INCOME SMOOTHING AND FINANCIAL PERFORMANCE OF TIER 11 COMMERCIAL BANKS IN KENYA

Dr. Rashid Simiyu Fwamba, Consolatta Nasimiyu, Carolyne Toroitich
Lecturer Kibabii University Kenya,
Lecturer Kibabii University Kenya,
Accountant Kaimosi University Kenya

ABSTRACT: *The most commonly used Income smoothing practices are attributed to bad corporate governance. Bank managers and bank accountants use strategies that seek to erode profit mechanisms that amount to severe consequences for the entire banking and finance industry. Therefore the purpose of this study was to determine the effect of income smoothing practices on financial performance of Tier II commercial banks in Kenya. The study was based on information theory, agency theory and positive accounting theory. This study adopted an exploratory research design in explaining the relationship between the independent and dependent variables. The target population for the study included10 CBK licensed tier II commercial banks in Kenya where 40 respondents were included: purposive sampling technique was used to select Finance managers, internal auditors and accountants. The researcher obtained sample from all the 10 tier II commercial banks in their head offices in Nairobi, Kenya. Primary data was collected using a structured Questionnaire while complimentary data was collected from published financial statements from CBK Supervisory reports. The data was analyzed using the Statistical Package for Social Sciences (SPSS) version 20, by use of both descriptive and inferential statistics. The study results revealed that Income Smoothing had an insignificant coefficient of 0.296 with the Financial Performance of tier II commercial banks in Kenya.. According to the findings, exclusion of liabilities activities are the source of funds for the banks. Based on these findings, the study recommended that watchdogs of the accounting practices need to exercise strict oversight on the extent to which Commercial bank adopt income smoothing issues. The study findings would form a timely and solid foundation that the banking industry pundits and policy makers would base most of their policy priorities in responding to the volatile accounting situation in Kenya today.*

KEYWORDS: income smoothing, financial performance, tier ii commercial banks, Kenya

INTRODUCTION

Background information

The resurgence of income smoothing in commercial banking has increasingly become an issue of international concern (Sanusi&Izedonmi, 2014). Income smoothing is a practice involving modifying accounting figures to meet the desires and expectations of organizational directors and managers through manipulation of earnings, use of loan provisioning, capital deductions, non-concealment of liabilities and the understatement of incomes (Bhasin, 2016). In the United States, famous financial scandals and loss of billions in the banking industries were heavily associated with misapplication of income smoothing practices including tax avoidance, off-balancing practices, income smoothing and misapplication of loan loss provisions.

In Australia, evidence shows that firms have been increasingly adopting income smoothing. According to Crouch, (2010), Australia has witnessed tremendous corporate failure, involving companies such as HIH Insurance, the largest corporate collapse in Australia, One Tel, Ansett Australia and Centaur Mining. Moreover, the global economic crisis from 2007 indicates that there have been more corporate casualties in the financial sector including financial institutions such as Allco, Bridge Corp, Fin Corp, Babcock and Brown (Jones, 2011). The continued corporate collapse and distress of major Australian companies has largely been associated with financial malpractices that come along with tremendous consequences.

In Ghana, most managers and companies were found to be using income smoothing in an attempt gain advantage over other stakeholders. According to Ndebugri&TweneboahSenzu, (2017), there is a gap that GAAP creates and it is this gap that permits the Ghanaian managers to practice of Income smoothing. The authors revealed that the most commonly used income smoothing method in the corporate sector of Ghana is Off Balance sheet financing while Managers and Chief Executive officers lead in the use of these manipulations.

The problems facing the Kenyan banks started back in 1986 and they culminated into major bank failures. By 1998 alone, 37 banks had collapsed in Kenya following the crises of; 1986 - 1989, 1993/1994 and 1998. Most of the larger local bank failures in Kenya involved extensive insider lending and use of flawed financial reporting. The Continental Bank of Kenya Limited and Continental Credit Finance Limited collapsed in 1986, Capital Finance Limited collapsed in 1987, and seven banks which had collapsed were merged in to the Consolidated Bank of Kenya limited in 1989, thirteen banks collapsed in 1993 and five banks collapsed between 1996 and 1999. In 1999 Trust Bank, the sixth largest bank in Kenya - in terms of deposits - collapsed due mainly to insider lending to directors and shareholders.

The most recent bank failure was witnessed chase Bank in 2016 and imperial bank in 2015 collapsed and the statutory management of Charter House bank. Despite the government's effort to streamline the banking sector by introducing statutory regulatory measures, more banks in Kenya continued to be liquidated or put under receivership. Between 2000 and 2006, six more banks collapsed. One of them, Charterhouse, had a litany of crimes from money laundering to tax evasion. Between 2007 and 2015, banks such as the Kenya Finance Corporation, Trade Bank, Trust Bank, Euro Bank, and Carter House had collapsed. Imperial Bank and Dubai bank were also placed under receivership due to financial malpractices and widespread manipulation of the banking system to conceal financial malpractices, indication of money laundering and cheque-kiting schemes in the bank, fictitious deposits and conflict of interest by shareholders and directors.

Statement of the Problem
The accounting problems facing Kenyan banks have been perennial and they have culminated into major bank failures. Most of the larger local bank failures in Kenya has involved extensive insider lending and use of flawed financial reporting in failed banks such as Continental Bank of Kenya Limited, Continental Credit Finance Limited, Capital Finance Limited, Trust, and Euro Bank to name but a few (Gathaiya, 2017).

According to Omoro, Aduda&Okiro (2015), manipulation of the banking system to conceal financial malpractices, indication of money laundering and cheque-kiting schemes in the bank, fictitious deposits and conflict of interest by shareholders and directors were noted to be some of the major factors causing crises among Kenyan banks. In 2016, Chase Bank was placed under receivership for 12 months after its directors were involved in a conspiracy to defraud the bank of billions of shillings. The managers also failed in reporting the bank's transactions involving money laundering proceeds by failing to maintain the records of customers who were transacting the money (Nyaga, 2017). Even though the management transferred the blame towards the accounting surrounding the bank's Islamic banking assets, it was determined that they were involved in unethical income smoothing practices (Karanja&Awuor, 2017).

Kamau, Namusonge, &Bichanga (2016), noted that corporate failures experienced by majority of the Kenyan commercial banks stem from the use of fraudulent financial reporting. The existing failures have had a negative impact on the stability of the financial system. The increased use of income smoothing practices in Kenyan commercial banks is one of the factors that continue to attract unsuspecting investors and banks continue to obtain undeserved accounting-based rewards as a result of providing misleading, exaggerated and deceptive bank financial information. Apparently, the extent of window-dressing of banks' financial reports blatantly violates the internationally accepted ethical standards of the accounting and auditing profession. The developments taking place in the Kenyan commercial banks have led to introduction of improved accounting systems. While it is evident that radical developments have taken place in banking industry, the impact of income smoothing practices on financial performance of commercial banks in Kenya is still an elusive question. Income smoothing's effect on financial performance of commercial banks is viewed as a double edged sword and there is no authoritative study that has been conducted to clear the air. Previous studies have provided mixed results regarding the effect of income smoothing on bank's financial performance. For instance, Studies by Nyabuti et al (2015) and Kamau, Mutiso&Ngui (2012) noted that income smoothing has a negative impact on financial performance. Studies by Mwania&Muganda (2011) indicated that when used appropriately, income smoothing has a significant contribution to financial performance. These studies have shown that there is a divided opinion on the significance of income smoothing practices in various sectors, the effect of these practices on financial performance is still misunderstood. It is at the center of such mixed conclusions that motivated and necessitated the need to carry out this study from a Kenyan context to establish relationship between income smoothing practices and financial performance of commercial banks.
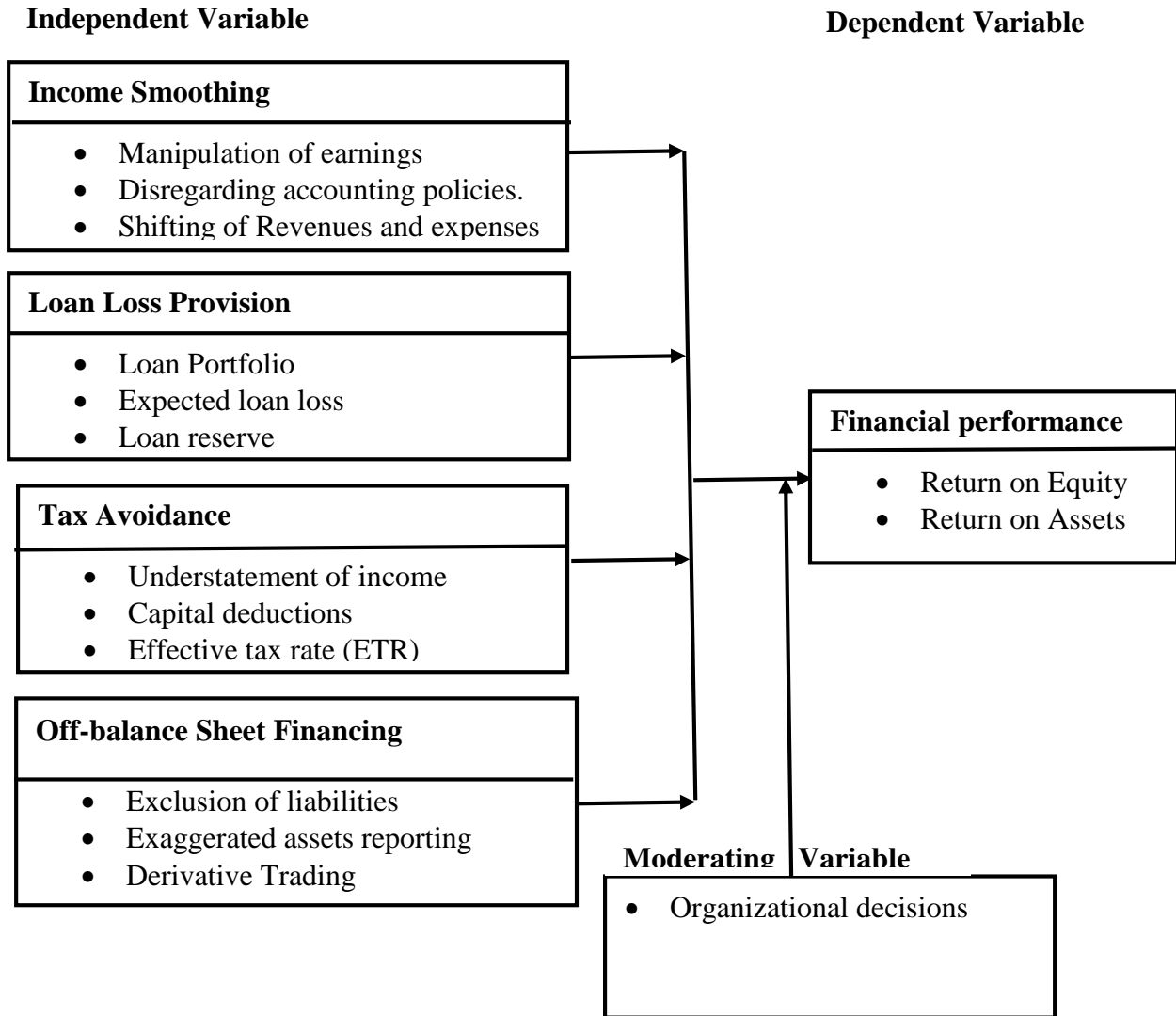
Specific objectives

i.   To establish the effect of income smoothing on financial performance of tier II Commercial Banks in Kenya

Research Hypothesis

 HO$_1$: Income smoothing has no significant effects on financial performance of tier II commercial banks in Kenya.

Conceptual Framework

A conceptual framework is a set of broad ideas and principles taken from relevant fields of enquiry and used to structure a subsequent presentation. The proposed study will utilize conceptual framework illustrated in Fig. 1 below in order to meet the objective of the research.

Independent Variable   **Dependent Variable**

Income Smoothing

- Manipulation of earnings
- Disregarding accounting policies.
- Shifting of Revenues and expenses

Loan Loss Provision

- Loan Portfolio
- Expected loan loss
- Loan reserve

Financial performance

- Return on Equity
- Return on Assets

Tax Avoidance

- Understatement of income
- Capital deductions
- Effective tax rate (ETR)

Off-balance Sheet Financing

- Exclusion of liabilities
- Exaggerated assets reporting
- Derivative Trading

Moderating Variable

- Organizational decisions

Figure 1.1: Conceptual Framework for the Study

Source: Researcher, 2018

LITERATURE REVIEW
Positive Accounting Theory
Positive accounting theory explains why accounting is what it is, why accountants do what they do and what effect this have on resource utilization (Godfrey et al., 2010). Positive accounting theory also focuses on the role of contracting cost and political cost considerations in explaining management motives for making accounting choices when markets possess semi strong form of market efficiency. Positive Accounting Theory finds its roots with the Efficient Market Hypothesis (EMH). The EMH was developed by Fama in the 1960's and is based on economic principles and assumes a perfect market where there is information symmetry and no transaction costs (Scott, 2015).

Positive Accounting Theory is important because of its vigorous emphasis on the entity's actual choice of financial accounting technique, specifically the financial reporting activity. It is refreshing because it provides insights regarding the nature of accounting institutions. Positive Accounting Theory tries to make good predictions of real world events and translate them to accounting transactions (Godfrey et al., 2010). The theory tries to explain and predict the actions such as which accounting policies firms will choose, how firms will react to newly proposed accounting standards as well as its overall intention is to understand and predict the choice of accounting policies across differing firms (Scott, 2015). It recognizes that economic consequences exist for all the actions taken by firms. This theory is linked to this study since it helps in understanding the managerial decisions and why certain financial are given preference over the others. It helps in the understanding of the accounting practices and their impact to the financial performance of a banking organization.

Empirical Review
This section reviewed specific literature and information from other researchers who carried out research in the same field of study. The specific areas covered here were Income smoothing, loan loss provisions, tax avoidance and off-balance financing.

Income Smoothing
Income smoothing is an earnings management strategy involving window-dressing financial statements. Swastika (2013) defined earning management as the "purposeful intervention by management in the earnings determination process, usually to satisfy selfish objectives". According to Chhabra (2016), earning management is the selection of accounting policy by the management to achieve some goals. The selection of that accounting policy is motivated from the efficiency and opportunistic purposes. Income smoothing refers to a wide range of good and bad practices such that it cannot be collectively termed as legal or illegal. According to Bao&Bao (2012), it involves the shifting of revenue and expenses among different reporting periods in order to present the false impression that a business has steady earnings. Management typically engages in income smoothing to increase earnings in periods that would otherwise have unusually low earnings.

ArbanaSahiti(2017) indicates that income smoothing is a particular form of income smoothing that aims to reduce the volatility of reported earnings. The researchers specify that income smoothing moderates year to year fluctuations in reported incomes by shifting earnings from peak years to

less successful periods. Peterson &Arun (2018) in their study of income smoothing among banks observe that income smoothing is an attempt to fool the various stakeholders by presenting them with more stable earnings over time. The researcher noted that doing this would provide various advantages. First of all, presenting smoothed and increasing earnings over the years would allow the market to easily predict the future of the firm. The firm would thus be perceived as less risky by the markets and would ultimately endure lower borrowing costs. Thus, there is existing study that has specifically narrowed down to examining the impact of income smoothing on commercial banks.

RESEARCH METHODOLOGY

Research design
The role of research design is to glue the entire project together (Jongbo, 2014) It is used in structuring the research and show how all the major parts of the project work together in addressing the central research question. For this study, an explanatory research design was adopted. The central focus of the study was to develop an understanding of the existing link between income smoothing practices and financial performance. According to Kothari (2008), an explanatory research design is appropriate for studies that examine relationships between independent and dependent variables and how they affect each other. The purpose of an explanatory research is to foster the recognition and clarification of a meaningful causal association by answering the "how" questions.

Population of the Study
Population can be defined as "the total number of units from which data can be collected", such as individuals, artifacts, events or organizations. It can also be described as population all the elements that meet the criteria for inclusion in a Study (Kothari 2010). The population of the study included 10 licensed and operational tier II commercial banks in Kenya as at December 31 2017 by the CBK. Thus; Bank of Africa Kenya, Bank of Baroda, Bank of India, CFC Stanbic Bank, Eco Bank, Family Bank, Housing Finance Bank, I&M Bank, National Bank and National Industrial Credit Bank (NIC) Bank. Table 3.1 summarizes the population of the study

Table 3.1: Population of the Study

Employees	2014	2015	2016	2017
Management	3241	4411	4211	3277
Supervisory	2362	2968	2682	2423
Clerical and secretarial	6730	5497	5263	6231
Support staff	1125	1600	1007	1056
Total	13458	14476	13163	12987

Source: CBK Supervisory report (2017)

Sampling Design

The study sample was derived using purposive sampling. Purposive sampling is a non-probability sampling procedure which does not afford any basis for estimating the probability that each item in the population has a chance of being included in the sample (Kothari, 2010). Purposive sampling technique was used to select finance officers, Accountants and Internal Auditors. The criterion of purposive sampling was based on their experience and their knowledge on financial statements.

Sample Size

A sample size refers the total number of items constituted from an aggregate group to develop a sample for the study. A sample size is effective in lowering the implied costs, promotes the generation of accurate results and enhances the speed of data collection (Kothari, 2010). For this study, purposive sampling technique was used in selecting internal auditors, heads of finance and accountants due to the virtue of their position in their banks and the level of knowledge they have on their banks' financial performance. This study included human population which was bank employees from the head offices: two (2) accountants, one (1) finance manager and one (1) Internal Auditor from each. These respondents were selected since they possess firsthand information regarding the practices relating to income smoothing in their respective banks. Table 3.2, gives a summary of sampling.

Table 3.2: Sampling size

Bank	Finance and Accounting Department	Internal Audit Department	TOTAL
Bank of Africa Kenya	3	1	**4**
Bank of Baroda	3	1	**4**
Bank of India	3	1	**4**
CFC Stanbic Bank	3	1	**4**
Eco Bank	3	1	**4**
Family Bank	3	1	**4**
Housing Finance Bank	3	1	**4**
I&M Bank	3	1	**4**
National Bank	3	1	**4**
National Industrial Credit Bank (NIC) Bank	3	1	**4**
TOTAL	**30**	**10**	**40**

Source: CBK 2017

Data Collection Method
This study relied on both primary and secondary data. The researcher used a self-administered questionnaire and content analysis in collecting primary data from the respondents as discuss in the sub-sections below.

Data analysis
The data collection in the study was guided by research objectives and research hypothesis. Both descriptive statistics and inferential statistics was used to analyze data. The descriptive statistics that was adopted in the study which mainly included percentage mean scores, frequencies and standard deviations. Inferential statistics on the other hand will measure or shows the relationship between or among variables. Inferential statistics included multiple linear regression. The analysis of the collected data was done using both descriptive and inferential statistics. Data was coded and using a Statistical Packages for Social Sciences (SPSS) version 20. The generated results were then presented using graphs, pie charts and frequency distribution tables so as to provide clear picture of the study findings at a glance.

Model Specification
The researcher considered a linear and multiple regression models as an analytical model for the study because there is more than one variable in the study. The model format is as follows:
$$(Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon)$$
Where:
Y=Financial Performance determined using profitability and other financial indicators and ratios
β_0= Constant
X_1= Income Smoothing
$\beta_1, \beta_2, \beta_3$ andβ_4= Parameters to be estimated
ε = error term or stochastic error
The researcher considered a linear and multiple regression models as an analytical with an inclusion of moderating variable. The model format is as follows:
$$(Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + Z + \varepsilon)$$
Y=Financial Performance determined using profitability and other financial indicators and ratios
β_0= Constant
X_1= Income Smoothing
X_2
$\beta_1, \beta_2, \beta_3$ and β_4= Parameters to be estimated
Z= Organization decisions
ε = error term or stochastic error

DATA ANALYSIS AND RESULTS

Descriptive characteristics of the variables under the study
The descriptive analysis included an assessment of the income smoothing practices (income smoothing, loan loss provision, tax avoidance and off-balance sheet items) and financial performance of commercial banks in Kenya. The statements were anchored on a five point Likert-

type scale ranging from 1=Strongly Disagree (SD), 2= Disagree (D), 3= Undecided (U), 4= Agree (A) and 5= Strongly Agree (SA) and respondents were asked to indicate the extent to which they agreed to the statements. Descriptive measures included percentage, frequency, mean and standard deviation.

Income Smoothing

The research sought to collect and analyze data on income smoothing on tier II commercial banks in Kenya. Income smoothing involves the shifting of revenue and expenses among different reporting periods in order to present the false impression that a business has steady earnings. Table 4.4 gives the summary of the findings.

Table 4.1: Income Smoothing

Statement		SD	D	N	A	SA
The future of the bank in the financial market can be predicted through the presentation of manipulated financial statements	Count	16	6	0	7	7
	%	44.4%	16.7%	0.0%	19.4%	19.4%
Shifting of revenues and expenses in the bank is less risky and hence it can help it in enduring lower borrowing costs	Count	8	7	10	10	1
	%	22.2%	19.4%	27.8%	27.8%	2.8%
The main earnings management policy used by this organization are based on efficiency and opportunistic purpose	Count	11	3	11	6	5
	%	30.6%	8.3%	30.6%	16.7%	13.9%
Deceptive accounts are used in our Bank to meet management objective rather than organizational objectives.	Count	7	5	5	10	9
	%	19.4%	13.9%	13.9%	27.8%	25.0%
Shifting of revenues and expenses in our bank is used to encourage and sustain shareholders.	Count	8	5	7	8	8
	%	22.2%	13.9%	19.4%	22.2%	22.2%
When the income patterns of the bank are manipulated, Earnings increases	Count	5	2	9	11	9
	%	13.9%	5.6%	25.0%	30.6%	25.0%

Table 4.1 indicates that majority of the respondents at 44.4% and 16.7% strongly disagreed and disagreed respectively that the future of the bank in the financial market can be predicted through the presentation of manipulated of financial statements, 19.4% and 19.4% agreed and strongly agreed respectively. In terms of shifting of revenues and expenses, 22.2% and 19.4% of the respondents strongly disagreed and disagreed respectively that shifting of revenues and expenses in the bank is less risky and hence it can help it in enduring lower borrowing costs, 27.8% neither agreed nor disagreed while 27.8% and 2.8% agreed and strongly agreed respectively. 30.6% and 8.3% strongly disagreed and disagreed respectively that main earnings management policy used by this organization are based on efficiency and opportunistic purpose, 30.6% neither agreed nor disagreed while 16.7% and 13.9% of the respondents agreed and strongly agreed respectively. Majority of the respondents, 27.8% and 25% agreed and strongly agreed respectively that deceptive accounts are used in their Banks to meet management objective rather than organizational objectives, 13.9% don't have an idea while 19.4% and 13.9% of the respondents strongly disagreed and disagreed respectively that deceptive accounts are used in their Banks to

meet management objective rather than organizational objectives. In terms of shifting of revenues and expenses in bank, majority of the respondents, 22.2% and 22.2% agreed and strongly disagreed that shifting of revenues and expenses in their banks is used to encourage and sustain shareholders, 19.4% neither agree nor disagree while 13.9% and 22.2% disagree and strongly disagree respectively that shifting of revenues and expenses in their banks is used to encourage and sustain shareholders. Majority of the respondents, 30.6% and 25% agree and strongly agree respectively that earnings increases when the income patterns of the bank are manipulated, 25% don't have an idea on the same while 5.6% and 13.9% of the respondents disagree and strongly disagree respectively that earnings increases when the income patterns of the bank are manipulated.

Financial Performance

In order to understand Financial Performance, the research collected data on the manner in which an organization's resources and competencies are utilized to achieve its desired set of objectives. Financial performance is concerned with using financial indicators in measuring the extent to which objectives have been achieved contribution to making available financial resources and supporting the bank with viable investment opportunities. The findings are as tabulated in Table 4.2.

Table 4.2: Financial Performance

Statement		SD	D	N	A	SA
Commercial banks use return on equity to measure their profitability	Count	4	1	4	14	13
	%	11.1%	2.8%	11.1%	38.9%	36.1%
Commercial banks use return on assets to measure their profitability	Count	2	5	5	16	8
	%	5.6%	13.9%	13.9%	44.4%	22.2%
Our Bank relays mostly on return on asset to maximize the profit margin	Count	3	0	9	17	7
	%	8.3%	0.0%	25.0%	47.2%	19.4%
Our Bank relays mostly on return on equity to maximize the profit margin	Count	0	1	10	18	7
	%	0.0%	2.8%	27.8%	50.0%	19.4%
Profit maximizes shareholders wealth in our bank	Count	3	1	8	15	9
	%	8.3%	2.8%	22.2%	41.7%	25.0%
Return on equity has a significant effect to our shareholders investments'	Count	1	2	5	21	7
	%	2.8%	5.6%	13.9%	58.3%	19.4%
The total asset has a significant effect to our profit margin	Count	2	1	8	18	7
	%	5.6%	2.8%	22.2%	50.0%	19.4%
The higher the return, the more productive and efficient management utilizes economic resources	Count	3	1	5	16	11
	%	8.3%	2.8%	13.9%	44.4%	30.6%

As indicated on the findings in table 4.2, majority of the respondents, 38.9% and 36.1% agreed and strongly agreed that Commercial banks use return on equity to measure their profitability, 11.1% didn't have an idea on the same while 11.1% and 2.8% strongly disagreed and disagreed respectively that Commercial banks use return on equity to measure their profitability. 44.4% and 22.2% of the respondents agreed and strongly agreed that Commercial banks use return on assets to measure their profitability, 13.9% neither agreed nor disagreed while 13.9% and 5.6% disagreed

and strongly disagreed that Commercial banks use return on assets to measure their profitability. Majority of the respondents, 47.2% and 19.4% agreed and strongly agreed that their bank relays mostly on return on asset to maximize the profit margin, 25% didn't have an idea over the same while 8.3% strongly disagreed that their bank relays mostly on return on asset to maximize the profit margin. 50% and 19.4% agreed and strongly agreed that their Bank relays mostly on return on equity to maximize the profit margin, 27.8% neither agreed nor disagreed while 2.8% disagreed that their Bank relays mostly on return on equity to maximize the profit margin. Majority of the respondents, 41.7% and 25% agreed and strongly agreed respectively that Profit maximizes shareholders' wealth in their banks, 22.2% nether agreed nor disagreed while 2.8% and 8.3% disagreed and strongly disagreed respectively that Profit maximizes shareholders' wealth in their banks. In terms of total assets, majority of the respondents, 50% and 19.4% agreed and strongly agreed that total asset has a significant effect to their profit margin, 22.2% had no idea over the same while 2.8% and 5.6% disagreed and strongly disagreed that total asset has a significant effect to their profit margin. Majority of the respondents, 44.4% and 30.6% agreed and strongly agreed respectively that the higher the return, the more productive and efficient management utilizes economic resources, 13.9% neither agreed nor disagreed while 2.8% and 8.3% disagreed and strongly disagreed respectively that the higher the return, the more productive and efficient management utilizes economic resources.

Inferential Analysis
The purpose of this study was to assessthe effect of Income smoothing Practices (Income Smoothing, Loan Loss Provision, Tax Avoidance and Off-Balance Sheet items) on financial performance of commercial banks in Kenya. Inferential analysis, which comprised of correlation analysis and Multiple Linear Regressions were both used to test research hypotheses at significance level of 0.05

Income Smoothing and Financial Performance of Tier II Commercial banks
The first objective of the study was to establish the effect of income smoothing on financial performance of tier II Commercial Banks in Kenya. To achieve this objective of the study, the researcher formulated and tested the following hypothesis:
H_{01}: Income smoothing has no significant effects on financial performance of tier II commercial banks in Kenya.
As indicated in the in the regression coefficient results as shown in 4.10 above, Income smoothing had a statistically insignificantly contribution on financial performance of tier II commercial banks in Kenya, ($B = 0.296, t = 1.810, p=0.079>0.05$); thus the study does not reject the null hypothesis and concludes that Income smoothing assessment does not have a significant influence on the financial performance of tier II commercial banks in Kenya.

FP =25.520 + 0.296**IS.**
The findings imply that income smoothing has the potential to predict as small as 29.6% of the financial performance. The hypothesis (H_{01}: *Income smoothing has no significant effects on financial performance of tier II commercial banks in Kenya*.) remains unchanged because income smoothing is only used by few banks to the extent that the results cannot be dependable for generalizations. According Hejazi *et al.,* (2010) in their longitudinal study, even though some of

the companies indulged in income smoothing, it had no significant effect on their ultimate return.

Income Smoothing with organizational decisions on the Financial Performance of Tier Commercial banks

As indicated in the in the regression coefficient results as shown in 4.11 above, Income smoothing with inclusion of organizational decisions had a significant contribution on financial performance of tier II commercial banks in Kenya ($B = 0.344$, $t = 2.136$, $p=0.040<0.05$). The findings, if p value is less than 0.05 at 95%, the study rejects the null hypothesis. This implies that when organizational decisions are made in favour of income smoothing, there will a positive effect on financial performance. A conscious decision by the organization to use income smoothing generates moderate profits.

Modelling the relationship between Income smoothing Practices and Financial Performance of the commercial banks

To determine the causal effect relationship between Income smoothing Practices and Financial Performance of Commercial Banks in Kenya, a Multiple Linear Regression model was used. Findings indicates that the study did not violate any assumption of Multiple Linear Regression analysis, thus the researcher went ahead to model the causal and effect relationship between Income smoothing Practices and Financial Performance of Commercial Banks in Kenya using Multiple linear regression technique.

Analysis of Variance (ANOVA)

To test for the goodness of fit of the model and how well he adopted Multiple Linear Regression model predict the dependent variable, Analysis of Variance (ANOVA) was used and the results were as in Table 4.4.

Table 4.4: ANOVA[a]

Model 1	Sum of Squares	df	Mean Square	F	Sig.
Regression	7.114	4	1.779	5.696	.001[b]
Residual	9.679	31	.312		
Total	16.793	35			

a.   *Dependent Variable: Financial Performance*
b.   *Predictors: (Constant), Income Smoothing, Loan Loss Provision, Tax Avoidance and Off-Balance Sheet Practices*

The ANOVA results as in table 4.4 indicates that the F-statistic was significant, $F (4, 31) = 5.696$, p 0.001< 0.05); an indication that the model was a good fit to the study data and that the independent variables were good predictors of the study response variable (Financial Performance of the Commercial Banks in Kenya).

Coefficient of Determination

The study sought to determine the proportion of the variance in the financial performance that is predictable from the income smoothing, tax avoidance, Loan Loss Provisions and Off-balancing

items. The test was conducted to aid in predicting future outcomes or the testing of hypotheses. Determination and the results were as in Table 4.12

Table 4.5: Coefficient of Determination

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	R Square Change	F Change	df1	df2	Sig. F Change
					Change Statistics				
1	.651[a]	.424	.424	.55877	.424	5.696	4	31	.001

a. *Predictors: (Constant), Income Smoothing, Loan Loss Provision, Tax Avoidance and Off-Balance Sheet Practices*

The study findings in table 4.5, indicates that the Adjusted R Square = 0.424. Thus, the model explained 42.4% of the total variation in the Financial Performance of Tier II commercial banks in Kenya.

Regression Coefficients
The study further sought to test the hypothesis of the study (causal effect relationship between Income smoothing Practices and Financial Performance of Commercial Banks in Kenya) and the findings were as shown in Table 4.6.

Table 4.6: Regression Coefficients

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	Correlations		
	B	Std. Error	Beta			Zero-order	Partial	Part
(Constant)	.778	.663		1.173	.250			
Income Smoothing	.069	.111	.103	.626	.536	.296	.112	.085

a. Dependent Variable: *Financial Performance*

As indicated in the regression coefficient results as shown in 4.6 above, Income smoothing had a Partially statistically insignificantly contribution in the on financial performance of tier II commercial banks in Kenya, ($B = 0.0.069$, $t = 0.626$, $p=0.536>0.05$); thus the researcher does not reject the null hypothesis and conclude that Income smoothing assessment do not have a significant influence in the financial performance of tier II commercial banks in Kenya.

Squaring the Part Correlation coefficient (in the coefficients results of table 4.6 the study derives an indication of how much of the total variance in the dependent variable is uniquely explained by a given predictor variable and how much 'R-squared' would drop if it weren't included in the model. Income smoothing had Part Correlation coefficient of 0.085, thus it uniquely explains $0.085^2 = 0.72\%$ (Part Correlation Coefficient Squared) of the variance in the financial performance of tier II commercial banks in Kenya.

The study therefore concludes at 5% level of significance that Income smoothing do not have a

significant influence in predicting the financial performance of tier II commercial banks in Kenya. This finding are consistent with that of Peterson &Arun (2018) who established that the best that income smoothing can achieve when applied by bank managers is to fool the various stakeholders but it has a limited potential in influencing financial performance and the future of the firm.

Therefore, the study adopted the following Multiple Linear Regression model to estimate the Financial Performance of tier II commercial banks in Kenya based on the four Income smoothing Practices.

FP = 0.778 + 0.069**IS**

Where;

FP = Financial Performance
IS = Income Smoothing

Organisational Decisions and Income smoothing Practices on the Financial Performance of the commercial banks

The study examined the moderating effect of Organisational Decisions on the relationship between Income smoothing Practices and the Financial Performance of the commercial banks in Kenya; a Hierarchical Multiple Regression Model was adopted. To avoid potentially problematic high multicollinearity with the interaction term, the variables were centred and an interaction term between Income smoothing Practices (Income Smoothing, Loan Loss Provision, Tax Avoidance and Off-Balance Sheet Practices) and the Moderator variable (Organisational Decisions) was created (Aiken & West, 1991). The results moderation effect examination was as detailed in table 4.7.

Table 4.7: Analysis of Variance (ANOVA[a]) after incorporation of the interaction between moderator and the Income smoothing Practices

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	7.114	4	1.779	5.696	.001[b]
	Residual	9.679	31	.312		
	Total	16.793	35			
2	Regression	8.502	5	1.700	6.153	.000[c]
	Residual	8.291	30	.276		
	Total	16.793	35			

a. *Dependent Variable: Financial Performance*
b. *Predictors: (Constant), Income Smoothing, Loan Loss Provision, Tax Avoidance and Off-Balance Sheet Practices*
Predictors: (Constant), Income Smoothing, Loan Loss Provision, Tax Avoidance and Off-Balance Sheet Items organisational decisions.

The model 2 ANOVA results in table 4.8 indicates that the F-statistic was significant, $F_{(5, 30)}$ = 6.153, p 0.000< 0.05); since p< 0.05 the model was significant hence a good fit to the study

Model Summary after inclusion of theOrganization decisionsand the Income smoothing Practices were tabulated as in table 4.8.

Table 4.8: Model Summary after inclusion of Organisation Decisions and the Income smoothing Practices

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics R Square Change	F Change	df1	df2	Sig. F Change
1	.651[a]	.424	.424	.55877	.424	5.696	4	31	.001
2	.712[b]	.507	.499	.52570	.083	5.022	1	30	.033

a. Predictors: (Constant), *Income Smoothing, Loan Loss Provision, Tax Avoidance and Off-Balance Sheet Practices*
b. Predictors: (Constant), *Income Smoothing, Loan Loss Provision, Tax Avoidance and Off-Balance Sheet Practices, Interaction Effect*
c. Dependent Variable: *Financial Performance*

The study findings in table 4.16, the second model (Model 2) after inclusion of the Interaction effect between Income smoothing Practices and Organisational Decisionswas significant as indicated by a significant F-change, $F (1, 30) = 5.022$, p $0.033 < 0.05$); this was an indication that there was a significant moderation effect of the Organisational Decisionson the relationship between Income smoothing Practicesand Financial Performance of the Commercial Banks in Kenya.According to Aebi, Sabato & Schmid (2012), organizational decision making is an important ingredient of cooperate governance and issues such as the banks' risk management structures have an effect on their financial performance. This therefore means that the interplay between decisions to use income smoothing practices and their ultimate influence on financial performance cannot be ignored. In banks where organizational decisions are made by board of directors while considering the input from other employees, positive results have been reported. Thus, in this study, organizational decisions explained 8.3% of the total variation in the Financial Performance of Commercial Banks in Kenya as indicated by the R Square Change= 0.083 as shown in the results of Model 2 in table 4.9 below. Hence, organizational decisions influence the interaction between income smoothing practices and financial performance of tier II commercial banks.

The Regression Coefficients after inclusion Organisational Decisions and Income smoothing Practices was computed the results are as in table 4.9

Table 4.9: Regression after inclusion of Organisational Decisions and Income smoothing Practices

Model		Unstandardized Coefficients B	Std. Error	Standardized Coefficients Beta	t	Sig.	Correlations Zero-order	Partial	Part
1	(Constant)	.778	.663		1.173	.250			
	Income Smoothing	.069	.111	.103	.626	.536	.296	.112	.085
2	(Constant)	.384	.648		.592	.558			
	Income Smoothing	.076	.104	.113	.732	.470	.296	.112	.085
	Interaction effect	.170	.076	.303	2.241	.033	.440	.379	.288

a. *Dependent Variable: Financial Performance*

To examine the moderation effect of Organisational Decisions on the relationship between Income smoothing Practices and the Financial Performance of the commercial banks in Kenya, the researcher formulated and tested the following hypothesis:

H_{05}: Organisational Decisions has no significant moderation effects on the relationship between Income smoothing Practices and the Financial Performance of the commercial banks in Kenya.
As indicated in the in the regression coefficient results as shown in 4.9 above, the Interaction effect between Income smoothing Practices and Organisational Decisions had a statistically significant contribution in explaining the variation in the financial performance of tier II commercial banks in Kenya, ($B = 0.170$, $t = 2.241$, $p=0.033 <0.05$); thus the study rejects the null hypothesis and concludes that Organisational Decisions have a significant moderation effects on the relationship between Income smoothing Practices and the Financial Performance of the commercial banks in Kenya. The moderated Multiple Regression model was therefore given as;
FP = 0.384 + 0.076**IS** + 0.170**IE**
Where;
FP = Financial Performance
IS = Income Smoothing
IE = Interaction

SUMMARY OF THE FINDINGS

Income smoothing on financial performance of tier II Commercial Banks
The first objective of this study was to establish the effect of income smoothing on financial performance of tier II Commercial Banks in Kenya. Findings indicate that the future of the bank in the financial market cannot be predicted through the presentation of manipulated financial statements as cited by majority of the respondents. There was a blinking observation from the study that shifting of revenues and expenses in the bank come along with a significant level of adverse risks for the bank. Depending on the management priorities, findings illuminated that earnings management policy used by Tier II Commercial banks are based on efficiency and opportunistic purpose. Notably, there was a unanimous conclusion among the respondents that banks use deceptive accounting in meeting management objective rather than organizational objectives. The study findings also revealed that earnings increases when the income patterns of the bank are manipulated. The results of the correlation analysis revealed that Income Smoothing had an insignificant coefficient of 0.296 with the Financial Performance of tier II commercial banks in Kenya

CONCLUSIONS

Income smoothing and financial performance of tier II Commercial Banks
Based on the findings, the study concludes that Income smoothing does not have a significant influence on the financial performance of tier II commercial banks in Kenya. If any influence exists, then it is weak or negligible. It is concluded that shifting of revenues and expenses in the bank is more risky and hence it does not help the commercial bank in enduring lower borrowing costs. The study also concludes that there is an increase in the use of deceptive accountingin

meeting management objective rather than organizational objectives. The study concludes that bank earnings increases when the bank management manipulates the income patterns of the bank.

Recommendations for policy
Based on the findings of this study, the following recommendation was made;
There is a need for the watchdogs of the accounting practices to exercise strict oversight on the extent to which Commercial bank adopts income smoothing issues

Suggestions for further research
This study was limited in scope in the sense that it only narrowed down to Tier II commercial banks in Kenya with a limited number of respondents to that effect. Future studies should be expansive in a manner that they should target Tier I banks as well with a wider scope of other employees that may be involved in practicing income smoothing.

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