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AN EVALUATION OF THE IMPLICATIONS OF EARNINGS MANAGEMENT DETERMINANTS IN THE BANKING INDUSTRY: THE CASE OF NIGERIA

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ABSTRACT

The objective of this paper was to ascertain the determinants of earnings management and to evaluate their implications. The study covered a period of 2005-2010. There were a total of twenty-three banks quoted on the stock exchange within the period. The study selected a sample of all eighteen of these banks quoted on the stock exchange as at 2010. The Pearson Product Moment Correlation was used to identify the determinants of earnings management. The results showed that audit committee size (AUDCOM), audit fee (AUDFEE), bank asset quality (BANKQUA), bank size (BANKSIZ) and board size (BSIZE) were all negatively correlated with abnormal loan loss provisions (ABBL). Other variables including auditor change (AUDCH), bank complexity (BANKCOMP), bank performance (BANKPER), board composition (BCOMP), director shareholding (DSHAR), and bank leverage (LEV) were positively correlated. The study recommended that audit committee size should be increased, bank inspector should focus on asset quality and leverage of the bank, and both bank size and board size should be increased. Furthermore, mandatory auditor rotation was unnecessary. Furthermore, non-executive directors should be appointed on the basis of competence while directors' shareholding should be balanced with other shareholdings.

Keywords: Earnings Management, Corporate Governance, Audit Quality.
JEL Classifications: E5, G21, G24, G32.

1. INTRODUCTION

Concerns about the reliability of financial statement are not novel. However, one factor that has heightened such concerns in recent times is what has been aptly referred to as earnings management. Levitt (1998) expressed these concerns over the level of earnings management and its consequences on resource allocation and Schipper (1989) has argued that excessive earnings management will distort information content of earnings. Healy and Wahlen (1999:6) stated that "earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers."

Sanusi (2012) and Brownbridge (1996) among others have provided anecdotal evidences of earnings manipulation in the Nigerian banking sector. Sanusi (2012:5) in particular, explained that one of the eight reasons for banking crisis in 2008 was "inadequate disclosure and transparency about financial position of banks." Various terminologies have been used to describe "inadequate disclosure and transparency". Amongst the terminologies used are accounts manipulation, income smoothing, big bath accounting, creative accounting and earnings management. Whatever the

terminology adopted, the whole essence is to mislead users of financial statements and to render financial reports unreliable with the motive of some private gains.

Extant literature have examined the relationship between earnings management and corporate governance (Bedard, Chtourou & Courteau, 2004; Peasnell, Pope & Young, 2000; Alonso, Azofra-Palenzuela & López-Iturriaga, 2005; Abdul Rahman & Ali, 2006; Xie, Davidson & Dadalt, 2003). The conclusions reached have been mixed. For example Alonso, *et al.* (2005) and Abdul Rahman & Ali (2006) found positive association between board size and earnings management, while Peasnell *et al*. (2000), Bedard *et al*., (2004) Xie *et al*. (2003) and Yu (2008) find a negative relationship between earnings management and board size. This mixed results have been found in the relationship between earnings management and other corporate governance variables like board composition (Bedard *et al*., 2004; Klein, 2002; Peasnell *et al*.,2000; Xie *et al*., 2003), change of CEO (Central Bank of Nigeria, 2010), audit committee size (Spira,1999 and Abdul Rahman & Ali, 2006) and board composition (Niu, 2006; Abdul Rahman & Ali, 2006; Peasnell *et al*.,2000; Bedard *et al*., 2004) and director shareholding ((Koh, 2003; Bergstresser & Philippon 2006).

DeAngelo (1981) explains that audit quality is the probability that the auditor will discover material misstatements and signals of financial distress, and the probability that the auditor will report these misstatements and signals. The probability that the auditor will discover material misstatement is a function of his competent, while the probability that he would report the misstatement is dependent on his integrity. Thus, it is the competence and integrity of the auditor that affects the quality of audit. The quality of audit will also affect the quality of financial reports. In this study, abnormal loan loss provision, which is a proxy for financial reporting quality is related to audit quality. Measures of audit quality includes auditor change and audit fee.

Finally, the association between abnormal loan loss provision and bank specific characteristic is examined within the context of the Nigerian banking sector. The characteristics of bank examined include bank size, bank complexity, bank asset quality, bank leverage and bank performance. In this study, we use abnormal loan loss provision as a proxy for earning management, and relate it to measures of corporate governance, audit quality and bank specific characteristics to determine whether these variables are associated with earnings management.

2. LITERATURE REVIEW

2.1 EARNINGS MANAGEMENT AND CORPORATE GOVERNANCE

Corporate governance is a factor that determines whether management will engage in earnings management or not. The earnings management literature has tried to show that weak governance is associated with greater earnings management (Beasley, 1996; Klein, 2002). Dayton (1984) stated that corporate governance include the processes, structures and relationships through which the board of directors oversee what the executives do. The Central Bank of Nigeria code of Corporate Governance (2006, para. 1.3) observes that “specifically for financial sector, poor corporate governance was identified as one major factor in all known instances of financial distress in the country.” Hence, poor corporate governance provides an impetus for earnings management. Corporate governance variables such as CEO duality, directors’ shareholding, board size, board composition, quality of audit committee have been found to relate to measures of earnings management (Bedard *et al*., 2004; Bello, 2011; Bowen, Rajgopal, and Venkatachalam, 2005; Chtourou, Bedard & Courteau, 2001; Tehranian, Cornett, Marcus & Saunder, 2006; Xie, Davidson & Dadalt, 2001;Zhou & Chen, 2004). Chtourou *et al*. (2001) and Bedard *et al*. (2004) examine the relationship between corporate governance and earnings management. Firstly, they examined the relationship between audit committee characteristics and the extent of corporate earnings management as measured by the level of income-increasing and income-decreasing abnormal accruals. Using two clusters of U.S. firms, one with comparatively high and one with

comparatively low levels of abnormal accruals in the year 1996, they find a significant association between earnings management and audit committee variables. They find that aggressive earnings management is negatively associated with the financial and governance expertise of audit committee members, with indicators of independence, and with the presence of a clear mandate defining the responsibilities of the committee. The association is similar for both income-increasing and income-decreasing earnings management. Secondly, they find that effective boards constraint earnings management as shown by association between less income increasing earnings management and increase in number of outside directors and directors' capability.

Xie *et al*. (2001) find that board and audit committee members with corporate or financial backgrounds are associated with firms that have smaller discretionary current accruals. They also find that board and audit committee meeting frequency is also associated with reduced levels of discretionary current accruals. They conclude that board and audit committee activity and their members' financial sophistication may be important factors in constraining the propensity of managers to engage in earnings management. Furthermore, Zhou & Chen (2004) examine the link between audit committee, features of the board of directors, and earnings management using loan loss provisions by commercial banks. Using loan loss provision model and discretionary loan loss provision model, they discover that banks with more active audit committees, that have greater governance expertise and more active boards are related with less earnings management.

Bello (2011) studies the relationship between corporate governance mechanisms and accounting ethics in Nigeria. The extent of influence of corporate governance mechanisms was estimated by probit analysis. Firms under study were divided into those involved in earnings management and those with less indication of earnings management. The probit regression outcomes disclose positive impact of board size and board performance and negative influence of board composition on ethical accounting practices. His result shows that enforcing corporate governance code will decrease considerably unethical accounting practices, thereby improving quality of accounting information.

Board size is often linked to board of directors' effectiveness, which is necessary for increased firm performance. Jensen (1993) argues that an "overcrowded" board is less likely to function effectively and is easier for the CEO to control. His argument is consistent with the view in the organizational behaviour theory that workers' productivity declines in larger work groups. Yermarck (1996) finds an inverse association between board size and firm value (Tobin's q). However, Eisenberg, Sundgren & Wells (1998) also report a negative correlation between board size and profitability for mid and small capitalized Finnish firms. The implication is that if board size improves performance, it would reduce earnings management.

Board composition is the subject of considerable dispute. Prior research on the effectiveness of the monitoring role of outside director seems to be determined by the situation in which it is studied. There has been substantial indication supporting the hypothesis that independent outside directors safeguard shareholders' concern in particular cases when there is an agency difficulty (Weisbach, 1988; Brickley & James, 1987; Byrd & Hickman, 1992). To the extent that independent outside directors monitor management more effectively than inside directors, companies with a greater percentage of independent directors will be less likely to engage in earnings management than those whose boards consist majorly of executive directors.

Audit committee size is another corporate governance variable. Archambeault & DeZoort (2001) find a significantly negative relationship between committee size and suspicious auditor switches, but Abbott, Paker & Peters (2000) find no significant association between size and earnings misstatements. Besides, Spira (1999) argues that audit committees are ineffective in improving the quality of financial reports. Abdul Rahman & Ali (2006) find a positive relationship between audit committee size and earnings management. Siregar & Utama (2008) argue that where there is positive relationship between earnings management and audit committee size it is attributed to efficient rather than aggressive earnings management.

Director shareholding is empirically found to be positively related to earnings management (Koh, 2003; Bergstresser & Philippon, 2006). This is because directors will want to increase the market value of their shareholding at all cost, even if they have to manipulate earnings. Not only is there indication that earnings are value relevant, but participants in the market do not see through earnings management behaviour of management (Koh, 2003; Bergstresser & Philippon, 2006; Healy & Wahlen, 1999).

The CBN prudential guidelines 2010, provides for a mandatory change in the CEO after ten years. This seems to suggest that the apex bank in Nigeria believe that a change in CEO, will improve corporate governance in banks. While a change is desirable, a change from competent to incompetent CEO to fulfill the letters of the law made not improve corporate governance.

2.2 EARNINGS MANAGEMENT AND AUDIT QUALITY

DeAngelo (1981) sees audit quality as the combined probability that the external auditor discovers an irregularity in financial statements, and then discloses it to the users of these statements. The probability of discovery is a matter of aptitude, whereas the probability of exposing the irregularity depends on the objectivity or independence of the auditor. If the auditor is well-trained, educated, exposed and experienced, his chances of detecting an irregularity are higher. Also, if he abides by ethical codes of conduct either willingly or by coercion from regulatory and professional bodies then, there is a greater likelihood of his being independent.

Extant literature has examined the relationship between earnings management and audit quality (Piot & Janin, 2005; Chen, Lin & Zhou, J., 2005; Gerayli, Yanesari & Ma'atoofi, 2011). Piot & Janin (2005) found no significant association between abnormal accrual, proxy for earnings management and presence of big five auditors, proxy for audit quality. Chen *et al*. (2005) study the effects of audit quality on earnings management and cost of equity capital for two sets of Chinese firms: state-owned enterprises (SOEs) and non-state-owned enterprises (NSOEs). Their results show that while high-quality auditors play governance role in China, that role is limited to a subset of firms and even under the same legal jurisdiction, the effects of audit quality (in the form of lower earnings management and cost of equity capital) vary across firms with different ownership structures. Gerayli *et al*. (2011) studied the impact of audit quality on earnings management of Iranian listed firms. They used auditor size, auditor industry specialization and independence as measures of audit quality, and discretionary accruals as measure of earnings management. Their study shows that discretionary accruals are negatively related to auditor size and auditor industry Specialization. They also provide evidence to support the hypothesis of the negative association between auditor independence and discretionary accruals. Overall, their study concludes that firms which are audited by high quality auditors are more likely to have less discretionary accruals, a finding that is consistent with prior research (Teoh & Wong, 1993; Becker, DeFond, Jiambalvo & Subramanyam, 1998; Rusmin 2010; Francis, Maydew & Sparks, 1999; Li & Lin, 2005). Additional evidences of the negative relationship between audit quality and size of abnormal accruals is provided by Ebrahim (2001) and Tendeloo & Vanstraelen (2001).

Carcello & Nagy (2004) find that duplicitous financial reporting occurs early in an auditor-client relationship. Geiger & Raghunandan (2002) found that corporate failure occurs significantly more often in the first five years of an auditor-client relationship. Myers, Myer and Omer (2003) find risky accounting choices to be constrained more effectively by longer auditor tenure. Finally, Gosh & Moon (2005) find proof that investors and rating agencies depend on audited financial reports more intensely as auditor tenure increases. All these studies point to the fact that the longer the auditor tenure the higher the audit quality and by extension the lower the tendency for earnings management.

However, standard setters and regulatory authorities often assume that earnings management is enhanced by longer audit tenure and hence the advocacy is often for mandatory audit client rotation. In the United States, the Sabane-Oxley Act advocates for a five-year rotation,

down from the previous seven. The European Commission advocates for a seven-year audit client rotation. In Nigeria, the CBN Prudential Guideline advocates for a tenure of 10 years.

Audit fee is often used to proxy auditor independence and hence audit quality. Kanagaretnam, Krishnan & Lobo (2010) examine auditor independence in the banking industry by analyzing the relation between fees paid to auditors and the extent of earnings management through loan loss provisions LLP. They find that unexpected auditor fees are unrelated to earnings management for large banks. For small banks, they find greater earnings management via under-provisioning of LLP by banks that pay higher unexpected total and nonaudit fees to the auditor. Their results suggest that auditor fee dependence on the audit client is associated with earnings management via abnormal LLP and is a potential threat to auditor independence for small banks.

2.3 EARNINGS MANAGEMENT AND BANK SPECIFIC CHARACTERISTICS

Specific bank characteristics such as bank leverage, bank asset quality, bank size, bank performance and bank complexity are related to earnings management. Bowen, Noreen & Lacey (1981), and DeFond & Jiambalvo (1994) indicate that there is a nexus between a firm's leverage and earnings management. In particular they suggest that the higher the gearing, the greater the tendency for earnings management. This is probably to hide risk implied by higher leverage (Warfield, Wild & Wild, 1995). Following CBN prudential guidelines (2010), leverage is computed as the ratio of total debt capital to total shareholders' funds.

The quality of assets of banks is the ratio of total loans to total assets. When asset quality is low, it means that this ratio will be high and vice versa. Low asset quality implies higher risks. Intuitively, the researcher suggests that the higher the risk of the banks, the greater the tendency for management to engage in earnings management.

Furthermore, López-Iturriaga & Saona (2005) included firm size and firm performance in their study as variables which, from their point of view, are likely to be related to earnings management. They measure firm size with the logarithm of total assets at book value and firm performance with the return on assets.

Finally, the researcher argues that bank complexity is another variable that will determine earning management of banks. Chaney, Jeter & Shivakumar (2004) expect that the complexity of a firm would affect the level of reported accrual. The number of subsidiaries can be used to proxy bank complexity. The study asserts that the more the number of subsidiaries of a bank, the greater the earnings management.

3. THEORETICAL FRAMEWORK

The theory upon which the study rests is the agency theory. Agency theory has its origins in the risk-sharing problem resulting from situations where co-operating parties have different viewpoints towards risks. This risk distribution problem is extended to contracting parties under the agency theory. The agency theory addresses agency associations in which one party called the principal gives work to another called the agent.

The agency theory aims at resolving the agency problem and the risk sharing problem. The agency problem arises because in an agency arrangement the goal of the principal is at variance with that of the agent, and it is difficult or costly for the principal to monitor the activities of the agent. On the other hand, the risk-sharing problem occurs because the agent and the principal have different risk attitudes, and they will therefore act differently when faced with same risk. To resolve these conflicts, the agency theory proposes a contract that will lead to a goal-congruence between principal and agent.

Agency theory as it applies to financial reporting has its roots in information economics. Jensen (1983) splits information economics agency theory into positivist and principal-agent dimensions. From a positivist dimension, Berles & Mean (1932) discuss the principal-agent

relationship in the context of large public corporations. Early major contributors to the positivist school include Jensen & Meckling (1976), Fama (1980), Fama & Jensen (1983) and Jensen (1984). Put together their contributions sum up to how absentee owners can control opportunistic behaviour of manager. For example, Fama (1980) suggests efficient capital market, and Jensen & Meckling (1976) propose equity ownership by managers. Eisenhardt (1989) proposes that where the contract between principal and agent is outcome-based and/or principal has sufficient information to monitor the agent, the agent is more likely to act in the interest of the principal.

From an agency theory viewpoint, earnings management is opportunistic. The dichotomy between owners and managers creates moral hazard and adverse selection challenges. These situations motivate managers to engage in earnings management.

4. METHOD AND MATERIALS

The population of the study comprises of all banks listed in the Nigeria Stock Exchange between 2006 and 2010. The total number of banks listed within the period was 24. Between these periods, population of the study was influenced by mergers and acquisitions, bank mortality and new entrants into the industry. However, it is observed that despite these inter-temporal influences, all operating banks as at 2010 maintained their listing status. Consequently, the list of quoted banks as at 2010 represents adequately the population of the study. As at 2010 there were 18 banks listed on the Nigerian Stock Exchange.

Archival data will used for the study. Data is sourced from published financial statements of these banks. Our main source of published financial reports is the Nigeria Stock Exchange floors in Lagos and Abuja. The Nigeria Accounting Standards Board (now Financial Reporting council), the Corporate Affairs Commission (CAC), the Central Bank of Nigeria and the Nigeria Deposit Insurance Commission are institutions that store published financial statements. The data is hand-collected from the annual reports.

The study employs a correlational analysis. We use the Pearson product-moment correlation because it measures association between variables at the interval level of measurement. Abnormal loan loss provision, which is a proxy for earnings management is related to corporate governance, audit quality and bank specific characteristics. This relationship is specified as follows:

$$ABLL = f(BSIZE, BCOMP, DSHAR, AUDCOM, CEOCH, AUDFEE, AUDCH,$$

$$BANKAQU, BANKCOMP, BANKSIZ, LEV, BANPER) \ldots\ldots\ldots \quad (1)$$

The variables are defined and measured as in Table 1. In particular ABLL, abnormal loan loss provision is measured as a modification of Kanagaretnam *et al*. (2010) as:

$$\mathrm{LLP} = \propto_0 + \alpha_1 \mathrm{LLAB} + \alpha_2 \mathrm{NPLAB} + \alpha_3 \Delta\mathrm{NPL} + \alpha_4 \mathrm{NBLW} + \alpha_5 \Delta\mathrm{TOTL} + \alpha_6 \mathrm{TOTL} +$$

$$\varepsilon_t \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots \quad (2)$$

The residuals from equation (2) are the abnormal loan loss provision. We expect a positive sign forα_2,α_3,α_4 and α_6. The higher Non-performing loan at beginning (*NPLAB*) the higher the loan loss provision (*LLP*) is expected to be and vice versa. The higher change in non-performing loan(ΔNPL), Net bad loans written off ($NBLW$), and total loans ($TOTL$) the higher the *LLP* is expected to be, and vice versa. There is no specification for the expectation of the relationship between change in total loan ($\Delta TOTL$) and *LLP*. These expectations are supported by Beaver & Engel (1996) and Kanagaretnam *et al*. (2010).

Table 1 Definition measurement of variables

Variables	*Definition*	*Measurement*	*Source*
ABLL	Abnormal Loan Loss Provision	Difference between total loan loss and normal loan loss	Kanagaretnam et al. (2010)
LLP	Loan loss provision	The loan loss provision for the year	Kanagaretnam et al. (2010)
BSIZE	Board Size	Number of directors on the board	Yermack, 1998 and Xie et al. ,2001
BCOMP	Board composition	Percentage of non-executive directors on the board	Byrd & Hickman, 1992 Weisbach, 1998
DSHAR	Directors' Shareholding	Percentage of shares held by directors	Shivdansani, 1993; Jensen, 1989 and Warfield et al. 1995
AUDCOM	Size of Audit Committee	Number of audit Committee members	Zhou & Chen, 2004
CEOCH	CEO Change	Dichotomous variable, 1 if CEO was change in the year and otherwise	CBN Prudential Guideline, 2010
AUDFEE	Total Audit Fees	Natural log total audit fees paid by bank as disclosed in annual report	Gerayli et al., 2011
AUDCH	Auditor change	Dichotomous variable, 1 if Auditor was change in the year and 0 otherwise	CBN Prudential Guideline, 2010
LEV	Leverage ratio	Total debt capital x 100 Total shareholders' fund	CBN Prudential Guideline, 2010.
BANKSIZE	Bank Size	Natural Log of total assets	Gerayli et al., 2011
BANKAQU	Bank Asset Quality	Total loans Total assets	As per prudential guidelines, 2010
BANK COMP	Bank Complexity	Number of bank subsidiaries	Author's suggestion
BANKP ER	Bank Performance Return of Equity	PAT X 100 Shareholders' fund	As per prudential guidelines, 2010

Source: Compiled by author, 2013

4. RESULTS AND DISCUSSIONS

The results of correlation analysis are given in table 2. The results show that audit committee size (AUDCOM), audit fee (AUDFEE), bank asset quality (BANKQUA), bank size (BANKSIZ) and board size (BSIZE) are all negatively correlated with abnormal loan loss provisions (ABBL). What this means is that the larger the audit committee size, the lower the abnormal loan loss provision. This result is not supported by Spira (1999), who argues that audit committee are ineffective in constraining earnings management. In fact, Abdul Rahman and Ali (2006) find a positive association between audit committee size and earnings management.

Audit fee shows a negative association with abnormal loan loss provision. This suggests that higher audit fee implies improved audit quality and hence, reduced abnormal loan loss provision. This result is not consistent with Gul *et al.* (2003) that find a positive correlation between audit fee and earnings management. However, Srinidhi *et al*. (2007) argue in line with the finding of this study that higher audit fee implies improved audit quality and hence reduced earnings management.

Bank asset quality also shows a negative relationship with earnings management. This implies that a bank with high asset quality will have less motivation to engage in earnings management. Morgan (2002) argues that banks engage in earnings management to hide asset substitution behaviour. Asset substitution like bank asset quality implies risk. Where asset quality is low, the tendency to engage in earning management is higher. Warfield *et al*. (1995) observes

that riskier firms might use more abnormal accruals to reduce the perception of risk as the result of this study indicates.

Table 2: Correlation Results

	AUDCOM	AUDFEE	AUDCH	BANKAQU	BANKCOMP	BANKPER	BANKSIZE	BSIZE	BCOMP	CEOCH	DSHAR	ABLL	LEV
AUDCOM	1												
AUDFEE	-0.05519	1											
AUDCH	-0.03243	0.034397	1										
BANKAQU	-0.00123	0.008814	0.033383	1									
BANKCOMP	-0.00265	0.367156	0.054184	0.00402	1								
BANKPER	0.023213	-0.05065	0.010082	-0.02382	-0.01951	1							
BANKSIZE	-0.02501	-0.11378	0.020993	-0.3797	-0.07533	-0.14666	1						
BSIZE	0.123793	-0.13364	-0.00994	-0.00922	-0.12864	-0.03443	0.00529	1					
BCOMP	-0.11841	0.256056	0.090201	-0.08336	0.445863	-0.10541	0.045175	-0.41998	1				
CEOCH	-0.08303	0.019613	-0.00374	0.11733	-0.05679	0.08937	-0.04208	-0.03645	0.051602	1			
DSHAR	0.022625	0.077677	0.093444	-0.17204	-0.14684	0.0216	0.158302	0.142368	0.01232	0.019177	1		
ABLL	-0.01872	-0.03741	0.154414	-0.2474	0.118807	0.212888	-0.01813	-0.07619	0.041876	0.042043	0.254891	1	
LEV	0.040013	-0.04198	0.041814	-0.0421	-0.07266	-0.08735	-0.1633	0.172872	-0.09875	0.252794	0.047565	0.105105	1

Source: Author's Computation Using E-Views 7.0

This study also finds that bigger banks have lesser tendency to manage earnings. Customer tends to have more confidence in bigger banks because of the safety of their deposits. Besides, reputational concerns tend to dissuade large banks from earnings management. However, a study like Pincus & Rajgopal (2002) finds a positive relationship between earning management and firm size. Board size is negatively correlated with abnormal loan loss provision. This result is supported by prior research findings (Peasnell, *et al.*,2000; Chtourou *et al*., 2001; Xie *et al*., 2003; Yu, 2008; Klein, 2002). However, other studies like Abbott *et al*. (2000) and Kao & Chen (2004) disagree with our finding. In fact Kao & Chen find a positive relationship between board size and earnings management.

Other variables including auditor change (AUDCH), bank complexity (BANKCOMP), bank performance (BANKPER), board composition (BCOMP), director shareholding (DSHAR), and bank leverage (LEV) are positively correlated. A change in auditor will increase abnormal accruals. This implies that a change in auditor will aggravate earnings management. Section 4.2 of the CBN Prudential Guideline (2010) provides that "the tenure of external auditors in a given bank shall be for a maximum period of ten years from date of appointment after which the audit firm shall not be reappointed in the bank until after a period of another 10years." This suggests that a change in auditor should constrain fraudulent financial reporting. The thinking is that a change in auditor will improve audit quality, as it removes the familiarity thrust threat. On the other side of the divide, the argument is that a change in auditor will imply learning by the new auditor and therefore provides opportunity for management to engage in earnings management because of the ignorance of the new auditor. Hence, management may be able to manipulate accounting numbers when switching between auditors (Nelson, Elliott & Tarpley, 2002; Kim & Kross, 1998). This study supports the finding that auditor change induces earnings management.

The complexity of the bank is positively correlated with earnings management as revealed by this study. This implies that the more the subsidiaries of a bank, the greater the tendency for

earnings management. This is supported by the Enron's case, where special purpose entity was used to manipulate accounts.

Bank performance is positively related to abnormal loan loss provision. Oosterbosch (2009) argued that a positive correlation between bank performance and loan loss provision indicates the presence of earnings management. He found a positive associate between bank performance and earnings management consistent with the result of this study. Board composition is positively related to abnormal loan loss provision. This is inconsistent with Bedard *et al*.(2004), Klein (2002), Peasnell *et al*. (2000) and Xie *et al*. (2003). This results may indicate that inclusion of incompetent non-executive directors oes not prevent earnings management. This is a case of "two bad heads are worse than one good one." Director's shareholding is positively correlated with abnormal loan loss provision. This implies a tendency for directors to engage in earnings management when they have significant holdings. This seems logical because directors will want to manage earnings to increase the value of their holdings as the happenings in the stock market indicate for the period of the study. Majority of empirical evidences available supports our findings (Koh, 2003; Bergstresser & Philippon, 2006). Managerial entrenchment weakens corporate governance effectiveness.

The study finds a positive correlation between earnings management and leverage of bank. This means that the more levered a bank, the more the tendency for the bank to manage earnings. This finding accords with the assertion of Morgan (2002) who argued that banks are prone to engage in earnings management to hide risky behaviour.

5. CONCLUSION AND RECOMMENDATIONS

This study sought to relate earnings management to audit quality, corporate governance and bank specific characteristics to find out the determinants of earnings management in the banking industry. We conclude that audit committee size (AUDCOM), audit fee (AUDFEE), bank asset quality (BANKQUA), bank size (BANKSIZ) and board size (BSIZE) will forestall earnings management. However, auditor change (AUDCH), bank complexity (BANKCOMP), bank performance (BANKPER), board composition (BCOMP), director shareholding (DSHAR), and bank leverage (LEV) will aggravate earnings management. Therefore to reduce earnings management audit quality most be improved, audit committee size should be increased, bank inspector should on asset quality and leverage of the bank, and both bank size and board size should be increased. Furthermore, indiscriminate change of auditor and increasing the number of bank subsidiaries are not recommended. Rather, non-executive directors should be appointed on the basis of competence. Directors' holding should be controlled.

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