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Ownership Structure and Discretionary Loss Provisions: The Moderating Effect of Audit Committee Independence

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Abstract

This study investigates the interactive effect of an independent audit committee on the relationship concerning ownership structure and discretionary loss provisions. The study utilizes 29 listed Nigerian financial institutions as a sample using data from 2006 to 2015. The results establish that audit committee independence negatively influences discretionary loss provisions. Furthermore, it is found that CEO, block and foreign ownership have a direct influence on discretionary loss provisions. Moreover, audit committee independence moderates these direct relationships negatively. While institutional ownership has a direct influence on discretionary loss provisions, similarly, audit committee independence moderates this direct relationship positively. Additionally, audit committee independence fails to moderate but has a direct influence on discretionary loss provisions. Conversely, audit committee independence fails to moderate the relationship between the executive and non-executive ownership with discretionary loss provisions. The study suggests that relevant authorities should impose laws to motivate firms to have more independent members in audit committee to reduce conflicts of interest between the executive and non-executive ownership over the audit committee members' composition to protect the interests of other shareholders.

Keywords: Audit Committee, Discretionary Loss Provisions, Financial Institutions, Ownership Structure.

1. INTRODUCTION

Accounting manoeuvres are used in accrual-based earnings manipulations by executives on the reported earnings (Maigoshi, Latif, & Kamardin, 2016). Like executive of non-financial firms, financial firms' the executives can use accruals to manage their income to fine-tune earnings to exploit firm and/or personal interest (Liu & Ryan, 2006; Norden, & Stoian, 2013). The sole difference between them is the technique used to participate in earnings management. Unlike managers in other industries, managers of financial firms usually employed loan loss provisions or loss reserve accrual (also known as an unearned premium or unexpired risks) to influence reported earnings (Chang, Shen, & Fang, 2008). Furthermore, the primary accruals of financial firms, loss provisions which play a more complex role than the accruals of non-financial companies for 2 reasons (Dou, Ryan, & Zou, 2018; Norden, & Stoian, 2013). Loss provisions are likely to replicate expected losses by executives (Anandarajan, Hasan, & McCarthy, 2006; Chang et al., 2008; Dou et al., 2018). The loss provisions cannot truthfully equal to the real losses also can contain a margin for erroneousness. This margin for erroneousness is what is raised to as the discretionary element of the loss provisions that have been manipulating by financial firms (Anandarajan et al., 2006; Bushman & Williams, 2012).

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Moreover, loss provisions are a quite great accrual for a financial firm and, thus, influences its earnings and shareholdings (Anandarajan et al., 2006). Nevertheless, management of these financial firms have inspirations to utilise the provisions of loan loss to manage earnings (Dou et al., 2018; Norden, & Stoian, 2013). Hence, it can be used for accrual earnings management. Moreover, previous studies largely claim that executives involve in earnings management for various motives and possibly work out their financial reporting discretion to affect stated earnings (Beatty & Liao, 2011; Bushman & Williams, 2012; Chang et al., 2008; Dou et al., 2018; Norden, & Stoian, 2013).

Notwithstanding any grounds for executives to manipulate earnings, earnings management activities indicate a conflict of interest between shareholders and management (Chang et al., 2008). When managers deviously manipulate earnings through discretionary loss provisions, shareholders may perhaps evade or pull out investment from financial firms with high discretionary loss provisions to minimize approaching losses (Ma, & Song, 2015). Furthermore, agency theory and resource dependence theory emphasise that an independent audit committee can decrease these earnings manipulation (Al-Rassas & Kamardin, 2015). Therefore, this study exactly investigates the moderating role of an independent audit committee on the relationship between ownership structure and discretionary loss provisions in the Nigerian financial sector.

2. LITERATURE REVIEW

According to Healy and Wahlen (1999) loan loss provisions are extremely reliant on management's decisions and openly related to the financial firms' vital assets and liabilities. Moreover, loan loss provisions are usually very huge proportionate to net income as well as firm's equity. Consequently, due to the significance of financial firms' loan loss provisions, it will likely to be a good measurement earnings management in financial institutions (Cohen, Cornett, Marcus, & Tehranian, 2014). However, for the insurance companies, in line with Beaver, McNichols, and Nelson, (2003); Gaver and Paterson (2004) the insurance loss reserve accrual (also known as unexpired risks or unearned premium) use as a discretionary loss provisions proxy. As loss reserves signify the major charge on insurers' accounts, whereas under-reserving decreases stated liabilities and rise insurance companies' assets, and as a result empowers insurance companies to appear safer than and vice versa (Veprauskaite & Adams, 2014). Moreover, Beaver et al. (2003) explain that insurance companies' managers can understate loss reserves with the aim of reducing stated loss liabilities and evade financial distress as well as insolvency.

Moreover, previous studies on ownership structure and discretionary accruals provide mixed findings. For instance, in line with the convergence of interest hypothesis, some scholars found a negative relationship between managerial ownership and discretionary accruals (Ali, Salleh, & Hassan, 2008; Alves, 2012; Alzoubi, 2016; Ramadan, 2016). However, consistent with entrenchment effects hypothesis, some scholars found a positive relationship between managerial ownership and discretionary accruals (Farouk & Hassan, 2014; Waweru & Prot, 2018). Also, in line with the convergence of interest hypothesis Ali et al. (2008); and Alzoubi (2016) established a negative relationship between non-executive ownership and discretionary accruals. However, the entrenchment effects hypothesis, Alzoubi (2016); and Darko, Aribi, and Uzonwanne (2016) claim a positive relationship between non-executive ownership and discretionary accruals. Furthermore, consistent with the efficient-enhancing effect hypothesis, Alves (2012); Kurawa and Saheed (2014); and Ramadan (2016) found an inverse relationship between block ownership and discretionary accruals. Whereas, in corroboration with outright expropriation hypothesis, Farooq and El Jai (2012); and Isenmila and Afensimi (2012) claimed a positive relationship between block ownership and discretionary accruals.

Furthermore, consistent with the active monitoring hypothesis, Ali et al. (2008), Guo, Huang, Zhang, and Zhou (2015); and Kim (2015) found a negative relationship between foreign ownership and discretionary accruals. However, in corroboration with transient investment hypothesis, Guo and Ma (2015); and Paik and Koh (2014) claimed a positive relationship between foreign ownership and discretionary accruals. Moreover, in line with efficient monitoring hypothesis, it had been claimed that an increasing institutional ownership leads to decreasing discretionary accruals in the companies (Yang, Chun, & Ramadili, 2009). Conversely, in line with hands-off passivity hypothesis, some studies have provided empirical evidence that institutional ownership increases firms' discretionary accruals (Alves, 2012; Agyei & Owusu, 2014; Emamgholipour & Mansourinia, 2013; Lemma, Negash, Mlilo, and Lulseged, 2018). Therefore, based on these inconclusive findings and opposing hypothesis there to introduce a moderating variable which may strengthen or weaken these relationships.

On the other hand, previous researchers provide proof that an independent audit committee is related to discretionary accruals (Al-Rassas & Kamardin, 2015; Amin, Lukviarman, Suhardjanto, & Setiany, 2018; Salleh & Haat, 2014). Moreover, the agency theory and resource dependence theory assert that an independent audit committee influences discretionary accruals (Al-Rassas & Kamardin, 2015). Likewise, previous studies claimed that audit committee characterised by many independent members is expected to be more effective in undertaking their motoring role and lower the discretionary accruals earnings manipulation (Al-Matari, Fadzil, & Al-Swidi,

2014; Lin, Li & Yang, 2006). Therefore, established on the agency theory and resource dependence theory, it is predicted that an independent audit committee should be competent in aiding the investors in the monitoring of the firm's discretionary accruals. Hence, hypothesise that:

H1: An independent audit committee moderates the relationship between ownership structure and discretionary loss provisions.

3. METHODOLOGY

This study uses the sample of 29 listed Nigerian financial institutions that existed from 2006 to 2015. The study excluded all firms that had been listed on the Nigeria Stock Exchange outside this period. Moreover, all firms without complete data were excluded. The period is chosen because it is the period in which the financial sector has undergone a series of restructuring in Nigeria.

Based on the established relationship between ownership structure and discretionary loss provisions, a direct effect model between dependent and independent variables are derived as:

$$DLP_{it} = \alpha_0 + \alpha_1 CO_{it} + \alpha_2 EO_{it} + \alpha_3 NO_{it} + \alpha_4 BO_{it} + \alpha_5 FO_{it} + \alpha_6 IO_{it} + \alpha_7 ACI_{it} + \alpha_8 FS_{it} + \epsilon_{it} \quad \text{Model 1}$$

Furthermore, a hierarchical model is developed by adding the interaction effect moderating variables audit committee independence on the above direct effect model as:

$$DLP_{it} = \alpha_0 + \alpha_1 CO_{it} + \alpha_2 EO_{it} + \alpha_3 NO_{it} + \alpha_4 BO_{it} + \alpha_5 FO_{it} + \alpha_6 IO_{it} + \alpha_7 ACI_{it} + \alpha_8 CO_{it} * ACI_{it} + \alpha_9 EO_{it} * ACI_{it} + \alpha_{10} NO_{it} * ACI_{it} + \alpha_{11} BO_{it} * ACI_{it} + \alpha_{12} FO_{it} * ACI_{it} + \alpha_{13} IO_{it} * ACI_{it} + \alpha_{14} FS_{it} + \epsilon_{it} \quad \text{Model 2}$$

Based on the previous studies the study variables are measurements are present in Table 1 as flows:

Table 1. Study Variables and Measurement

Variable	Acronyms	Measurement	Previous Studies
Dependent Variable			
Discretionary loan loss provisions	DLP	The absolute value of accruals loan loss provisions to total liabilities	Beatty and Liao (2011); Norden and Stoian (2013); Kazemian and Sanusi (2015)
Independent Variables			
CEO Ownership	CO	The proportion of shares held by CEO shareholding to total shares	Alves, (2012); Liu and Tsai (2015)
Executives' ownership	EO	The proportion of executive directors' shareholding to total shares	Alzoubi (2016); Said, Zainuddin and Haron (2009); Sani and Musa (2017)
Non-Executives' ownership	NO	The proportion of non-executive directors' shareholding to total shares	Alzoubi (2016); Bhagat and Black (2001); Darko et al. (2016)
Block Ownership	BO	The proportion of owners with above 5% shareholding to total shares	Fitri, Irianto, and Mardiaty (2017); Miko and Kamardin (2015).
Foreign Ownership	FO	The proportion of foreign investors shareholding to total shares in the firm	Guo and Ma (2015); Greenaway, Guariglia, and Yu (2014).
Institutional Ownership	IO	The proportion of institutional investors shareholding to total shares in the firm	Lemma et al. (2018); Miko and Kamardin (2015)
Moderating Variable			
Audit Committee Independence	ACI	The proportion of non-executive audit committee members to a total number of audit committee members	Al-Matari et al. (2014); Al-Rassas and Kamardin (2015); Amin et al. (2018)
Control Variables			
Firm Size	FS	Natural logarithm of total asset	Azzali and Mazza (2018); Sani and Madaki (2016); Waweru and Prot (2018)

4. DATA ANALYSIS AND DISCUSSION OF RESULTS

Table 2 which shows the result for the descriptive statistics for all variables of the study, discloses the average discretionary loan loss provisions of 5.1%, with a standard deviation of 7% from one firm to another. Moreover, some of the firm under study have almost 0% of their total liabilities as reported discretionary loan loss provisions. Whereas, some firms have almost 42.8% of their total liabilities as reported discretionary loan loss provisions. Furthermore, the sampled firms have an average of 0.9% as CEO shareholding with the variability of 1.94% along with a minimum of 0% and a maximum of 13.61%. Likewise, the sampled firms have an average of 1.4% executive ownership with the standard deviation of 2.44% and a minimum of 0% and a maximum of 13.61%. Moreover, the range of the non-executive directors' shareholding of the sampled firm is between 0 to 85.61% with a mean and standard deviation of 15.64% and 18.92% respectively. Furthermore, the average block shareholding is 34.51% with a difference of 25.43%. While some of the sampled firms have no block shareholding,

some other firms have as much as 85.89 as block shareholding. Likewise, range of foreign shareholding is between 0.00% to 85.89%, with an average and standard deviation of 11.78 and 18.78% respectively. Also, the reported range of institutional shareholding is between 0% to 85.89%, with an average and standard deviation of 36.30% and 25.24% respectively. Also, the range of audit committee is between 66.70% to 100% with independent members. Whereas, the sampled firms have an average 95.40% independent members in their audit committee with a standard deviation of 9.5%. Whereas, for the skewness and kurtosis all variables have below 3.00 and 10.00 respectively with exception of CEO ownership which has 3.236 and 14.560 respectively. This is due to a high disparity among the CEO shareholding in the Nigerian financial sector.

Table 2. Descriptive Statistics of Study Variables

Variable	OBS	Mean	Std. Dev.	Min	Max	Skewness	Kurtosis
DLP	290	0.051	0.070	0.000	0.428	2.145	8.097
CO	290	0.009	0.019	0.000	0.136	3.236	14.560
EO	290	0.014	0.024	0.000	0.136	2.329	8.067
NO	290	0.156	0.189	0.000	0.856	1.602	4.905
BO	290	0.345	0.254	0.000	0.859	0.183	1.843
FO	290	0.118	0.188	0.000	0.859	1.742	5.219
IO	290	0.363	0.252	0.000	0.859	0.145	1.877
ACI	290	0.954	0.095	0.667	1.000	-1.911	5.389
FS	290	18.422	2.302	13.838	22.264	0.022	1.465

Based on Table 3, the dependent variable discretionary loan loss provisions positively correlated with the block ownership and institutional ownership at 1% level of significance. Meanwhile, discretionary loan loss provisions negatively correlated with audit committee independence and firm size at 1% level of significance. While the association between discretionary loan loss provisions and foreign ownership was significant and negative at 5%. However, the correlation between discretionary loan loss provisions and non-executive ownership is positive and significant at 10%. Whereas, the association between CEO ownership with the executive ownership was positive and significant at 1%. However, the association between CEO ownership with the institutional ownership was negative and significant at 1%. While CEO ownership association with the block ownership is negative and significant at 5%; likewise, CEO ownership association with the foreign ownership was negative and significant at 1%. Similarly, executive ownership negatively correlated with block ownership and institutional ownership at 1%. And a negatively correlated with foreign ownership at 5%. Likewise, the association between non-executive ownership with the block ownership was positive at 1% significant level. Conversely, the association between non-executive ownership with an independent audit committee and firm size was negative and significant at 1%. Similarly, non-executive ownership positively correlated with the foreign ownership at 5%. The correlation between block ownership was positive with the foreign ownership and institutional ownership at 5%, but it has a negative and significant relationship with the firm size at 1%. Similarly, block ownership negatively correlated with an independent audit committee at 5%. Whereas, the correlation between foreign ownership and institutional ownership was positive and significant at 1% and with firm size at 5%. However, institutional ownership has a significant negative relationship with firm size at 1%. Correspondingly, an independent audit committee has a positive correlation with firm size at 1%. Moreover, the range of variance inflation factor (VIF) is between 1.23 to 6.07 which specifies the absence of Multicollinearity problem.

Table 3. Pearson Correlation Matrix of the Variables

	DLP	CO	EO	NO	BO	FO	IO	ACI	FS	VIF
DLP	1.0000									
CO	0.0600	1.0000								2.52
EO	0.0315	0.7703***	1.0000							1.23
NO	0.1049*	-0.0553	-0.0524	1.0000						2.58
BO	0.2962***	-0.1351**	-0.2123***	0.3227***	1.0000					6.07
FO	-0.1324**	-0.1000*	-0.1334**	0.1406**	0.4361***	1.0000				1.57
IO	0.2479***	-0.1511***	-0.2258***	0.3341***	0.8975***	0.4919***	1.0000			5.67
ACI	-0.2558***	0.0841	0.0235	-0.1607***	-0.1203**	0.0497	-0.0863	1.0000		1.15
FS	-0.5552***	0.0248	0.0892	-0.3519***	-0.4557***	0.1328**	-0.3393***	0.3381***	1.0000	1.82

***, **, * indicates that the estimates significance levels at 1%, 5% and 10% respectively.

As discussed earlier, an independent audit committee is expected to moderate the relationship between ownership structure and discretionary loan loss provisions. Therefore, to examine this moderating effect hierarchical regression had been run. Furthermore, to choose an appropriate regression method, diagnostic tests have run. These tests comprise of autocorrelation, cross-sectional dependence, Hausman specification, heteroscedasticity, and Breusch and Pagan Lagrangian Multiplier (BPML) have been run on the hierarchical regression equation. Based on BPML as well as Hausman specification tests a random effect is preferred in both models. Furthermore, from both models, there is the absence of autocorrelation in panel data. However, evidence has shown an existence of group-wise heteroscedasticity and cross-sectional dependence problems in the dataset. Therefore, to solve these problems an adjusted Driscoll and Kraay's standard errors were run as recommended by Hoechle, (2007). This is presented in table 4.

Table 4. Results of Discretionary loss provisions Direct and Hierarchical Models Using Fixed-Effects with Driscoll and Kraay's Standard Errors

DLP	Direct Model		Hierarchical Model	
	Coef.	t	Coef.	T
CO	0.1249	0.4600	15.1601***	4.0400
EO	0.2075*	1.7500	1.1489	0.9300
NO	-0.0466*	-1.7800	-0.2492	-0.9700
BO	-0.0025	-0.0700	0.8150***	2.8900
FO	-0.0489*	-1.7500	0.4667*	2.0200
IO	0.0582***	3.2700	-0.4913	-1.6000
ACI	-0.0672**	-2.2600	0.1317	1.3400
CO*ACI			-15.2060***	-4.1600
EO*ACI			-0.8177	-0.6200
NO*ACI			0.2071	0.7900
BO*ACI			-0.8527***	-3.0100
FO*ACI			-0.5394**	-2.2200
IO*ACI			0.5934*	1.8200
FS	-0.0150***	-6.9800	-0.0143***	-7.3700
Cons	0.3803***	6.3000	0.1664	1.6800
R-square	0.3539		0.3878	
Prob > F	0.0000		0.0000	
BPLM test for random effects	0.0102		0.0405	
Hausman specifications	0.5413		0.9336	
Pesaran's test of cross-sectional independence	0.0000		0.0000	
Modified Wald test for Groupwise heteroskedasticity	0.0000		0.0000	
Wooldridge test for autocorrelation in panel data	0.2488		0.1505	

***, **, * indicates that the estimates significance levels at 1%, 5% and 10% respectively.

As in Table 4, it is shown that an independent audit committee has a negative influence on discretionary loss provisions. This is consistent with agency theory and findings of Al-Matari et al. (2014); Lin et al. (2006) that an independent audit committee reduces discretionary accruals. Furthermore, CEO ownership is found to have an insignificant positive effect on discretionary loss provisions. Conversely, the presence of an independent audit committee makes it significant negative. Hence, this means an independent audit committee improves the relationship between CEO ownership and discretionary loss provisions. As for the overall executive ownership impact on the discretionary loss provisions, executive ownership has a direct positive and significant effect on discretionary loss provisions. This is consistent with the entrenchment effects hypothesis and findings of Farouk and Hassan (2014); Waweru and Prot, (2018). However, an independent audit committee has not been able to moderate this relationship in the Nigerian financial sector. This may be because the entrenchment behaviour of executive directors will not let them align with an independent audit committee in monitoring the firm's financial activities.

Furthermore, non-executive ownership has a direct effect significant negative on discretionary loss provisions. This is consistent with the convergence of interest hypothesis and findings of Ali et al. (2008); and Alzoubi (2016). However, an independent audit committee was not able to moderate such relationship. This is due to the entrenchment behaviour of non-executive directors will prevent them to support an independent audit committee to effectively monitor the firm's financial activities. Moreover, block ownership has a negative insignificant effect on discretionary loss provisions. However, this insignificant effect had been upturned to significant by the presence of an independent audit committee as a moderating variable. This indicates that an independent audit committee improves the relationship between block ownership and discretionary loss provisions.

Likewise, foreign ownership has a significant negative effect on discretionary loss provisions. This is consistent with the active monitoring hypothesis and findings of Ali et al. (2008), Guo et al. (2015); and Kim (2015). Similarly, an independent audit committee strengthens this negative relationship. Finally, institutional ownership has a significant positive effect on discretionary loss provisions. This is consistent with the hands-off passivity hypothesis and findings of Alves (2012); Agyei and Owusu (2014); Emamgholipour and Mansourinia (2013); and Lemma et al. (2018). Similarly, an independent audit committee strengthens this positive relation. This indicates that an independent audit committee worsens the relationship between institutional ownership and discretionary loss provisions. This may be because of hands-off passivity monitoring behaviour of some institutional investors may not let them align with an independent audit committee to effectively monitor firm's financial activities.

5. CONCLUSION

From the research findings, it is found that non-executive and foreign ownership have a direct negative influence on discretionary loss provisions. Whereas, executive and institutional ownership have a direct positive influence on discretionary loss provisions. However, CEO ownership and block ownership do not have a significant influence on discretionary loss provisions. Moreover, it can be observed that an independent audit committee

strengthens the negative relationship between some type of ownership (CEO, block and foreign) and discretionary loss provisions. These support both agency theory and resource dependency theory arguments that audit committee independence will help in effective monitoring firm financial activities to curtails discretionary earnings manipulations. Whereas, an independent audit committee worsen the relationship between institutional ownership and discretionary loss provisions. This is due to the in hands-off passivity approach of institutional investors that prevent them assist an independent audit committee in monitoring financial activities.

However, the presence of audit committee independence fails to moderate the influence of executive and non-executive ownership on discretionary loss provisions. This may be due to the entrenchment behaviour of both executive and non-executive shareholders may stop them to support an independent audit committee monitoring the firm's financial activity effectively. Hence, this study suggests that regulators in Nigerian financial should strengthen the provision for more independence of audit committee. Specifically, the regulators should minimize the influence of both the executive and non-executive ownership on the audit committee members' composition to safeguard the interests of other types of shareholders.

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