

THE IMPACT OF AUDIT COMMITTEE CHARACTERISTICS ON EARNINGS QUALITY: EVIDENCE FROM LISTED COMPANIES IN SRI LANKA

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Abstract

This study examines the impact of Audit Committee Characteristics on Earnings Quality of Public Listed Companies in Sri Lanka. Several prior studies have examined this relationship in developed countries. There appears to be a dearth of literature on the subject in developing and Asian countries, and Sri Lanka in particular. This study contributes to the existing literature by integrating both Audit Committee Characteristics and Earnings Quality. A quantitative approach was adopted in the study to find answers to the research questions. Audit Committee Size, Audit Committee Independence, Number of Audit Committee Meetings, Financial Experience of Audit Committee Members and Percentage of Common Stocks Owned by Audit Committee were used as independent variables and Earnings Quality was used as the dependent variable of the study. Pooled data regression is used to analyse data. The used dataset covers all companies in the Colombo Stock Exchange in Sri Lanka except banks, finance and insurance companies and collected data for 5 5-year period from 2020 to 2024. Based on the regression estimate obtained, the study concludes that the earnings quality is significantly influenced by the financial experience of members of the audit committee and ownership of stocks by members of the audit committee, while the size of the audit committee, degree of independence of the audit committee and audit committee meetings have reported an insignificant impact on audit report lag. Findings of the study will be useful to identify the impact of disclosure quality on the financial performance of the listed companies in Sri Lanka. Findings also provide useful insights to regulators and policymakers in coming up with appropriate policies.

Keywords: Audit Committee Characteristics, Corporate Governance, Earnings Quality, Sri Lanka

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Introduction

Corporate governance has created significant changes in business environments in general and in the accounting and auditing professions. Interest in the role of audit committees has increased in the last few years because it is the tool of corporate governance, whose aim is to increase the questioning of the board of management and to increase the role of audit and its independence, after several financial failures of many local and international companies (Hamdan & Mushtaha, 2011). The Wild (1994) study found that the credibility and fairness of financial reports issued by companies depend on the existence of an audit committee emerging from management councils of such companies, while Martinez and Fuentes (2007) found that an audit committee would be more active in the process of monitoring financial statements and limiting the differences between the management and the external auditor. This reduces the company's probability of receiving qualified opinions from the external auditor, resulting from accounting errors or non-commitment to accounting standards. Many countries and local and international vocational bodies now spend more effort issuing instructions and standards, which, when adopted, help restore credibility in the financial data declared.

This also helps in activating the audit committee's role, which consolidates the functioning and independence of the external auditor as an impartial party providing their opinion on the declared financial data fairly and objectively. In July 2002, the USA's Sarbanes-Oxley law was described by analysts to be the most significant and comprehensive American legislation since the formation of the SEC because of its impact on general companies and independent accountants. Some of the large reforms that the legislation included were the right of declaration, submission of financial reports by foreign general companies' corporate governance, and accounting auditors' monitoring. According to Article 301 of the legislation, a particular part was made stressing the duties and formation of an audit committee to secure the safety and credibility of the external auditor's report, who might be subjected to managerial pressure. As for Sri Lanka, much legislation supporting corporate governance was issued to regulate the work of audit committees in Sri Lankan companies. This study attempts to discuss such legislation related to audit committees to ensure their Sri Lankan companies. Afterwards, the study tries to test the role played by audit committees in improving earnings quality. Qaraqish (2009) sees that earnings quality means the absence of such earnings from estimations and substitutes by which the company tries to get a targeted net return.

This study fills a knowledge gap about the ways in which audit committee attributes affect the quality of earnings in developing nations, especially Sri Lanka. There is still a dearth of empirical data from Sri Lanka despite a wealth of studies conducted in developed settings. As a result, the goal of this study is to determine how ownership, financial knowledge, meeting frequency, audit committee size, and independence impact the quality of earnings. By employing data from Sri Lankan listed companies to explore these correlations empirically, the study particularly seeks to close this gap.

Therefore, the issue is that rising market frameworks lack adequate empirical research. Determining the degree to which these audit committee attributes affect profit quality and offering insights that guide governance improvements in Sri Lanka are the main goals. Therefore, this study's main goal is to investigate how audit committee features affect the profit quality of Sri Lankan listed businesses. By doing this, it hopes to improve knowledge of the governance frameworks that support the integrity of financial reporting in developing nations.

Literature Review

Resource dependence theory, stakeholder's theory and agency theory are theories that have been recognised by the most extensively employed theoretical framework in accounting and corporate governance studies. Thus, for the aim of this research, agency theory is used as the theoretical framework in order to give a powerful theoretical framework. In this perspective, agency theory provides an obvious understanding of audit committee characteristics and earnings quality and admits these as the most important overseeing mechanisms that attenuate agency costs, regulate conflict of interest, and mitigate earnings management in the Sri Lankan context. An agency relationship arises when one or more principals (e.g., an owner) engage another person as their agent (or steward) to perform a service on their behalf (Jensen and Meckling, 1976).

Thus, the theoretical background of this study relies on the agency theory for two reasons: First, agency theory explains the demand for monitoring provided by audit committees and external auditors. Indeed, auditors and audit committees are perceived as agents of principals, which can lead to further concerns about trust, threats to objectivity and independence and an ongoing need to find further mechanisms such as regulation to align the interests of different stakeholders. Second, corporate governance actors, such as audit committees and external auditors, provide monitoring whose main value is dependent on their ability to decrease the likelihood that the company's financial reports contain breaches. Agency theory predicts that as agency problems become more severe, management will demand higher quality monitoring in an effort to ensure financial reporting quality to stakeholders. The major goal behind forming the audit committee is to increase auditing quality and the

questioning of the board of directors. Arens et al. (2009) define it as a group of people selected from members of the board of directors who are responsible for retaining the independence of the auditor. Conflicts between managers and outside auditors may exist in choosing alternative accounting procedures. Since auditors are appointed by the firm, they are subject to dismissal if divergent opinions cannot be resolved.

To a lesser extent, financial reports are often negotiated. In order to produce unbiased financial reports, audit committee members are appointed to act independently in order to resolve conflicts between the managers and outside auditors (Klein, 2002). Many studies were concerned with checking the qualities of audit committees as one of the tools of corporate governance, with many influences like controlling earnings management, improving financial reports, and earnings quality. The study of Stewart & Munro (2007) from Australia focused on the results of frequent meetings on the audit committee. They determined that the presence of an audit committee, the number of its meetings and the auditor's attendance for such meetings reduces audit risks, and that the external auditor believes that the presence of an audit committee is an important factor in reducing substantial risks of auditing. They further determined that reducing such risks is also affected by frequent meetings of the audit committee and the auditor's attendance of such meetings. Many of the definitions of earnings quality revolve around the two previous ones. Earnings quality is the ability of the present earnings to provide a real picture of the company and its ability to survive in the future.

The significance of earnings quality stems from the earnings on which many parties depend when they make their decision (Dechow & Dichev, 2002). Baxter & Cotter (2009) studied the formation and characteristics of audit committees and their impact on improving earnings quality in a sample of Australian companies before obligatory requirements were introduced to audit committees in 2003. The results of that study showed that forming an audit committee reduces earnings management but does not reduce accrual estimation errors. The study also showed that there was a significant relation between the financial experience of members of the audit committee and earnings quality improvement. The other qualities of the audit committee did not have any relatively significant relationship with earnings quality. Various studies provided many other factors influencing earnings quality. Teitel & Machuga (2010) found that supporting rules of corporate governance contributed to the improvement of earnings quality. The Blue-Ribbon Panel raised the issue of the background and experience of the audit committee that can affect their effectiveness. The Panel suggests that audit committee members should be financially literate.

Although earlier studies looked closely at audit committee traits and profit quality in industrialised nations, there is still little data from Sri Lanka. By empirically investigating these links in a growing market framework, this study closes this knowledge gap and offers insights into how governance methods function in various institutional contexts. The findings add to the larger global conversation on audit governance in emerging economies, which extends beyond the Sri Lankan context. For other emerging economies with different institutional frameworks, enforcement strategies, and cultural norms than developed countries, they provide comparative insights. Thus, by demonstrating how contextual factors influence audit committees' effectiveness in guaranteeing profit quality, the study adds to the body of knowledge on global governance.

Methodology

This study's sample consists of companies listed in the Colombo Stock Exchange (CSE) except banks, finance and insurance companies because they are highly regulated and follow a different form for their financial statements. In choosing the sample for the study, the following were considered: the study period for the empirical study is five years (From 2020/2021 to 2023/2024), and data were drawn from 180 listed non-financial companies. Independent variables of the research study are audit committee characteristics of the listed entities in CSE. This has been measured by using audit committee independence, the number of audit committee meetings, the financial experience of audit committee members and the percentage of common stocks owned by audit committee members. The dependent variable is earnings quality. Panel data regression analysis was used with EViews as part of a quantitative research methodology. Discretionary accruals were measured using the modified Jones (1991) model, with audit committee characteristics acting as independent variables.

Having reviewed each methodology and in light of their differences, this study has chosen to adopt a quantitative approach as it is more suited to the purposes of this research. The research focuses on finding the relationship between audit committee characteristics on the earnings quality of listed companies in CSE. CSE consists of 283 companies representing 20 GICS industry groups as of 31st December 2020. The corpus of the study is composed of all companies listed on CSE; the final sample consists of 180 companies. The secondary data are collected from annual audited financial statements and annual reports of each company accessed through the CSE website. The secondary data extracted were analysed using the multiple regression technique to test the formulated hypotheses. Moreover, supportive analysis will be carried out using descriptive statistics, which provide information on mean, standard deviation, minimum and maximum values of the set of data analysed, testing the assumptions of the linear regression model (autocorrelation, multicollinearity and homoscedasticity). Since this research consists of

panel data, the analysis will be conducted using EViews statistical software. Regression analysis, correlational analysis, and descriptive statistics will be used in the analysis stage.

Earnings quality was evaluated using the modified Jones model from 1991, as refined by Dechow et al. in 1995, which focuses on estimating discretionary accruals, a well-known indicator of earnings management. This model is appropriate for the Sri Lankan context as it considers the differences in accrual-based accounting practices typical in developing countries. Likewise, the chosen characteristics of the audit committee—such as size, independence, frequency of meetings, financial expertise, and ownership—are in line with the corporate governance code requirements in Sri Lanka and align with previous research on governance effectiveness in emerging markets.

Accordingly following regression model is formulated for the current study.

$$DA_{i,t} = \beta_0 + \beta_1 ACSIZE_{i,t} + \beta_2 ACINDP_{i,t} + \beta_3 ACMEET_{i,t} + \beta_4 ACEXP_{i,t} + \beta_5 ACOWNER_{i,t} + \beta_6 BIG4_{i,t} + \beta_7 COMSIZE_{i,t} + \beta_8 FINLEV_{i,t} + \beta_9 MGTOWN_{i,t} + \beta_{10} EATURN_{i,t} + \varepsilon_{i,t}$$

Where:

$DA_{i,t}$: the dependent variable discretionary accruals (Represents Earnings Quality) measured by Jones (1991) model for the company (i) in the year (t)

$ACSIZE_{i,t}$: number of audit committee members for the company (i) in the year (t) $ACINDP_{i,t}$: number of independent non-executive members in the audit committee for the company (i) in the year (t)

$ACMEET_{i,t}$: number of audit committee meetings for the company (i) in the year (t)

$ACEAAP_{i,t}$: number of members who are qualified in accounting, financial and banking. (i) in the year (t)

$ACOWNER_{i,t}$: percentage of common stocks owned by the audit committee for the company (i) in the year (t)

$BIG4_{i,t}$: control variable, dummy variable, size of the audit firm with the value of 1 if audited by Big4 and 0 otherwise for the company (i) in the year (t)

$COMSIZE_{i,t}$: is the control variable, the company size measured by the natural log of total assets for the company (i) in the year (t)

$FINLEV_{i,t}$: control variable, financial leverage ratio, total debts/total assets of the company (i) in the year (t)

$MGTOWN_{i,t}$: control variable, the percentage of the Common Stocks Owned by Members of the Board of Directors for the company (i) in the year (t)

$EATURN_{i,t}$: control variable, external auditor turnover, measured by the natural logarithm of external auditors' fee (i) at the end of the year (t)

Results and Analysis

Descriptive statistics

The largest DA is 11.34, which indicates maximum, and the minimum of 5.36 represents the lowest DA in the selected sample period. The mean DA for the sample is 0.39 with a standard deviation of 0.58. In case of ACSIZE maximum and minimum values for this variable are 6 and 2, respectively. The mean ACSIZE for the sample period is 3.14 with a standard deviation of 0.71. The largest ACINDP is 5, which is the maximum, and the minimum of 3 represents the lowest ACINDP in the sample period. The mean ACINDP for the sample period is 2.59 with a standard deviation of 0.458. The minimum ACMEET represents 1, and the maximum ACMEET represents 18 in the selected sample period. The mean of ACMEET for the sample period is 4.56 with a standard deviation of 1.82. The largest ACEXP is 4, which is the maximum, and the lowest of 1, represents the total number of financial expertise in the sample period. The mean ACEXP for the sample is 1.58 with a standard deviation of 0.76. The table also demonstrates that the percentage of shares owned by audit committee members (ACOWNER) ranged from zero to 78 percent, with a mean of 0.7 percent.

Table 1
Descriptive statistics

	DA	ACSIZE	ACINDEP	ACMEET	ACEXP	ACOWNER
Mean	0.393316	3.148889	2.594444	4.565556	1.584444	0.007666
Median	0.249451	3.000000	3.000000	4.000000	1.000000	0.000000
Maximum	11.34491	6.000000	5.000000	18.00000	4.000000	0.781034
Minimum	5.36E-07	2.000000	1.000000	1.000000	0.000000	0.000000
Std. Dev.	0.589083	0.710676	0.693985	1.820393	0.763883	0.060693
Skewness	9.838929	0.633239	0.438935	3.239304	1.025136	11.73349
Kurtosis	163.0497	3.787278	3.087981	19.35943	3.728644	145.8805
Jarque-Bera	975117.0	83.39154	29.18990	11610.13	177.5453	786208.1
Probability	0.000000	0.000000	0.000000	0.000000	0.000000	0.000000
Sum	353.9843	2834.000	2335.000	4109.000	1426.000	6.899624
Sum Sq. Dev.	311.9698	454.0489	432.9722	2979.132	524.5822	3.311562
Observations	900	900	900	900	900	900

(Source: Authors' Compilation)

Correlation analysis

There is a positive correlation for ACSIZE with DA. The correlation between ACINDEP and DA represents a positive correlation. In the case of determinants of earnings quality, the correlation between the ACMEET and DA is negative. ACOWNER, BIG4 and COMSIZE negatively correlated with DA independently. ACEXP, FINLEV and MGTOWN positively correlated with DA independently.

Table 2
Correlation analysis

Variable	ACSIZE	ACINDEP	ACMEET	ACEXP	ACOWNER	BIG4	COMSIZE	FINLEV	MGTOWN
DA	0.0831	0.0502	-0.0372	0.0161	-0.0306	-0.1213	-0.0151	0.1112	0.0140

(Source: Authors' Compilation)

Table 3
Multicollinearity analysis

Correlation	DA	ACSIZE	ACINDEP	ACMEET	ACEXP	ACOWNER
DA	1.000000					
ACSIZE	0.083171	1.000000				
ACINDEP	0.050249	0.596196	1.000000			
ACMEET	-0.037209	0.154952	0.090187	1.000000		
ACEXP	0.016185	0.394810	0.296533	-0.014784	1.000000	
ACOWNER	-0.030628	-0.037480	-0.085344	-0.017978	-0.035726	1.000000

(Source: Authors' Compilation)

Further, all the regressions used in the current study are adjusted using the Huber White Sandwich estimator, which provides control for heteroscedasticity and autocorrelation using the E-views statistical package. Outliers were identified in every variable and were removed using Microsoft Excel software before proceeding with the regression analyses.

Table 4
Hausman test

Correlated Random Effects - Hausman Test			
Equation: Untitled			
Test cross-section random effects			
Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	7.027141	10	0.7229

(Source: Authors' Compilation)

These results led to accepting the null hypothesis of the Hausman test, and therefore, the estimator of the random effect will yield identical results. Thus, the random effect model is more appropriate for the analysis.

Regression analysis

Since first objective of the current study is to examine the impact of audit committee characteristics and earnings quality. As discussed, based on the results of the Hausman test and redundant test, for which the results are summarised, the random effect model is proven to be more appropriate for the current study. Accordingly, the results of the random effect regression are summarised above. The results indicate that ACEXP significantly affects DA at the 5 percent level, and ACOWNER significantly affect DA at the 5 percent level, which leads to accepting H4 and H5. However, the ACEXP coefficient and ACOWNER coefficient are both negative. In contrast, ACSIZE, ACINDP, and ACMEET are not significant, which leads to rejecting H1, H2 and H3. In considering the probability value of the F-statistic, it reveals that the overall model is significant at the 5 percent confidence level, hence the probability value of the F-statistic represents 0.0005. When considering R-squared, all independent variables collectively explain 62% of the dependent variable of earnings quality. Since the Durbin-Watson value is around 2, there is no autocorrelation in the sample.

The study admits that Sri Lanka and developed market discrepancies may be explained by structural and institutional differences. For instance, the relationship between audit committees and profit quality may change as a result of Sri Lanka's concentrated ownership structures, relatively young capital market, and laxer implementation of governance standards. The inability to directly apply results from industrialised markets thus emphasises the importance of this study in placing governance effects in a developing country. The independence and efficacy of audit committees may be weakened by Sri Lanka's strong family ownership concentration, lax regulatory enforcement, and cultural norms that place a strong emphasis on relational governance. These elements impact the supervisory practices of audit committee members, which in turn impact the results of earnings quality. A more sophisticated understanding of why governance systems in Sri Lanka could produce different outcomes than in developed environments can be gained by acknowledging such institutional restrictions. The results show that while size, independence, and meeting frequency have no discernible impact on earnings quality, audit committee members' financial knowledge and ownership do. This implies that personal incentives and technical proficiency can be more important in gauging efficacy than just structural characteristics. The findings reveal contextual variations stemming from Sri Lanka's governance environment, while also aligning with other research (Hamdan & Mushtaha, 2011).

Conclusion

In light of the findings of the study and the critical discussion of the factors that impede the audit committee characteristics, it is possible to make the following recommendations to increase earnings quality in Sri Lanka: It was found that stock ownership by members of the audit committee reduces their independence and limits their ability to improve earnings quality. Based on these findings, it can be recommended to limit the ownership of the audit committee. In general, there is a recommendation to the organisers of works of listed companies, like the stock market and government authorities, to support the mechanism of corporate governance. This will secure more transparency in disclosures, reduce practices of earnings management, and improve earnings quality, as they all leave a significant impact on the economic decisions of many parties. This study aims to identify the impact of disclosure quality on the financial performance of the listed companies in Sri Lanka. There are lack studies have been conducted in relation to this topic. The importance of this study is to look for relationships between the audit committee characteristics and earnings quality in Sri Lanka, which regularly takes steps towards the regulatory and legislative structure to support economic development. This distinguishes this study from other studies conducted in the United States and Australia.

The benefit of this study is not limited to the investors but will help the whole stakeholders that affect and get affected by the organisation. Even though all knows that the audit committee is important to the company. This study will go one step further and explain the relationship between audit committees and earnings quality. So, it will help regulators and policymakers in coming up with appropriate policies. The findings of this study could be compared with other Asian or developing countries that share similar socio-economic environments, as well as with other developed countries. The results of this study should help researchers or other parties interested in the audit committee characteristics since they highlight the most significant factors that may cause earnings quality in the Sri Lankan context.

Anyhow, the reliance on secondary financial data may overlook qualitative factors, such as managerial attitudes and internal control quality. Hence, future research could adopt mixed methods or extend the study period to enhance generalizability. To validate the results, future research might do cross-country assessments across similar growing economies, such as Malaysia or India. Understanding the contextual governance issues in developing economies will also be strengthened by incorporating qualitative insights from board and audit committee member interviews.

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