EARNINGS MANAGEMENT PRACTICES IN COMMERCIAL BANKS LISTED AT THE COLOMBO STOCK EXCHANGE: EVIDENCE FROM SRI LANKA

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Abstract

The purpose of this study is to examine whether commercial banks listed on Colombo stock exchange engage in Earnings Management (EM) practices. EM has become a major concern in the corporate world as plenty of avenues are available for managers to do so, despite the fact that accounting standards have stipulated with clear guidelines, rules and principles. Legitimacy theory provides a basis for corporate to appear as a legal person before stakeholders in order to carry out their operations smoothly. Therefore, shareholders, auditors, managers, accountants, and regulators are concerned whether financial statements have been manipulated. Previous studies find that managers engage in earnings management practices around the world by using different tools and techniques. Hence, this study attempts to investigate whether there are adequate factors that can be used by potential stakeholders to see whether banking companies listed on Colombo Stock Exchange engage in EM techniques. Several earnings management tests are carried out to test the extent to which managers engage in EM based on financial statements of ten banks for the years between 2010 to 2016. A conceptual framework comprising various motives and factors for managers to engage in EM practices developed based on literature review. Further, the study focuses on the awareness of managers, auditors and shareholders about EM practices. Study does not find strong evidence to conclude that commercial banks in Sri Lanka are engaging in EM practices. Major reason is found to be stringent compliance requirements to be complied by banks form local and international perspectives.

Key words: Earnings Management, Commercial Banks, Sri Lanka, Financial Reporting, Operating Assets.

Introduction

The process of EM is used by many corporations in the world, knowingly or unknowingly with the mere expectation of seeking higher profits. Unfortunately, few loopholes in the accounting standards have provided enough space for the use of EM practices and have committed many financial frauds in the commercial world. The term EM can be defined as 'the transformation of financial accounting figures from what they actually are to what

prepares desire by taking advantage of the existing rules and for ignoring some or all of them'.(Naser,1993) This is simply a way of manipulating real financial information to hide losses and sugarcoat the profits of the firm. The financial reporting process should be highly accurate and reliable as the financial statements are the mediums by which both internal and external stakeholders acquire information about the performance and financial condition of firms. Due to the variety of stakeholders of a corporation with diverse interests, preparation of financial statements is a highly demanding process, as the company needs to satisfy the requirements of all such stakeholders. Hence, with this conflicting situation, companies require to maintain a balance between the accounting processes according to the needs of the situation. Therefore, as a remedy, accountants practice EM techniques as a way of satisfying company goals. But manipulating accounts and betraying stakeholders is a great economic shock in the long term, as manipulated accounts will direct investors towards wrong decisions, via higher company profits with an increase in the share prices by creating an inflationary situation in the economy.

At present, the world has become much more commercialized and profit maximization has gained a considerable weight among the main business goals. As a mode of reaching this ultimate goal, most of the companies in the world have narrowed towards to manipulate their company accounts. Being manipulation of accounts has become a common practice in the current business world; Earnings Management has reached a considerable attraction in the accounting literature, especially for the last few decades.

Both the term Creative Accounting and Earnings Management is referring to the same practicing of manipulating accounting to influence the reported figures being remaining within the accounting rules and laws in order to satisfy the requirements of the management by sugarcoating the real picture of the firm in front of stakeholders. There is no globally accepted or legal definition of the term EM and therefore most of the authors have defined the term on their own perspectives. Anglo-Saxon is the first person, who wrote about creative accounting in his literature in 1970s. (Tassadaq & Malik, 2015, p.548). Thereafter, many scholars came up with their own definitions of the term. These scholars discussed the term EM based on the theories of agency theory, shareholders theory, legitimacy theory, information theory, resource dependency theory and positive accounting theory.

Researchers have identified many reasons for the firms to engage in EM. Satisfying the desires of shareholders regarding high profits, dividends may bring in problems of high taxes, demand for higher wages and bonus etc. In one hand, lower profit trend may have a negative image in the minds of the investors regarding investment choice. Therefore, this requires the accountants to maintain a balance between their financial performance and the needs of the stakeholder, therefore the companies resort to practice of EM. (Bora &Saha, 2016, p.236) More specifically, this study examines whether the commercial banks in a developing country like Sri Lanka also practice EM techniques to reach their desired goals. Fernando and Kelum (2011) have proved in their study on EM practices in Sri Lanka, that most of the quoted companies do apply income management practices when preparing and presenting financial

statements. But there is no any study has done previously to investigate whether the commercial banks in Sri Lanka even practice EM.

Most of the researchers have argued that income smoothing is one of the aspects the companies follow for EM. Rather than showing volatile profits with a series of dramatic rises and falls, the companies prefer to report a steady trend of growth in profits and in order to achieve this; the companies unnecessarily make high provisions for liabilities, or understating expenses and overstating assets. There are some reported cases like the case of Satyam Computers, where the companies have positioned fictitious expenses into the profit and loss account and siphoned off the funds. Bora and Saha (2016) and Fox (1997) reports on how accounting policies at Microsoft Corporation, USA are designed, within the normal accounting rules, to match reported earnings to profit forecasts. A large part of the profit is deferred to future years to cover potential up gradation and customer support costs when Microsoft sells software. Bora &Saha ,2016, p.736)Apart from income smoothing, the management of the company practice EM to maintain or boost share price both by reducing the apparent levels of borrowing and by creating the appearance of a good profit earning trend.

According to the conceptual framework of the study, the independent variables of pressure from managers, contractual obligations, necessity of managing taxes and share prices and to overcome political costs, act as motivating factors for the companies to follow Earnings Management through misleading accounting of data and misleading presentation of data.

Most of the researches have demonstrated that the pressure from the managers on their employees to achieve the company goals by any mean have direct influence on their practicing of EM. By adopting to the view of Fennell (1997) and Peterson (2003) defined ethical pressure as a situation in which the employees feel pressured by their peers, supervisors, and other members of the organization to compromise their personal values in order to achieve organization goals resulting in an ethical conflict for employee.(Tian& Peterson, 2016, p.10)

Based on Healy and Wahlen (1999) and Fong (2006) defined that the EM takes place when managers exercise judgment in financial reporting and in structuring transactions to adjust financial reports with an aim to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers.

According to Stangova and Vighova (2016) most of the companies in the world practice EM with the aim of managing taxes. Accordingly, the companies use EM techniques to reduce corporate income taxes by increasing the costs of the accounting entity by including the costs that are not foreseen by the Law on income tax and also the firms reduce their own tax liabilities for the value added tax through application of the deduction of VAT on purchases, which the Act on VAT does not allow. The study done by Desai and Dharmapala (2006) demonstrates tax avoidance as a highly attributing factor for EM.

According to Gosh (2010) EM may be employed in exchange for a variety of expected rewards among them being political gains. McBarnet (2005) further asserts that both complex fraud and complex manipulation through legal EM has been brought out into the open. He expresses that one of the reasons why EM is practiced is to carefully avoid taxes, therefore reducing political costs. Moreover the accounting information is designed more to meet other demands, including reduction in political costs and determination of income taxes and dividend payments. (Van &Vanstraelen, 2005)
The share prices of a company is an influential factor to attract more and more shareholder to the company as share prices is one of the indicators that indicate company performance. Therefore, most of the companies manipulate their real accounts to manage attractive share prices.

Insider trading is commonly practicing in the business world with the aim of making higher profits. Insider dealings refers to a situation where an insider or a related party trades based on price sensitive non- public information obtained during the performance of the assigned duties at the corporation, it also involves breach of trust and confidence or where the confidential information was misappropriated from the company. (Bewaji,2012)

The primary objective of the current study is to investigate the financial variables of a commercial bank that can be used to investigate whether banks are practicing EM. Moreover, the sub objectives of this study include;

- Investigating stakeholders'; managers, auditors and shareholders understanding and awareness of EM in the Commercial banks of Sri Lanka.
- Investigating whether there are adequate evidences to suspect whether commercial banks in Sri Lanka are using EM techniques.
- Identifying the factors influencing banks in Sri Lanka to practice EM techniques.

The study uses the following hypothesis to investigate whether the variables of pressure from managers, contractual obligations, tax management, share price management and political cost overcoming will affect for the commercial banks in Sri Lanka to practice EM techniques.

- H_0: Pressure from Managers has no effect on Earning Management practices of CSE listed banks in Sri Lanka

  H_1: Pressure from Managers has an effect on Earning Management practices of CSE listed banks in Sri Lanka
- H_0: Contractual Obligations has no effect on Earning Management practices of CSE listed banks in Sri Lanka

  H_1: Contractual Obligations has an effect on Earning Management practices of CSE listed banks in Sri Lanka
- H_0: Tax Management has no effect on Earning Management practices of the CSE listed banks in Sri Lanka

H_1: Tax Management has an effect on Earning Management practices of the CSE listed banks in Sri Lanka

- H_0: Share price Management has no effect on Earning Management practices of the CSE listed banks in Sri Lanka

  H_1: Share price Management has an effect on Earning Management practices of the CSE listed banks in Sri Lanka

- H_0: Political cost overcoming has no effect on Earning Management practices of the CSE listed banks in Sri Lanka

  H_1: Political cost overcoming has an effect on Earning Management practices of the CSE listed banks in Sri Lanka

Methodology

Mainly quantitative methodology was used in this study as it dealt with whether firms have engaged in EM practices that are associated with manipulation of numbers. Some aspects such as factors influenced for manipulation and behaviousrs of managers are involved in the study therefore, it is essential to use a mixed methodology; both quantitative and qualitative, which will increase the reliability and accuracy of the research output

Financial statements of 10 commercial banks listed in the CSE were carefully examined for the period between 2010 -2016 in order to elicit if any EM techniques has been used. The following ratio of Earnings as a percentage of operating assets was used basing on the following assumptions to test whether the selected sample has used EM techniques during 2010-2016.

$$Earnings\ as\ a\ percentage\ of\ Operating\ assets = \frac{Earnings\ for\ the\ year\ t}{Operating\ Assets\ t-1}$$

Assumptions:

1. If there are larger variations in the earnings as a percentage of operating assets for more than five consecutive financial years, it is assumed to be; that the banks have manipulated their earnings.

2. If there are no huge changes in between the earnings as a percentage of operating assets in between the years; it is assumed that the banks have not manipulated their earnings.

Moreover, structured interviews were employed to investigate the awareness of managers, auditors and shareholders about the use of EM by commercial banks in Sri Lanka. For that, a close ended questionnaire has been prepared by incorporating the key objectives of the study. The Cronbach's Alpha test was conducted to confirm the reliability of the questionnaire statistically.

Pressure from managers, Contractual obligations, Tax management, Share price management and Political cost over comings are found to be the main reasons for banks to practice EM. (Kamau,C.G,2016; Bora,J.,&Saha, A,2016). Therefore, this study investigates whether the above identified factors by previous researchers are influencing the banks in Sri Lanka as well. In order to disclose this factor, the research uses a questionnaire covering seven sections supporting with an interview guide. The questionnaire has been administered among 107 respondents representing Chief Managers, Senior Auditors and major individual shareholders across all the banks listed in the CSE.

Research Results and Discussion

The study is based on a descriptive analysis and a regression analysis of data, collected using the survey questionnaire and analyzing of financial statements of selected commercial banks for 2010-2016. SPSS 20.0 was used as the data analyzing software package for regression analysis and Excel 2010 was used for the descriptive analysis. The data collected in this study is evaluated, discussed and inferences made, in an effort to address the specific objectives of the study. Descriptive statistics were used to analyze the data on each variable. The descriptive analysis discusses the awareness of three respondent groups on EM and the financial ratios obtained by calculating Earnings as a percentage of Operating Assets of the banks. Further, the study examines the dependent variable of 'Earning Management' with different influencing factors affecting for the banks to engage in EM practices.

The obtained results show that the banks are not practicing EM techniques.The following table shows the results obtained by calculating the equation shown in the methodology, for each bank in the sample for the period of 2010-2016.

Table 1.0 : Earnings as a percentage of Operating Assets in banks listed at CSE

Bank / Year	Commercial bank	DFCC	HNB	NDB	Amana	NTB	Pan Asia bank	Sampath bank	Seylan bank	Union bank
2010	0.02	0.06	0.02	0.02	-0.04	0.16	0.03	0.02	0.01	0.01
2011	1.46	0.11	0.02	0.02	-0.01	0.02	0.03	0.02	0.01	0.02
2012	1.25	0.06	0.02	0.03	0.02	0.03	0.02	0.03	0.01	0.02
2013	1.03	0.05	0.02	0.05	-0.03	0.03	0.00	0.01	0.02	0.00
2014	1.07	0.04	0.02	0.02	0.00	0.03	0.01	0.02	0.02	0.00
2015	1.06	0.03	0.02	0.01	0.01	0.02	0.02	0.02	0.02	0.01
2016	1.22	0.02	0.03	0.01	0.00	0.02	0.01	0.02	0.02	0.01

(Source: Survey Data)

The above table clearly shows that the earnings as a percentage of operating assets of almost all the commercial banks listed in CSE for the period of 2010-2016 has not changed in larger percentages. Therefore, according to the assumptions discussed in the methodology, the

results obtained by conducting the test proves that the Sri Lankan commercial banks listed in the CSE has not manipulated their earnings for the period of 2010- 2016 via Earnings Management techniques. This result is very favorable for all the stakeholders of the commercial banks in Sri Lanka. It is because, a sound banking system free from earnings manipulations contributes to the effectiveness of intermediation, maturity transformation, payment facilitation, credit allocation, financial investments and financial discipline. In a country like Sri Lanka where there is a bank dominated financial system, which the banks contribute for 56% of the assets in the financial system and 77% of GDP, the result obtained in the study by calculating earnings as a percentage of operating assets is favorable for all the stakeholders related to the commercial banks in Sri Lanka, being the result proves that there is no such strong evidences to describe that the commercial banking sector is manipulating their earnings. Bank's financial reports present the bank's financial power and they use the information in order to decide whether they can overcome the possible risk or not in the financial environment. On the other hand, financial information users also need the information regarding the bank reports for their investment decisions. The central bank of Sri Lanka has highly regulated the banking sector in the country under a continuous supervision. The financial reports of the banks are under a strict audit which would lead them to provide reliable financial information compared to other institutions. On the other hand, reporting reliable financial information has a huge importance for banks in order to be trustworthy and reputable in the financial sector. Therefore, the financial accounts of the banks are getting audited regularly within the bank as well as by external auditors assigned to the banks. Therefore, the chances of manipulating the accounts of public listed banks in Sri Lanka are very limited. But it is obvious that the regulation cannot guarantee for a zero failure in the banking system. Hence,it can control the banks from Earnings Management practices to a certain level as the loopholes in the regulations of Sri Lankan banking system is very low being the regulations are some times more higher than the required level in order to protect the banks from failures.

The results obtained through the following multiple regression model reveals that there is a week positive relationship between all the five independent variables, i.e., Pressure from managers, Contractual obligations, Tax management, Share price management and Political cost over comings .

$$EM = 1.454 + 0.197\ (MP) + 0.059\ (CO) + 0.113\ (MT) + 0.117\ (MSP) + 0.104(OPC)$$

The results in the following table indicate that the coefficient of determination (R^2) of 0.149 and coefficient of correlation (R) of 0.387. This means that about 14.9% of the variation in EM is explained by the study model. However 85.1% of the variation in EM is unexplained by the model. Adjusted R2 is a modified version of R2 that has been adjusted for the effect of increase in the number of predictors in the model. (Kamau,2016) The adjusted R2 of 0.107 which is slightly lower than the R2 value is a precise indicator of the relationship between the independent and the dependent variable because it is sensitive to the addition of irrelevant variables. The adjusted R2 indicates that 10.7% of the changes in EM is explained by the model and 89.3% is not explained by the model.

Table 1.1: Overall model of Dependent and independent variables

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.387[a]	.149	.107	.44028

a. Predictors: (Constant), MPC, MCO, MPM, MMSP, MMT

The R value points to a week linear relationship between Pressure from managers, Contractual obligations, Tax Management, Share price management, Political cost over comings and Earnings Management among banks in Sri Lanka. The result suggests that there is a lesser tendency for banks in Sri Lanka to practice EM techniques, depicting that the relationship between the dependent and independent variables taken to the study are week but positive.

The ANOVA test in the table 1.2 indicates that the independent variables of the model have a significant effect on Earnings Management among Sri Lankan banks since the p value is 0.004 which is less than 5% level of significance. Being it is very close to 5%, it implies that the level of significance is very low when considering the influence of independent variables to the dependent variable of EM among banks in Sri Lanka.

Table 1.2: ANOVA of dependent and independent variables

ANOVA[a]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	3.440	5	.688	3.550	.004[b]
	Residual	19.578	101	.194		
	Total	23.019	106			

a. Dependent Variable: MEM

b. Predictors: (Constant), MPC, MCO, MPM, MMSP, MMT

Out of the identified five independent variables, Pressure from managers shows the strongest relationship while the relationship of other independent variables to the dependent variable is week. This means that the influence of all the above independent variables on Earnings Management among the companies in Sri Lanka is not strong. Even though these independent variables effect on the practice of EM in other countries according to Kamau (2016) and Tian& Peterson (2016) there is not much more influence from these variables to the EM practices of Sri Lankan firms and therefore there may be another different factors will have affected to the EM practices of Sri Lanka.

The model estimates suggest that the hypothesized model is not explained by the data collected. It is because, except in the first hypothesis, in all the other four hypothesis, the alternative hypothesis was rejected and the null hypothesis was taken. It is because, only in

the first hypothesis, the p value 0.011<0.05 making the coefficient of pressure from managers is significant in the model.

The awareness of the shareholders and auditors about the earnings management practices of the commercial banks is very important. The results obtained in checking the awareness of auditors and shareholders on EM practices of banks indicate that the auditors and shareholders are unaware on this EM practices while few of the managers are aware on this practicing. Even though the results of the study prove that the Sri Lankan banks listed at CSE are not practicing EM, it is essential for all the stakeholders to be aware of this EM practicing being their unawareness can lead them to wrong business decisions and make the whole economy of the country inefficient.

Summary, Conclusions and Recommendations

According to the results of the study, there are no evidences to suspect that the banks in Sri Lanka are practicing EM, probably because they are highly regulated and under the strict supervision of CBSL. Further, the study ensures that the awareness and knowledge of most of the Sri Lankans on EM is not at a standard level. Moreover, the research evaluates the factors that influence EM practices of banks in Sri Lanka. The results obtained by the study indicate that there is a positive relationship (R= 0.387) between pressure from managers and Earnings Management. The regression analysis showed that there is a positive relationship between the independent variable managers' pressure and Earnings Management.

Following the findings of the study, it is recommended that the financial information should not be biased to one party, giving individual benefits through information asymmetry, as it will make the economy inefficient by providing more chances for stakeholders to take wrong business decisions. Therefore, the reliability and transparency of the financial information is very necessary.

For further maintenance of this favorable accounting reporting of the Sri Lankan banks in the same unbiased manner during each financial year, the study recommend following recommendations.

- It is necessary to encourage the issuance of extended audit reports by the independent auditors.
- Performance based compensation should be avoided in order to reduce the temptation of influencing the EM practices.
- Corporate governance should be improved in order to improve the quality of the financial reporting to increase the confidence of investors in company's financial report.
- Accountants and bookkeepers should be encouraged to participate for business ethics training programs each year.
- Earnings Management should be introduced to the Syllabus of accounting students in order to stress on the ethical aspects of accounting and to improve the awareness of future shareholders on EM practices of banks.

- The internal audit department of banks should be more independent, active, efficient and strict their supervision..
- Government and other regulatory agencies should implement clear rules and legal framework regarding the EM practices of banks.

The findings of this study contributed to reduce the research gap of locally to international. It is because, there was no previous research has done in Sri Lanka on EM practices of commercial banks in the country. Being the topic EM is not in the syllabuses of accounting students in most of the Sri Lankan universities and therefore they are not familiar with the term earnings management and as a result their awareness of the EM practices if banks are in a very minimum level. Therefore, the findings of this study have contributed in filling this knowledge gap in local literature on the subject Earnings Management and guided the university students to study more on this term Earnings Management.

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