

**DETERMINANTS OF ACCOUNTING POLICY CHOICES UNDER INTERNATIONAL  
ACCOUNTING STANDARDS  
-EVIDENCE FROM SRI LANKA-**

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## **CONTENTS**

<b>ABSTRACT .....</b>	<b>3</b>
<b>INTRODUCTION &amp; OVERVIEW .....</b>	<b>4</b>
<b>PROBLEM JUSTIFICATION AND PROBLEM STATEMENT .....</b>	<b>5</b>
JUSTIFICATION OF THE RESEARCH ISSUE.....	5
PROBLEM STATEMENT .....	5
<b>RESEARCH QUESTIONS AND OBJECTIVES .....</b>	<b>6</b>
RESEARCH QUESTIONS.....	6
RESEARCH OBJECTIVES .....	6
<b>LITERATURE REVIEW .....</b>	<b>7</b>
<b>SIGNIFICANCE OF THE STUDY .....</b>	<b>10</b>
<b>SCOPE OF THE STUDY .....</b>	<b>10</b>
<b>CONCEPTUAL DIAGRAM .....</b>	<b>11</b>
<b>RESEARCH DESIGN AND METHODS.....</b>	<b>11</b>
RESEARCH APPROACH .....	11
POPULATION AND STUDY SAMPLE .....	11
THE ACCOUNTING POLICY CHOICES.....	13
MODEL SPECIFICATION .....	13
<b>RESULTS AND ANALYSIS .....</b>	<b>15</b>
<b>LIMITATIONS OF THE STUDY .....</b>	<b>19</b>
<b>CONCLUSION .....</b>	<b>19</b>
<b>REFERENCES .....</b>	<b>21</b>

## **ABSTRACT**

### **Purpose**

The purpose of this paper is to examine the determinants of accounting policy choices under International Accounting Standards (IAS/IFRS). Since the study is based on the Sri Lankan context, we mainly concern on Sri Lanka Accounting Standards and the Sri Lanka Financial Reporting Standards (LKAS/SLFRS).

### **Research Design/Methodology**

The sample is consisted with 219 listed companies out of the 299 listed companies in Colombo Stock Exchange. We mainly focused on three IAS based accounting policy choices namely; *inventory valuation, PPE depreciation, PPE revaluation* and seven determinants of accounting policy choice namely; *firm size, capital intensity, investment opportunity set, financial leverage, profitability, ownership and taxation*. Research study conducted using the secondary data and data is gathered through annual reports for the financial years 2015/2016 and 2016/2017.

### **Findings and practical implications**

Our findings included the impact of determinants on accounting policy choices. Accordingly, it is found that there is a positive relationship between Investment Opportunity Set, Financial leverage, Profitability, Firm's ownership structure, Taxation and negative relationship between Firm Size and Capital intensity. Based on these findings it is possible to explore the underline factors persuade managers to misuse the accounting policies.

### **Practical Implication**

Results of the research suggested that, as some flexibility exists in IASB's accounting standards, this may allow managers to use income-increasing/decreasing methods. Since the flexibility provided by the IASB's accounting standards allow managers to misuse the accounting policies, it is required to concern on the scope for regulators and standards setters to reduce the alternative methods which are likely improve firms' reporting quality.

### **Contribution to the literature**

There is dearth in research studies on this topic in Sri Lankan context. Thus, this research paper enhances the existing literature by providing new knowledge.

Keywords: Accounting policy choices, International Accounting Standards, Sri Lanka

## **INTRODUCTION & OVERVIEW**

Accounting Policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements. (Sri Lanka Accounting Standards 2015 pg. 576) Accordingly these are specific principles, methods or rules used by financial reporting system in order to present fair and true value of the reporting entity. International Accounting Standard Board has given the freedom to choose certain accounting policies for the reporting entity with the intention of allowing managers to choose an accounting policy by which they can enhance the true and fairness of the economic information provides by the entities. Due to these circumstances, companies and stakeholders are restricted to compare companies as different companies use different accounting policies they have applied. Institute of Chartered Accountants of Sri Lanka is the main developer of accounting standards in Sri Lankan context based on the International accounting standards prescribed by IASB.

Prior researches as Skinner (1993) & Astami and Tower (2006, p.6) has identified several factors that affects the managements' selection of accounting methods and economic consequences of such accounting policies. Accounting policy choice researchers as Skinner (1993), Astami and Tower (2006) and Ali and Ahmed (2017) have hypothesized that those factors drives managers' selection of alternative accounting methods either to maximize or minimize accounting profit. These research findings were in line with the Positive Accounting Theory.

Through reviewing the prior literature, we identified that there is a lack of research on the determinants of accounting policy choices in Sri Lankan context. Accordingly, this study was conducted to address the above said gap. This study mainly uses the information published in annual reports by listed companies in Colombo Stock Exchange (CSE) for the financial years of 2015/2016 and 2016/2017, as the main source of information and adopt the quantitative research approach same as prior research studies of Skinner (1993), Astami and Tower (2006) and Ali and Ahmed (2017).

The research is structured as follows. Section two of the study includes justification of the problem and the literature review. Section 3 discusses the research methodology by addressing the Population, sample and the strategy and the section 4 discuss the results of the data analysis and the final section provides conclusion and recommendations.

## **PROBLEM JUSTIFICATION AND PROBLEM STATEMENT**

### **Justification of the Research Issue**

Sri Lanka is one of a middle-income country which is being currently developing in every sector. Companies in the country, places a vital role in respect of the development of all economic, social and cultural aspects of Sri Lanka. Directions of a country depend on its leaders' economic, social and cultural policies who control the country as such directions of companies depend according to the choices made by the managers of those companies. Hence, accounting policy choices which are made by company's board of directors plays a vital role in developing companies overall financial and non-financial performances.

End product of every financial function is the annual report published by the company from the hand of its directors. Financial data consist in those report can be compared with each report published by different companies. As different accounting polices employed by different mangers comparison would be more difficult. Numerous factors have impact on choices of accounting policies as an examples Profitability, Taxation, Size of the firm, Financial Leverage can be highlighted. Managers' perspective on such factors decide which policies to be followed. Sometimes conflict of interest of managers towards company have major impact on the choices made by managers.

We are attempting to identify the relationships with different accounting policy determinants and choices of managers in srilankan contest by conducting this research.

### **Problem Statement**

Financial data plays a virtual role in decision making process of every economy. Accuracy and consistency of financial data is the most important aspect which has been discussing over the years. Accounting policy choices of managers directly affect to the output of the financial process. Managers are selecting different accounting policies which affect comparison, consistence and understandability of accounting outcomes.

Different accounting policies are selected by considering numerous of different factors. As most of the companies are profit oriented and always try to show profits to its stakeholders, companies might cunningly use accounting policy treatment to show temporary profits. As an example, company might shift to diminishing marginal depreciation method from straight line depreciation method to show higher future profits. Because of that a society need to understand what those factors behind those choices of managers.

Thus, this research study will examine the main determinants of accounting policy choices of Sri Lankan listed companies.

## **RESEARCH QUESTIONS AND OBJECTIVES**

### **Research Questions**

1. Does the firm size affect the accounting policy choice of the firm?
2. Does the capital intensity affect the accounting policy choice of the firm?
3. Does the investment opportunity affect the accounting policy choice of the firm?
4. Does the financial leverage affect the accounting policy choice of the firm?
5. Does the profitability affect the accounting policy choice of the firm?
6. Does the ownership structure affect the accounting policy choice of the firm?
7. Does the taxation affect the accounting policy choice of the firm?

### **Research Objectives**

The objective of the study is

- to identify the determinants of the accounting policy choices and,
- to measure the impact of those determinants on accounting policy choices.

## **LITERATURE REVIEW**

Principle based IFRS allows flexibility within accounting standards by stipulating alternative accounting policies to treat specific accounting issues (Carmona & Trombetta, 2008). Adopting an accounting policy involves basically three steps namely; initial stage-flexibility in financial reporting, intermediate stage-accounting policy choice and final stage- policy choice review (Iatridis & Joseph ,2005). The choice of accounting policy depends on the two perspectives of Positive Accounting Theory such as Efficiency perspective and Opportunistic perspective. Opportunistic managers deviate from efficiency perspective due to various persuading factors when determining the accounting choice (Watts & Zimmerman, 1978).

There have been large numbers of research works to identify the persuading factors or determinants behind accounting policy choice of managers. Majority of the prior literature considers the below mentioned factors as determinants.

### ***Firm size***

Researches argue that large scale firms are subject to several negative influences such as, government and public scrutiny, legal regulations, high tax rates etc. As a result, large scale firms tend to adopt profit reducing accounting policies to avoid political cost (Jensen & Meckling 1978, cited in Rahmen & Scapens,1988). Further, Watts & Zimmerman's, Hagerman & Zmijewski's, Hangerman's, Dyl's observations in the year of 1978,1979,1981,1989 respectively cited in Ali & Ahmed 2015 highlighted that large companies employ income reducing accounting policies. Inoue & Thomas (1996) highlighted the fact that policy selection of Japanese managers is influenced by size of the firm. Holland (1998) investigated the relationship between the company size and corporate tax burden and found that there is a relationship among accounting policy choice, company size and corporate tax burden. On the other hand, Ali and Ahmed (2015, p.442) found that there is a negative association with firm size for South Asian firms.

However, Astami and Tower (2006) whose study was based on 442 listed companies in Asian Pacific region, stated (2006, p.17) that firm's profitability and size of the firm does not necessarily explain the policy choices. Similarly, Rahman and Scapens (1988, p.31) tested applicability of firm size, risk, capital intensity and market power & monopoly rent in developing countries, using evidence from Bangladesh and found that multinational firms which are large in size do not adopt income reducing accounting policies.

### ***Capital intensity (Assets -in -place)***

Capital intensive firms report higher profits than labour intensive firms and are expected to use income decreasing accounting policies to distort the actual profit with a view of avoiding political costs (Hagerman & Zmijewski 1979). Further, Gaver and Gaver (1993) argued (cited in Ali and Ahmed 2015) that firms which are capital intensive possess high possibility of generating higher accounting earnings in comparison to the high-growth alternative firms. Astami and Tower (2006, p.6) discovered a negative association between accounting policy selection and assets in place. Skinner (1993) claimed capital intensive companies

select income increasing accounting alternatives. However, Ali and Ahmed (2015) did not identify capital intensity as a determinant in the context of South Asia.

### ***Investment Opportunity Set (IOS)***

Astami and Tower (2006, p.18) elaborated that investment opportunity set as a significant factor. Firms with higher investment opportunities are found adopting income increasing accounting policies. Nevertheless, the study found the Indonesian firms behave in considerably different from other firms in Asia Pacific region, by adopting income decreasing accounting policies. IOS is found associating negatively with income increasing accounting policies (Ali & Ahmed, 2015).

### ***Financial leverage***

Financial leverage or debt to equity factors is identified as a significant determinant factor by most of the research work. Generally, leveraged firms are found adopting income increasing accounting policies in order to meet requirements of banks, irrespective of the corresponding increase in tax payments (Tzova ,2006). Inoue and Thomas (1996) stated that debt to equity hypothesis as a key determinant in terms of Japanese managers. A negative relationship was found between financial leverage and income increasing accounting policies by Astami and Tower (2006). Similarly, a negative association was found in respect of South Asian countries by Ali and Ahmed (2015). However, the study of Tzova (2006, p.375) found that accounting policy decisions of Greek firms are not substantially affected by financial leverage due to the existence of relationships other than lender-borrower (bank as a share owner). Nevertheless, non-tax cost can still appear in a situation where a close relationship with banks does not exist.

### ***Profitability***

Management incentives are linked with measures of profitability (Watts and Zimmerman, 1978). Profitability is identified as the proxy for incentive schemes.

When the incentive schemes of managers are associated or linked with firm's profitability; managers tend to adopt income increasing accounting policies due to the influence of personal interest (Inoue & Thomas, 1996). Watts and Zimmerman (1978, p.116) identified management incentives as a key determinant factor of accounting choice unless other interested groups such as shareholders interfere.

Astami and Tower (2006) emphasized that profitability of the firm does not explain accounting policy choice. Equivalent results were experienced by Ali and Ahmed (2015).

### ***Firm's ownership structure***

Almost all the prior researches identified firm's ownership structure as a significant determinant. Accountability towards owners arising through separation of ownership and consequential performance-based management incentive schemes motivate managers to adopt accounting policies to match with their personal interests in general. Astami and Tower (2006) who investigated about Asian-Pacific region found

firms with high surveillance by owners tend to adopt income increasing accounting policies. Dhaliwal et al. identified ownership structure as a major factor (Dhaliwal 1982, cited in Astami & Tower 2006, p.6). Further, the extent of public ownership was found with a positive association against income increasing accounting policies (Ali & Ahmed 2015).

However, ownership factor is not considered as significant for Greek firms (Tzovas 2006). Tzovas (2006) claimed that for “closely held firms” which the involvement of owners is comparably high and no necessity of management incentive schemes consequently, experience lesser non-tax costs than firms with substantial public ownership. Such firms in Greece are found executing tax reducing accounting policies due to the effect of insignificant non-tax cost.

### ***Taxation***

Inoue & Thomas (1996) elaborated that, taxation also has significant influence over selection of accounting policies as financial reporting system and tax have positive relationship with financial reporting system. Firms tend to select a tax reducing accounting policy in a business environment where accounting policies and tax guidelines are almost indifferent to each other, as of in Greece (Tzova 2006). Remarkably, taxation is not recognized as a significant determinant for South Asian countries in the research of Ali & Ahmed (2015). Furthermore, it is assumed that income increasing accounting policies are adopted irrespective of high taxation, when the management recognizes the corresponding benefit of share price booms are important than the loss of increased tax (Tzovas,2006).

### **Hypothesis development**

Prior research work has tested number of hypotheses to identify determinant factors of accounting policy choice. In order to identify the persuading factors behind accounting policy choice in Sri Lanka we develop following hypotheses with respective to literature. Developed hypotheses are based on the roots of Costly Accounting Theory and Positive Accounting Theory.

According to Costly Accounting Theory, a firm is connected or linked through contracts with internal and external parties (Ronen & Yari 2008, cited in Ali & Ahmed, 2015). Fields et al. (2001) states that agency conflicts are expected to diminish through contracting. Positive Accounting Theory is concerned with economic incentives of managers for making accounting decisions (Zmijewski & Hagerman 1981).

Hypothesis 01: Managers of large scale firms adopt income increasing/decreasing accounting policies.

Hypothesis 02: Managers of capital intensive firms adopt income Increasing/decreasing accounting policies.

Hypothesis 03: Managers of firms with high IOS adopt income increasing/decreasing accounting policies.

Hypothesis 04: Managers of firms with great debt to equity ratio income increasing accounting policies.

Hypothesis 05: Managers of firms which the incentive scheme is connected with profitability use income increasing accounting policies.

Hypothesis 06: Managers of firms with wide public ownership adopt income increasing accounting policies.

Hypothesis 07: Managers of firms with high effective tax rates select income decreasing accounting policies.

## **SIGNIFICANCE OF THE STUDY**

Accounting has been used as a tool for income/earnings manipulation by managers globally (Holthausen 1995). Availability of alternative accounting policies within accounting standards is a major contributing factor to above issue. A manager's decision of appropriate accounting policy is influenced by several corporate and personal considerations.

We identified factors that would affect accounting policy choice by referring to prior literature related to international context. To the best of our knowledge, empirical evidence is not available for Sri Lankan context in this regard. Our study empirically examines the determinant factors of accounting policy choice of Sri Lankan managers. Honest financial reporting is encouraged by the study for the well-being of the society. Further, the study enlightens the users of financial information the determinants that the reported financial performance is positively or negatively associated with. Most importantly, knowledgeable managers can immerse to the findings of the study to avoid prejudiced policy decisions.

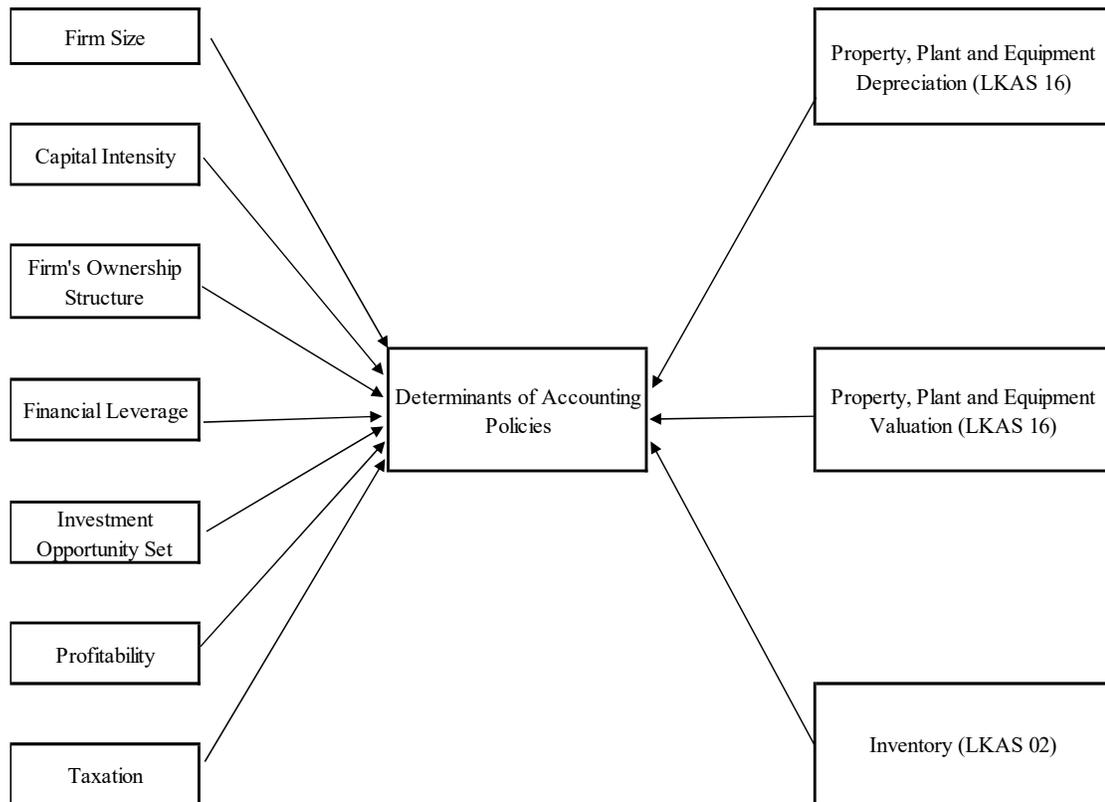
## **SCOPE OF THE STUDY**

This study covers behavior of companies listed in Colombo stock exchange in terms of their choices towards accounting policy choices. This study covered 18 sectors out of 20 sectors in Colombo Stock Exchange.

Following 7 hypothesis are covered by this study

- Firm's ownership structure
- Capital intensity
- Taxation
- Financial leverage
- Investment opportunity set (IOS)
- Size of the firm
- Profitability

## CONCEPTUAL DIAGRAM



## RESEARCH DESIGN AND METHODS

### Research Approach

Quantitative research approach is employed as researcher can quantify the problem by way of generating numerical data or data that can be transformed into useable statistics.

### Population and Study Sample

In order to select the research sample, we have considered all 299 listed companies in the Colombo Stock Exchange (CSE) under 20 categories as the population as at 31.03.2018. We have considered the listed companies as our population because of the requisite of those listed companies to publish their annual reports. Because of the accessibility of the information over accounting policy choices through their annual report notes, we have considered the CSE listed companies as our population.

The main interest of our study is to identify the determinants of the accounting policy choices for depreciation and inventory policy choices, we have excluded the 82 entities of those 299 firms which falls under the category of Investment Fund, Banking, Finance and Insurance sector as these entities do not have material depreciable assets and inventory. According to that we considered the rest of 217 listed firms as our

study sample. Accordingly, 434 firm-years (i.e. 2015/2016 and 2016/2017) have been selected as our research sample. However, we have excluded 105 firm-years from our sample due to three main reasons. Hence, total sample of 329 listed companies in CSE has been selected for our study. Firstly, we excluded few listed companies from our sample selected due to unavailability of information, secondly, to remove outliers. Thirdly, there were few listed companies that have not defined their accounting policy choices separately. For instance, some companies have mentioned their inventory policy as recognizing at the lower of cost or Net Realizable Value (NRV) instead of stating the inventory valuation method of FIFO, WAC in their annual reports. To determine the accounting policy choices, the notes to the financial statements were referred (Table I).

**Table I.** Sample size and distribution according to industry

Sector ID	Sector Type	Number of Firm years
1	Beverage Food and Tobacco (BFT)	35
2	Chemical and pharmaceuticals (C&P)	9
3	Construction and Engineering(C&E)	8
4	Diversified Holding (DIV)	33
5	Footwear and Textiles (F&T)	4
6	Health and Care (HLT)	12
7	Hotels and Travels (H&T)	52
8	Information Technology (IT)	2
9	Land and Property (L&P)	22
10	Manufacturing (MFG)	66
11	Motors (MTR)	14
12	Oil Palms (OIL)	3
13	Plantations (PLT)	36
14	Power & Energy (P&E)	9
16	Stores Supplies (S&S)	6
17	Telecommunication (TLE)	4
18	Trading (TRD)	14
	Total	329

## The accounting policy choices

We selected three accounting policies and analysed the policy choice of selected sample of 329 firm years.

Accounting Policy	Description
Inventory Valuation (LKAS 02)	Whether company value their stock using FIFO or WAC
Property plant and equipment depreciation (LKAS 16)	Whether company use straight line depreciation method or reducing balance depreciation method or combination of those two policies.
Property plant and equipment valuation (LKAS 16)	Whether company follow cost model or revaluation model

Table II elaborates the accounting treatments practiced by surveyed listed companies. Table II demonstrates that most of the Sri Lankan listed entities i.e. 60 per cent of the sample adopt Weighted Average Costing method to value their closing inventory whereas 30 per cent of the selected sample employed FIFO to value their closing inventories and only the 9.7 per cent of selected sample of companies' choose a combination of FIFO and Weighted Average costing methods to value their finished goods, Work in Progress and Raw material inventory separately. Table II elaborates that 97.87 percent of firms choose straight line method whereas, 2.13 percent of firms choose the reducing balance depreciation method over the straight line depreciation method, indicating that firms choose income increasing accounting policy choices when measuring property, plant and equipment depreciation. 76.60 percent of firms employed combination of historical cost and revaluation model to value their property, plant and equipment while, 21.88 per cent of firms choose historical cost model and only 1.52 per cent of companies employed revaluation model to measure property, plant and equipment.

*Table II. Accounting treatments practiced by surveyed listed companies*

Inventory				Depreciation				Property, plant and equipment			
Accounting Policies	Score	n	(%)	Accounting Policies	Score	n	(%)	Accounting Policies	Score	n	(%)
FIFO	2	99	30.09	SL	2	322	97.87	HC	2	72	21.88
WA	1	198	60.18	RB	1	7	2.13	REV	1	5	1.52
Combination	1.5	32	9.73	Combination	1.5	0	0	Combination	1.5	252	76.60
<i>N</i>		329	100	<i>N</i>		329	100	<i>N</i>		329	100

## Model Specification

In order to empirically examine the determinants of accounting policy choice in Sri Lankan context, we selected accounting policies for inventory valuation, depreciation method and PPE valuation which alternative treatment is available. Policy choice score is used as the dependent variable for the purpose of

measurement, which is in line with literature (Skinner 1993, Astami & Tower 2006). Ali and Ahmed (2015) apply the measurement concept in Skinner (1993) and Astami & Tower (2006) with regard to the South Asian region and as a result we identify the policy choice score as appropriate to our study.

According to Ali and Ahmed (2015, p.437) ‘policy choice score for each firm which is the aggregate score of three accounting methods divided by the number of accounting measurement methods’. To measure the degree of income increasing/decreasing policy choices, scores are given for 1 to 2 (Ali and Ahmed 2015). Each company receives a score for three policies selected, based on the alternative they apply for Accounting.

Score	Alternative policies for inventory valuation	Alternative polices for depreciation	Alternative polices for PPE valuation
1	Weighted average (WA)	Reducing balance	Revaluation
1.5	Combination of two	Combination of two	Combination of two
2	First in first out (FIFO)	Straight line	Historical cost

Above scores are based on the prior literature and alternative methods that result in an increase of income comparatively, is given higher marks than other alternatives. Application of FIFO method against WAC, Straight line depreciation against reducing balance and Revaluation method of PPE than Historical cost method result in increase of income. Since those policies are given higher marks than other alternatives (Ali & Ahmed, 2015, pp .437-438).

Data collected as above for the sample is fed to the following multiple regression model which is consistent with the analysis of Ali and Ahmed (2015).

$$PCSCORE = \beta_0 + \beta_1 FSIZE + \beta_2 ASTIP + \beta_3 IOS + \beta_4 FLEV + \beta_5 PRFT + \beta_6 WHSOWN + \beta_7 ETR + \beta_8 INDDUM + \epsilon_i$$

Ali and Ahmed (2015, p.439) specify the above abbreviations as follows.

PCSCORE =accounting policy choice score;

FSIZE =log10 of the book value of total assets of the reporting entity at the year-end;

ASTIP =book value of property, plant and equipment (PPE)/total assets;

IOS =gross PPE/market value of the firm (market value of equity + book value of debt);

FINLEV =ratio of total debt to the book value of total tangible assets;

PRFT =operating profit/operating revenues;

OWNGP =percent of share ownership held by the general public;

ETR =income tax expense divided by net income before tax;

INDDUM: =industry dummies;

B<sub>0</sub>, B<sub>1</sub>, B<sub>2</sub>... b<sub>8</sub> =the regression estimates; and

ε<sub>i</sub> =the stochastic disturbance term.

## RESULTS AND ANALYSIS

### *Descriptive statistics and Pearson's correlation matrix*

Table III present descriptive statistics for dependent variable, composite score for the eighteen sectors included in the analysis and independent variables. The mean composite score is 1.643, while maximum score is 2.00, indicating managers of Sri Lankan firms use more income-increasing method than income-decreasing methods. This result is complying with Nelson M. Waweru, Ponsian Prot Ntui, Musa Mangena, (2011) and Franck Missonier-Piera, (2004) who find their sample companies used more income increasing methods. These two studies were conducted in Tanzania and Switzerland respectively. Financial leverage as represented by mean total debt to total assets shows Sri Lankan companies not heavily depend on debt financing instead equity financing. Reason for such scenario could be justified by factors such as higher interest rate charged by debt market, higher debt covenants imposed by banks. Mean Investment opportunity set (IOS) suggest that Sri Lankan companies invest less money in long term physical assets denoted by property plant and equipment. This result is consistent with Muhammad Jahangir Ali, Kamran Ahmed, (2017) where their mean IOS is almost equals to our results in their sample of companies in south asia. Highest standard deviation among variables used in the analysis reported in profitability at 3.813 and suggest that profitability of Sri Lankan companies significantly different with each other from its mean. In order to manage non-normal data, we used log (base 10) of the variables whose values are large in size. Size reflected by total assets is one variable that used log 10 base in regression analysis.

**Table III.** *Descriptive statistics for dependent and independent variables*

Variable	N	Mean	Min	Max	Median	SD	Skewness
PCSCORE	329	1.643	1.000	2.000	1.667	0.178	0.176
LTASSETS	329	9.620	7.655	11.443	9.667	0.667	-0.209
CAPINT	329	0.369	0.000	0.996	0.309	0.260	0.558
IOS	329	0.708	0.001	4.844	0.486	0.696	1.954
FINLEV	329	0.255	0.000	3.486	0.205	0.281	5.189
PRFT	329	0.476	-2.729	60.313	0.109	3.813	13.635
OWNGP	329	0.279	0.001	0.997	0.257	0.168	1.472
TAX	329	0.202	-2.101	11.505	0.155	0.749	11.197

**Notes:** where, PCSCORE = policy choice score; LTASSETS = log10 of the book value of total assets of the reporting entity at the year-end; CAPINT = book value of property, plant and equipment (PPE)/ total assets; IOS = gross PPE/market value of the firm (market value of equity + book value of debt); FINLEV = ratio of total debt to the book value of total tangible assets; PRFT = operating profit/operating revenues; OWNGP = % of share ownership held by general public; TAX = income tax expense divided by net income before tax

Table IV presents the Pearson correlation matrix for dependent and independent variables used in studying the determinants of accounting policy choices of Sri Lankan managers. Table present that Highest absolute correlation reported by the matrix is between capital intensity and investment opportunity set (0.550) followed by a correlation coefficient of 0.178 between investment opportunity set and financial leverage. These two correlation coefficients are below the threshold level of 0.8. Hence, we can claim that our model does not have multicollinearity problems. This is also evidenced by estimated variance inflation factors(VIF) in regression analysis presented in Table V. Variance inflation factor of all variables used in the analysis is less than 2, indicating that there is less influence from one independent variable to another independent variable in terms of its correlation with each other.

**Table IV.** Correlation matrix for dependent and independent variables

Variables	PCSCORE	LTASSETS	CAPINT	IOS	FINLEV	PRFT	OWNGP	TAX
PCSCORE	1.0000							
LTASSETS	-0.0018	1.0000						
CAPINT	-0.1730*	-0.0623	1.0000					
IOS	-0.0928	0.1420*	0.5500*	1.0000				
FINLEV	0.0726	0.1670*	-0.0699	-0.1780*	1.0000			
PRFT	0.0898	0.0893	-0.0809	-0.0690	0.0496	1.0000		
OWNGP	0.0601	-0.1150**	-0.0002	-0.0669	0.0329	-0.0426	1.0000	
TAX	0.0282	-0.1077***	-0.0128	-0.0397	0.0541	-0.0143	-0.0685	1.0000

**Notes:** \*Significant at the 0.01 level; \*\*Significant at the 0.05 level; \*\*\*Significant as at the 0.1 level; where, PCSCORE = policy choice score; LTASSETS = log10 of the book value of total assets of the reporting entity at the year-end; CAPINT = book value of property, plant and equipment (PPE)/ total assets; IOS = gross PPE/market value of the firm (market value of equity + book value of debt); FINLEV = ratio of total debt to the book value of total tangible assets; PRFT = operating profit/operating revenues; OWNGP = % of share ownership held by general public; TAX = income tax expense divided by net income before tax

#### *Multivariate results*

Table V summarize the multi regression result between policy choice score and independent variables in Sri Lankan companies. Coefficient estimated by the Regression model also presented in the table V with their respective prediction used in hypothesis. The results of the model show adjusted  $R^2$  of 4.40 per cent and

significant at the 1 per cent level. We found firm size is negatively related to policy choice score indicating that large firms adopt income decreasing policies. This result is aligned with Positive Accounting Theory (PAT) where Watts and Zimmerman (1986) argue that large firm tend to adopt income decreasing policies to minimize political cost.

Capital incentive firms report higher profits than labour intensive firms and are expected to use income decreasing accounting policies to distort the actual profit with a view of avoiding political costs (Hagerman & Zmijewski (1979). Our results show that capital intensity is negatively associated with policy choice score in Sri Lankan companies. It is significant at the 1 per cent level indicating that companies with higher capital intensity adopts income decreasing methods. This result is aligning with above findings. This outcome is support our hypothesis (H2).

**Table V.** *Multivariate results of determinants of accounting policy choice*

Variables	Predicted sign	Coefficient	t-stat	p-value	VIF
Constant		1.716	11.33	0.000	
Firm Size(LTASSETS)	+/-	-0.007	-0.43	0.666	1.14
Capital intensity(CAPINT)	+/-	-0.124	-2.72	0.007*	1.49
Investment Opportunity Set(IOS)	+/-	0.008	0.46	0.643	1.58
Financial leverage (FINLEV)	+	0.040	1.10	0.274	1.09
Profitability(PRFT)	+	0.004	1.44	0.150	1.02
Firm's ownership structure(OWNGP)	+	0.066	1.13	0.260	1.03
Taxation(TAX)	-	0.006	0.48	0.632	1.03
$R^2$		4.40%			
Adjusted $R^2$		2.40%			
F-statistics		2.13**			
N		329			
Sig.		0.04			

**Notes:** \*Significant at the 0.01 level; \*\*Significant at the 0.05 level; where, PCSCORE = policy choice score; LTASSETS = log10 of the book value of total assets of the reporting entity at the year-end; CAPINT = book value of property, plant and equipment (PPE)/ total assets; IOS = gross PPE/market value of the firm (market value of equity + book value of debt); FINLEV = ratio of total debt to the book value of total tangible assets; PRFT = operating profit/operating revenues; OWNGP = % of share ownership held by general public; TAX = income tax expense divided by net income before tax

Astami and Tower (2006) identified investment opportunity set as a major consideration of management when choosing an accounting policy. Our results support results of Ali & Ahmed (2015) who also found that IOS is positively associated with accounting methods chosen by their sample of companies. A negative relationship is found between financial leverage and income increasing accounting policies by Astami and

Tower (2006). Similarly, our results also found that firms with higher financial leverage adopts income increasing policies to show higher profits to comply with debt covenants. Accountability towards owners arising through separation of ownership and consequential performance-based management incentive schemes motivate managers to adopt accounting policies to match with their personal interests in the Sri Lankan business context. Accordingly, we found percentage held by general public is positively associated with accounting methods indicating higher the percentage held by general public more the policies choose toward increasing income. Main reason behind this outcome is that companies with higher profit margin attached more general public towards the company in turn company can raise more capital at lower cost. We found that taxation is positively associated with policy choice score indicating companies adopt income increasing policies in the context where tax rates are raising. This result does not support our hypothesis (H7). However, such contradictory result has been found by Muhammad Jahangir Ali, Kamran Ahmed, (2017) in south Asian companies.

We conducted our analysis further by running separate regression analysis for each sector in the sample of Sri Lankan companies to identify the potential influence arising from differences in sectors towards accounting methods selected by Sri Lankan companies. We selected sectors which have thirty or more ( $n \geq 30$ ) firms years for above purpose. Table VI summarize the outcome of the regression output.

**Table VI.** Sector-wise multivariate results of determinants of accounting policy choice

Variables		Overall Model	Manufacturing	Hotels	Plantation
Constant	Coefficient	1.716	1.566	1.364	-0.070
	(p-value)	(0.000*)	(0.001*)	(0.000*)	(0.957)
Firm Size(LTASSETS)	Coefficient	-0.007	-0.010	0.042	0.156
	(p-value)	(0.666)	(0.828)	(0.129)	(0.252)
Capital intensity(CAPINT)	Coefficient	-0.124	-0.286	-0.132	-0.451
	(p-value)	(0.007*)	(0.060***)	(0.069***)	(0.163)
Investment Opportunity Set(IOS)	Coefficient	0.008	0.214	-0.023	0.062
	(p-value)	(0.643)	(0.003*)	(0.176)	(0.154)
Financial leverage(FINLEV)	Coefficient	0.04	0.045	-0.267	0.426
	(p-value)	(0.274)	(0.790)	(0.003*)	(0.012**)
Profitability(PRFT)	Coefficient	0.004	0.084	-0.085	0.016
	(p-value)	(0.150)	(0.095***)	(0.346)	(0.888)
Firm's ownership structure(OWNGP)	Coefficient	0.066	0.336	-0.149	0.414
	(p-value)	(0.260)	(0.050**)	(0.012**)	(0.007*)
Taxation(TAX)	Coefficient	0.006	0.155	-0.045	-0.024
	(p-value)	(0.632)	(0.308)	(0.145)	(0.439)
$R^2$		4.40%	25.47%	40.91%	57.23%
Adjusted $R^2$		2.40%	16.48%	31.51%	46.53%
F-statistics		2.13	2.83	4.35	5.35

**Notes:** \*Significant at the 0.01 level; \*\*Significant at the 0.05 level; \*\*\*Significant at the 0.10 level; where, PCSCORE = policy choice score; LTASSETS = log10 of the book value of total assets of the reporting entity at the year-end; CAPINT = book value of property, plant and equipment (PPE)/ total assets; IOS = gross PPE/market value of the firm (market value of equity + book value of debt); FINLEV = ratio of total debt to the book value of total tangible assets; PRFT = operating profit/operating revenues; OWNGP = % of share ownership held by general public; TAX = income tax expense divided by net income before tax

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### LIMITATIONS OF THE STUDY

We identified following areas that limits the scope of the study. We identify determinant factors in the perspective of managers; however, determinant factors for incorporating flexibility to standards can be investigated.

Our study focuses on inventory valuation, depreciation and PPE valuation policies to identify the determinant factors which considered limited accounting standards. The policy choice determinants can be varied in an extended study considering all accounting standards that consider areas such as IP valuation, Fair Value measurement etc. In addition, comparative study can be designed to compare the determinants with cross country- wide and industry –wide. Above limitations can be extended to new research topics.

### CONCLUSION

Main purpose of our research is to evaluate the determinants of accounting policy choices in Sri Lankan context. Most of the researchers have conducted “Accounting policy choice” studies for the developed countries based on different time periods such as pre IFRS/IAS adoption and post IFRS/IAS adoption. However, to the best of our knowledge there is a dearth of researches regarding accounting policy choices in Sri Lankan context after IFRS adoption. In that perspective this research addresses to fill the gap.

We identified seven determinants of accounting policy choices based on the prior researches and three accounting policies. Accordingly, we examined the effect of firm size, capital intensity, investment opportunity set, financial leverage, profitability, ownership and taxation to accounting policy choices. (*Alternative policies for inventory valuation, Alternative polices for depreciation, Alternative polices for PPE valuation*). Our sample consisted with 329 firm-years out of 434 firm-years excluding the Insurance and Baking Industry, investment funds and the outliers.

The relationship between the determinants and the accounting policy choice was evaluated by developing and using multiple regression model. Analyzing the relationship between the accounting policy choice and the variables (Determinants) it is observed that there is a positive relationship between Investment Opportunity Set (IOS), Financial leverage (FINLEV), Profitability (PRFT), Firm’s ownership

structure(OWNGP),Taxation(TAX) and negative relationship between Firm Size (LTASSETS) and Capital intensity (CAPINT).

Variables	Predicted sign	Actual Sign
Constant		1.716
Firm Size(LTASSETS)	+/-	-
Capital intensity(CAPINT)	+/-	-
Investment Opportunity Set(IOS)	+/-	+
Financial leverage (FINLEV)	+	+
Profitability(PRFT)	+	+
Firm's ownership structure(OWNGP)	+	+
Taxation(TAX)	-	+

Apart from that, it is observed that model is significant in an overall manner. However, analysis of the individual determinants suggest that except from the IOS other variables are not significant in determining accounting policies.

However, our results are not in consistent with the prior researches. As per the literature review the firm size, IOS, ownership by the general public and financial leverage determine accounting policy choice. Further the relationship between policy choices and the determinants are in line with the prior researches except for the taxation. Since our results are deviate from the prior findings we conducted an analysis based on the sectors. Since we use only three accounting policies to this research, future researches can be based on more accounting policies and can explore the scope of the research to SME sectors.

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