stakeholders through discretions which they the managers have.

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).

Management has relatively low discretion in reporting the cash inflows and outflows as at the end of the fiscal period. The cash balances must be equal to the beginning balances plus the net flows that occurred during the period. Researchers also assume that cash is costly and difficult to manipulate. Consequently, most of the literatures on earnings management have focused on management of accrual earnings. For example, in manufacturing firms, depreciation and accounts receivables, which accrue the earned but not yet received revenues, form the majority of their accruals. Earnings management studies hypothesize that at least some portion of accruals may
result from management discretion and have other purposes than neutrally reflecting the current financial performance (Balsam, 1998; Healy, 1985; Healy & Palepu, 1993).

The flexibility and consequently the discretion in accrual accounts has given managers the right to make “hard” accounting choices like the use of LIFO or FIFO in stock (inventory) valuation, straight line as opposed to reducing balance in depreciation, capitalizing or expensing R&D costs. Further, managers have the discretion to alter the timing of recognition of revenues and expenses by, e.g., advancing recognition of sales revenue through credit sales, or delaying recognition of losses by waiting to establish loss reserves. Loan loss reserve has been reported to be the main form of practicing earnings management in commercial banks (Cornett, McNutt & Tehranian, 2009).

Further, Creative accounting, aggressive accounting, big bath accounting, window dressing, earnings smoothing has been used by some researchers to refer to earnings management based on the fact that there is no standard universally accepted definition of earnings management (probably due to the fact it is a difficult practice to conceptualize, detect and measure). In the same vein, Dechow and Skinner (2000) noted that The US SEC often also includes outright fraud as earnings management and hence, the academic literature usually focuses on earnings management activities that fall within the Generally Accepted Accounting Principles (GAAP).

Banking regulations 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. 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.

The agency theory is based on the relationships that exist between owners of the business who are referred to as principal and the managers who are referred to as agent. In most modern organizations, the principal is either too busy or lack the managerial capacity to run the day to day activities of the business. This necessitates the principal to bring in a knowledgeable outsider to run the affairs of the business in a most profitable way. However, being too busy or lacking the requisite skills to manage the business imply that the principal cannot monitor the activities of the manager perfectly.
Managers are responsible for managing the business profitably and are also responsible for preparing financial statement of the organization at the end of the period. Consequently, managers are usually given incentives to meet or to beat earnings target and hence receive bonuses that are tied to the firm’s earnings (i.e. performance related). With the authority given to managers and information asymmetry between managers and owners, the managers are likely to use the discretion they have on accruals and overstate earnings. This however, reduces the reliability of financial statement.

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.

3.1 Methodology and Model Specification
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.

Additionally, Beatty et al (2002) model is used in this to estimate 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 achieved with the modified Beatty et al (2002) model as stated thus;

\[
\text{LOSS}_{it} = \alpha_{it} + \beta_1 \text{LASSET}_{it} + \beta_2 \Delta\text{NPL}_{it} + \beta_3 \text{LLR}_{it} + e_{it} \]

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, et al. 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.

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.

In the prudential guide line issued by the CBN in 2010, the coefficients of β₄ to β₈ are regarded as specialized loans and hence, additional guidelines regarding their provision are required and are treated separately. While the coefficient of β₉ 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:

\[
\text{LOSS}_{it} = \alpha + \beta_1 \text{LASSET}_{it} + \beta_2 \Delta\text{NPL}_{it} + \beta_3 \text{LLR}_{it} + \varepsilon_{it} \]

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 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:
The study predicts that a high level of earnings management will result in 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 achieve the objective of this study, this study used quantitative methods to analyse the data collected. The method of data analysis is divided into three parts. 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 statistically significant to make valid conclusions and recommendations. 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).

### 4.1 Result and Discussion

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 carried out to test the statistically significance of the residuals. The T-Test result is stated thus:

Table 4.1: T-Test Result

<table>
<thead>
<tr>
<th></th>
<th>t</th>
<th>df</th>
<th>Sig. (2-tailed)</th>
<th>Mean Difference</th>
<th>Lower</th>
<th>Upper</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings Management</td>
<td>91.266</td>
<td>76</td>
<td>.000</td>
<td>.56583</td>
<td>.5535</td>
<td>.5782</td>
</tr>
</tbody>
</table>

*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**

<table>
<thead>
<tr>
<th></th>
<th>N</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Mean</th>
<th>Std. Deviation</th>
<th>Skewness</th>
<th>Kurtosis</th>
</tr>
</thead>
<tbody>
<tr>
<td>EM</td>
<td>77</td>
<td>.43</td>
<td>.68</td>
<td>.5658</td>
<td>.05440</td>
<td>-.549</td>
<td>.274</td>
</tr>
</tbody>
</table>

*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 management 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. **Conclusion and Recommendation**

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 quarter.

Finally, the study recommends that the regulatory agencies responsible for maintaining financial reporting quality like the SEC, CBN FRC should device a means of monitoring financial statements of reporting organisations (banks in particular) quarterly. 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.

**References**


