IFRS Adoption and Earnings Management in Sri Lanka

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Abstract

Earnings management can be influenced or impacted by any number of factors. The adoption of International Financial Reporting Standards (IFRS) in Sri Lanka in the year 2012 has provided an opportunity to analyse the impact of these standards on the earnings management practices of firms and companies in the country. In order to study the available literature in this subject area, a search protocol was devised and applied to narrow down the number of works that were relevant. First search terms were created on the basis of the original intent of the article' study subject. Variations of these terms were applied to the online search engine of 'Google Search' in order to produce the widest possible number of results. The produced results were narrowed on the basis of number of filters, including not going beyond page 4 of the search results, and using the Scholarly Works filter of the Google Search engine. Subsequently, results were further narrowed down based on the geographic and contextual relevance. Upon applying this search protocol, four works were identified to be further analysed. The systematic review showed that there was a significant paucity of relevant literature in this area, possibly due to the recent adoption of IFRS in the Sri Lankan companies and firms.

Keywords: IFRS, Earnings Management, Sri Lanka, Accounting

Introduction

Earnings management for any company can be driven by a number of factors. One factor that has been highlighted in recent scholarly works is the adoption of International Financial Reporting Standards (IFRS) and its implication for earnings management, specifically in the context of the country of Sri Lanka.

In this article, the details of a systematic review conducted on available literature on this subject are presented. In order to fully understand the subject matter at hand, brief explanations of both earnings management and IFRS standards are outlined. Thereafter, the search protocol devised to conduct the systematic review is described in detail. Next, the article contains descriptions of each of the scholarly works and reports that were shortlisted through the aforementioned search protocol. Finally, thoughts and observations from the systematic review are presented along with some suggestions for future research in this area, with the latter acting as a conclusion to the article.

Earnings Management and International Financial Reporting Standards

Earnings management can be described as a practice or set of techniques that allow accounts or financial statements to be manipulated in order to present a better picture than what exists in reality. Colloquially it is often referred to as 'cooking the books'. Companies may engage in earnings management for a variety of reasons in order to present their financial status as better than it is. (Cengage, n.d.; Investopedia, 2018)

International Financial Reporting Standards or IFRS refers to a set of standards and rules created by the International Accounting Standards Board that prescribe how accounts should be maintained and reported in financial statements. These are internationally accepted standards that help companies remain transparent in their financial accounting and help them attain credibility at the international level. These standards also allow financial statements to be easily interpreted by any entity as they are common based on the IFRS. It is important to remember that not all countries in the world have adopted these standards. At present, around 100 countries in the world require adherence to IFRS, most of them based in Asia, South America and the European Union. Some of the issues governed by these standards include Operating Segments, Financial Instruments, Consolidated Financial Statements and Joint Arrangements. (Corporate Finance Institute)

Devising a Search Protocol

In order to find literature relevant to the topic at hand so that a systematic review could be conducted, a search protocol was devised.

The first step of the search was to coin the correct search terms. These search terms were created on the basis of the original intent of the article' study subject. A number of variations of the search terms were formulated so that the widest possible number of results could be obtained that had any relevance to the systematic review. Below are some of the compound search terms that were used.

- "IFRS and Earnings Management in Sri Lanka"
- "International Accounting Standards and Earnings Management in Sri Lanka"
- "IFRS and Earnings Management in Asia"
- "International Accounting Standards and Earnings Management in Asia"
- "Factors of Earnings Management in Sri Lanka"
- Influence of Adopting IFRS on Earnings Management"

Once the search terms were formulated, they were entered into a search engine. The search engine used in this systematic review was that of 'Google Search' in order to obtain the widest range of articles from various different digital libraries such as JSTOR and Research Gate.

A number of filters and steps were then applied in order to narrow down the results to only the relevant ones. First, the search filter on 'Google Search' named 'Scholarly Articles' was applied. This resulted in the search results being narrowed down to only the scholarly works. Next, due to the limited scope of this article and its short length, no search results past page 4 of the Google Search Scholarly Articles results were considered. Next, due to the specific geographic focus of this article, articles that were not primarily about Sri Lanka or did not mention Sri Lanka as one of their case studies were eliminated. Similarly, articles that did not discuss the issue of both the international standards IFRS and earnings management were eliminated.

Search Protocol Results

Unfortunately, it was evident that there were only a few articles on this particular subject or referring to it in some way. As a result only four articles were chosen to be further analysed as part of the systematic review. These articles are listed below in no particular order. The descriptions also contain some details about the scholarly works themselves, as well as the author, their scope and the results they produced.

The first work analysed is 'The Impact of IFRS/SLFRS Adoption on the Earnings Management of Sri Lankan Firms' by authors Kosgollage Anura Udayakumara and Prageeth Weerathunga. This work most closely linked to the topic of this review article. The authors' intention was to understand the impact of the mandatory adoption of International Financial Reporting Standards (IFRS/SLFRS) on the earnings management practices of Sri Lankan firms, in particular whether it has reduced or deterred them from using earnings management practices. The authors studied the previous standards used by Sri Lankan firms, i.e. Sri Lankan Accounting Standards (SLAS). According to the authors, they initially predicted that earnings management would reduce as a result of the adoption of IFRS in 2012. However, upon conducting their study, they found the opposite to be true. The authors studied the data of 157 firms listed on the Colombo Stock Exchange over two different financial years – one before the adoption of IFRS in the financial year of 2009-10 and one after the adoption of IFRS in the financial year of 2013-14. They authors found that in the aftermath of the mandatory adoption of IFRS, the companies' financial statements showed a greater amount of 'income smoothing' and therefore showed a greater level of earnings management. This was in direct contradiction to their original hypothesis. The authors suggest that there is a potential for Sri Lankan firms to improve their financial reporting and more potential for them to apply the IFRS in a more consistent and accurate manner in order to do so. (Udayakumara & Weerathunga, 2015)

The next work is 'The Effect of Leverage and IFRS Convergence on Earnings Management through Real Activities Manipulation in Asia' by authors Maulia Dewi Anggraeni and Ratna Wardhani. While not exclusively about Sri Lanka, this work does also analyse the impact on Sri Lankan companies. The authors' aim with this study was to understand the impact of leverage and IFRS convergence on the earnings management of companies through real activities manipulation, also known as RAM. Moreover, they wanted to understand the moderation role played by IFRS convergence in the relationship between leverage and RAM. Apart from this, the authors sought to see if different factors such as country economic size, governance quality and IFRS adoption strategy had any impact. In order to conduct this study, the authors chose six Asian countries that had already adopted the international standards of IFRS. These countries were China, Hong Kong, Indonesia, Malaysia, the Philippines, and Sri Lanka. From these six countries, the authors studied panel data and cross country analyses using 19,744 observations. The study found that leverage had a significant negative affect on RAM whereas IFRS had a positive impact on RAM. The authors found that in the aftermath of IFRS convergence the negative impact of leverage on RAM actually was higher. Moreover, the study also showed that there was mixed empirical evidence of the relationship between leverage and IFRS, and the moderation effect of IFRS on RAM, depending on the specific institutional context of the data studied, thereby confirming that the institutional contexts is a determining factor. The authors also concluded that regulators in these six countries needed to monitor the quality of financial reporting more in order to improve it and also needed to take steps to protect creditors. (Anggraenni & Wardhani, 2017)

The third study analysed is 'Impact of IFRS adoption in Sri Lanka: An evaluation of financial reporters' perception' by author Habeeb Mohamed Nijam. In this study, the author aimed to study whether the perceived impact of the adoption of international standards of IFRS had any impact on the characteristics of Sri Lankan firms. In order to do this, author chose to study all of the companies that were listed in the Colombo Stock Exchange (CSE) under bank, finance and insurance sector companies. This totalled to sixty-two companies in all. The author employed a survey method and created questionnaires for the financial and accounting professionals to answer. In order to analyse the data produced by the questionnaire, the author used the techniques of principal component analysis and one-sample Wilcoxon signed-rank test. Through the results of these analyses, the author found that there is a perception that by adopting the

IFRS, there has been a significant improvement in financial reporting, as well as in other factors in Sri Lankan firms. According to author, despite the increased cost of financial reporting due to the adoption of IFRS, the perception is that the move has been an overall gain. Thus, despite the increased expenditure, the perception is that it is worth it as there is a net gain for the Sri Lankan firms. Moreover, the study found that the size and profitability of the firms studied had a positive and significant association with the perceived impact of the adoption of IFRS to the level and quality of financial reporting of the firms themselves. The author concludes that this study contributes to the overall literature by providing a perspective and data from the point of view of a developing country and developing economy. (Nijam, 2016)

The fourth scholarly work that has been studied is 'The Impact of International Financial Reporting Standards Adoption on Accounting Quality: Evidence from Sri Lanka' by author PR Weerathunga. It is important to note that the author of this article is one of the two authors of the first article listed in this systematic review, i.e. 'The Impact of IFRS/SLFRS Adoption on the Earnings Management of Sri Lankan Firms' by authors Kosgollage Anura Udayakumara and Prageeth Weerathunga. However, the article is listed under a different name and has only one of the authors credited. Thus it has been taken as a separate work. The work follows the same methodology as the first article. 157 firms listed in the Colombo Stock Exchange were analysed through their financial reporting in two periods – one in a financial year before the adoption of IFRS and one after the adoption of IFRS – and the resultant financial reports were studied for their differences. The author studied eight different measures to gauge accounting quality relating to earnings smoothing, managing towards earnings targets, timely loss recognition and value relevance. The author made a distinction, stating that a firm was said to have improved financial accounting quality if they reported less earnings management (less income smoothing, less evidence of earnings management towards financial targets, more timely loss recognition and higher levels of value relevance). The author found that the study's results show that accounting quality of the firms in Sri Lanka actually improved after the mandatory adoption of IFRS in 2012 in terms of two of the measures, i.e. they showed that there was less management towards earnings targets and that there was more timeliness of loss recognition. On the other hand, the study did not show improvement in two of the other measures, i.e. there had been no improvement in the quality of accounting and financial report with regards to reducing earnings smoothing and improving value relevance. Thus, it can be stated that the results were mixed in this study. Apart from this, similar to the first study, this study also showed that income smoothing, or earnings smoothing had gone up post the adoption of IFRS. (Weerathunga, 2015)

Observations

A further qualitative analysis of the four scholarly works produced as a result of the search protocol that was devised specifically for this systematic review reveals a few observations. These observations are listed below, once again in no particular order.

- The biggest takeaway from the systematic review was that there is a significant paucity of relevant literature in this field, particularly in the context of studying the impact of IFRS adoption on Sri Lanka, Sri Lankan companies and firms, and earnings management in particular. This may be due to the fact that the international standards were adopted in Sri Lanka only in 2012. Thus, not enough time may have passed in order for there to be adequate literature on this subject of the impact of adopting IFRS on earnings management practices in Sri Lankan companies and firms.

- Interestingly, the first and fourth articles share an author. In the case of the first article, there were two authors, i.e. Kosgollage Anura Udayakumara and Prageeth Weerathunga, whereas with the fourth article, only Weerathunga has been listed as an author. Moreover, the subject matter is strikingly similar, as is the overall methodology applied. However, different outcomes are highlighted. Whereas both contend earnings smoothing or income smoothing actually increased after the adoption of IFRS in the 157 Sri Lankan firms studied, the fourth article also states that there was improvement in the other factors, and that there was actually less management towards earnings targets and more timeliness of loss recognition. Thus, these results are not in exact alignment. The results of the fourth article can be stated as being mixed.
- It is also interesting to note that there were some counterintuitive results. Chiefly, the assumption that overall, adopting international financial reporting standards would result in lesser instances of earnings management. However, this was not the case and in some cases, there was actually more earnings management after to the adoption of IFRS.
- The second paper studied showed that there was mixed evidence of the relationship between leverage and IFRS, and the moderation effect of IFRS on RAM, depending on the specific institutional context of the data studied. Thus, it was actually important to understand the institutional context of the companies studied. This study also had a broader context, studying the impact of IFRS adoption in six different countries in Asia.
- Interestingly, the third paper showed that there was actually a net increase in financial reporting costs due to the adoption of IFRS, but that these costs were perceived well as financial reporting under IFRS was perceived as a net gain. As this article dealt with perception as a key factor, it was also interesting to see that adherence to these international standards was considered an important step, despite an increased cost.
- It was also the view of some of the authors that financial reporting and the quality of financial reporting required more regulation in Sri Lanka in order to improve their quality.

Conclusion

There is a true lack of available, relevant literature on this topic on the link between the adoption of international financial reporting standards in Sri Lanka and the earnings management of firms and companies. As mentioned previously, this could be due to the fact that IFRS was adopted just recently in 2012, and as such, not enough time has passed to allow a wealth of scholarly research on this topic. However, this is an important and key area for future study. Researchers in this field and working on Sri Lankan commerce and economy would benefit from studying the link between IFRS and earnings management, especially as some of the existing literature do not provide a definitive answer on the link.

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