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# Do Audit Committee Attributes Affect Firm Performance of Sri Lankan Firms?

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## ABSTRACT

This study intended to examine the association between audit committee (AC) attributes and firm performance in Sri Lanka. The research analysed a sample of 100 firm listed in Colombo Stock Exchange (CSE), Sri Lanka for the period 2014-2018. Regression analysis was used to estimate the association between AC attributes and performance. The outcomes revealed that AC attributes of firms, namely AC size, AC independence and AC financial expertise are significantly correlated to firm performance while there is no statistical significant impact of AC size on Tobin's Q. An exception was AC meetings which had an insignificant impact on both performance measures (ROA and Tobin's Q). In conclusion, the results suggest that more active (i.e., more independent members, members with accounting background and a high frequency of meetings) ACs lead to improvement in the effective monitoring mechanism of the firm which indicates that firms can possibly enhance their performance by executing good governance of the firm. Thus, effort should be made to look at this research in a more elaborate viewpoint and across the countries. The effect of AC attributes on firm performance should fully examined in future research.

**Keywords:** audit committee, firm performance, Sri Lanka

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## INTRODUCTION

The Audit Committee (AC) is the substantial board sub-team owing to its particular role of defensive the interest of investors in connection to financial lapse and control (Kallamu & Saat, 2015). The main part of an AC is to supervise the firm's corporate reporting practices, the evaluation of financial reports, inside accounting controls, the auditing practice and more recently, its risk/uncertainty management practices (Klein, 2002). Alike to trends international (DeZoort, Hermanson, Archambeault, & Reed, 2002), the Sri Lankan Code of Best Practice on Corporate Governance (CA, 2017) commands the core corporate governance role of the AC as considering how firms should choose and put in accounting policies for corporate reporting, content of corporate reporting and regulate the structure, implement internal control and risk management principles and to sustain an right association with the firm's auditors. The shareholders and other participants of the firm have activated to understand the significance of worthy corporate governance practices in defensive their interests. Various philosophers of corporate governance have strained to inspect the association between firms' corporate governance and the broad well-being of a firm. Accepting improved corporate governance methods and process, such as an improved AC, expands observing of management and decreases information irregularity challenges. Though, some prior literatures have shown that an AC is an powerful corporate governance tool comprising its part in detection of firms' internal control imperfections, perfections the role of non-executive directors and organising internal and external auditors' responsibilities (Bédard, Chtourou, & Courteau, 2004; Bronson, Carcello, Hollingsworth, & Neal, 2009). Likewise, prior literatures have also revealed that the purpose of an AC encompasses to the discharge of non-monetary information of a firm (Akhtaruddin & Haron, 2010). Whereas the study on the association between AC attributes and performance have reported mixed outcomes. Prior studies have also mainly focused on industrialised countries, while a limited some studies have been connected to emerging countries. Sri Lanka is an emerging economy that is emerging from three decades of civil war and there has been considerable economic progress in the last few years. In this context, this study endeavoured to provide observed evidence on the effect of AC attributes on firm performance in Sri Lanka. This study would hopefully benefit researchers, practitioners and policy-makers in Sri Lanka and other similar countries through exploring

the effect of AC attributes on firm performance and following policies to advance its current status.

## LITERATURE AND HYPOTHESES DEVELOPMENT

The prior literature proposes that efficiency of an AC is developed when the AC is well resourced, non-executive and has members with accounting expertise (Iyer, Bamber, & Griffin, 2012). Therefore, the study developed hypotheses regarding AC attributes and firm performance.

### Theoretical Background

#### Agency theory

The Agency Theory (AT) assumes that the interests of the principal and agent vary and that the principal can reduce this by giving enticements to the agent and incur costs from events planned to monitor the personal-interest actions of the agent (Jensen & Meckling, 1976; Hill & Jones, 1992) With the intention of decrease information irregularity, there is the essential for corporate governance methodologies including board sub-teams composed of board directors with the suitable characteristics such as expertise, experience and independence to reduce the self-centred interests of agents (Wiseman, Cuevas-Rodríguez, & Gomez-Mejia, 2012).

#### Stewardship theory

The Stewardship Theory (ST) recommends that leaders are afraid about the well-being of the investors and complete firm performance, and this denies the AT which trusts that agents are self-centred and individualistic (Donaldson & Davis, 1991). The philosophy proposes that having a majority of firms' directors on a board will enhance effectiveness and harvest good results than a bulk of non-executive directors on a sub-committee (Al-Mamun, Yasser, & Rahman, 2013). The ST also commends that firm's board directors will be able to assist heavily in firms' decisions of the board sub-teams due to their knowledge.

### Related Literature and Hypothesis Development

The next is an effort to review the key findings of the most recent studies conducted on AC attributes.

## **Size of AC**

The key role of an AC is to assist the board directors of the firm in supervising corporate reporting (Carcello & Neal, 2003). The Sri Lankan code on corporate governance follows the listing necessities of the Colombo stock exchange (CSE) that the AC shall contain of at least three directors. Though, there is no exactly suggested size for an AC, prior literatures seem to suggest three to five board members (DeZoort, Hermanson, Archambeault, & Reed, 2002; Abbott, Parker, & Peters, 2004). There is a query whether a bigger AC size would lead to more effective monitoring. Increasing more board directors to AC can ensure an adequate knowledge base, and decrease the options of the committee as a whole being significantly impacted by directors (Vafeas, 2005). Prior studies have afford inconsistent output on the role of AC size in a numerous characteristics of a firm. Bigger AC are likely to hold members with diverse experience to monitor corporate reporting process more efficiently (Baxter & Cotter, 2009). Though, bigger AC may face a free riding problem that can reduce their monitoring efficiency (Lipton & Lorsch, 1992). As a result, Hypothesis 1 is:

*H<sub>1</sub>: There is a significant and positive association between AC size and firm performance*

## **Frequency of AC meeting**

The Code of Corporate Governance of the Sri Lanka states that an AC shall meet as a minimum four times a year, with authority to organise supplementary meetings, as circumstances require. A more active AC is anticipated to offer an effective monitoring device. As a best practice, AC meeting should be arranged as a minimum once a year (Saleh, Iskandar, & Rahmat, 2007). Though, the total number of meetings depends on a firm's TOR (terms of reference) and the difficulty of a firm's operations. Prior studies note that there is a significant relationship between AC meetings and reporting quality (Abbott, Park, & Parker, 2000). Other research have revealed no association between AC meetings and reporting quality (Bedard, Chtourou, & Courteau, 2004). As a result, Hypothesis 2 is:

*H<sub>2</sub>: There is a significant and positive association between frequency of AC meetings and firm performance.*

### **AC independence**

In the Sri Lankan context, the Code of Best Practices (2017) commends that ACs have a minimum three directors of whom as a minimum two should be independent. If there are more board directors of the firm, the bulk should be independent. Prior studies conducted in AC literature have produced mixed results. Literature show that independent directors of the board are able to offer liberated opinions to the firms' administration as of their promising to act more freely than non-independent board directors (Vicnair, Hickman, & Carnes, 1993; Weisbach, 1988). As a result, non-executive directors would reduce the probability of corporate reporting challenges (McMullen & Raghunandan, 1996). As a result, Hypothesis 3 is:

*H<sub>3</sub>: There is a significant and positive association between independence of ACs and firm performance.*

### **AC financial expertise**

A financial expertise within an AC is defined as a director having finance/accounting contextual skill/ experience (Iyer, Bamber, & Griffin, 2012). The Sri Lankan best practices on CA (2017) commends that at least one AC member should have recent and relevant financial experience. McDaniel and Maines (2002) propose that the focus of discussions about corporate reporting quality is better when financial expertise are part of the AC. McMullen and Raghunandan (1996) revealed that firms with difficulties are unlikely to have AC directors with financial skill/experience. Consequently, the market reacts positively to the appointment of AC with financial expertise (Davidson, Xie, & Xu, 2004). As a result, Hypothesis 4 is:

*H<sub>4</sub>: There is a significant and positive association between financial expertise on the AC and firm performance.*

### **Control variables**

The potential relations between AC attributes and firm performance can be related by other factors such as the profit, business structure, size of the firm, and other corporate governance-related proxies such as board independence (Saleh, Iskandar, & Rahmat, 2007). In view of that, this study controls for other proxies such as size of the board based on prior literature (Klein, 2002).

The conceptual framework below graphically represents the relationship among variables.

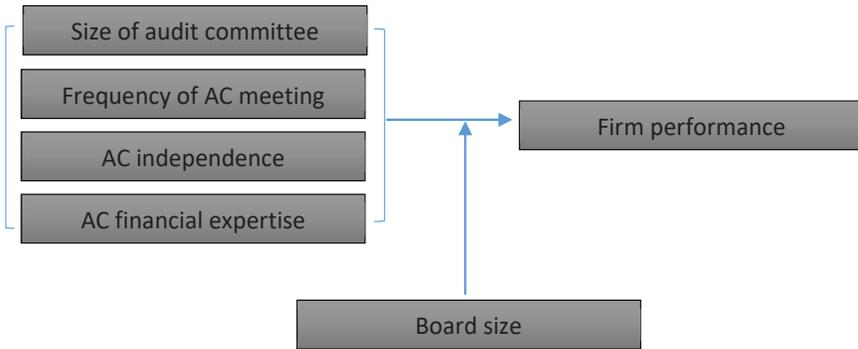


Figure 1: Conceptual Framework

## METHODOLOGY

### Sample Design

The population in this study was the 295 listed firms on the CSE, as at March 2016. This research excluded financial industry because of their sole financial attributes, intensity of regulation, and/or intensive use of leverage are likely to confound the outcomes being studied (Pratheepkanth, Hettihewa, & Wright, 2015). Similarly, the risk of missing data was reduced by eliminating firms that were not listed throughout the sample period. After the removals 100-firms sample, randomly drawn from listed firms in the CSE (Saunders, Lewis, & Thornhill, 2012), were analysed.

The data sources were the 2014-18 financial statements. The financial reports were preferred for two causes (Lang & Lundholm, 1993; Bozzolan, Favotto, & Ricceri, 2003) such as they are considered a significant source of firm information by external users and the disclosure level in financial reports is significantly connected with the amount of firm information communicated to the market and to investors using other media.

## Audit Committee Attributes' Measures

As suggested by Rahmat, Iskandar, and Saleh (2009); Saleh, Iskandar, and Rahmat (2007); Kallamu and Saat, (2015) and Akhtaruddin and Haron (2010), the AC size, AC meetings, AC financial expertise and AC independence were used to measure AC attributes.

**Table 1: Variable Measurement**

<b>Variables</b>	<b>Measures</b>	<b>Symbols</b>
AC Size	Number of board directors on AC	SAC
AC meetings	Number of AC meetings held during the financial year	MAC
AC independence	Independent directors on ACs/ Number of board directors on audit committees	INAC
AC financial expertise	Dummy variables would either take the value of 1 if one or more for AC members who have financial expert, otherwise it would take the value of 0.	FEAC

## Firm Performance Measures

As recommended by the prior literature, the impact of AC attributes on firm performance was discovered using many measures of firm performance (i.e. return on assets (ROA), net profit ratio (NP), earnings per share (EPS), Tobin Q (TQ) and price earnings ratio (PE) (Kallamu & Saat, 2015; Malik & Makhdoom, 2016; Al-Tamimi, 2012). This research measured firm performance using an accounting and market viewpoint. The ROA and TQ were measured in terms of a five year average during 2014-18.

## RESULTS AND DISCUSSION

### Descriptive Analysis

Table 1 displays the descriptive statistics of the proxies. Size of AC in the selected firms, averaged two members and 60 percent of the members were independent directors. The Sri Lankan code on corporate governance follows the listing requirement that ACs shall comprise of minimum three directors of whom at least two should be independent (CA, 2017). Dalton, Daily, Johnson, and Ellstrand (1999) revealed a positive association between

size and the monitoring function of the board that resulted in advanced performance. The many prior studies have revealed an association between AC independence and firm performance (Bédard, Chtourou, & Courteau, 2004). The chairman of the AC should be non-executive as per the Sri Lankan code on corporate governance (CA, 2017). The role of the chairman is to coordinate the AC’s schedule, to be the first point of connection with external auditors and to track AC meetings. The results showed that the AC’s met about two times a year, the total number of meetings depended on the firm’s TOR and the complexity of the firm’s operation. The code of governance of Sri Lanka notes that ACs shall meet as a minimum four times an annum, with authority to convene supplementary meetings, as circumstances require. The amount of AC meetings do not deliver any sign about the level of work accomplished during the meeting (Menon & Williams, 1994). In contrast, they note that ACs without any meeting/ with a few number of meetings is less likely to be a worthy monitor. The results also show that 73 percent of them have accounting knowledge, proposing agreement with the commendation of the Sri Lankan code (2017) for members of ACs should have common accounting knowledge, as a minimum one of whom is preferably the chairman, should have fresh and appropriate knowledge in corporate reporting and control, comprising knowledge of governing requirements. McDaniel and Maines (2002) recommend that the attention of conversation about corporate reporting quality is better when financial experts are part of the AC. In terms of the control variables, board size of the selected Sri Lankan selected firms, averaged at 10 and ranged from five to 21 members. The mean size of the TQ was 1.111, whilst the average profitability was 4.3%.

**Table 2: Descriptive Statistics**

Variable	Minimum	Maximum	Mean	STD
Size of AC	1.000	5.000	2.330	0.527
Frequency of AC meetings	1.000	4.000	2.410	0.569
AC independence	0.600	1.000	0.603	0.144
AC financial expertise	0.000	1.000	0.730	0.446
Board size	5.000	21.00	10.080	1.006
TQ	-0.160	3.051	1.111	1.782
ROA	-0.210	0.213	0.043	0.006

## Regression Analysis

Table 2 presents the outputs of regression analysis on the effect of an AC attributes on the firm performance. The model R<sup>2</sup> value of both performance ratios (ROA and TQ) indicated that 11.9-11.3 percent of the observed variability in performance measures can be explained by AC attributes. The F-value of the ANOVA and significance level (Table 2) show that both ROA and TQ models made significant outcomes.

**Table 3: Regression Analysis**

	<b>Model ROA</b>	<b>Model TQ</b>
Constant	2.785 (0.034)	1.304 (0.062)
Size of AC	2.338 (0.038)	2.140 (0.057)
Frequency of AC meetings	1.815 (0.073)	1.604 (0.064)
AC independence	2.986 (0.026)	3.041 (0.001)
AC financial expertise	2.031 (0.045)	1.699 (0.050)
Board size	2.458 (0.048)	2.393 (0.019)
R	0.345	0.335
R Square	0.119	0.113
F	2.546	2.384
Sig	0.033	0.044

The size of ACs was found to have a significant and positive effect on ROA which specifies that firms with more board members, more various knowledge and skills are engaged by the AC to improve monitoring. This is constant with the Resource Dependence Theory (RDT) (Dalton, Daily, Johnson, & Ellstrand, 1999). The size of ACs was found to be insignificant at the 5% level of significance with TQ. This was a sign of lower long-term debts in the capital structure among Sri Lankan firms. The occurrence of AC meetings had no effect on both firm performance measures. The insignificant coefficient could be a result of the less frequent meetings (AC's meet about two times a year in Sri Lanka) to demote the monitoring function of the firm.

AC independence was found to have a positive and significant coefficient on both performance measures, proposing that independent AC members are effective in controlling the function of a firm. This results is constant with Beasley, Carcello, Hermanson, and Lapedes (2000) who documented that financial reporting scams are more likely to arise in firms with fewer-AC independence. The results also document that AC accounting proficiency have a positive and significant effect on performance measure ROA and TQ. Thus it could be explained that existence of more board members with an accounting contextual knowledge and skill would activate more conventions to be held due to more corporate reporting issues being discussed.

Board size had a positive and significant impact on all measures of firm performance. Van den Berghe and Levrau (2004) argued that growing the digit of Board of Directors offers an improved pool of knowledge and thus larger Board Members are likely to have more abilities and skills at their disposal. Similarly, the RDT proposes that higher Boards may have a better ability to form environmental links and protected critical resources (Goodstein, Gautam, & Boeker, 1994)

## CONCLUSION

This study examined whether firm performance is influenced by AC attribute variables for selected listed firms in Sri Lanka for the sample period of 2014-2018. The outcomes of the research note that the association between AC attributes and firm performance has fair-to-strong predictive association in Sri Lanka. This maybe because the rules and guidelines were followed strictly by the firms in the sample period. The prime outcomes in this study are: first, the results note that the size of ACs is significantly connected to ROA, though the association is insignificant with TQ. Consequently, hypothesis  $H_1$  is supported for ROA as accounting performance measure and not-supported for TQ as market-based performance measures. Second, the frequency of AC meetings was not reveal to be connected to firm performance. Thus,  $H_2$  is not supported. Third, AC independence and AC financial expertise were found to be significantly related to firm performance. Thus, hypothesis  $H_3$  and  $H_4$  is supported in the case of Sri Lanka. Also, board size was found to be related to performance measure. Theoretically, it implies that active (i.e., proportion of the members possess accounting

knowledge and a high frequency of meeting) AC lead to an improved and effective monitoring mechanism in firms. This implies that firms can possibly enhance their performance by executing more active ACs. The level of AC activity reflects governance, and it should enhance the consistency of financial reporting quality. A prime constraint in this study flows from the difficulties inherent in discovering and adjusting for variations in the AC, financing portfolio and/or business scope across companies. Like most prior studies, this study examined only selected proxies for firm performance. There are numerous features which impact on firm performance and not all of them were utilised in this research to control the models mainly because of their lack of availability in the database. Future work can continue to examine the relationship between audit committees (ex., legal movement, gender diversity etc.) and firm performance.

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