

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

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ABSTRACT

One of the most serious concerns presently facing the accounting profession is the growing complexity, extension, and significance of issues adjoining fair value measurements. The fair value accounting is liable for enhancing financial destruction. The many researchers and practitioners criticized the fair value accounting and blame for it causing economic failure. The use of fair value accounting on financial reporting must investigate base on the requirement of such stakeholders. This paper 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. In this research, 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 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 after controlling bank-specific features. We found evidence that; banks reported fair value assets and liabilities are positively associate with provision for loan loss. We supplementary use the fair value hierarchy to identify which level of fair value assets & liabilities associated with provisions for loan loss. We found the evidence that the level 2 fair value assets and liabilities are a predominant determination for the association between provisions for loan loss. With all these evidence consistent with past research and present us, banks use the fair value measurements to manage the earnings.

Keywords: provision for loan loss, earnings management, fair value, level 2 fair value assets and liabilities, IFRS 13, security gains and losses

1. INTRODUCTION

One of the most serious concerns presently facing the accounting profession is the growing complexity, extension, and significance of issues adjoining fair value measurements. The Statement of Financial Accounting Concepts No. 8 (2010) of the Financial Accounting Standard Board (FASB) defines relevance, and faithful representation is the fundamental features of financial information quality. The fast expansion of different kinds of fair value measurements techniques will rise complexity, volatility, increased sensitivity to economic

fluctuations. According to [1], changing in the traditional historical cost-based accounting system to fair value base market-oriented accounting system shall create a new area of earnings quality research [1]. As he mentions *“fair-value accounting is represents a potentially sea-changing development in the accounting environment. Fair-value accounting essentially follows from the explicit rejection of the concept of conservatism by standard setters in the newly proposed conceptual framework for financial reporting (IASB, 2008). Changing to a fair-value-based accounting system portends a marked shift from the traditional historical cost-based accounting model upon which our existing earnings quality research is based. How a fair value accounting model is likely to impact earnings quality, and what earnings quality will look like under such a model is very much an open question”*. Accordingly, to change in the traditional historical cost-based accounting system into the market based fair value accounting system; create the opportunity for our existing research-providing problem of what is the impact of a fair value measurement system on the earnings management?

The increasing application of fair value accounting in financial reporting has given rise to a range of challenges for those in developing nations. These challenges included lack of technical knowledge, the prevalence of inactive markets in developing countries, difficulties associated with the variation in techniques used to ascertain fair values across different industries, general complexities in ascertaining fair values, and the incorporation of future events and conditions into valuations. The business organization in the transitional and developing economies in South Asia depend on a large extent on equity capital although lack of equity market is analyzing’ institution operated. Many business organizations, the majority of debt capital consists of a bank loan or other kind of loan rather than the debt capital instruments. Thus, the debt capital market in the transitional and developing economies in South Asia is under-developed. Hence, the attention of financial reporting has oriented towards the needs of investors on equity markets, bankers and other financial institution who provide the loans and other users in the transitional and developing economies in South Asia. The provision of adequate training and technical guidance observed as the primary means of mitigating these concerns.

2. RELATED LITERATURE AND METHODOLOGY

The association between fair value accounting and earnings management is a key research design choice; however, before we establish the association between fair value accounting and earnings management, we focus on the evolution of earnings management and models & proxies for earnings management. The empirical research studies of earnings management are mostly base on a proxy for management discretion. However, that evidence is controversial due to complications originate from the earnings management proxies [2], [3]. According to the McNichols (2000), the accruals use as a proxy for management discretion in two ways. Such as the specific accrual approach and the aggregate accruals approach [3]. The specific accruals approach is adopting a specific portion of discretionary, such as provision for loan loss for banks [4], provision for bad debt, and provision for property-casualty insurers. The aggregate accruals have several issues of correlated omitted variables and low power. The most commonly used of Jones 1991 models are like to be correlated with performance and growth.

The ‘earnings management define as the tactical exercise of managerial discretion in manipulating the earnings figure reported to outside viewers. The ‘earnings management accomplished principally by timing reported or actual economic events to transfer the earnings between periods. The earnings can manage by actually swiping income over time. It is simply rearranging an earnings amount from one year to another year. The earnings management arise from the game of information disclosure that managers and external parties must play. The investors make their decisions based on information collect reported

earnings announcements. To enhance the investor interest, the manager manages the earnings and in spite of the real earnings sacrifice and manager manage the earnings in a self-serving manner such as continue with incentives, enlargement the incentives or present their performance, etc. 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.

2.1 Fair value accounting

2.1.1 What is it and what are the key arguments?

The primary users of financial statements are the actual and potential investors as per the Financial Accounting Standard Board. A fair value representing the main idea is that actual and potential investors can make the decision on their investment in more effectively. Under the fair value accounting, preparation of financial statement required to use market values for more relevant representation of the financial statements. Therefore, under this fair value accounting system, the income statement has documented the potential and not fully realized income and losses due to the recognition of unrealized gains and losses to make even the value of assets and liabilities at their market price even those assets and liabilities do not subject to trade. This indicates the profound change in accounting system compares to the historical cost accounting system. Fair value estimate using expected future cash flows of assets and liabilities more like to have the gain to capture the portion of income accruing for the current year. This could be beneficial for investor motivated on the ability to generate future cash flow from existing assets.

2.1.2 Fair value and discretion in accounting measurement

The fair value defines as the “fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, ” [5](IFRS 13.9). The fair value generally refers to the market value if there are active markets for assets or liability or active markets are unavailable then fair value calculates using valuation techniques by referring the asset or liability realize in the market. Furthermore, fair value referring to the liquid market value for balance sheet elements, although balance sheet elements do not trade in liquid markets which enabling to exercise judgment over the measurements. However, this estimation process creates countless opportunities for exercise the earnings management practices which can lead to poor quality of financial reporting [6]–[12]. Furthermore, bankers, banking regulators, researchers, and many others argue that one of the key factors of the global financial crisis was a fair value measurement paradigm. The fair value measurement paradigm is amplifying the financial crisis by creating a round of dropping prices for causing the financial collapse and thereby escalating the overall risk in the economic system [13].

Where fair value income is becoming unreliable or volatile and frequently being a subject of managerial judgment when the market is distressed or illiquid. Dichev *et al.*, 2012 state that CFOs disagree with the current standard setting on a number of issues including the sheer number of promulgated rules, the top-down approach to rule-making, the neglect of the matching principle, and the emphasis on fair value accounting [14]. The accounting system based on fair value helpful for various stakeholders which provide useful information for an economic decision [15]. Ayres *et al.* 2017 provide evidence showing that firms with higher fair value intensity have more accurate analyst earnings forecasts [16]. They find significant positive associations between analyst forecast accuracy and Level 1 and Level 2 fair value measurements and do not find such association for Level 3 measurements. Some show that the hypothesis of an increase in earnings quality after IFRS adoption. [17], [18] The study supports the relevance of fair value, as indicated by the predictive ability for performance. According to [19] fair value earnings cannot aggregate into components that can be used to assess firm value, as well as components that provide information about various types to

shocks to value, e.g., effects of changes in expected cash flows. This disaggregation is possible because fair value embodies expected return on the firm's assets, as well as current expectations of future cash flows and risk. Thus, fair value earnings can be used to assess firm value. [20] show the evidence of mandatory adoption of IFRS improves earnings quality in all countries. They further indicate that the impact of mandatory adoption of IFRS on earnings quality is stronger the higher the level of privacy in a country. [21] show a strong relationship between fair value accounting and earning management for US banks; results for European listed banks do not provide any reliable evidence.

Wang and Zhang 2017 argue that fair value accounting affects agency conflicts between debtholders and shareholders via its impact on financial reporting [22]. There are many investigate the source of input information used to calculate the fair values to measure the value relevance [23]–[25]. According to their results, level 1 and level 2 fair values are high value relevant. Besides, if financial statements prepared base on fair values estimation, it is commonly believed that the fair value amount will change from period to period than historical cost base financial reporting system [26].

Beatty et al. (2002) examine banks' earnings management incentives by comparing the use of discretionary provisions to avoid earnings decreases for publicly traded versus privately held banks[27]. They find that public banks use more discretion in the provision for loan loss to achieve earnings targets than private banks. If the ability to use provisions for loan losses, losses to manage earnings are limited, then we should find evidence of lower earnings management. Adoption of IFRS has significantly changed earnings management behavior, engaged in relatively greater earnings management when compared to the less risky. The focus on bank fair values arises primarily due to the greater extent of fair value accounting requirements for banks relative to nonfinancial firms and due to the evolution of fair value accounting around banking crises. There is a rich literature based on financial accounting choices of bank holding companies and earnings manipulation practices. Previous research studies elaborate on that banks are motivated to meet regulatory capital requirements and earnings targets and to decrease the taxes. Financial reporting standards require that bank managers estimate provisions for loan loss to reflect changes in expected future loan losses. This process allows them wide latitude for discretion in the estimation of provisions for loan loss. How managers use that discretion and the underlying motivations for their behavior are questions that have received much attention from academics. The objectives can be accomplished by dealing accruals such as provisions for loan losses, losses or adjusting investment strategies ,loan charge-offs, security gains [27]–[31]. Banks have an inducement to handle earnings because accounting earnings deliver firm information to investors and play a vital role in firm performance evaluation and accounting-based diminishing. Beatty et al. (2002) deliver evidence that public banks report more small earnings growths than private banks [27]. The authors display that public banks are possible to use loan loss provisions and security gains and losses to overcome earnings decreases than private banks.

2.2 Research Design

2.2.1 The provision for loan loss

The provision for loan loss plays a considerable role in bank accounting literature. The investigation of a single accrual to the marginalization of utmost other accruals in the banking literature compares with the literature examining non-financial firms, which tends to study overall earnings, total accruals or total current accruals. The loan loss provisions are accruals of essential importance to bank performance, and because they are assessments of loan losses, loan loss provisions reflect information asymmetry, which is the greater importance of the banking literature.

Banking allows a textured examination of accounting policy choices by focusing on loan loss provisioning behavior. Provision for loan loss is a crucial accounting policy choice that directly influences the volatility and cyclicity of bank earnings, as well as information properties of banks' financial reports with respect to reflecting loan portfolios' risk attributes.

185 While both the FASB and IASB have long required the use of the incurred loss model for
186 provision for loan loss, the complexity of loan portfolios allows substantial scope for
187 discretion within the prescribed rules. When a bank delays recognition of an expected
188 provision for loan loss, it creates an overhang of unrecognized expected losses that carry
189 forward to the future. Loss overhangs can increase capital inadequacy concerns during
190 economic downturns by compromising the ability of loan loss reserves to cover both
191 unexpected recessionary loan losses and loss overhangs from previous periods.

192 Furthermore, prior research discovers that banks' incentive to achieve earnings is linked to
193 managers' compensation. Dechow et al. (2010) display that managers have a compensation
194 incentive to employ securitization improvements under SFAS 140. The research based on
195 financial reporting in the banking industry, some research studies precisely observe flexible
196 choice on loan loss provisions that significant accrual of bank holding companies.

197 The research studies discover that loan loss provisions can be decomposed into a
198 component that might be predicted and another component which is subject to managerial
199 discretion. The market prices these two components differently [4]. Wahlen (1994) discovers
200 a positive association between discretionary loan loss provisions and future cash flow
201 increases after controlling for the unexpected change in non-performing loans and
202 unexpected loan charge-offs [32]. The banking industry regarded as more like de earnings
203 manipulation when compared to other industries. When studying earnings management,
204 discretionary provisions for loan loss and discretionary security gains are essential tools
205 used by bank managers for managing earnings. Some researchers provide evidence that
206 bank managers tend to raise discretionary provisions for loan loss and discretionary security
207 gains in periods of high operating earnings in order to lower volatility of reported earnings.
208 These findings supported by many studies focusing on banks [4], [28], [33]. All these studies
209 concluded that, in the discretionary provisions for loan loss and discretionary security gains
210 used by banks as a mechanism for aggressive earnings management, mainly for stock
211 market purposes. The similar conclusions arrive by the on their research. Therefore, in this
212 research define the following hypothesis

213
214 H1 Higher is the dependence of market value by fair value accounting; in particular,
215 considering the impact of fair value hierarchy for assets and liabilities measured under fair
216 value is more likely to increase possible association with the earning management

217
218 To deliver more straight evidence of earnings management, we examine two components of
219 banks' earnings that researchers have shown are subject to manipulation: provision for loan
220 loss and security gains and losses realized. Bank managers can possibly escape reporting
221 small earnings declines by undervaluing the loan loss provision by using fair value
222 measurements. Bank managers may also be able to avoid a small decline in earnings by
223 realizing more security gains or fewer security losses. Therefore, in this research define the
224 following two testable hypotheses

225
226 H1a: The Banks reporting fair values assets and liabilities more likely have a positive
227 association with the provision for loan loss of the banks after controlling for other bank-
228 specific features.

229 H1b: Banks reporting higher level 2 fair values assets and liabilities are more likely to have a
230 positive association with the provision for loan loss of the banks after controlling for other
231 bank-specific features.

232 Beaver et al. (1989) argue that this positive association between market value and loan loss
233 reserves suggests that managers convey to the market that the bank's earnings power can

withstand an increased provision for loan loss hit to earnings. Elliot et al. (1991) also find a positive market reaction to large banks' announcements of increased provisions for loan loss for their problem loans made to lesser-developed countries. In contrast, these large banks experience negative market returns surrounding Bank of Boston's announcement of large charge-offs, when the loans are written-off as uncollectible. Elliot et al. (1991) posit that the market interprets loan loss provisions favorably as a signal of banks' willingness to deal with the problem loans and that the market reacts negatively to charge-offs because charge-offs reduce a bank's capital adequacy ratio, while provisions for loan loss actually increase the capital adequacy ratio during this period [34]. Griffin et al. (1991), examining a similar context, also interpret the positive market reaction for large banks' additions to provisions for loan loss as credible signals about banks' intentions and abilities to resolve the bad debt situations [35].

2.3 Research Methodology

We discuss the research methodology including the research design, by providing empirical evidence related to the research. Empirical research provides the sources of empirical information, the measurement variables, and measurement procedures in the analysis of fair value accounting. In addition to we discuss the variable construction and the sample selection procedure in this section.

2.3.1 Discretionary provisions for loan loss and discretionary security gains and losses

We intend to use the following regression models from [27] to estimate the discretionary provisions for loan loss and discretionary security gains and losses.

$$PLL_{i,t} = \alpha + \beta_1 \log(TA)_{i,t} + \beta_2 \Delta NPL_{i,t} + \beta_3 FV_{i,t} + \beta_4 RLL_{i,t} + \beta_5 RELOAN_{i,t} + \beta_6 CLOAN_{i,t} + \beta_7 DILOAN_{i,t} + \beta_8 AGLOAN_{i,t} + \beta_9 HLOAN_{i,t} + \beta_{10} OLOAN_{i,t} + YEARDUMMY_{i,t} + \varepsilon_{i,t} \quad 1$$

257

$$PLL_{i,t} = \alpha + \beta_1 \log(TA)_{i,t} + \beta_2 \Delta NPL_{i,t} + \beta_3 FVL1_{i,t} + \beta_4 FVL2_{i,t} + \beta_5 FVL3_{i,t} + \beta_6 RLL_{i,t} + \beta_7 RELOAN_{i,t} + \beta_8 CLOAN_{i,t} + \beta_9 DILOAN_{i,t} + \beta_{10} AGLOAN_{i,t} + \beta_{11} HLOAN_{i,t} + \beta_{12} OLOAN_{i,t} + YEARDUMMY_{i,t} + \varepsilon_{i,t} \quad 2$$

258

$$SGLR_{i,t} = \alpha + \beta_1 \log(TA)_{i,t} + \beta_2 TSGL_{i,t} + YEARDUMMY_{i,t} + \varepsilon_{i,t} \quad 3$$

<i>PLL</i>	Provision for loan loss divided by the average total loans ((beginning + End)/2)
<i>Log(TA)</i>	Natural log of total assets
<i>ΔNPL</i>	change in nonperforming loans, divided by the average total loans
<i>FV</i>	The sum of assets and liabilities measured at fair value divided by the total assets at the starting of the year
<i>FVL1</i>	The sum of level 1 assets and liabilities measured by fair value divided by the total assets at the starting of the year
<i>FVL2</i>	The sum of level 2 assets and liabilities measured by fair value divided by the total assets at the starting of the year
<i>FVL3</i>	The sum of level 3 assets and liabilities measured by fair value divided by the total assets at the starting of the year
<i>RLL</i>	Reserve loan loss balance at the start of the year divided by the total loans at

	the end of the year
<i>RELOAN</i>	loans to the real estate divided by total loans
<i>CLOAN</i>	commercial loans divided by total loans
<i>DILOAN</i>	loans to depository institution loans divided by total loans
<i>AGLOAN</i>	loans to agricultural productions divided by total loans
<i>HLOAN</i>	loans to households and individuals divided by total loans
<i>OLOAN</i>	Other loans, divided by total loans
<i>SGLR</i>	security gains and losses realized the end of year divided by total assets at the starting of the year
<i>TSGL</i>	total security gains and losses, (security gains and losses realized plus unrealized security gains and losses) divided by total assets at the starting of the year

259

260 According to prior research, we have identified the provisions for loan loss are change with
261 changes of nonperforming loans [4], [27], [28], [36]–[38]. Also, provisions for loan loss are
262 increasing with increasing of bank size [27]. Further, provisions for loan loss are fluctuate
263 based on loan size [4], [27], [32]. Subsequently, past research found that the security gains
264 and losses realized are enhancing with the total security gains and losses [27], [31]. The
265 above two regression models are derived from the variation model used by [27]. We add few
266 fair value measurements variable to original regression models to estimate the impact of fair
267 value changes on provision for loan loss. The impact of overall total fair value changes on
268 provision for loan loss is tested by the equation (1). In equation (2), we further study the fair
269 value changes in the fair value hierarchy by replacing *FV* with *FVL1*, *FVL2*, and *FVL3*. We
270 anticipate that the coefficient of *FV* is positive and significant. If the coefficient of *FV*, *FVL1*,
271 *FVL2*, and *FVL3* are positive and significant, provide us the evidence of fair value
272 measurements more likely enhance the provision for loan loss of the bank including financial
273 institutions.

274 Equation (2) assess the influence of the three fair value levels independently. By referring to
275 the fair value hierarchy, the level 1 fair value assets and liabilities are directly observable
276 inputs from the active markets, indicating that managers have no or minimal discretion when
277 measuring the level 1 fair value assets and liabilities. Therefore, we do not expect that the
278 level 1 fair value assets and liabilities are significantly influenced the earnings management.
279 Hence, we do not expect that the coefficient of *FVL1* is significant. However, the manager
280 can use indirectly observable from inactive market inputs or use internal measurement
281 models base on judgment and assumptions, when it comes to level 2 and level 3 fair value
282 assets and liabilities. This situation implies that managers can have more discretion over
283 level 2 and level 3 fair value assets and liabilities measurements. However, the manager
284 has more discretion over the level 3 fair value assets and liabilities, banks manager
285 apparently, do not able to manipulate the earnings due to a few reasons. Initial, the bank
286 required to report more details disclosure when it comes to the level 3 fair value assets and
287 liabilities under the IFRS 13 and central banks regulations. This reflects that many banks
288 reported that few items of level 3 fair value assets and liabilities compared to level 1 and
289 level 2. According to the bank's financial statements, many banks reported level 3 fair value
290 assets and liabilities is Freehold land and buildings and the fair value changes in freehold
291 land and building directly credited to the equity rather than earning other than freehold land
292 buildings reported under the investment properties. Hence, the bank managers have a small
293 room of earning discretion over the level 3 fair value assets and liabilities. Therefore, we do
294 not expect to coefficient on level 3 fair value assets and liabilities are significant. Finally, we

295 expect that the level 2 fair value assets and liabilities do more room of manipulation compare
 296 to the other two levels due to use indirectly observable from inactive market inputs and less
 297 disclosure requirement compare to level 3 fair value assets and liabilities under the IFRS 13.
 298 Therefore, we expect that the coefficient of *FVL2* is positive and significant.

299 In order to get better estimation from the equations, we control the change in bank size,
 300 changes in nonperforming loans, bank types, and changes in cash flows subsequent to the
 301 [27]. The change in total assets controls for growth, and the natural log of the total assets
 302 controls for bank size. If more extensive and higher- growth banks are increasingly more
 303 profitable or more likely to manage earnings to avoid reporting a decline in earnings, then
 304 the coefficients on the change in total assets (ΔTA) and natural log of the total assets
 305 ($\text{Log}(TA)$) should be positive. The change in nonperforming loans ΔNPL controls for the
 306 effect of changes in the quality of the loan portfolio on nondiscretionary changes in earnings.
 307 The change in nonperforming loans (ΔNPL) is an important predictor of the loan loss
 308 provision, which is a major component of earnings. We use the change in nonperforming
 309 loans because our dependent variable is the change in earnings. An increase in
 310 nonperforming loans should lead to an increase in the loan loss provision and a decrease in
 311 earnings; therefore, we predict a negative coefficient on ΔNPL . The variables such as loans
 312 to the real estate divided by total loans (RELOAN), commercial loans divided by total loans
 313 (CLOAN), loans to depository institution loans divided by total loans (DILOAN), control for
 314 changes in the characteristics of the loans in each bank's portfolio because these
 315 characteristics may affect nondiscretionary changes in earnings. We do not predict how
 316 these variables are likely to affect the sign of provision for loan loss. We estimate the
 317 discretionary provisions for loan loss and the discretionary security gain and losses by using
 318 residual estimation from equation (1) and equation (3) respectively. These residuals further
 319 used for the logistic regression analysis.

320 **2.3.2 Data and sample selection**

321 As stated at the following table, there are 299 companies listed in the Colombo Stock
 322 Exchange as of 29th March 2018 with a Market Capitalization of Rs. 3,032.7Bn, and out of
 323 299 listed companies. Our sample base on the period from 2013 to 2017, which cover the
 324 adopting period of IFRS 13 fair value measurement. Sri Lanka adopted IFRS Standards and
 325 the IFRS for SMEs Standard for all companies including banking institution. Those standards
 326 became operative for financial statements for periods beginning on or after 1 January 2012
 327 ("IFRS - Sri Lanka," n.d.). All domestic companies whose securities trade in a public market
 328 are required to use Sri Lanka Financial Reporting Standards (SLFRS), which are nearly
 329 identical to IFRS Standards.

330 Table 1 panel A; present the sample selection procedure. The initial sample includes 62
 331 banking, financial and insurance companies which all the listed in the Colombo Stock
 332 Exchange of the period of 2013 to 2017. We reduce the 09 insurance companies that not
 333 cover our research scope and initial sample includes 265 bank-year observations for 53
 334 individual banks. From the initial bank-year sample of 265, we reduce banks with missing
 335 data and the missing data on fair value assets and liabilities. Therefore, the final sample
 336 includes 220 bank-years observations for 44 individual banks.

337 **Table 1 Panel A: Sample selection**

	Bank-years	Unique Banks
Listed companies		299
Bank, financial and insurance sector	310	62
Less: Insurance companies	(45)	(09)
Banking institution including financial companies	265	53

Less: Banks with missing years data	(15)	(03)
Less: Observations with missing data on fair value assets and liabilities	(30)	(06)
Final sample	220	44

3. RESULTS AND DISCUSSION

3.1 Descriptive Statistics

3.1.1 Composition of fair value assets and liabilities

Figure 1 examines the composition of fair value assets and liabilities of the banks. According to figure 1, the total of fair value assets and liabilities, 89% are fair value assets, and 11% are fair value liabilities.

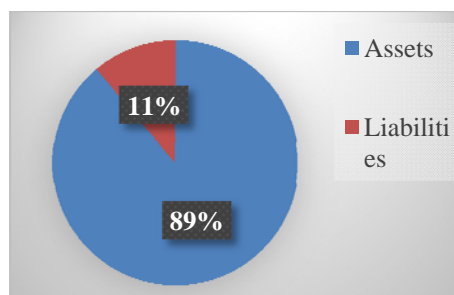


Figure 1 Panel A: Composition of fair value assets and liabilities

Figure 2 shows the composition of fair value assets and liabilities in each level of the fair value hierarchy. The level 2 fair value assets and liabilities account for around 54% of total fair value assets and liabilities measurements, and the level 2 assets and liabilities is the most significant component of the fair value measurements. The level 1 fair value assets and liabilities account for around 32% of total fair value assets and liabilities measurements and the level 1 assets and liabilities is the second most significant component of the fair value measurements. The level 3 fair value assets and liabilities account for around 14% of total fair value assets and liabilities measurements the level 3 assets and liabilities is the lowest component of the fair value measurements.

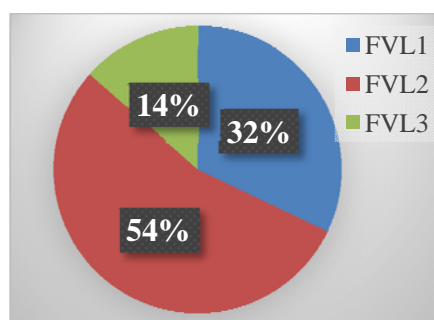
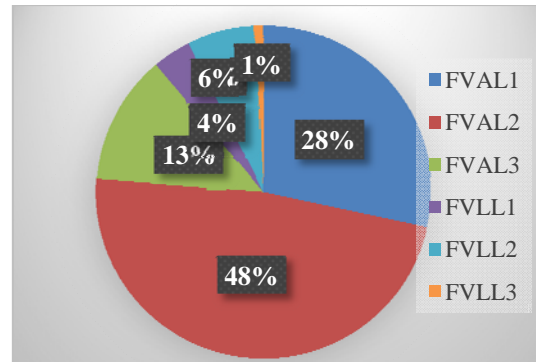


Figure 2 Composition of fair value assets and liabilities on a fair value hierarchy

Figure 3 shows the composition of fair value assets and fair value liabilities separately in each level of the fair value hierarchy. The level 2 fair value assets account for around 48% of total fair value assets and liabilities measurements and it almost nearly half of the total fair value measurements. The level 1 fair value assets account for around 28% of total fair value assets and liabilities measurements, and the level 1 assets are the second most significant

364 component of the fair value measurements. The level 3 fair value assets account for around
 365 13% of total fair value assets and liabilities measurements. The level 2 fair value liabilities is
 366 account for 6% of the total fair value assets and liabilities measurements, while The level 1
 367 fair value liabilities and The level 3 fair value liabilities are account for 4% and 1% of the total
 368 fair value assets and liabilities measurements respectively.

369



370

371 Figure 3 Composition of fair value assets and fair value liabilities on each level of the fair
 372 value

373 3.2 Multivariate tests

374 In here, we estimate the provisions for loan loss after introducing the fair value variables.
 375 Table 2 presents the statistical output of provisions for loan loss including fair value assets
 376 liabilities. The adjusted R-Squire equal to 41.2% As we expected, the sign of *FV* is positive
 377 and significant. The coefficient of *FV* accounted as 0.019 at 0.000 significant level. This
 378 implies that banks are reporting fair values assets and liabilities more likely to have a
 379 positive association with the provision for loan loss of the banks. This finding is consistent
 380 with our first and second hypothesis.

381 Furthermore, the variable of *Log(TA)*, *ΔNPL*, are significant at 1% level. Further, we explain
 382 the natural log of the total assets controls for bank size. If more extensive and higher- growth
 383 banks are increasingly more profitable or more likely to manage earnings to avoid reporting
 384 a decline in earnings, then the natural log of the total assets (*Log(TA)*) should be positive.
 385 The change in nonperforming loans *ΔNPL* controls for the effect of changes in the quality of
 386 the loan portfolio on nondiscretionary changes in earnings. The change in nonperforming
 387 loans (*ΔNPL*) is an essential predictor of the loan loss provision, which is a major component
 388 of earnings. We use the change in nonperforming loans because our dependent variable is
 389 the change in earnings. An increase in nonperforming loans should lead to an increase in
 390 the loan loss provision and a decrease in earnings; therefore, we predict a negative
 391 coefficient on *ΔNPL*, and we got the negative coefficient. The variable of *RLL*, *AGLOAN*,
 392 *HLOAN*, and *OLOAN*, significant at 1% level while variable *CLOAN* significant at 5% level.
 393 However, *RELOAN* and *DLOAN* are not significant. We do not predict how these variables
 394 are likely to affect the sign of provision for loan loss. However, among this variable, the
 395 reserve for loan loss give the highest contribution to provisions for loan loss while and the
 396 coefficients *RLL* is 0.824 at 1% significant level. This implies that the large reserve for loan
 397 loss at the starting of the year will report the more substantial provision for loan loss. In
 398 addition to that the bank size also positively and significant association with Provisions for
 399 loan loss and all other significant variables are negatively associated with provisions for loan
 400 loss. However, our primary research finding implies that banks are reporting fair values
 401 assets and liabilities more likely to have a positive association with the provision for loan loss
 402 of the banks. This finding provides evidence for our first and second hypothesis.

Table 2 Estimating provisions for loan loss including fair value assets and liabilities

$$PLL_{i,t} = \alpha + \beta_1 \log(TA)_{i,t} + \beta_2 \Delta NPL_{i,t} + \beta_3 FV_{i,t} + \beta_4 RLL_{i,t} + \beta_5 RELOAN_{i,t} \\ + \beta_6 CLOAN_{i,t} + \beta_7 DILOAN_{i,t} + \beta_8 AGLOAN_{i,t} + \beta_9 HLOAN_{i,t} \\ + \beta_{10} OLOAN_{i,t} + YEARDUMMY_{i,t} + \varepsilon_{i,t}$$

Variables	Coefficient Estimate	p-value
INTERCEPT	0.031	(0.005) ***
Log(TA)	0.002	(0.001) ***
ΔNPL	-0.251	(0.000) ***
FV	0.019	(0.000) ***
RLL	0.824	(0.000) ***
RELOAN	-0.112	0.251
CLOAN	-0.027	(0.035) **
DILOAN	0.003	0.721
AGLOAN	0.017	(0.000) ***
HLOAN	0.041	(0.005) ***
OLOAN	-0.041	(0.000) ***
N	220	
Adj R-sq	0.412	
Year variables	Yes	

*, **, *** indicate significance at 10%, 5%, 1% level, (two-tailed), respectively.

Table 3 present the statistical results of provisions for loan loss including fair value assets liabilities in more deeply by considering levels of fair values. In table 7, we replace the *FV* with *FVL1*, *FVL2*, and *FVL3* to measure the impact of three levels of fair value hierarchy. The coefficient on *FVL1* is positive but insignificant. This indicates that managers have no or minimal discretion when measuring the level 1 fair value assets and liabilities due to level 1 fair value assets and liabilities are directly observable inputs from the active markets. As we expect and consistent with our third hypothesis, the *FVL2* coefficient estimate to positive 0.012 and p-value estimate to 0.000 which is significantly influenced provision for loan loss. This provides evidence of banks report more level 2 fair value assets and liabilities in the financial statements are more likely to manage the earnings to avoid the earnings falls. The *FVL3* coefficient also significant however influence is negligible. Consequently, the positive relationship between total fair values assets & liabilities and provision for loan loss increases more likely determined by the level 2 fair values assets and liabilities compared to the other two levels of fair value hierarchy.

Table 3 Estimating provisions for loan loss including level of fair value assets and liabilities

$$PLL_{i,t} = \alpha + \beta_1 \log(TA)_{i,t} + \beta_2 \Delta NPL_{i,t} + \beta_3 FVL1_{i,t} + \beta_4 FVL2_{i,t} + \beta_5 FVL3_{i,t} \\ + \beta_6 RLL_{i,t} + \beta_7 RELOAN_{i,t} + \beta_8 CLOAN_{i,t} + \beta_9 DILOAN_{i,t} \\ + \beta_{10} AGLOAN_{i,t} + \beta_{11} HLOAN_{i,t} + \beta_{12} OLOAN_{i,t} + YEARDUMMY_{i,t} \\ + \varepsilon_{i,t}$$

Variables	Coefficient Estimate	p-value
INTERCEPT	0.033	(0.011) **
Log(TA)	0.003	(0.000) ***
ΔNPL	-0.312	(0.000) ***
FVL1	0.001	0.124
FVL2	0.012	(0.000) ***
FVL3	0.000	(0.000) ***

RLL	0.756	(0.000) ***
RELOAN	- 0.142	0.254
CLOAN	- 0.031	(0.036) **
DILOAN	0.002	0.542
AGLOAN	0.015	(0.002) ***
HLOAN	0.051	(0.000) ***
OLOAN	- 0.034	(0.003) ***
N	220	
Adj R-sq	0.435	
Year variables	Yes	

*, **, *** indicate significance at 10%, 5%, 1% level, (two-tailed), respectively.

3.3 Robustness and sensitivity tests

We implement several robustness checks to assess the sensitivity of our results to our research design choices.

3.3.1 The provisions for loan loss one-year ahead and fair value assets and liabilities

First, we change the time period base on the assumption that the change in fair value may influence the future earnings of the banks. The fair value, itself defined as the present value of future expected cash flow. Therefore, change in fair value today will affect the future earnings of the banks. To capture this, we estimate the regression between provisions for loan loss one-year ahead on fair value variables. Similar to earlier, first we used the total fair value as a proxy and then replaced the *FV* with *FVL1*, *FVL2*, and *FVL3* to measure the impact of three levels of fair value hierarchy. The coefficient on *FV* is positive and significant. Table 4 presents the statistical results of provisions for loan loss one-year ahead on fair value variables. Similar to earlier, consistent with the above results, the sign of *FV* is positive and significant. The coefficient of *FV* accounted as 0.009 at 0.012 significant level. This implies that banks are reporting fair values assets and liabilities more likely to have a positive association with the provision for loan loss of the banks. This finding is continuously consistent with our first and second hypothesis.

Table 5 presents the statistical results of provisions for loan loss one-year ahead including fair value assets liabilities in more deeply by considering levels of fair values. Similar to earlier, in table 5, we replace the *FV* with *FVL1*, *FVL2*, and *FVL3* to measure the impact of three levels of fair value hierarchy.

Table 4 Estimating provisions for loan loss one-year ahead

$PLL_{i,t+1} = \alpha + \beta_1 \log(TA)_{i,t} + \beta_2 \Delta NPL_{i,t} + \beta_3 FV_{i,t} + \beta_4 RLL_{i,t} + \beta_5 RELOAN_{i,t} + \beta_6 CLOAN_{i,t} + \beta_7 DILOAN_{i,t} + \beta_8 AGLOAN_{i,t} + \beta_9 HLOAN_{i,t} + \beta_{10} OLOAN_{i,t} + YEARDUMMY_{i,t} + \varepsilon_{i,t}$		
Variables	Coefficient Estimate	p-value
INTERCEPT	0.042	(0.012) **
Log(TA)	0.025	(0.000) ***
ΔNPL	-0.125	(0.005) ***
<i>FV</i>	0.009	(0.012) **
RLL	0.758	(0.000) ***
RELOAN	- 0.103	0.425
CLOAN	- 0.051	(0.024) **
DILOAN	0.010	0.524
AGLOAN	0.031	(0.001) ***
HLOAN	0.026	(0.031) **

OLOAN	- 0.021	(0.000) ***
N	220	
Adj R-sq	0.235	
Year variables	Yes	

*, **, *** indicate significance at 10%, 5%, 1% level, (two-tailed), respectively.

The coefficient on *FVL1* is significant, but the impact is negligible. This indicates that managers have no or minimal discretion when measuring the level 1 fair value assets and liabilities due to level 1 fair value assets and liabilities are directly observable inputs from the active markets. As we expect and with consistent with our third hypothesis, the *FVL2* coefficient estimate to positive 0.008 and p-value estimate to 0.000 which is significantly influenced provision for loan loss one-year ahead. Hence, this provides evidence of banks report more level 2 fair value assets and liabilities in the financial statements are more likely to manage the earnings to avoid the earnings falls. The *FVL3* coefficient is significant, but the influence is negligible. Consequently, the positive relationship between total fair values assets & liabilities and provision for loan loss increases more likely determined by the level 2 fair values assets and liabilities compared to the other two levels of fair value hierarchy.

Table 6 shows the estimation results of discretionary security gains and losses one-year ahead data. The adjusted R-square estimate to 32.5%. The variable *TSGL* estimate to 0.184 at 1% significant level. Which mean total security gains and loss is positive and significantly associated with the discretionary security gains and losses. Overall, the estimated results are consistent with prior research [4], [27], [31] of discretionary loan loss provision models and discretionary security gains and losses models.

Table 5 Estimating provisions for loan loss one-year ahead and level of fair value assets and liabilities

$PLL_{i,t+1} = \alpha + \beta_1 \log(TA)_{i,t} + \beta_2 \Delta NPL_{i,t} + \beta_3 FVL1_{i,t} + \beta_4 FVL2_{i,t} + \beta_5 FVL3_{i,t} \\ + \beta_6 RLL_{i,t} + \beta_7 RELOAN_{i,t} + \beta_8 CLOAN_{i,t} + \beta_9 DILOAN_{i,t} \\ + \beta_{10} AGLOAN_{i,t} + \beta_{11} HLOAN_{i,t} + \beta_{12} OLOAN_{i,t} + YEARDUMMY_{i,t} \\ + \varepsilon_{i,t}$		
Variables	Coefficient Estimate	p-value
INTERCEPT	0.124	(0.016) **
Log(TA)	0.008	(0.000) ***
ΔNPL	-0.284	(0.000) ***
FVL1	0.001	0.181
FVL2	0.008	(0.000) ***
FVL3	0.000	(0.000) ***
RLL	0.574	(0.002) ***
RELOAN	- 0.439	0.351
CLOAN	- 0.064	(0.027) **

DILoAN	0.004	0.341
AGLoAN	0.021	(0.000) ***
HLoAN	0.037	(0.001) ***
OLoAN	- 0.046	(0.005) ***
N	220	
Adj R-sq	0.325	
Year variables	Yes	

*, **, *** indicate significance at 10%, 5%, 1% level, (two-tailed), respectively.

Table 6 Estimating security gains and losses realized one-year ahead

$$SGLR_{i,t+1} = \alpha + \beta_1 \log(TA)_{i,t} + \beta_2 TSGL_{i,t} + YEARDUMMY_{i,t} + \varepsilon_{i,t}$$

Variables	Coefficient Estimate	p-value
INTERCEPT	0.002	(0.421)
Log(TA)	0.003	0.214
TSGL	0.184	(0.000) ***
N	220	
Adj R-sq	0.325	
Year variables	Yes	

*, **, *** indicate significance at 10%, 5%, 1% level, (two-tailed), respectively.

3.3.2 Estimating provisions for loan loss with a dichotomous variable

Second, we re-estimated equations by reintroducing *FV* with a dichotomous variable of *FVD*. Further, we elaborate the equation (2), by swapping *FVL1*, *FVL2*, and *FVL3* with a dichotomous variable of *FVDL1*, *FVDL2*, and *FVDL3*. We anticipate that the coefficient of *FVD*, *FVDL1*, *FVDL2*, and *FVDL3* are positive and significant. If the coefficient of *FVD*, *FVDL1*, *FVDL2*, and *FVDL3* are positive and significant, provide us the evidence of fair value measurements more likely enhance a positive association with the provision for loan loss of the banks. Table 7 shows the estimation results of discretionary security gains and losses. The results are consistent with our main results that the coefficient of *FVD* is positive significant. The coefficient of *FVD* accounted as 0.011 at 0.007 significant level. This implies that banks are reporting fair values assets and liabilities more likely to have a positive association with the provision for loan loss of the banks. This finding is continuously consistent with our first and second hypothesis.

Table 7 Estimating provisions for loan loss with a dichotomous variable of *FVD*

$$PLL_{i,t} = \alpha + \beta_1 \log(TA)_{i,t} + \beta_2 \Delta NPL_{i,t} + \beta_3 FVD_{i,t} + \beta_4 RLL_{i,t} + \beta_5 RELOAN_{i,t} + \beta_6 CLOAN_{i,t} + \beta_7 DILOAN_{i,t} + \beta_8 AGLOAN_{i,t} + \beta_9 HLOAN_{i,t} + \beta_{10} OLOAN_{i,t} + YEARDUMMY_{i,t} + \varepsilon_{i,t}$$

Variables	Coefficient Estimate	p-value
INTERCEPT	0.971	(0.075) *
Log(TA)	0.067	(0.000) ***
ΔNPL	-0.568	(0.000) ***
FVD	0.011	(0.007) ***
RLL	0.864	(0.000) ***
RELOAN	- 0.201	0.651
CLOAN	- 0.057	(0.067) **
DILOAN	0.081	0.821

AGLOAN	0.057	(0.000) ***
HLOAN	0.064	(0.036) **
OLOAN	- 0.016	(0.000) ***
N	220	
Adj R-sq	0.191	
Year variables	Yes	

*, **, *** indicate significance at 10%, 5%, 1% level, (two-tailed), respectively.

Table 8 presents the statistical results of provisions for loan loss including dichotomous variable fair value assets liabilities in more deeply by considering levels of fair values. The consistent with our main results the coefficient on *FVDL1* is insignificant. This indicates that managers have no or minimal discretion when measuring the level 1 fair value assets and liabilities due to level 1 fair value assets and liabilities are directly observable inputs from the active markets. As we expect and consistent with our third hypothesis, the *FVDL2* coefficient estimate to positive 0.004 and p-value estimate to 0.000 which is significantly influenced provision for loan loss one-year ahead. Hence, this provides evidence of banks report more level 2 fair value assets and liabilities in the financial statements are more likely to manage the earnings to avoid the earnings falls. The *FVDL3* coefficient is significant, but the influence is negligible. Consequently, the positive relationship between total fair values assets & liabilities and provision for loan loss increases more likely determined by the level 2 fair values assets and liabilities compared to the other two levels of fair value hierarchy.

3.3.1 Re-construction using median regression

So far, we have directed the analysis engaging the regression measures by using the mean of the variables. Table 2 suggests that the means of variables slight differ from the median may suggest that the distribution is might not symmetric. To address this, we use an additional testing procedure to construct the median regression. In table 13, we recorded the results of re-testing original equation using the median regression. We are comparing these results with our main results. The coefficient of *FV* remains positive and significant. Therefore, the median regression methodology supports our main interpretations.

Table 8 Estimating provisions for loan loss with a dichotomous variable of *FVDL1*, *FVDL2*, and *FVDL3*

$$PLL_{i,t} = \alpha + \beta_1 \log(TA)_{i,t} + \beta_2 \Delta NPL_{i,t} + \beta_3 FVDL1_{i,t} + \beta_4 FVDL2_{i,t} + \beta_5 FVDL3_{i,t} + \beta_6 RLL_{i,t} + \beta_7 RELOAN_{i,t} + \beta_8 CLOAN_{i,t} + \beta_9 DILOAN_{i,t} + \beta_{10} AGLOAN_{i,t} + \beta_{11} HLOAN_{i,t} + \beta_{12} OLOAN_{i,t} + YEARDUMMY_{i,t} + \varepsilon_{i,t}$$

Variables	Coefficient Estimate	p-value
INTERCEPT	0.251	0.821
Log(TA)	0.014	(0.000) ***
ΔNPL	-0.331	(0.000) ***
FVDL1	0.002	0.328
FVDL2	0.004	(0.000) ***
FVDL3	0.001	0.241
RLL	0.641	(0.000) ***
RELOAN	- 0.327	0.412
CLOAN	- 0.081	(0.047) **

DILOAN	0.011	0.341
AGLOAN	0.036	(0.000) ***
HLOAN	0.087	(0.000) ***
OLOAN	- 0.067	(0.000) ***
N	220	
Adj R-sq	0.261	
Year variables	Yes	

*, **, *** indicate significance at 10%, 5%, 1% level, (two-tailed), respectively.

Table 9 Re-construction using median regression

$$PLL_{i,t} = \alpha + \beta_1 \log(TA)_{i,t} + \beta_2 \Delta NPL_{i,t} + \beta_3 FV_{i,t} + \beta_4 RLL_{i,t} + \beta_5 RELOAN_{i,t} + \beta_6 CLOAN_{i,t} + \beta_7 DILOAN_{i,t} + \beta_8 AGLOAN_{i,t} + \beta_9 HLOAN_{i,t} + \beta_{10} OLOAN_{i,t} + YEARDUMMY_{i,t} + \varepsilon_{i,t}$$

Variables	Coefficient Estimate	p-value
INTERCEPT	1.521	(0.524)
Log(TA)	0.091	(0.000) ***
ΔNPL	-0.941	(0.000) ***
FV	0.008	(0.000) ***
RLL	0.725	(0.000) ***
RELOAN	- 0.342	0.421
CLOAN	- 0.071	(0.007) **
DILOAN	0.061	0.641
AGLOAN	0.034	(0.000) ***
HLOAN	0.024	(0.054) *
OLOAN	- 0.051	(0.000) ***
N	220	
Adj R-sq	0.214	
Year variables	Yes	

*, **, *** indicate significance at 10%, 5%, 1% level, (two-tailed), respectively.

4. CONCLUSION

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. This 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 estimate the provisions for loan loss after introducing the fair value variables. Table 6 presents the statistical output of provisions for loan loss including fair value assets liabilities. As we expected, the sign of *FV* is positive and significant. The coefficient of *FV* accounted as 0.019 at 0.000 significant level. Therefore, our primary research finding implies that banks are reporting fair values assets and liabilities more likely to have a positive association with the provision for loan loss of the banks. This finding is consistent with our first and second hypothesis. Further, we examine the fair value assets liabilities in more deeply by considering levels of fair values. In table 3, we replace the *FV* with *FVL1*, *FVL2*, and *FVL3* to measure the impact of three levels of fair value hierarchy. The coefficient on *FVL1* is positive but insignificant. As we expect and consistent with our third hypothesis, the *FVL2* coefficient estimate to positive 0.012 and p-value estimate to 0.000 which is significantly influenced provision for loan loss. This provides evidence of banks report more level 2 fair value assets and liabilities in the financial statements are more likely to manage the earnings to avoid the earnings falls. The *FVL3* coefficient also significant however influence is negligible. Consequently, the positive relationship between total fair values assets & liabilities and provision for loan loss increases more likely determined by the level 2 fair values assets and liabilities compared to the other two levels of fair value hierarchy. We implement several robustness checks to assess the sensitivity of our results to our research design choices. All these robustness checks and the sensitivity analysis provide evidence for that banks are reporting fair values assets and liabilities more likely to have a positive association with the provision for loan loss of the banks and the level 2 fair values assets and liabilities is key are determine item use for earnings management. We found the evidence for our hypothesis that banks report more fair value measurements on assets and liabilities to look likely to see fewer earnings volatility due to manager use the fair value measurements, especially level 2 fair value assets and liabilities smooth the earnings.

However, this reading has some limitations. First, we use a sample of banking industry including financial institutions listed under Colombo stock exchange. Generally, the financial industry is highly regulated by Central banks and security & exchange commission. Therefore, these test results cannot generalize to other industries. Second, our tests of the discretionary components of the provision for loan loss and discretionary components security gains and losses biased toward finding earnings management for both licensed commercial banks and financial institutions. Third, there are maybe unknown variables (and therefore uncontrolled) which may influence our test results. In summary, we find that, consistent with our expectation, 1) banks reported fair value assets and liabilities are positively associate with provision for loan loss. 3) The level 2 fair value assets and liabilities are a predominant determination for the association between banks reported fair value assets and liabilities associated with provision for loan loss. With all these evidence consistent with past research and present us, banks use the fair value measurements to earnings management.

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