

Audit Committee Characteristics, Gender Diversity and Earnings Management: Evidence from Listed Companies in Sri Lanka

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Abstract

The study aims to explore the impact of audit committee characteristics and gender diversity on the earnings management of listed companies in Sri Lanka. The sample comprises 107 companies listed on the Colombo Stock Exchange (CSE) for the five years from 2017 to 2021. The audit committee size, independence, financial expertise, and the number of audit committee meetings proxy for audit committee characteristics while gender diversity is measured by the number of female directors on the board. This study used discretionary accruals as a signal of the presence of earnings management. The results reveal that audit committee size and gender diversity have a negative effect on the earnings management practices of listed companies. A low level of audit committee independence has a major effect as a device in mitigating earnings management.

JEL classification: G3, G39

Keywords: Audit committee characteristics, audit committee size, earnings management, gender diversity

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1. Introduction

The purpose of this study is to examine how audit committee characteristics and gender diversity influence earnings management practices in Sri Lankan listed companies. There has been substantial interest in understanding the role of the audit committee in corporate governance. Analyzing the impact of audit committee characteristics has the potential to significantly enhance the understanding of the role of auditors in earnings management. Managers throughout the globe are compelled to use earnings management due to the pressure on firms to fulfill earnings predictions and analyst expectations. Because their compensation is sometimes based on the success of their companies, managers are motivated to manipulate earnings. Earnings management is the process by which managers use the latitude offered by accounting laws and standards to align a company's reported earnings with a targeted or preferred level (Mishra & Malhotra, 2016).

Earnings management skews financial reporting's accuracy and reliability, which can impede the ability of investors and other stakeholders to make accurate decisions. Financial information asymmetry prevents capital markets from operating effectively and presents a challenge for regulators trying to increase the stability and transparency of financial markets. According to Ajit et al. (2013), investors must be shielded from accounting fraud, financial misbehavior, and unethical earnings management techniques in order for funds to keep flowing into Indian capital markets.

Agency theory contends that management may not act in the best interests of investors when its interests conflict with those of its shareholders. Because management remuneration is typically linked to reported profitability, managers are motivated to manipulate reported earnings and often have the power to do so (Healy & Wahlen, 1999). As a result, an auditor must have reasonable confidence that financial statements are free of serious misstatements, protecting investors' interests. Higher-quality auditors are more likely to disclose errors and irregularities found during audits and less likely to tolerate questionable accounting practices. A well-recognized method for boosting investor trust and encouraging greater involvement in the capital markets is corporate governance.

Gender diversity of the board can symbolize board diversity in general, and agency theory encourages board diversity (Milliken & Martins, 1996). Because a board with varied representation is more balanced, it is less probable for a single person or a small group of persons to dominate decision-making, improving the board's independence. In this context, female directors might add to the diversity and independence and hence play a pivotal role in deterring and detecting earnings management.

Two basic theories, gender theory, and agency theory suggest that greater gender diversity may contribute to better board effectiveness. From a gender theory perspective, an individual's gender determines his or her behavior (Eagly, 1987). Gender differences among males and females vary from society to society, as do social differences and how they interact with one another. Terjesen et al. (2016) posit that men are expected to be more assertive and aggressive than women. According to Rosener (1995), women are more flexible and able to manage ambiguous situations. These gender differences may be relevant factors that influence the effectiveness of the board of directors. From an agency theory perspective, Virtanen (2012) finds that females are more likely to take active roles on boards of directors.

A board audit committee must be established to manage the financial reporting and auditing process in accordance with corporate governance rules in the majority of developed and developing nations. Because it gives financial statements more authority and increases public confidence in the external auditor's integrity, professional accounting and auditing associations encourage the creation of audit committees. Choosing alternative accounting processes may

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lead to conflicts between managers and external auditors. Since auditors are hired by the company, they may be fired if conflicts cannot be reconciled. Members of the audit committee are chosen to work independently to settle disputes between the managers and outside auditors in order to provide fair financial reports (Saleh et al., 2007).

There have been limited studies in the Sri Lankan context on the impact of corporate governance on earnings management, and the previous evidence has been mixed. Kankanamge (2016) examines the impact of board characteristics on earnings management in Sri Lanka, employing the performance-adjusted discretionary accrual model developed by Kothari et al. (2005) to measure earnings management. The study's findings indicate that board characteristics such as board size, board composition, board financial expertise, and board meetings play a significant influence in limiting earnings management in Sri Lanka's listed companies. Rajeevan and Ajward (2019) use the Roy Chowdhury model to measure the earnings management of selected listed businesses in Sri Lanka to provide empirical evidence of the impact of corporate governance characteristics on the level of earnings management. Their findings reveal that CEO-Chair duality is positively associated with earnings management.

Puwanenthiren (2018) examines the correlation between audit committee characteristics and earnings management using a sample of 100 listed firms in Sri Lanka. The study finds that audit committee size, audit committee independence, and frequency of audit committee meetings are significant to reduce earnings management. But Rajeevan and Ajward (2019) investigate the association between designated corporate governance attributes and the degree of earnings management of selected quoted companies in Sri Lanka. Based on the findings, audit committee characteristics such as audit committee size, audit committee independence, audit committee meetings, and audit committee skills do not have any significant association with earnings management. Moreover, Bandara and Wijekoon examine (2021) the impact of female directors on earnings management. The findings of the study provide useful insights to Sri Lankan corporates to determine the best practices of board governance and to policymakers to strengthen corporate governance practices of Sri Lanka as it has a close link with earnings management. Based on prior studies, there are contradictory findings in the few studies conducted in the context of Sri Lanka. Hence, this study aims to address this gap in the literature by investigating the effect of audit committee characteristics and gender diversity on earnings management practices in Sri Lankan listed companies.

The audit committee size, independence, financial expertise, and the number of audit committee meetings are proxies for audit committee characteristics while gender diversity is measured by the number of female directors on the board. This study used discretionary accruals as a signal of the presence of earnings management. Firm size and leverage are considered the control variables. We use a sample of 107 companies listed in the food, beverage and tobacco, consumer services, and capital goods sectors for the period from 2017 to 2021. The results indicate that audit committee size has a negative impact on earnings management. Furthermore, Gender diversity has a negative association with earnings management. This research will benefit academics, researchers, policymakers, and practitioners in Sri Lanka and other similar countries to understand the relationship between audit committee characteristics and earnings management, as well as to design boards to mitigate earnings management practices.

The remainder of this study is structured as follows. Section two reviews the extant literature and hypothesis. Section three describes the methodology of the study. The fourth section presents and discusses the results. The summary and conclusions are provided in section 5.

2. Literature and Hypothesis

2.1 Audit committee size and earnings management

The size of the audit committee, as defined by the number of members, is seen as a gauge of the resources available for the audit committee's efficiency. A large audit committee could be quite effective in reducing earnings management practices. However, the empirical data do not seem to be conclusive. Few studies show that the size of the audit committee is negatively associated with earnings management practices (Klein, 2002; Yang & Krishnan, 2005; Mishra & Malhotra, 2016). Therefore, a larger audit committee has a positive impact on the quality of financial reporting. Some studies find that the size of the review board is positively related to earnings management (Mohammed et al., 2017; Ismail et al., 2009, Ismail & Kamarudin, 2017). However, some studies suggest that the size of the audit committee is not significantly correlated with discretionary provisions (Alkdai & Hanefah, 2012; Setiawan et al., 2020).

We hypothesize that the larger the size of the audit committee the less the incidence of earnings management, and hence the audit committee size and earnings management will be negatively related.

H₁: The size of the audit committee is negatively related with earnings management.

2.2 Audit committee independence and earnings management

Independence is considered an essential attribute of an audit committee to fulfill its oversight function. As mentioned in agency theory, the independence of the directors of the audit committee plays a fundamental part in the fruitful observation of administrative behavior (Fama & Jensen, 1983). Furthermore, as argued by Bedard and Gendron (2010), independent members of the audit committee are more likely to work objectively without the influence of management. According to several studies, there is a positive association between earnings management and audit committee independence (Mohammad & Wasiuzzaman, 2020; Fodio et al., 2013), while others find no such association (Yang & Krishnan, 2005; Rahman & Ali, 2006; Lin & Hwang, 2010). The independence of audit committee members was found to be negatively correlated with earnings management by Soliman et al., (2014) and Mouratidou (2020), respectively.

We hypothesize that a large proportion of independent auditors leads to a lower incidence of earnings management, and hence the audit committee independence and earnings management will be negatively related.

H₂: The audit committee independence is negatively related with earnings management.

2.3 Audit committee financial expertise and earnings management

Audit committee members can perform their oversight responsibilities more successfully if they have expertise in matters relating to accounting, finance, and auditing. This expertise helps the members of the audit committee to become more familiar with financial and operational reports. Bedard et al., (2004), and Carcello et al., (2006) find that the presence of at least one member with financial expertise is associated with a reduced possibility of destructive earnings management. Marra et al., (2011), and Hossain et al., (2011) observe that the financial expertise of the audit committee is negatively related to earnings management. Dhaliwal et al., (2007) and Chang and Sun (2009) find a positive relationship between the

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quality of provisions and accounting professionals. However, Puwanenthiren (2018) reports that the audit committee's financial acumen had no significant effect on the management of earnings. This finding is similar to other extant studies (Chang & Sun, 2009; Bedard et al., 2004; Hossain et al., 2011; Marra et al., 2011; Abdullah et al., 2010).

Based on the previous evidence, the current study predicts that the higher the financial expertise in the audit committee the less the incidence of earnings management, and hence the audit committee's financial expertise and earnings management will be negatively related.

H₃: The financial expertise of the audit committee is negatively related with earnings management.

2.4 Audit committee meetings and earnings management

The number of audit committee meetings describes the activities of the audit committee. It is expected that a large number of audit committee meetings may dampen earnings management. Ghosh et al. (2010) and Klein (2002) find a positive association between the number of audit committee meetings and earnings management. García et al., (2012), Juhmani, (2017), and Rahman and Ali (2006) find that meetings between the audit committee and the internal auditor are not materially related to earnings management. Consequently, Ghafran and OSullivan, (2013), Saleh et al. (2007) and Skousen et al. (2009) show a negative association between audit committee meetings and earnings management.

This study predicts that the larger the number of audit committee meetings the less the incidence of earnings management, and hence the audit committee meeting and earnings management will be negatively related.

H₄: The number of audit committee meetings is negatively related with earnings management.

2.5 Gender diversity and earnings management

The various experiences, expertise, and abilities of female board directors might strengthen the firm's governance. These attributes expand the board's capacity to perform its important role of management oversight and monitoring (Bear et al., 2010). Hence, if the board detects earnings manipulation, female directors will be more inclined to avoid the potential negative repercussions from earnings misrepresentation than their male counterparts. Moreover, Byrnes et al. (1999) state that in numerous decision-making circumstances, women are more cautious than males. They are more likely than men to move decisively to improve earnings quality since they are more sensitive to reputational harm and the danger of lawsuits. Therefore, it is usually expected that women will approach earnings management with caution (Gul et al., 2009). Few extant studies offer evidence that gender diversity in corporate boards enhances financial reporting quality (Krishnan & Parsons, 2008; Gul et al., 2011; Srinidhi et al., 2011; Gavius et al., 2012). These studies suggest that firms with higher levels of female representation on the board are less likely to manipulate earnings. Also, Thiruvadi and Huang (2011) and Pucheta-Martínez et al. (2016) find consistent evidence that companies with a higher number of female directors have better financial reporting quality.

Hence, this study hypothesizes that the larger the number of female directors the less the incidence of earnings management, and hence gender diversity and earnings management will be negatively related.

H₅: Gender diversity is negatively related with earnings management.

3. Methodology

3.1 Data and sample

We use secondary data collected from the annual reports of companies listed on the Colombo Stock Exchange of Sri Lanka for the period from 2017 to 2021. The study's population consists of 112 companies listed under the food, beverage and tobacco, consumer services, and capital goods sectors. Based on the availability of annual reports for the sample period, the final sample consists of 107 companies.

3.2 Model specification

We use the modified-Jones model (1991) for measuring earnings management. It has been demonstrated that the modified-Jones model detects earnings management more accurately than other discretionary accruals models (Dechow et al., 1995). According to Dechow (1994), discretionary accruals often provide managers the opportunities to manipulate earnings due to the flexibility available. To detect earnings management, Healy (1985) was the first to introduce discretionary accruals. It is presumed discretionary accruals fall under managerial discretion while non-discretionary accruals provide no room for manipulation of earnings. Total accruals are assessed from the amount of accrual discretion, and non-discretionary accruals (Demirkan et al., 2012).

First, total accruals are measured as net income minus cash flows from operations.

$$TACC_t = NI_t - CFO_t \quad (1)$$

Then, the Modified-Jones model is specified as follows:

$$\frac{TACC_t}{A_{t-1}} = \alpha_1 \frac{1}{A_{t-1}} + \alpha_2 \frac{(\Delta REV_t - \Delta REC_t)}{A_{t-1}} + \alpha_3 \frac{PPE_t}{A_{t-1}} + \varepsilon \quad (2)$$

Where,

$\frac{TACC_t}{A_{t-1}}$ = Total accruals in year t divided by total assets in year $t - 1$

ΔREV_t = Revenues in year t less revenues in year $t - 1$

ΔREC_t = Net receivables in year t less net receivables in year $t - 1$

PPE_t = Gross property plant and equipment in year t

A_{t-1} = Total assets in year $t - 1$

ε = Residuals in year t

$\alpha_1, \alpha_2, \alpha_3$ = Parameters to be estimated

Parameters are estimated using the ordinary least squares regressions (OLS). $\alpha_1, \alpha_2,$ and α_3 are company-specific coefficients assessed from the subsequent cross-sectional regression.

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Non-discretionary accruals (NDACC) are calculated as follows:

$$\frac{NDACC_t}{A_{t-1}} = \alpha_1 \frac{1}{A_{t-1}} + \alpha_2 \frac{(\Delta REV_t - \Delta REV_{t-1})}{A_{t-1}} + \alpha_3 \frac{PPE_t}{A_{t-1}} + \varepsilon \quad (3)$$

The discretionary accruals are calculated by the following formula.

$$DACC_t = TACC_t - NDACC_t$$

To study the impact of audit committee characteristics and gender diversity on earnings management, we specify the following model.

$$EMGT_{it} = \beta_0 + \beta_1 ACSIZE_{it} + \beta_2 ACINDE_{it} + \beta_3 ACEXPRT_{it} + \beta_4 ACMEET_{it} + \beta_5 GEND_{it} + \beta_6 FIZE_{it} + \beta_7 LEVER_{it} + \varepsilon_{it} \quad (4)$$

Where EMGT is the measure of earnings management. It is proxied by discretionary accruals which are equal to total accruals less nondiscretionary accruals. ACSIZE is the audit committee size, which is measured by the number of audit committee members. The ACINDE represents the independence of the audit committee, frequently regarded as an essential characteristic influencing the committee's effectiveness in overseeing the financial reporting process. It is measured by the ratio of independent non-executive directors to the total number of directors on the audit committee. The ACEXPRT is the financial knowledge of the audit committee which is measured by the ratio of audit committee members with financial expertise to the total number of audit committee members. It has been argued that effective oversight by an audit committee requires that its members possess sufficient expertise in accounting and auditing to independently assess the matters that are presented to them. The ACMEET proxies for audit committee meetings and is expressed as meeting frequency. Gender diversity (GEND) represents the number of female directors on the board. In addition, firm size (FSIZE) and leverage (LEVER) are used as control variables. The FSIZE is calculated as the log of total assets, and the LEVER is measured by the debt-to-equity ratio.

4. Discussion of Results

Table 1 presents the descriptive statistics of the study. The average size of the audit committee is 3 directors, and 55.2% of the directors on audit committees are independent. Furthermore, 57.4% of members of the audit committee members have financial expertise. On average, the audit committee meets 5.7 times a year, and approximately 7% of the audit committee members are female.

Table 2 shows the correlation matrix of the variables used in the study. The correlation between audit committee size and earnings management is -0.113 and significant at 5%. This negative relationship between audit committee size and earnings management suggests that earnings management practices can be mitigated when the number of members in the audit committee increases. Audit committee independence and earnings management have a positive relationship suggesting that having a large proportion of independent auditors will increase the incidence of earnings management. Board gender diversity is also significantly negatively correlated with the earnings management of listed companies in Sri Lanka. It means that companies with higher levels of female representation on the board are less likely to manipulate

earnings. However, audit committee financial expertise and audit committee meetings are not significantly correlated. The control variables, firm size, and leverage are also not correlated with earnings management either.

Table 1

Descriptive Statistics

	ACSIZE	ACINDE	ACEXPERT	ACMEET	GEND	FSIZE	LEVER	EMGT
Mean	3.274	0.552	0.574	5.663	0.072	8.076	0.312	-0.506
Median	3.000	0.500	0.666	5.000	0.100	7.573	0.445	-0.178
Maximum	5.000	1.000	1.000	6.000	0.250	11.324	0.610	1.042
Minimum	2.000	0.200	0.000	1.000	0.000	5.841	0.015	-4.181
Std. Dev.	0.695	0.261	0.254	3.168	0.070	1.478	7.552	0.911

Note: ACSIZE is audit committee size, ACINDE is audit committee independence, ACMEET is the frequency of audit committee meetings, ACEXPERT is audit committee financial expertise, GEND is gender diversity, FSIZE is firm size, LEVER is leverage, and EMGT is the measure of earnings management.

Table 2

Correlations Matrix

	Correlation (p-value)						
	ACSIZE	ACINDE	ACEXPERT	ACMEET	GEND	FSIZE	LEVER
ACINDE	-0.108** 0.012						
ACEXPERT	-0.362** 0.000	0.539** 0.000					
ACMEET	0.013 0.761	-0.273** 0.000	-0.106** 0.014				
GEND	0.030 0.476	-0.060 0.160	-0.086** 0.046	-0.146** 0.000			
FSIZE	0.000 0.991	-0.313** 0.000	-0.364** 0.000	0.154** 0.000	0.010 0.805		
LEVER	-0.010 0.804	-0.039 0.360	-0.001 0.965	0.149** 0.000	0.030 0.479	-0.032 0.456	
EMGT	-0.113** 0.008	0.105** 0.014	0.048 0.267	-0.005 0.901	-0.127** 0.003	-0.013 0.755	0.029 0.490

Note: ACSIZE is audit committee size, ACINDE is audit committee independence, ACMEET is the frequency of audit committee meetings, ACEXPERT is audit committee financial expertise, GEND is gender diversity, FSIZE is firm size, LEVER is leverage, and EMGT is the measure of earnings management.

**Significant at 5%

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The variance inflation factors showed no evidence of multicollinearity among the audit committee variables, gender diversity, and control variables. Further, Augmented Dickey-Duller (ADF) tests indicated that all the variables are stationary and data have no unit root.

Table 3 represents the output of panel data regressions. To get unbiased results, panel data regressions with both fixed and random effect models are employed. According to Hausman's test, the random effect model is the most appropriate one for this investigation at the significant level of 5% ($\chi^2=3.3183$, $p=0.8541$). In the results, the adjusted R^2 shows that 84.80% of the variation in earnings management is explained by audit committee size, audit committee independence, audit committee financial expertise, audit committee meetings, gender diversity, and control variables. The F-statistic of the regression indicates that the model is a good fit ($F = 2.2956$, $p<0.05$).

The results for the random effect regression model show that the audit committee size has a negative impact on earnings management at the 5% significant level. Consistent with our hypothesis 1, this result indicates that a larger audit committee reduces earnings management practices. A large audit committee provides more top-management monitoring and increases the quality of financial reports. This can enhance internal governance practices and improve the resources of internal monitoring activities. This finding is also consistent with some previous evidence (Klein, 2002; Yang & Krishnan, 2005; Mishra & Malhotra, 2016).

Table 3

Panel Data Regression Results

Variables	Coefficient (P-value)
ACSIZE	-0.1343** (0.0072)
ACINDE	0.4171** (0.0256)
ACEXPERT	0.0256 (0.8711)
ACMEET	-0.0061 (0.4726)
GEND	-0.4394** (0.0500)
LEVER	0.0007 (0.7852)
FSIZE	0.0325 (0.4764)
Constant	-0.4793 (0.3434)
Adj-R ²	0.8480
F statistics	2.2956
Prob>F	0.0000
Hausman test	3.3183 (0.8541)

Note: ACSIZE is audit committee size, ACINDE is audit committee independence, ACMEET is the frequency of audit committee meetings, ACEXPERT is audit committee financial expertise, GEND is gender diversity, FSIZE is firm size, LEVER is leverage, and EMGT is the measure of earnings management.

**Significant at 5%

Furthermore, audit committee independence has a positive influence on earnings management at a 5% significant level. Compared to other corporations, a low level of board independence recorded fewer earnings management practices. Hence, H_2 is not supported by the finding. Audit committee financial expertise and audit committee meetings have not shown any significant impact on earnings management. So, H_3 and H_4 are not supported by findings. Gender diversity has a negative impact on earnings management at a 5% significant level.

Therefore, H₅ is supported by finding which is collaborated with prior studies (Thiruvadi & Huang, 2011; Pucheta-Martínez et al., 2016). Control variables, firm size, and Leverage have no significant impact on earnings management.

5. Summary and conclusions

The present study examines the impact of audit committee characteristics and gender diversity on the earnings management of listed companies in Sri Lanka from 2017 to 2021. The study included 107 companies in the food, beverage and tobacco, consumer services, and capital goods sectors listed on the Colombo Stock Exchange. Based on panel data regression analysis, this research reveals that the audit committee size has a negative impact on earnings management as a larger number of auditors with wide knowledge and experience can more effectively monitor the financial reporting process. Furthermore, Gender diversity has a negative association with earnings management since women on the board are more vigilant to evade the potential negative consequences of earnings misrepresentation.

The results of the study show that certain audit committee characteristics are essential for raising the standard of financial reporting quality in Sri Lanka. These findings suggest that having a large number of directors on the audit committee and increasing gender diversity should be considered important in mitigating potential earnings management and enhancing reporting quality of financial reports.

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