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THE IMPACT OF CORPORATE GOVERNANCE MECHANISMS ON EARNINGS MANAGEMENT: EVIDENCE FROM BANKS IN ETHIOPIA

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ABSTRACT

This research examined the impact of corporate governance mechanisms on earnings management through discretionary loan loss provision, using panel data of 10 banks for the period 2006 to 2010. The study is crucial given the fact that there is no research on bank earnings management in Ethiopia. Based on discretionary loan loss provision model and random effect GLS regression, the study finds that education, experience and objectivity of internal auditor are negatively and significantly associated with earnings management. The study also finds a negative and significant relation between audit committee meeting frequency, active general board of directors and earnings management. The study contributes to the understanding of the relationship between internal audit quality, audit committee, board characteristics and earnings management in banks, which has been less explored in prior studies. The findings of this study have implications for banks, bank regulators and bank owners in that the study finds internal audit quality, audit committee meeting and active general board of directors as important mechanisms of banks' corporate governance.

KEYWORDS

Banks, Corporate governance, Discretionary loan loss provision, Earnings management, Ethiopia.

INTRODUCTION

According to Agency theory, managers and shareholders should have an identical objective that is to maximize the firm's value. An agent is required to run the firm on behalf of the owners and makes decisions in favor of them. However, sometimes managers of the firm might perform in best of their interest at the cost of shareholders (Jensen & Meckling, 1976). One of the potential approaches that managers exercise such personal benefit is via earnings management, because it is carried out purposefully and knowingly to mislead stakeholders or influence earnings based compensation.

Earnings based compensation is a contract regarding bonus paid to managers and directly tied to a target net income. This benefit therefore, induces managers involve in earnings management by manipulating accounting standards or structuring business transactions to reach the target net income (Healy and Wahlen, 1999). In a bad period, where earnings are expected to be less than the target, managers reduce or delay recognition of expenses (e.g., provisions for loan losses) to increase earnings. Conversely, in good period managers defer the recognition of revenue or increase expenses to reduce earnings and use them in a bad period. In addition, managers may also manage earnings to avoid loss, violation of debt covenant (if debt agreements rely on the reported earnings), to reduce earnings variance and to meet capital adequacy ratio requirement. However, the intention is unobservable; no one can be certain whether it is performed to attain personal benefit or firms' benefit (Yaping, 2005). In short, this highlights how the problem emerges.

Earnings management has similar traits both in non-financial and financial firms; the only difference is a technique in which managers practice it. In case of financial firms particularly in banks, earnings management arises through estimation of loan loss provisions. Bank managers determine the level of provision for loan loss to capture the expected loss on loan portfolios. Since the amount of the provision is subject to managers' estimation and judgment, it may include bias, which is called discretionary loan loss provision (unfair portion of provision for loan loss). With this regard, National Bank of Ethiopia requires all banks to estimate adequate provisions for loan loss. This is to mean that the provisions should not be less or exceed the expected loss on loans. However, it is difficult to determine whether the loan loss provision is adequate or not. It might be individuals' benefit based estimated rather than appropriately estimated (Wall and Koch, 2000).

Despite managers' intention, discretionary loan loss provisions have enormous effect on banks operations. First, it leads to inappropriate valuation of assets and misallocation of resources. An increase in loan loss provision reduces net income and retained earnings. A decrease in loan loss provision increases net income and retained earnings. Accordingly, it distorts efficient economic activities of banks. Second, loan loss provisions may be used as a tool to reduce earnings volatility or earnings variance, which in turn improve perception of bank risk among investors and enhance stock price stability (Biurrun, 2010). Finally, discretionary loan loss provision may in part contribute to financial distress because it leads to agency problem that arises from deviation in interest between management and shareholders.

Banking industry is more regulated than other industries in Ethiopia. Nevertheless, the earnings reported by banks are not examined from earnings management viewpoint. Therefore, this study aims at assessing the relation between internal audit quality, audit committee, board characteristics and earnings management by banks in Ethiopia.

LITERATURE REVIEW

As feasible solutions to earnings management, prior researchers argue several mechanisms to reduce earnings management. For example, Yu (2004) finds that earnings management tends to be lower in companies followed by more financial analysts. Biurrun (2010) reports the role of regulation and supervision in mitigating bank earnings management. Effective audit committee and external audit quality are also suggested in literature as monitoring devises of opportunistic behavior practice (e.g., Chen et al, 2005; Lin et al., 2010). A growing number of studies explore the relation between audit committee, board characteristics, external auditor, financial analysts and earnings management in non-financial firms. However, the role of internal audit quality in reducing earnings management have been less explored both in non-financial and financial firms. Current studies using GAIN database by Prawitt et al. (2009), Lin et al. (2010) and Pizzini et al (2010) confirm that internal audit quality reduces earnings management in non-financial firms. Zhou and Chen (2004) argue audit committee and board characteristics as corporate governance mechanisms used to curb earnings management by commercial banks. However, they did not include internal audit quality in their model, which is a vital entity's corporate governance.

A variety of studies shed light on the relationship between audit committee and earnings management. However, the results are mixed. For instance, Carcello and Neal (2000), Zhou and Chen (2004), Klein (2002), and Ebrahim (2007) find a positive relation between effective audit committee (meeting frequency and

independence) and earnings management. Bedard et al. (2004) find that firms with 100 percent independent audit committee and with at least one financial expert in the audit committee are negatively associated with aggressive earnings management. They found insignificant association between the number of audit committee meeting and the level of earnings management. Effective audit committee is expected be independent, financial experts, frequently meet and high members. In other words, audit committee might not meaningfully discharge its responsibility unless it is independent, active as well as possess financial expertise. The presence of independent and accounting or finance experts in the audit committee are particularly important for effectiveness of audit committee (Nan and Nan, 2004). The Blue Ribbon Committee (1999), and Krishnan (2005) also address the importance of the financial expertise of audit committee members and argue that financial expertise of audit committee members is important to meaningfully deal with the complexity of financial reports and reduces the occurrence of financial misstatement.

DeZoort and Salterio (2001) argue that audit committee members with financial reporting and auditing background is more likely to understand auditor judgments and to support the auditor in auditor-management disagreements. In addition, Piot and Janin(2007) suggests the presence of audit committee appear to be an effective device to protect discretion behavior.

Board of directors represents the shareholders and make decisions that are in the best of the interest of shareholders. Sanjaya (2011) shows the higher agency problem within a company leads to higher earnings management. In this condition, the role of board of director is to align the interest of shareholders and managers (Jensen and Meckling 1976). Specifically, board of directors is commonly responsible for hiring, evaluating, firing top management, assigning duties, providing expert advice to management, keeping shareholders' interest and providing reports about the company's performance to them, reviewing compensation for managers and directors, corporate strategies, budget and financial statement, changes to capital structure and ensuring effective communication with shareholders and stakeholders (Nan and Nan, 2004). Board of directors is also responsible to assure the adequacy of loan loss provisions (Directive No. SBB/43/ 2008, National bank of Ethiopia).

There are controversial notions on how a board of directors would be structured. According to agency theory, a board needs to comprise high proportion of outside directors. It suggests that due to their presumed independence from management, they are more effective in decision and leads to better firm performance (Jensen and Meckling, 1976). In contrast, stewardship theory notes high proportion of inside directors in the board. It also suggests inside directors are favored for their depth of knowledge, access to current operating information, technical expertise and commitment to their firm (Donaldson and Davis, 1991). Agency theory also believes that high board of directors is more efficient in making decisions and more control managers of the firm. On the other hand, there is an idea that large board size may not be productive in decision because of ineffective communication among directors (Nan and Nan, 2004).

Empirical studies also provide evidences that are consistent to the theories. Iqbal and Strong (2010), Cornett et al. (2009), Ebrahim (2007), and Xie et al. (2003), find that a larger board and a percentage of independent directors in a board are associated with lower levels of discretionary accruals, indicating a larger board and high proportion of independent directors is more effective in monitoring such accruals. They also suggest larger boards with more directors having diverse educational and technical backgrounds and skills have multiple perspectives to improve the quality of a firm's decision-making and are more likely to protect shareholders' interests. Conversely, Zhou and Chen (2004) find insignificant association between independence of directors and earnings management. Ali shah et al. (2009), and Epps and Ismail (2009) report a positive relationship between discretionary accrual and board size, suggesting the larger the board, the more ineffective in its monitoring function. As a practical matter, how much time and effort directors devote to board meetings may also be an indicator of board effectiveness, for instance, the frequency and length of board meetings, and the directors' attendance rate (Nan and Nan, 2004).

Previous studies (Chen et al., 2005; Prawitt et al., 2009; Lin et al., 2010) have found several variables in addition to internal audit function (IAF), audit committee (AC) and board characteristics (BC) that are likely to affect earnings management. However, data unavailability constrains the number of control variables that can be included in the model to only two variables: earnings before tax and loan loss provisions(EBTP) and financial leverage.

Bank managers also use EBTP to manage earnings. In consistency to this view, Zhou and Chen (2004) and Fonseca and Gonzalez (2008) find a positive and significant relationship between EBTP and discretionary loan loss provision. While EBTP is high, managers increase discretionary loan loss provision to decrease earnings. Conversely, they decrease discretionary loan loss provision when EBTP is low to increase earnings.

The empirical evidences on the relation between leverage and earnings management is mixed. Piot and Janin (2007) reports a negative relation between leverage and discretionary accrual, suggesting debt holder may represent a safeguard devise in income decreasing earnings management. According to this finding, income manipulation is less or not the matter in high leveraged firms like banks. However, Abdelghany (2005) finds that high leverage firms manage earnings in order to avoid debt covenant violation. In a condition that a debt agreement between firms and lenders rely on the earnings reported, managers of the firm may engage in earnings manipulation to make the agreement effective and avoid violation.

OBJECTIVES OF THE STUDY

This study intends to investigate the impact of corporate governance mechanisms on earnings management by banks as measured by discretionary loan loss provision. More specifically the study aims at achieving the following objectives:

- To critically examine the potential role of internal audit quality in mitigating earnings management
- To investigate the extent to which effective audit committee plays a role in constraining earnings management
- To examine the role that effective board of directors plays in reducing earnings management

RESEARCH HYPOTHESES

After reviewing and weighting empirical studies on how internal audit function quality, effective audit committee and board of directors associate to earnings management, three directional hypotheses are developed as follows:

H1: *An Internal Audit Function Quality is significantly associated with low level of Earnings Management*

H2*: An Effective Audit Committee is significantly related to low level of Earnings Management*

H3*: An Effective Board of Directors is significantly associated with low level of Earnings Management*

SIGNIFICANCE OF THE STUDY

This study provides important contributions to the literature of the relationship between internal audit quality, audit committee, board characteristics and earnings management by banks. The findings of the study may have direct contributions to banks, regulators and other stakeholders in that it finds internal audit quality (education level, professional experience and independence of internal auditors), audit committee meeting frequency and active general board of directors as important indicators of effective corporate governance. Therefore, banks can pay careful attention to their internal audit practice as it plays potential role in enhancing the integrity and reliability of financial reports. Banks may also consider audit committee meeting along with active board of directors as important control devises for the managers.

The results may serve bank regulators to consider internal audit functions as a vigor element of bank's corporate governance that previously did not get substantial attention. The regulator may also need the results to identify the key mechanisms for banks effective corporate governance that would highly increase the soundness of banks performance.

The results provide hint to the general shareholders on how to establish effective corporate governance that could highly reduce interest conflict. Previously, shareholders have relied on the general board of directors and external auditor reports to hear about their bank operations. In addition, these results provide important governance areas that shareholders need to give consideration to make bank managers effectively serve their interest.

RESEARCH METHODOLOGY

SAMPLE AND SAMPLING TECHNIQUES

The population from which the sample is drawn for this study includes all banks (15 banks as of 2010) operating in the country. We exclude other financial firms like insurance and microfinance because their operating system and reporting procedure is different from banks. Indeed, the way in which managers manipulate earnings differs from firm to firm, for example at banks, estimating loan loss provision is subject to earnings management, which is not a case at other firms. For this reason, study on earnings management requires to emphasis on a single industry rather than comprehensive industries. Firms in a single industry are expected to have identical operational system and use similar techniques to manage earnings. As the banks with the required data are limited in number, we selected banks which have six years financial data, and excluded banks with less than six years operating life. Specifically, ten banks (three public and seven private banks) were selected based on judgmental sampling. This sampling technique is used because banks were selected in terms of financial data availability for six years. As a result, the study has 50 observations. The time period covered is from 2006 to 2010.

METHOD OF DATA COLLECTION

This study used two sources of data: primary data and secondary data. Primary data was gathered through questionnaire. Secondary data include financial reports i.e., balance sheet, income statement and notes to financial reports (2005 to 2010) and directly collected from banks. The data on inflation rate was collected from National Bank of Ethiopia. The financial data for 2005 was collected only to compute the ratio of variables scaled by lagged total assets and outstanding loans.

MODEL SPECIFICATION AND MEASURING VARIABLES

MEASURING EARNINGS MANAGEMENT

Following Beatty et al. (2002) and Nichols et al. (2008) to detect earnings management, we break down loan loss provision into two parts: discretionary and nondiscretionary, of which the first is the proxy for earnings management. As they cannot be observed directly from financial statements, they are estimated indirectly. In a first step, a model is used to predict the level of loan loss provisions. In a second step, discretionary loan loss provisions are calculated as the reported loan loss provisions minus the predicted loan loss provision.

To estimate loan loss provisions, we run the following panel regression model:

$$LLP_{i,t} / TL_{i,t-1} = \beta_0 + \beta_1 (\Delta LOAN_{i,t} / TL_{i,t-1}) + \beta_2 (LLA_{i,t-1} / TL_{i,t-1}) + \beta_3 (GROWTH_{i,t} / TA_{i,t-1}) + \beta_4 LnTA_{i,t} + \beta_5 INFL_{i,t} + \beta_6 (OUTLOAN_{i,t} / TA_{i,t-1}) + \varepsilon_{i,t} \quad (1)$$

Where:

i	=	bank index
t	=	year index
$LLP_{i,t}$	=	loan loss provision
$TL_{i,t-1}$	=	total loan
$TA_{i,t-1}$	=	total assets
$\Delta LOAN_{i,t}$	=	change in total loans
$LLA_{i,t-1}$	=	total allowance for loan losses
$GROWTH_{i,t}$	=	change in total revenue
$LnTA_{i,t}$	=	natural logarithm of total assets
$INFL_{i,t}$	=	general inflation rate
$OUTLOAN_{i,t}$	=	*outstanding* loans
$\varepsilon_{i,t}$	=	residual term= $\eta_i+\alpha_{i,t}$

We then estimate nondiscretionary LLP using the estimated $\hat{\beta}_0$, $\hat{\beta}_1$, $\hat{\beta}_2$, $\hat{\beta}_3$, $\hat{\beta}_4$, $\hat{\beta}_5$ and $\hat{\beta}_6$

$$NLLP_{i,t} / TL_{i,t-1} = \hat{\beta}_0 + \hat{\beta}_1 (\Delta LOAN_{i,t} / TL_{i,t-1}) + \hat{\beta}_2 (LLA_{i,t-1} / TL_{i,t-1}) + \hat{\beta}_3 (GROWTH_{i,t} / TA_{i,t-1}) + \hat{\beta}_4 LnTA_{i,t} + \hat{\beta}_5 INFL_{i,t} + \hat{\beta}_6 (OUTLOAN_{i,t} / TA_{i,t-1}) \quad (2)$$

Where:

$NLLP_{i,t}$ = non discretionary *LLP*

Discretionary LLP can be estimated by deducting equation (2) from equation (1) as follows:

$$DLLP_{i,t} = LLP_{i,t} - NLLP_{i,t} \quad (3)$$

Where:

$DLLP_{i,t}$ = Discretionary LLP

Furthermore, managers may manage earnings up or down ward. However, in this study, the absolute value of DLLP is considered.

MEASURING INDEPENDENT VARIABLES

I. INTERNAL AUDIT QUALITY

Professional internal audit standards and prior studies (SAS No. 9, 2007; Christopher et al., 2008; Prawitt et al., 2009; Lin et al.,2010; Pizzini et al., 2010) suggest internal audit function (IAF) quality characteristics entail competence, objectivity, fieldwork quality and size. In measuring competence, we used two variables as advised by Prawitt et al., (2009), namely *Education* and *Experience*. As internal auditor is more competent, he /she can effectively does internal audit practice and reduce the probability of income manipulation by managers. In this study, *education* is defined as a percentage of auditing staff members who have accounting background (i.e., diploma, 1st degree, 2nd degree or professional certificate in accounting and auditing). *Experience* is defined as the average experience of auditing staff members as auditor. *Objectivity* is related to the reporting line of the internal auditor within the entity (SAS 9, 2007, paragraph, 10). Following this standard, we make objectivity as indicator variable that takes one, if the internal auditor reports to an officer of sufficient status to ensure the internal audit quality (Audit Committee or Board of Director) and zero if not. One can expect that internal auditor is independent if he/she directly communicates to and reports to the board/ audit committee. The literature also suggests that internal audit *size* as an important factor of internal audit function. Internal audit *size* is the number of auditing staff. Generally, this study defines internal audit quality by education level, experience, objectivity and size.

II. AUDIT COMMITTEE

Following Blue Ribbon Committee (1999) and Zhou and Chen (2004), the study employed three variables as indicators of effectiveness of audit committee; namely *independence, meeting frequency* and *financial expertise*. *Independent audit committee* is defined as a percentage of outside directors (who are not employees or are non- management of the bank) in the audit committee. *Audit committee meeting* is defined by the number of times audit committee meeting held per annum. For the purpose of this study, *financial expertise* is defined as a percentage of audit committee members with accounting, auditing and finance expertise (who have diploma, 1st degree, 2nd degree or professional certificate in accounting, auditing and finance).

III. BOARD CHARACTERISTICS

The existing literature suggests various variables that have important contributions for board of directors' effectiveness, for example, independence, size, meeting, attendance rate on meeting, hours spent per meeting, managerial ownership, activeness of outside directors and the general board of directors (Nan and Nan, 2004;). However, due to data unavailability, we considered only four variables, which are expected to be the major factors for an effective board. These are *board size*, *independent directors*, *activeness of independent directors*, and *activeness of the general* board of directors. *Board size is* defined as the number of directors who serve on a board. *Independence of directors* is defined as a percentage of outside directors in the board and who are not employees of the bank. *Active independent directors* is defined as the extent that the independent directors actively participate in board discussion, altering or adding and disapproving board meeting agenda set by chief executive officer when appropriate. Following Nan and Nan (2004), the study measured this variable using three questions formed with continuous scale and coded as 0- Never, 1-Rarely, 2- Sometimes and 3- Regularly. To make a single value for this variable first, the response for each question is added together, and then, divided by its maximum value (9). Lin et al. (2010) and Pizzini et al. (2010) also used this measurement device. *Activeness of the general board of directors* is defined in terms of the degree to which board of director actively discharge their functions and

responsibilities in corporate governance. Specifically, reviewing and making final decision on appointments of senior management, compensation for senior management, corporate strategies, oversees potential conflict of interest, ensures the integrity of the bank's financial reporting and actively communicates with shareholders and stakeholders (Nan and Nan, (2004). This variable is measured using six questions formed with continuous scales and coded as 1 – strongly disagree, 2- disagree, 3- somewhat agree, 4- agree and 5- strongly agree. To construct a single variable, the response for each question is sum up together and divided by its maximum value (30).

The study included two control variables in the model: *Earnings before tax and loan loss provision (EBTP)* and financial Leverage. *Earnings before tax and loan Loss provision* is measured as dividing EBTP by lagged total assets. Leverage is measured as total debt divide by total assets. Inclusion of these control variables results in the following panel regression model

$$DLLP_{i,t} = \alpha + \beta_1 EDUIA_{i,t} + \beta_2 IAID_{i,t} + \beta_3 AVEXP_{i,t} + \beta_4 IASIZE_{i,t} + B_5 ACFEX_{i,t} + \beta_6 ACID_{i,t} + \beta_7 ACM_{i,t} + \beta_8 BSIZE_{i,t} + \beta_9 OSD_{i,t} + B_{10} ACOSD_{i,t} + \beta_{11} ACBD_{i,t} + \beta_{12} EBTP_{i,t} + \beta_{13} LEV_{i,t} + \varepsilon_{i,t} \quad (4)$$

Where:

DLLP = discretionary loan loss provision
EDUIA = percentage of internal audit member with accounting background
IAID = independence of internal auditor
AVEXP = *the* average years of experience of internal audit staff members as auditor
IASIZE = number of internal audit department staff
ACFEX = the percentage of audit committee members with accounting, auditing and finance expertise
ACID = the percentage of outside directors in the audit committee
ACM = the number of times audit committee meeting held per annum.
BSIZE = the numbers of directors serve on a board
OSD = the percentage of outside directors in the board
ACOSD = activeness of outside directors
ACBD = activeness of the general board of directors
EBTP = earnings before tax and provision scaled by lagged total assets
LEV = total debt divided by total assets
$\varepsilon_{i,t}$ = error terms = $\acute{\eta}_i + \alpha_{i,t}$

ESTIMATION METHOD

The selection of estimation methods whether fixed effect or random effect model is based on the use of the Hausman test. The Hausman test was run and the output demonstrate p- values 0.8687 for model 1 and 0.1448 for model 2 favoring random effect model in both cases. The Breusch - Pagan Lagrangian multiplier test was also used to fix on whether a random effect regression or ordinary least square (OLS) regression is appropriate. The results from the test reveal significant p- values 0.0468 and 0.0486 for mode 1 and 2, respectively again the random effect regression is appropriate. Accordingly, the estimations are made using the random effect Generalized Least Square (GLS) regression, with cluster robust standard errors. The cluster robust controls both heteroskedasticity and autocorrelation in the models.

RESULTS AND DISCUSSION

TESTING OLS ASSUMPTIONS

MULTICOLLINEARITY

The degree of multicollinerity among variables is measured based on variance inflation factors (VIF) suggested in the rule-of - thumb. As per this usual threshold, if the variance inflation factor on each variable is less than ten and 1 / VIF exceed 0.1, multicollinerity is not a serious problem.

TABLE 4 (a): VIF FOR MODEL 1 VARIABLES

Variable	VIF	1/VIF
LnTA	2.32	0.431452
ΔLOAN	2.00	0.499650
OUTLOAN	1.72	0.582913
GROWTH	1.45	0.687589
LLA	1.45	0.688096
INFL	1.09	0.914868
Mean VIF	**1.67**	

Here, the variance inflation factor (VIF) for all variables is significantly less than 10 and the 1/VIF significantly exceeds 0.1. Therefore, we concluded that multicollinearity is not a serious concern in this model.

TABLE 4 (b): VIF FOR MODEL 2 VARIABLES

VARIABLE	VIF	1/VIF
ACM	8.20	0.121961
ACFEX	4.88	0.205107
IDAC	4.30	0.232420
IASIZE	3.47	0.287895
ACOSD	3.24	0.308322
IAID	3.17	0.315203
ACBD	2.84	0.351647
AVEXP	2.40	0.416585
EBTP	2.08	0.480428
BSIZE	2.00	0.500689
LEV	1.90	0.527076
EDUIA	1.72	0.582209
OSD	1.72	0.582362
Mean VIF	**3.22**	

The variance inflation factor (VIF) for all variables is less than the threshold that is ten. Similarly, the 1/VIF significantly exceeds 0.1. Therefore, we concluded that multicollinearity is not a serious problem in this model.

NORMAL DISTRIBUTION OF RESIDUALS

This assumption is assessed using the Shapiro-Wilk test for normality. The p- values for the two models are insignificant and We fail to reject the null hypothesis. We conclude then the residual has normal distribution pattern.

Shapiro-Wilk W test for normal data **(Model 1)**

Variable	Obs	W	V	z	Prob>z
Residual	50	0.97829	1.021	0.044	0.48245

Shapiro-Wilk W test for normal data **(Model 2)**

Variable	Obs	W	V	z	Prob>z
Residual	50	0.97665	1.098	0.200	0.42080

REGRESSION RESULTS

Table 1 reports the Random- Effect Generalized Least Squares (GLS) results of model 1 obtained by regressing loan loss provision (*LLP*) on six independent variables. The model is significant at *Wald chi2 = 59.92, df = 6, p- value <0.01.* This model aimed at predicting loan loss provisions reported on the income statement.

As can be observed in Table 1, the coefficient (β **=** .056, z =2.54, p < 0.05) of change in outstanding loan (*ΔLOAN)* is positive and statistically significant. It implies an increase in outstanding loans by one percent influences loan loss provisions in positive direction by 0.056 percent. A growth of outstanding loans might be due to an increase in demand for loan or implemented liberal credit policy with low credit standard requirement. Such events therefore, may result in high loan default, which substantially increase loan loss provision.

A significant positive coefficient (β **=** .203, z =2.45) on loan loss allowance (LLA) (p < 0.05), indicates banks use previous provisions to set the current level of provision. Zhou and Chen (2004) find a positive relation between loan loss allowance (LLA) and loan loss provisions (LLP), suggesting banks with high allowances persist to provide higher amounts for loan losses.

TABLE 1: REGRESSION RESULTS OF MODEL 1

Dependent variable: Loan Loss Provision (LLP)					
Variables	**Expected sign**	**β**	**Robust Std. Err**	**z-value**	**p - value**
Constant		-9.368	3.078	-3.04	0.002***
ΔLOAN	+	.056	.022	2.54	0.011**
LLA	+	.203	.083	2.45	0.014**
GROWTH	-	-.194	.133	-1.46	0.145
LnTA	+	.658	.251	2.62	0.009***
INFL	+	.022	.014	1.52	0.128
OUTLOAN	+	3.626	1.026	3.53	0.000 ***

R- sq: = 0.5080
Wald chi2(6) = 59.92
Prob > chi2 = 0.0000
N= 50
Banks = 10 Obs. Year 2006 – 2010
***Note**: ***, **, represent significance level at the 1% and 5% respectively*
*LLP = ΔLOAN + LLA + GROWTH + LnTA + INFL + OUTLOAN * significant at p < 0.01*

The study finds that bank size *(LnTA)* influences loan loss provision positively and significantly (β =.658, z = 2.62, p < 0.01). In fact, a larger bank relatively engages in various loan transactions that may result in high loans default. Liu and Ryan (1995) argue that larger banks may have higher levels of business and hence, they are expected to have higher loan loss provision (LLP) to take account of increased activity and risk. Accordingly, this result suggests that larger banks tend to have more loan loss provision. The result in Table 1 also shows a positive and significant (β =3.626, z = 3.53, p < 0.01) relation between outstanding loans to total asset ratio and loan loss provision. This indicates a bank with high proportion of total loan portfolios to its total asset is more likely to have higher loan loss provision.

HYPOTHESES TEST

To perform this, we follow Beatty et al.(2002); Chang et al. (2008); Zhou and Chen (2004); and Fonseca and Gonzalez (2008) using discretionary loan loss provision (DLLP) as a dependent variable to test the three hypotheses developed in this study. The study employed Random-effect Generalized least squares (GLS), with cluster robust standard error. The model is significant at *Wald chi2 (13) = 61.53, p – value < 0.01* and explains 63.09 percent (R-sq) variance in discretionary loan loss provision (DLLP). In testing hypotheses, we initially restate them in null form. Accordingly, we begin with the null hypothesis pertaining to internal audit quality that is:

Ho *: Internal Audit Quality is not significantly associated with Earnings Management*

To test this hypothesis, we used four variables as attributes of internal audit quality (IAQ), namely: *education (EDUIA)*, *experience (AEXP), objectivity (IAID)* and *size (IASIZE)*. The results are summarized in Table 2. Table 2 shows a significant negative coefficient (β = -.021, z = -3.05, p-value < 0.01) on education *(EDUIA).* The result shows internal auditors' education (accounting background) is related to low earnings management. The result also argues that higher education level of internal auditors is more likely to mitigate earnings management. In deed, education level is the most important major traits of internal auditors because it determines their skills and knowledge to understand the complexity of financial process, the likelihood of income manipulation, income manipulation techniques used by managers, and even to deal with accounting standards and its application in accounting estimates, accruals, and valuation of transaction. A current study, on non-financial firms by Lin et al. (2010) support this notion that material weakness disclosure is relatively high in a firm with quality internal auditor measured by education level.

As expected, the experience of internal auditor negatively and significantly influences discretionary loan loss provision (β = -.362, z = -3.26, p- value < 0.01), demonstrating that the more experienced the auditor, the more he/she curbs earnings management. An auditor with adequate experience in auditing would carry out internal audit with high diligence.

Table 2 shows that objectivity of internal auditor is significantly and negatively (in the expected sign) related to discretionary loan loss provision (β = -1.011, z =-2.53, p- value < 0.05). It implies an internal auditor who independently performs internal audit is more likely to detect management discretion. In line with the result, Christoper et al. (2008) confirm that internal auditors are independent when they functionally report to audit committee or boards.

A significant unexpected positive coefficient on internal audit size *(IASIZE)* (β = .014 , z = 3.32, p < 0.01), implies that larger internal audit staff is associated with high level of earnings management. This unexpected positive relation support the notion that internal audit size can be a proxy for the overall demand the bank has for auditing (Prawitt et al., 2009). Because a greater bank's demand for auditing may reflect its difficulty to monitor managers and thus, managers might exercise managing earnings largely. This view may hold true in the short run but it may not in the long run.

Ho : *An Effective Audit Committee is not significantly associated with Earnings Management*

As shown in Table 2, audit committee meeting *(ACM)* shows a significant negative influence on DLLP (β = -.034, z = -3.76, p < 0.01). The result implies that audit committee meeting frequency reduces the level of discretionary loan loss provision. The result argues that audit committee that meets more frequently is more likely to manage the bank's financial reports and mitigates income manipulation. In consistency to this notion, Zhou and Chen (2004) report that the number of times audit committee meeting held is negatively related to discretionary loan loss provision at commercial banks.

The coefficient on percentage of outside directors (ACID) in the audit committee is significant and unexpected positive (β = .0096, z = 2.59, $p < 0.01$). Existence of high outside directors in the audit committee is unproductive unless they regularly attend audit committee meeting. In such events, therefore, an increase in outside directors in the audit committee results in high discretionary loan loss provisions.

Ho : An Effective Boards of directors is not significantly associated with Earnings Management

As expected, active board of directors *(ACBD)* is significantly and negatively related to discretionary loan loss provision (β = -.035, z = -2.33, $p < 0.05$). This indicates the extent that board of directors actively carries out their responsibilities particularly: formulating long- term strategy, selecting, monitoring, and replacing chief executive officer (CEO), reviewing directors' remuneration, overseeing potential interest conflict, ensuring the integrity of financial reporting, maintaining proper disclosure and active communication with shareholders and stakeholders is associated with reduced level of discretionary loan loss provision. The coefficient on board size *(BSIZE)* reveals unexpected positive and significant (β = .259, z = 5.35, $p < 0.01$) association with DLLP. It suggests that the larger board size is related to high level of discretionary loan loss provision or earnings management. This unexpected sign may arise due to the reason that small board is more efficient with decision-making and better monitor earnings management than large board (Epps and Ismail, 2009). This result is also consistent to the notion that small board size mitigates earnings management (Ali shah et al., 2009). The percentage of outside directors (OSD) in the board shows the expected negative coefficient but highly insignificant (β = -.015, $p > 0.1$), while the coefficient on active outside directors (ACOSD) is unexpected positive and significant (β =.030, z = 2.89, $p < 0.01$). It implies that a bank with higher percentage of outside directors would relate to less income manipulation.

TABLE 2: REGRESSION RESULTS OF MODEL 2

Dependent variable : Discretionary Loan Loss Provision(DLLP)					
Variables	**Expected sign**	**β**	**Robust Std. Err**	**z-value**	**p- value**
Constant		3.817	2.277	1.68	0.094*
EDUIA	-	-.021	.0069	-3.05	0.002***
IAID	-	-1.011	.400	-2.53	0.012**
AVEXP	-	-.362	.111	-3.26	0.001***
IASIZE	-	.014	.003	3.32	0.001***
ACFEX	-	.0098	.008	1.29	0.198
ACID	-	.0096	.004	2.59	0.009***
ACM	-	-.034	.0091	-3.76	0.000***
BSIZE	-	.259	.048	5.35	0.000***
OSD	-	-.015	.018	-0.79	0.428
ACOSD	-	.030	.0105	2.89	0.004***
ACBD	-	-.035	.015	-2.33	0.020**
EBTP	+	.118	.095	1.24	0.215
LEV	+	-.6009	.516	-1.17	0.244

R-sq: = 0.6309
Wald chi2 (13) = 61.53
Prob > chi2 = 0.0000
N= 50
Note: ****, **, *, represent significance level at the 1%, 5% and 10% respectively*
DLLP = EDUIA +IAID +AVEXP + IASIZE +ACFEX +ACID + ACM + BSIZE +OSD + ACOSD + ABD + EBTP + LEV significant at p < 0.01*

CONCLUSIONS

This study examined the impact corporate governance mechanisms, i.e., internal audit quality, effective audit committee and effective boards of directors have on earnings management, using five years data of ten Ethiopian banks through the period 2006 to 2010. The study revealed that education (accounting background), experience, and objectivity of internal auditor are significantly and negatively associated to earnings management. It suggests a bank with competent and independent internal auditors would substantially mitigate management discretion and provides quality financial information to shareholders and stakeholders.The study finds that audit committee meeting frequency is inversely and significantly related to earnings management. It implies that the more audit committee meets frequently, the more it evaluates, analyzes and ensures the financial reporting process and reduces management bias or opportunistic behavior. The study also finds a significant negative relation between activeness of the general board of directors and earnings management. This result argues that active boards of directors who effectively carry out their functions could reduce management discretion. The overall results show that internal audit indicators are more significantly and negatively related to earnings management than indicators of effective audit committee and board of directors. Thus, the study suggests that internal audit quality plays an important role than audit committee and board of directors in reducing earnings management.

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