Survey of earnings management practices in commercial banks listed at the Colombo Stock Exchange: An empirical study

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Introduction

The process of Earnings Management (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, this conflicting situation of companies require accountants 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. Therefore, the current study is primarily based on the objective of investigating the financial variables of the commercial banks that can be used to enquire whether banks are practicing EM. The sub objectives of the study are to investigate the awareness of stakeholders, managers, auditors and shareholders on the practice of EM by commercial banks of Sri Lanka, investigating whether there are adequate evidences to suspect that the commercial banks are using EM techniques and identifying the factors influencing banks in Sri Lanka to practice EM techniques.

Methodology

EM, being one of the best methods used by firms to play with numbers, the research methodology needs to be highly quantitative. At the same time, no commercial banks would like to reveal the fact of using EM via an interview. Hence, it is essential to use a mixed methodology; both quantitative and qualitative, which will increase the reliability and accuracy of the research outcome. A conceptual framework which comprised of various factors affecting EM practices developed based on a previous research. All listed commercial banks were employed in the study sample, among which we selected key stakeholders were selected for the survey through a mixed sampling approach combined with systematic sampling and convenience sampling. A structured interview was carried out to triangulate and enhance the confidence of research findings. SPSS 20.0 and Excel 2010 were employed as data analyzing software packages.

The hyper geometric distribution was used to decide the sample size of this study being there are only 25 commercial banks licensed in Sri Lanka; the population of the study which is very small. Therefore, the sample of this study is 20.001 which is approximated to 20 commercial banks. However, since there is only 10 public listed commercial banks in Sri Lanka at present, all the 10 commercial banks were included to the sample under the convenience sampling method. The respondents to the questionnaire were selected from each bank employing a mixed sampling technique combining systematic sampling and convenience methods.

The study is based on descriptive analysis and regression analysis on the data collected using the survey questionnaire and analyzing of financial statements of selected commercial banks for the period 2010-2016. Financial statements of 10 commercial banks listed in Colombo Stock Exchange (CSE) were carefully examined for the period between 2010 -2016 in order to elicit whether banks practice EM techniques. The following ratio of earnings as a percentage of operating assets was used based 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; that the banks have manipulated their earnings.
2. If there are no huge positive or negative changes in the earnings as a percentage of operating assets in 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, 2016; Bora & Saha, 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.

Results and discussion

The data collected in this study were evaluated 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. The results for the constructs of EM and influencing factors for EM obtained by the Cronbach Alpha reliability test were well above the threshold level indicating a high level of internal consistency of the constructs. Rest of the constructs other than "pressure from managers and "overcome political costs" reside above the threshold level of 0.7 Further, the study examines the dependent variable of EM with different influencing factors affecting for the banks to engage in EM practices.

The multicollinearity test showed that there was no multicollinearity among the independent variables since all the variables had a VIF of less than 10. This indicates that multicollinearity is not a problem in this study. Therefore the study retained all the explanatory variables.

Table 1 in the appendix, proves that the commercial banks in Sri Lanka have not practiced EM techniques for the year 2010 to 2016 as per the equation of earnings as a percentage of operating assets. The results obtained through the following multiple regression model reveal that there is a positive relationship between all the five independent variables, i.e., pressure from managers (MP), contractual obligations (CO), tax management (MT), share price management (MSP) and political cost over comings (OPC).

Table 1 Result of multiple regression analysis

R = 0.387 F = 0.004	Adj. R square =0.107		F value = 3.550	Sig
Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	1.454	.558		2.607	.011
MPM	.197	.076	.249	2.590	.011
MCO	.059	.098	.064	.601	.549
MMT	.113	.134	.152	.841	.402
MMSP	.117	.149	.140	.787	.433
MPC	.104	.076	.130	1.373	.173

a. *Dependent Variable: MEM*

The results in Table 1 indicate that the coefficient of determination (Adj. R^2) of 0.107 and coefficient of correlation (R) of 0.387. The R value points to a weak 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 weak but positive. Result in Table1 indicates that the independent variables of the model have a significant effect on EM among Sri Lankan banks since the p value is 0.004 which is less than 0.05 level of significance. Being it is very close to 0.05, 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.

From all the identified five independent variables, pressure from managers shows the strongest relationship to the dependent variable of EM. The relationship of other independent variables to the dependent variable is week. Therefore, the model estimates suggest that the hypothesized model is not explained by the data collected. Figure in the appendix proves that the awareness of the stakeholders of the banks on the Earnings management practices is not in a satisfactory level. According to the figure, more than half of the stakeholders agree that they are unaware about the EM practices of the commercial banks in Sri Lanka.

Conclusion and recommendations

According to the results of the study, there are no evidences to suspect that the banks in Sri Lanka are practicing earning management, probably because they are highly regulated under the strict supervision of CBSL. Further, the study

ensures that the awareness and knowledge of most of the Sri Lankans on earning management is not at a standard level. Moreover, the research evaluates the factors that influence earning management practices of banks in Sri Lanka. The results obtained by the study indicate that there is a positive relationship between pressure from managers and earnings management. The regression analysis showed that there is a positive impact from managers' pressure on earnings management of the Commercial Banks. 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.

References

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Appendices

Table 1 Earnings as a percentage of Operating Assets in banks listed at CSE

Bank / Year	Commercial	DFCC	HNB	NDB	Amana	NTB	Pan Asia	Sampath	Seylan	Union
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

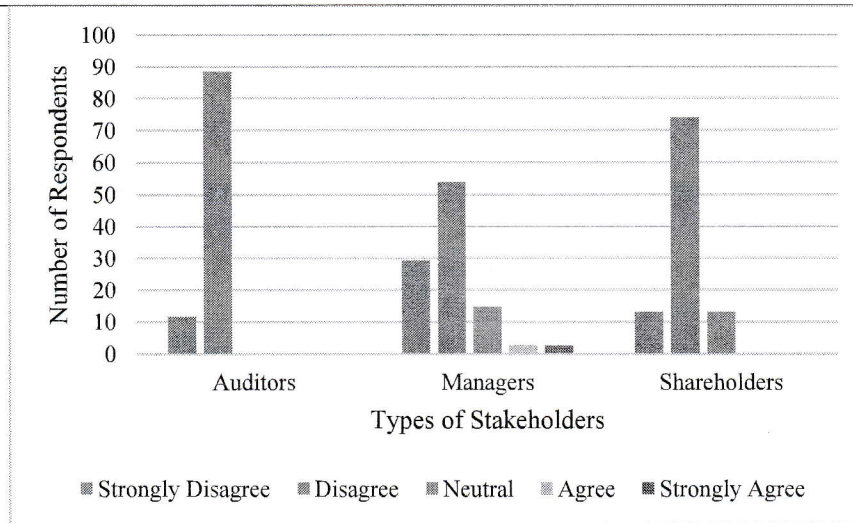|	Strongly Disagree	Disagree	Neutral	Agree	Strongly Agree
Auditors	11.63	88.37	0	0	0
Managers	29.27	53.66	14.63	2.44	2.44
Shareholders	13.04	73.91	13.04	0	0

Figure 1 Awareness of the stakeholders on the Earnings Management practices of Commercial Banks

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