

# CORPORATE GOVERNANCE AND EARNINGS MANAGEMENT: A SRI LANKAN PERSPECTIVE

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## **Abstract**

***This study analysed the relationship between earnings management and corporate governance variables including board characteristics and audit committee characteristics because board of directors and audit committee are vital in corporate governance. 50 listed companies in Colombo Stock exchange were taken as the sample of the study. CEO duality, board independence, number of board meetings, board size, number of audit committee meetings and audit committee members with financial expertise were considered as corporate governance variables. In order to decrease the bias of the independent variables, firm size, return on assets and leverage were used as control variables. The magnitude of Discretionary Accruals was used as the proxy for earnings management which was measured using the modified Jones model. Findings showed that CEO duality is positively and significantly linked with earnings management while board size, board meetings and audit committee with financial expertise are negatively and significantly associated with earnings management.***

***Keyword: Audit Committee, Board of Directors, Corporate Governance, Earnings Management***

## **1.INTRODUCTION**

Major business failures and accounting scandals such as Enron (2001), One.tel (2001), WorldCom (2001) which happened all over the world during the past few decades have cracked investor confidence and have raised several questions on the effectiveness of a firm's

internal control system. In Sri Lankan context Pramuka bank, Seylan bank, Golden key, ETI Finance company collapses have been key aspects of governance scandals. Corporate governance has come into action in order to address above mentioned business failures. Broadly, corporate governance system is the governance of company by the Board of directors and shareholders. Corporate governance is sometimes viewed as a business culture raising economic growth by creating confidence of investors (Robert, 2013).

According to Hypo (2004), earnings management can be described as using judgments and provisions by the management in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying performance of the company or to motivate or influence stakeholders based on outcomes that depend on reported accounting numbers.

Earnings management has three modes namely 'White', 'Grey' and 'Black'; but it is difficult to differentiate between each other. However, generally white earnings management is accepted since sometimes it is towards entity's goodness. Grey earnings management is opportunistic only to management and black earnings management gathers misrepresentations, mal-practices which lead to manipulations and ultimate collapses (Xue & Hong, 2016).

Within the Sri Lankan context there are various financial reporting standards, rules and regulations, compliance requirements, publishing requirements in order to address earnings management practices. Although there are above mentioned mechanisms to reduce earnings manipulation within the company, there are still possibilities for management to influence the financial results. In order to mitigate those loopholes,

organizations should cultivate sound control environment within the company.

The broad objective of this study is to identify the relationship between selected corporate governance variables and earnings management practices in listed companies in Sri Lanka. The corporate governance provisions established by the code of best practice issued by Institute of Chartered Accountants of Sri Lanka is used as benchmark practices for this study. For the evaluation purposes, a sample of 50 listed companies from Colombo stock exchange based on market capitalization has been selected. This study depicts how the CEO duality, board independence, number of board meetings, board size, audit committee meetings and audit committee members with financial expertise affect for the earnings management.

This study is expected to contribute to fill the gap in the local literature in order to help all stakeholders, especially policy makers and regulators, to evaluate and contribute to the development of plans.

## 2.LITERATURE REVIEW

Although corporate governance is an old concept, the need of corporate governance practices getting renewed due to different growing managerial practices in the world. 'Corporate governance can be defined as a mechanism that is employed to reduce the agency cost that arises as a result of the conflict of interest between managers and shareholders' (Uwuigbe, Peter & Oyeniya, 2014, p. 161). Also, Man and Wong (2013) explained corporate governance as an internal system encompassing policies, processes, and people that serve the needs of shareholders and other stakeholders by directing and controlling management.

On the other hand, Lee and Yeh (2006) have identified earnings management as the choice by a manager of accounting policies, or actions affecting earnings, so as to achieve some specific reported earnings objective. According to Xie, Davidson & DaDalt (2003), earnings management occurs when accrual accounting techniques are used to record the financial impact of any transaction or any other event which has cash concerns for the entity, not only in the period in which cash was paid or received but also in the period in which such transaction or any other event had arisen.

Iraya, Mwangi & Muchoki (2015) have observed a positive relationship between CEO duality and earnings

management in a research conducted in Kenya. Another study conducted by Roodposhti and Chamshmi (2011) have shown a positive significant association between the existence of CEO-Chairman duality and earnings management. Moreover, Iqbal, Zhang, & Jebran (2015) have concluded that CEO- chair duality and earnings management are positively correlated.

In terms of board independence, Xie et al. (2003) have concluded that a board of directors with a higher proportion of independent directors is negatively associated with the discretionary accruals and their findings suggest that a higher number of independent directors is related with better monitoring, eventually result in decreasing discretionary accruals. Further, Iraya et al. (2015) have found that earnings management is negatively related with board independence. Contrary to these findings, some researchers have found out a positive or no relationship between board independence and discretionary accruals. In a study conducted by Amer and Abdelkarim (2010) in Palestinian context, have examined that Board independence was positively related with earnings management. In addition, Kang, Leung, Morris & Gray (2013) have found that in Australian listed companies, Board independence was not associated with earnings management.

With regard to the number of meetings held by the Board of Directors, Xie et al. (2003) found a negative relationship between earnings management and frequency of board meetings. Similarly, a study conducted by Abbadi, Hijazi & Al-Rahahleh (2016) in Jordan observed that earnings management is affected negatively by overall categories of corporate governance index represented by corporate governance variables including board meetings. Contrary to the above findings, the study of Ahmed (2013) has shown no significant relationship between the number of board meetings and discretionary accruals in Malaysian context.

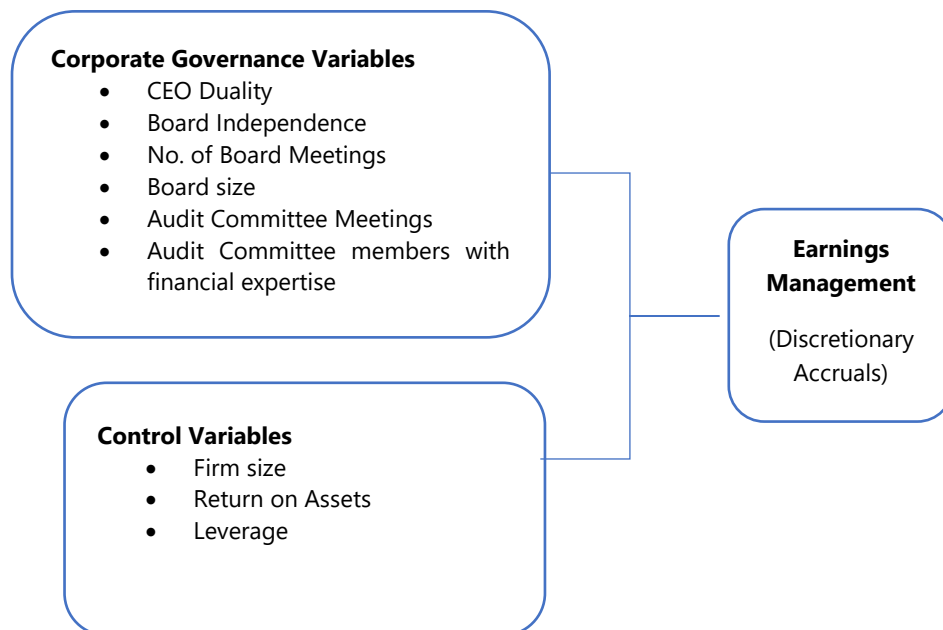
According to Uwuigbe et al. (2014), earnings management practices can be very common managerial practices in developing countries such as Nigeria where the research concluded that larger board of directors with diverse knowledge can mitigate the earnings management practices effectively than smaller boards as they are more likely to have independent directors with more corporate and financial expertise. As a supporting to the above finding Abed, Attar & Suwaidan

(2012) emphasized that size of the board of directors is the only variable that had a significant relationship with the earnings management practices. On the other hand, Xie et al. (2003) found that board size is negatively associated with the level of discretionary accruals, as a large number of board members with varied expertise leads to effective monitoring. Also Iraya et al. (2015) have observed a negative relationship between board size and earnings management in the context of Kenya. The findings of Xie et al. (2003) have shown a negative association between the number of audit committee meetings and the level of earnings management implying that a more active audit committee is associated with a reduced level of discretionary current accruals. Also Saleh, Iskandar & Rahmat (2007) observed that firms which held more audit committee meetings recorded fewer earnings management practices compared with other firms in Malaysian context. Abbott, Parker & Peter (2004) stated a negative relationship between the audit committee's financial expertise and occurrence of earnings restatement. Further, Xie et al. (2003) also identified that when the audit committee is comprised of more independent outside directors with high financial expertise, earnings management is less likely to occur. It was also found

that firms which had more knowledgeable audit committee members and held more audit committee meetings recorded fewer earnings management practices compared with other firms (Saleh et al., 2007). Based on the above literature, this study is focused on Board characteristics (CEO duality, Board independence, frequency of Board meetings Board size) and audit committee characteristics (frequency of audit committee meetings, financial expertise of the audit committee members) which are expected to create an impact on the level of earnings management practices of listed companies in Colombo Stock Exchange.

### 3.METHODOLOGY

As this study investigates the relationships between selected corporate governance variables and degree of earnings management in a sample of listed companies in Colombo Stock Exchange (CSE), a quantitative approach was followed. Moreover, most of the previous researchers (Chen, Elder & Hsieh, 2007; Xie, Davidson & DaDalt, 2003) have used a similar quantitative approach in examining the relationship between corporate governance features and earnings management.



### **3.1. Sample**

A sample of 50 listed companies were selected from the population of 314 companies listed in Colombo Stock Exchange in Sri Lanka. The sample was selected based on the market capitalization. Therefore listed companies with the highest market capitalization were selected to the sample based on judgmental sampling. However the companies under the Bank, Finance and Insurance sector were excluded from the sample because this industry is strictly regulated and is likely to have fundamentally different cash flows and accrual processes (Roodposhti & Chamshmi, 2011). Also, it is impracticable to measure accruals using the Jones model in the Bank, Finance and Insurance sector. Therefore 50 companies for 3 years (2015-2017) resulting 150 firm-year sample was observed. Annual reports of selected listed companies were taken as the source of data collection.

### **3.2. Independent variables**

According to prior research corporate governance variables which are associated with earnings management include CEO duality (Gelderen, 2013; Roodposhti & Chamshmi, 2011; Iqbal et al. 2015), Board independence (Gelderen, 2013; Roodposhti & Chamshmi, 2011; Kim & Yoon 2008; Kang et al. 2013), Board meetings (Abbadi et al. 2016), Board size (Amer & Abdelkarim, 2010), Audit committee meetings (Saleh et al., 2007) and Audit committee financial expertise (Al-Rassas & Kamardin, 2016). So, we selected the above-mentioned variables as independent variables for the corporate governance aspect.

#### **3.2.1. CEO duality**

CEO duality is where the chairperson of the board and the CEO of the company being held by separate persons. This variable was identified by referring to the section of Governance in the particular annual reports.

One of the main roles of the chairperson of the board is to monitor the CEO's responsibilities and tasks (Jenson, 1993). And also, Anderson, Deli & Gillan (2003) have investigated that the separation between CEO and chairperson positively influence the information content of accounting earnings. Further, Dechow, Sloan, &

Sweeney (1996) have observed that firms whose CEO is also the chair of the board of directors are more likely to be exposed to accounting enforcement actions.

H1: There is a negative association between earnings management and CEO duality where chairperson and CEO are two separate persons.

#### **3.2.2. Board Independence**

Code of best practice on corporate governance in Sri Lanka specifically recommended that the number of non-executive directors in the board should be at least two or one third of total number of directors whichever is higher. Board independence was measured by considering the number of independent directors as a percentage of total number of directors.

Independence of the board from management can be identified as one of the best internal governance conditions (Beasley, 1996). And also, they have the ability to mitigate the agency problem between shareholders and management. Therefore, it is desirable to have directors, independent from the management to secure the board independence properly.

Beasley (1996) and Dechow et al. (1996) have found that the percentage of independent directors on the board is negatively associated with the possibility of frauds in financial statements.

It is expected that having more independent directors is more likely to be an effective monitoring system and hence, more likely to control earnings management.

H2: There is a negative relationship between board independence and earnings management.

#### **3.2.3. Board Meetings**

Also, it is required by the Code of best practice on Corporate Governance to hold the Board meetings at least once in every quarter of a financial year in order to effectively execute board's responsibilities.

Number of board meetings which is used to measure board activity can be identified as a good alternative for the directors' monitoring effort (Adams, 2003). According to Menon and Williams (1994), boards that do not meet or meet only a few times are not likely to be effective monitors. As a contradictory opinion, it is argued that Board meetings are not essentially useful because routine tasks take much of limited time that

directors and CEO waste together to set the agenda for Board meetings (Lorca, Sanchez-Ballesta & Gracia-Meca, 2011).

However, in Sri Lankan context it can be observed that board members meeting frequently may also lead to frauds or collusions in the organizations.

H3: There is a positive relationship between Board meetings and earnings management.

### 3.2.4. Board Size

Board size was measured by the number of Board of Directors of the company. Xie et al. (2003) have observed that earnings management is less likely occur in organizations with boards having a greater number of directors. And also, a larger Board size assumes a superior supervision of the management team and a higher quality of corporate decisions (Pearce & Zahra, 1992).

H4: There is a negative relationship between Board size and earnings management.

### 3.2.5. Audit Committee Meetings

The findings of Xie et al. (2003), suggested a negative relationship between the frequency of audit committee meetings and the level of earnings management. Saleh et al. (2007) has observed that more audit committee meetings recorded fewer earnings management practices compared with other firms.

H5: There is a negative relationship between frequency of audit committee meetings and earnings management

### 3.2.6. Audit Committee Financial Expertise

Abbott et al. (2004) reported a negative association between the audit committee's financial expertise and occurrence of earnings restatement. Further, Xie et al. (2003) also stated that when the audit committee is comprised of more independent outside directors with high financial expertise, earnings management is less likely to occur.

H6: There is a negative association between the audit committee's financial expertise and the occurrence of earnings restatement.

## 3.3. Dependent Variable

The magnitude of Discretionary Accruals (DA) is used as the proxy for earnings management. Dechow et al. (1995) depict that the modified Jones model is the most powerful model to identify earnings management among the alternative models to measure discretionary accruals. Also, as previous researches have used the modified Jones model in measuring accruals (Kang et al., 2013; Patrick, Paulinus & Nympha, 2015; Uwuigbe et al., 2014), we chose the cross sectional modified Jones model to measure discretionary accruals.

The discretionary accruals are calculated as follows. First, total accruals are measured as net income minus cash flows from operations.

$$TA_{i,t} = NI_{i,t} - CFO_{i,t}$$

Then discretionary accruals are estimated by deducting non-discretionary accruals from total accruals, where all accrual variables are scaled by lagged total assets to control for potential scale bias.

$$\frac{TA_{i,t}}{A_{i,t-1}} = \alpha_1 \left( \frac{1}{A_{i,t-1}} \right) + \alpha_2 \left( \frac{\Delta REV_{i,t}}{A_{i,t-1}} \right) + \alpha_3 \left( \frac{PPE_{i,t}}{A_{i,t-1}} \right) + \varepsilon_{i,t}$$

$$\frac{NDA_{i,t}}{A_{i,t-1}} = \alpha_1 \left( \frac{1}{A_{i,t-1}} \right) + \alpha_2 \left( \frac{\Delta REV_{i,t} - \Delta REC_{i,t}}{A_{i,t-1}} \right) + \alpha_3 \left( \frac{PPE_{i,t}}{A_{i,t-1}} \right)$$

$$\frac{DA_{i,t}}{A_{i,t-1}} = \frac{TA_{i,t}}{A_{i,t-1}} - \left\{ \alpha_1 \left( \frac{1}{A_{i,t-1}} \right) + \alpha_2 \left( \frac{\Delta REV_{i,t} - \Delta REC_{i,t}}{A_{i,t-1}} \right) + \alpha_3 \left( \frac{PPE_{i,t}}{A_{i,t-1}} \right) \right\}$$

The discretionary accruals will be calculated by the following formula.

$$DA_{i,t} = TA_{i,t} - NDA_{i,t}$$

Abbreviations

$TA_{i,t}$  = total accruals for company  $i$  in year  $t$

$NI_{i,t}$   
= net income before discontinued segments and extra ordinary items

$CFO_{i,t}$  = Cash flows from operations

$A_{i,t-1}$  = total assets for company  $i$  in year  $t - 1$

$\Delta REV_{i,t}$  = change in revenue for company  $i$  in year  $t$

$PPE_{i,t}$   
 = net property, plant and equipment for company in  
 $i$  year  $t$

$NDA_{i,t}$   
 = non discretionary accruals for company in  $i$  year  $t$

$\Delta REC_{i,t}$   
 = change in receivables for company  $i$  in year  $t$

$DA_{i,t}$  = discretionary accruals for company in year  $t$

$\varepsilon_{i,t}$  = residual for company  $i$  in year  $t$

### 3.4. Control variables

In order to decrease the bias of the independent variables, this study has controlled for other governance variables examined in prior studies that may potentially affect the level of earnings management (Amer & Abdelkarim, 2010). Therefore, firm size, return on assets and leverage were used as control variables for the study which had been used by most of the prior researchers. (Kang et al., 2013; Chen et al., 2007).

The firm size hypothesis provides that due to large political visibility of large firms, they are more likely to manage earnings to decrease their political visibility (Watts and Zimmerman, 1986). As an opposing view, large companies may have lower incentives for earnings management as they are subject to more analysis from investors and financial analysts. When Return on Assets (ROA) rises, earnings management practices have increased illustrating a significant positive relationship (Amer & Abdelkarim, 2010; Chen et al., 2007). Thus, ROA is incorporated in to this research as rate of return on total lagged assets ratio. Managers use discretionary accruals to achieve debt covenant requirements (DeFond & Jiambalvo, 1994; Sweeney, 1994). Managers in more levered firms are more likely to implement aggressive earnings management practices to prevent violation of debt agreements (Watts and Zeimermann, 1986). In order to gain more concessions from creditors, financially distressed companies might manage earnings downward DeAngelo, DeAngelo & Skinner (1994).

### Model Specification

Following regression model was used in order to test the relationship between corporate governance variables and earnings management of the 50 listed companies after incorporating the control variables identified by previous researchers.

$$ADA = \alpha + \beta_1 CD + \beta_2 BDIN + \beta_3 BDSIZE + \beta_4 BDMEET + \beta_5 ACMEET + \beta_6 ACFX + \beta_7 SIZE + \beta_8 ROA + \beta_9 LEV$$

Where:

ADA= the absolute value of discretionary accruals calculated by cross sectional modified Jones model

CD = indicator variable coded 1 if the positions of CEO and Board chair person is held by two person, 0 if otherwise

BDIN = percentage of independent directors of the board

BDSIZE =the number of board of directors

BDMEET =the number of board of directors' meetings

ACMEET = the number of audit committee meetings

ACFX = the number of members with a financial and accounting qualification as a percentage to the total number of members of the audit committee

SIZE =the natural log of total assets

ROA =rate of return on lagged total assets ratio

LEV = ratio of total debt to total asset

## 4. DATA ANALYSIS AND PRESENTATION

### 4.1. Descriptive statistics

Table 1 provides descriptive statistics for the full sample of the research. The average of discretionary accruals for the absolute value is 0.0008. It is noted that on average 4% of directors are independent in the sample taken for the study and it is also clear that 84% of the companies considered for the sample, appoint two personnel for CEO and Chairman of the board. As per the descriptive statistics on average director board of the companies meet 6 times a year and on average,

there are 8 members in the board of the companies selected for the sample. Audit committees meet 5 times

on average per year while 4% of the audit committee members have financial expertise.

**Table 1: Descriptive Statistic\***

| Table 1: Descriptive Statistic* |     |          |         |         |                |
|---------------------------------|-----|----------|---------|---------|----------------|
|                                 | N   | Mean     | Minimum | Maximum | Std. Deviation |
| ADA                             | 150 | .00080   | .00000  | .00870  | .001234        |
| CD                              | 150 | .840     | .0      | 1.0     | .3678          |
| BDIN                            | 150 | .42504   | .2222   | .8333   | .13739         |
| BDSIZE                          | 150 | 8.587    | 5.0     | 13.0    | 1.9079         |
| BDMEET                          | 150 | 6.087    | 2.0     | 21.0    | 3.5444         |
| ACMEET                          | 150 | 5.020    | 1.0     | 18.0    | 2.5401         |
| ACFX                            | 150 | .4725    | .25     | .75     | .1440          |
| SIZE                            | 150 | 16.31326 | 14.417  | 18.776  | .935086        |
| ROA                             | 150 | .084219  | -3.0642 | .5878   | .2869167       |
| LEV                             | 150 | .89217   | .001    | 9.225   | 1.379396       |

\* Descriptive statistics are based on 150 firm-year observations

Table 2 presents the Pearson correlation matrix for the dependent and independent variables for the sample. Several hypotheses are supported by the correlations, but the testing is based on the regression analysis.

Board independence (BDIN) and Audit committee meetings (ACMEET) are negatively and insignificantly correlated with absolute discretionary accruals (ADA), whereas the relationships for Board meetings (BDMEET) are positively and insignificantly related. However, these results show a significant positive relationship between CEO duality (CD) and absolute discretionary accruals whereas Board size (BDSIZE) has a negative significant association under

0.05 significant level. Further, Audit committee with financial expertise (ACFX) shows significant negative relationship with absolute discretionary accruals under 0.01 significant level.

In the context of control variables, Firm size (SIZE) is negatively correlated with absolute discretionary accruals (ADA) while Return on assets (ROA) and Leverage (LEV) variables show a positive relationship with absolute discretionary accruals (ADA).

Table 2: Correlation Matrix for Dependent and Independent Variables \*

|        | ADA     | CD     | BDIN   | BDSIZE | BDMEET | ACMEET | ACFX    | SIZE  | ROA     | LEV |
|--------|---------|--------|--------|--------|--------|--------|---------|-------|---------|-----|
| ADA    |         |        |        |        |        |        |         |       |         |     |
| CD     | .186*   |        |        |        |        |        |         |       |         |     |
| BDIN   | -.014   | -.116  |        |        |        |        |         |       |         |     |
| BDSIZE | -.180*  | -.009  | -.012  |        |        |        |         |       |         |     |
| BDMEET | .032    | -.061  | .322** | .349** |        |        |         |       |         |     |
| ACMEET | -.037   | .032   | .028   | .232** | .222** |        |         |       |         |     |
| ACFX   | -.208** | .130   | .040   | -.053  | .088   | -.100  |         |       |         |     |
| SIZE   | -.057   | -.156* | .190** | .201** | .058   | .104   | -.205** |       |         |     |
| ROA    | .012    | .021   | -.012  | -.088  | .021   | -.061  | .120    | -.093 |         |     |
| LEV    | .040    | -.106  | .060   | .052   | .015   | -.037  | -.040   | .122  | -.402** |     |

\*. Correlation is significant at the 0.05 level (1-tailed). \*\*. Correlation is significant at the 0.01 level (1-tailed).

Source: Survey data (2019)

#### 4.2. Regression results

Table 3: Multiple Regression Analysis

| ADA       |                |             |         |           |       |
|-----------|----------------|-------------|---------|-----------|-------|
| Variable  | Predicted sign | Coefficient | Sig.    | Tolerance | VIF   |
| Intercept |                | 0.003       | .101    |           |       |
| CD        | -              | .234        | .004*** | .940      | 1.063 |
| BDIN      | -              | -.036       | .673    | .829      | 1.206 |
| BDSIZE    | -              | -.231       | .009*** | .799      | 1.252 |
| BDMEET    | +              | .173        | .059*   | .733      | 1.363 |
| ACMEET    | -              | -.046       | .574    | .899      | 1.112 |
| ACFX      | -              | -.280       | .001*** | .915      | 1.093 |
| SIZE      | ?              | -.033       | .697    | .858      | 1.166 |



|     |   |      |      |      |       |
|-----|---|------|------|------|-------|
| ROA | ? | .046 | .591 | .818 | 1.223 |
| LEV | ? | .092 | .289 | .818 | 1.223 |

a. Dependent Variable: ADA

\*, \*\* and \*\*\* denote significance at the 0.10, 0.05 and 0.01 levels respectively.

|                 |       |
|-----------------|-------|
| F- Value        | 2.904 |
| Sig of F- Value | 0.004 |
| R <sup>2</sup>  | 0.104 |
| N               | 150   |

## 5. DISCUSSION OF FINDINGS

Main purpose of CEO duality (CD) is to reduce the power concentration on one person and to enhance the board independence. From an agency theory perspective, under CEO duality, the board considerably weakens its ability to monitor management objectively. Jensen et al. (1993) raises an objection to such a structure and suggests a complete separation between the two functions. Contrary to the expectations, it is observed that CEO duality has a positive significant relationship with discretionary accruals.

Board independence (BDIN) can be taken as a critical factor that affects the faithful representation and reliability of financial reporting. This variable (BDIN) examines the structure of the board by directors who possess independence and how it affects earnings management. As per general rule, when board consists with majority of independent directors, it is expected to influence over more effective supervising and monitoring function which would lead to reliable preparation of financial statements. Therefore, higher the independent members in the board are expected to reduce earnings management and accounting manipulation and to enhance the faithful representation of financial statements. As expected, it shows a negative relationship between Board independence and earnings management.

The number of directors in the board is also an important factor in determining the effectiveness of the

decision making. This variable, board size is measured by the total number of directors in the board (BDSIZE). As per the expectation, research outcome shows a negative significant relationship between the board size and earnings management. It could be predicted that Board size being large or small have a significant impact on the level of earnings management practices in listed companies in the study sample under 0.01 level significance.

According to the Code of Best Practice on Corporate Governance, it is a necessity for the boards to meet regularly. According to Adams (2003), number of board meetings (BDMEET) can be regarded as a mechanism for the directors' monitoring process. In contradictory to the above view, it can be assumed that board's meet regularly may lead to frauds or collusions as well. In that perspective, it is predicted that there is a positive association between the number of board meetings and earnings management. As expected, the results of the study indicate that greater the number of board meetings influence earnings management in a positive manner. The findings of the study depict a significant positive relationship between frequency of board meetings and earnings management according to 0.10 significance level.

Audit committee meetings (ACMEET) were expected to have a negative relationship with absolute discretionary accruals as more active audit committee is expected to provide an effective monitoring mechanism. Therefore, agreeing to the hypothesis, this study shows a negative association between number of audit committee meetings and discretionary accruals.

Complying with the results of studies conducted by Abbott et al. (2004) and Xie et al. (2003), this study also depicts a significant negative relationship between audit committee financial expertise (ACFX) and absolute discretionary accruals. It can be seen that number of financial and accounting expertise can have a significant impact on earnings management under 0.01 level of significance.

With respect to the control variables, firm size has a negative coefficient, depicting that larger the size of the firm, will less likely to manage earnings because they may subject to more analysis from investors and financial analysts which is contradicting with the findings of Watts and Zimmerman (1986). The positive coefficient of ROA may suggest that firms with higher return on assets are associated with higher earnings management which is complying with the findings of Chen et al. (2007). The positive coefficient of the leverage variable, which is consistent with the results of DeFond and Jiambalvo (1994) and Sweeney (1994), suggested that earnings are managed to achieve debt covenant requirements.

According to the Model summary (R2 and Sig of F-value), regression model is valid for the sample used for the study.

## 6. CONCLUSION AND CONTRIBUTIONS

This study investigated whether CEO duality, larger board size, board independence, number of board meetings, number of audit committee meetings and audit committee with more financial expertise would reduce the level of absolute discretionary accruals.

This cross-sectional analysis showed that board independence and audit committee meetings are negatively and insignificantly associated with earnings management. On the other hand, findings showed that CEO duality is positively and significantly linked with earnings management. It is a contradiction with the hypothesis which expected a negative relationship between CEO duality and earnings management. This study further found that board size, board meetings and audit committee with financial expertise are negatively and significantly associated with earnings management. Control variables (return on assets, leverage) are negatively associated with earnings management except

the firm size variable which is positively related with earnings management.

As this paper reviews board characteristics and audit committee characteristics of listed firms in Colombo stock exchange and their relationship with earnings management, this study contributes to the existing literature related to corporate governance and earnings management.

However, this study has considered only two aspects of the corporate governance which are Board characteristics and audit committee variables and only 50 companies were used as the sample of the study. Also, results of the study show a relationship between earnings management and corporate governance instead of explaining causation between corporate governance characteristics and earnings management.

Therefore, future research may need to examine how other aspects of corporate governance impact on earnings management.

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