Asian Journal of Finance (2024) 1(1), 29-45

Journal homepage: https://www.sab.ac.lk/mgmt/ajf/
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Article

Audit Committee Characteristics and Earnings Management: Evidence from Companies Listed in Colombo Stock Exchange, Sri Lanka

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Received
04 October 2022
Revised
10 October 2023
Accepted
28 April 2024
Published
05 September 2024

Citation: S. Balagobei & G. Keerthana. (2024). Audit Committee Characteristics and Earnings Management: Evidence from Companies Listed in Colombo Stock Exchange, Sri Lanka. *Asian Journal of Finance 1*(1), 29-45. https://doi.org/

Asian Journal of Finance
© Faculty of Management Studies Sabaragamuwa University of Sri Lanka
ISSN: 2806-5107

Abstract: *The study aims to examine the influence of audit committee characteristics on the earnings management of listed companies in Sri Lanka. Secondary data of listed firms on the Colombo Stock Exchange (CSE) was collected for the five-year period from 2017 to 2021. For data analysis, 107 companies listed on CSE were selected as samples, and a quantitative technique was employed. Audit committee size, audit committee independence, audit committee financial expertise, and audit committee meetings are proxies for audit committee characteristics while firm size and leverage are considered as control variables. This study used discretionary accruals as a signal of the presence of earnings management. The techniques of Pearson's Correlation and panel data regression were employed to estimate the association between the audit committee characteristics and earnings management. The empirical findings reveal that audit committee independence and audit committee meetings significantly influence the earnings management of listed companies in Sri Lanka. Therefore, there is strong evidence that a low level of audit committee independence and audit committee meetings have a major effect as a device in mitigating earnings management. This study contributes significantly to improving one's understanding of the interactive role of audit committee characteristics.*

Keywords: Audit committee characteristics, audit committee financial expertise, audit committee independence, earnings management.

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1. INTRODUCTION

Managers throughout the globe have been compelled to use earnings management due to the pressure on firms to fulfill profit predictions and analyst expectations. Because their income

is based on the success of their companies, managers are motivated to manipulate earnings. Earnings management is the process by which business managers use the latitude offered by accounting laws and standards to align a company's reported earnings with a targeted or preferred level (Mishra & Malhotra, 2016).

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

A well-recognized method for boosting investor trust and encouraging greater involvement in the capital markets is corporate governance. There are several definitions of corporate governance have been offered by researchers. It has always been the goal of the various definitions to maximize shareholder value while maintaining fairness for the company's other stakeholders.

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

A board audit committee must be established to manage the financial reporting and auditing process in accordance with corporate governance rules in the majority of developed and developing nations. Because it gives financial statements more authority and increases public confidence in the external auditor's integrity, professional accounting, and auditing associations, encourage the creation of audit committees. Choosing alternative accounting processes may lead to conflicts between managers and external auditors. Since auditors are hired by the company, they may be fired if conflicting recommendations cannot be reconciled. Financial reports are negotiable to a lesser extent. Members of the audit committee are chosen to work independently to settle disputes between the managers and outside auditors to provide fair financial reports (Saleh et al., 2007).

There have been limited studies in the Sri Lankan context on the impact of audit committee characteristics on earnings management, and the results have been inconsistent. Simultaneously, each research is unique in terms of the methods and techniques used. There are various financial reporting standards, rules and regulations, compliance requirements, and disclosure requirements to address earnings management practices in Sri Lanka. According to Pornupatham (2006), adopting international accounting and auditing

standards has not even in industrialized countries, provided sufficient and acceptable assurance that financial reporting does not involve earnings management. Kankanamge (2016) examined the impact of board characteristics on earnings management, employing the performance-adjusted discretionary accrual model developed by Kothari et al., (2005) to evaluate earnings management. The study's findings indicate that one of the key foundations of corporate governance board characteristics plays a significant influence in limiting profit management in Sri Lanka's listed companies. Rajeevan and Ajward (2019) used the Roy Chowdhury model to measure earnings management in selected listed businesses in Sri Lanka to provide empirical evidence for the impact of corporate governance characteristics on the level of earnings management.

Given the contradictory findings in the extant studies and the scarcity of research in the context of Sri Lanka, this study aims to address a gap in the literature by investigating the effect of audit committee characteristics on earnings management practices in Sri Lankan listed companies. Hence, the issue remains unsolved providing scope for additional research. Moreover, the authors used various models to analyze earnings management since this study is based on the Modified Jones model. Hence, this study examines the impact of audit committee characteristics and earnings management practices in Sri Lankan listed companies.

The problem statement for this study could be defined as ‟To what extent do audit committee characteristics impact earnings management practices in Sri Lankan listed companies" due to the varied and conflicting evidence available and the paucity of literature on the Sri Lankan perspective. This research will benefit academics, researchers, policymakers, and practitioners in Sri Lanka and other similar countries by investigating the relationship between audit committee characteristics and intellectual earnings management and developing strategies to improve the current situation.

2. LITERATURE REVIEW

2.1 Theoretical Background

Agency Theory

Agency theory states that managers and owners of a corporation are divided into two groups, each of which will take steps to ensure their own financial security. The agency relationship is portrayed as a legal arrangement in which the principal authorizes the agent to conduct tasks on their behalf, including making decisions (Jensen & Meckling, 1976). When creating financial statements for an organization, this conflict may lead the agents to prepare the information in a way that serves just their interests. Therefore, the agent could make financial statements that are not accurate to benefit financially.

A good example of corporate governance control is the audit committee. These committees play a crucial role in the system of decision-making for internal control by boards

of directors (Kalbers & Fogarty, 1998). In areas with high agency costs, Bradbury (1990) proposed that audit committees would be voluntarily used to enhance the quality of information flows between the principal and the agent. A key strategy for enhancing the caliber of corporate financial reporting processes has been extensively advocated by audit committees.

Bounded Rationality Theory

In Simon's (1990) view, a "decision" is the connection between rationality and behavior, while a "choice" is the act of selecting one practical behavioral alternative over another. Every behavior involves a practical selection, whether it is conscious or not. The process of arriving at this selection is called a decision. Rationality is a significant factor in decision-making, assuming that the decision-makers are inherently rational. Otherwise, it is the relationship between predetermined goals and the means to achieve them that determines the efficacy of the decision-making process.

Many social science models assume that humans are rational beings, who make decisions based solely on logic and not influenced by emotions. However, the bounded rationality theory challenges this assumption. Herbert Simon's theory of bounded rationality differentiates between "substantive" and "procedural" rationality. According to this theory, an agent is considered rational if they have a clear idea of what constitutes success and won't settle for anything less than the best. Meanwhile, procedural rationality refers to the decision-making process that involves deliberation, time, and intensity that vary according to the choices made. This theory suggests that capital market motives influence stock values, revealing inefficiency in reflecting intrinsic values.

When it comes to decision-making, the bounded rationality model suggests that it's not always possible to choose the option that offers maximum utility, even for relatively simple problems. This is because testing all possible options or alternatives can be difficult. Additionally, people's goals, values, and desires are influenced by various environmental factors, making it harder to make a decision that's ideal for everyone involved. Even if someone believes that they have chosen the best option available, they may be missing out on other alternatives that could be even more beneficial to them. In other cases, people may mistakenly believe that certain opportunities are advantageous when they're really not. Ultimately, the best decision may not always be the one that is made.

Information Asymmetry Theory

Ensuring equal access to information for all investors has always been a major concern for securities regulators and is a fundamental aspect of U.S. disclosure regulation. Information asymmetry occurs when some parties in business transactions have access to information that others do not (Scott, 2003). When managers have an information advantage over external information users, it can create information asymmetry, which allows managers to use their discretion in preparing and reporting accounting information for their own benefit.

Richardson (2000) conducted an empirical study in 2000 to investigate the correlation between information asymmetry and earnings management forecasted by Dye (1988) and Trueman and Titman (1988). When information asymmetry is high, stakeholders lack the necessary resources, incentives, or access to relevant information to monitor managers' actions, which can lead to the practice of earnings management (Schipper, 1989).

Information asymmetry refers to a situation where one party involved in a transaction has access to more or superior information than the other party. It's common for the seller to possess more knowledge than the buyer, although the opposite can also occur. This situation can be harmful because one party can take advantage of the other party's lack of knowledge, potentially leading to unfavorable outcomes (Dadbeh & Mogharebi, 2013).

Audit Committee Characteristics

According to the objectives, duties, and responsibilities put on them, audit committee (AC) concepts differ. According to Al-Thuneibat (2006), the organization's non-executive directors comprise the audit committee. The audit committee was established primarily to raise issues with the board of directors and improve the quality of audits. According to Arens et al., (2009), it is a group of people chosen from the board of directors who are in charge of ensuring the auditor's independence. Several studies examined the features of the audit committee as a tool of corporate governance, with several influences such as regulating earnings management or enhancing financial reports, and earnings quality.

Earnings Management

Earnings management (EM) and accrual accounting are inextricably related. Accounting regulations do not entirely limit managers' options for accounting policies and practices. Managers are given a great deal of freedom to select a policy that best serves their individual goals while staying within the bounds of accounting practice. Thus, earnings management occurs without breaking any accounting rules (Chandrasegaram et al., 2013).

This policy selection flaw allows the management to manipulate earnings to affect the financial data. Earnings, as an organization's ultimate success metric, are used by numerous stakeholders to make investment and lending decisions. As a result, management will select the optimum policy to maximize earnings. Cheng and Warfield (2010) identified two elements of earnings management. First, when it comes to dealing with compensation contracts, debt commitments, and political costs, managers perceive it as an opportunistic behavior to maximize utility. The second way that earnings management is seen is from the perspective of efficient contracting (efficient earnings management), where it gives managers the freedom to safeguard themselves and the business by foreseeing unforeseen events to the benefit of all parties to the contract.

According to Iturriaga and Hoffmann (2005), earnings management may occur because of an agency problem. Managers may manipulate earnings to "window dress" financial statements to strengthen their position, hide information that stakeholders should

be aware of, or sway the results of contracts that depend on the reported accounting figures. There are many underlying managerial motives to control earnings. These include, among other things, scenarios where a corporation declared a loss in the previous fiscal year, affecting short-term stock prices, and meeting capital market expectations.

2.1 Empirical Review and Hypotheses Development

Audit committee size and earnings management

The size of the AC, as defined by the number of members elected, is seen as a gauge of the resources available for the AC's efficiency. A large audit committee could be quite effective at reducing the frequency of earnings management. However, the empirical data do not seem to be conclusive. The sizes of the AC and earnings management practice have a substantial negative association (Galal et al., 2023; Klein, 2002; Yang & Krishnan, 2005; Mishra & Malhotra, 2016). Therefore, large ACs should have a positive impact on the quality of financial reporting. Ismail and Kamarudin (2017) document that the size of the review board was positively associated with earnings management (Mohammed et al., 2017; Ismail et al., 2009). In contrast, the size of the AC is not significantly related to discretionary provisions (Alkdai & Hanefah, 2012; Setiawan et al., 2020). Therefore, the current study hypnotized:

H_1 - The size of the audit committee has a significant negative impact on the earnings management of the companies listed in the Colombo Stock Exchange, Sri Lanka

Audit committee independence and earnings management

Independence is considered an essential attribute of an AC to fulfill its oversight function. As mentioned in agency theory, the independence of the directors of the AC plays a fundamental part in the fruitful observation of administrative behavior (Fama & Jensen, 1983). Furthermore, as argued by Bédard and Gendron (2010), independent members of the AC are more likely to work independently and objectively without the influence of management. According to certain studies, there is a positive association between earnings management and AC independence (Mohammad & Wasiuzzaman, 2020; Fodio et al., 2013), while others find no such association (Yang & Krishnan, 2005; Rahman & Ali, 2006; Lin & Hwang, 2010). The independence of AC members and earnings management was found to be negatively correlated by Soliman et al., (2014) and Mouratidou (2020), respectively. In 2022, Nikulin et al., (2022) revealed that a higher level of audit committee independence and the presence of financial expertise on the committee are associated with lower earnings management. Therefore, the following hypothesis is developed**:**

H_2 - The independence of the audit committee has a significant positive impact on the earnings management of the companies listed in the Colombo Stock Exchange, Sri Lanka

Audit committee financial expertise and earnings management

An audit committee's members can perform their oversight responsibilities more successfully if they have the expertise and expertise in matters relating to accounting and auditing. This advantage can assist the members of the audit committee in becoming more familiar with financial and operational reports. Bedard et al., (2004), and Carcello et al., (2006) found that the presence of at least one member with financial expertise is associated with a reduced possibility of destructive earnings management. Marra et al., (2011), and Hossain et al., (2011) observed that the financial expertise of the AC is negatively related to earnings management. Dhaliwal et al., (2007) and Chang and Sun (2009) find a positive relationship between the quality of provisions and accounting professionals. However, in 2018, Puwanenthiren (2018) asserted that the AC's financial acumen had no significant effect on the management of earnings. (Chang & Sun, 2009; Bedardb et al., 2004; Hossain et al., 2011; Marra et al., 2011; Abdullah et al., 2010). Based on these arguments, the current study predicts that;

H_3 - The financial expertise of the audit committee has a significant negative impact on the earnings management of the companies listed in the Colombo Stock Exchange, Sri Lanka

Audit committee meetings and earnings management

The number of AC meetings describes the activities of the AC. It is expected that a large number of AC meetings may dampen earnings management. Ghosh et al., (2010), and Klein (2002) indicated a positive association between the numbers of AC meetings and earnings management. García et al., (2012), Juhmani, (2017), and Rahman and Ali (2006) found that meetings between the AC and the internal auditor were not materially related to earnings management. Consequently, Ghafran and OSullivan, (2013), Saleh et al., (2007), and Skousen et al., (2009) found a negative association between AC meetings and earnings management. Hence, this study predicts;

H_4 - Audit committee meetings have a significant positive impact on the earnings management of the companies listed on the Colombo Stock Exchange, Sri Lanka

3. RESEARCH METHODOLOGY

3.1 Sample and Data

The research exerted the quantitative method and deductive approach with secondary data collected from the annual reports of listed companies. The study's population consists of all companies listed on the CSE under the industrial sectors of Food, Beverage and Tobacco, Consumer Services, and Capital Goods sectors. The total population of 112 companies listed under the above-mentioned industry sectors was selected as the sample for the current

study. However, the final sample is determined by the data available in the yearly report. The annual reports of 107 companies, whose samples range from 2017 to 2021, were used.

Table 1: *Sample of the Study*

Sectors	Population	Sample
Food, beverages, and Tobacco	47	45
Consumer services	36	35
Capital goods	29	27
	112	107

Source: *Authors' source*

Model Specification

The modified Jones model is applied in this study (Dechow et al., 1995). It has been demonstrated that the modified Jones model detects earnings management (EM) more accurately than other DAC models (Dechow et al., 1995). Therefore, the study used the econometric model to determine how audit committee characteristics affect earnings management, which is based on the literature and theoretical framework of this study. The model is specified and discussed as follows:

$$EM = \beta_0 + \beta_1 ACIZE + \beta_2 ACINDE + \beta_3 ACEXPERT + \beta_4 ACMEET + \beta_5 FSIZE + \beta_6 LEVER + \varepsilon$$

The model used *ACSIZE* to reflect the audit committee size, which is determined by the number of audit committee members. The *ACINDE* symbolizes the independence of the audit committee, frequently regarded as an essential characteristic influencing the committee's effectiveness in overseeing the financial reporting process. Audit committee independence is the proportion of independent non-executive directors to the total number of directors on the audit committee. The *ACEXPERT* demonstrates the financial knowledge of the audit committee. It has been argued that effective oversight by an audit committee requires that its members possess sufficient expertise in accounting and auditing to independently assess the matters that are presented to them. It measures the proportion of audit committee members with financial expertise to the total number of audit committee members. The *ACMEET* is an acronym for audit committee meetings expressed as meeting frequency. It has been suggested that the audit committee is not necessarily relied on by the board of directors to strengthen its monitoring ability merely because it was constituted. In addition to those variables, firm size (FSIZE) and leverage (LEVER) were used as control variables. The *FSIZE* is calculated as the log of total assets and the *LEVER* is measured by considering the debt-to-equity ratio.

Table 2: *Measurement of Variables*

Variables	Acronym	Measurement
Independent variables		
Audit committee size	ACSIZE	Number of audit committee members
Audit committee independent	ACINDE	Proportion of independent directors to audit committee size
Audit committee expertise	ACEXPERT	The proportion of audit committee members with financial expertise to the total number of audit committee members
Audit committee meetings	ACMEET	Number of meetings held in a financial year
Control variables		
Firm size	FSIZE	The natural logarithm of total assets
Leverage	LEVE	Long-term debt to total equity.
Dependent variables		
Earnings management	ERMGT	□□□□□ = □□□□□ − □□□□□□

Source: *Authors' source*

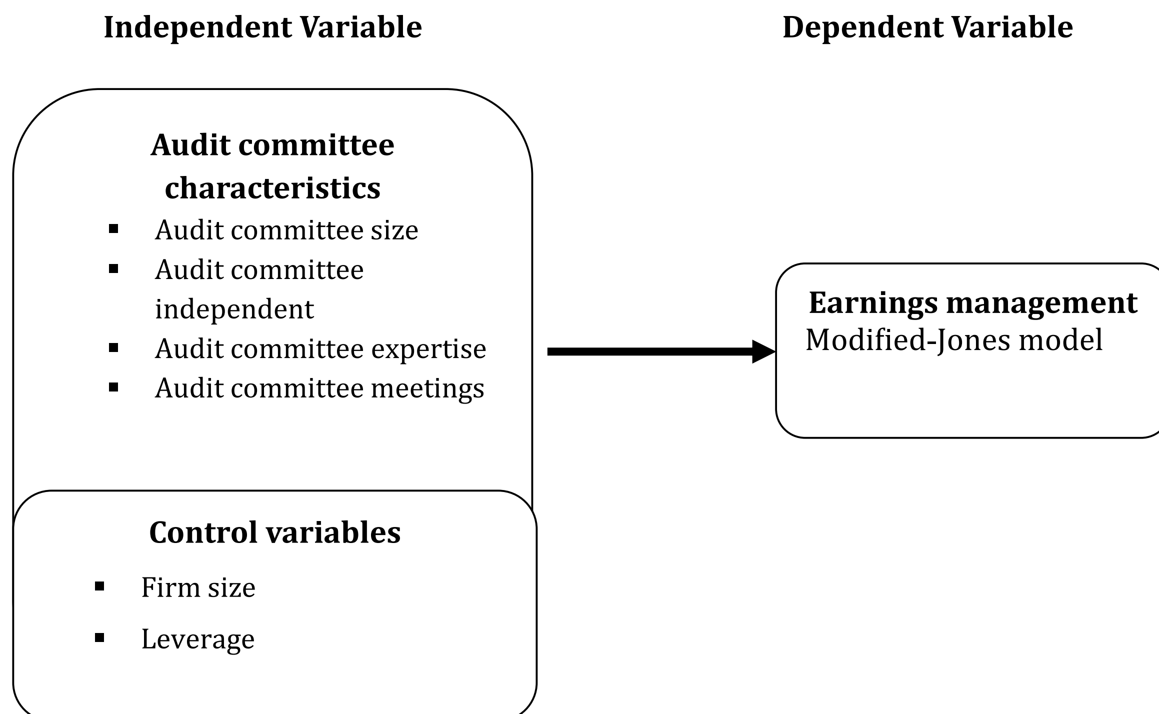

Figure 1: *Conceptual Framework*

Source: *Authors' source*

4. DATA ANALYSIS & RESULTS

Table 3 presents the summary of the descriptive statistics of the study. The value of earnings management of selected companies lies between -0.375 and 4.116, whereas the standard deviation is 1.633. The average audit committee size for the selected companies is approximately 3, with a range of 2 to 5. The average audit committee independence is 79%, with a range between 0.6 and 1 with a standard deviation of 0.149. Audit committee meetings have an average value of 5 with a range from 2 to 9. Audit committee expertise lies within the range of 0.25 to 1, with an average of 68.4%. The mean value of firm size is 7.593 with a minimum value of 6.243 and a maximum value of 1o.627. Leverage lies within the range of 0.016 to 1.720 with an average of 0.549.

Table 3: *Descriptive Statistics*

	Mean	**Maximum**	**Minimum**	**Median**	**Std. Dev**
ACSIZE	3	5	2	3	0.783
ACINDE	0.79	1	0.600	0.75	0.149
ACMEET	5	9	2	4	1.448
ACEXPERT	0.684	1	0.25	0.667	0.230
FSIZE	7.593	10.627	6.243	7.433	1.131
LEVER	0.549	1.720	0.016	0.510	0.390
FM	-1.059	4.116	-0.375	-2.601	1.633

Source: *Authors' source*

Table 4*: Correlation Matrix*

	ACSIZE	ACINDE	ACMEET	ACEXPERT	LEVE	FSIZE	EM
ACSIZE	1.000						
ACINDE	0.648**	1.000					
	0.000						
ACMEET	0.514**	-0.373**	1.000				
	0.000	0.011					
ACEXPERT	0.674**	0.588**	-0.351**	1.000			
	0.000	0.000	0.017				
LEVE	0.021	0.399**	-0.008	-0.142	1.000		
	0.888	0.006	0.954	0.350			
FSIZE	0.276	-0.203	0.060	-0.763**	0.272	1.000	
	0.066	0.179	0.693	0.000	0.070		
EM	0.082	0.126**	0.079**	0.011	-0.006	-0.008	1.000
	0.591	0.008	0.003	0.940	0.965	0.059	

Source: *Authors' source*

*** Significant at a level of 5%*

Table 4 shows that the correlation coefficient between audit committee independence and earnings management is 0.126 which is significant at the 0.05 level. Hence, it represents a positive relationship between audit committee independence and earnings management. Audit committee meetings and earnings management have a positive relationship with a correlation coefficient of 0.079 at 0.05 significant levels. However, audit committee size and audit committee expertise have not shown a significant relationship with earnings management at the significant level of 5%. The control variables of firm size, and leverage, are also not correlated with earnings management.

Table 5: *Variance Inflation Factor Test*

Variable	Coefficient Variance	Centered VIF
C	3.8715	NA
ACSIZE	3.1913	2.922048
ACINDE	9.7214	3.221422
ACMEET	4.4812	1.406147
ACEXPERT	8.7314	6.921842
LEVER	7.4313	1.685909
FSIZE	1.9413	3.703687

Source: *Authors' source*

Table 5 shows the results of the VIF test to detect the multicollinearity problem. The results show that the value of the centered VIF is less than 10. Thus, the multicollinearity problem was absent among the audit committee variables and control variables as all VIFs are less than 10.

Table 6: *Augmented Dickey-Duller (ADF) Test*

Variables	t statistics	Probability
ACSIZE	-6.086103	0.0000
ACINDE	-7.168478	0.0000
ACMEET	-4.723889	0.0004
ACEXPERT	-3.076927	0.0357
LEVER	-3.136666	0.0314
FSIZE	-2.969234	0.0457
ERMGT	-6.509312	0.0000

Source: *Authors' source*

Table 6 depicts the Augmented Dickey-Duller (ADF). H_0 can be ruled out because all of the variables' P-values are smaller than 0.05. As a result, all the variables are stationary, proving that they do not depend on one another throughout time. Additionally, it is determined that data has no unit root at zero latency.

Table 7: *Heteroskedasticity Test*

F-statistic	0.784495	Prob. F (6,38)	0.5875
Obs*R-squared	4.959698	Prob. Chi-Square (6)	0.5490
Scaled explained SS	60.69033	Prob. Chi-Square (6)	0.0000

Source: *Authors' source*

Table 7 illustrates the results of the heteroskedasticity test for the study. The probabilities of chi-square for all models are higher than the 5% significant level. It is concluded that the regression model's residual variance is constant.

Table 8 represents the output of panel data regression analysis. To get unbiased results, panel data regression with both fixed effects and random effects models is employed. According to Hausman's test, the random effect model is the most appropriate one for this investigation, where the probability is higher than the significant level of 5% (chi.sq=2.557957, p=0.0677). In the results, the adjusted R-squared shows a value of 0.62928 which means a 62.93% variation in earnings management is explained by audit committee size, audit committee independence, audit committee financial expertise, audit committee meeting, and control variables. F statistics indicate that the model is fit (F = 16.5851, p<0.05) and produces statistically significant results when the explanatory variable is chosen, combined, and evaluated as the report's substantial value.

Table 8: *Regression Analysis*

	Random effects	**Fixed effects**
Audit committee size	6.0973 (0.2692)	5.3942** (0.052)
Audit committee independence	4.4816** (0.0391)	1.0827 (0.0626)
Audit committee financial expertise	-1.2431 (0.0655)	-1.6241 (0.0626)
Audit committee meeting	7.2821** (0.0137)	1.2100 (0.6957)
Firm size	3.7221 (0.9309)	-1.3959 (0.6116)
Leverage	-7.4483 (0.3608)	-1.4265** (0.0158)
Year dummies	0.000	0.000
Constant	-5.9775 (0.3264)	6.9309 (0.8722)
R^2	0.62928	0.74185
Prob>F	16.5851 (0.0471)	14.456 (0.0448)
Random-effect	Yes	No

Fixed-effect	No	Yes
Groups	107	107
Observations	535	535
Hausman test		2.557957 (0.0677)

Source: *Authors' source*
*** Significant at a level of 5%*

In evaluating the model based on the results of the random effect regression model, the result shows that audit committee independence has a positive impact on earnings management at 5% significant levels. Therefore, H_2 is supported by finding. The findings indicate that a low level of audit committee independence reduces earnings management practices. This finding is similar to Mohammad and Wasiuzzaman (2020) and Fodio et al., (2013). Audit committee meetings have a significant positive influence on earnings management at a significant level. Compared to other corporations, fewer audit committee meetings recorded less earnings management practices. Hence, H_4 is supported by the findings. This finding is also by previous findings of Ghafran and O'Sullivan, (2013) and Saleh et al., (2007). Audit committee size and audit committee financial expertise have not shown any significant impact on earnings management. So, H_1 and H_3 are not supported with findings. Control variables, firm size, and Leverage have no significant impact on earnings management at a 5% significant level.

5. DISCUSSION AND CONCLUSION

According to this study's assertion, which is by past research and is supported by the agency's theoretical framework, audit committees can significantly improve the accuracy of financial reporting while preventing accrual-based distortion of that reporting. To evaluate the arguments, the following factors were regressed on earnings management as determined by the modified Jones model: audit committee size, audit committee financial expertise, audit committee meetings, and audit committee independence. The results of the study show that audit committee characteristics are essential for raising the standard of financial reporting quality in Sri Lanka.

The following policy suggestions are offered in the context of the research work. According to the study, there should be regulations that set a minimum attendance requirement for audit committee meetings. The efficiency of the audit committee will unquestionably be impacted if fewer than 50% of members show up for committee meetings. The study concludes by advising companies to make sure the audit committee has a sufficient number of independent directors.

ACKNOWLEDGEMENT

The authors would like to thank the anonymous reviewers for their excellent reviewer suggestions in completing this study.

CONFLICT OF INTEREST

The authors declare no conflicts of interest.

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