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The Influence of Corporate Governance on Earnings Management in Listed Manufacturing Companies in Sri Lanka

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Abstract— the main objective of this paper is to investigate the influence of corporate governance on earnings management in listed manufacturing companies in Sri Lanak. The most of prior studies were conducted in US and Newzealand. . However, very few studies have taken place in emerging economies like Sri Lanka. The Study used Secondary data of 30 manufacturing companies (2013-2017). Data were analyzed using regression analysis and E-views Packages. The findings of the study are board members with Finance expertise and CEO duality has a negative significant relationship with earning management and board meeting has a positive significant relationship with earning management, that depict firms which have two separate positions for chief Executive officer and chairman are more effective in reducing earning management, then board may have professionally qualified directors that effect to the Reducing Earning management, Board meetings are effected to increase the earning management.

Index Terms— Agency Theory, Board Characteristics, Corporate Governance (CG), Discretionary Accrual (DA), Earning Management, Colombo Stock Exchange (CSE)

1 Introduction

The purpose of this study is to examine the relationship between corporate governance practices and its effect on earnings management in listed manufacturing companies in Sri Lanaka. The study was used corporate governance provisions established by the code of best practice issued by Institute of Chartered Accountants of Sri Lanka and Securities and Exchange Commission of Sri Lanka. Major business failures and accounting scandals which happened all over the world during the past few decades have dented investor confidence and have raised several questions on the effectiveness of a firm's internal control system, enterprise risk management and governance structures. Corporate Governance has come into action in order to address above mentioned business failures. Agency conflict, one of underlying concept of corporate governance. 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 fostering economic growth by building up 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. The most of the studies on earnings management for managerial incentives have been conducted in USA, UK, Australia and New Zealand. However, very few studies have taken place in emerging economies like Sri Lanka, but it's worthwhile to conduct, this is an important research area to work on to fill this gap in the literature, Sri Lanka would be an ideal research site because Sri Lanka adopted corporate governance on 2008.

1.1 Research Question

"What is the impact of corporate governance on earning management?"

1.2 Research Objective

"To investigate the impact of corporate governance on the earnings management."

2 Methodology

Population of our study is all manufacturing sector companies listed in Colombo stock Exchange in Sri Lanka. The manufacturing Sector Have 43 Companies but in this research only got 30 listed companies because of unavailability of information. The data collection is for 5-years period from year 2013 to the year ended 2017. Quantitative method employed to examine the relationships between the independent variable (CEO duality, board independent, board expertise, board meetings, board size, firm size, ROA) and dependent variable (earning management).

Accruals includes a wide range of earning management techniques available to manage when preparing financial statement such as accounting policy choices and Accounting estimates (Augustine, 2014).The magnitude of discretionary accruals (DA) is used as the proxy for earnings management. dechow, et al. (1996) depict that the modified Jones model is the most powerful model to identify earnings management among the alternative models to measure discretionary accruals. As previous researches have used the modified Jones model in measuring accruals Kang, et al. (2013), the study chose the cross sectional modified Jones model to measure discretionary accruals.

$$TACC\ it / A\ it\ -1 = \alpha 1t\ (1/A\ it\ -1)] + \alpha 2i\ [(\Delta REV\ it - \Delta REC\ it)/A\ it\ -1] + \alpha 3i\ [PPE\ it / A\ it\ -1] + \alpha 4i\ (ROA\ it) + \varepsilon\ it \quad (1)$$

Where, TACC is the total accrual measured as the difference between net income and operating cash flows for firm *i* in year t. A_{it} is total assets for firm *i* in year t; ΔREV is the change in operating revenues; ΔREC is the change in net receivables. PPE is gross property, plant, and equipment; ROA it is ratio of net income divided by assets for firm *i* in year t. t and t-1 are time subscripts and *i* is the firm subscript. All variables are scaled by prior year total assets A_{t-1} to control for heteroscedastisity.Following regression model was used in order to test the relationship between corporate governance variables and earnings management of the 30 listed companies after incorporating the control variables identified by previous researchers.

$$ADA=\alpha+\beta 1CD+\beta 2BDIN+\beta 3BDSIZE+\beta 4BDMEET+\beta 5BDFX+\beta 6SIZE+\beta 7ROA \quad (2)$$

Where:

ADA = the absolute value of discretionary accruals calculated by cross sectional modified Jones model (Earnings Management), **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, **BDFX** = the number of directors with a financial and accounting qualification as a percentage to the total number of directors of the board

Control variable:

SIZE = the natural log of total assets, **ROA** = rate of return on lagged total assets ratio

2 Results and findings

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	18.813	73.512	0.256	0.050
BDFX	-5.972	23.590	-0.253	0.011
BDIN	18.408	22.189	0.830	0.408
BDMEET	0.916	1.045	-0.877	0.034
BDSIZE	-0.534	1.918	-0.278	0.781
CEODUAL	-8.352	7.993	1.045	0.048
LNFSIZE	5.743	3.410	1.684	0.003
ROA	11.450	21.132	0.542	0.589

R-squared	0.657	Mean dependent var	51.184
Adjusted R-squared	0.551	S.D. dependent var	17.173
S.E. of regression	17.270	Sum squared resid	42353.810
F-statistic	0.760	Durbin-Watson stat	2.126
Prob(F-statistic)	0.000		

The R squared is 0.6570 which indicates that about 65.7 percent effect the variables to the manufacturing sector companies earning management then that indicate that corporate governance factors effect to the company good earning management in other words, about 65.78 percent of the variance in the dependent variable is clarified by the independent variables that are encompassed in the model.

According to the regression results, there is positive significant relationship between board members with finance expertise and the earning management. Which is confirmed by the positive coefficient of -5.97 and the probability value of 0.0105 that is less than the 5%. The study results indicate that there is a positive insignificant relationship between board independence and the earning management (DA). Which is confirmed by the positive coefficient of 18.4 and the probability value of 0.4082 that is greater than the 5%. There is positive significant relationship between board meeting and the earning management (DA). Which is confirmed by the positive coefficient of 0.9162.and the probability value of 0.0342 that is less than the 5%. There is negative significant relationship between the CEO duality and earning management (DA). Which is confirmed by the Negative coefficient of -8.35.and the probability value of 0.0478 that is less than the 5%. There is positive significant relationship between firm size and the earning management (DA). Which is confirmed by the positive coefficient of 5.74.and the probability value of 0.0034 that is less than the 5%.

3 Conclution

According to the regression analysis of impact of Corporate Governance on Earnings management following findings were revealed.

- There is negative relationship between board members with finance expertise and earning management.
- There is positive relationship between board meeting and earning management.
- There is negative significant relationship between CEO duality and earning management
- There is positive significant relationship between firm size and earning management.

Based on the above findings this study can conclude that, listed manufacturing companies in Sri Lanka our cross-sectional analysis showed that CEO duality and board meeting are positively and significantly associated with earnings management. Then board members with finance expertise and earning management negatively significant relationship with earning management. That depict firms which have two separate positions for chief executive officer and chairman are more effective in reducing earning management than firms which do not. Also, firms with large number of directors have lessor amount of earnings management than firms with small board size.

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