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Earning management in Brazilian financial institutions

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RESUMO

Gerenciamento de resultados em instituições financeiras brasileiras

No presente trabalho, tem-se como objetivo estudar o gerenciamento de resultados em uma amostra representativa de 123 bancos no mercado brasileiro entre os anos de 2001 e 2012. Dado o papel importante que os bancos desempenham na economia de um país, é necessário entender que existem fatores discricionários envolvidos no relato de rentabilidade de uma instituição financeira. Regras de provisionamento de crédito para as instituições financeiras brasileiras estão descritas na Resolução 2682/99 do Conselho Monetário Nacional. Por causa da discricionariedade permitida nessa resolução, a provisão para perdas de crédito é usada como instrumento de gerenciamento de resultados, o que não é uma prática ilegal, mas esse comportamento afeta a percepção de risco dos agentes e analistas, e eles devem estar cientes disso e compreendê-lo. Os resultados mostram que o provisionamento de crédito é usado como um mecanismo de gerenciamento de resultados para suavizar o lucro líquido das instituições financeiras brasileiras. Os bancos brasileiros procuram evitar não somente o lucro líquido antes de despesas com provisão e impostos negativos, mas também lucro líquido antes de despesas com provisão e impostos inferiores em relação ao período anterior. Ao contrário de estudos anteriores, não está claro se os bancos procuram evitar lucro líquido inferior a um determinado grupo de pares.

Palavras-chave: instituições financeiras brasileiras, gerenciamento de resultado, provisão de crédito, regressão com dados em painel.

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1. INTRODUCTION

Several authors who have studied earnings management in banking have found empirical support for the claim that banks use the loan loss provision for earnings management (Anandarajan, Hasan, & Vivas, 2003; El Sood, 2012). The authors have also found evidence of earnings management when there is a positive relationship between financial institutions' expenditures on loan loss provisions and their outcomes. Thus, a better outcome motivates greater spending on loan loss provisions to mitigate gains (Ahmed, Takeda, & Thomas, 1999; El Sood, 2012; Kanagaretnam, Lobo, & Yang, 2005).

There are several goals of earnings management. The main objective is typically income smoothing, which is used either when the previously established earnings are high, thus reducing the reported earnings, or when the earnings are considered low, to increase the reported earnings (Zenderski, 2005). In this context, managers attempt to avoid presenting negative net income or a decrease in profit in relation to the previous period (Bornemann, Kick, Memmel, & Pfingsten, 2012). The main objectives of this behavior are to transmit an image of solidity and good performance to the market (Goulart, 2007) and to influence agents' risk perception (Balboa, López--Espinosa, & Rubia, 2013; El Sood, 2012), in addition to other personal goals of managers such as maintaining dividends and contractual bonuses, which are generally at least partially tied to a financial institution's performance (El Sood, 2012). A manager can also choose to continue an earnings management position, even if it may compromise the quality of the presented accounting figures or if it entails future sacrifices by the organization (Martinez, 2001). Financial institutions also seek to meet goals where they can be compared with an industry benchmark or the performance of a peer group (Bornemann *et al*., 2012).

In Brazil, National Monetary Council (*Conselho Monetário Nacional* – CMN) Resolution 2682/99 established the regulatory framework for loan loss provision accounts. The expenses associated with a loan loss provision account are based on the risk level of the loan portfolio, which is defined by specific criteria in relation to the debtor and the guarantees involved. Because the regulation only suggests guidelines and not objective criteria that determine risk ratings, the Central Bank has delegated to financial institutions the freedom to define credit models at each institution's discretion, resulting in possible inconsistencies related to loan loss provision accounts.

Bornemann *et al*. (2012) carried out the following tests in the German banking market: (i) assessed whether banks avoid a decrease in net income (excluding loan loss provisions) in relation to the previous period, thus seeking to achieve lower outcome variability; and (ii) assessed whether banks seek to avoid a decrease in net income (excluding loan loss provisions) in relation to its peer group. Previous studies on the Brazilian banking market focused on evaluating whether firms practiced earnings management using a provision account. These studies tested the hypothesis of a positive relationship between a financial institution's expenses and earnings, which would constitute income smoothing (Goulart, 2007; Zenderski, 2005).

The present study aims to investigate earnings management in Brazilian banking, and the study's main contribution is an unprecedented examination of the reasons for earnings management by Brazilian banks, following the framework established in the study by Bornemann *et al*. (2012). The focus of this study is the loan loss provision account management because it is a financial institution's main discretionary account. Second, banks have high leverage, which makes them vulnerable to volatility in asset prices and requires them to make constant adjustments to their loan loss provision accounts to maintain adequate coverage of their loan portfolios (Gonzalez, 2007). Thus, the credit provision account is closely associated with the earnings account and has an important effect on a bank's profitability.

The two-stage least squares (2SLS) method is used; this approach is unprecedented for Brazil and was not used by Bornemann *et al.* (2012). Additionally, this study is the first in the Brazilian market to employ data from the financial crisis of 2007-2009; these data are used as control variables in the investigation of the reasons for earnings management by Brazilian banks.

The study is extremely important because financial statements are the main source of public information on banks, and they serve as a tool to determine banks' current economic and financial position, their potential for growth, and future trends (Assaf, 2007). Additionally, because banks also have systemic importance in a country's economy, it is essential to be able to discern whether and to what extent earnings management occurs in the Brazilian banking market.

2. LITERATURE REVIEW AND HYPOTHESES

The regulation that controls the credit provisioning rules in Brazil is Resolution 2682 of the Central Bank of Brazil from December 21, 1999. As defined by the law, a credit rating must be based on some criteria set by the Central Bank and should include at least certain criteria defined by the Resolution. These criteria are the identified provisions in which there is a direct relationship between the credit provision and customers' credit risk.

Although Resolution 2682 results in the evaluation of credit risk by financial institutions, the regulation does not specify the characteristics for each risk category. Thus, each bank is responsible for evaluating each of the elements of the Resolution according to its own criteria and must define its own proprietary model for risk assessment (Parente, 2000). The Resolution introduced a framework for the evaluation of credit risk in financial institutions, but it allowed some freedom