

Title: Earnings Management by using Level 2 Fair Value Assets and Liabilities: Evidence from Banking Industry of Sri Lanka

1. My editorial decision is to publish as is.
2. I suggest revised title:
“ Using Statistical Methodology: Do accounting rules on loan losses and security gains contribute to Earnings Management for the Banking Industry in Sri Lanka?”
3. The article is well-written, informative and interesting. The main conclusions make good common sense to me, that the larger the banking company the more managers will use discretionary accounting provisions—reduced loan losses and more realized security— to avoid reporting earnings declines.
4. The literature review is excellent. The discussion of the methodology and of the results is excellent. This is a most wonderful article.
5. The conclusion is excellent:
“ The fair value accounting is liable for enhancing financial destruction. Many of researchers have criticized and put the blame on it for causing financial failure. The objective of financial reporting is to present the decision-useful financial information about the firm to the stakeholders such as investors, lenders and other creditors, etc. The use of fair value accounting on financial reporting must be investigated base on the requirement of such

stakeholders. This dissertation study the samples of licensed commercial banks and the financial institution listed under the Colombo stock exchange to examine the association between fair value accounting and earnings management. The research study we are examining the provisions for loan loss and discretionary security gains and losses by introducing the fair value assets and liabilities. We used the statistical methodology follow by Beatty et al. (2002) to test the banks reported fair value assets and liabilities associated with earnings management both provisions for loan loss. We test several robustness tests and sensitivity analysis for our research design. We use both the current year and one-year ahead data test the provision for loan loss, discretionary security gains, and losses. "

6. I read closely the *.zip file you sent me. On MS_SAJSSSE_48329.docx make these changes:

- (a) In the abstract delete the sentence: The fair value accounting is liable for enhancing financial destruction.
- (b) In the abstract 3rd line delete the word The and start the sentence with Many.
- (c) In the abstract delete the sentence: The use of fair value accounting on financial reporting must investigate base on the requirement of such stakeholders.
- (d) In the abstract rewrite the sentence to read: This paper studies licensed commercial banks and the financial institution listed under the Colombo stock exchange to examine the association between fair value accounting and earnings management.
- (e) In the abstract 10 lines should be followed not follow.
- (f) In the abstract delete the sentence: We supplementary use the fair value hierarchy to identify which level of fair value assets & liabilities associated with provisions for loan loss
- (g) In the abstract rewrite the sentence to read: Our evidence is consistent with past research and persuades us that banks use fair value measurements to manage the earnings.
- (h) Page 1 Introduction rewrite the sentence to read: The Statement of Financial Accounting Concepts No. 8 (2010) of the Financial Accounting Standard Board (FASB) defines relevance, and faithful representation as the fundamental feature of financial information quality.
- (i) Page 1 Introduction last line should raise not rise.
- (j) line 28 will not shall.
- (k) line 29 delete word is.
- (l) Line starting 29 rewrite sentence to read: Accordingly, the change from the traditional

historical cost-based accounting system to the market based fair value accounting system creates the opportunity to research the impact of a fair value measurement system on the earnings management.

- (m) Line starting 29 rewrite sentence to read: The business organizations in the transitional and developing economies in South Asia depend on a large extent on equity capital.
- (n) Delete sentence starting line 54: The provision of adequate training and technical guidance observed as the primary means of mitigating these concerns.
- (o) Line starting 79 rewrite sentence to read: To enhance the investor interest, the manager manages the earnings in a self-serving manner such as to continue with incentives, to enlarge the incentives or to present better their performance, etc.
- (p) Line 82 starting delete sentence: Apparently, such pay packages designed to consider misrepresenting possibilities and may have been familiar slightly to counter earnings management if so, finding evidence of earnings management is more significant.
- (q) Line 89 starting delete sentence: A fair value representing the main idea is that actual and potential investors can make the decision on their investment in more effectively.
- (r) Line starting 106 rewrite sentence to read: The fair value generally refers to the market value if there are active markets for assets or liability. If active markets are unavailable then fair value calculates using valuation techniques by referring the asset or liability realized in the market.
- (s) Line starting 109 rewrite sentence to read: Furthermore, fair value refers to the liquid market value for balance sheet elements, despite that balance sheet elements do not trade in liquid markets. Thus managers exercise judgment over the measurements.
- (t) Line starting 202 delete sentence: The banking industry regarded as more like earnings manipulation when compared to other industries.
- (u) Line starting 211 delete sentence: The similar conclusions arrive by the on their research.
- (v) Line starting 214 rewrite sentence to read: H1 Higher the dependence on market value by fair value accounting for measuring assets and liabilities the more likely earnings management.
- (w) Line 278 delete word are and word the.
- (x) line 285 replace word do with are. Line 285 delete word Initial, then The bank is
- (y) line 290 replace word is with as

(z) sentence starting 289 should read: According to the bank's financial statements, many

banks reported level 3 fair value assets and liabilities as freehold land and buildings. The fair value changes in freehold land and building is directly credited to the equity rather than to earnings other than freehold land buildings.

(a) line 294 the sentence should read: We expect that the level 2 fair value assets and liabilities have more room for manipulation compared to the other two levels. This is due to use of indirectly observations from inactive market inputs and due to less disclosure requirements compared to level 3 fair value assets and liabilities under the IFRS 13.

(b) Line 400 delete word However,

(c) Line 575 the sentence should read: Our evidence is consistent with past research and persuades us that banks use fair value measurements to manage the earnings.

7. I have no other corrections to make.