

**Audit Committee, Board Characteristics and Earnings Management by Commercial
Banks**

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Abstract

This paper investigates the relationship between audit committee, board characteristics and earnings management through loan loss provisions by commercial banks. Based on our loan loss provision model and discretionary loan loss provision model, we find that banks with more active audit committees, audit committees with greater governance expertise and more active boards are associated with less earnings management. When we further classify firms into high and low earnings management groups, we find that the number of audit committee meetings, audit committee members' governance expertise, and board meetings are negatively related to earnings management for low earnings management banks. For the high earnings management group, audit committee size, independence, meetings, and board size play an important role in constraining earnings management. Our study contributes to the understanding of the relationship between audit committees, board characteristics and earnings management in commercial banks, which has generally been excluded in previous studies. Our findings have implications for stakeholders and policymakers in that we find audit committee meetings, audit committee members' governance expertise, and board meetings are important mechanisms of corporate governance.

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I. INTRODUCTION

The integrity of financial reporting has been a consistent concern among regulators and practitioners, especially after high-profile accounting scandals involving once well-respected companies such as Enron, WorldCom and Xerox. The majority of the corporate scandals involved firms which had aggressively applied generally accepted accounting principles. For example, Enron shifted its liability and losses to non-consolidated special purpose entities. This led to an unexpected nonrecurring charge of \$1.01 billion in October 2001 when it was required to recognize those amounts. The United States General Accounting Office reports that, of the 919 financial restatements announced between 1997 and 2002, 39% were due to premature revenue recognition. Coffee (2003, 21) observes that “while earlier in the decade (of 1990s), managements may have attempted to hide ‘excessive earnings’ in ‘rainy day reserves’ in order to use such funds later to smooth out undesired declines in the firm’s earnings, by the end of the decade these same firms were robbing future periods for earnings that could be recognized immediately. In short, ‘income smoothing’ gave way to more predatory behavior.” Such predatory behavior has caused the decrease of investors’ confidence in financial reporting. In order to improve investors’ confidence in the integrity of financial reporting, the NYSE and the NASDAQ proposed new governance rules with regard to boards of directors and audit committees for listed firms in August 2002. For example, the NYSE’s August 1, 2002 press release stated that:

The New York Stock Exchange's board of directors today approved significant changes in its listing standards aimed at helping to restore investor confidence by empowering and ensuring the independence of directors and strengthening corporate-governance practices.

On November 4, 2003, the SEC approved most of the proposed corporate governance rules by the NYSE and the NASDAQ (Klein 2003). The Sarbanes-Oxley Act also has specific requirements concerning the function, independence and financial expertise of audit committees. The common thread running through these requirements from the NYSE, the NASDAQ and the Sarbanes-Oxley Act is that better corporate governance can improve the integrity of financial reporting. This paper seeks to provide evidence on this issue by linking audit committee, board characteristics with earnings management through loan loss provisions by commercial banks.

A large body of accounting literature has developed to investigate earnings management among firms in response to various incentives (Healy and Wahlen 1999). However, practitioners and regulators often have very different perceptions of earnings management than do accounting academics. Practitioners and regulators often see earnings management as pervasive and problematic while academics have not been able to provide convincing evidence (Dechow and Skinner 2000). McNichols (2000) argues that much of the controversy is due to the measurement error inherent in the widely used aggregate accruals method such as the Jones (1991) model. She suggests that progress in future earnings management studies can come from the application of specific accruals. We focus on earnings management through loan loss provisions by commercial banks in response to the call for such research from McNichols. In contrast with previous studies examining the relation between corporate governance and earnings management in non-financial firms using aggregate accruals from the Jones (1991) model (Klein 2002;

Xie et al. 2003; Bedard et al. 2004),¹ we focus on a single industry and an account where discretion is likely to be present – loan loss provisions for commercial banks. Prior studies provide evidence that commercial banks use loan loss provisions to manage their earnings (Beatty, Chamberlain and Magliolo, 1995; Beatty, Ke and Petroni, 2002; Ahmed et al. 1999), and our study is not subject to many of the concerns about the measurement of discretionary accruals associated with many similar studies (Guay et al. 1996; McNichols 2000; Kothari et al. 2005).²

An audit committee plays an important monitoring role to assure the quality of financial reporting and corporate accountability (Carcello and Neal 2000). As a liaison between the external auditor and the board, an audit committee bridges the information asymmetry between them, facilitates the monitoring process (Klein 1998), and enhances the independence of an auditor from management (Mautz and Newmann 1977). A properly functioning audit committee is thus critical in enhancing effective oversight of the financial reporting process and achieving high quality financial controls. Since the SEC has become concerned that the audit committees are failing to do their jobs properly (Lublin and MacDonald 1999), the Blue Ribbon Committee recommendations addressed the importance of audit committee composition and operational characteristics such as their independence, financial literacy, and activities. Larger audit committees, with legitimate power delegated by boards, are expected to contribute to the effectiveness of the committee, given audit committee effectiveness as a function of audit committee power (Kalbers and Fogarty 1993). Klein (2002) finds there is a negative relation

¹ For example, Klein (2002, 380) states that ‘I also exclude 53 banks (SIC codes: 6000 to 6199) and 36 insurance companies (SIC codes: 6300-6411) because it is difficult to define accruals and abnormal accruals for financial services firms’. Bedard et al. (2004, 19) excludes financial firms for similar reasons.

² This is also acknowledged in Bedard et al. (2004, 15). Bedard et al. (2004, 15) make it clear that ‘our results are subject to the inherent limitations of our measure of earnings management’.

between audit committee independence and abnormal accruals. She also finds that reductions in audit committee independence are accompanied by large increases in abnormal accruals. In addition, 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 as measured by the two subsamples of 100 firms each from both ends of the distribution (i.e., the 100 largest positive and the 100 largest negative abnormal accruals). Carcello and Neal (2000) find that the greater the percentage of affiliated directors on the audit committee, the lower to probability the auditor will issue a going-concern report. Xie et al. (2003) find that audit committee meeting frequency is associated with reduced levels of discretionary current accruals. The expertise of audit committee members is also important for dealing with the complexities of financial reporting (Kalbers and Fogarty 1993), reducing the existence of internal control problems (Krishnan 2005), and reducing the occurrence of financial restatements (Abbott et al. 2004). Carcello and Neal (2003) find that audit committees with greater governance expertise are more effective in shielding auditors from dismissal after the issuance of new going-concern reports. Therefore, we investigate the relationship between the five characteristics of the audit committee (size, independence, activity, financial expertise, and governance expertise) and earnings management through loan loss provisions by commercial banks.

According to agency theory, separation of ownership and control leads to a divergence in the pursuit of managerial interests versus owners' interests (Jensen and Meckling 1976), and thus monitoring managerial decisions becomes essential for boards of directors to assure that shareholders' interests are protected (Fama and Jensen 1983),

and to ensure reliable and complete financial reporting. Since earnings management misleads users of financial statements by providing them with false information about a firm's true operating performance, boards of directors may have a monitoring role in constraining the occurrence of earnings management. Xie et al. (2003) find that a larger board is associated with lower levels of discretionary current accruals, indicating a larger board is more effective in monitoring such accruals than a smaller board. Klein (2002) finds a negative relation between board independence and abnormal accruals. Reductions in board independence are accompanied by large increases in abnormal accruals. Xie et al. (2003) find that earnings management is less likely to occur or occurs less often in companies with boards having both more independent outside directors and directors with corporate experience. They also find that more active boards, as proxied by the number of board meetings, are associated with a lower level of earnings management. Therefore, we examine whether a board's characteristics (size, independence, activity) are associated with earnings management through loan loss provisions by commercial banks.

We find that commercial banks with more active audit committees and with greater governance expertise engage less in income-increasing earnings management. We also find evidence that more active boards are associated with less income-increasing earnings management in commercial banks. When we classify firms into high and low earnings management groups, the number of audit committee meetings, audit committee members' governance expertise, and board meeting frequency play an important role in constraining earnings management for the low earnings management group. For the high earnings management group, audit committee size, audit committee independence, audit committee meetings, and board size play an important role in constraining earnings

management.

Our study contributes to the understanding of the relationship between audit committees, board characteristics and earnings management in commercial banks, which has generally been excluded in previous studies. Our findings have implications for stakeholders and policymakers in that we find audit committee meetings, audit committee members' governance expertise, and board meetings are important mechanisms of corporate governance. While these are important aspects of corporate governance, the current regulations of the NYSE, the NASDAQ and the SOX generally leave these areas to the discretion of boards of directors and audit committees.

We extend the study of corporate governance and earnings management to financial firms, and focus on loan loss provision, a specific account which is subject to management discretion by commercial banks. This provides us with a very powerful setting to investigate the impact of corporate governance on earnings management through the links between audit committee, board characteristics and loan loss provisions.

The remainder of the paper is organized as follows. The next section describes the related research and hypotheses development. Section III describes the research design. Sample selection and tests of the relation between audit committee characteristics, board characteristics, and earnings management through loan loss provisions are discussed in Section IV. Section V is the summary and conclusion.

II. RELATED RESEARCH AND HYPOTHESES DEVELOPMENT

Audit committees and boards of directors have continued to be the subject of heightened public expectations for greater corporate accountability, which is evidenced from the recommendations and reports from the National Commission on Fraudulent

Financial Reporting (the Treadway Commission), the Public Oversight Board of the SEC Practice Section (AICPA 1994) and the Blue Ribbon Commission (BRC 1999). More specifically, “an increasing focus on earnings management, motivations to meet Wall Street earnings expectations...” were part of the impetus of the BRC’s recommendations. As to the financial institutions, the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) was enacted to mandate stricter reporting requirements for commercial banks and savings institutions. These corporate governance reforms are intended to enhance audit committee effectiveness and improve the quality of financial reporting. Recent accounting scandals such as Enron and WorldCom have caused the loss of investor confidence in the integrity of financial reporting. The NYSE and the NASDAQ responded to the accounting scandals by proposing new governance rules for listed firms. On November 4, 2003, the SEC approved most of the proposed corporate governance rules (Klein 2003). The SOX, among other things, specifies requirements for public company audit committees (see Section 301 Public company audit committees and Section 407 Disclosure of audit committee financial expert).

The Role of Audit Committee

An audit committee plays an important monitoring role to assure the quality of financial reporting and corporate accountability (Carcello and Neal 2000), and audit committee composition is an important factor in effective monitoring (Beasley 1996; Carcello and Neal 2000), and therefore the composition of an audit committee may have a direct role in constraining earnings management. Audit committee composition has been the focus of many governance reform efforts, and all companies listed on major stock exchanges such as NYSE and NASDAQ must now maintain an audit committee

with at least three solely independent directors, except in certain restricted circumstances (e.g., BRC 1999; NASD 1999; SEC 1999; SEC 2003). Kalbers and Fogarty (1993) propose that audit committee effectiveness is perceived as a function of audit committee power. A larger audit committee with increased organizational status and power delegated by the board of directors is thus more likely to be recognized as an authoritative body by the management and the external and internal auditors. We thus expect that a larger audit committee is likely to be a more effective mechanism, since audit committee members have increased responsibilities and organizational status and power for their monitoring roles after recent governance reform efforts.³

Effective audit committees meet regularly to ensure that the financial reporting process is functioning properly, and therefore a well-functioning and active audit committee may be able to prevent earnings management. Menon and Williams (1994) find that audit committee effectiveness can be measured by the number of audit committee meetings. An active audit committee is more likely to influence managements' and/or boards' decisions. Bedard et al. (2004) find there is no relationship between the number of audit committee meetings and the level of earnings management; however, Xie et al. (2003) find that the number of audit committee meetings is negatively associated with discretionary current accruals, suggesting that audit committee meeting frequency is an important factor in constraining the propensity of managers to engage in earnings management.

The Blue Ribbon Committee's recommendations also address the importance of the financial literacy and expertise of audit committee members. Expertise of audit

³However, Xie et al. (2003) find no significant relation between audit committee size and earnings management as measured by discretionary current accruals.

committee members is also important for dealing with the complexities of financial reporting (Kalbers and Fogarty 1993), and reducing the occurrence of financial restatements (Abbott et al. 2004). DeZoort and Salterio (2001) find that audit committee members with corporate governance experience and financial reporting and auditing knowledge are more likely to understand auditor judgments and to support the auditor in auditor-management disputes, and more likely to address and detect material misstatements. Carcello and Neal (2003) find that audit committees with greater governance expertise are more effective in shielding auditors from dismissal after the issuance of new going-concern reports.

In summary, the previous literature finds that audit committee size, independence, meetings, financial expertise, governance expertise are all important factors affecting the effectiveness of audit committees, and therefore are more likely to be associated with loan loss provisions by commercial banks. Therefore, we propose and test the following hypothesis:

HYPOTHESIS 1: Banks with larger, more independent, more active audit committees and audit committees with greater financial expertise and governance expertise are less likely to engage in earnings management through loan loss provisions.

The Role of Board of Directors

According to agency theory, the separation of ownership and control leads to a divergence in the pursuit of managerial interests versus owners' interests (Jensen and Meckling 1976), and thus monitoring managerial decisions becomes essential for the board of directors in order to protect shareholders' interests (Fama and Jensen 1983), and to ensure the integrity of the financial reporting process. Director integrity and board

effectiveness play important roles in ensuring the quality and reliability of financial reporting (Cadbury Report 1992, 22). Therefore we can expect that board composition will be an important factor in influencing whether or not a firm engages in earnings management.

Prior studies have used board size to measure directors' expertise (Bacon 1973; Herman 1981). Jensen (1993) suggests that board size is a value-relevant attribute of corporate boards. 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, are more likely to represent shareholders' interests, and therefore are less susceptible to CEO domination. Zahra and Pearce (1989) argue that board composition is pivotal in enhancing the performance of a board's control role. When the board size is large, board committees could help to improve effectiveness of the board's monitoring role. Dalton et al. (1999) also document that a larger board provides better environmental links and more expertise. Xie et al. (2003) find that a larger board is associated with lower levels of discretionary current accruals, indicating a larger board is more effective in monitoring such accruals than a smaller board.⁴

Recommendations from the Cadbury Committee (1992) and the Blue Ribbon Committee (1999) presume that independent directors play more important monitoring roles than non-independent directors. Independent directors also have incentives to develop a reputation as experts in decision control and monitoring (Fama and Jensen 1983). Prior studies confirm the role of outside directors in the governance of public

⁴ However, there is also empirical evidence showing that smaller boards are more likely to have better monitoring quality because agency problems (e.g., free-riding problems among directors and process losses) increase with board size (Yermack 1996; Eisenberg et al. 1998; Hermalin and Weisbach 1998, 2003).

companies. Beasley (1996) finds a negative relation between the percentage of independent directors on the board and the likelihood of financial fraud, whereas Dechow et al. (1996) find that firms with a large percentage of independent directors on the board are less likely to be subject to SEC enforcement actions for alleged violations of GAAP. Therefore, we expect that banks with a greater percentage of independent directors on the board will be less likely to engage in earnings management through loan loss provisions.

Boards of directors that meet longer and more frequently are more likely to provide an effective check and balance on management. Conger et al. (1998) suggest that the number of times a board meets is an important resource in improving the effectiveness of a board. However, Vafeas (1999) finds that the annual number of board meetings is inversely related to firm value, which is due to increases in board activity following share price declines. He further finds that operating performance improves following years of abnormal board activity. These studies suggest that board activity is an important dimension of board operations. Therefore, effective boards should meet regularly (even frequently) to stay on top of accounting and control-related matters, remain informed and vigilant, and thus ensure that the financial reporting process is functioning properly. We expect that boards of directors that meet frequently will be more effective in monitoring the integrity of financial reporting, and thus more likely to constrain earnings management by commercial banks.

In summary, board size, independence and meeting frequency all influence the effectiveness of a board, which in turn are related to levels of earnings management by commercial banks. Therefore, we propose the following hypothesis:

Hypothesis 2: Banks with larger, more independent and more active boards are less likely to engage in earnings management through loan loss provisions.

III. RESEARCH DESIGN

Bank Loan Loss Provisions

Numerous studies indicate that bank managers exercise discretion over loan loss provisions, and that loan loss provisions are significant in relation to bank income (e.g., Ahmed et al 1999). Incentives to manage loan loss provisions include signaling, earnings management, and capital management.

Signaling arguments suggest that banks use discretionary loan loss provisions to signal that earnings will be higher in subsequent periods (Wahlen 1994; Beaver and Engel 1996). In contrast, earnings management arguments (e.g., Beatty et al. 1995; Collins et al. 1995) suggest that loan loss provisions will be high when earnings are high, under the assumption that managers have incentives to smooth earnings. Another argument is that managers exercise discretion over loan loss provisions for capital management purposes (Ahmed et al. 1999; Beatty et al. 1995), since increases in loan loss provisions increase regulatory capital.

Although most of these previous studies examine management incentives to using discretion to increase loan loss provisions, this does not imply that bank managers do not use discretion to reduce loan loss provisions to meet earnings targets. For example, the argument that managers increase loan loss provisions when earnings are high is a smoothing argument that also implies that managers will use discretion to decrease loan loss provisions when earnings are low. Also, while Ahmed et al. (1999) find that managers use discretion to increase loan loss provisions for capital management purposes, they find that this incentive is reduced after the 1991 revisions to bank capital requirements. Further,

this incentive to increase loan loss provisions only exists for banks that have relatively low levels of capital.

In most settings, bank managers are likely to have the same incentives as managers in other industries to manage loan loss provisions for earnings management purposes. Beatty et al. (2002) find that publicly-traded banks manage loan loss provisions and realized securities gains and losses to meet earnings targets. Further, auditors' incentives are such that they are likely to allow managers less discretion in managing loan loss provisions downward to increase income. For example, Kinney and Martin (1994) perform a meta-analysis of error adjustment studies involving over 1,500 audits, and find that a significant majority of auditor-proposed adjustments reduce earnings. Auditors are often sued for allowing income overstatements, but are rarely sued for allowing understatements (St. Pierre and Anderson 1984).

Previous research on bank loan loss provisions (e.g. Wahlen 1994; Ahmed et al. 1999) focus on the total loan loss provision. Consistent with this research, we test for a relation between audit committees and board characteristics and loan loss provisions.

Loan Loss Provision Model

We use the following regression model to test our hypotheses that relate the loan loss provisions with audit committees and board characteristics in commercial banks.

$$\begin{aligned}
 LLP_{it} = & \beta_0 + \beta_1 AC_{it} + \beta_2 ACOUT_{it} + \beta_3 ACMTG_{it} + \beta_4 AC_FXP_{it} + \beta_5 AC_GXP_{it} \\
 & + \beta_6 BD_{it} + \beta_7 BDOUT_{it} + \beta_8 BDMTG_{it} + \beta_9 BIG5_{it} + \beta_{10} RACR_{it} + \beta_{11} EBPT_{it} \\
 & + \beta_{12} FEBPT_{it} + \beta_{13} LGMV_{it} + \beta_{14} CGNPL_{it} + \beta_{15} CGLN_{it} + \beta_{16} WO_{it} \\
 & + \beta_{17} ALLOW_{it} + \varepsilon_{it}
 \end{aligned} \tag{1}$$

where:

- LLP: loan loss provisions/average loans outstanding
- AC: number of audit committee members;
- ACOUT: percentage of outside directors on the audit committee;

ACMTG:	number of audit committee meetings;
AC_FXP:	1 if the audit committee has a financial expert, 0 otherwise;
AC_GXP:	average number of directorships in other public companies held by audit committee members;
BD:	number of board members;
BDOUT:	percentage of outside directors on the board;
BDMTG:	number of board meetings;
BIG5:	1 if the auditor is member of the Big 5; 0 otherwise
RACR:	either the risk adjusted capital ratio – tier 1 (RACR1) or the risk adjusted capital ratio – total (RACRT)
EBTP:	earnings before taxes and loan loss provision/average total assets
FEBTP:	one year ahead change in EBPT
LGMV:	log of market value
CGNPL:	change in non-performing loans
CGLN:	change in outstanding loans/average loans
WO:	write-offs/average loans
ALLOW:	Beginning loan loss allowance/average loans

The main research variables of interest are audit committee characteristics (measured by AC, ACOUT, ACMTG, AC_FXP, and AC_GXP), and board characteristics (measured by BD, BDOUT, BDMTG). Hypothesis 1 predicts that banks with better audit committee mechanisms (size, independence, meetings, financial expertise, and governance expertise) are associated with less income-increasing earnings management through loan loss provisions by commercial banks. Therefore, we expect the coefficients of audit committee variables (AC, ACOUT, ACMTG, AC_FXP, and AC_GXP) are significantly positively related to loan loss provisions by commercial banks. Hypothesis 2 predicts that larger, more independent and more active boards are positively associated with loan loss provisions by commercial banks, and therefore the coefficients of BD, BDOUT and BDMTG are expected to be positively related to loan loss provisions. Many other variables may also affect the loan loss provisions for banks.

Prior studies examine the relation between auditor size and total discretionary accruals based on the modified Jones (1991) model. Becker et al. (1998) find that

companies with non-Big 5 auditors (a proxy for lower audit quality) report discretionary accruals that significantly increase income compared to companies with Big 5 auditors. Francis et al. (1999) find that firms which hire a Big 5 auditors report lower discretionary accruals, consistent with Big Five auditors constraining opportunistic reporting of accruals. Given the evidence in Becker et al. (1998) and Francis et al. (1999), we expect the Big 5 auditors constrain earnings management through loan loss provisions by commercial banks.

We use either the risk-adjusted Tier 1 capital ratio (RACR1) or risk-adjusted total capital (RACRT) to control for banks' incentives to increase loan loss provisions to increase regulatory capital. Because banks have an incentive to increase loan loss provisions when the capital ratio is low, the relation between the loan loss provision and capital ratio measures is expected to be negative.

Earnings before taxes and loan loss provisions (EBTP) controls for the incentive to use the loan loss provision to smooth earnings by increasing the loan loss provision when earnings are high. The following year's change in earnings before taxes and loan loss provisions (FEBPT) controls for incentives to use loan loss provisions to signal future earnings. Accordingly, the coefficients of EBPT and FEBPT are expected to be positive.

The log of market value (LGMV) is used to control for possible size effects impacting loan loss provisions. The change in non-performing loans (CGNPL), change in outstanding loans (CGLN), and loan write-offs (WO) control for the amount and characteristics of loans expected to impact the loan loss provision. We also control for the beginning loan allowance (ALLOW) since the loan loss provision and the effect of write-offs on the provision are related to the extent of the amount previously provided for loan losses.

IV. SAMPLE SELECTION AND RESULTS

Sample Selection

Our sample consists of 989 observations for the period 2000-2001 from Bank Compustat satisfying the following criteria data requirement: (1) audit committee and board data are hand collected from proxy statements filed to the SEC; (2) data for estimating the discretionary loan loss models and control variables are available from Compustat and/or Bank Compustat.

Results

Table 1 reports the descriptive statistics for all the variables used in this study. The mean loan loss provision is 0.4% of average outstanding loans. The mean (median) number of audit committee members for our bank sample is 4.3 (4), which is comparable with Xie et al. (2003) for non-financial companies. About 88% of the firms have 100% independent audit committees. The audit committees meet about 5 times annually, higher than the 4 meetings reported in Xie et al. (2003). Eighty-three percent of the audit committees have a financial expert while the average audit committee member holds 0.53 directorships. On average, there are about 11 members per board while the median number of board members is 10. The board size is smaller than the 12.48 board members reported in Xie et al. (2003). On average, 80 percent of the board members are outsiders, and the board meets about 10 times a year. Approximately 60% of the banks use a Big 5 auditor. The average bank reports earnings before taxes and the loan loss provision equal to 1.8% of average total assets.

[Insert Table 1 about here]

Table 2 reports the correlations among the dependent and independent variables.

The correlations support several predictions; however, the formal tests are based on multivariate regression analysis. Audit committee size (AC), number of audit committee meetings (ACMTG), audit committee members' governance expertise (AC_GXP), board size (BD), and the percentage of outside directors in a board (BDOUT) are all significantly positively correlated with loan loss provisions. This means banks with those characteristics are associated with higher levels of loan loss provisions, indicating lower levels of earnings management. Loan loss provisions are positively related to the use of a Big 5 auditor, suggesting Big 5 clients engage in less income-increasing loan loss management. The positive relation between loan loss provision and LGMV indicates that larger banks tend to have more loan loss provisions. The negative relationship between loan loss provisions and the capital ratios indicate banks are using loan loss provision to satisfy regulatory capital requirement. Loan loss provisions are also found to be positively related to earnings and forward change in earnings, suggesting banks are smoothing income and signal future earnings through loan loss provisions. As expected, the total loan loss provision is positively related to changes in non-performing loans and writeoffs.

[Insert Table 2 about here]

Audit Committee and Board Characteristics and Loan Loss Provision

Table 3 reports the regression results using the loan loss provision model in Equation 1. Hypothesis 1 predicts that banks whose audit committees are larger, more independent, more active, and have greater financial expertise and greater governance expertise, engage less in earnings management. The significantly positive coefficient on ACMTG and AC_GXP suggests that the number of audit committee meetings and audit committee

members' governance expertise are associated with higher loan loss provisions, indicating a reduced level of earnings management. However, we find no significant relation between loan loss provision and audit committee size, independence, and financial expertise.

Hypothesis 2 predicts that larger, more independent and active boards are likely to engage less in earnings management through loan loss provisions, so the coefficients on board size (BD), board independence (BDOUT), and board meetings (BDMTG) are expected to be positive. The coefficient on BDMTG is significantly positive for the loan loss provision model, suggesting that active boards are associated with reduced levels of earnings management. However, we find no significant relation between loan loss provisions and board independence and size.

As to the control variables, the Big 5 auditors are associated with higher loan loss provisions, consistent with the results of prior studies for non-financial services companies which find that the Big 5 auditors are associated with lower levels of discretionary accruals (Becker et al. 1998; Francis et al. 1999).

We use either the risk-adjusted Tier 1 capital ratio (RACR1) or risk-adjusted total capital ratio (RACRT) to control for banks' incentives to increase loan loss provisions to increase regulatory capital. Column 3 and 4 examine the relation of loan loss provisions and independent variables based on RACR1 and RACRT, respectively. Column 3 reports that the coefficient for Tier-1 risk adjusted capital ratio is significantly negative, consistent with banks using loan loss provisions for capital management. Loan loss provisions are positively related to earnings and forward earnings, consistent with income smoothing and signaling motivations to manage capital. As expected, there is a

significant and positive relation between loan loss provisions and write-offs of loans. However, the coefficients on the change in non-performing loans and change in outstanding loans variables are generally not significant. Loan loss provisions are positively related to the beginning allowance, indicating that banks with relatively high allowances continue to provide higher amounts for loan losses. In the fourth column, we replace the Tier 1 capital ratio with the total risk adjusted capital ratio since Ahmed et al. (1999) report that the effect of loan loss provisions differs for risk-adjusted Tier 1 ratio and risk-adjusted total capital ratio. The results using the total capital ratio are qualitatively similar.

[Insert Table 3 about here]

High Earnings Management Banks and Low Earnings Management Banks

We classify banks into High Earnings Management Banks and Low Earnings Management Banks according to their outstanding loan adjusted loan loss provisions. Firms with above the sample median loan loss provisions are classified as low earnings management banks while firms with below the sample median loan loss provisions are classified as high earnings management banks. Table 4 reports the separate regression results for these low and high earnings management banks based on risk-adjusted Tier 1 ratio and risk-adjusted total capital ratio, respectively.

For the low earnings management bank group, the number of audit committee meetings, and audit committee members' governance expertise are positively related to loan loss provision, suggesting active audit committees and audit committee members' governance expertise constrain earnings management. However, the number of board meetings is only significant for low earnings management banks. For the high earnings

management banks, audit committee size, independence, meetings, and board size are all significantly related to loan loss provisions. The regression results for the control variables are qualitatively similar to those reported in Table 3.

[Insert Table 4 about here]

Robustness Check

Discretionary Loan Loss Provision Model

We also estimate the discretionary portion of the bank loan loss provision based on the following model:

$$LLP_{it} = a_0 + a_1CGNPL_{it} + a_2CGLN_{it} + a_3WO_{it} + \epsilon_{it} \quad (2)$$

Where:

- LLP: loan loss provisions/average loans
- CGNPL: change in non-performing loans
- CGLN: change in outstanding loans/average loans
- WO: write-offs/average loans
- DLLP: discretionary loan loss provision, measured by the residuals from the above regression

We also test whether audit committee and board characteristics are related to discretionary loan loss provisions using the following regression model:

$$DLLP_{it} = \beta_0 + \beta_1AC_{it} + \beta_2ACOUT_{it} + \beta_3ACMTG_{it} + \beta_4AC_FXP_{it} + \beta_5AC_GXP_{it} + \beta_6BD_{it} + \beta_7BDOUT_{it} + \beta_8BDMTG_{it} + \beta_9BIG5_{it} + \beta_{10}RACR_{it} + \beta_{11}EBPT_{it} + \beta_{12}FEBPT_{it} + \beta_{13}LGMV_{it} + \beta_{14}ALLOW_{it} + \epsilon_{it} \quad (3)$$

DLLP represents discretionary loan loss provision, measured by the residuals from the previous regression. Other variables are as defined in equation 1. The results are qualitatively similar as those reported in Table 3, which further confirms that audit committee meeting and board meetings are associated with discretionary loan loss provisions, suggesting more active audit committees, audit committees with greater governance expertise and more active boards are associated with reduced level of

earnings management by commercial banks.

[Insert Table 5 about here]

V. SUMMARY AND CONCLUSIONS

In this study, we examine whether corporate governance, as measured by audit committee and board characteristics, are associated with less income-increasing earnings management through loan loss provisions by commercial banks. Based on our loan loss provision model at Table 3, and discretionary loan loss provision model at Table 5, we consistently find that banks with more active audit committees, audit committees with better governance expertise, and more active boards are associated with less income-increasing earnings management by banks. When we further classify firms into high and low earnings management group, we find that the number of audit committee meetings, audit committee members' governance expertise, and the number of board meetings play an important role in constraining earnings management for low earnings management banks. For the high earnings management group, audit committee size, independence, meetings, and board size play an important role in constraining earnings management. The positive relation between loan loss provisions and the Big 5 auditors is consistent with research in other settings that Big 5 auditors are associated with lower discretionary accruals (Becker et al. 1998; Francis et al. 1999).

Our study contributes to the understanding of the relationship between audit committees, board characteristics and earnings management in commercial banks, which are generally excluded in previous studies. Our findings have implications for stakeholders and policymakers in that we find audit committee meetings, audit committee members' governance expertise, and board meetings are important mechanisms of

corporate governance. While these are important aspects of corporate governance, the current regulations of the NYSE, the NASDAQ and the SOX generally leave these areas to the discretion of the board of directors and audit committees.

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Table 1
Descriptive Statistics for Dependent and Independent Variables
(n=989)

Variable	Mean	Stdev	Lower quartile	Median	Upper quartile
LLP	0.004	0.005	0.001	0.003	0.005
DLLP	0.000	0.004	-0.002	-0.001	0.001
AC	4.308	1.466	3	4	5
ACOUT	0.880	0.168	0.750	1	1
ACMTG	5.017	2.662	4	4	6
AC_FXP	0.828	0.377	1	1	1
AC_GXP	0.527	0.736	0.000	0.286	0.750
BD	10.719	4.057	8	10	13
BDOUT	0.799	0.125	0.750	0.833	0.889
BDMTG	10.427	4.013	7	12	13
BIG5	0.598	0.491	0	1	1
RACR1	11.207	3.773	8.800	10.630	12.700
RACRT	14.803	5.738	11.600	13.040	15.700
EBTP	0.018	0.008	0.013	0.017	0.022
FEBTP	-0.001	0.005	-0.003	-0.001	0.001
LGMV	18.647	1.831	17.376	18.249	19.535
CGNPL	0.003	0.150	-0.001	0.001	0.004
CGLN	0.115	0.171	0.028	0.090	0.170
WO	0.001	0.003	0.000	0.000	0.000
ALLOW	0.012	0.006	0.009	0.011	0.014

LLP: loan loss provision /average loans outstanding
DLLP: discretionary loan loss provision
AC: number of audit committee members;
ACOUT: percentage of outside directors on the audit committee;
ACMTG: number of audit committee meetings;
AC_FXP: 1 if the audit committee has a financial expert, 0 otherwise
AC_GXP: average number of directorships in other public companies held by audit committee members;
BD: number of board members;
BDOUT: percentage of outside directors on the board;
BDMTG: number of board meetings;
BIG5: 1 if the auditor is member of the Big 5; 0 otherwise
RACR1: the risk adjusted capital ratio – tier 1
RACRT: the risk adjusted capital ratio – total
EBTP: earnings before taxes and loan loss provision/average total assets
FEBTP: one year ahead change in EBTP
LGMV: log of market value
CGNPL: change in non-performing loans
CGLN: change in outstanding loans/average loans
WO: write-offs/average loans
ALLOW: beginning loan loss allowance/average loans

Table 2
Correlation Matrix for Dependent and Independent Variables
(p-values are in parentheses, n=989)

	DLLP	AC	ACOUT	ACMTG	AC_FXP	AC_GXP	BD	BDOUT	BDMTG	BIG5	RACR1
LLP	0.897 (0.001)	0.075 (0.018)	0.024 (0.445)	0.177 (0.001)	0.048 (0.128)	0.243 (0.001)	0.156 (0.001)	0.103 (0.001)	-0.013 (0.685)	0.165 (0.001)	-0.054 (0.092)
DLLP		0.010 (0.743)	0.006 (0.862)	0.156 (0.001)	0.037 (0.243)	0.091 (0.004)	0.047 (0.142)	0.060 (0.059)	0.053 (0.097)	0.089 (0.005)	-0.013 (0.679)
AC			0.067 (0.037)	0.054 (0.089)	0.067 (0.036)	0.113 (0.001)	0.415 (0.001)	0.252 (0.001)	-0.007 (0.820)	0.076 (0.017)	0.024 (0.450)
ACOUT				0.030 (0.345)	0.013 (0.686)	-0.062 (0.052)	0.098 (0.002)	0.119 (0.001)	0.005 (0.867)	0.057 (0.073)	0.010 (0.755)
ACMTG					-0.036 (0.254)	0.093 (0.003)	0.125 (0.001)	0.043 (0.172)	0.074 (0.019)	0.128 (0.001)	-0.018 (0.579)
AC_FXP						0.102 (0.001)	0.050 (0.118)	-0.016 (0.608)	-0.051 (0.108)	0.074 (0.020)	-0.012 (0.710)
AC_GXP							0.236 (0.001)	0.074 (0.021)	-0.122 (0.001)	0.165 (0.001)	-0.152 (0.001)
BD								0.312 (0.001)	-0.217 (0.001)	0.236 (0.001)	0.063 (0.048)
BDOUT									0.018 (0.578)	0.081 (0.011)	0.070 (0.028)
BDMTG										-0.146 (0.001)	0.001 (0.965)
BIG5											-0.142 (0.001)
RACR1											
RACRT											
EBTP											
FEBTP											
LGMV											
CGNPL											
CGLN											
WO											
ALLOW											

Table 2 (Continued)

	RACRT	EBTP	FEBTP	LGMV	CGNPL	CGLN	WO	ALLOW
LLP	-0.189 (0.001)	0.213 (0.001)	0.125 (0.001)	0.268 (0.001)	0.011 (0.719)	-0.049 (0.122)	0.433 (0.001)	0.285 (0.001)
DLLP	-0.161 (0.001)	0.101 (0.002)	0.168 (0.001)	0.019 (0.558)	0 (1.000)	0 (1.000)	0 (1.000)	0.198 (0.001)
AC	-0.110 (0.001)	0.112 (0.001)	-0.030 (0.349)	0.237 (0.001)	-0.021 (0.519)	-0.003 (0.913)	0.149 (0.001)	0.142 (0.001)
ACOUT	0.012 (0.708)	0.065 (0.043)	0.006 (0.838)	0.146 (0.001)	0.006 (0.861)	-0.035 (0.274)	0.044 (0.171)	0.032 (0.312)
ACMTG	-0.149 (0.001)	0.072 (0.024)	-0.014 (0.663)	0.181 (0.001)	-0.011 (0.730)	-0.065 (0.041)	0.075 (0.019)	0.212 (0.001)
AC_Finexp	0.010 (0.765)	0.014 (0.655)	-0.026 (0.419)	0.060 (0.061)	0.004 (0.890)	-0.022 (0.489)	0.027 (0.394)	0.066 (0.037)
AC_Govexp	-0.150 (0.001)	0.135 (0.001)	-0.042 (0.188)	0.415 (0.001)	-0.005 (0.887)	0.017 (0.593)	0.372 (0.001)	0.118 (0.001)
BD	-0.182 (0.001)	0.186 (0.001)	-0.027 (0.394)	0.490 (0.001)	0.000 (0.988)	0.065 (0.040)	0.264 (0.001)	0.215 (0.001)
BDOUT	-0.075 (0.019)	0.086 (0.007)	-0.050 (0.115)	0.179 (0.001)	-0.007 (0.825)	0.035 (0.276)	0.112 (0.001)	0.187 (0.001)
BDMTG	0.031 (0.324)	-0.127 (0.001)	-0.043 (0.173)	-0.213 (0.001)	0.003 (0.917)	0.040 (0.213)	-0.134 (0.001)	-0.073 (0.022)
BIG5	-0.155 (0.001)	0.141 (0.001)	-0.031 (0.332)	0.470 (0.001)	0.006 (0.840)	-0.022 (0.495)	0.206 (0.001)	0.163 (0.001)
RACR1	0.662 (0.001)	0.161 (0.001)	0.126 (0.001)	-0.118 (0.001)	0.059 (0.065)	-0.009 (0.769)	-0.091 (0.004)	0.117 (0.001)
RACRT		-0.031 (0.325)	0.109 (0.001)	-0.206 (0.001)	0.034 (0.287)	-0.101 (0.002)	-0.093 (0.003)	-0.168 (0.001)
EBTP			0.313 (0.001)	0.472 (0.001)	0.031 (0.334)	0.036 (0.257)	0.277 (0.001)	0.234 (0.001)
FEBTP				-0.026 (0.410)	0.088 (0.006)	-0.024 (0.452)	-0.048 (0.128)	0.073 (0.021)
LGMV					-0.012 (0.714)	-0.063 (0.049)	0.579 (0.001)	0.279 (0.001)
CGNPL						0.023 (0.463)	-0.001 (0.971)	-0.023 (0.465)
CGLN							-0.122 (0.001)	-0.180 (0.001)
WO								0.250 (0.001)

Please see table 1 for notations.

Table 3
Regression of Loan Loss Provision on Audit Committee and Board Characteristics
(t-statistics are in parentheses)

	Pred Sign	Full Sample	Full Sample
INTERCEPT	?	0.005 (2.40)**	0.007 (3.19)***
AC	+	-0.0001 (-0.71)	-0.0001 (-0.86)
ACOUT	+	0.0003 (0.39)	0.0004 (0.54)
ACMTG	+	0.0002 (3.88)***	0.0002 (3.52)***
AC_FXP	+	0.004 (1.07)	0.0004 (1.25)
AC_GXP	+	0.0006 (3.09)***	0.0006 (3.04)***
BD	+	0.00004 (0.99)	0.00002 (0.55)
BDOUT	+	0.001 (1.13)	0.001 (1.10)
BDMTG	+	0.0006 (1.98)**	0.0006 (2.00)**
BIG5	+	0.0007 (2.52)**	0.0007 (2.49)**
RACR1	-	-0.0001 (-1.88)*	
RACRT	-		-0.0001 (-4.59)***
EBTP	+	0.038 (1.91)*	0.035 (1.82)*
FEBTP	+	0.106 (4.32)***	0.114 (4.68)***
LGMV	?	-0.0004 (-3.12)***	-0.0004 (-3.28)***
CGNPL	+	0.0001 (0.14)	0.0001 (0.14)
CGLN	+	0.0005 (0.72)	0.0001 (0.18)
WO	+	0.605 (11.53)***	0.619 (11.88)***
ALLOW	+	0.112 (4.99)***	0.094 (4.20)***
N		989	989
Adj R-square		26.20%	27.50%

***, **, and * denote significance at the 1, 5, and 10 percent levels respectively: one-tail test where appropriate.

Please see table 1 for notations.

Table 4
Regression of Loan Loss Provision on Audit Committee and Board Characteristics
for Low Earnings Management and High Earnings Management Banks
(t-statistic in parentheses)

	Pred Sign	Low Earnings Management Banks	Low Earnings Management Banks	High Earnings Management Banks	High Earnings Management Banks
INTERCEPT	?	0.012 (3.79)***	0.011 (3.59)***	0.0005 (0.48)	0.001 (1.51)
AC	+	-0.0001 (-0.63)	-0.0001 (-0.62)	0.0001 (1.84)**	0.0001 (1.62)**
ACOUT	+	0.0003 (0.25)	0.0004 (0.32)	0.0005 (1.54)*	0.001 (1.77)**
ACMTG	+	0.0001 (1.57)*	0.0001 (1.52)*	0.0001 (2.99)***	0.0001 (2.63)***
AC_FXP	+	0.001 (0.97)	0.001 (1.04)	0.0001 (0.53)	0.0001 (0.96)
AC_GXP	+	0.001 (2.23)**	0.001 (2.32)**	-0.0001 (0.75)	-0.0001 (0.92)
BD	+	-0.00002 (-0.41)	-0.00004 (-0.63)	0.0001 (3.75)***	0.0001 (3.40)***
BDOUT	+	0.002 (1.05)	0.002 (0.94)	0.0004 (0.92)	0.0004 (1.01)
BDMTG	+	0.0001 (2.40)***	0.0001 (2.40)***	0.00001 (0.43)	0.000002 (0.14)
BIG5	+	0.002 (3.21)***	0.002 (3.28)***	-0.0001 (-1.10)	-0.0001 (-1.12)
RACR1	-	-0.0001 (-1.79)**		-0.00003 (-1.88)**	
RACRT	-		-0.00006 (-1.14)		-0.00005 (-5.87)***
EBTP	+	0.009 (0.32)	0.002 (0.09)	0.025 (2.46)***	0.024 (2.53)***
FEBTP	+	0.109 (3.19)***	0.111 (3.26)***	-0.012 (-1.04)	-0.007 (-0.64)
LGMV	?	-0.001 (-4.15)***	-0.001 (-3.96)***	-0.0001 (-0.90)	-0.00006 (-1.18)
CGNPL	+	-0.0003 (-0.22)	-0.0005 (-0.45)	-0.0006 (-1.42)*	-0.0007 (-1.53)*
CGLN	+	-0.0002 (-0.19)	-0.0003 (-0.28)	0.0001 (0.43)	-0.00006 (-0.17)
WO	+	0.518 (8.12)***	0.523 (8.17)***	0.091 (1.00)	0.097 (1.10)
ALLOW	+	0.295 (6.54)***	0.284 (6.34)***	-0.043 (-5.18)***	-0.051 (-6.37)***
N		494	494	495	495
Adj R-square		29.96%	29.68%	11.60%	16.95%

***, **, and * denote significance at the 1, 5, and 10 percent levels respectively: one-tail test where appropriate. Firms with above the sample median LLP are classified as low earnings management banks while firms with below the sample median LLP are classified as high earnings management banks. Please see table 1 for notations.

Table 5
Regression of Discretionary Loan Loss Provision on Audit Committee and Board Characteristics

	Pred Sign	Full Sample	Full Sample
INTERCEPT	?	0.003 (1.33)	0.004 (2.02)**
AC	+	-0.0001 (-0.81)	-0.0001 (-0.94)
ACOUT	+	0.0003 (0.38)	0.0004 (0.54)
ACMTG	+	0.0002 (3.73)***	0.0002 (3.38)***
AC_FXP	+	0.0003 (0.96)	0.0004 (1.13)
AC_GXP	+	0.001 (3.09)***	0.0006 (3.05)***
BD	+	0.00005 (1.20)	0.00003 (0.70)
BDOUT	+	0.001 (1.15)	0.001 (1.10)
BDMTG	+	0.0001 (2.18)**	0.0001 (2.16)**
BIG5	+	0.001 (2.86)***	0.001 (2.79)***
RACR1	-	-0.0001 (-1.79)**	
RACRT	-		-0.0001 (4.54)***
EBTP	+	0.038 (1.93)**	0.034 (1.79)**
FEBTP	+	0.112 (4.60)***	0.120 (4.97)***
LGMV	?	-0.0004 (-3.97)***	-0.0004 (-4.01)***
ALLOW	+	0.108 (4.96)***	0.093 (4.32)***
N		989	989
Adj R-square		9.55%	11.14%

***, **, and * denote significance at the 1, 5, and 10 percent levels respectively: one-tail test where appropriate.

Please see table 1 for notations.