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Role of the Audit Committee to improve the quality of reported earnings (Study on Sri Lankan Banking, Finance and Insurance Industry (2015-2017))

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ABSTRACT: *The Purpose of this paper aims to examine the impact of audit committee characteristics on financial reporting quality in Sri Lanka during the period from 2015-2017. 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 (2015) used to operationalize the audit committee characteristics. To measure the financial reporting quality, Kothari, Lenon and Wesley (2005) performance adjusted discretionary accrual model used. 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 50 listed firms in Sri Lanka from 2015-2017. Banking, Finance and Insurance sector has been selected for the study since it was one of the developing sectors in Sri Lanka which had number of developments in Sri Lanka. Regression results showed a strong negative relationship between audit committee characteristics and financial reporting quality in Sri Lankan listed firms. It emphasizes that audit committee characteristics are significant and impact to the earnings management and therefore to enhance the financial reporting quality in the hospitality sector in Sri Lanka. The findings based on this study provide useful information to the firms about the importance of strong and effective audit committee to 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, Hospitality firms*

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I. BACKGROUND OF THE STUDY

Sri Lanka is a country which was under a British ruling system until 1948. After gaining independence in 1948 government took the fully power and authority of administration of all the firms operates in Sri Lanka. Due to this until 1970s almost all the firms in Sri Lanka were government owned enterprises. But there was a significant change in Sri Lankan economy after 1977 due to the changes in the economic policy adopted by the new government. This is because open economy policy was introduced in 1977 and privatization system was incorporated. This open economy policy leads to market oriented economy which completely changes the traditional economic system of self sufficiency which was prevailing at that era. As a consequence of this Sri Lankan economy opened for local as well as foreign investors and most of the government companies ownership shifted to private owned companies. Trading agreements among the countries were signed and foreign trade barriers were removed with the trading partners. Further capital market in Sri Lanka develops with the investments and there was demanding of a regulatory mechanism to systematically govern the private organizations which were emerging at that era. Because of this government strengthen the regulatory mechanism through the companies act No.17 of 1982, establishment of Securities and Exchange Commission in 1987 mainly to guide the private companies' best governance. But with the rapid development in the private sector in Sri Lanka and the changes in the business environment, challenges for the businesses are continuously increasing. Therefore Cabrallel (2003) identified that regulators and stakeholders recognized the need for further initiatives to ensure the effective corporate governance practices by the listed companies.

II. RESEARCH PROBLEM

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 there 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 non existence 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.

The US Government responded to those global corporate scandals with the Sarbanes Oxley Act (SOX) in January 2002. The SOX is designed to review financial reporting and legislative audit requirements and applies to publicly listed companies. One of the important monitoring / controlling mechanism introduced by the SOX is audit committee to enhance the financial reporting quality. In Sri Lanka, current corporate governance code applicable is ICASL and SEC jointly issued code of best practice of CG (2013). The latest amendments to the code took into consideration relevant developments in best practices worldwide and emerging matters specific to Sri Lanka. In this code also corporate governance principles related to the audit committee has given a higher emphasized. But after introducing those CG principles there was not any study investigating the degree of effectiveness of the audit committee to enhance the reliability of the numbers in the published financial statements of Sri Lankan public companies. This study tries to fill this gap by investigating the audit committee characteristics to enhance the reliability of the numbers in the published financial statements. Based on the above following research problem has been developed. “Whether an effective audit committee can constrain the earnings management of Sri Lankan listed firms “?

III. OBJECTIVE OF THE STUDY

To investigate the impact between the audit committee characteristics (ACC) and financial reporting quality in Sri Lankan listed firms

1. LITERATURE REVIEW

The audit committee 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). The UK corporate governance code (2003) recommends the formation of an independent and active audit committee with sufficient financial experts. Further it emphasized that the audit committee should review the significant financial reporting issues and judgments made in preparing the company’s financial statement and agrees to a conclusion with the managers that those are reasonable assumptions and judgment to facilitate the financial reporting. Section 301 of the Sarbanes-Oxley Act (2002) requires all audit committee members to be independent. The Smith Committee in the UK (2003), through the January 2003 Higgs Report, also recommends that audit committees of all listed firms have independent directors (Smith Committee, 2003). Using a sample of 692 publicly traded U.S. firms, Klein (2002) investigates whether earnings management is related to audit committee independence. Klein (2002) finds a negative association between earnings management and the proportion of outside directors on the audit committee, or audit committees comprising majority independent directors and earnings management. In the wave of this reform, in 2003, the Australian Stock Exchange (2003) issued a non-mandatory set of principles suggests that the audit committee comprise non-executive directors with at least one independent director being the chairperson of the audit committee. The frequency of meetings indicates an active audit committee that devotes time to rectifying any immediate issues and offers a better review and oversight environment, which, in turn, may assist in detecting earnings management. Empirical studies suggested that firms with the higher number of audit committee meetings experience less financial restatement (Abbott , 2004), are less likely to be sanctioned for fraud as well as aggressive accounting (Abbott & Parker ,2000; Beasley , 2000) are associated with lower EM incidence (Xie, Davidson & Dadalt ,2003).

2. 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 (Warfield and Wild, 1992, Davidson, and DaDalt, 2003, Peasnell, Pope, and Young, 2005, Ahmed, Hossain, and Adams, 2006, Cornett, McNutt, and Tehranian, 2009, Wang, Sheu, and Chung ,2011) . 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 emerging market like Sri Lanka. Thus this study tries to fill this gap that exists in the Sri Lankan context.

3. CONCEPTUAL FRAMEWORK

Audit committee characteristics such as size, independence, frequency of meetings and financial expertise used as independent variables of the study. Dependent variable is earnings management which is measured by using the discretionary accruals. If there are more discretionary accruals then earnings management is more and manager's opportunistic behavior to manage the earnings to accomplish their self interest objectives are high.

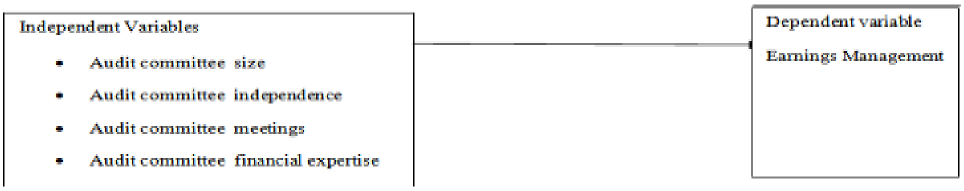

Figure: 1: Conceptual framework

IV. RESEARCH METHOD

4. SAMPLE

This study included fifty (50) Colombo stock exchange listed companies in the manufacturing industry.

4.1 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.

4.2 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.

Table 1: Operationalisation of dependent and independent variables

Code	Variable Name	Proxy
ACSIZE	Audit committee size	Total Number of members serving on the audit committee to participate in the decision making of the firm.
ACINP	Audit committee Independence	This is a dummy variable. The committee should include at least two non-executive directors or such number of non-executive director's equivalent to one third of total number of directors, whichever is higher. If the above requirement satisfy=1, Otherwise=0.
ACFEXP	Audit committee financial Expertise	This is a dummy variable. If the committee consists of majority of the directors who are financial experts =1, otherwise=0. Financial expertise of the board should include academic and professional qualifications in finance and the at least 5 years of experience dealing with the financial matters in the industry.
ACMEET	Audit committee meetings	Total number of meetings held within a particular financial year.
DA	Discretionary accruals	This is the dependent variable of the study and proxy to measure the earnings management. Absolute value of the discretionary accruals estimated by the Kothari, Leone and Wesley (2005) model. Absolute value of discretionary accruals is calculated by the residuals represented by the error term of the ordinary least square regression method.

Source: Author

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.

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

$$TA_{i,t} = NI_{i,t} - CFO_{i,t} \longrightarrow \boxed{2}$$

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

$$DA_{i,t} = \frac{TA_{i,t}}{A_{i,t-1}} - \frac{NDA_{i,t}}{A_{i,t-1}} = \varepsilon_{i,t} \longrightarrow \boxed{4}$$

$$DA_{it} = \beta_0 + \beta_1 ACSIZE + \beta_2 ACINP + \beta_3\ ACFEXP + \beta_4\ ACMEET \longrightarrow \boxed{5}$$

Thus,
$TA_{i,t}$ = 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

V. FINDINGS AND DISCUSSIONS

Table 2 represents the results of the descriptive statistics and the correlation matrix. According to the results firms are having average size of eight directors in the audit committee while the average numbers of audit meetings are six. That means audit committee directors are meeting at least twice per financial year to discuss about the matters in the firm.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. 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 2014-2016 and enhance the financial reporting quality and transparency.

Table 2: Descriptive statistics of the main constructs and Correlation Matrix

Variables	Mean	Median	Standard Deviation	Absolute Residuals	ACFEXP	ACMEET	ACINDP
ACSIZE	8.08	8	2.39	.093	.045*	-.057	.652*
ACFEXP	0.83	1	.378	.030		.341	.445*
ACMEET	5.95	5	2.97	-.112			-.315*
ACINDP	0.45	3	.91	-.012			

*. Correlation is significant at the 0.05 level (1-tailed), Source: Author

Table 3: 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	
No. of Firm Years	100	

*Significant at the 0.05 level , Source: Author

VI. 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 in the manufacturing industry. 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 audit committee 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 contributes to improve the financial reporting quality and transparency of the banking and finance industry related firms

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