

Relationship between Audit Committee Characteristics and Earnings Management in Sri Lanka (2013-2015)

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Abstract- The Purpose of this paper aims to examine the impact of audit committee characteristics on earnings management in Sri Lanka during the period from 2013-2015. Audit committee size, audit committee independence, audit committee meetings and audit committee financial expertise used in this study as audit committee characteristics. Institute of Chartered Accountants of Sri Lanka and Securities and Exchange Commission jointly issued code of best practice of corporate governance (2013) used to operationalize the audit committee characteristics. To measure the earnings management, Kothari, Lenon and Wesley (2005) performance adjusted discretionary accrual model used and ordinary least squares regression method (OLS) used to examine the effect of audit committee characteristics on performance adjusted discretionary accrual model for a sample of 150 listed firms in Sri Lanka from 2012-2015. Regression results showed a strong negative relationship between audit committee characteristics and earnings management in Sri Lankan listed firms. The findings based on this study provide useful information to the firms about the importance of strong and effective audit committee to constrain the earnings management and enhance the financial reporting quality and transparency and the stakeholders to investigate the effectiveness of the audit committee of the firm prior to have the confidence on the numbers appeared in the financial statements to make their decisions effectively.

Keywords- *Audit committee characteristics; Earnings management; financial reporting quality; Sri Lanka*

I. BACKGROUND OF THE STUDY

Sri Lanka experienced a continuous flow of corporate governance scandals from 1990s. Initiated by the bankruptcy of Pramuka Bank in late 1990s, downfall of Vanik Incorporation in early 2000, collapse of Pramuka in October, 2002, thereafter the fall of Golden Key, in 2008, collapse of Sriram Finance in 2010, collapse of Central Investment and Finance company (CIFL) in 2012, and the recent collapse of Touchwood PLC in 2013 brought the discussions of the corporate governance into a more important and open forum than earlier. All these collapses occurred overnight by giving a big shock to the all their stakeholders and to the whole country. But until bankruptcy occurred these firms were

suffering with the severe issues with related to their financial performances, liquidity and solvency from a long period. But the financial statements were unable to signal the symptoms of the financial failures through the published financial statements. Further, most of these bankrupt companies were finance companies, which were under the tight scrutiny of the regulatory bodies like Central Bank of Sri Lanka which mandatorily require periodical financial reporting. This gives a strong indication that despite the regulatory requirements management of these companies practice earnings management to materially misstate the financial statements and mask the true financial performance and position to mislead the stakeholders. One of the main reasons for materially manipulating these financial statements is nonexistence of an effective audit committee to monitor the financial reporting activities of the managers. None of the above firms were having an audit committee during that period to monitor and control the opportunistic behavior of the managers of those firms.

II. OBJECTIVE OF THE STUDY

- To investigate the relationship between the audit committee characteristics (AC) and earnings management in Sri Lanka.

III. LITERATURE REVIEW

Audit committee takes over the board function to oversee the firm's financial reporting process. It plays a significant role in the monitoring process of financial reporting carried out by the directors of the firm and auditing is used by firms to reduce agency costs (Jensen and Meckling, 1976; Watts and Zimmerman, 1986). Thus audit committee helps to alleviate the agency conflicts between the top management and the shareholders by improving the quality of financial reporting and reducing the information asymmetry between inside managers and outsider shareholders. Audit committee size is one of the significant characteristics that contribute to its effectiveness. If the audit committee size is too small then an insufficient number of directors to serve the committee in occurring and thus decrease its monitoring

effectiveness (Vafeas, 2005). Also, when a committee size is too large, the directors' performance may decline because of the coordination and process problems and hence highlight another reason for weak monitoring (Jensen, 1993; Vafeas, 2005). The perfect average of the audit committee size is between 3 and 4 members (Abbott, Parker & Peter 2004; Vafeas, 2005; Xie, 2003). Vicknair, Hickman and Cames (1993) argue that, in order to function effectively, audit committees must be independent of the management as this allows both the internal and external auditors to remain free of undue influences and interferences from corporate executives. Similarly, Choi, Jeon and Park (2004) found that, when members of the audit committee hold shares in their firm, they are less effective in mitigating earnings management. Thus, the independence of the audit committee is a key factor in enhancing its role in preventing misstatements in the financial statements. Krishnan and Visvanathan, (2009) found a positive association between audit committee meetings and audit fees, suggesting that the firms with higher number of audit committee meetings demand more assurances and higher quality audit from their auditors. In order to provide more assurances and higher quality of external audit, the auditors may need to perform additional audit work in terms of enlarging the audit scope and increasing the audit testing levels, which results in both higher audit fees and higher audit quality. As a result, the higher the frequency of an audit committee meeting is the more effective monitoring function. Beasley (1996) found that firms with fraud records had fewer audit committee meetings than those without fraud records. Another important variable which could affect the effectiveness of the audit committee is the member financial expertise. Audit committee members may have intentions to curb earnings management for shareholders, but they may not be able to do so without certain level of financial knowledge. Agrawal and Chadha (2003) which find the incidence of audit committee members with accounting or finance background on audit committee is negatively related to the probability of earnings restatement. In Sri Lanka still there is no published paper to evaluate the effect of audit committee characteristics to the earnings management.

IV. ORIGINALITY OF THE STUDY

There are number of empirical studies around the world performed to investigate the effect of audit committee on EM and some studies strongly support audit committee as an effective controlling mechanism to constrain the EM, while some of the studies did not find sufficient evidences to support audit committee as a strong controlling mechanism. Most of these studies conducted on developed countries like UK, USA, Australia and New Zealand .But the contextual settings of these developed countries differ significantly from those of emerging markets like Sri Lanka and as results of this developed country's findings cannot be perfectly aligned and generalized without considering the

contextual differences .Therefore findings of these studies of the developed countries cannot be perfectly aligned to the emèrging market like Sri Lanka.

V. RESEARCH METHOD

A. Population and Sample

This study included all the listed companies in the Colombo Stock Exchange (CSE) during the period of 2012-2015. One Hundred and Sixty (160) CSE listed companies excluding companies in the banking, finance and insurance industry included in the sample.

B. Data Collection

This study uses secondary data and such data were collect from the published financial statements in the annual reports of the companies listed in the listed company directory.

C. Operationalisation and Data Analysis

Operationalisations of the variables are done based on the ICASL and SEC code of best practice of corporate governance (2013) and previous empirical findings. Kothari, Lenon and Wesley (2005) performance matched discretionary accrual model applied to detect the non discretionary accruals of the firms. Ordinary least regression (OLS) model used to test the relationship between the board characteristics and earnings management.

VI. FINDING AND DISCUSSION

Table 2 represents the results of the descriptive statistics and the correlation matrix. According to the results firms are having average size of three in the audit committee while the average numbers of audit meetings are approximately three. That means audit committee directors are meeting at least once in each quarter. Size of the audit committee is positively correlated with the financial expertise and the independence of the audit committee, while negatively correlated with the committee meetings. Financial expertise of the audit committee members is positively correlated with the committee meetings and the independence. Table 3 represents the OLS regression results of the study. According to the results all the audit committee characteristics significantly affect to the earnings management of the firms. Size of the audit committee is having a significant positive relationship to the discretionary accruals while financial expertise, independence and frequency of the meetings of the audit committee are having a significant negative relationship to the earnings management of the firms.

$$\frac{TA_{i,t}}{A_{i,t-1}} = \beta_0 + \beta_1 \left(\frac{1}{A_{i,t-1}} \right) + \beta_2 \left(\frac{\Delta REV_{i,t} - \Delta REC_{i,t}}{A_{i,t-1}} \right) + \beta_3 \left(\frac{PPE_{i,t}}{A_{i,t-1}} \right) + \beta_4 (ROA_{i,t \text{ or } i,t-1}) + \varepsilon_{i,t} \quad (1)$$

$$TA_{i,t} = NI_{i,t} - CFO_{i,t} \quad (2)$$

$$\frac{NDA_{i,t}}{A_{i,t-1}} = \beta_0 + \beta_1 \left(\frac{1}{A_{i,t-1}} \right) + \beta_2 \left(\frac{\Delta REV_{i,t} - \Delta REC_{i,t}}{A_{i,t-1}} \right) + \beta_3 \left(\frac{PPE_{i,t}}{A_{i,t-1}} \right) + \beta_4 (ROA_{i,t \text{ or } i,t-1}) \quad (3)$$

$$DA_{i,t} = \frac{TA_{i,t}}{A_{i,t-1}} - \frac{NDA_{i,t}}{A_{i,t-1}} = \varepsilon_{i,t} \quad (4)$$

$$DA_{it} = \beta_0 + \beta_1 ACSIZE + \beta_2 ACINP + \beta_3 ACFEXP + \beta_4 ACMEET \quad (5)$$

When,

$TA_{i,t}$ = Total accruals of firm i in year t , $NDA_{i,t}$ = Non discretionary accruals of firm i in year t , $A_{i,t-1}$ = Total assets of firm i in year $t-1$, $\Delta REV_{i,t}$ = Change in revenue of firm i in year t , $\Delta REC_{i,t}$ = change in receivables of firm i in year t , $PPE_{i,t}$ = Gross property, plant and equipment of firm i in year t , $ROA_{i,t}$ = Return of assets of firm i in year t , $TA_{i,t}$ = Total accruals of firm i in year t , $DA_{i,t}$ = Discretionary accruals of firm i in year t , $\varepsilon_{i,t}$ = Residuals of firm i in year t , $\beta_0, \beta_1, \beta_2, \beta_3, \beta_4$ = Firm specific parameters calculated by the OLS regression model, NI_{it} = Net profit after tax of firm i in year t , CFO_{it} = Cash flow from operation of firm i in year t

This is consistent with the previous empirical findings of the Beasley (1996), Chang (1999), Dechow, Sloan and Sweeney (1991), Vafeas (2005), Uzun (2004) which studies the relationship between the audit committee characteristics and earnings management. R square of the model tested is .626. It indicates that the explanation of the discretionary accruals through the audit committee characteristics is significant and therefore audit committee of the firm is highly influencing to impact to the earnings management of the listed companies during the period of 2013-2015 to constrain the earnings management of the firms.

VII. CONCLUSION

Based on the results of this study it can be concluded the Audit committee characteristics which is one of the key constitute in corporate governance are significant to constrain the earnings management

and enhance the financial reporting quality and transparency of the listed firms in Sri Lanka. A firm with small audit committee size, but with majority of the independent non executive directors who are serving in the committee with sound financial expertise is capable of constraining the earnings management practices of the managers of the firms and enhances the financial reporting quality. Furthermore if firm can have more frequent board meetings it can constrain the earnings management practices of the managers also. Thus the relationship between the audit committee characteristics to constrain the earnings management is significant and strong in Sri Lankan context. Once the firm is having a strong audit committee with those characteristics it constrains the earnings management of the firms.

TABLE 1: DESCRIPTIVE STATISTICS OF THE MAIN CONSTRUCTS AND CORRELATION MATRIX

Variables	Mean	Median	Standard Deviation	Absolute Residuals	ACFEXP	ACMEET	ACINDP
ACSIZE	3.08	8	2.39	.093	.045*	-.057	.652*
ACFEXP	0.83	1	.378	.030		.341	.445*
ACMEET	2.95	5	2.97	-.112			-.315*
ACINDP	0.95	3	.91	-.012			

TABLE 2: REGRESSION RESULTS

Independent variables	Beta Coefficient	P Value
ACSIZE	0.296	0.032*
ACINP	-0.089	0.037*
ACFEXP	-0.108	0.039*
ACMEET	-0.098	0.043*
R Square	0.626	
F Statistics	16.125	

*. Correlation is significant at the 0.05 level (1-tailed).

Number of observations: 450 firm years ;

* Significant at the 0.05 level

When,

ACSIZE = Audit committee size, ACINP= Audit committee Independence, ACFEXP= Audit committee financial Expertise, ACMEET= Audit committee meetings, DA=Discretionary accruals

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