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Managing specific accruals vs. structuring transactions: Evidence from banking industry

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ABSTRACT

This study investigates earnings management through managing specific accruals vs. structuring transactions in the banking industry. This paper explores the circumstances under which banks manipulate loan loss provisions vs. circumstances that lead banks to structure loan sales and securitizations for the purpose of achieving earnings benchmarks. Empirical results show that banks manage earnings through loan loss provisions, before resorting to structuring transactions, to avoid small earnings decreases and or just meet or beat analysts' forecasts. The findings imply that structuring loan sales and securitizations is more likely to be used as a secondary instrument. In addition, I find that the earnings of banks with lower discretionary loan loss provisions and higher discretionary gains from loan sales and securitizations are priced more negatively, suggesting that investors impose incremental penalties on the joint use of loan loss provisions and gains from loan sales and securitization to meet or beat earnings benchmarks.

1. Introduction

Existing literature has consistently documented evidence that companies manage earnings through manipulating specific accruals. Examples abound where companies adjust accounting estimates, such as bad debt expense (McNichols & Wilson, 1988), loan loss provisions in the banking industry (Beatty, Chamberlain, & Magliolo, 1995; Beatty, Ke, & Petroni, 2002; Kanagaretnam, Lobo, & Mathieu, 2003), and insurance loss estimates in the insurance industry (Adiel, 1996; Beaver, McNichols, & Nelson, 2003), to manage earnings. Alternatively, companies can manipulate earnings through real activities manipulation (Roychowdhury, 2006). For example, companies structure issues of contingent convertible bond to manage diluted earnings per share (Marquardt & Wiedman, 2005). In addition, gains from securitizations have been used to manage earnings (Dechow, Myers, & Shakespeare, 2008; Karaoglu, 2005; Niu & Richardson, 2004).[1] A recent article in *New York Times* cites industry specialists who describe securitizations as "*the thing about gain on sale accounting is that you can create a machine that just manufactures earnings out of thin air*".

Although previous studies suggest that companies may have opportunities to influence earnings via the two available instruments – managing specific accruals and structuring transactions, no study to date has explicitly investigated how managers trade off real and accrual manipulations in a regulated industry – the banking industry. I fill this gap in the literature. Graham, Harvey, and Rajgopal (2005), Zang (2007), and Cohen and Zarowin (2010) examine the relation between accrual-based and real earnings management in non-banking sector.[2] The motivations to manipulate earnings may differ in the regulated industry. For instance, bank regulators establish the minimum capital requirements and intervene in the operations of banks with inadequate capital (Beatty et al., 1995). Furthermore, banking companies provide a fertile ground for research to isolate the specific accruals from structuring transactions. Focusing on a single regulated industry enables me to better measure earnings management activities. This research design helps me compare the differential costs and benefits associated with each instrument, thus providing insight into how earnings management is achieved.

Following prior research (Beatty et al., 1995; Beatty et al., 2002), I use discretionary loan loss provisions as a proxy for managing specific accruals, given that loan loss provisions are a very important accrual

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[1] Securitization is the process of transferring loans to qualifying special purpose entities through the issuance of debt. A unique feature of securitization is that the issuer receives cash instantly from outside investors and pays back this obligation when the securitized financial assets are collected. Securitization has several advantages over traditional bank financing. First, securitization enables banks to transfer illiquid assets to third parties and therefore firms obtain cash flows without waiting for customers to pay. Second, securitization is viewed as off-balance sheet financing, which favorably affects leverage ratio.

[2] Zang (2007) and Cohen and Zarowin (2010) provide evidence suggesting that managers prefer real activities manipulation compared to accrual-based earnings management. This is because real earnings management is less likely to draw auditor or regulatory scrutiny, and therefore has a higher probability of being undetected.

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for banks. Discretionary gains or losses (gains, hereinafter) from loan sales and securitizations are used as a proxy for structuring transactions at least for two reasons.[3] First, managers have high level of judgment and discretion in reporting gains on loan sales and securitizations.[4] Second, loan sales and securitizations are of particular interest, because they have expanded dramatically over the last decade. Securitizations give banks significant opportunities to affect accounting outcomes, as loans constitute over half of the balance sheet in commercial banks, and securities resulting from securitizations were the largest segment in debt market in 2005, totaling $7.4 trillion (Dechow et al., 2008).[5]

I build on previous research (Cohen & Zarowin, 2010; Zang, 2007) by examining how and when bank managers use loan loss provisions and securitizations to manage reported earnings based on the respective costs and benefits. I argue managers' choice of each instrument is a function of the firms' ability to use the instrument and the costs of doing so. As compared to managing earnings through specific accruals, structuring transactions such as securitizations is more complex. Securitization is a timing consuming process and incurs higher direct costs. Therefore, managing earnings through accruals provides a cheaper way to influence financial statements. However, managing loss loan provisions has its own costs. A reduction on loan loss provisions increases reported earnings, but it may signal poor future prospects or even result in a violation of regulatory standards (Kanagaretnam et al., 2003). The conflicting directions arising from multiple objectives restrict the use of loan loss provisions. Managers are more likely to utilize loan loss provisions to meet earnings targets if the magnitude of earnings manipulation is close to the limit of loan loss provisions. This study I focus my attention on firms that slightly meet earnings targets, since these firms have a strong motivation to manage earnings. In particular, firms just meeting earnings targets have intrinsic earnings that are close to earnings targets (Lee, 2007) and therefore they have the ability to manage earnings by picking a cheaper instrument first.

Consistent with the predictions, I find that banks use loan loss provisions, before resorting to structuring transactions, to avoid small earnings decreases and to just meet or beat analysts' forecasts. Specifically, gains from loan sales and securitizations are only used to manage earnings when pre-securitization earnings (i.e., earnings before the gain on loan sale and securitization) are lower than prior year's level and when pre-securitization earnings per share are less than analysts' forecasts. The findings of this study suggest that structuring transactions are more likely to be used in specific circumstances as a secondary tool. Additional analysis indicates that the results are robust after controlling for the simultaneity of discretion choices.

The second part of this study is to examine how investors in the market react to earnings management when banks disclose loan loss provisions and loan sales and securitizations. Previous research (Niu & Richardson, 2004; Wahlen, 1994) has examined the financial reporting consequences of these two instruments independent of each other. There is no evidence on how the joint use of these two instruments affects stock prices. A natural follow-up question is to investigate the incremental economic consequences of earnings management when both of these two instruments are used to meet earnings targets. Consistent with the hypotheses, I find that earnings with lower discretionary loan loss provisions and higher discretionary gains from loan sales and securitizations are priced more negatively. The results suggest that investors appear to recognize the tools for achieving earnings benchmarks and appropriately impose an incremental penalty when loan loss provisions and securitization gains are used simultaneously. In sum, this paper provides empirical evidence that investors may see through earnings management in the banking industry. A potential explanation is that, as a result of bank regulation, investors have access to extensive disclosures that are related to specific accruals and securitizations (Healy & Wahlen, 1999).[6]

This paper makes several contributions to the current literature. First, this study extends the literature by examining how managers use multiple tools to manage earnings. It is one of the first to investigate how managers trade off real vs. accrual management in banking industry. Investigation of management manipulation using specific accruals vs. structuring transactions is an extension of earnings management research. This extension is important because banks provide a natural setting to isolate loan loss provisions from loan sales and securitization gains, thus enabling me to develop more reliable measures of managerial discretion over earnings. The findings of this study help us understand the rationale for managers' choices of these instruments to avoid small earnings declines and to just meet or beat analysts' forecasts. Second, this paper adds to a growing body of research that documents the capital market consequences of earnings management. My results suggest that market participants punish firms to a greater extent when managing specific accruals and structuring transactions are used simultaneously. In this sense, the findings of this study have implications in making investment decisions. In addition, evidence on market efficiency with the joint use of these two instruments is likely to be of interest to standard setters.[7] Finally, this paper presents evidence on how managers use the fair value accounting under SFAS140 to structure transactions in meeting earnings benchmarks, thus providing insights into the attributes that relate to the recent subprime crisis.[8]

The remainder of this paper is organized as follows. Section 2 reviews the literature and develops the hypotheses. Section 3 introduces the empirical models. Section 4 describes the samples. Section 5 presents the results, and Section 6 summarizes the paper.

[3] Besides loan sales and securitization, I assert that banks structure other transactions for earnings management. For instance, Beatty et al. (1995) documents that gains on sale of securities, gains on sale of fixed assets, and gains on pension settlement also can be used for earnings manipulation. As compared to securities sales and fixed asset sales, securitization can be more complicated and/or more costly to structure. For example, securities sales typically do not involve setting up qualifying special purpose entities.

[4] In a typical securitization, firms retain some interest in the receivables in order to obtain the desired credit rating. Thus, less than 100% of the receivables are sold. The accounting rule SFAS140 requires the retained interest to be recorded at the fair value. In contrast to securitization, loan sales are the whole "pure" assets sales without any future involvement by the transferor. In loan sales, managers exercise discretion over the timing and selection of loans to be sold. But in the case of securitizations, managers have additional discretion in reporting gains from retained interests due to the fair value treatment (Karaoglu, 2005). As a result, the impact on financial reporting is higher for securitizations than for loan sales.

[5] Specifically, Dechow et al. (2008) find that 13% of their sample firms report securitization gains, and the magnitude of securitization gains is sufficient to convert an accounting loss into a profit.

[6] Such explanation is consistent to the theory that the key element for market discipline to play depends on information that is observable (Flannery, 2011). The ability of investors to interpret information on bank behavior is enhanced when extensive disclosures of loan loss provisions and securitizations are provided.

[7] Healy and Wahlen (1999) review the academic literature on earnings management and indicate that standard setters are interested in a set of questions, including which specific accruals are used to manipulate earnings, the magnitude and frequency of earnings management, and the economic consequences of earnings management. Evidence in addressing these questions would help accounting regulators determine the need for financial standards to be revised.

[8] The recent financial crisis has led to the debate about the use of fair value accounting rule SFAS140, which applies to financial instruments retained (retained interest) after a securitization. Critics argue that fair value accounting has significantly contributed to the financial crisis, given that it is difficult to evaluate the reasonableness and accuracy of the reported securitization gains and thus managers may take the advantage of using fair value to achieve desired accounting outcomes. Proponents argue that fair value increases the transparency of financial reporting and the undesirable consequences of fair value are driven by market inefficiencies, investor irrationality, or unreliable fair value model (Dechow et al., 2008). A recent study by Barth and Landsman (2010) indicates that although fair value accounting plays little role in the financial crisis, financial institutions need to improve the disclosures relating to asset securitizations. SFAS166, *Accounting for Transfers of Financial Assets,* and SFAS 167, *Amendments to FASB Interpretation No. 46R* were passed in 2010 to address the limitations of fair value accounting.