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ANTECEDENTS OF EARNINGS MANAGEMENT AMONG ISLAMIC BANKS: EVIDENCE FROM BANGLADESH

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ABSTRACT

There are many factor that lead firms to adopt accounting principles to manipulate their financial statements. Financially distressed enterprises for various purposes including contractual renegotiations and concealing of financial distress might surrender to earnings management. Bad management or other factors can result in a decrease in a listed company's financial performance that eventually results in insolvency, in such cases, investors and creditors can suffer considerable financial loss and the impact on the overall economy and society as whole (Chen et al., 2010). This study attempts to understand the impact of selected corporate governance factors on earnings management practices among Islamic Banks in the context of a developing country, Bangladesh. All seven listed Islamic Banks are included in the study and secondary data extracted from their audit financial statements of 2013 were run through OLS regression. The model adopted from Geraldes Alves (2011), who studies non – financial listed companies in Portugal, was found statistically significant for Islamic Banks in Bangladesh. Only one independent variable, Board Composition (Bcomp), has significant influence on Earnings Management while two control variables, Option and Leverage statistically influenced the dependent variable in the study. The result provides valuable input for the investors to understand the influence of board composition on company's earning management behavior. This study contributes significantly by providing empirical evidence on earning management practices among Islamic Banks in Bangladesh.

KEYWORDS: *Earnings Management, Islamic Banks, Jones Model, Income, Financial Companies.*

INTRODUCTION

Earnings management is the practice of discretionary accounting choices to achieve a desired level of reported earnings. Accrual accounting provides management with discretion in the reporting of earnings and thus provides opportunity for managers to engage in earrings management in IPO (Chen et al., 2005). Studies on earnings management are growing and most of the previous studies generally documented the magnitude of accrual management with corporate governance factors such as board independence and audit committee independence (Klein, 2002). Earning management posits a problem for the external users of financial information, mostly investors, as they rely on the income related information disseminated by the listed companies through annual report while making investment decision. It is evident that researchers focused mostly on examining the earnings management practices of non – financial companies at this early stage. As a result, this study focused on the financial sector to check the differences, if any, exists between the earnings management practices between financial and non-financial sector. More specifically, the focus on Islamic Banks are from the understanding that

they are deemed to be more accountable toward the stakeholder and goes through the strict compliance monitories to Audit and Shariah committee. Any evidence of earnings management found among them will generate concern and might attract researcher attention to study the overall industry and gain a closer look into this growing problem of systematic misrepresentation of income.

PROBLEM STATEMENT

Earnings management is a technique used by companies to report favorable financials positions which are not real. This practice of misrepresentation of income could severely affect stakeholders. Investors can be misled to make an ill-advised decision, creditors' rights can be impinged and economy might be negatively affected. Researchers has just began to notice this practice among companies and it is early to reach to a conclusion of how badly the economy might be affected by the earnings management practices of listed companies. The reason is lack of available literature. But, it can be undoubtedly concluded that investors are directly affected. While the evidence on capital market motives for earnings management is abundant, the academic literature on the relationship between earnings management and corporate governance of listed firms are scarce. This study is an attempt to fill the gap and contribute to the literature of earnings management to assist investors in avoiding the traps of earnings management and secure their investment with reliable information.

OBJECTIVES

This study was initiated to investigate the impact of corporate governance variables on earnings management practices of Islamic Banks in Bangladesh. More specifically, this study focus on understanding whether Board Size, Board Composition and Audit Committee affect earnings management practices of Islamic Banks.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Groff and Wright (1989) and Christie and Zimmerman (1994) were the first to investigate earnings management related to corporate control contests. Most earnings management studies examine whether companies manage earnings in response to some economic incentive. One of the most common earnings management tools is reporting revenue before the seller has performed under the terms of sales contract (SEC, SAB No. 101, 1999). Aharony et al. (2000) found that the level of motivation for earnings management varied from industry to industry; in the highly regulated petrochemical industry – where state owned companies enjoy a quasi – monopolistic position, with governmental subsidies and undemanding criteria for a stock market listing – the intention to manipulate earnings was relatively weak. Islamic Banks in Bangladesh operate in a highly regulated environment where their activities are scrutinized by Audit and Shariah committee. This regulatory environment might provide less opportunity for them to engage in earnings management. Francis et al. (1998) found that high – accrual firms have greater opportunity for opportunistic earnings management and have an incentive to hire a big five auditor to provide assurance that earnings are credible. Jensen (1993) suggest that board size is negatively related to the ability of the board to pursue long – term strategic goals. Increased board size lead to more experienced independent directors (Xie et al., 2003), so it is likely to diminish managers' opportunistic manipulation such as earnings management. Board composition has the potential to reduce agency problem and increase earnings quality. Klein (2002) found that a significant negative association between the magnitude of abnormal accruals and the percentage of outside directors on the board. Pope et. al (1998) found that a significant negative association between income increasing accruals and the proportion of outside board members. There have been several studies on the influence of audit committee on corporation's financial reporting quality. A common expectation is that independent audit committee directors would ensure better financial reporting (SEC, 1999) and the expectation is generally supported by existing empirical evidence (Abbott et al., 2000).

Based on the above discussion, the following hypotheses have been posited:

- H1. *Board size affects earning management behavior among Islamic Banks.*
- H2. *Board composition affects earning management behavior among Islamic Banks.*
- H3. *Audit Committee affects earning management behavior among Islamic Banks.*

METHODOLOGY

The study used annual reports of listed Islamic Banks to analyze the relationship between the variables proposed by the modified Jones model. The dependent variable, earnings management, is

measured by using Discretionary accruals (DACC) as a proxy. Discretionary Accruals (DACC) are the residuals provided by the OLS regression which used Total Accruals (TACC) as dependent variable and change in revenue (REVC), change in balance with other banks (RECC) and the level of gross property, plant and equipment (PEE) as independent variables. All variables and the intercept are divided by lagged total assets in order to avoid problems of heterscadasticity. The modified Jones model is provided as follows:

$$\frac{TACCit}{TAit-1} = \alpha_1 (1 / TA_{it-1}) + \alpha_2 (\frac{REVC-RECC}{TAit-1}) + \alpha_2 (PPE_{it} / TA_{it-1}) + e_{it}$$

Independent variables include Board Size, Board Composition and Audit Committee. Board size (Bsize) is measured by the total number of board member for the bank, Board composition (Bcomp) is measured by dividing non - executive board member over total number of board members and Audit committee (Audit) is calculated as an indicator variable, taking the value of 1 when the firm has an audit committee and 0 otherwise.

Three control variables are used in the regression model along with independent variables. Bergstresser and Philippon (2006) found that managers are more likely to engage in earnings management when they hold stock options. Stock option (Option) takes a value of 1 if the manager hold stock option otherwise 0. Positive accounting theory suggests that managers of large firms are more likely to exploit latitude in accounting to reduce political cost (Watts and Zimmerman, 1978). Higher debt level increases the risk of violating debt covenants managers may be motivated to manipulate earnings to comply with debt covenants (Jiang et al., 2008). Firm size (Size) is calculated as the logarithm of market value of equity. Leverage (Lev) is calculated as the ratio between book value of all liabilities and the total asset of the firm.

The regression equation is presented below:

$$DACC_{it} = \beta_{0+} \beta_1 (BSize_{it}) + \beta_2 (BComp_{it}) + \beta_3 (Audit_{it}) + \beta_4 (Option_{it}) + \beta_5 (Size_{it}) + \beta_6 (Lev_{it}) + e_{it}$$

RESULTS

Descriptive Statistics

Table – 1:Descriptive Statistics

	Minimum	Maximum	Mean	Std. Deviation
Bsize	7	23	15	5.447
Bcomp	0	0.9	0.65	0.308
Audit	1	1	1	0
Option	0	1	0.429	0.535
Size_log	8.81	10.64	10.009	0.574
Lev	0.89	1.65	1.023	0.277
DACC	-1.291	1.768	-0.016	0.94
Valid N (list wise)				

The descriptive statistics in Table – 1 provide a brief introduction of the Banks under study. There are some variations in board size (Mean = 16, SD = 5.447) and board composition (Mean = .65, SD = .308), while all the banks haa audit committee (Mean = 1, SD = 0). The control variables has variations in scores and the dependent variable (DACC) has both positive and negative values (Mean = -.016, SD = .94).

Correlation Analysis

Table – 2:Pearson Correlation Results

		DACC	Bsize	Bcomp	Option	Size_log	Lev
Pearson Correlation	DACC	1.00					
	Bsize	0.20	1.00				
	Bcomp	-0.18	0.58	1.00			
	Option	-0.05	0.52	0.11	1.00		
	Size_log	0.63	0.11	-0.09	-0.38	1.00	
	Lev	-0.13	-0.66	-0.62	-0.34	-0.06	1.00

Pearson correlation results indicate that board size has a weak positive correlation with DACC while board composition is negatively related with the dependent variable. Among the control variables, both option and leverage negatively affects DACC while firm size has a strong positive relationship with DACC. None of the independent variables are highly correlated with each other. So, the problem of homoscedasticity is non – existent.

Regression Analysis

Table – 3: Regression Statistics

	Dependent Variable DACC	
Independent Variables	Coefficient	t - Stat
(Constant)	34.824	16.596*
Bsize	.107	9.376
Bcomp	-13.313	-23.110*
Option	-2.809	-16.555*
Size_log	-1.167	-9.480
Lev	-14.575	-24.010*
R square	.999	
Adjusted R square	.995	
F Statistics	229.672*	

** indicates p value < 0.05*

The regression results indicates that the model used to examine the impact of corporate governance variables and earnings management are statistically significant with a p value less than 0.50. The model could account for 99.50% percent variation in dependent variable and this might be the reason of running regression with a small sample size. If more banks are included in the analysis, the adjustedR^2 is expected to decrease. Table – 3 also indicates that among the three independent variables, only board composition has statistically significant influence on DACC (β = - 13.313, t = - 23.11, p < 0.50). This mean, adding each independent member to the board will decrease earnings management by 13.31 TK. This findings supports pervious literature. Among the control variable, stock options and leverage was found statistically significant.

CONCLUSION

Board of directors have the responsibility to monitor the types of information provided to the stakeholders by the managers through financial statements. The effectiveness of the board will reduce manager's ability to engage in earnings management. This study takes the first step to investigate the ability of board of directors and audit committee to influence and control Islamic Bank manager's intention toward earnings management. Result produced through this study may not be generalized due to lower amount of sample size but provides valuable insight about the issues concerning earnings management practices in Bangladesh. The amount of non - executive board members present was found to have significant impact on earnings management. This non liner relationship among board composition and earnings management should provide greater

influence on both financial and non-financial listed companies to appoint more independent members to be more transparent and reliable in providing information to the stakeholders.

AREA FOR FURTHER RESEARCH

There are few limitations of this study. Only Islamic Banks were included to get a preliminary insight about the earnings management practices in the Banking sector. But conventional banks are the dominant players in the banking industry in Bangladesh. So, it would be beneficial to repeat this study by including all banks and check whether the results are consistent with the preliminary findings of this paper. Another way to go is by comparing the results between Islamic and Conventional Banks due to the different nature of their operation.

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