EARNINGS MANAGEMENT, ACCOUNTING GIMMICKS AND DUMMY GIANTS

C. Vidanage[1]

[1]*Department of Accounting, Faculty of Management and Finance, University of Colombo*

INTRODUCTION

The “earnings” which are also called the bottom line or the net income is the single most important line item in financial statements (Degeorge, Patel, & Zeckhauser, 1999). Any person irrespective of his or her knowledge of finance and accounting tends to refer the amounts of earnings of entities in order to draw up conclusions on their performance. Given the importance of earnings, it is crystal clear that managers are vigilant and have a vital interest in how they are reported. Here, managers evaluate the effects of available accounting choices so that they can make the best possible decisions for the entity. Theoretically, earnings indicate the extent to which an entity has engaged in value-added activities and accordingly assist resource allocation in capital markets (Lev, 1989). Therefore, managing earnings of an entity is equal to managing the future of that entity.

The Sri Lanka Accounting and Auditing Standards Act, No. 15 of 1995 and the regulations made under the Act have defined certain enterprises to be Specified Business Enterprises (SBEs). The Act imposes certain duties and obligations on SBEs and their directors, officers and auditors, the default of which would result in various penalties. Even though the current position of accounting in the country is considerably admirable, there are many accounting standard violations which can be identified by analyzing the annual accounts of certain SBEs. For instance, it has been revealed that certain SBEs have misstated their financial statements through improper valuation of assets, provisions and tax liabilities, recognition of unrealized incomes as realized incomes, incorrect computation of gains and erroneous capitalization of expenses all of which come under the umbrella term “earnings management.” Those accounting violations are mainly highlighted through qualified audit reports, and sometimes the Sri Lanka Accounting and Auditing Standards Monitoring Board (SLAASMB) as the main regulatory body which keeps an eye on these actions issue undertakings demanding rectifications in near future. Since these material misstatements directly affect the elements of financial statements and distort the true picture of those SBEs, it is quite questionable to determine how the agency theory is maintained under this kind of a fraudulent environment. In other words, it is interesting to observe why Sri Lankan SBEs use earnings management techniques to misstate financial statements even though there is a risk of losing stakeholders and corporate image.

As objectives, this research explores commonly and generally used earnings management techniques by SBEs and their implications on elements of accounting. It is expected that the achievement of these objectives would nourish academic, commercial and regulatory tiers of the country, and the findings have been aligned to agency theory in a way which may feed the existing literature on earnings management.

METHODOLOGY

This research applies the interpretivism approach. It implies a subjective epistemology and the ontological belief that reality is socially constructed. That is there is no one objective or universal reality that can be seen and that the reality or realities are constructed by social actors in social interaction. This also assumes subjective, multiple, mutable, and context-dependent realities (Collinson, 2012). As such, the objectives of the current study can be well explored through the application of an interpretative standpoint.

[1] [1]Chamikara Vidanage. Phone: 0779439390, Fax: 0117559914, E-mail:chamividanage@gmail.com

The multiple case study approach is adopted for the current research as the research strategy. This enables the author to gather evidence from a variety of scenarios and then filter the findings to meet the objectives of the research. Since earnings management has different dimensions, a broader area of it can be encompassed from the aforementioned research strategy.

Eight SBEs were selected for the current study in the light of the purposive sampling technique. The application of purposive sampling technique allows identifying most critical and relevant cases for the study. The selected SBEs for the current study represent both manufacturing and service sectors of Sri Lanka, and different financial periods so that a broad conclusion can be drawn on them. Moreover, it detects whether the earnings management techniques in both manufacturing and service sectors have similarities and have changed over time.

Semi-structured interviews were conducted with the Director and Manager of Technical Division of SLAASMB, Audit Manager and Assistant Audit Manager of PricewaterhouseCoopers. The duration of each interview was between 45 - 60 minutes. The interviews enabled exploring of the opinions, experiences, and feelings of the interviewees, thereby making the analysis sound and complete. Therefore, it can be identified as the best technique to gather data for this study. The information collected by the interviewees at SLAASMB helped to understand the regulatory background for the research problem and the audit managers' opinions gathered through interviews helped in analyzing the impact of earnings management on elements of accounting. In addition to interviews, data was also collected from review of publications of SLAASMB and annual reports of selected SBEs. The use of multiple sources in this manner facilitated the drawing of the conclusions of the study.

RESULTS AND DISCUSSION

The nature of SBEs is inherently ample in many aspects relative to ordinary type of businesses so that direct control and supervision are impractical. In this kind of a situation, the owners of the SBEs have to appoint some agents on behalf of them and with this, a principal (owner) – agent (manager) relationship originates. In an ordinary situation, both principal and agent try to maximize their utility or the return, and unfortunately both of them have different interests. However, it is usually the agent that has the information advantage over the principal (Adams, 1994) so that the expectations of the agent can be achieved as he wishes showing dummy performance to the principal.

The earnings management and management's response to material and significant misstatements can broadly be categorized into two main areas. Those are management disagreements with SLAASMB and management disagreements with auditors. Management disagreements with auditors can be further divided as misstatements for which undertakings were not given by SLAASMB and misstatements for which undertakings were given by SLAASMB.

One of the famous cases which can be analyzed under management disagreements with SLAASMB is the argument between TI PLC and SLASSMB on the biological assets valuation. The case is taken critically by both parties and neither of them is willing to give up their individual opinion even at the present moment.

The issue arose after publishing the annual report of year 2005/2006 by the company and as per SLASSMB's view, the plants of the TI PLC had been overvalued by violating the provisions in IAS 41 (Agriculture). The plants were valued by the company at a value in excess of Rs.5000 per plant whereas the replacement cost was likely to be around Rs.500. Furthermore, the discounts rates used by the company to measure future cash flows were also highly unrealistic. In the year 2011/2012, the company had made a revaluation of its biological assets and earned Rs.200 million gain which was also questionable to the auditors. These facts indicate how powerful the company is to keep its financial statements as it wishes irrespective of the regulatory involvement.

The moral hazard concept argues that shareholders would assess the managers' performance by looking at the financial outcomes of their businesses due to the inability of direct supervision (Subramanian, 2006).This behavior may lead to shrinking in the managers' duties because they know that direct supervision will not be exercised. Accordingly, the managers might put less effort to reflect the true picture of the business which is also called "taking it easy on the job". They tend to apply illogical judgment to massage the figures in the annual accounts. The following two cases reflect management disagreements with auditors for which undertakings were not given by SLAASMB.

In the annual report of L PLC for year 2009/2010, the auditors had made a qualification pointing some significant misstatements. The company had not made a provision for impairment of the carrying values of investments in two of its subsidiaries and the company believed that the subsidiaries would be able to improve its performance in the near future. However, one subsidiary had been incurring losses the accumulated loss of which was 329.4 million at the reporting date and the other one had met a going concern issue. L PLC had been applying its own judgments neglecting the audit recommendations.

NL PLC is an example for a SBE, the audit reports of which have been qualifying for years due to many reasons. In year 2009/2010 the company's annual accounts had been qualified because of an accounting treatment that did not comply with the Finance Leasing Act, No.56 of 2000. The correction of which would reduce the year's profit by Rs. 63 million. In year 2011/2012, several audit qualifications had been made in the annual accounts of the company. Three subsidiaries of NL PLC had identified revenue and costs related to construction contracts the amounts of which were substantially different from the amounts that had to be recognized. On the other hand, another three subsidiaries were incurring continuous losses indicating their inability to continue as going concerns. However, NL PLC had prepared its consolidated financial statements on going concern basis without making the required adjustments. Moreover, the accuracy, existence and completion of completeness, some balances in trade and other receivables were also unable to be verified.

As per the desk reviews carried out by SLASSMB, they identify some annual accounts which are qualified by the auditors and entail material and significant misstatements. Since the misstatements strongly affect the elements of the financial statements, the SBEs are required to resubmit the annual accounts with the stipulated adjustments.

According to the BDJW Ltd. case, the company had not provided for the diminution in value of an investment for the year 1999/2000 which is not temporary and agreed to write off Rs. 517 million after getting the directions from SLASSMB. If the company did not receive that kind of a direction, the financial position of the company would be overstated continuously regardless of the audit qualifications. It might help the managers to receive some performance based incentives, and specially grab the attention of current and potential shareholders by giving higher dividends and illustrating attractive ratios. The same misstatement can be observable in LC Limited the adjustment of which made a provision of Rs.147 million and in the case of LHC Limited, the company had not written off an irrecoverable portion of debt which amounted to Rs.76 million that overstated the current assets, net assets and working capital of the company artificially.

There are certain situations where the SBEs try to keep expenses as assets in the statement of financial position and enhance the periodic performances accordingly. For instance, KH Co. Ltd had incurred expenses on architect's fees and other preliminary work related to a project which was suspended later. The incurred amount Rs.3 million had been recognized in the statement of financial position for the year 1999 as an investment rather than writing off to the statement of comprehensive income leaving a chance to overstate the asset base of the company. On the other hand, some SBEs tend to incorporate financial figures even though the reliability of which is not justifiable to the management staff as well. In the LKC Limited case, the company included a balance of Rs.1 billion in the statement of financial position for the year 2002 as inter-site current account under non-current assets. Even though the balance represented the net assets of the factory and hotel site at cost, management was unable to prove the accuracy of the value which had to be impaired later as per the directions given by SLASSMB.

It was revealed from the interviews that some managers are reluctant to accept audit opinions in order to rectify the misstatements in the annual accounts and they are very much confident about their judgments and future expectations. Moreover, the lack of awareness of the general public regarding the regulatory involvement in identifying material and significant misstatements and their insufficient financial sense give incentives to the managers to incorporate material and significant misstatements in their annual accounts.

CONCLUSIONS/RECOMMENDATIONS

As per the findings of this research study, there are some SBEs which are issuing financial statements with material and significant misstatements and qualified audit reports, but are not willing to accept their mistakes to the regulatory bodies of the country, especially to SLASSMB and ask for required adjustments. On the other hand, there are some SBEs which are having autonomy of their financial judgments so that the material and significant misstatements will not be adjusted until they are given a supreme order.

As far as the elements of financial statements are concerned, “assets” can be considered as the entrance of earnings management for many SBEs. Rather than increasing equity through the appreciation of incomes and gains, most of the SBEs tend to attack their assets base, and make a considerable hit to the bottom line of the statement of comprehensive income and strengthen the equity position accordingly. Further, it is evident that the earnings management techniques of manufacturing and service organizations are almost similar in nature and they have not been changed drastically over the time.

Due to the information asymmetry, managers are strong enough to finger the financial statements in their own ways and this might assist them to meet their personal goals while getting the attention of the current and potential shareholders. Moreover, the desk reviews carried out by SLASSMB to analyze the financial statements may not be the only cure for earnings management since SLASSMB is selecting the financial statements on a sample basis. The SBEs which are outside the selected sample can also have material and significant misstatements which shall not be corrected in future.

The risk of tarnishing the image of a SBE through these financial misstatements depends on the nature of the SBE and to which extent that SBE takes it as seriously. Earnings management will be a crucial concept especially for those SBEs that represent the financial market of the country such as banks and they always tend to avoid audit qualifications and keep their annual accounts clean. SBEs which have a low business risk may go ahead with their opinions even under audit qualifications because they know that undertakings and publication of such errors may not be strong enough to discontinue their operations.

The main responsibility to identify the accounting gimmicks in the financial statements rests on auditors. In this regard, they should always ask for clarifications for vague accounting practices, demand alterations for inappropriate management judgments as much as possible and qualified and adverse audit opinions have to be given under worst scenarios. As mentioned by Adams (1994), appointment of in-house internal auditors may be a sound mechanism to mitigate the information shrinking and signal the principals that agents are acting in a responsible manner. Shareholders on the other hand should ask for true and fair financial statements especially when audit qualifications are entailed in the financial statements in which attractive figures have been presented. Shareholders should be vigilant about the financial aspects of their companies and responsible parties should be questioned regarding the accounting treatments which are subject to audit qualifications. In addition to that, the desk review process of SLAASMB has to be expanded more so that detection of material and significant misstatements can be improved. Furthermore, its findings should be spread out in different means so that the general public will be more aware of the seriousness of earnings management. Conclusively, the principal-agent relationship should be backed by management integrity, and the transparency in operations of SBEs will also be supportive to differentiate dummy giants from those that are real.

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ACKNOWLEDGEMENT

First and foremost I would like to thank Ms. D.G.S. Damayanthi, for being my supervisor for this research. Her guidelines were very much helpful to carry out this research fruitfully.
I would also like to thank the Director and Manager of Technical Division of SLAASMB for sharing their ideas on accounting misstatements.
At last, but not least, I appreciate the assistance given by the Manager and Assistant Manager of PricewaterhouseCoopers in many ways to make this research a success.