Loan Loss Provision and Earnings Management: The Lawyers' Role in China

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ABSTRACT

IFRS 9 was issued to replace IAS 39 and overcome several matters that hindered IAS 39. Subjectivity and professional judgements delay from recognising loan loss provisions to facilitate earnings management practices and procyclicality. Prior studies have shown that earnings management has increased with the implementation of IFRS 9. This finding reflects the low disclosure quality related to financial instruments among banking industry firms. Lack of proper enforcement may result in limited compliance delivered by these banks. While the role of regulators in ensuring compliance is undeniable, the presence of legal officers and lawyers still play their role in ensuring high legal compliance, including compliance with the accounting standards. Using the panel data of 203 local Chinese banks from 2019 to 2022, this study examined whether the earnings management proxied by the correlation between loan loss provision and earnings before tax and provision has increased after IFRS 9 adoption. An analysis was also conducted to identify whether the lawyers' ratio moderates the relationship between IFRS 9 adoption and earnings management. The results indicate that earnings management has increased after adopting IFRS 9, which aligns with previous studies. The results showed that the lawyer's number negatively moderates the relationship between IFRS 9 adoption and earnings management. Findings from this study indicate that lawyers are more critical in constraining earnings management in the IFRS 9 era. We believe the current study extends the existing knowledge by comprehending the effects of IFRS 9 on earnings management in a developing country's legal context. It provides insights into the dynamics of interplay between IFRS 9, earnings management, and legal systems.

Keywords: Earnings management, IFRS 9 adoption, lawyer, China.

INTRODUCTION

Since the 2008 global financial crisis, the International Accounting Standard 39, Financial Instruments: Recognition and Measurement (IAS 39) has faced significant criticism. Scholars and practitioners believe that the impairment loss model under IAS 39 delays the recognition of provisions for financial instruments, thereby contributing to the severity of the financial crisis (Gornjak 2020; Kund & Rugilo 2021; Malovaná & Tesařová 2022). The deficiencies of IAS 39 highlights the need for new accounting standards to better align with the evolving economic environment (Al-Hanandeh et al. 2020). In 2014, the International Accounting Standard Board (IASB) launched the International Financial Reporting Standard 9 – Financial Instruments (IFRS 9) (Gomaa et al. 2019), aiming to address the shortcomings of IAS 39. IFRS 9 became effective for annual reporting periods beginning on or after January 1, 2018 (Kyiu & Tawiah 2023).

IFRS 9 introduced the expected credit loss (ECL) model, which replaced the incurred loss model (ICL) under IAS 39. The key difference between the two models is on future information whether it should be considered when the provisions are recognised. Under the ICL, the loan loss provisions (LLP) can only be recognised when clear evidence shows that a credit loss has happened (Novotny-Farkas, 2016). The recognition of provisions in advance is prohibited (Gornjak 2023). Instead, the ECL model allows financial institutions to estimate future credit loss and recognise it in the current period (Volarevi & Varović 2018). This forward-looking approach introduced by IFRS 9 was designed to ensure that the LLP is recognised as early as possible and to assist in improving provisioning capabilities that reflect changes in credit risk (Kim et al. 2021).

In addition to compensating for the deficiencies of IAS 39, the ECL model also introduces a high degree of subjectivity and professional judgements that may facilitate earnings management (Jin et al. 2018). For example, the management determines the related criteria to a significant increase in credit risk, as well as the model used to calculate the credit loss, which can directly affect the timing and amount of the provisions. This flexibility can be a double-sided sword (Lilien et al. 2020). It can facilitate the improvement of accounting quality by providing accounting information that matches the specific situation of the individual company (Lilien et al. 2020). Nevertheless, it can also be utilised to explore the private benefits, such as managing earnings to meet stakeholder targets (Lilien et al. 2020).

Prior studies have indicated that there is an increase in earnings management after implementing IFRS 9 due to the high flexibility (Nnadi et al. 2023; Norouzpour et al. 2023). Nevertheless, those studies are mainly focused on European countries where accounting standards are guidelines followed by companies and has no legal effective[1]. Different from European countries, accounting standards are a kind of law in China. Whether the legalised influence of IFRS 9 affects earnings management or vice versa is still unknown. Additionally, the lawyer

is an important component of the legal system since they pose legal expertise and help the regulators and investors by offering expert advice on interpreting and applying laws (Kamarudin et al. 2020). What is the role of lawyers in the relationship between IFRS 9 adoption and earnings management are also unknown. Addressing these gaps contributes to understanding how legalised IFRS 9 influences earnings management among the Chinese local banks. Additionally, exploring the role of lawyers as intermediaries reveal their influence in either curbing or facilitating earnings management. This may enhance the understanding of the interaction between IFRS 9 and earnings management in diverse regional legal settings in China.

Institutional Theory suggests that organisations are influenced by the rules, norms, and regulatory frameworks. These institutional factors can shape the organisations' behaviours, such as financial reporting practices. In European countries, accounting standards are seen as guidelines rather than legally binding, whereby firms there may engage in earnings management differently compared to China, where these standards are embedded in law. The role of legalised accounting standards in China creates a distinct institutional environment. Understanding how Chinese accounting standard influence corporate behaviour requires examining the specific legal and regulatory pressures such as the pressure from lawyers since they may act as institutional agents. Thus, institutional theory helps in address the gap by considering how the legal status of accounting standards and lawyers influences earnings management practices.

Chinese accounting standards have converged to IFRS since 2006 (Hao et al. 2019). In China, accounting standards are a law with legal enforceability (Li & Bao 2023), making the legal environment to be more linked to enforcing IFRS. Firms and managers face heightened legal risk when accounting practices deviate from accounting standards. Earnings management typically involves creative accounting techniques, which may question the true and fair view of the firm's financial performance and mislead investors (Menicucci 2020). Although sometimes earnings management is unavoidable due to the flexibility of the accounting standards, it can be considered illegal behaviour, as the true and fair view remains the supreme target of the accounting standards (Kirk 2006). This is especially true in the Chinese legal framework, where accounting standards are legally binding (Li & Shi 2023).

When earnings management happens and the auditors fail to detect it, the investor can report the case to the regulatory supervisors or sue the auditor and the company (Xu et al. 2022). As of August 31, 2024, three Chinese big auditors (i.e., Ruihua, Lixin, & Zhonghui) and 11 listed companies were reported to the regulatory supervisor or sued due to extreme earnings management activities. Investors probably need to hire lawyers during the process of reporting the case to the regulatory supervisors or during the litigation process because of the complex procedure that requires legal expertise. For example, evidence collection is essential whether reporting to regulatory supervision or pursuing litigation. Without legal assistance, investors may struggle to provide appropriate evidence and defend their rights (Zhu 2023). Additionally, lawyers are experts in utilising the legal aspects to ensure their clients could win the lawsuit. This situation will encourage investors to sue the auditors and banks, leading to more litigation pressure to the auditors and banks. The increased litigation pressure in turn helps to constrain the earnings management activities. Therefore, lawyers may have a crucial role in influencing earnings management activities[2].

The central objective of the current research is to investigate the impact of IFRS 9 adoption on earnings management. Additionally, the study investigates the impact of the lawyers' ratio on the relationship between IFRS 9 adoption and earnings management. This research explores legal expertise significantly in the formation of earnings management within the context of IFRS 9 implementation. Prior studies on earnings management typically exclude financial institutions as earnings management in the banking industry cannot be measured by the commonly used model, such as the Jones model (Shen & Huang 2013). Although the central banks strictly regulate the banks, earnings management can still exist due to the flexibility of the accounting standards. Since IFRS 9 significantly influences banks as they hold large amounts of financial instruments, this research only focuses on banks. Further, China has a large territory with numerous local banks (i.e., the banks that operate within a specific province). This allows the current research to investigate the impact of the provincial legal environment on the relationship between IFRS 9 adoption and earnings management. Thus, the sample of this research consists of 203 local commercial banks in China.

IFRS 9 became mandatory for these Chinese local banks on January 1, 2021. Thus, the research period is from 2019 to 2022, encompassing two years before and after the mandatory adoption of IFRS 9. The finding revealed that after the adoption of IFRS 9, earnings management increased. The lawyers' ratio also weakens the relationship between IFRS 9 adoption and earnings management.

This research contributes to the existing literature in several ways. First, it extends the existing research landscape by investigating the impact of IFRS 9 adoption on earnings management in the banking industry, specifically within the intricate dynamics of an Asian developing country, i.e., China. This geographical expansion adds a dimension to our understanding of the effect of IFRS 9. Second, it provides insights into how the transition to IFRS 9 impacts earnings management practices in a region characterised by a civil law system and the high influence of lawyers. Third, the focus on a transitional institutional setting enhances the relevance and applicability of the findings. It offers a nuanced perspective on the challenges and opportunities associated with

implementing IFRS 9 in contexts where institutional frameworks are evolving. This setting broadens the research scope and enriches the scholarly discourse surrounding the global adoption of IFRS 9, which adds value to understanding its implications. Fourth, this research contributes to our understanding of the lawyers' role by examining the influence of the lawyers' ratio on the interplay between IFRS 9 and earnings management. This provides novel insights into the intricate mechanisms shaping financial practices within the distinctive contours of the Chinese legal environment.

The remainder of this research is as follows. The second section elaborates on the literature review. The third section develops the hypothesis for the study. The fourth section proposes the research design, followed by the fifth, which presents the empirical results. The sixth section concludes the study.

LITERATURE REVIEW

IFRS 9 AND EARNINGS MANAGEMENT'S ACTIVITY

Since the mandatory of IFRS 9, some empirical studies have been conducted to investigate the relationship between IFRS 9 adoption and earnings management. The results generally indicated that earnings management has increased along with the implementation of the new standard (Guo et al. 2019). Researchers argued that when the impairment loss model shifted from the incurred loss model to the expected credit loss model, the discretion involved increased significantly, leaving room for opportunism activities (Novotny-Farkas 2016). For example, Nnadi et al. (2023) investigated the impact of IFRS 9 on the earnings management activities among European banks. Their results indicated that the non-listed banks are more likely to conduct earnings management activities after the new standard's mandatory. They also suggested that audit quality cannot constrain these opportunistic behaviours of banks; merely adopting a set of high-quality accounting standards cannot secure the improvement of the accounting quality.

Some other studies analysed reasons for the IFRS 9 to increase earnings management. They argued that the reason mainly lies in the IFRS 9's high flexibility, embodied by several aspects (Ertan et al. 2019). The first one is the discretion in the judgement of significant credit risk increases in the financial instruments (Gornjak 2020; Chen et al. 2022). Second, flexibility is also embodied by the reversible financial assets between different stages (Deloitte 2016). Third, selecting an appropriate model for estimating expected credit losses (ECL) under IFRS 9 also involves a significant degree of discretion (IASB 2014).

The studies mentioned above generally indicated that adopting IFRS 9 has facilitated earnings management activities. However, they mainly focused on European countries. Studies seldom examine the relationship between IFRS 9 adoption and earnings management outside Europe. In addition, the institutional settings, which always influence the consequences of IFRS adoption, vary in different countries. The impact of IFRS 9 on earnings management and the factors influencing their relationship in non-euro countries were limited. Hence, it signals the need for a study to understand the relationship between IFRS 9 and earnings management in diverse institutional settings.

LEGAL ENVIRONMENT AND EARNINGS MANAGEMENT

Prior studies have underscored the importance of the legal environment in constraining earnings management. It can deter opportunistic behaviour by insiders, reduce earnings management, and promote transparency in financial reporting. Ultimately, it will benefit outside investors and stakeholders (Hung 2001; Leuz et al. 2003). Some researchers moved forward and shed light on more specific legal factors that affect earnings management activities. For example, Norouzpour et al. (2023) argue that regulatory supervision depends on government enforcement and is an important factor influencing earnings management. The penalties from the regulatory supervisor discourage and deter the management's motivation to manage earnings. Nevertheless, the existing literature omitted lawyers representing private enforcement.

As a critical component of the legal system, lawyers represent individuals, businesses, and other entities in various legal matters. They advocate for their clients' interests and rights in legal proceedings, such as negotiations, trials, and settlements. Some researchers define earnings management (EM) as illegal because EM distorts the accounting information and misleads investors (Septiari & Maruli 2017). However, it is legal for others as it does not violate the legal framework (Capalbo et al. 2018). Under the Chinese legal system, most researchers agree that earnings management is illegal. The reason is that the Chinese accounting standards, which converged to IFRS in 2006, are established through law and have legal enforceability (Hao et al. 2019; Li & Bao 2023). Since an accurate and fair view of financial reporting is the supreme target of IFRS, EM can be defined as illegal activities (Ning 2005; Kirk 2006).

Lawyers influence earnings management activities mainly through putting higher litigation risk on the auditors and companies. Legal provisions hold auditors liable for negligence or malpractice. Auditors may face legal consequences, including fines, suspension, or revocation of licences if they fail to detect or report the

wrongdoings committed by companies. They can be sued for failing to uncover inappropriate activities such as earnings management or fraudulent activities. When an auditor is negligent or commits malpractice and the interests of investors are infringed, lawyers can help investors pursue legal remedies, including seeking compensation, damages, or rescission of investments (Kamarudin et al. 2020). The potential for legal consequences increases auditors' accountability, encouraging them to perform more thorough and unbiased audits to avoid litigation (Choi et al. 2018). This pressure from lawyers plays a role in ensuring that auditors conduct their work with greater rigour and thereby reduce earnings management activities (Yung & Root 2019). Meanwhile, when auditors are sued, the companies that are audited by the sued auditors will probably be sued. Thus, the pressure from lawyers may also help to constrain the motivation of banks' management to conduct earnings management activities.

In summary, adopting IFRS 9 introduces a heightened level of flexibility, which offers management increased discretion. This flexibility, however, presents a double edge. On one hand, it allows companies to convey information that accurately mirrors their unique financial conditions. Conversely, this latitude can also be exploited for earnings management. The ultimate impact of this flexibility, whether positive or negative, appears to be closely tied to the adequacy of legal support indicated by the number of lawyers involved. The effectiveness of IFRS 9 in generating positive outcomes hinges significantly on how legal services can mitigate the risks associated with the potential misuse of this newfound discretion.

HYPOTHESIS DEVELOPMENT

Agency Theory states that managerial discretion is often closely associated with earnings management activities (Frykström & Li 2018). The introduction of flexible accounting standards introduces an element of ambiguity and amplifies opportunities for opportunistic actions (Ismail et al. 2013). Earnings management materialises when managers exercise their judgement in financial reporting and transaction structuring. This discretion enables them to manipulate financial statements, either mislead certain shareholders about the genuine economic performance or influence contractual outcomes reliant on reported accounting figures (Healy & Wahlen 1999). The latitude granted to managers when preparing financial reports creates the conditions for earnings management. Therefore, any alterations in the extent of managerial discretion permitted by accounting standards can influence the degree of earnings management (Ismail et al. 2013).

IFRS 9 gives banks more discretion in estimating and recognising credit losses on financial assets, creating opportunities for earnings management (Jackson 2018). On the one hand, banks have discretion in determining what constitutes a significant increase in credit risk and the point at which credit risk increases to a level that triggers the recognition of lifetime ECLs. Managers may attempt to manage earnings by manipulating the significant increase in credit risk to recognise expected credit losses on financial assets earlier or later than they should. For example, management can delay the transfer of financial assets to a higher credit risk stage and postpone the credit loss. In this way, the provisions will be less, and the earnings will be increased (Gomaa et al. 2019). Conversely, management can also accelerate the transfer of financial assets to a higher credit risk stage to create reserves. Management may attempt to transfer the financial assets to a higher credit risk stage to recognise ECLs earlier than necessary, and this can reduce reported earnings and reverse the surplus reserves on rainy days (Gomaa et al. 2019).

On the other hand, management can also apply discretion in selecting models for estimating credit losses to manage earnings. However, these models can lead to different values of credit losses. Therefore, banks may use this discretion to select a model that produces a more favourable estimate of credit losses. For instance, management may attempt to select inappropriate models that result in lower ECL estimates. They may use overly optimistic assumptions or models that cannot adequately capture the risks of certain financial assets, thus boosting reported earnings (Nnadi et al. 2023).

Further, even when appropriate models are used, management may be biased and favour the inputs of the models. They may use optimistic assumptions about the likelihood of default or recovery rates or adjust historical data to make it more favourable so that the ECL estimates can be manipulated (Nnadi et al. 2023). Moreover, management can adjust the models themselves. They may attempt to adjust the models themselves and change the parameters of the models or adjust the weightings given to different inputs, then manipulate ECL estimates (Nnadi et al. 2023). Based on the Agency Theory and prior studies, that the following hypothesis is generated:

H_1 The adoption of IFRS 9 increases earnings management

Institutional Theory suggests that institutional factors shape an organisation's behaviour (Scott 2015). Accounting standards are an important institutional factor that determines the accounting practices of organisations. In China, accounting standards are a kind of law that is highly linked to lawyers. Lawyers, as skilled advocates, certainly excel in presenting their clients' cases. They adeptly argue legal points, present evidence, and conduct effective cross-examination of witnesses to fortify their clients' positions.

Auditors are crucial for detecting earnings management activities as they are responsible for ensuring the accuracy and integrity of a company's financial statements (Choi et al. 2018). Lawyers representing investors often bring legal actions or pursue investigations when auditors fail to identify material misstatements or fraudulent practices. The threat of potential legal consequences heightens auditors' accountability, pushing them to carry out more thorough and impartial audits to minimise the risk of litigation. This legal pressure ensures that auditors approach their tasks with increased diligence and reduce earnings management activities. When lawyers effectively defend the interests of investors, it often results in punitive measures against the wrongdoers. This punitive action sends a clear message to the auditors and potential earnings management cases, discouraging earnings management activities (Motz et al. 2020).

Lawyers play more critical roles in the IFRS 9 era than in the IAS 39 era. Under IAS 39, banks will recognise the loan loss provisions (LLP) when the loss occurs. Under such rules, whether the loss has occurred is a fact. It does not involve estimating the future conditions. The flexibility and the uncertainty of the provisions are relatively low. However, the estimation of provisions under IFRS 9 involves future conditions with a lot of professional judgements, such as assessing the significant increase in credit risk during the ECL calculation process and others (Nnadi et al. 2023). Hence, managers will use this subjectivity to manipulate earnings. As the solid legal system can restrict earnings management, the legal system's role in the IFRS 9 era is more profound than that in the IAS 39 era. When the legal system is strong enough to constrain earnings management, the flexibility of IFRS 9 may not necessarily increase earnings management and vice versa.

In summary, the adoption of IFRS 9 can have an impact on earnings management by allowing for greater discretion in financial reporting. However, the presence of lawyers may limit earnings management by enhancing the auditors' accountability and increasing the firm's litigation risk. When more lawyers are available, individuals, businesses, and organisations have better access to professional legal expertise. The increased availability of legal knowledge may increase the litigation risk faced by the auditors as lawyers representing investors may pursue auditors for failing to detect or report financial irregularities (Kamarudin et al. 2020). As more lawyers are available to build and support such cases, auditors face a higher risk of being sued for negligence or misconduct if their audits fail to detect earnings management in a company's financial reports. The increased litigation risk may have the potential to force auditors to conduct more rigorous audit approaches and reduce earnings management activities. Thus, the lawyer's ratio may moderate the relationship between IFRS 9 adoption and earnings management. Based on the Institutional Theory and prior studies, we predict that:

H_2 The lawyers' ratio moderates the relationship between IFRS 9 adoption and earnings management.

RESEARCH METHODOLOGY

SAMPLE SELECTION

The sample for this study is banks that operate in Chinese provinces, as they hold many financial instruments and are more affected by IFRS 9. There are two types of banks in China, which the first category is nationwide operation banks permitted to operate throughout the country and the second is local banks that only operate within their province or city. These banks mainly include the city commercial banks and the rural commercial banks. Due to the small population of the nationwide operation banks (18), the statistical methodology can hardly be used for them (Mundfrom et al. 2005). Therefore, the sample for this study is limited to local banks. The current study categorises the local banks into three according to their listed status, namely banks listed both in China and abroad, banks only listed in China, and non-listed banks.

PERIOD OF STUDY

This study covers four years of observation starting from 2019, which is to be consistent with the adoption of IAS 39 and IFRS 9. Chinese accounting standard has converged to IFRS (or IAS) since 2006 (Hao et al. 2019). Before IFRS 9 was launched, the Chinese accounting standard for financial instruments followed IAS 39 (Hao et al. 2019). In 2014, IFRS 9 was launched by IASB. China amended the accounting standard for financial instruments correspondingly for the purpose of IFRS convergence. The Chinese Accounting Standards (CAS) 22 - Financial Instruments Recognition and Measurement, CAS 23 - Transfer of Financial Assets, and CAS 24 - Hedge Accounting are purely moulded based on corresponding IFRS 9 (Chen et al. 2022). These new standards have taken effect in the financial reporting of banks listed in China and abroad since January 1, 2018. The new standard took effect on January 1, 2019, for banks only listed in China. The new standard became mandatory for unlisted banks on January 1, 2021. As most local banks are unlisted, the new standard became mandatory on January 1, 2021. Then, the research period will be from 2019 to 2022, i.e., two years before and two years after the mandatory IFRS 9. The period from 2019 to 2020 represents the IAS 39 period, and the period from 2021 to 2022 represents the IFRS 9 period.

DATA COLLECTION

We collected lawyers' data from the statistical yearbooks by province. When collecting banks' data from the WIND database, we excluded banks with missing data from our sample. Meanwhile, listed banks were also excluded as they adopted the IFRS 9 earlier than the non-listed banks. Hence, we obtained final data from 203 banks and 812 firm-year observations.

DATA ANALYSIS

The data analysis involves three steps. The first step is to investigate whether banks manage earnings through LLP. In the banking industry, manipulating the LLP is a popular way to manage earnings (Alhadab & Al-Own 2019). LLP is the most significant bank accrual (Kothari et al. 1999). Its change can directly lead to a change in earnings. Following Nnadi et al. (2023), this study measures earnings management by the relationship between LLP and earnings before tax and provision (EBTP). EBTP involves two parts, namely earnings before tax (EBT) and LLP. In other words, EBTP=EBT+LLP. If banks intend to manage earnings and make it more stable, they typically recognise less LLP to inflate EBT when the EBT is low and vice versa. Thus, from the statistics perspective, when earnings management exists, the EBT will be stable, and the EBTP will show a high correlation with LLP. This is a popular way that was used by prior studies (e.g., Nnadi et al. 2023; Beatty & Liao 2014) to examine earnings management in the banking industry. Therefore, the correlation between LLP and EBTP can be a proxy of earnings management in which the higher the LLP and EBTP correlation coefficient, the higher the earnings management. This research also introduced the lagged items, which are LLPit-1 and LLPit-2 (Beatty & Liao 2014; Bikker & Hu 2002; Olszak et al. 2017, 2018). Equation 1 shows the basic model.

$$LLP_{it} = \beta_0 + \beta_1 EBTP_{it} + \beta_2 GDP_{it} + \beta_3 LLP_{it-1} + \beta_4 LLP_{it-2} + \beta_5 NPL_{it} + \beta_6 SIZE_{it} + \beta_7 LOAN_{it} \quad (1)$$
$$+ \beta_8 LLA_{it} + u + v + \varepsilon_{it}$$

In this model, LLPit is the dependent variable, and EBTPit is the independent variable. Others are control variables that aim to ensure the validity and reliability of the results. Table 1 defines these variables.

TABLE 1. Definitions of variables

Variables	Definition
LLP	Loan loss provision rate, which equals the loan loss provision divided by the total asset
EBTP	The ratio of earnings before tax and LLP to the total asset
GDP	Real gross domestic product growth rate at the province level
LLP (-1)	Loan loss provision rate of the prior year
LLP (-2)	Loan loss provision rate of the year before the prior year
NPL	Nonperforming loan rate at the beginning of the year, which equals the nonperforming loan divided by the total loan
SIZE	The size of the bank, which is proxied by the logarithm of the total assets
LOAN	Loan growth rate
LLA	The ratio of the loan loss allowance at the beginning of the year, which equals the loan loss allowance divided by the total loan
e	Error term

The second step is to test the impact of IFRS 9 adoption on earnings management. To this end, we introduce a dummy variable, IFRS 9, to represent the adoption of IFRS 9. The analysis was performed based on Model 2.

$$LLP_{it} = \omega_0 + \omega_1 EBTP_{it} \times IFRS9 + \omega_2 EBTP_{it} + \omega_3 IFRS9 + \omega_4 GDP_{it} + \omega_5 LLP_{it-1} \quad (2)$$
$$+ \omega_6 LLP_{it-2} + \omega_7 NPL_{it} + \omega_8 SIZE_{it} + \omega_9 LOAN_{it} + \omega_{10} LLA_{it} + \varepsilon_{it}$$

In this model, LLPit is the loan loss provision rate, and EBTPit is the earnings before tax and provisions. GDPit is the current year's GDP growth. LLPit-1 and LLPit-2 are the lagged items, representing last year's LLP and the year before last year's LLP, respectively. NPLit represents the non performing loan ratio. SIZEit is the bank's total asset. LOANit is the loan growth rate. LLAit is the loan loss allowance. IFRS 9 is a dummy variable, which equals 1 in the IFRS 9 period and 0 in the IAS 39 period.

The third step is to test the impact of the lawyers' ratio on the relationship between IFRS 9 adoption and earnings management. In this step, we introduce a variable (LR), representing the ratio of lawyers' number to the population at the province level. More lawyers means more availability of legal expertise and more sufficient legal services, which may increase the litigation risk faced by the auditors since lawyers may pursue auditors for failing to detect or report financial irregularities. The analysis was performed based on Model 3.

$$LLP_{it} = \varphi_0 + \varphi_1 EBTP_{it} \times IFRS9 \times LR_{it} + \varphi_2 EBTP_{it} \times IFRS9 + \varphi_3 EBTP_{it} \times LR_{it} \hspace{2em} (3)$$
$$+ \varphi_4 LR_{it} \times IFRS9 + \varphi_5 EBTP_{it} + \varphi_6 IFRS9 + \varphi_7 LR_{it} + \varphi_8 GDP_{it}$$
$$+ \varphi_9 LLP_{it-1} + \varphi_{10} LLP_{it-2} + \varphi_{11} NPL_{it} + \varphi_{12} SIZE_{it} + \varphi_{13} LOAN_{it}$$
$$+ \varphi_{14} LLA_{it} + \varepsilon_{it}$$

Apart from the LR variable, the definitions of other variables in this model are the same as in Equation 2.

EMPIRICAL RESULTS

DESCRIPTIVE ANALYSIS

Table 2 presents the statistical analysis of the study. The dataset reveals variability across various financial and economic variables, highlighting diverse practices and conditions among the banks. The following paragraphs discuss the descriptive statistics in detail.

Variable	Obs	Mean	Std. Dev.	Min	Max
LLP	812	0.700	0.359	0.001	3.661
EBTP	812	1.561	0.507	0.085	3.953
IFRS 9	812	0.500	0.500	0.000	1.000
LR	812	3.944	1.514	1.610	21.443
LLP (-1)	812	0.768	0.385	0.001	2.623
LLP (-2)	812	0.795	0.420	0.001	3.138
LLA	812	4.267	1.463	1.416	11.017
SIZE	812	10.774	0.501	9.69	12.049
GDP	812	5.487	2.355	0.200	12.85
NPL	812	1.948	1.156	0.360	11.101
LOAN	812	16.538	7.790	0.412	65.984

Note: LLP represents loan loss provision, measured by the ratio of loan loss provision to the total asset. EBTP represents earnings before tax and provision, measured by the ratio of earnings management before tax and provision to the total assets. IFRS 9 is a dummy variable, which equals 1 if period is after IFRS 9 adoption and 0 otherwise. LR represents the lawyer ratio, measured by the ratio of lawyers to the population at the province level. LLP (-1) and LLP (-2) are lagged items. LLA represents loan loss allowance, measured by the ratio of loan loss allowance to the total loan. SIZE represents the size of the banks, measured by the logrithem of the bank's total assets. GDP is the real GDP growth rate. NPL represents the nonperforming loan, measured by the ratio of nonperforming loan to the total loan. LOAN represents the loan growth rate.

The mean of LLP is 0.700, with a moderate standard deviation of 0.359, ranging from 0.001 to 3.661, indicating diverse loan loss reserves (Pastiranova & Witzany 2022). The average EBTP is 1.561, with a standard deviation of 0.507, showing variability in pre-tax earnings (Olszak et al. 2017). About 50% of observations comply with IFRS 9, reflecting its binary nature (Pastiranova & Witzany 2022). The lawyer ratio averaged at 3.944 but showed high variability (standard deviation of 1.514) with a wide range from 1.610 to 21.443, pointing to notable regional disparities (Halegua, 2016). The lagged LLP figures show minor fluctuations over time, with slight increases and variations in mean and standard deviation (Pastiranova & Witzany 2022). Loan loss allowance has a mean of 4.267, reflecting diverse provisioning strategies (Laeven & Majnoni 2003). Firm size shows modest variation with a mean of 10.774 and standard deviation of 0.501 (Beatty & Liao 2014). The GDP growth rate, with a mean of 5.487 and standard deviation of 2.355, highlights diverse economic conditions (Pastiranova & Witzany 2022). NPL average at 1.948, showing significant variability across firms (Breed et al. 2023), while the mean loan growth rate of 16.538, with a standard deviation of 7.792, illustrates the wide range of loan expansion strategies (Bikker & Metzemakers 2005).

PEARSON CORRELATION

Table 3 presents the Pearson correlation analysis for this study.

TABLE 3. Pearson correlation

	LLP	EBTP	LR	GDP	LLP (-1)	LLP (-2)	IFRS 9	LOAN	LLA	NPL	SIZE
LLP	1										
EBTP	0.522***	1									
	0										
LR	-0.261***	-0.044	1								
	0	0.209									
GDP	0.051	0.139***	-0.187***	1							
	0.145	0.000	0								
LLP (-1)	0.676***	0.449***	-0.209***	0.161***	1						
	0	0	0	0							
LLP (-2)	0.453***	0.346***	-0.117***	0.0120	0.698***	1					
	0	0	0.001	0.740	0						
IFRS 9	-0.135***	-0.248***	0.179***	0.172***	-0.140***	-0.112***	1				
	0.000	0	0	0	0.000	0.001					

LOAN	-0.050	0.013	0.0570	0.0110	-0.020	0.003	-0.159***	1			
	0.156	0.704	0.105	0.752	0.577	0.942	0				
LLA	0.083**	0.285***	0.0390	0.106***	0.363***	0.477***	-0.127***	0.002	1		
	0.017	0	0.270	0.002	0	0	0.000	0.955			
NPL	0.188***	-0.217***	-0.406***	0.075**	0.252***	0.190***	-0.067*	-0.247***	0.225***	1	
	0	0	0	0.032	0	0	0.056	0	0		
SIZE	-0.041	-0.245***	0.172***	-0.105***	-0.177***	-0.313***	0.103***	0.110***	-0.508***	-0.215***	1
	0.244	0	0	0.003	0	0	0.003	0.002	0	0	

Note: LLP represents loan loss provision, measured by the ratio of loan loss provision to the total asset. EBTP represents earnings before tax and provision, measured by the ratio of earnings management before tax and provision to the total assets. IFRS 9 is a dummy variable, which equals 1 if the period is after IFRS 9 adoption and 0 otherwise. LR represents the lawyer ratio, measured by the ratio of lawyers to the population at the province level. LLP (-1) and LLP (-2) are lagged items. LLA represents loan loss allowance, measured by the ratio of loan loss allowance to the total loan. SIZE represents the size of the banks, measured by the logarithm of the bank's total assets. GDP is the real GDP growth rate. NPL represents the nonperforming loan, measured by the ratio of nonperforming loan to the total loan. LOAN represents the loan growth rate.

t statistics in parentheses

* $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

REGRESSION ANALYSIS

Table 3 presents the findings of the regression analyses for the study. The Column 1, row 1 presents the earnings management that exists, which is the prerequisite of the research. The coefficient of EBTP is positive (0.574) and statistically significant at the 1% level. This finding suggests that for every 1 percentage increase in EBTP, LLP is expected to increase by 0.574, indicating a strong positive correlation between LLP and EBTP (Nnadi et al. 2023). When the EBTP is high, the LLP increases. When the EBTP is low, the LLP tends to be correspondingly low. This outcome implies that earnings management exists and banks utilise LLP as a mechanism to manage earnings (Nnadi et al. 2023). These results are in line with the prior study that was conducted by Nnadi et al. (2023).

TABLE 4. Regression results

	(1) LLP	(2) LLP	(3) LLP
EBTP	0.574***	0.567***	0.336***
	(15.34)	(15.04)	(3.72)
IFRS9*EBTP		0.047*	0.238**
		(1.66)	(2.46)
LR*IFRS9*EBTP			-0.051**
			(-2.28)
LR*EBTP			0.067***
			(2.78)
IFRS9*LR			0.061**
			(2.07)
LR			-0.117**
			(-2.52)
IFRS9		0.267***	0.050
		(4.31)	(0.39)
GDP	0.009	0.011	0.010
	(1.04)	(1.21)	(1.10)
LOAN	-0.003**	-0.003**	-0.002**
	(-2.12)	(-2.11)	(-2.02)
LLA	-0.063***	-0.063***	-0.066***
	(-5.45)	(-5.44)	(-5.71)
NPL	0.119***	0.116***	0.116***
	(8.75)	(8.49)	(8.54)
SIZE	-0.704***	-0.748***	-0.618***
	(-3.04)	(-3.22)	(-2.63)
LLP (-1)	0.199***	0.195***	0.177***
	(6.26)	(6.14)	(5.53)
LLP (-2)	-0.049*	-0.048*	-0.050*
	(-1.70)	(-1.68)	(-1.77)
_cons	7.312***	7.761***	6.691***
	(2.92)	(3.09)	(2.63)
N	812.000	812.000	812.000
r2_a	0.752	0.753	0.757
F	51.281	46.021	33.564
Bank	Yes	Yes	Yes
Year	Yes	Yes	Yes

Note: LLP represents loan loss provision, measured by the ratio of loan loss provision to the total asset. EBTP represents earnings before tax and provision, measured by the ratio of earnings management before tax and provision to the total assets. IFRS 9 is a dummy variable, which equals 1 if the period is after IFRS 9 adoption and 0 otherwise. LR represents the lawyer ratio, measured by the ratio of lawyers to the population at the province level. LLP (-1) and LLP (-2) are lagged items. LLA represents loan loss allowance, measured by the ratio of loan loss allowance to the total loan. SIZE represents the size of the banks, measured by the logarithm of the bank's total assets. GDP is the real GDP growth rate. NPL represents the nonperforming loan, measured by the ratio of nonperforming loan to the total loan. LOAN represents the loan growth rate.

t statistics in parentheses

* $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

Column 2, row 2 presents findings for H_1. The coefficient of IFRS9*EBTP is calculated as 0.047, showing a positive and statistically significant relationship at the 10% level. This indicates that IFRS 9 contributes an additional 0.047 basic points to the relationship between LLP and EBTP. IFRS 9 strengthens the positive

association between LLP and EBTP, increasing earnings management activities. This finding supports our Hypothesis 1, which posits that adopting IFRS 9 exacerbates earnings management.

Finally, Column 3 presents findings for H$_2$. In Column 3, the coefficient of LR*IFRS9*EBTP is -0.051, signifying a negative and significant relationship at the 5% level. This result reveals that LR contributes -0.051 basic points to the relationship between LLP and IFRS9*EBTP. LR weakens the positive relationship between IFRS 9 adoption and earnings management, supporting Hypothesis 2, which suggests that the lawyer ratio negatively moderates the relationship between IFRS 9 adoption and earnings management activities.

ROBUSTNESS TEST

Section 6 presents some findings on the robustness of our analyses. First, following Olszak et al. (2017), we dropped the two lagged items, i.e., the LLP (-1) and LLP (-2). Second, we replaced LLP (the ratio of the LLP to the total asset) with LLPR (which means the loan loss provision rate equals the rate of LLP to the total loan). Table 4 presents the results of the robustness analyses. The analysis reveals that the results do not significantly change, indicating our findings' robustness.

TABLE 5. Robustness test

	(1) LLP	(2) LLP	(3) LLP	(4) LLPR	(5) LLPR	(6) LLPR
EBTP	0.607***	0.597***	0.315***	0.938***	0.919***	0.443***
	(15.91)	(15.54)	(3.41)	(15.09)	(14.71)	(2.93)
IFRS9*EBTP		0.060**	0.309***		0.107**	0.350**
		(2.02)	(3.16)		(2.24)	(2.19)
LR*IFRS9*EBTP			-0.067***			-0.071*
			(-2.93)			(-1.90)
LR*EBTP			0.081***			0.138***
			(3.29)			(3.42)
IFRS9*LR			0.078***			0.106**
			(2.62)			(2.17)
LR			-0.130***			-0.225***
			(-2.73)			(-2.89)
IFRS9		0.219***	-0.072		0.016	-0.348
		(3.46)	(-0.55)		(0.15)	(-1.63)
GDP	0.006	0.009	0.009	-0.003	0.001	0.000
	(0.69)	(0.91)	(0.93)	(-0.17)	(0.07)	(0.03)
LOAN	-0.003**	-0.003**	-0.003**	-0.007***	-0.007***	-0.006***
	(-2.40)	(-2.38)	(-2.25)	(-3.26)	(-3.25)	(-3.17)
LLA	-0.050***	-0.050***	-0.057***	-0.056***	-0.057***	-0.063***
	(-4.47)	(-4.49)	(-5.09)	(-3.10)	(-3.12)	(-3.41)
NPL	0.136***	0.132***	0.130***	0.163***	0.156***	0.153***
	(9.87)	(9.51)	(9.48)	(7.27)	(6.91)	(6.79)
SIZE	-0.646***	-0.702***	-0.538**	-0.293	-0.395	-0.242
	(-2.71)	(-2.93)	(-2.25)	(-0.75)	(-1.01)	(-0.62)
_cons	6.679***	7.256***	5.835**	2.967	4.008	2.998
	(2.59)	(2.80)	(2.24)	(0.71)	(0.95)	(0.70)
N	812.000	812.000	812.000	812.000	812.000	812.000
r2_a	0.737	0.738	0.746	0.751	0.752	0.756
F	58.197	50.726	35.190	47.100	41.362	28.056
Bank	Yes	Yes	Yes	Yes	Yes	Yes
Year	Yes	Yes	Yes	Yes	Yes	Yes

Note: LLP represents loan loss provision, measured by the ratio of loan loss provision to the total asset. LLPR represents the ratio of loan loss provision to the total loan. EBTP represents earnings before tax and provision, measured by the ratio of earnings management before tax and provision to the total assets. IFRS 9 is a dummy variable, which equals 1 if the period is after IFRS 9 adoption and 0 otherwise. LR represents the lawyer ratio, measured by the ratio of lawyers to the population at the province level. LLP (-1) and LLP (-2) are lagged items. LLA represents loan loss allowance, measured by the ratio of loan loss allowance to the total loan. SIZE represents the size of the banks, measured by the logarithm of the bank's total assets. GDP is the real GDP growth rate. NPL represents the nonperforming loan, measured by the ratio of nonperforming loan to the total loan. LOAN represents the loan growth rate.

t statistics in parentheses
* $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

CONCLUSION

The transition to the Expected Credit Loss (ECL) model under IFRS 9 represents a significant regulatory shift for banks. This change has sparked debates over its potential economic implications, driven partly by the broader managerial discretion allowed under IFRS 9 compared to its predecessor, IAS 39. Consequently, this research aims to address this discourse by offering empirical evidence of IFRS 9's economic impacts, mainly focusing on its influence on earnings management. The objective is to provide standard setters and policymakers with evidence of the consequences of adopting IFRS 9, thus enhancing the banking sector's future regulations.

This research investigated the impact of IFRS 9 adoption on the earnings management activities in China while considering the moderate role of the lawyers' ratio. Based on the panel data of 203 Chinese local banks from 2019 to 2022, the results revealed that adopting IFRS 9 has facilitated earnings management activities. This result aligns with prior studies, which indicated that earnings management increased after adopting IFRS 9 (e.g., Nnadi et al. 2023). Further, this research tested the impact of the lawyers' ratio. The result indicated that it negatively moderates the relationship between IFRS 9 adoption and earnings management. This means that lawyers played

a more critical role in constraining earnings management in the IFRS 9 era. The findings of this research provide extra evidence to the Institutional Theory, which suggests that accounting standards are not alone and constantly interact with other institutional factors.

This research contributes to the literature by providing evidence of the relationship between IFRS 9 and earnings management in China, an Asian developing country. This study reexamined the relationship between IFRS 9 adoption and earnings management activities in a different institutional setting (i.e. outside European countries). This replication is critical for verifying the reliability of prior studies' findings and ensuring their generalisability across different contexts. Our findings confirm and extend the original results, providing additional support for the negative role of IFRS 9 in earnings management and adding value to our understanding of the effect of IFRS 9 in an evolving context.

This research also contributes to the literature by revealing the impact of lawyers on the relationship between IFRS 9 adoption and earnings management. This research provides insights into the intricate mechanisms of how lawyers shape financial practices, emphasising the role of lawyers in constraining earnings management activities. Standard-setters and policymakers can leverage our findings to improve accounting standards and formulate corresponding policies and procedures capable of enhancing financial reporting practices, increasing lawyers, and constraining earnings management.

The conclusions of the empirical analysis are noteworthy. Nevertheless, there are several limitations that can be identified in this research: first, data availability and inadequacy. The financial data after the adoption might not be adequate because the implementation is effective on January 1 2021. Therefore, financial data are available for only two fiscal years (e.g. 2021 and 2022), which might have a short-term effect and cannot represent the long-term effect of IFRS 9 adoption. Future research may focus on the long-term effect of IFRS 9. Second, the sample in this research only involves local banks. This is due to the population of nationwide banks that is small and statistically adequate for the analysis. IFRS 9 may have different effects on different types of banks. Thus, future research may focus on the impact of IFRS 9 on diverse types of banks.

NOTES

1. Source: website of EUR-Lex. https://eur-lex.europa.eu/EN/legal-content/summary/international-accounting-standards-ias-regulation.html
2. Source: http://www.csrc.gov.cn/csrc/c101971/zfxxgk_zdgk.shtml

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