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An Empirical Study on Corporate Governance and Financial Reporting Quality? Evidence from Listed Entities in Sri Lanka

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Abstract: *The concept of Corporate Governance (CG) has become a contemporary focus in both accounting and finance arenas .This plays a vital role, especially in the process of assuring financial reporting quality (FRQ). The purpose of this paper is to investigate the relationship between selected CG characteristics and the level of FRQ in Sri Lanka. The study was carried out using secondary data obtained through published annual reports from 209 companies listed in the Colombo Stock Exchange (CSE) during 2017 to 2020 including 836 firm year observations. Six selected CG characteristics (Board Size, Board Independence, CEO Duality, Audit Committee Size, Audit Committee Independence, and Audit Committee Accounting Expertise) and the level of FRQ has been evaluated by absolute value of discretionary accruals (ADA) using Panel linear regression analysis. It was found that, a significant positive relationship between the audit committee accounting expertise and FRQ, while a significant negative relationship was found between Board Size and FRQ. However the other remaining CG characteristics were not significantly influenced on the level of FRQ. Overall, this analysis highlights the importance of having a comparatively smaller board size and composition the members in the audit committee with financial and accounting background to enhance FRQ and transparency. The findings of this study expect to have a significant policy implication for policy makers and regulators in terms of formulating strategies and policies on CG best practices in Sri Lanka. Similarly, the entities should promote smaller board size and recruiting, especially majority of independent non-executive directors with sufficient accounting skills and financial experience with the aim of curtailing the adverse earnings management practices to improve FRQ.*

Keywords: *Corporate Governance, Absolute Value of Discretionary Accruals, Financial Reporting Quality, Colombo Stock Exchange Sri Lanka*

JEL Classification: G34, G38

1. INTRODUCTION

The Corporate Governance (CG) plays a vital role specially in the process of assuring Financial Reporting Quality (FRQ) (Alzeban, 2019; Cohen,

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Krishnamoorthy & Wright, 2004). The ultimate purpose of preparing financial reports is to improve the quality of decisions made by all the current and potential investors. However, the users can make quality decisions, only with the availability of quality financial information. Thus, the corporations should certify the financial reporting quality in terms of reliability, relevance, timeliness, and biasness.

According to past studies, there are several factors that could impact on determining the level of FRQ. According to Alzeban (2019), empirical relationship could be found between the audit committee, CEO, the quality of external audit and FRQ. Further, Uwuigbe, Felix, Uwuigbe, Teddy, and Irene (2018) found that the board size, board independence, and director's tenure and its impact on the quality of financial reporting. However, the literature disclosed that the weak CG leads to financial crisis. Similarly, less attention on CG characteristics may be the reason for the recent corporate collapses that happened over the globe including Sri Lanka [1]. For example, Freddie Mac scandal in 2003 December, American International Group scandal in 2005 can be seen as global failures of the companies in the recent past which provides evidence for CG weaknesses. Therefore, studying separately on these governance characteristics is more important to meet the quality of financial reports to satisfy the expectations of current and potential investors.

Although considerable empirical work has been published regarding the relationship between CG and FRQ (Alzoubi, 2014; Johl, Johl, Subramaniam & Cooper, 2013; Phuong & Hung, 2020), the scope of the above studies was different to the current study. In this paper, the researchers tried to collectively examine the relationship between six different CG characteristics namely, Board Size, Board Independence, CEO Duality, Audit Committee Size, Audit Committee Independence, and Audit Committee Accounting Expertise and the level of FRQ in Sri Lanka as significantly less recent studies were found in connection to the current scope in the Sri Lankan context. Further, it has been given mixed conclusions by previous empirical studies relating to this area where, we are trying to examine the relationship in local context. Hence the present study contributes to the literature by meeting the research objective of investigating the impact of selected CG characteristics on FRQ in Sri Lanka. Further, it will enhance the awareness on CG being an important factor in the business arena followed by the corporate managers and Board of Directors (BOD), as they are the major party who responsible to the owners of the company. Similarly, this will be useful for the regulatory institutions, policy makers, and professional accounting bodies to rethink regarding the future CG provisions.

2. LITERATURE REVIEW

2.1. Understanding the concept of Corporate Governance (CG)

There is no single definition of CG that can be applied to all situations and jurisdictions. Nevertheless, there are some commonly accepted definitions. The most widely used is "the system by which companies are directed and controlled" (Cadbury Committee, 1992). According to Weerasinghe and Ajward (2017), CG is an umbrella term which contains specific issues regarding the governance of the firm, arising from the interactions between shareholders, BODs, senior management, and other stakeholders. Although the corporate governance has been exhaustively defined as a mechanism for controlling, leading, and investigating the activities of the firm by promoting corporate fairness, transparency, and accountability with the aim of creating shareholders' wealth, for the purpose of this study it would be emphasized on the wider definitions that embrace a set of policies, structures, customs, laws, and procedures which define the controlling and administrating of owner's resources (Onuorah & Chi-Chi, 2016). Further, Paulinus, Oluchukwu and Somtochukwu (2017) suggested that the corporate governance structure which combines internal as well as external mechanism leads the organization towards its ultimate objectives while also achieving its stakeholders' interests. Alzoubi (2014) and Onuorah *et al.* (2016) have identified the board of directors as the key powerful control factor of any organization for scrutinizing the management activities, where the shareholders invest for getting them to pursue their interests in a fair manner. Such investments are evident in the structure of board, CEO duality, quality of the audit committee, executive compensation, and director's shareholding etc.

Despite the different definitions to the concept of CG, there is a commonly accepted rationale behind the emergence of that notion; the 'Agency Problem' (Berle & Means, 1932; Jensen & Meckling, 1976). The agency problem aroused due to the separation of ownership and management in the large corporations, where the managers (agents) trying to maximize their own benefits at the cost of owners (principals). Apart from said (equity) agency problem, scholars (John & Senbet, 1997; Triantis & Daniels, 1995) have revealed that there are many more agency problems for various other stakeholders which may also require proper CG mechanism to mitigate.

When considering the CG in Sri Lankan context, it has become significant during the last two decades due to happening some isolated incidents of corporate failures, certain economic reforms, and series of recent scandals (i.e Pramuka Bank, Vanik Corporation, Trading suspension of Entrust PLC, and Swarnamahal Finance PLC) in Sri Lanka. The first Sri Lanka code of best practices on CG was introduced in 1997 by the Institute of Chartered Accountants of Sri Lanka (CASL) to deal with Sri Lankan listed companies. It was based on the Anglo-Saxon model of corporate governance and was a blueprint of Cadbury code (1992). The 1997 code was replaced by CASL code of best practices which was introduced in March 2003 based on the Hampel report (1998). During the year 2008, the standards of CG were introduced into the CSE listing rules and made as a mandatory compliance for listed companies in Sri Lanka by developing a joint initiative of CASL and SEC (Colombo stock exchange, 2008). Subsequently, certain revisions for code of CG best practices have been made by CASL and SEC over a period in order to incorporate with recent global developments (Senaratne & Gunaratne, 2008; Weerasinghe *et al.*, 2017).

Accordingly, the Sri Lankan listed companies are now delt with a comprehensive model of corporate governance, which represents a mixture of both mandatory (companies act 2007, CSE listing rules, SEC directives and codes, CBSL directives for banks and financing companies) and voluntary (code of best practices of CG – CASL 2017) rules of corporate governance.

2.2. Understanding the concept of Financial Reporting Quality (FRQ)

Financial reporting in its ideal sense, is the first source of independent communication about the management performance which helps investors, creditors, and other users to assess the basis for economic decision making on providing resources to the entity. The publicly held firms evaluate their financial position and performance through financial reporting information those generated as a major outcome of external reporting system. Further, financial reporting is the financial results which a company releases to the public in terms of financial statements, other financial information on company's website, annual reports issued to shareholders, notes and other disclosers. Although, financial as well as non-financial disclosers might be communicated in different means, the traditional financial statements are always the most significant reports (Alzoubi, 2014; Paulinus *et al.*, 2017; Trai, Kha, Trung & Dung, 2018).

Quality is a broad concept that can be measured comparatively. According to Cohen *et al.* (2004) the past researchers show a vague concept on financial reporting quality. In light of these, Cooray, Gunarathne, and Senarathne (2020) suggested that the concept of FRQ, is an important aspect for its related parties to assure that financial reports, disclosers, and other non-financial reports minimizing any asymmetry of information and improve the usefulness of decision making, whereas Cohen *et al.* (2004) argued that the auditors, audit committee participants, and managers are now struggling with defining financial reporting quality. So that, accounting literature has much focused on the factors such as earnings management, financial restatements, and frauds which clearly demonstrate the attainment of high-quality financial reports, rather than defining FRQ.

Consequently, the latest research studies, being aware of the two general perspectives that are widely emphasized in the assessment of FRQ. The first perspective focuses on the providing useful financial information to the users whereas, the second perspective relies on the sufficiency of the information provided to the users in order to guarantee the protection of investors (Paulinus *et al.*, 2017). The stakeholders of the entity have different and possibly conflicting information needs. Thus, the perspectives on the evaluation of financial reporting quality are also varying accordingly. As a result, this study puts its almost effort to concentrate on FRQ in terms of accruals model that will be considered as a comprehensive measurement tool for financial reporting quality.

2.3. Theoretical background

The concept of CG originated with multiple theories. The two most pertinent grand theories considered to explain the agency conflicts and the need of CG are Agency theory and the Stakeholder theory that can be viewed as two main theories amongst many other applicable theories such as Resource dependence theory and Stewardship theory. Agency theory is the predominant theory since it considered to be given the birth to the concept of CG. However, all of them can be treated as different lenses to see the concept of CG from different and interesting angles. The particular angle or the perspective of CG from which looking at will decide the appropriateness of a more suitable theory.

Agency Theory was defined in two aspects as, economic perspective (Ross, 1973) and the institutional perspective (Mitnick, 1973). Costs associated with a lack of goal congruence between two parties were brought to the fore by Ross (1973) and were further explored by Jensen & Meckling (1976). The separation of ownership and management provides the opportunity for management (agents) to act in their own self-interest by maximizing their own wealth and power at the expense of the owners (principals) (Fama, 1980; Jensen & Meckling, 1976). Since this relationship is not harmonious; indeed, so-called agency conflicts, or conflicts of interest between agents and principal arise. This is known as "Agency Problem".

Hence, the companies try to limit this agency problem through a solid and effective CG policies such as including independent non-executive directors to the board, forming an audit committee to ensure the fair management, and establishing two separate positions for CEO and chairman (Uwuigbe *et al.*, 2018; Weerasinghe *et al.*, 2017). Thus, such kind of adequate control mechanisms should be established along with good corporate governance in order to direct the behavior of the managers and to compel them to act in the best interests of the shareholders.

Considering the stakeholder theory, which was founded by Freeman, it emphasizes on different stakeholder groups of a corporation and recommendations on how the management should serve the interests of all those parties. This theory suggests that the companies have a social responsibility to restructure the CG framework, apart from the owner-manager relationship and identifies each set of interest groups (Paulinus *et al.*, 2017). In stakeholder theory, the principal-agent problem has been further widened, because of concerning the interests of multiple principals as central to the sustainability of the business firm. Compared with the agency theory, this theory demonstrates corporate governance in a holistic view, as a control mechanism which created for efficient operations of a firm (Manawaduge, 2012). According to Weerasinghe *et al.* (2017), CG best practices, as the stakeholder theory point of view, should protect the interests of broad stakeholders and not only of shareholders.

Resource dependence theory views a firm as an open system, dependent upon external organizations and environmental contingencies (Pfeffer & Salancik, 1978). Corporate boards are viewed as a means to manage external dependency (Pfeffer & Salancik, 1978), reduce environmental uncertainty (Pfeffer, 1972) and reduce transaction costs associated with environmental interdependency (Williamson, 1984) in linking the organization with its external environment. Hence the board is considered as a part of both the organization and its environment.

Stewardship Theory presents a contrasting view to Agency theory, which is 'managers are essentially trustworthy individuals and therefore good stewards of the resources entrusted to them' (Donaldson, 1990; Donaldson & Davis, 1991, 1994). Donaldson and Davis (1991) state that 'managers are principally motivated by achievement and responsibility needs' and once they are given the responsible, self-directed work, organizations may be better served to free-managers, under non-executive director dominated boards. Accordingly, Stewardship theory suggests that managers are naturally trustworthy; thus, there will be no major agency costs (Donaldson & Davis, 1994). It assumes that in general, managers want to do a good job and will act as effective stewards of an organization's resources. As a result, senior management and shareholders are better seen as partners. Hence, the main function of the board is not to ensure managerial compliance with shareholders'/members' interests as per agency theory, but to improve organizational performance.

2.4. Empirical Evidence between Corporate Governance and FRQ

The impact of CG characteristics on FRQ has comprehend through several prior studies (Abdulmalik & Ahmad, 2016; Amrah & Obaid, 2019; Sepasi, Deilami & Tavakoli, 2017). However, contradictions in the literature were found in various CG attributes and its sub-components. When investigating the relationship between Board Size (BDSIZE) and FRQ variety of views were highlighted. Companies with large director boards boost the transparency and credibility of the accounting data by acting as a strong controlling mechanism. These factors have proved through many prior studies by representing the strong positive relationship between board size and financial reporting quality (Phuong *et al.*, 2020; Shah, Rashid & Shahzad, 2019). In contrast, Hassan (2011) and Paulinus *et al.* (2017) have expressed that large board size misplaced the strong governance as they have a lower level of coordination and a higher probability of issues related with free riders. Further, in comparison to larger boards, smaller boards will foster a high degree of communication and more active in timely decision making. This is justified by the studies of Chalaki, Didar, and Riahinezhad (2012) and Chiedu (2014) which emphasize the negative association between board size and financial reporting quality measured through discretionary accruals.

Secondly when analyzing the literature on Board Independence (BDIND) and FRQ, a plenty of studies (Alzoubi 2014; Ibrahim & Jehu, 2018) have shown a significant positive relationship between the board independence and FRQ which suggest independent members of BODs voluntarily disclose more relevant information on corporate financial administration and thereby indirectly serving to maximize shareholders value. Inversely, Chalaki *et al.* (2012) and Onuorah *et al.* (2016) have proved that there is no such relationship among board independence and financial information quality in their studies, where the independent directors are less competent as they possess limited information on company's operation and their presence on the board may have no impact on FRQ.

CEO duality emphasizes to the situation where one person simultaneously carries the positions of both chairman of the board and CEO. Agency theory advocated the importance of separation between these two persons in order to ensure better management and satisfying the shareholders' interests (Shah *et al.*, 2019). Alzoubi (2014) has stated that CEO duality has negatively impact on financial reporting quality measured through abnormal accruals, as it damages the firm value and sustainability of the firm in long run. Nevertheless, other studies have indicated CEO duality improves the firm value because of bringing an extra power to CEO to mitigate the ambiguity in decision making. Trai *et al.* (2018) has focused on the positive relationship between CEO duality and FRQ as it minimizes the extra cost which arises due to the separation of two roles.

Considering the Audit committee and FRQ, theoretically as per the resource dependency theory, larger audit committee size (ACSIZE) higher the resourcefulness of the entity which improves FRQ. This is due to having a wider knowledge base and varied expertise members in the committee. Accordingly, Eyenubo, Mohammed and Ali (2017), Shankaraiah and Amiri (2017) has shown a positive relationship between the variable of audit committee size and FRQ. On the other hand, some studies (Majiyebo, Okpanachi, Nyor, Yahaya, & Mohammed, 2018) have suggested larger audit committees are more likely to increase risk of material misstatements by depicting a negative relationship among audit committee size and FRQ As a result, many regulatory bodies such as Blue-Ribbon committee in US (1999), ASX corporate governance council in Australia (2003), and combined code in UK (2008) have recommended, at least three members as the appropriate size for the audit committee.

Audit committee independency is a foremost characteristic influencing committee competence and effectiveness in managing financial information process. The presence of an audit committee with majority of independent directors ensures a strong controlling mechanism by reducing the agency cost, improving the internal controls, and thereby paving the way to high quality disclosures. The extant literature provides evidence that firms with a higher proportion of independent directors report lower discretionary accruals, thus enhancing overall FRQ (Hasan, Kassim & Hamid, 2020; Kibiya, Che-Ahmad & Amran, 2016). However, Majiyebo *et al.* (2018) and Shah *et al.* (2019) in their studies, have documented that role of the independent audit committee is rather limited in controlling and monitoring the management behavior over reducing earnings manipulation and therefore present an adverse association between audit committee independence and FRQ.

It is very crucial to having audit committee members with in-depth knowledge and experiences on accounting standards and auditing procedures in order to improve the credibility of financial statements, hence enhance the FRQ more effectively. This characteristic of audit committee has received a considerable attention in the previous literature that indicates a positive relationship between audit committee financial, accounting expertise and FRQ (Alzeban 2019; Hassan 2011; Nuraini 2015). In contrast, some studies have found an insignificant relationship which argue that having a financial expert in audit committee is not enough component for improving the quality of financial information (Hasan *et al.*, 2020; Kibiya *et al.*, 2016). According to Shankaraiah *et al.* (2017) some accounting expertise in the audit committee assess the subjective judgements of the management, meet more frequently, and more often disagree with the financial reporting decisions of the management and finally result an inadequate monitoring over the reporting process.

Considering the empirical evidence in local context, there is a dearth of studies on CG and FRQ in Sri Lanka due to the nature of emerging economy. Kankanamge (2015) has studied the impact of board characteristics on earnings management measured using discretionary accruals model, in Sri Lanka during the period from 2012-2015 and found that there is a significant relationship between board size, board independence, board financial expertise and earnings management of the firms and thereby enhancing the FRQ and transparency. Further, Kankanamge and Shantha (2015) in their study, has documented the impact of audit committee characteristics (audit committee size, independence, meetings, financial expertise) on FRQ which results a strong negative relationship between these characteristics and discretionary accruals. According to De Silva, Manawaduge and Ajward (2017) audit committee financial and accounting expertise has a negative relationship on the level of earnings management, while other selected corporate governance characteristics have not any influence on the level of absolute discretionary accruals. Moreover, Cooray *et al.* (2020) has emphasized the effect of governance mechanisms on the quality of integrated reporting that shows a plenty of mixed evidence between corporate governance components and qualitative characteristics of integrated reporting. (See the Appendix A for summary of the empirical evidence.)

When exploring the empirical evidence in the global and local context, contradictory mixed results were found on the relationship between CG characteristics and FRQ. Hence, the current study focuses on filling the empirical gap through further studying on the same area by introducing six independent variables (Board Size, Board Independence, CEO Duality, Audit Committee Size, Audit Committee Independence, and Audit Committee Accounting Expertise) and the level of FRQ in Sri Lanka.

3. RESEARCH METHODOLOGY

3.1. Collection and Sampling

Data and information were collected using annual reports of companies excluding the banks, finance companies, and insurance companies as these industries are strictly regulated and apply different methods in their financial reporting including fundamentally different cash flows and accrual processes (De Silva *et al.*, 2017). The sample consisted with 209 companies listed in CSE during 2017 and 2020. The stratified random sampling technique was used in order to select the companies to the sample. Table 1 shows the composition of the sample of the study.

Table 1: The sample presentation

Description	*2017*	*2018*	*2019*	*2020*	*Pooled*
Companies listed in CSE.	296	284	289	286	1,155
Less: Banks	(15)	(16)	(16)	(16)	(63)
Less: Diversified Financials	(51)	(50)	(53)	(53)	(207)
Less: Insurance	(11)	(11)	(11)	(11)	(44)
Study population	219	207	209	206	841
Relevant sample size (According to Morgan table)					260
Less: Missing data	(14)	(15)	(11)	(11)	(51)
Final sample					209

3.2. Hypotheses Development

Companies with large director boards boost the transparency and credibility of the accounting data by acting as a strong controlling mechanism. Most of the literature (Phuong *et al.*, 2020; Shah, Rashid & Shahzad, 2019) support the argument that a higher board size would be preferred for lesser board size to generate high quality financial reporting. Similarly it was evident that the independent members of BODs voluntarily disclose more relevant information on corporate financial administration and thereby indirectly serving to maximize shareholders value (Alzoubi 2014; Ibrahim & Jehu, 2018) which ultimately supports for a positive impact on FRQ. Considering the CEO duality, agency theory also advocated the importance of separation between these two persons in order to ensure better management and satisfying the shareholders’ interests (Shah *et al.*, 2019). Hence, with the support of theses arguments in the literature, the first three hypothesis were developed as follows.

H1: There is a significantly positive relationship between board size and FRQ (Chalaki *et al.*, 2012; Phuong *et al.*, 2020).

H2: There is a significantly positive relationship between board independence and FRQ (Ibrahim *et al.*, 2018).

H3: There is a significantly positive relationship between CEO duality and FRQ (Shah *et al.*, 2019; Trai *et al.*, 2018).

Based on the prior literature, the audit committee is considered as an additional internal governance mechanism whose influence may improve the quality of financial reporting. In this respect, an audit committee has three main characteristics that should be taken into consideration, these are; audit committee expertise, audit committee size, and independence. Hence, in the study, we consider those three characteristics will have a positive impact on FRQ. However, as stated in literature review section , there were also some studies that proved the contrary situations, so we believe it is necessary to test these three hypotheses in order to discover the relationship between audit committee size, independence, and expertise attributes and FRQ in Sri Lankan context.

Therefore, with the support of the literature, AC characteristics (Cooray *et al.*, 2020; De Silva *et al.*, 2017; Kankanamge *et al.*, 2015; Shankaraiah *et al.*, 2017) following hypotheses were designed.

H4: There is a significant positive relationship between audit committee size and FRQ (Eyenubo *et al.*, 2017; Shankaraiah *et al.*, 2017).

H5: There is a significant positive relationship between audit committee independence and FRQ (Hasan *et al.*, 2020).

H6: There is a significant positive relationship between audit committee accounting expertise and FRQ (Alzeban 2019; Madhurangi and Abeygunasekera 2021).

3.3. Conceptualization

The conceptual diagram of the research study is depicted by figure 1, which specifies the holistic view on statistical relationship between CG variables and FRQ. As the FRQ is not only associated with CG practices by companies but also being impacted by certain economic factors such as firm size, leverage which would enhance the quality of financial information, thus identified as control variables of this research.

According to the resource dependency theory, a larger number of directors on the board might be beneficial for high quality financial reporting. Larger the size of the board directors in the board may give more opportunities than smaller boards. Similarly, agency theory also supports the Board Independence and CEO duality which will also have a positive impact of FRQ. Regarding audit committee characteristics and FRQ, the resource dependency theory presumes that, the audit committee serves as a source of advice and counsel for the BOD to bring valuable resources to the organization (Zábojníková, 2016) and the have a positive relationship between audit committee characteristics and FRQ. When a small AC lacks with diversified skills and expertise provided by a large audit committee, it would make them ineffective. An audit committee with an appropriate amount of members allows them to make use of their knowledge for stakeholders' advantage (Goodstein, Gautam, & Boeker, 1994). Even though the several contrary results were found, most of the empirical studies also supported this theoretical relationship where the conceptual framework has been developed based on findings of the literature.

Hence, following the studies of Alzoubi (2014), Hasan *et al.* (2020), Kankanamge *et al.* (2015), and Shah *et al.* (2019), the study identifies the common CG characteristics related to board structure and audit committee to be influential on the FRQ. Further, the conceptual framework of the study realizes two factors that influence FRQ.

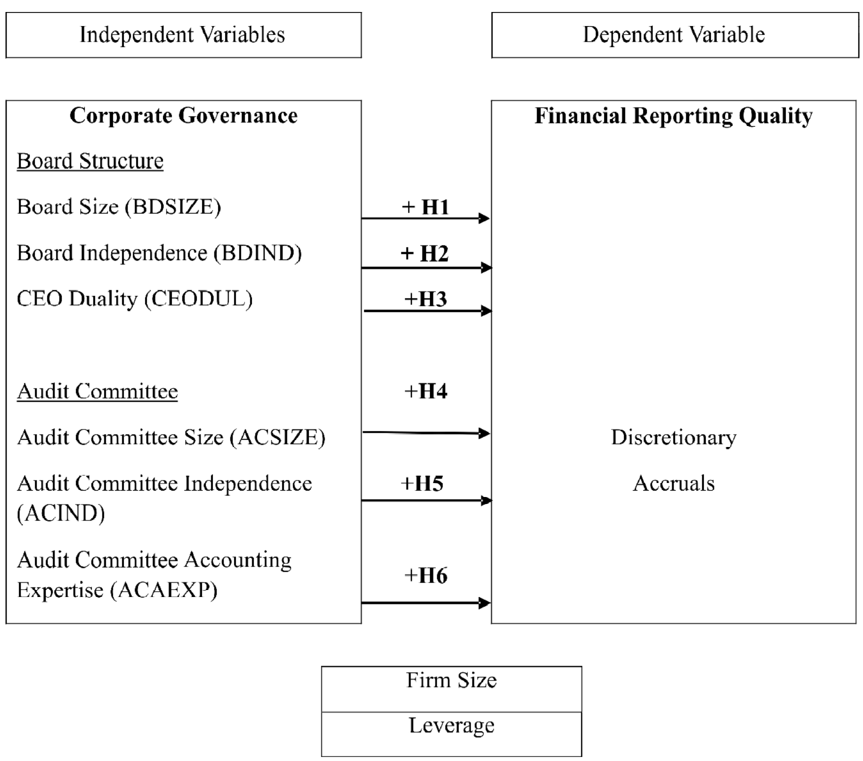

Figure 1: Conceptual framework of the study

Further, the study has adopted the following basis of measurement presented in Table 2, as proxies of quantifying each individual governance components, FRQ, and control variables.

Table 2: Operationalization

Key Concept	*Variables*	*Definition*	*Measurement*	*Extant Studies*
Independent variables -	Board Size (BDSIZE)	Number of directors serving on the board	Total number of board of directors	(Chalaki et al., 2012; Onuorah et al., 2016)
CG characteristics	Board Independence (BDIND)	Number of independent directors serving on the board	Total number of independent non-executive on the board	(Ibrahim et al., 2018)
(Board Structure and Audit Committee)	CEO Duality (CEODUL)	One person simultaneously occupies the positions of both chairman and CEO	Coded as "0 director" if CEO and chairman roles are separated and "1" otherwise	(Alzoubi 2014; Trai et al., 2018)
	Audit Committee Size (ACSIZE)	Number of members constituting the audit committee	Total number of members in the audit committee	(Kankanamge et al., 2015; Shankaraiah et al., 2017)
	Audit Committee Independence (ACIND)	Number of independent directors who comprise the audit committee	Total number of independent non-executive directors on the audit committee	(Cooray et al., 2020; De Silva et al., 2017)
	Audit Committee Accounting Expertise (ACAEXP)	Number of members with finance / accounting expertise on the audit committee	Total number of members with finance or / and accounting background in the audit committee	(De Silva et al., 2017)
Dependent variable FRQ	Absolute Discretionary Accruals (ADA)	Discretionary accruals ignoring the signs (positive or negative)	Absolute value of discretionary accruals measured using Modified Jones model (see the section below on determining FRQ)	(Alzeban 2019; De Silva et al., 2017)
Control variables -	Firm Size (FSIZE)	Natural logarithm of sales	Log (Revenue)	(De Silva et al., 2017; Trai et al., 2018)
Firm size and leverage	Leverage (LEV)	Ratio of total debt to total assets	Total liabilities divided by total assets	(Hasan et al., 2020; Johl et al., 2013; Kibiya et al., 2016)

3.4. Model Specification-Determining Financial Reporting Quality

Among accounting-related measures of FRQ, accruals earnings quality is very important in reflecting the performance of the organization and thereby produces more relevant financial information. The dependent variable of the study is FRQ, measures as the absolute value of the discretionary accruals. The absolute value of discretionary accruals depicts a negative relationship with FRQ. Therefore, when the absolute value increases, the magnitude of earnings management raises hence the FRQ decreases. Many prior research has applied the accrual-based earnings management technique, when evaluating the association between corporate governance and FRQ (Alzeban 2019; Alzoubi 2014; De Silva *et al.*, 2017).

Different models can be used to estimate discretionary accruals, and Dechow *et al.* (1995) provides evidence that the modified Jones model is the most powerful model compared to other existing models to observe FRQ. Accordingly, the absolute value of discretionary accruals is derived based on the study of De Silva *et al.* (2017) as follows:

Step 1 - The total accruals are estimated by subtracting net cash flows from operating activities from net income as the cash flow approach.

$$TA_{i,t} = NI_{i,t} - CFO_{i,t} \tag{01}$$

Step 2 - The calculation of the coefficient parameters separately for each industry (industry average α values) by regressing equation 2 (modified Jones model) below.

$$TA_{i,t} / A_{i,t-1} = \alpha_1 (1 / A_{i,t-1}) + \alpha_2 (\Delta REV_{i,t} - \Delta REC_{i,t} / A_{i,t-1}) + \alpha_3 (PPE_{i,t} / A_{i,t-1}) + e_{i,t} \tag{02}$$

Step 3 - Assigning the above calculated industry average α values to each of the firm year variables and then calculating non-discretionary accruals for each firm year separately.

$$NDA_{i,t} / A_{i,t-1} = \alpha_1 (1 / A_{i,t-1}) + \alpha_2 (\Delta REV_{i,t} - \Delta REC_{i,t} / A_{i,t-1}) + \alpha_3 (PPE_{i,t} / A_{i,t-1}) \tag{03}$$

Step 4 - The discretionary accruals are determined by subtracting non-discretionary accruals (calculated under equation 3) from total accruals (calculated under equation 1).

$$DA_{i,t} / A_{i,t-1} = TA_{i,t} / A_{i,t-1} - NDA_{i,t} / A_{i,t-1} \tag{04}$$

Where:

$TA_{i,t}$ = Total Accruals of the firm i for the year t

$NI_{i,t}$ = Net Income before discontinued segments of the firm i for the year t

$CFO_{i,t}$ = Net cash Flows from operating activities of the firm i for the year t

$\Delta REV_{i,t}$ = Change in revenue for the firm i from year t-1 to t

$\Delta REC_{i,t}$ = Change in receivables for the firm i from year t-1 to t

$PPE_{i,t}$ = Value of the property, plant, and equipment of the firm i for the year t

$A_{i,t-1}$ = Total assets for the firm i at the end of year t-1

$NDA_{i,t}$ = Non-discretionary Accruals for firm i in year t

$DA_{i,t}$ = Discretionary Accruals for firm i in year t

$e_{i,t}$ = Residual for firm i in year t

3.5. Regression model

To investigate the impact of CG characteristics on FRQ, a regression model has been established following De Silva *et al.* (2017).

$$ADA_{i,t} = \alpha + \beta_1 BDSIZE_{i,t} + \beta_2 BDIND_{i,t} + \beta_3 CEODUL_{i,t} + \beta_4 ACSIZE_{i,t} + \beta_5 ACIND_{i,t} + \beta_6 ACAEXP_{i,t} + \beta_7 FSIZE_{i,t} + \beta_8 LEV_{i,t} + e_{i,t} \quad \textbf{(05)}$$

Where:

$ADA_{i,t}$ = Absolute discretionary accruals measured using Modified Jones model

$BDSIZE_{i,t}$ = Number of board of directors

$BDIND_{i,t}$ = Number of independent non-executive directors on the board

$CEODUL_{i,t}$ = Coded as "1" if CEO and chairman roles are separated, and "0" otherwise

$ACSIZE_{i,t}$ = Number of members in the audit committee

$ACIND_{i,t}$ = Number of independent non-executive directors on the audit committee

$ACAEXP_{i,t}$ = Number of members with finance or/and accounting qualifications in the audit committee

$FSIZE_{i,t}$ = Natural logarithm of sales

$LEV_{i,t}$ = Ratio of total debt to total assets

4. DISCUSSION OF THE RESULTS

4.1. Descriptive Statistics

Under the descriptive analysis, firstly a descriptive statistic of variables with mean, median, maximum, minimum, standard deviation have been presented in the Table 3.

Table 3: Descriptive Statistics

	ADA	*BD SIZE*	*BD IND*	*CEO DUL*	*AC SIZE*	*AC IND*	*ACA EXP*	*FSIZE*	*LEV*
Mean	0.070	8.122	3.134	0.899	3.865	3.981	1.598	24.975	0.457
Median	0.037	8.000	3.000	0.000	3.000	3.000	1.000	22.040	0.489
Maximum	0.954	14.000	7.000	0.000	5.000	5.000	4.000	26.116	0.953
Minimum	3.034	4.000	2.000	0.000	2.000	1.000	1.000	14.145	0.112
Std. Dev.	0.075	2.033	1.064	0.162	0.762	0.678	0.716	1.895	0.226
Skewness	3.856	0.564	0.944	-2.28	0.817	0.546	1.019	-0.421	0.351
Kurtosis	11.366	3.172	3.211	2.113	3.413	3.359	3.133	3.403	2.401
Observations	836	836	836	836	836	836	836	836	836

Note: Definitions of these variables are depicted in table 2

Accordingly, there are 836 number of observations, and the mean value represents the average value of observations. Considering the mean value, ADA shows 0.070 of average value, BDSIZE represents 8 directors, BDIND represents 3 directors, whereas ACSIZE demonstrates 3 members, ACIND represents 3 members, and ACAEXP represents 1 member. The maximum is the highest value among each of the stated variables and minimum depicts the lowest value compared with related variables. Standard deviation measures the level of spread from the central value. Accordingly, ADA presents the lowest standard deviation of 0.075, that emphasizes most of the values are concentrated around the mean value, while BDSIZE presents the highest standard deviation of 2.033, which describes the values are highly spread over the mean value.

The normal distribution of the observations is measured through skewness and kurtosis of the descriptive analysis. In light of this study, majority of the variables illustrate a right skewed distribution indicating most of the companies record values of each variable less than its mean value. Moreover, this study demonstrates a leptokurtic distribution for all of its dependent and independent variables that represents most of the values are closely gathered around the average/mean value.

4.2. Correlation Analysis

Table 4: Correlation Analysis

Correlation	*ADA*	*ACAEXP*	*ACIND*	*ACSIZE*	*BDSIZE*	*BDIND*	*CEODUL*	*FSIZE*	*LEV*
ADA	1.000000								
	———								
ACAEXP	-0.652563	1.000000							
	0.003102	——-							
ACIND	-0.027158	0.279741	1.000000						
	0.8110	0.0000	——-						
ACSIZE	0.008763	0.344826	0.642007	1.000000					
	0.04762	0.0000	0.0000	——-					
BDSIZE	0.058114	-0.015685	-0.02330	0.065285	1.000000				
	0.3602	0.8051	0.7138	0.3039	——-				
BDIND	-0.051292	0.288261	0.531333	0.230194	-0.122310	1.000000			
	0.4285	0.0000	0.0000	0.0002	0.0534	——-			
CEODUL	0.040433	0.203117	0.334682	0.230736	-0.021328	0.577746	1.000000		
	0.5246	0.0012	0.0000	0.0002	0.7372	0.0000	——-		
FSIZE	-0.142522	0.064896	0.135371	-0.022756	-0.093012	0.139869	0.129801	1.000000	
	0.0242	0.3068	0.0324	0.7203	0.1425	0.0270	0.0403	——-	
LEV	0.072992	0.046238	0.032535	-0.010307	-0.087908	0.016441	0.099114	0.442374	1.000000
	0.2502	0.4667	0.6087	0.8712	0.1658	0.7959	0.1180	0.0000	——-

Note: $^{**}p<0.05$ denotes the significance less than 5%, $^{***}p<0.01$ denotes the significance less than 1%

Table 4 presents Pearson correlations of variables in this study. It can be observed that the board size shows a weak positive significant relationship with the absolute discretionary accruals (+0.058))and thereby represents a negative impact on FRQ. However, a weak negative association can be seen between the board independence (-0.051), audit committee independence (-0.027) and absolute value of discretionary accruals. Thus, it proves when the board and audit committee have more independent directors, financial reporting quality is more likely to improve with lesser board size. CEO duality reports a weak positive relationship (0.040) with discretionary accruals of the study and audit committee size shows a weak significant positive relationship (0.008) with absolute discretionary accruals. Hence, these variables depict a negative relationship with firms' FRQ, as the value of discretionary accruals adversely impact on the quality of financial reporting. Audit committee accounting expertise shows a moderate significant negative relationship (-.0.652) with absolute discretionary accruals, thus depicts a positive impact on FRQ.

Further, audit committee accounting expertise is the only variable that represents a systematic relationship with discretionary accruals and none of the other board and audit committee characteristics has depicted a significant relationship with the absolute discretionary accruals at any of the significant levels of $p<0.01$, $p<0.05$, $p<0.10$. However, considering the control variables, it is noted that the firm size shows a significantly weak negative association with absolute discretionary accruals. Finally, leverage presents a weak positive relationship on the absolute discretionary accruals and thereby negatively effect on FRQ.

4.3. Regression Analysis

Table 5: Regression Analysis

Variable	*Coefficient*	*Std. Error*	*t-Statistic*	*Prob.*
C	**0.362540**	0.090825	2.054185	**0.0487**
BDSIZE	**0.007450**	0.030863	0.614858	**0.0484**
BDIND	-0.001495	0.032954	-0.391822	0.7402
CEODUL	0.006497	0.058788	0.614233	0.5302
ACSIZE	0.008301	0.036134	1.094451	0.2809
ACIND	-0.007607	0.037605	-0.821737	0.4067
ACAEXP	**-0.014055**	0.027892	1.013812	**0.0023**
FSIZE	**-0.086643**	0.031943	-1.965255	**0.0370**
LEV	**0.095625**	0.048877	4.230625	**0.0000**
DUMMY	0.851874	0.091825	2.054185	0.0000

DUMMY_2	0.344219	0.030863	0.614858	0.0000
DUMMY_3	0.354792	0.032954	0.321822	0.0000
R-squared	0.602186			
Adjusted R-squared	0.591123			
Durbin-Watson stat2.048142	2.039140			
F-statistic	21.87138			
Prob (F-statistic)	0.000000			

Note: The dependent variable is absolute discretionary accruals; Number of observations is 836.DUMMY is the dummy variables included in the model to remove non-normalities.

Table 5 represents the results of multiple regression analysis based on the random effect model as confirmed by the Hausman specification test. The value of adjusted R-squared 0.591 indicates that all the independent variables in the model jointly represent to the extent of nearly 60% variation of the dependent variable, discretionary accruals. Further, the F-statistic value of 21.87138 with the probability value of 0.000000 indicates the usefulness and statistical efficiency of the model at 99% significant level to analyze the collected data.

The results of the regression analysis, shows that the board size and audit committee accounting expertise are the only variables which effect on FRQ. Audit committee accounting expertise depicts a significant negative association on discretionary accruals with a coefficient value of -0.014055 (*p=0.0023*), which in turn shows a significant positive relationship on FRQ. Therefore, the last hypothesis of H6 is supported. However, the board size depicts a significant positive association on discretionary accruals with coefficient value of 0.007450 (*p=0.0484),* which in turn shows a significant negative relationship on FRQ. Thus, H1 is not supported.

No other selected CG variables are significantly related with FRQ (*p*>0.05) measured through the absolute value of discretionary accruals. Hence, not supporting the hypotheses. These findings are similar to Hasan *et al.* (2020), Majiyebo *et al.* (2018), Adewale and Babajide (2019), Khan, Rehman, Zeeshan, and Afridi (2020), Subhasinghe and Kehelwalatenna (2021), Chalaki *et al.* (2012), Shah *et al.* (2019), and Uwuigbe *et al.* (2018). In relation to the control variables, firm size shows a significant negative correlation with -0.086643 value of coefficient (*p=0.0370)* whereas, leverage represents a significant positive correlation with 0.095625 coefficient (*p=0.0000*). These findings suggest that the larger firms show a high propensity on increasing FRQ and a firm that records a high degree of leverage is less likely to improve FRQ. The research works of De Silva *et al.*

(2017) and Subhasinghe *et al.* (2021) have also confirmed the similar findings on this in Sri Lankan context.

According to the regression output, audit committee accounting expertise can be considered as the most important variable to enhance FRQ, as the absence of audit committee accounting expertise might lead to poor FRQ. Similarly, it emphasise the impaortance of having a small board size to improve the FRQ.These findings are supported by previous studies in the literature (Alzeban 2019; Hasan *et al.*, 2020). They suggested that, when the audit committee comprises members with a background in accounting and finance, it causes the lower levels of discretionary accruals hence, improving FRQ. Further, regression analysis shows that board size negatively affects on FRQ through a positive coefficient with ADA. Therefore, it is difficult to prove that the board with high number of directors enhances the quality of financial reporting process. Chiedu (2014) and Ibrahim *et al.* (2018) are some studies which depict similar evidence between board size and FRQ. Nevertheless, some contradictory results were shown by studies of Kankanamge (2015) and Phuong *et al.* (2020).

5. SUMMARY AND CONCLUSION

Current study examines the association between CG characteristics on FRQ in Sri Lankan listed companies. The study examined six selected CG variables including board size, board independence, CEO duality, audit committee size, audit committee independence, audit committee accounting expertise and the level of FRQ using the absolute discretionary accruals. Less number of corporate governance related studies have been carried out in developing economies compared to the developed countries (for example, Alzeban 2019; Amrah *et al.*, 2019; Johl *et al.*, 2013). However, only few studies have been conducted on the relationship between corporate governance and FRQ in Sri Lankan context and the evidence of these are inconclusive. Similarly, each study varies one another based on the methodology adopted during the research. Accordingly, this study has become significant in order to bridge the gap in literature by providing empirical evidence on the association between corporate governance and FRQ in Sri Lanka using a sample of 209 listed companies in CSE from year 2017 to 2020.

The output indicates that all the identified corporate governance characteristics except board size and audit committee accounting expertise do not presenting a significant relationship with absolute discretionary accruals. These findings were rationalized getting support from the extant literature of previous studies (Chalaki *et al.*, 2012; Khan *et al.*, 2020; Madhurangi *et al.*, 2021; Subhasinghe *et al.*, 2021). Furthermore, it emphasizes the importance of the audit committee participants with membership in a recognized professional accounting body and sufficient finance and accounting literacy. That might decrease the number of fraudulent activities, while also enhancing the effectiveness of internal control process. Another main argument is that these experts provide appropriate advice on the problems relating to finance and reduce the likelihood of an agency problem forming within the organization, as they have considerable financial acumen and knowledge. Therefore, the quality of financial reporting process improves (De Silva *et al.*, 2017; Hasan *et al.*, 2020; Kibiya *et al.*, 2016). Similarly, findings of the study demonstrate that a larger board has a tendency to be less vigilant, commit less time and effort to review and decision making. So that, the number of directors on the board may not really impact on enhancing FRQ.

The current study contributes to the literature by bringing the empirical gap on investigating the CG characteristics on FRQ. Findings of this research are expected to have a significant policy implication for policy makers and regulators in terms of formulating strategies and policies on corporate governance best practices in Sri Lanka. Similarly, the findings of the research study should have an important implication for corporate sectors who aim to maximize the corporate value from the effective governance mechanisms. Further, relevant regulatory bodies should deeply emphasize on enhancing the financial reporting discloser requirements in the annual reports to provide a good insight to the users of the financial statements. For instance, the investors have a good opportunity to get a clear understanding on firms' performance by studying financial reports before making relevant investment decisions. Our study is subject to limitations of the characteristics of a frontier stock market excluding the banking and finance sector due to unique features. The extension of this type of study to other institutional settings may be a direction for future research.

Notes

1. Entrust Securities PLC in 2016, Swarnamahal Financial Services PLC in 2018, and PC Pharma PLC in 2018 (Colombo Stock Exchange [CSE], 2019).

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Appendix A

Table A1: Summary of the empirical evidence

Author and year	*Country and description of the study*	*Results*
Onuorah and Chi-Chi (2016)	Nigeria, during the period of year 2006-2015	Positive relationship between board size and FRQ while, negative relationship between board independence, AC size and FRQ
Chalaki, Didar, and Riahinezhad (2012)	Iran, listed companies in Tehran stock exchange during the period of 2003-2011	No relationship between corporate governance attributes (including board size, board independence) and FRQ
Alzoubi (2014)	Jordan, 86 industrial listed companies in the Amman stock exchange for the years 2008-2010	Negative correlation between salient board features and earnings management measured through discretionary accruals other than CEO duality
Majiyebo, Okpanachi, Nyor, Yahaya, and Mohammed (2018)	Nigeria, 15 listed money deposit banks over a period of ten years 2007-2016	Negative relationship between AC independence and discretionary accruals whereas, no relationship between AC size and discretionary accruals
Phuong and Hung (2020)	Vietnam, listed energy enterprises in Vietnam stock market from 2010-2018, 2162 observations	Board size, board independence and CEO have positive influence on FRQ
Ibrahim and Jehu (2018)	Nigeria, 576 Nigerian firms between 2011-2016	Negative association between board independence and abnormal accruals and no relationship between board size and abnormal accruals
Kankanamge and Shantha (2015)	Sri Lanka, listed firms during the period of 2012-2015	A strong negative relationship between audit committee characteristics and discretionary accruals
Madurangi and Abeygunasekara (2021)	Sri Lankan banking sector, 30 licensed commercial and specialized banks during 2014-2018	No relationship between audit committee effectiveness (measured through AC size, AC meetings frequency, AC financial / accounting expertise) and FRQ