THE IMPACT OF CORPORATE GOVERNANCE ON EARNING MANAGEMENT OF LISTED NON-FINANCIAL COMPANIES IN SRI LANKA

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INTRODUCTION

This research study has been carried out to determine the impact of corporate governance on earning management of non-financial companies listed in Sri Lanka while filling the gap due to the dearth of study and not identifying the effects of selected corporate governance factors, such as CEO duality, board independence, board meetings, board size and audit committee meetings and board committee attributes, on the management of earnings. The magnitude of Discretionary Accruals was used as the proxy for earning management which was measured using the modified Jones model. This research has adopted a descriptive research design and a quantitative approach. The sample for the study was selected from 30 non-financial companies listed in CSE, and data for the study were collected from published annual reports, the CSE website, and the respective firm's website from 2016 to 2022, and gathered data were analyzed using descriptive and inferential statistics. The research findings of the present study emphasize that there is a significant impact of board independence and audit committee meetings on earning management and other selected corporate governance characteristics are not found to have a significant impact on earning management. Thus the study has derived a reformation of policies with the implications of corporate governance and fund providers' consideration of critical corporate governance attributes in making funding decisions as implications based on research findings.

Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. Earnings management is a strategy used by a firm's management to consciously influence the earnings of the company so that the results meet a pre-established target. Companies will attempt to maintain the figures generally steady by adding and subtracting cash from reserve accounts to avoid having years of particularly good or negative earnings. Several global corporations including Enron, WorldCom, Nortel, Parmalat, and Tyco, experienced business failure due to poor corporate governance standards and accounting fraud (Sorensen and Miller, 2017). Large companies including Pramuka Savings, Development Bank, Golden Key Credit Card Company, Vimukthi Corporation, and Lanka Marine Services Ltd. collapsed as a result of subpar corporate governance processes. Sri Lanka is likewise susceptible to such business failures (Edirisinghe, 2015). This is a mixed finding in the international context. Jesus and Emma (2013) investigated whether corporate governance affected earnings management in Latin American markets. Alghamdi (2012) investigated how Saudi-listed firms managed their earnings as well as the function of corporate governance and external audit in emerging markets.

Kankanamage (2015) evaluated the effect of board characteristics on earnings management in the Sri Lankan context, and the study employed the performance-adjusted discretionary accrual model developed by Kothari, Leone, and Wasley (2005) to measure earnings management. Rajeevan and Ajward (2019) used the Roy Chowdhury Model to quantify earnings management in chosen listed businesses in Sri Lanka and produced empirical data regarding the relationship between designated corporate governance traits and the degree of earnings management. Numerous researches on corporate governance have been conducted locally, but few studies have examined how it affects or is related to earnings management. In particular, this study is directed toward investigating whether there is an impact of corporate governance on earning management and whether there are comparable differences in the context of listed non-financial companies in the Colombo Stock Exchange. This study provides empirical evidence for earning management adjustment from all listed non-financial companies in Colombo Stock Exchange, in identifying the corporate governance factors that can be affected a firm's earning management. Moreover, the study will be beneficial to the constituents such as corporate managers of listed non-financial firms, Fund providers, and future researchers. One of the major limitations identified was only considering board characteristics as the corporate governance variables and does not consider the quality of accruals.

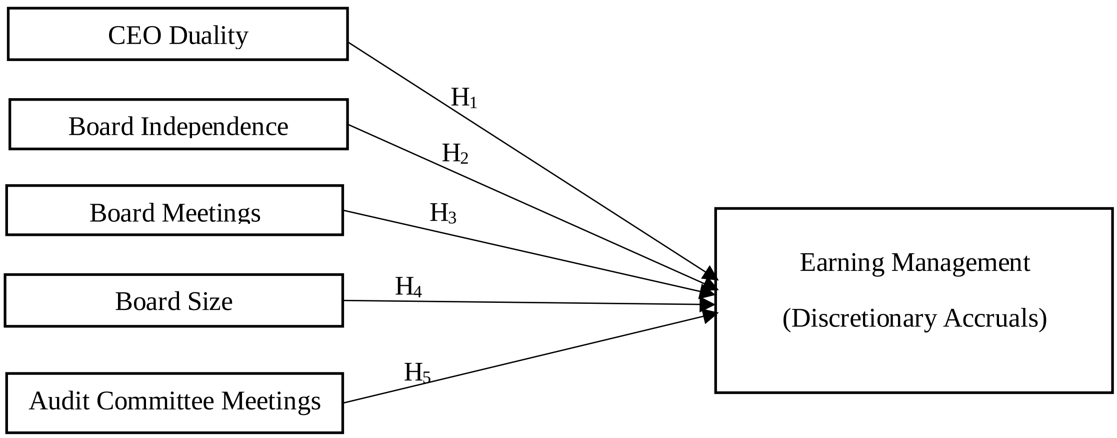
Accordingly, the problem statement of the study can be recognized as to what extent the corporate governance impact on earning management of listed non-financial companies in Sri Lanka, with five specified objectives.

METHODOLOGY

The descriptive research design and a quantitative approach were used to analyze the data in this study. All listed non-financial companies on the Colombo Stock Exchange (CSE) were used for the population for this study. There were 294 listed companies on the CSE representing 20 business sectors (as of 30th September 2022). According to the Global Industry Classification Standard (GICS).

Figure 1

Conceptual Framework



The sample included 30 non-financial companies listed in CSE, excluding insurance, finance, and banking institutions because they are highly governed by stringent rules and regulations and follow diverse methods of accounting treatment for their financial statements. To test a wide range of listed non-financial firms from Sri Lanka and data for the study were collected from published annual reports, the CSE website, and the respective firm's website from 2016 to 2022. Furthermore, Descriptive Statistics, Correlation Analysis, and Multiple Regression Analysis Methods were used for data analysis via SPSS and STATA software.

Figure 1 presents the Conceptual Framework developed for the current study. Meantime five hypotheses were identified as H_1: CEO duality significantly impacts on earning management of listed non-financial companies in Sri Lanka; H_2: Board independence significantly impacts on earning management of listed non-financial companies in Sri Lanka; H_3: Board meetings significantly impact on earning management of listed non-financial companies in Sri Lanka; H_4: Board size significantly impact on earning management of listed non-financial companies in Sri Lanka; H_5: Audit committee meetings significantly impact on earning management of listed non-financial companies in Sri Lanka.

RESULTS AND DISCUSSION

Descriptive Analysis

Table 1, provides descriptive statistics for the full sample of the research. It shows the mean, minimum, maximum, and standard deviation of the variables. Discretionary accruals, a measure of earning management, show the average to be -0.011 with a standard deviation to be 2.805 and values ranging from a minimum of -33.774 to a maximum of 14.908.

Table 1

Descriptive Statistics

	Minimum	Maximum	Mean	Std. Deviation
ADA	-33.774	14.908	-0.011	2.805
CD	0	1	0.367	0.483
BS	5	15	9.314	2.486
BI	0.333	1.000	0.701	0.170
NOBM	1	14	5.724	2.959
ACM	3	19	5.310	2.506

Correlation Analysis

Table 2 presents the Pearson correlation matrix and CEO duality (CD) is positively and insignificantly correlated with absolute discretionary accruals (ADA). Board size (BS) is negatively and insignificantly correlated with absolute discretionary accruals (ADA), whereas the relationship for Board independence (BI) is positively and significantly related and the number of Board meetings (NOBM) is positively and insignificantly related. Although the variable of Board members with Audit Committee Meetings (ACM) is negatively and significantly correlated with absolute discretionary accruals (ADA).

Table 2

Correlation Matrices

	ADA	CD	BS	BI	NOBM	ACM
ADA	1					
CD	0.010	1				
BS	-0.010	-0.021	1			
BI	0.141^{*}	-0.215^{**}	-0.162^{*}	1		
NOBM	0.036	0.125	0.336^{**}	-0.047	1	
ACM	-0.165^{*}	-0.217^{**}	0.185^{**}	-0.055	0.310^{**}	1

* $P< 0.05$, ** $P< 0.01$

Panel data analysis

Indicated in the test summary of the Hausman test, the random effect model is the most appropriate because of manipulated p- the value of the Hausman test indicates a greater than 0.05 level.

Multiple Regression Analysis

The following Table 3 presents the results of the multiple regression analysis. This model was performed by using the main independent variables of the study.

Model 1

$ADA\ it = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5$

Where, DA it represents Discretionary accruals, for Company i in year t. Discretionary accruals, a proxy for earnings management are estimated by subtracting non-discretionary accruals from total accruals where all accrual variables are scaled by the lagged total assets. β_0 is the line intercept, $\beta 1$- $\beta 5$ is the co-efficient of independent variables X1, X2, X3, X4, and X5 and are independent variable representing. (X_1 - represents CEO duality; has been measured by the percentage of the shares owned by the Managers, X_2 - represents Board independence is the percentage of independent outside directors in the board and is usually referred to non - executive directors; has been measured by ratio of non-executive directors to total number of directors, X_3 – represent Board meetings is the total number of meetings held with the representation of majority of board of directors, X_4 - represents Board Size is the total number of executive and non-executive directors in the board, have been measured by no of directors in the board, X_5 – is represent Audit committee meetings is the number of audit committee meetings for firm, have been measured by frequency of audit committee meetings to number of audit committee meetings per year).

For the result of the multiple regression analysis, the Table shows that the R-squared values indicate the proportion of the variation in the dependent variable explained by the model. The within R-squared is 0.047, suggesting that around 4.7%% of the variation in DA is explained by the included variables. The R-squared is 0.136, indicating that around 13.6% of the variation is due to differences between entities. The overall R-squared is low at 0.053, indicating that the model as a whole does not explain a significant portion of the variation in DA

Table 3

Regression Model One

Random Effects Panel Regression

ADA	Coef.	Std. Err.	z	P>|z|	[95% Conf.	Interval]
CD	-0.028	0.533	-0.050	0.959	-1.073	1.018
BS	0.052	0.096	0.540	0.590	-0.137	0.241
BI	2.824	1.415	2.000	0.046	0.052	5.597
NOBM	0.074	0.085	0.870	0.385	-0.092	0.240
ACM	-0.221	0.099	-2.230	0.026	-0.415	-0.027
R-squared:						
within						0.047
between						0.136
overall						0.053
Number of obs:						210
Prob > F						9.840
Prob > chi2						0.080

According to the regression result, the coefficient for CD is -0.028, but it is not statistically significant at conventional significance levels (p = 0.959), thereby rejecting the hypothesis. This implies that there is no strong evidence to support a significant impact between the CD and ADA. Also, the coefficient for BS is 0.052, and it is not significant at a 10% significance level (p = 0.590), thereby rejecting the hypothesis. This suggests that there is no strong evidence to support a significant impact between BS and ADA. It is important to emphasize that the findings of this study agree with those of Malik (2015) and Fadzilah (2017).
The result of the importance of existing an independent member among the board of directors as the results show, the coefficient for BI is 2.824, and it is statistically significant at a 5% significance level (p =0.046), thereby accepting the hypothesis. This indicates that a higher BI is associated with higher DA. So, we conclude that the board's independence will lead to reducing earnings management through real activities and these findings are consistent with those of Xie et al. (2003), Chouaibi et al. (2018), and Liu and Tsai (2015).
The multiple regression analysis shows that the coefficient for NOBM is 0.074, and it is not statistically significant (p =0.385) thus the hypothesis is not accepted. This suggests that there is no strong evidence to support a significant impact between NOBM and DA. The findings of this study are contradictory to Liu and Tsai's (2015) analysis, but they are consistent with those of previous studies like Ahmed's (2013) and Fadzilah's (2017).
The result also shows that the coefficient for ACM is -0.221, and it is statistically significant (p =0.026), thereby accepting the hypothesis. This implies that there is strong evidence to support a significant impact between the ACM and DA and audit committee meetings (ACM) were expected to have a negative impact on absolute discretionary accruals, as a more active audit committee is predicted to offer a more effective monitoring mechanism. Therefore, this study shows a negative impact between a number of audit committee meetings and discretionary accruals. The p-values for the F-test (Prob > F) and the chi-square test (Prob > chi2) are both high (p < 0.01), indicating that the overall model is statistically not significant. In conclusion, based on this random effects panel regression analysis, the results suggest that the BI and ACM have a statistically significant association with ADA. However, the impact between the CD, BS, and NOBM with DA is not statistically significant. The overall model explains a limited proportion of the variation in ADA.

CONCLUTION AND IMPLICATIONS

The research findings of the present study emphasize that there is a significant impact of board independence (BI) and audit committee meetings (ACM) on earning management, and other selected corporate governance characteristics are not found to have a significant impact on earning management. Thus the study has derived a reformation of policies with the implications of corporate governance and fund providers' consideration of critical corporate governance attributes in making funding decisions as implications based on research findings.However, this study has considered only 30 companies as the sample of the study and only considering board characteristics as the corporate governance variables and does not consider the quality of accruals.According to this study,only board independece (BI) and audit committee meetings(ACM) have a significant impact on earning management.
Therefore, future research may need to examine how other aspects of corporate governance impact earnings management and need to incorporate other sectors, qualitative aspects, and the need of considering non-listed non-financial firms.

***Keywords*:** Corporate governance, colombo stock exchange (CSE), earning management

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