The Impact of Audit Committee to Enhance the Financial Reporting Quality and Transparency: Evidence from Sri Lankan Listed Firms

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ABSTRACT
This paper aims to examine the impact of audit committee characteristics on financial reporting quality in Sri Lanka during the period from 2012-2015. Audit committee size, audit committee independence, audit committee meetings and audit committee financial expertise are used in this study as audit committee characteristics. The code of best practice of corporate governance (2013) jointly issued by Institute of Chartered Accountants of Sri Lanka and Securities and Exchange Commission is used to operationalise the audit committee characteristics. The financial reporting quality is measured using Kothari, Lenon and Wesley (2005) performance adjusted discretionary accrual model. Then, the audit committee characteristics of a sample of 150 listed firms in Sri Lanka from 2012-2015 are regressed against their performance adjusted discretionary accruals to examine the effect of audit committee characteristics on financial reporting quality. The results show 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 affect to the earnings management and therefore to enhance the financial reporting quality. 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, Audit committee, Corporate governance, Earnings management, Financial reporting quality*

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1. Introduction

Corporate governance (CG) is an emerging field all around the world and it monitors how governance practices of the organization takes place to the best interest of stakeholders in a firm.CG mechanism seeks to accomplish the interests of all the stakeholders' without giving prominence to any stakeholder. Due to the separation of ownership and control, shareholder involvement for the firm is less and managers are empowered to act on behalf of the shareholders. Through this delegation process, managers are getting a higher authority and control to run the business and make managerial decisions. But the expectations of the managers and the shareholders cannot be perfectly aligned with each others .This creates an agency conflict among themselves in a business. In such circumstances earning management is used by the managers to use their professional judgment in financial reporting to materially misstate the financial statement numbers to accomplish self-interest objectives.

Issue of earnings management have been receiving a higher attention and focus concern from the government, accounting professional bodies as well as the public, particularly after the high profile corporate governance scandals such as Enron, WorldCom, Satyam Computers, Pelmet which were occurred throughout the world. Most of these CG scandals termed as major accounting scandals because underlying cause for the failure was materially misstate the financial statements to mask the true financial information of the firm by using EM practices due to lack of corporate governance specially a weaker monitoring mechanism in the firms. Therefore, Sarbanes Oxley Act in 2002 emphasized the significance of a strong Audit committee to constrain the earnings management in firms to enhance the financial reporting quality and transparence. The characteristics of those audit committee are size of the audit committee, independence of the audit committee, audit committee meetings and the financial expertise of the audit committee.

Beginning with the new millennium witnessed a series of corporate governance scandals around the world. They are classified as major accounting scandals since the underline cause for these failures surrounded around the material manipulation of financial statements to conceal the true financial performance and the position of the firm and mislead the stakeholders. Most of these scandals occurred in developed countries like USA, UK, Germany, Italy and Netherlands. These are the countries introduced International Accounting Standards (IAS), International Financial Reporting Standards (IFRS) and the General Accepted Accounting Principles (GAAP) as pioneers in the accounting profession. Further, globally recognized audit firms audited the financial statements of these companies by using advanced auditing methodologies to detect the material misstatements in the financial statements. But those giant companies were tend to collapse by deteriorating their liquidity and the profitability disregarding a strong regulatory mechanism behind and professional background in accounting surrounded.

Further, it has been observed that accountants and financial economists that central to these corporate failures adopt systematic deficiencies in accounting practices due to poor governance systems by those firms (Bowen, Duchame & Shores,1995). Goncharov (2010) identified core of these scandals were usually the phenomenon of earnings management due to the lack of proper governance mechanisms. KPMG corporate governance survey (2010), highlighted that the causes of corporate failures in Sri Lanka attributed to the lapses, such as abuse of power and resources to commit financial reporting irregularities for window dress the financial statements supported with the inadequate internal controls. Therefore lack of systematic CG practices persuaded managers to commit EM which led to the major corporate failures around the world and in Sri Lanka.

The US Government responded to the 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. In the wake of numbers of corporate accounting scandals, the Sarbanes-Oxley Act (2002) was introduced to protect investors by improving the accuracy and reliability of corporate financial reporting disclosures. In the SOX 2002, major attention has been given to the existence of the audit committee. In UK also there are some major developments to the combined code emphasizing the importance of protecting the financial reporting quality through best governance such as introducing an independent audit committee.

2. Statement of the Problem

In Sri Lanka also, ICASL and SEC jointly issued code of best practice of CG 2013, which introduced certain reforms by paying higher emphasis on the financial reporting transparency, accountability and the audit. In this code also higher emphasis has been given to the formulation and implementation of an audit committee. Thus this study investigates whether the audit committee of a firm is capable to constrain the earnings management and improve the financial reporting quality and transparency of the listed firms in Sri Lanka.

3. Objective of the Study

To investigate the impact between the audit committee characteristics (AC) and financial reporting quality in Sri Lanka.

4. Literature Review

The audit committee plays a significant role in the monitoring process of financial reporting carried out by the directors of the firms and auditing is used by the 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 statements and agrees to a conclusion with the managers that those are reasonable assumptions and judgment to facilitate the financial reporting. Code of best practice on CG (2013) issued jointly by ICASL and SEC, principle D.3, states that the board should establish formal and transparent arrangements for considering how they should select and apply accounting policies, financial reporting and internal control principles and maintaining an appropriate relationship with the company's auditors. The code of best governance practice requires that the committee should be largely independent, highly competent and possess high level of integrity. It is responsible for the review of the integrity of financial reporting and oversees the independence and objectivity of the external auditors. Xie, Davidson and Dadalt (2001) investigated the roles of the audit committee on earnings management using a sample of 282 firms. They found that existence of audit committee is associated with reduced level of discretionary accruals. It appears that the 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 it's 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). Yang and Krishnan (2005) found that EM is lower for the firms that have large size of audit committee. This may suggest that having a sufficient number of audit committee members increases the efficiency of its monitoring function in terms of financial reporting integrity. Chen and Zhou (2007) found that the firms with large audit committee sizes are more concerned about their auditors' reputations and assign the big four auditors. In brief, the larger the audit committee size is the more effective financial reporting monitoring. Bédard, Chtourou and Courteau (2004) argue that the larger the audit committee, the more likely it is to uncover and resolve potential problems in the financial reporting process because it is likely to provide the necessary strength and diversity of views and expertise to ensure effective monitoring. But, Lin and Yang (2006) found that audit committee size is negatively related to earnings management, implying that a certain minimum number of audit committee members may be relevant to the quality of 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 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 earning 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, 'Principles of Good Corporate Governance and Best Practice Recommendations'. It suggests the audit committee comprise non-executive directors with at least one independent director being the chairperson of the audit committee. Davidson et al. (2005) study the association between non-executive directors on audit committees and earnings management based on a

cross-section of 434 Australian listed firms for the year 2000. The results of the study show that audit committees with majority non-executive directors are associated with a significant reduction in earnings management.

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) and are associated with lower EM incidence (Xie, Davidson & Dadalt ,2003). These studies suggested that audit committees that meet regularly during the financial year are associated with effective monitoring. The more frequent they meet, the more efficient they discharge their oversight responsibilities. 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, the more effective the monitoring function is Xie, Davidson and Dadalt (2003) argue that audit committee meeting frequency is associated with reduced levels of discretionary accruals and expect that more active audit committees will be more effective monitors. Beasley (1996) found that firms with fraud records had fewer audit committee meetings than those without fraud records. However, Spira (1999) concludes that audit committees meetings are largely.ceremonial and that they are largely ineffective in improving financial reporting. This leads to the following hypothesis.

Regulators from various countries realize the importance of financial expertise for improving the audit committee's effectiveness. They believe that the relevant experience or technical knowledge is crucial for effective accounting oversight (Kalbers & Fogarty, 1993). For example, the Sarbanes-Oxley Act (2002) mandates that at least one member of the audit committee must be a financial expert. In the UK, the Smith report (2003) echoes the views of the Sarbanes-Oxley Act and specifies that at least one audit committee member must have significant, recent and relevant financial expertise. Similarly, the audit committee of listed companies in New Zealand are required to have at least one member with an accounting or financial background. Despite these regulatory requirements, there is lack of sufficient empirical support for an association between financial expertise and earnings management. In U.S., not all published literature documents a significant negative association between financial expertise and earnings management. For example, while Bedard . (2004) find that financial expertise is associated with a significant decrease in earnings management,

5. Conceptual Framework

The conceptual framework of the study depicts in the figure 1. Independent variables are the audit committee characteristics, which were select, based on the code of best practice of corporate governance jointly issued by the ICASL, SEC. Dependent variable is earnings management measured by the Kothari, Lenon, and Wesley (2005) performance adjusted discretionary accrual model.

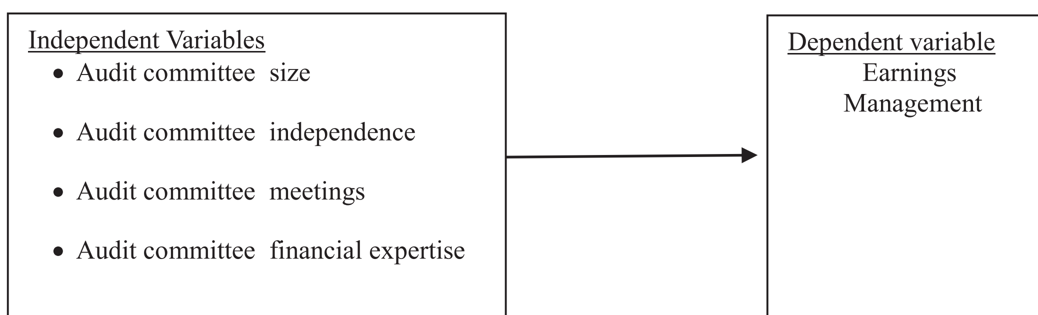

Figure: 1: Conceptual framework

6. Research Method

Research method includes the sample of the study, method of data collection, operationalisation of independent and dependent variables.

6.1 Population and Sample

This study included all the listed companies in the Colombo Stock Exchange (CSE) during the period of 2011-2014.One Hundred and Sixty (160) CSE listed companies excluding companies in the banking, finance and insurance industry included in the sample.

6.2 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.

6.3 Operationalization and Data Analysis

Table 01 depicts the operationalisation of dependent and independent variables used in this study to examine the impact of audit committee characteristics on earnings management.

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. 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.

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.

$$\frac{\mathrm{TA}_{i,t}}{\mathrm{A}_{\mathrm{i,t-1}}} = \beta_0 + \beta_1\left(\frac{1}{\mathrm{A}_{\mathrm{i,t-1}}}\right) + \beta_2\left(\frac{\Delta\mathrm{REV}_{\mathrm{i,t}} - \Delta\mathrm{REC}_{\mathrm{i,t}}}{\mathrm{A}_{\mathrm{i,t-1}}}\right) + \beta_3\left(\frac{\mathrm{PPE}_{\mathrm{i,t}}}{\mathrm{A}_{i,t-1}}\right) + \beta_4\left(\mathrm{ROA}_{\mathrm{i,t\ or\ i,t-1}}\right) + \varepsilon_{\mathrm{i,t}} \quad ------(1)$$

$$\mathrm{TA}_{\mathrm{i,t}} = \mathrm{NI}_{i,t} - CFO_{i,t} \quad ------(2)$$

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

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

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

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

7. 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.

Before conducting the OLS regression preliminary analysis is conducted to ensure the assumptions of multivariate analysis such as normality, homoscedasticity, linearity and multicollinearity are tested. To test the normality, skewness index and kurtosis index are used (Kline, 2004). Variables follow a univariate normal distribution since the skewness index is less than 3 and kurtosis index is less than 10. Linearity also tested by using the scatter and residual plots. It was observed that all the scatter plots are scatter around zero and have an oval shape. Homoscedasticity tested by using the graphical approach. The residual plots drawn to observe linearity no funneling was observed which ensure that variances of their error terms are constant. Variance Inflation Factor (VIF) and tolerance statistics are used to test multicollinearity. Generally accepted threshold level of VIF is 10 (O'Brien, 2007) and the tolerance value should be closer to 1 (Field, 2009). For all the variables of this paper VIF is less than 10 and the tolerance level is less than 1. After ensuring the assumptions of the multivariate analysis following findings were observe in the OLS regression analysis.

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 .726. 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 constrain the earnings management of the listed companies during the period of 2012-2015 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).

Table 3: Regression Results

Independent variables	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	0.726	

*Significant at the 0.05 level

8. Conclusion

Based on the results of this study it can be concluded the Audit committee characteristics which is one of the key constitutes 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 a 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 contributes to improve the financial reporting quality and transparency of the firms.

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