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Specialization, and Banks??? Discretionary Use of the Loan Loss Provision

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In this study, we examine whether banks' use of the loan loss provision (LLP) to manage earnings is related to (a) the extent to which banks hold assets subject to fair value reporting and (b) the utilization of an industry specialist auditor. we discover that banks with a greater proportion of assets subject to fair value reporting (i.e., higher fair value exposure) use less LLP-based earnings management but more transaction-based earnings management (i.e., earnings management achieved by timing the belief of gains/losses). We also find that banks engaging industry specialist auditors use less LLP-based earnings management. Our findings suggest that banks' use of the LLP to manage earnings is more limited once they have access to alternative earnings management tools and once they engage an auditor with more industry knowledge. Our results should be informative to regulators, members of the banking system , and academics curious about the earnings management behavior of banks.

Some of the reasons for earnings management practices ask the conflict of interest between managers and shareholders, alongside information asymmetries that limit the utilization of efficient contracts to unravel them, Lambert (1984), Fudenberg and Tirole (1995).

For example, managers with stock options in their compensation packages could make discretionary accounting decisions to distort profits and share prices round the period of time when these stock options are getting to be exercised, Bergstresser and Philippon (2006). Other explanations are supported the existence of market frictions, in order that shareholders will enjoy a discount in earnings volatility over time. Within this literature, income smoothing can answer signalling purposes, Barnea, Ronen and Sadan (1975); to the intention of reducing potential losses from shareholders' liquidity trade, Goel and Thakor (2003); to save lots of on profit taxes, Beatty, Chamberlain and Magliolo (1995), Collins, Shackelford and Wahlen (1995), Rozycki (1997); or to lower the perceived probability of bankruptcy, Trueman and Titman (1988).

Evidence on whether income smoothing practices obey to the aim of bank managers to mislead investors and other interested parties or, on the contrary, they respond to market imperfections, might be obtained if banks had at their disposal a way to smooth earnings that was transparent to investors. If income smoothing practices did only respond to efficiency considerations, once a transparent smoothing device was introduced, then managers would scale back or eliminate the utilization of discretionary loan loss provisions to manage earnings. On the opposite hand, if banks were trying to mislead investors, income smoothing will continue afterwards. Hunton, Libby and Mazza (2006) find that more transparent reporting requirements will reduce earnings management or will change the main target of earnings management to less visible methods.

On the contrary, if banks continue using loan loss provisions (other than the statistical provision) to smooth earnings after year 2000, the conclusion would be that they are aware that outsiders can use an equivalent measure of profits than before to guage performance by simply adding back the statistical provision to internet accounting profit. This finding would support the reason of smoothing in terms of managers' interests to obtain private benefits at the expense of shareholders, alongside failures in managerial evaluation and compensation practices.