

Earnings Management and Corporate Governance Issues in the Banking and Finance Sector : A Review of Literature

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Abstract

Focusing on the impact of earnings management and the importance of corporate governance mechanism, this study aimed at reviewing the existing literature available on earnings management and its association with corporate governance mechanism. In this paper, an attempt was made to establish a relationship between earnings management and corporate governance mechanisms in case of firms representing the banking and finance sector. From the review of existing literature, we attempted to develop a framework and get a direction for further research work in this area.

Keywords: earnings management, corporate governance mechanism, discretionary accruals

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For a business, it is difficult to report consistent earnings figure for a longer period of time in this ever changing business environment. The changing economic conditions, technological development, innovation in science and technology, climate condition, legislations, political and legal environment, customer's choices, and preference etc., each factor influences appropriately to this rapidly changing business environment for a company. In such incessantly changing market condition, it is almost impossible for a company to give a consistent financial performance and earnings figure. Managers try to reduce the effect of changing business environment and attempt to produce a consistent financial report (Leuz, Nanda, & Wysocki, 2003).

In order to give a smooth earnings report on many occasions managers are involved in earnings management practices. As GAAP allows the management of a firm to make a choice among available alternative accounting practices to record differential financial information and provide alternative for computation of earnings, many times managers use such discretionary powers to influence the actual financial information and produce an income smoothing manipulated financial report (Kumari & Pattanayak, 2013, 2014). Such manipulative accounting practices distort the actual financial information of a company and provide misleading financial information to the firm's different stake holders. Any type of manipulation in firm's financial earnings either directly or indirectly using alternative accounting techniques is called earnings management (Scott, 1993 ; Watts & Zimmerman, 1990). The early research based on agency theory identified earnings management as managers' choice of discretionary practices to manipulate earnings with an intention of increasing their incentive and control over company affair.

According to Healy (1985), managers have inside information, which provide them an opportunity to

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influence the financial reporting process for personal benefits such as maximizing bonus or incentive and increasing control over companies' affair. Schipper (1989) identified earnings management as a purposeful intervention in the external financial reporting process with the intent of obtaining some private gains. A similar observation can be obtained from Leuz et al., (2003), who described earnings management as the alteration of firms reporting economic performance by the insiders to either mislead some stakeholders or to influence contractual outcomes. It is an income smoothing practice through which companies try to keep the financial figure relatively stable by adding or removing cash from reserve as per their discretion. A company is most likely to involve in earnings management practices when it habitually fails to meet investors' expectations and is often involved in producing materially misleading financial information.

Even though the reporting process follows all the accounting standards and laws they may go against the ethics of accounting standards and laws. Researches show that in most of the cases earnings management and weak corporate governance are the reasons behind accounting frauds and contributed substantially towards the sudden fall of some of the large business entities like Enron (USA), Bank of Credit and Commerce International (UK), WorldCom (USA), Subprime Mortgage (USA), Satyam Computers (India), and many others in different parts of the world. According to Agrawal and Chadha (2005), poor corporate governance mechanism and manipulative financial reporting process has been the reason behind many recent financial reporting scandals. In response to increasing numbers of financial scandals, different governing bodies and stock exchange of various countries establish certain codes of good corporate governance practice and make it mandatory for implementation in different business entities. In India, Clause 49 of SEBI Act has made it mandatory for every listed company to produce a corporate governance report along with the annual financial report.

As per the definition of Organization for Economic Co-operation and Development (OECD, 2004), corporate governance is the system by which business corporations are directed and controlled. The Indian SEBI Act, 2000 defines corporate governance as a set of systems, process and principles which ensure that a company is governed in the best interest of all shareholders. Corporate governance is the mechanism through which management of a company is governed in the best interest of all stakeholders; it insures the role of managing body as agent working for the inalienable rights of shareholders as principal and true owner of the business. Code of corporate governance practice specifies the role and responsibilities of different parties in an organisation; it provides a frame work for structuring the company's board of directors and other inside bodies of a business entity. It provides basic rules and procedures for making corporate decisions through a fair channel directing personnel and participation by the independent nominees and committees. Corporate governance code specifies rules for board of directors, audit committee, compensation committee, shareholders participation and other stakeholders; it provides a structure through which a company aims to attain its organizational objective while governing in the best interest of its shareholders (Birla, 2000 ; Cadbury Committee, 1992; OECD, 2004; The Sarbanes-Oxley Act, 2002).

The relationship between earnings management and corporate governance mechanism has been an area of research in recent times. The changing business scenario raises the concern of regulators as well as researchers to emphasise the need of good corporate governance practices. From early research literatures, the Agency theory states that low insider ownership (both for management and Board of directors) implies poor alignment of interests between management and shareholders (Jensen & Meckling, 1976), which leads managers with low ownership to manage accounting numbers so as to increase earnings based compensations, relax contractual constraints or avoid debt covenants (Healy, 1985; Holthausen, Larcker, & Sloan, 1995). It has been identified in various researches that low corporate governance in a company creates room for practicing earnings management (Beasley, 1996 ; Dechow, Sloan, & Sweeney, 1996 ; Klein, 2002 ; Myers & Skinner, 2000 ; Nelson, Elliott, & Tarpley, 2002 ; Osma & Noguer, 2007 ; Peasnell, Pope, & Young, 2000 ; Sarkar, Sarkar, & Sen, 2006 ; Xie, Davidson, & Dadalt, 2003).

Most of the researches state that good corporate governance mechanism is the most appropriate control measure for managements' opportunistic behavior. Dechow et al., (1996) observed that managers of companies with low level of governance have more discretionary powers to involve in earnings management. According to

Buniamin, Johari, Rahmen, & Rauf (2012), firms with weaker governance structures allow managers to exercise their discretionary powers over board to influence the decision making process of the company. A review of existing research literature provides that active monitoring by board of directors, independent members, independent audit committees, other insider governing bodies as well as an active and informed shareholders' group will contribute significantly to the process of constraining earnings management practices (Davidson, Goodwin-Stewart, & Kent, 2005; Mitra, 2002; Xie et al., 2003).

Considering the significant relationship the earnings management practices have with corporate governance mechanism, the present study is an attempt to analyze the effect of earnings management practices on banking and financial sector of an economy through the review of existing research literature. This review is an attempt to identify the association between earnings management and different attributes of corporate governance in context with banking and financial sector.

Governance Pattern of the Financial and Banking Sector

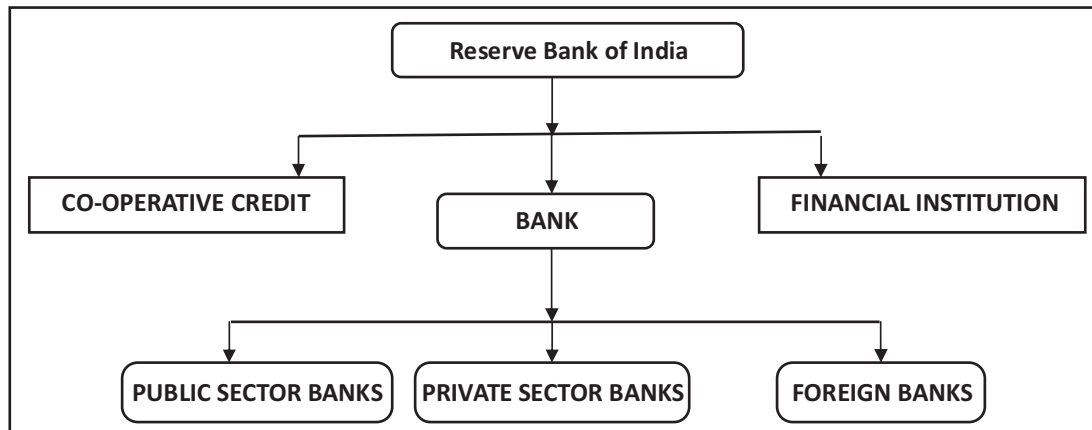
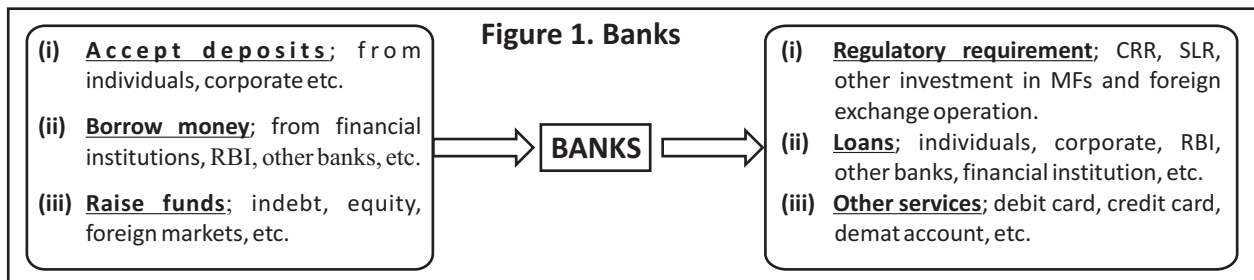
Financial sector plays a key role in economic growth and development of an economy. The basic function of a financial sector is proper allocation of resources to increase the return on investment and reduce risk (Schumpeter, 1911). Financial sector is responsible for channelizing saving of common man to investment in different development projects for sustainable growth of an economy. Financial sector of an economy is an important tool to create strong incentives for the investment in order to promote development and increase productivity (Robinson, 1952). It widens the access to available assets in an economy and creates a larger market for the domestic business. The actual role of financial sector is providing an environment where everyone can participate in growth process and get benefitted from improve economic condition (Levine, 1997). The financial sector includes all the institutions in an economy offering financial services to public, business firms and other financial institutions.

In its broadest definition, financial sector includes different intermediaries ranging from banking industry, stock exchanges, and insurance industry, to credit unions, microfinance institutions and money lenders (DFID, 2004). King and Levine (1993) and Levine (1997) in his study identifies five basic functions of financial intermediaries such as; (a) savings mobilization, (b) Risk management, (c) Acquiring information about investment opportunities, (d) Monitoring borrowers and exerting corporate control and (e) Facilitating the exchange of goods and services.

Thus, in many ways financial sector is responsible for growth and development of an economy. The technological development reduces the international market to a global village and the innovations in financial securities market enhance the scale of investment opportunities. Hence, financial sector of an economy has more important roles to play in its sustainable growth and development. Considering the importance of financial sector in an economy, this study tries to focus on the banking industry which is considered as a key element in the financial sector of an economy.

Banks play the central role in economy of a country. Banks works as financial regulator of an economy and mobilize money in the system by collecting money from the saver and providing financial support to the others. Banks are most important of all financial institution since, its holds the major share of financial market (Subroto, 2011). Banks are the primary financial institution which caters to the need of capital and credit to the different section of the society. Economic development is primarily based on the best utilization of resources and thus making best use of the credit availability in their systems play a significant role in the economic development (Claessens, 2005). An efficient banking system regulates the money in a manner to promote industrial, infrastructure, service sectors and overall growth and development of an economy (Kumbhakar & Sarkar, 2003).

Figure 1 is the diagram showing the function of banks. In India RBI (reserve bank of India) is the central bank which is governs by the Banking regulation Act, 1949. RBI monitors and regulates the working of other public sector and private sector banks of India. Interest rate fluctuations, cash reserve ratio, statutory liquidity ratio and other open market operations are different tools through which the central bank regulates the supply of money in



Indian economy. The Figure 1 also illustrates the structure of Indian financial sector; RBI works as the central bank of the country and regulates the function of other financial institution constitute of banks, co-operative institution and other financial institutions.

A good range of literature is available reflecting the association between earnings management practices and corporate governance mechanism which state the importance of governance pattern for restricting manipulative earnings management practice. It has been quoted by Sundararajan and Balino (1991) that the undesirable banking practices such as poor risk diversification, inadequate loan evaluation, and fraudulent activities were as much responsible as other macroeconomic factors in causing banking crisis which shook the financial systems of countries such as Argentina and China. In various studies governance quality is also been linked to the success of the financial development and good corporate governance is identified as a tool to promote fare business practices for restricting manipulative earnings management practice (Meca & Ballesta, 2009 ; The World Bank, 1999).

In banking industry the margin of error is considered to be very small and any sort of failure in banking system may become responsible for a big crash to the overall financial market of an economy therefore it is very important that there should be a transparency in financial reporting process and information disclosure. Gillian et al., (2002) in their study observed that there exist a linear relationship between corporate governance attributes and quality of reported earnings. According to the study of Macey and O'Hara (2003), the unique features of banking sector require special attention on the quality of governance pattern in the organization. According to Nam (2004), the issues of high leverage, greater need of public confidence and huge disparity in the maturity of assets and liabilities make banking companies and their governance issues more special than other firms. Therefore, it is needed that the banking and finance sector firms should be properly governed with high standard of corporate governance mechanism to insure transparency of business information and reliable reporting and disclosure process. According to Donal and Weintrop (2006), firms with good corporate governance system provides more reliable financial reporting and disclosure. In a similar study, Giroud and Mueller (2011) found that weak governance of a firms lead to lower return on equity, poor operating performance, and also increase the possibility of opportunistic earnings management practices.

Sarkar et al. (2006) in their study observe that companies with a good corporate governance system based on the board independence, institutional ownership and independent audit committee have lower degree earnings management and higher return on equity. Since banks play the key role in economy and usually account for major part to play in financial performance an economy and its role becomes even more important in case of a developing economy. Going through the literature review we identify that a good corporate governance system can prevent banking system from a big financial crisis, hence the governance of banks should be always kept on par to keep a check on banks performance.

Earnings Management

Earnings management takes place when companies' management has an opportunity to influence the actual reported earnings in its financial report by making a choice between alternative accounting practices and manipulating the accounting numbers by managing accruals. Through literature review it has been identified that managers use the discretion of making a choice between alternative accounting practices provided by GAAP for window dressing the actual financial information of a company and practice to provide an expected smooth financial report to its stakeholder for the purpose of maintaining its market share and goodwill (Beasley, 1996 ; Dechow et al., 1996 ; Klein, 2002 ; Nelson et al., 2002 ; Osmo & Nogueira, 2007 ; Peasnell, et al., 2000 ; Sarkar et al., 2006 ; Xie et al., 2003)

According to Demsetz and Lehn (1985), central bank impose certain statutory capital and liquidity ratio requirement on banks, which create considerable pressure on bank manager to produce a desirable financial results which may cause earnings management for smooth earnings. In the context of income smoothing earnings management practices within the banking industry, the transaction entries of loan loss provisions is very important for reporting final earnings (Greenwalt & Sinkey, 1988). Bank practicing earnings management either practice accruals management through loan loss provisions or influence earnings by manipulating earnings from sale of securities. Literature review of research work regarding earnings management in banks suggest that banks with constant higher reported earnings are more likely to involve in manipulating its earnings through loan loss provisions. According to Beaver and Engel (1996), the negative (positive) values of loan loss provisions are related with the income increasing (decreasing) earnings management practices. Hamza and Taktak (2009), in his study of Tunisian banks finds that bank manipulate its earnings by manipulating the amount of loan loss provision. Thus it has been evidence from earlier research that for calculating earnings management in banking industry the amount of loan loss provision has been used as proxy for earnings management.

Earnings Management in Banks and the Corporate Governance Mechanism

Corporate governance is the system by which companies are directed and controlled (OECD, 2004). In the other words, 'Good corporate governance' is simply 'Good businesses'. It is a set of systems, processes and principles which ensure that a company is governed in the best interest of all stakeholders. Corporate governance practices promote corporate fairness, transparency and accountability (SEBI, 2000). The corporate governance mechanism defines the distribution of rights and responsibilities among shareholders, the board of directors, managers, auditors, other stakeholders, and outlines the rules and procedures for corporate decisions. A review of research in this regard states that corporate governance system is the most suitable control mechanism for restricting opportunistic earnings management practices (Healy, 1985, Holthausen et al., 1995, Peasnell, Pope, & Young, 2005 ; Sarkar et al., 2006). Most of the research studies state that managers of companies with low governance quality have greater discretion to engage in opportunistic earnings management practice (Jensen & Meckling, 1976, Dechow et al., 1996).

Several initiatives have been taken by various regulatory bodies to improve governance pattern and promote good corporate governance practices in India Clause 49 in SEBI Act has been introduced to promote good corporate governance practices which made it mandatory to produce corporate governance report for every listed

Table 1. Available Literature on Association between Earnings Management and Corporate Governance Practices (In case of banking and finance sector)

Sl.No.	Author	Year	Proxy for earnings management	Control mechanism for earnings management
1.	Healy & Wahlen	1999	Discretionary accruals; Loan loss provision; Revenue from sale of securities	Board size; Board independence; Audit committee; CEO compensation; Insider member.
2.	Arena	2008	Discretionary accruals; Loan loss provision; Sale of securities	Good corporate governance practice
3.	Macey & O'Hara	2003	Liquidity ratio, deposits and fund, capital requirements and loan amount.	Role and responsibilities of governing bodies and separation of ownership and control
4.	Chen, Elder, & Hsieh	2005	Loan loss provision and capital gain from sale of securities	Percentage of independent directors and supervisor and percentage of financial expert in the board
5.	Andres & Vallelado	2008	Loan loss provision and sale of securities	Board size; Board independence; Percentage of non- executive directors; Institutional ownership
6.	Cornett, Mcnutt, & Tehranian	2009	Loan loss provision and capital gain from sale of securities	Compensation to CEO; board independence; percentage of insider director; board size and nominee directors.
7.	Katrodia	2009	Discretionary accruals	Board of director, audit committee, board independence and corporate governance practice.
8.	Bea, Hamao, & Kang,	2009	Bank loan ratio	Regulatory rules and legal enforcement: governance system
9.	Biurrun & Rudolf	2010	Income smoothing, Loss avoidance and Income smoothing practice measure by bank accruals, loan loss provision and income from sale of securities.	Regulatory restrictiveness, Official supervision, Private supervision, Financial structure and Financial development measure.
10.	Molenaar	2010	Loan loss provision	Corporate governance mechanism
11.	Brahmbhatt, Patel, & Patel	2012	Discretionary accruals	Corporate governance standards according to India code of corporate governance

12.	Cohen, Cornett, Marcus, & Tehranian	2014	Loan loss provision and sale of securities	Policy implication of corporate governance system.
13.	Barth, Gómez-Biscarri, Kasznik, & López-Espinosa	2012	Loan loss provision and sale of securities	Good corporate governance practice
14.	Man	2013	Discretionary accruals	External corporate governance- the legal/ regulatory system and the takeover force; Internal corporate governance- Board structure, composition and meetings; audit committees; compensation committee; ownership structure; institutional shareholder.
15.	Iannotta & Cattolica	2013	Loan loss provision	Good corporate governance
16.	Abaoub, Homrani, & Gamra, S.B.	2013	Discretionary accruals; Loan loss provision	Corporate governance system

company in compliance with certain specific parameters. Below given table provides a list of research studies undertaken regarding earnings management and corporate governance practices in banking and finance sector.

Discussion

From the review of prior research studies undertaken it can be identifies that in most of the prior studies related to earnings management practice banking and finance sector, corporate governance has been suggested as a useful control mechanism to restrict manipulative earnings management. Kealy and Wahlen (1998), in their review of available literature on earnings management and founds that in case of banking industry loan loss provisions are used as discretionary accruals and consider such provision as proxy for earnings management; and good corporate governance system are considered to be control mechanism for restricting manipulative earnings management practices. In a similar study undertaken by Arena in (2003) from Latin and East Asian banks it is found that banks usually use loan loss provisions and sale of securities to manipulate its earnings. The analysis of this study suggests that for restricting earnings management in banks standard corporate governance practices should be introduced to the banking sector as a control mechanism.

According to Cornett, et al., (2009), an analysis of large U.S. banks holding companies identifies the fact that bank uses its discretion attach to the loan loss provision for managing earnings and corporate governance attributes such as CEO compensation, board size and board independence have a direct relationship with the manipulative earnings management. Abaoub, et al., (2013) in their study of Tunisian banking industry observe that in banking sector basically loan loss provisions are used as discretionary items through which earnings management practices are performed and for restricting such manipulative practices good corporate governance system should be introduced to the organization as a controlling system. Thus, from the review of existing research literature it is evident that corporate governance system works as restrictive measure for earnings management practices.

Conclusion

Zment practices and corporate governance mechanism. In most of the studies corporate governance mechanism is found as a control measure for restricting manipulative earnings management practices. It has been observed that most of the research activities are concentrated on non-banking sectors based in developed countries like U.S. and U.K. Therefore considering the importance of banking and finance sector in an economy there is a need for more research works to be undertaken in developing countries like India.

Though the relationship between different attributes of corporate governance and earnings management through management of discretionary accruals are complex from this review of available literature it has been identified that for the purpose of quantifying earnings management in banking industry, loan loss provisions and sale of securities and investments are considered as discretionary items. Whereas, corporate governance attributes such as board size, board composition, board independence, compensation committee, audit committee and institutional ownership considered to be control measure for restricting earnings management practices (Kang, Cheng, & Gray, 2007 ; Tusiime, Nkundabanyanga, & Nkote, 2011 ; Yang, Chun, & Ramadili, 2009). Therefore, the literature survey identified the direction for future research to be performed for establishing relationship between specific corporate governance attributes and earnings management practices in an economy.

Managerial Implications

Banks play central role in an economy hence it's important for an economy that the business of its banking system should be efficient and transparent. With analysis of this review of literature we can identify the areas of concern which should be focused for restricting manipulative earnings management practice in Indian banking industry. This review of literature provide evidence that corporate governance mechanism is important for smooth functioning of banks and banks use loan loss provision and capital gain/loss on sale of securities and investment as a tool for earnings management. The top level management and regulatory bodies can take these facts into consideration while forming policies for restricting earnings management.

Limitations of the Study and Scope for Further Research

The current literature review has only taken into consideration a small part of literature on earnings management in banking system. This study can be extended to a survey of literature available in context of earnings management in whole financial sector including banking and non banking firms, insurance companies, securities and investment firms and other financial institutions and intermediaries. One can also takes into consideration non financial sector like manufacturing, software and others for study the cause and effect of earnings management, and relationship between earnings management and corporate governance mechanism. Since, very few works has been done in this context in developing country so there is great scope for further research in this topic.

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