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Directors' Loans, Directors' Shareholdings and Earnings Management Practices: Evidence from Banks Listed on the Nigerian Exchange Group

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Abstract

The incidence of bank failures has led to different investigations in the banking sector. A major recurring issue has been that the books do not reflect the true and fair position as a result of earnings management (EM) practices which has misled stakeholders as to the position of the organisations. Anchored on the agency theory, the study investigated the role that directors' loans and shareholdings play in the EM practices of banks listed on the Nigerian Exchange Group. Employing the ex-post facto research design, the study made use of the discretionary loan loss provision as a proxy to measure the EM practices in the eleven listed banks used as its sample. The Ordinary least square regression was used to determine the relationship that exists among the directors' shareholdings, directors' loans and EM practices in the banks while controlling for the effect of firm size and financial performance. The study found that directors' shareholdings has a negative and significant relationship with EM practices while directors' loans has a negative and significant relationship with EM practices. The study concluded that due to the significance of these relationships of the independent variables to EM practices, there should be stricter guidelines with regards to directors' loans by the regulatory authorities.

Keywords: *directors' loans, directors' shareholdings, earnings management, listed banks, Nigeria Exchange Group*

1. Introduction

Financial scandals which rocked the corporate world in the early 2000s questioned the role accounting plays in conveying the economic reality of the organization (Hassen, 2014). The incidence of the scandals raised the question as to the trustworthiness of the published financial statements in truly representing the financial performance and position of the reporting entity. Such scandals are indicative of earnings management (EM) practices which has been associated with various incentives including the agency problem (principal-agent relationship), information asymmetry, managerial contracting and political costs (Liu, Harris & Omar, 2013).

EM refers to circumstances where managers apply their subjective judgment in financial reporting and the structuring of transactions which leads to alterations in the financial reports and misleads the users as to the economic performance of the organization as well as influence contractual outcomes (Healy & Wahlen, 1999).

Due to the delicate position the executives of an organization occupy, it is important that they are adequately remunerated which can be in form of financial or non-financial remuneration (Mgbame, 2017). Financial remuneration usually includes monetary compensation in the form of salaries, bonuses, fees and allowances to both executive and non-executive directors', the non- financial remuneration are usually in the form of advances/loans as well as having shares in the business.

The role compensation plays in the EM practices has been the focus of various studies such as Bebchuk, Fried and Walker (2002) which argue that executives have the power to influence their own pay, and they use this power for rent extraction which can lead to misreporting. Also, Zhou, Wang, Zhang and An (2016) finds a positive association between real EM and executive compensation. Jensen (2001) also explains the positive relationship between EM and compensation in stock options by the fact that the leaders are not paid for what they do, but for what they do on a target which encourages them to play the system by manipulating the way to achieve these targets.

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The focus of most of these studies have however been on the financial remuneration without recourse to the non-financial remuneration especially in Nigeria which necessitates an investigation into the kind of influence that directors' non-financial remuneration play in the incidence of EM practices in the organisation. Anchored on the agency theory reflecting the conflict of interest which could exist as a result of the separation of ownership from management, this study evaluated the relationship that exists between directors' shareholdings and loans and EM practices in Nigeria towards understanding the impact that directors' non-financial compensation have on the practice of EM in published financial statements within the country. The study specific objectives were to:

i. evaluate the effect of directors' shareholdings on EM practices
ii. determine the effect of directors' loans on EM practices

2. Literature Review

2.1 Conceptual Review

2.1.1 Directors' Shareholdings

The ownership of shares in a particular organization confers the title of shareholder whose ownership is determined by the ratio of shares owned to the total number of outstanding shares (Kristanti, Riyadh, Ahmed, Alfaiza, Steelyana, Lutfi & Beshr, 2024). The ownership of shares is not however restricted to outsiders as directors' who are directly involved in the decision making of an organization can also own shares within the organization which is usually captured as a corporate governance characteristic. The study thus refers to directors' shareholdings as the ownership stake that directors' have within the organization which could be direct or indirect.

2.1.2 Earnings Management (EM)

This is the deliberate alteration of an organisations financial statements with the aim of achieving specific goals such as fulfilling earnings targets, influencing stock prices or portraying a financial image in contrast with the actual economic situation (Brennan, 2021). It involves the manipulation of an organisations external financial reporting process as a result of the managers personal benefit (Schipper, 1989) using various techniques that portrays the organisation in a light other than what it truly is. The study thus measures EM using discretionary provision for loan loss due to the peculiarity of the sector studied i.e. the banking sector.

2.2 Theoretical Review

2.2.1 Agency Theory

The study is anchored on the agency theory which explains the conflict of interest that arises as a result of the separation of ownership from control of modern businesses (Usman & Abubakar, 2012) which requires that an agent (management) is recruited to see to the day to day affairs of the organization. The theory suggests compensation for mutual benefits that would enhance positive performance of the organisation (Khan, Khidmat, Ullah & Khan, 2019). Thus, compensation contracts are utilized by the shareholders (principal) to reduce agency costs and motivate managers (agents) interests in maximizing firm value. Directors' compensation which could be in various forms- cash, stock options, loans or their combination- is therefore used as a settlement for the directors' towards ensuring they act in the firms best interest.

This may however lead managers to distort the true picture of the firm in order to achieve their selfish interest on performance based contracts as compensation contracts have been found to provide an insight for opportunistic driven EM (Zouari, Lakhal & Nekhili, 2012). Thus, agency theory can help to explain how the quest for settling the managers for the firms benefit through compensation can lead to the practice of EM. The theory is very relevant to the study as it has been used in many previous similar studies such as Usman and Abubakar (2012); Bouaziz, Salhi and Jarboui (2019); Khan, Khidmat, Ullah and Khan (2019); Mohammed (2020).

2.3 Empirical Review

Executives' opportunistic behavior has been associated with increased stock options as a form of compensation (Cohen, Dey & Lys, 2008) as it has been found to induce executives to manipulate earnings with the intention of meeting favorable factors of option grants (Vafeas & Waegelein, 2007). Stock options of bank executives were found to be significantly and positively associated with the EM of their banks by Uygur (2013) who studied the association between bank executives' incentives and EM making use of the banking industry unique characteristic (i.e. provision for loan losses and reserve-for-loan-loss) in determining the EM activities in the banks.

Although, Laux and Laux (2009) provided contrary evidence as they opined that changes in incentives leads to the altering of monitoring efforts, thus EM may not increase even though equity incentives are increased. The use of stock option compensation has been associated with motivating EM practices in order to meet performance targets or thresholds (Shrieves & Gao, 2002; Cheng & Warfield, 2005; Bergstresser & Philippon, 2006); it has also been associated with earnings restatements by Burns and Kedia (2006); Efendi, Srivastava and Swanson (2007). The findings of Francis, Lafond, Olsson and Schipper (2004) also suggest that the use of opportunistic accruals is more common in firms whose managers hold a large portfolio of stock options. Similarly, Burns and Kedia (2006), Cheng and Warfield (2005), Bergstresser and Philippon (2006) found that high-dose compensation stock options creates a perverse incentive for EM practices.

A positive relationship between CEOs equity compensation and accruals was discovered by Bergstresser and Philippon (2006) while stock option grants are positively associated with the probability of missing earnings targets among firms that manage earnings downwards (McAnally, Srivastava & Weaver, 2008). Meek, Rao and Skousen (2007) find a positive relationship between annual CEO stock option compensation and the absolute value of discretionary accruals, implying the likelihood that EM increases when CEO compensation in the form of stock options is higher. Sanoran and Wong (n.d.) also find that the effect of executive compensation on discretionary accruals and cost of equity capital is not uniform across different types of executive compensation.

Cohen, Dey and Lys (2008) corroborate that an increase in accrual-based EM is concurrent with increases in the proportion of equity-based executive compensation. Chen and Li (2011) also finds that equity compensation motivates income-increasing EM only when the firm has characteristics associated with lower financial reporting quality as the association between equity compensation and discretionary accruals varies substantially across the distribution of the firms' financial reporting quality. Prihastomo and Khafid (2018) also found that bonus compensation has a negative significant effect on EM and a positive effect on financial performance. Mohamed (2020) using primary and secondary data in studying the association between executive directors' remuneration and EM among banks in Kenya established that there is negative but not statistically significant association between executive compensation and EM. Though, stock compensation and bonus payment had a positive impact on EM while cash compensation had no impact on EM from analysis of the primary data. Also, Armstrong, Jagolinzer and Larcker (2010) find that relatively higher levels of CEO equity incentives lead to a decreased incidence of accounting irregularities.

Bao, Li and Dong (2008) finds that compensation incentive is a motivation for EM in China though different EM behaviors are differently impacted by different compensation incentives. Chou and Chan (2018) who found that high CEO compensation increases the real EM activities within an organization. Also, Marilyn (2014) who examined the relationship between EM and CEO compensation (option and incentive component) during the periods 2004 to 2013 found a positive relationship between the real EM and the CEO compensation of the sampled firms. However, Hassen (2014) who focused on the banking sector discovered a negative association between executive compensation and EM. Most of these studies are however based on the financial renumeration given to the directors' without recourse to the non-financial remuneration.

Kristanti, Riyadh, Ahmed, Alfaiza, Steelyana, Lutfi and Beshr (2024) found that greater directors' shareholdings leads to a reduction in the EM practices carried out by firms in Iraq between 2013 and 2018 with frequency of board meetings having no significant moderating effect on this relationship. Also, Al-Fayoumi, Abuzayed and Yan (2010) opines that an increase in directors' share ownership would reduce the incidence of EM. Saona, Muro and Alvarado (2020) found that EM reduces as the voting rights of controlling shareholders are increased and that an inverse U-shaped relationship exists between insiders ownership and earnings manipulation suggesting that directors' shareholdings would lead to a lower level of EM practices. Kjerland, Haugdal, Sondergaard and Vagslid (2020) also found that share ownership by directors' positively affects EM practices in firms listed on the Oslo Stock Exchange. However, Cho and Chung (2022) discovered that EM has a significant positive relationship with board ownership indicating that EM increases as the members of the board have

increased shareholdings using 480 firms listed on the Ho Chi Minh and Hanoi Stock Exchanges between 2012 and 2017. This indicates differing evidence on the relationship between the directors' shareholdings and EM practices in organisations which could be as a result of difference in time or location where such studies were carried out.

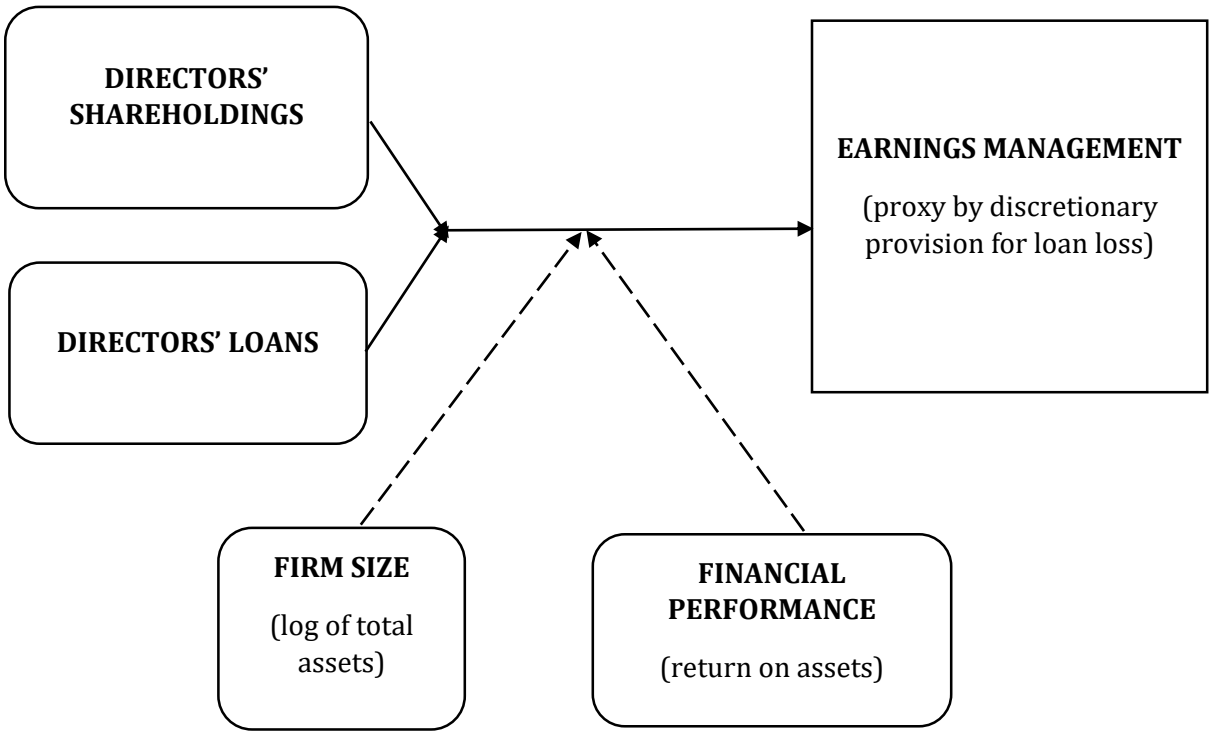
In Nigeria, Moses, Ibanichuka and Ofurum (2020) in their study on the role of executive compensation on the real EM activities of organisations in the industrial goods sector found that equity incentives and executive compensation have a positive but insignificant effect on real activity management as it is causes only 6.9% variation on the real activity management. However, Zubair and Abubakar (2021) finds that a significant relationship exists between executive compensation (share-based payments, fixed salary and allowances and bonuses) and EM (accrual based) among listed industrial goods firms in Nigeria. Salawu, Adeyemi and Obigbemi (2024) also found a significant relationship between non-executive directors' fees and allowance and EM practices in Nigeria while other forms of financial compensation studied were found to have an insignificant relationship, all forms of compensation except executive compensation have a positive effect on EM practices among banks listed on the NGX. The studies in Nigeria only focused on the financial aspect of compensation without recourse to the non-financial compensation which is the gap this study intends to address with focus on the banks listed on the NGX.

The study thus hypothesizes that:

$H0_1$: Directors' shareholdings has no significant effect on EM practices in banks listed on NGX

$H0_2$: Directors' loans has no significant effect on EM practices in banks listed on NGX

The study conceptual model is as presented below:



Source: *Authors conceptualization (2023)*

The apriori expectation is that directors' shareholdings and loans would influence the EM practices of the focus organisations while firm size and financial performance are used as control variables.

3. Methodology

The study employed the ex-post facto research design in gathering data on compensation related to the listed commercial banks. The focus is due to various corporate scandals that have been linked to the financial sector and the fact that executives of these organisations receive excess compensation packages even in the midst of the economic downturn (Abdulkadir, 2021).

There are currently twenty-two (22) commercial banks under the purview of CBN although only thirteen (13) of these banks are listed on the NGX as at 31st December, 2022 and form the study population. However, ECO bank -which is an international corporation- reporting currency is in the U.S. dollars which is not in tandem with what is generally obtainable in the sector, thus it was eliminated from the population. Also, Guaranty Trust Holding Company (GTCo) does not have adequate financial statements for the period under review (2015-2021) as it was listed in the year 2020. The study thus made use of eleven (11) listed commercial banks in Nigeria that satisfied the required criteria of having financial statements during the period under review (2015-2021) employing census method of sampling.

The study made use of the discretionary provision for loan loss calculated using the Beaver and Engel (1996) model which has been adopted in literature for determining EM practices in the banking industry (Mohammed, 2020). The model is used to determine the EM in banks financial statements by deducting non-discretionary provision for loan losses from the total provision for loan losses as shown below:

$$\textbf{Total PLLs}_{it} = \beta_0 + \beta_1 NPL_{it-1} + \beta_2 CHGNPL_{it} + \beta_3 CHGLOANS_{it} + \varepsilon \quad \textbf{..... (1)}$$

All of the variables are deflated by the NPL_{it-1}. The fitted values of **(1)** are used in determining the non-discretionary provision for loan loss as follows:

$$\textbf{NPLLs}_{it} = \beta_0 + \beta_1 NPL_{it-1} + \beta_2 CHGNPL_{it} + \beta_3 CHGLOANS_{it} \quad \textbf{..... (2)}$$

The difference between the total provision for loan loss and non-discretionary provision for loan loss is used in determining the discretionary provision for loan loss (proxy for EM) as follows:

$$\textbf{DPLLs} = \text{Total PLLs} - \text{NPLLs} \quad \textbf{..... (3)}$$

where:

$\textbf{Total PLLs}_{it}$ = total provision for loan losses of bank "i" at time "t"
$\textbf{NPLLs}_{it}$ = non-discretionary provision for loan loss of bank "i" at time "t"
$\textbf{NPL}_{it-1}$ = non-performing loans for bank "i" at the beginning of the period (time "t-1")
$\textbf{CHGNPL}_{it}$ = change in the value of non-performing loans of bank "i" at time "t"
$\textbf{CHGLOANS}_{it}$ = change in the value of loans of bank "i" at time "t"
DPLLs = discretionary provision for loan loss of bank "i" at time "t"

Prior literature have identified various factors that can influence EM practices apart from directors' shareholdings and loans which are the focus of this study. Thus, in line with previous similar studies (Mohammed, 2020; Ugyur, 2013; Bergstresser & Philippon, 2006), the study also included bank size and financial performance as variables related to compensation and, therefore, controlled for them.

The following OLS regression model is then adopted for determining the relationship between directors' shareholding and loans and EM practices of banks.

$$DPLLs = \beta_0 + \beta_1 DS + \beta_2 DL + \beta_3 FS + \beta_4 FP + \varepsilon \quad \textbf{..... (4)}$$

where

DS= directors' shareholdings
DL = directors' loans
FS = firm size
FP = financial performance
ε = error term

Variables	Definition and Measurement
DS	percentage of shares owned by directors' and their related parties in bank "i" at time "t"
DL	naira value of loans granted to directors' and their related parties in bank "i" at time "t"
FS	Firm size for bank "i" at time "t", measured by the logarithm of the total assets at time "t"
FP	Return on assets, measured as the ratio of earnings before interest and taxes (EBIT) to total assets for firm "i" at year "t"

In describing the properties of the data collected, the study employed the use of descriptive statistics such as mean, median, maximum, minimum, standard deviation, skewness, kurtosis. Inferential statistics was also carried out making use of the OLS regression in analysing the relationship between the dependent and independent variables of the study as it helps with explaining the degree of cause and effect of variables and their level of association (Kothari, 2004) All analysis were carried out using Eviews version 10 software after collecting the required data from the financial statements of the studied banks.

4. Results

Table 1: Descriptive Statistics of Independent and Control Variables

	Directors' Shareholdings(%)	Directors' Loans (₦'000)	Firm Size	Financial Performance (%)
Mean	1.487795	12135506	9.262515	0.016911
Median	0.071356	1401193	9.235499	0.012428
Maximum	17.82682	97733264	9.950967	0.094579
Minimum	0.000246	0.00E+00	8.130196	-0.10553
Std. Dev.	4.332834	2.17E+07	0.408231	0.020622
Skewness	3.042023	2.210305	-0.375253	-1.75718
Kurtosis	10.64594	7.393587	2.692657	19.74264
Jarque-Bera	306.3186	113.2991	2.110178	938.9726
Probability	0	0	0.348161	0
Sum	114.5602	8.49E+08	713.2137	1.302111
Sum Sq. Dev.	1.43E+03	3.25E+16	12.66561	0.032319
Observations	77	77	77	77

Source: *Eviews version 10 computation (2023)*

The mean directors' shareholding is 1.49% with a standard deviation of 4.33%. The maximum shareholding is 17.83% while the minimum is 0.000246%. This shows that veto power does not lie heavily in the hands of a few individuals in these public organisations. A scrutiny of the banks financial statements also show that some directors' do not have any vested interest in the banks.

The mean directors' loans is ₦12,135,506,000 with a standard deviation of ₦21,744,273,000. The maximum loan given to directors' and their related parties is ₦97,733,264,000 while the minimum loan is zero. This indicates that directors' in some banks do borrow a large sum of money while others do not. This could be due to varying individual bank policies. The mean firm size and financial performance is 9.26 and 0.017% respectively with standard deviation values of 0.41 and 0.02% respectively.

Table 2: Descriptive Statistics of Dependent Variable (Earnings Management)

Year	Mean	Median	Maximum	Minimum	Std. Dev.	Skewness	Kurtosis
2015	18635774	9008547	104000000	-1725331	28920313	2.609564	8.302002
2016	24036580	5416942	199000000	-5769101	58653146	2.722204	8.674375
2017	6507912	4729297	164000000	-207000000	90290306	-0.697016	4.600449
2018	27578942	5904545	250000000	-131000000	93882624	0.989501	4.507851
2019	8741465	7378183	59850626	-36052251	23825112	0.339731	3.767978
2020	19684502	23840708	42635712	-12972066	17371443	-0.483776	2.148816
2021	22375965	8823178	67211039	-3376897	24365428	0.639178	1.979756

Source: *Eviews version 10 computation (2023)*

The mean DPLLs for all years was positive, indicating that on average, Nigerian banks were using EM to overstate their profits. The minimum DPLLs for 2015 was negative, indicating that some banks may have actually reduced their reported profits. The maximum DPLLs for 2021 was ₦67,211,039,000 indicating that some banks continued to engage in aggressive EM practices. The year 2018 had the highest income increasing EM (₦250,000,000,000) while the year 2017 has the highest income decreasing EM (₦207,000,000,000). Least income decreasing EM was recorded in 2021 (₦3.376,897,000) while the least income increasing EM occurred in the year 2020 (₦42,635,712,000). The descriptive statistics suggest that EM was prevalent in the Nigerian banking sector during the period covered by the study, with some banks engaging in high income increasing EM practices and others engaging in income decreasing EM practices.

Table 3: Directors' Shareholdings and EM

Dependent Variable: DPLLS
Method: Panel Least Squares
Sample: 2015 2021
Periods included: 7
Cross-sections included: 11
Total panel (balanced) observations: 77

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Directors'_shareholdings_	-3718926	1325368	-2.805958	0.0064
Financial_performance	-164000000	298000000	-0.552508	0.5823
Firm_size__log_of_total_asset	50010175	14976620	3.339216	0.0013
C	-437000000	137000000	-3.183296	0.0021
R-squared	0.514899	**Mean dependent var**		18223020
Adjusted R-squared	0.482635	**S.D. dependent var**		55144273
S.E. of regression	49854968	**Akaike info criterion**		38.33768
Sum squared resid	18100000000	**Schwarz criterion**		38.45944
Log likelihood	-1472.001	**Hannan-Quinn criter.**		38.38639
F-statistic	6.660571	**Durbin-Watson stat**		1.112855
Prob(F-statistic)	0.000488			

Source: *Eviews version 10 computation (2023)*

The results in table 3 indicate that directors' shareholdings have a negative and statistically significant effect on EM, as indicated by the probability value of 0.0064. This suggests that directors' shareholdings has a significant effect on EM practices which means that as the shareholding of directors' in the company increases, the level of EM decreases. The R-squared value of 0.214899 indicates that the independent variables explain about 51.49% of the variation in the dependent variable. The study therefore rejects null hypothesis one due to the significant effect directors' shareholding was found to have on EM practices in the Nigerian financial sector. This is in line with the findings of Kristanti, Riyadh, Ahmed, Alfaiza, Steelyana, Lutfi and Beshr (2024); Saona, Muro and Alvarado (2020) but is in contrast with the findings of Cho and Chung (2022).

Table 4: Directors' Loans and EM

Dependent Variable: DPLLS				
Method: Panel Least Squares				
Sample: 2015 2021				
Periods included: 7				
Cross-sections included: 10				
Total panel (balanced) observations: 70				
Variable	**Coefficient**	**Std. Error**	**t-Statistic**	**Prob.**
Directors'_loans_	-0.366754	0.209946	-1.746894	0.00853
Firm_size__log_of_total_asset	19672427	12789298	1.538194	0.1288
Financial_performance	2.45E+08	2.34E+08	1.044809	0.2999
C	-1.73E+08	1.16E+08	-1.488328	0.1414
R-squared	0.623821	**Mean dependent var**		8394225
Adjusted R-squared	0.6083995	**S.D. dependent var**		39225980
S.E. of regression	37542467	**Akaike info criterion**		37.77529
Sum squared resid	9.30E+16	**Schwarz criterion**		37.90377
Log likelihood	-1318.135	**Hannan-Quinn criter.**		37.82632
F-statistic	3.109024	**Durbin-Watson stat**		1.009416
Prob(F-statistic)	0.03223			

Source: *Eviews version 10 computation (2023)*

Table 4 shows the results of the regression of the dependent variable, DPLLS, on the independent variable (directors' loans) and control variables (firm size and financial performance). The coefficient of directors' loans is -0.366754, indicating a negative and significant relationship between directors' loans and EM practices (t-statistic= -1.746894, p-value< 0.05). The coefficient of firm size is positive, indicating that larger firms tend to have higher EM, but it is not statistically significant. The coefficient of financial performance is positive, indicating that firms with better financial performance tend to have higher EM, but it is also not statistically significant.

The R-squared value is 0.623821, indicating that the independent variable (directors' loans) explains 62.38% of the variation in DPLLS. Overall, the results suggest that directors' loans have a significant negative impact on EM therefore leading to the rejection of null hypothesis two.

5. Conclusion

The study was able to find evidence of EM practices in the focus organisations in Nigeria as the DPLLs was both positive and negative but never zero, which shows that both income increasing and income decreasing EM practices were carried out in these banks. Although, more banks carried out income increasing EM as the value of the largest income decreasing EM is higher than the largest income increasing EM.

The study found that directors' loans and shareholdings have a significant effect on EM practices and is negatively related to EM practices which means that an increase in the shareholdings of the directors' would translate to reduced EM practices which is the expectation that the directors' would ensure that their organisations are doing the right thing as soon as they have a stake in it. However, the study did not measure the level at which this relationship stops been significant which is a limitation. Directors' loans were however found to have a positive relationship with the EM practices of the studied organisations. This translates to an increase in the EM practices as a result of the directors' and their related parties borrowing from the organization.

6. Recommendations

In line with the studys findings, the following recommendations are made:

Regulatory agencies should monitor and introduce stricter guidelines for loans to directors' and their related parties

Guidelines for mandatory disclosure of all directors' remuneration should be instituted

There should be more stringent policies against EM practices to reduce the incidence of bank failures

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