

The Use of Loan Loss Provisions for Earnings, Capital Management and Signalling by Australian Banks

Abstract

This research is motivated by the fact that there is a paucity of research on the earnings management practices of banks in Australia. Research on the practices of North American, European and Asian banks provided conflicting evidence. In this study, we examine whether Australian banks engage in earnings, capital management and signalling, and, if so, the extent to which loan loss provisions (LLPs) are used for this purpose. Our results indicate that banks in Australia use loan loss provisions to manage earnings. Further, listed commercial banks engage more aggressively in earnings management using LLPs than other banks. We also find that earnings management behaviour is more pronounced after implementation of the Basel Accord. We do not find evidence to indicate a relationship between LLPs and capital management. This may be because loan loss reserves no longer constitute part of Tier I capital in the numerator of the capital adequacy ratio. Overall, however, we find a significant understating of loan loss provisions in the post-Basel period relative to the pre-Basel period. This indicates that reported earnings may not reflect the true economic reality underlying those numbers. Finally, Australian banks do not appear to use LLPs for signalling future intentions of higher earnings to investors.

Keywords: *Earnings management, capital management, signalling, Australian banks*

JEL classification: C23; G14, M41