# Impact of audit committees and boards on the quality of reported earnings: A study of listed Diversified Holdings industry in Sri Lanka

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## Abstract

The purpose of this study is to examine the relationship between audit committees (AC) and board of directors with earnings quality of the firms listed on diversified holdings sector, over the period 2012/13 to 2016/17 by using AC proxies, namely AC expertise, AC independence, and AC meetings and board structure variables such as board expertise, board independence, and board size. For the study, a sample of 17 companies has been selected, and Standard Jones Model (1991) has been employed for calculating discretionary accruals. Results from correlation and regression analysis suggests that measures of AC - audit meetings and board structure- board size are significantly related to earnings quality in a manner that is generally consistent with the predictions of agency theory. Furthermore, the results depicted insignificant negative impact of other AC and board characteristics on discretionary accruals, except board expertise, which had an insignificant positive impact on discretionary accruals.

*Keywords: audit committee (AC),* board characteristics (BOD), discretionary accruals (DACC) *and earnings quality*

## Introduction

Over the past two decades, Corporate Governance (CG) system and practices have gained significant attention because of corporate scandals taken place around the world at prominent companies such as Waste management company, Enron, Worldcom, Tyco, Bernie Madoff, and Satyam appear to have shaken the confidence of investors. Amid a growing number of financial reporting scandals, the role of Audit Committees (AC) and boards in corporate governance has been the topic of active debate among policymakers, managers, investors, and academics. There is great attention on the Board of Directors (BOD) to discharge their duties with high ethical values and accountability in their commitment to good governance practices. The AC plays a significant role in CG regarding the organization's direction, control, and accountability. Moreover, the quality of financial reporting ensures the accuracy of the company's reported financials and their usefulness for forecasting future cash flows. In contrast, earnings quality measures fulfill a crucial objective of financial reporting, which is improving decision usefulness for investors.

Given that AC is the principal liaison between management and auditors and is chiefly responsible for reporting on earnings quality to the BOD. Due to the separation of ownership and control, agency conflict arises among managers and shareholders in a business. In such circumstances, the managers use managemento to use their professional judgment in financial reporting to materially misstate the financial statement numbers to accomplish their self-interest objectives (Kankanamage, 2015). Among the measures established to reduce the self-serving nature of the agent is an independent AC. Therefore, there is a high demand for governance mechanisms such as Board subcommittees composed of directors with the appropriate attributes such as independence, expertise, and experience to prevent or reduce the agent's selfish interest. Also, issues of earnings manipulation created the need for reliable, high-quality financial reporting. Therefore, the study focuses that an appropriately structured AC and Board will act to ensure high quality of reported earnings (QRE).

## Literature Review

One of the objectives of CG is to ensure that the financial report has high quality and reliable data. The earnings information in the financial report that investors will analyze before making any decision in investment. Therefore, if the earnings information has low quality and contains inaccurate data, the investors may make wrong decisions. The executives are considered the agents responsible for preparing the financial statements and business performance for the shareholders. Previous studies have focused on the role of the board of committee on operating AC and external auditor to observe the AC's effectiveness, supervise and oversee financial reports. This partly depends upon the BOD constitutionnd the AC of each firm that are factors of a good quality profit account (Bradbury, 2004). The management division holds more information over shareholders in which asymmetric information is generated between them (Jensen & Meckling, 1976, Healy & Palepu, 2001). Shareholders will ensure financial reporting prepared by administrators to affirm the accuracy of the prepared report. In general, the management division uses services provided by professional external auditors to conduct the audit and comment on financial reports and verify whether or not the report is prepared in compliance with generally accepted accounting standards. Auditor’s opinion on financial reports can assure users. According to theories, auditors will perform to benefit shareholders and reduce agency problems between the agent and the principal. It is possible that administrators would hire auditors who serve high-quality standards. The relationship between CG and information quality has been vigorously debated in developed countries (Agrawal & Chadha, 2005); (Brown, Falaschetti & Orlando, 2010). There are few studies on corporate financial reporting in the context of Sri Lanka, such as (Kajananthan, 2012), (Velnampy & Pratheepkanth, 2013) and (Kankanamage, 2015).

## Methodology

### Sample selection

The sample is selected from 299 companies listed on the CSE during 2012/13-2016/17, representing 20 business sectors asof 29$^{th}$ March 2018. The whole diversified holdings sector is selected as a sample where it consists of nineteen companies. Two companies are excluded from the sample. This leaves a final sample of 17 companies.

### Mode of analysis

Secondary data gathered was organised in spreadsheets for analysis. STATA 12 is used and interpreted with different statistical tools like descriptive statistics, correlation, and regression analysis.

### Hypotheses of study

$H_1$: There is a significant impact of audit committee characteristics on QRE.

$H_2$: There is a significant impact of board characteristics on QRE.

$H_3$: There is a significant relationship between audit committee characteristics and QRE.

$H_4$: There is a significant relationship between board characteristics and QRE.

## Results and Discussions

### Correlation analysis

Table 1. Correlation analysis

| | DACC | Audexp | Audindp | Audmeet | Bdexp | Bdindp | Bdsize |
|---|---|---|---|---|---|---|---|
| DACC | 1.0000 | | | | | | |
| Audexp | -0.0809 | 1.0000 | | | | | |
| | 0.4619 | | | | | | |
| Audindp | -0.1286 | -0.3729** | 1.0000 | | | | |
| | 0.2408 | 0.0004 | | | | | |
| Audmeet | -0.2198* | -0.3531** | 0.1477 | 1.0000 | | | |
| | 0.0445 | 0.0010 | 0.1801 | | | | |
| Bdexp | 0.0780 | 0.5416** | -0.3492** | -0.0164 | 1.0000 | | |
| | 0.4781 | 0.0000 | 0.0011 | 0.8825 | | | |
| Bdindp | -0.0920 | -0.0985 | 0.4724** | 0.0097 | -0.0405 | 1.0000 | |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| | 0.4023 | 0.3698 | 0.0000 | 0.9302 | 0.7127 | | |
| Bdsize | -0.2453* | -0.0941 | -0.2045 | 0.3055** | -0.0059 | -0.1709 | 1.0000 |
| | 0.0237 | 0.3917 | 0.0604 | 0.0047 | 0.9576 | 0.1179 | |

*Significant at 0.05 level , **Significant at 0.01 level

According to Table 1, the correlation matrix shows a negative relationship between DACC, Audexp, Audindp, Audmeet, Bdindp, and Bdsize, which means that an increase in audit expertise, audit independence, audit meeting, the board size, and board independence leads to a reduction in discretionary accruals by the firms, hence this improves the earnings quality and vice versa. However, this negative relationship is weak in form. However, there is a significant negative relationship that exist among discretionary accruals, audit meetings, and board size. Moreover, there is a positive relationship between DACC and bdexp, which means that bdexp leads to an increase in discretionary accruals and vice versa, however, the positive relationship between DACC and bdexp is very weak (0.0780).

## Regression analysis

AC characteristics are interrelated with board characteristics for these reasons and consistent with (Klein, 2002). The regression analysis was carried out separately to determine the impact of AC characteristics on the discretionary accrual and the board characteristics on the discretionary accruals. As such, the results for audit committee characteristics and discretionary accrual are appended below.

Table 2: Regression analysis (Audit committee characteristics)

| DACC | Coef | Std. Err. | t | P>\|t |
|---|---|---|---|---|
| Audexp | -.010673 | .027426 | -0.39 | 0.698 |
| Audindp | -.0440819 | .0395788 | -1.11 | 0.269 |
| Audmeet | -.0035148 | .0017435 | -2.02 | 0.047 |

R-squared = 0.0693
Adjusted R squared = 0.0335

In this model, R square value depicts that a 6.93% change in the DACC is explained by the Audit committee variables under review (Audexp, Audindp, and Audmeet), leaving 93.07% of the change in DACC as unexplained. Here the value of an adjusted R square is 0.0335, Slightly less than the value of 0.0693. The model is considered to be overall statistically significant, giving the prob F statistics value of nearly 0.000, and it means that the variables used in the regression specification can jointly predict the quality of reported earnings. According to the results, all the AC characteristics have a negative relationship with DACC, wherein the relationship between DACC and Audmeet is significant.

Table 3: Regression analysis (Board characteristics)

| DACC | Coef. | Std. Err | t | P>\|t\| |
|---|---|---|---|---|
| Bdexp | .0267333 | .0380357 | 0.70 | 0.484 |
| Bdindp | -.0509999 | .0386676 | -1.32 | 0.191 |
| Bdsize | -.007582 | .0030124 | -2.52 | 0.014 |

| | | |
|---|---|---|
| R-squared | = | 0.0837 |
| Adjusted R-squared | = | 0.0497 |

In this model, R square value depicts that 8.37% change in the DACC is explained by the Board characteristics under review (Bdexp, Bdindp, and Bdsize), leaving 91.63% of the change in DACC is due to other factors. Here the value of an adjusted R square is 0.0497, Slightly less than the value of 0.0837. The model is considered to be overall statistically significant, giving the prob F statistics value of 0.0251, and it means that the variables used in the regression specification can jointly predict the quality of reported earnings. According to the results, Board characteristics such as Bdindp and Bdsize have a negative relationship with DACC, wherein the relationship between DACC and Bdsize is significant, while board expertise has a positive relationship with DACC.

## Conclusions

This research study has also investigated audit and board characteristics' impact on the quality of reported earnings (using discretionary accruals. A sample of 17 companies, listed on the Colombo Stock Exchange, had been selected, and 5years of data from the year 2012/13 to 2016/17 had been used for panel data analysis. The results of linear regression model depicted a significant effect of audit meetings, and board size has been observed on discretionary accruals. Thus, it has been concluded that manipulating earnings can be restricted/reduced by increasing the percentage of independent non-executive directors, appointing directors with accounting and financial expertise to the board, having more meetings. The relationships reported are in line with the results of previous researchers.

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