

# Factors Influencing Earnings Management in Sri Lanka

Asanga Jayawardhana,

Central Queensland University, Australia

## Abstract

Earnings management can be influenced by a number of factors that need to be analysed further to find out how influential they are and also how exactly they influence. In order to conduct a systematic review of available literature on the topic of factors influencing earnings management, specifically in the context of companies and firms in Sri Lanka, a search methodology was devised and applied to the online search engine 'Google Search'. From here, results were narrowed down in a systematic manner. First, only scholarly articles were isolated using Google's Scholarly Articles filter. Second, article beyond the first few pages were eliminated due to constraints of space and time. Third and last, articles pertaining the specific topic at hand as well as the narrow geographical context of Sri Lanka were chosen. This resulted in five articles being selected for further analysis. Analysis showed that there were a number of factors studied that had correlations to the degree of earnings management practices in Sri Lankan companies. The systematic review also showed that there remains a significant scope for further study and research to fill in the gaps of existing literature.

**Keywords:** Earnings Management, Sri Lanka, Drivers, Factors

## Introduction

Earnings management (EM) as a practice is influenced by any number of factors. These factors can act as drivers of earnings management, can be the result of earnings management or can have an undetermined association with the practice of earnings management.

The aim of this systematic review is to examine some of the factors influencing earnings management, specifically in the context of the country of Sri Lanka via the systematic review of available literature. In order to conduct a systematic review, a methodology was specifically designed to generate results through an online search. The results were narrowed using necessary criteria and the final results were discussed and further analysed to tease out relevant observations.

## Earnings Management and Drivers of Earnings Management

Before proceeding, it is important to gain a more thorough understanding of the concept of earnings management.

Earnings management or EM is a set of practices, techniques or methods through which the financial reporting of a company or firm is presented in the best possible light, whether or not those statements accurately represent the truth of the financial health of said company or firm. Whether it is to attract investors, to adhere to mandatory standards or to present a false idea of the company, earnings management is used for many reasons by companies and firms around the world. (Cengage, n.d.; Investopedia, 2018)

As mentioned previously, one set of factors influencing earnings management may be determinative. These can be termed as drivers of earnings management. Different researchers have come up with different drivers for earnings management. The poor health of a company or

a poor performance in the previous financial year can be some of the drivers. (Heidarpoor, Rafiee, & Rafiee, 2014) Other factors can be motives related to the capital market, management compensation contracts, external contracts and regulatory & political costs. (Mangala, 2017)

Thus, it can be said that drivers of earnings management are dependent on the situation of the company, economic health of the country, political climate, and individual actions as well; therefore, drivers of earnings management can be myriad and context-dependent.

## **Systematic Review: Search Methodology**

A systematic review depends heavily on the methodology of the search. In order to conduct this search, a methodology was specifically designed with the intention of answering the specific questions raised by this paper. A number of steps were taken along the way that are described in detail here.

First, a list of search criteria was constructed. This list included compound search terms that can be entered into search engines to find the appropriate and relevant articles. These search terms were derived from the original research intent of this systematic review, i.e. factors that influence earnings management in Sri Lanka. Below are some of the search terms used for this systematic review.

1. "Earnings Management in Sri Lanka"
2. "Practices of Earnings Management in Sri Lanka"
3. "Earnings Management in South Asia"
4. "Drivers of Earnings Management in Sri Lanka"
5. "Factors of Earnings Management in Sri Lanka"
6. "Influencing Earnings Management in Sri Lanka"

These and other search terms were entered into the online search engine 'Google Search'. Google Search was chosen over online databases containing extensive troves of scholarly works, such as JSTOR or Lexis Nexis, due to its wide reach and in order to not restrict results to any one or two digital databases.

Once the search terms were entered into the Google Search engine, the 'Scholarly Results' tab was used to filter the results further to only scholarly and research works. Thus, any other types of search results, such as newspaper or magazine articles, videos and reports published by international organizations, were automatically eliminated from consideration. Further, due to the limitation of a short article, no results beyond the first five pages of search results were considered. Since each page of search results on Google Search contain ten results, in total no more than fifty articles were examined. Moreover, articles not pertaining to the subject of earnings management were automatically eliminated as were articles that did not have the Sri Lankan context as a primary point of consideration or at least as one of the case studies.

## **Search Results**

By applying this search methodology a few articles were shortlisted to be further analysed for the systematic review. Below is a description of each of the works, as well as their broad conclusions. These results are discussed further in the following section.

The first article analysed is titled 'Impact of IFRS adoption in Sri Lanka: An evaluation of financial reporters' perception' and has been written by author Habeeb Mohamed Nijam. The aim of the study was to examine the perceived impact of the adoption of International Financial

Reporting Standards on the characteristics of Sri Lankan firms. The author shortlisted sixty-two companies listed in the Colombo Stock Exchange that pertained to banking, finance and insurance. Next, the author distributed questionnaires to the finance and accounting staff of these companies in order to further interrogate his premise. By mathematically analysing the data produced by the answers to the questionnaires by the finance and accounting staff of sixty-two companies, the author was able to produce a set of results. According to the author's conclusions, whether accurate or not, there is a perception that adopting the International Financial Reporting Standards has improved financial reporting, implying that there is a perception that this has caused a reduction in earnings management practices. The author also found that the size and profitability of the firms studied had a positive and significant association with the perception of the impact that the adoption of the International Financial Reporting Standards had to the level and quality of financial reporting. (Nijam, 2016)

The second article analysed is titled, 'Association between Earnings Per Share and Earnings Management: Evidence from Manufacturing Companies in Sri Lanka' and has been written by authors P.L.B.A. Imeshika, I.N. Manawadu and R.M.R.B. Rajapakshe. The authors set out to examine whether Earnings per Share (EPS) can be manipulated by earnings management in listed manufacturing companies in Sri Lanka. The authors set out with an underlying assumption that they claimed was in contrast to existing literature, namely they assumed that the chances of using earnings management to manipulate earnings per share or EPS would be limited or restricted. In order to prove this hypothesis, the authors performed a multiple case study and analysed data from ten different companies in the field of manufacturing in Sri Lanka. They authors studied the companies for two different time periods, one before the adoption of the International Financial Reporting Standards and one after the adoption of these standards, and this was done using both qualitative and quantitative data. Further analysis showed that the standards provided by the Sri Lanka Accounting Standards (LKASs) resulted in a lower tendency to manipulate earnings per share. Therefore, the authors concluded that earnings management was reduced under the LKAS' usage and inherent strength. According to the authors, the research also showed that a stronger internal corporate culture and an increase in ethical behaviour on the part of the manufacturing companies also reduced the possibility earnings management occurring when earnings per share was calculated. (Imeshika, Manawadu, & Rajapakshe, 2014)

The third work analysed is titled 'The Impact of Situational and Demographic Factors on Ethical Perceptions of Earnings Management Practices among Professionals' and has been written by author Roshan Ajward. The author has aimed to examine factors of earnings management in the context of Sri Lankan companies. These are one, situational factors, (namely nature, direction, materiality and intention of earnings management practices), and two, selected demographic features (namely gender, age, sector, employment status, tenure, educational qualifications, and professional qualifications). The author aimed to find out if situational factors and demographic features played a role on the ethical perceptions of earnings management practices among professionals in Sri Lanka. In order to conduct this study, the author surveyed ninety professionals who were in auditing and/or accounting with a prepared questionnaire. The author found that the ethical perceptions of these surveyed professionals in auditing and accounting were influenced or impacted by the afore-mentioned situational factors but not by the previously mentioned demographic factors, as the results were different according to each of the situational factors but not according to the demographic factors. (Ajward, 2015)

The fourth work analysed is titled ‘The Relationship between Board Characteristics and Earnings Management: Evidence from Sri Lankan Listed Companies’ by author C. A. Kankanamage. The author set out to study the relationship between the characteristics of the board of a company and the practice of earnings management in the context of companies listed in Sri Lanka. In particular, the author wishes to study if the former had an impact on the latter. In order to do so, the author selected a sample of one-hundred-and-sixty listed firms from Sri Lanka from the period of 2012-2015. Then, by using ordinary least squares, or OLS, regression, the data from these companies was analysed. Interestingly, the author found that there was a statistically significant relationship between different characteristics of the board and the practice of earnings management. Therefore, characteristics such as the size and composition of the board, the financial expertise of the board members and the meetings of the board, all had a significant relationship with earnings management at firms. The author concluded that having an effective board in any firm contributed to improving financial reporting quality and transparency, thereby reducing instances or practice of earnings management. (Kankanamage, 2015)

The fifth and final work analysed is titled ‘The Relationship between Selected Corporate Governance Mechanisms and Degree of Earnings Management in Selected Sri Lankan Listed Companies’ by authors A.B. Sakura De Silva, Athula Manawaduge and Roshan Ajward. The authors’ aim with this study was to examine whether there was any relationship between selected corporate governance mechanisms and the degree of earnings management, specifically in the context of selected companies listed in Sri Lanka. In order to do so, the authors selected seventy-seven companies listed on the Colombo Stock Exchange. These companies were selected on the basis of certain criteria, including those that had the highest market capitalization for the period of 2014-2016. The authors selected around ten corporate governance characteristics and also studied the level of earnings management in the seventy-seven companies they had previously shortlisted. The authors found that most of the governance mechanisms that they had examined adhered to best practices in corporate governance. At the same time, earnings management practices were still evident in the selected firms. The authors also found that the expertise of the governing board of the company in the fields of finances and accounting had a negative relationship to the degree of earnings management or absolute discretionary accruals. (Silva, Manawaduge, & Ajward, 2017)

## Discussion and Conclusion

A number of observations were evident from performing the systematic review and they are worthy of further examination and discussion. These are listed below in no particular order.

- Interestingly, there were a fair number of articles pertaining not only to the subject of different factors influencing earnings management, but also performed in the specific context of Sri Lankan companies or firms. Therefore, it was possible to obtain a good snapshot of some of the factors that had specific pertinence to the country context.
- However, there are still significant gaps and more work needs to be done to find out how these factors may all interplay amongst each other and the exact nature of the influence of each of these factors on the degree of earnings management.
- Two out of five articles mentioned the adoption of the International Financial Reporting Standards or IFRS. The mandatory adoption of IFRS took place in Sri Lanka in the year 2012. And therefore, there has been an attempt to gauge the impact of these financial reporting standards on the practice of earnings management in Sri Lankan companies.

- Of the two articles discussing IFRS, the first concluded that accurate or not, there was a perception that the international standards had reduced earnings management and improved financial reporting and that due to this perception, despite greater costs due to adhering to IFRS, their adoption was perceived as a net gain. In the second article, the authors noted that actually adherence to the Sri Lanka Accounting Standards resulted in reduced earnings management. Therefore, this is a point of difference that can be studied further.
- Interestingly, both the fourth and fifth articles analysed found that there was a link between the characteristics of the board of a company and the degree of earnings management. The fourth article found that the size and composition, the financial expertise and the number of meetings of the board, had a significant relationship with earnings management. According to the author a strong and effective board improved financial reporting and reduced instances of earnings management. On the other hand, in the fifth article, the author concluded the expertise of the company's board in finances and accounting had a negative relationship to the degree of earnings management. This is another area that bears further exploration and research.
- The fifth article also found that despite adhering to the best practices of internationally recognized corporate governance, Sri Lankan firms still had instances of earnings management, meaning that such an adherence was not enough of a factor or driver to prevent EM.
- Another interesting facet was exposed by the third article which found that situational factors, such as the nature, direction, materiality and intention of earnings management practices had an impact on the ethical perceptions of earnings management practices among auditing and accounting professionals in Sri Lanka, whereas demographic features such as gender, age, sector, employment status, tenure, educational qualifications, and professional qualifications did not seem to have an impact.

It is important to note there are limitations to this systematic review. As mentioned previously, due to the constraints of brevity and the limitations created by a narrow subject matter that has been further whittled down by a geographic focus, only a few articles were found that had direct relation to the topic of the systematic review. Therefore, only a few scholarly articles were reviewed. More study is required to fill in the gaps that exist in the present literature. It would also be interesting to explore how the different factors may interact with each other and how this interaction could further influence the practice of earnings management in Sri Lankan companies and firms.

## References

- Ajward, R. (2015). The Impact of Situational and Demographic Factors on Ethical Perceptions of Earnings Management. *NSBM Journal of Management*, 1(2).
- Cengage. (n.d.). *Earnings Management*. Retrieved October 13, 2018, from Cengage: [https://www.cengage.com/resource\\_uploads/downloads/032459237X\\_174365.pdf](https://www.cengage.com/resource_uploads/downloads/032459237X_174365.pdf)
- Heidarpoor, F., Rafiee, S. Z., & Rafiee, S. Z. (2014). Drivers of Earnings Management: The Profit and Loss before Earning Management. *International Journal of Accounting and Financial Reporting*, 4(2).

- Imeshika, P., Manawadu, I., & Rajapakshe, R. (2014). Association between Earnings Per Share and Earnings Management: Evidence from Manufacturing Companies in Sri Lanka. *Proceedings of the Peradeniya Univ. International Research Sessions*. Peradeniya University.
- Investopedia. (2018, March 2). *What is earnings management?* Retrieved October 13, 2018, from Investopedia: <https://www.investopedia.com/ask/answers/191.asp>
- Kankanamage, C. A. (2015). The Relationship between Board Characteristics and Earnings Management: Evidence from Sri Lankan Listed Companies. *Kelaniya Journal of Management*, 4(2).
- Mangala, I. D. (2017). A Brief Mapping of Earnings Managements Drivers and Restraints. *Journal of Commerce and Accounting Research*, 6(3).
- Nijam, H. M. (2016). Impact of IFRS adoption in Sri Lanka: An evaluation of financial reporters' perception. *International Journal of Managerial and Financial*, 8(2).
- Silva, A. S., Manawaduge, A., & Ajward, R. (2017). The Relationship between Selected Corporate Governance Mechanisms and Degree of Earnings Management in Selected Sri Lankan Listed Companies. *CA Journal of Applied Research*: .