

**AUDIT COMMITTEE ATTRIBUTES AND FIRM PERFORMANCE:  
EVIDENCE FROM LISTED COMPANIES IN COLOMBO STOCK  
EXCHANGE**

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**ABSTRACT**

The Audit Committee (AC) is the potential mechanism that reduces the principal and agent problems (agency problems) in organizations and investigating this mechanism separate from alternate corporate governance mechanisms may have led to different results in the literature. The purpose of this study is to empirically examine the impact of AC attributes on firm performance of listed companies in Sri Lanka. Firm performance is measured by Return on Assets (ROA) and Tobin's Q (TQ) while AC attributes consists of AC size, AC independence, AC meetings and AC financial expertise. Sixteen listed companies in Colombo Stock Exchange were selected as the sample. In this study, data was collected from secondary sources and hypotheses are examined by using multiple regression analysis. The results reveal AC attributes such as AC size, and AC independence have a significant impact on both ROA and TQ. AC meeting and AC financial expertise are not found to have a significant impact on firm performance.

**Keywords:** Audit Committee; Audit Committee Financial Expertise; Audit Committee Independence; Audit Committee Meetings; Audit Committee Size; Firm Performance

**JEL Classification:** M40

**1. INTRODUCTION**

AC is one of the main pillars of the corporate governance system in Sri Lankan companies. In steering companies through today's complex business environment, boards are going to need strong leadership from their ACs. The quality of the audit and assurance practice is governed by the Sri Lanka Auditing Standards and Sri Lanka Accounting Standards lay down by the Institute of Chartered Accountants of Sri Lanka. ACs are considered a main constituent of effective corporate governance systems. Their core responsibility is to oversee the process of financial reporting to make sure managers ethically report their firm's performance and to reduce information asymmetry. The intricacy of the financial and accounting reporting

issues reviewed by AC members requires substantial director resources in terms of the number of directors, director expertise and time dedicated to the committee work (Sultana, 2015). Accordingly, AC monitoring effectiveness depends on the committee's size, independence (Klein, 2002), expertise (Kusnadi et al., 2016) and meeting frequency (Anderson et al., 2004).

The AC is one of the committees of the board of directors in the organization. Its major function is to perform the monitoring role of the board through evaluation of presentable financial information to investors and other users of financial information, to run the internal control systems provided by management, and to conduct its subsequent audit processes. Members of the AC are appointed among independent and non-executive managers by the board. The AC, as the representative of the company board provides the guarantee and secures the increase of shareholders' interest.

In light of major accounting scandals (e.g. WorldCom and Enron) and the 2008 financial crisis, the role of corporate governance, particularly the audit committee, in ensuring financial reporting integrity has been greatly empowered (Wilbanks et al., 2017). AC are considered a main constituent of effective corporate governance systems. Their core responsibility is to oversee the process of financial reporting to make sure managers ethically report their firm's performance and to reduce information asymmetry.

According to the Code of Best Practice on Corporate Governance (2013) issued jointly by the Securities and Exchange Commission of Sri Lanka and the Institute of Chartered Accountants of Sri Lanka, the AC should be comprised of a minimum of two independent non-executive directors or exclusively by non-executive directors, a majority of whom should be independent, whichever is higher. The guideline further requires that the chairman of the committee should be a non-executive director, appointed by the board. Due to the position of AC as the most important committee and the fact that prior studies have shown that not all of the ACs are effective, this paper examine the impact of AC attributes on the performance of listed companies in Sri Lanka in order to determine which of the AC attributes enhances performance of listed hotels and travels in Sri Lanka.

Therefore, the purpose of the study is to investigate the audit committee attributes on firm performance of Sri Lankan listed companies for the financial year 2012-2017. Performance measurement system plays an important role in evaluating the achievement of firms' goals, compensating managers and developing strategies.

With increasing competition and technology changes, designing a performance measure is critical to survival and success of institutions.

### **Problem Statement**

The AC helps to management to achieve the goals of the organization, some of which include ensuring that management fulfils its responsibilities in preparing financial reports and improvement in financial performance. Although many Sri Lanka listed companies had appointed an AC as in many other Asian countries (OECD White Paper 2003), a transparent procedure was absent in the determination of directors' remuneration in them (Senaratne and Gunaratne, 2007). The prominence of AC in Sri Lankan companies may have been associated with the dominance of accounting professionals in the boards of these companies and the developed accounting profession in Sri Lanka (Senaratne, 2007). However, the appointment of a nomination committee to oversee board appointments including succession planning and performance evaluation of directors is not yet mandatory for listed companies except for licensed commercial banks for which it is mandatory under the Central Bank Direction. It is questionable why the Listing Rules have not made the establishment of a nomination committee mandatory. A proper and transparent procedure on board appointments is a key to have an effective board as the roles and responsibilities of directors underpin the task of corporate governance. The lack of transparency in the board appointments has also been found as a negative corporate governance feature in many Sri Lankan listed companies (Senaratne & Gunaratne, 2007). Hence, this area needs special attention.

AC has been largely criticized for the decline in shareholders' wealth and corporate failure. Some of the reasons stated for these corporate failures are the lack of internal control by the audit committee directors, and audit committee meets for just formality. As a result, various ACs features are reforms in this study of the impact of audit committee on firm performance. AC characteristics and performance are considered as an important problem nowadays in the Hotels and Travels companies in Sri Lanka. Conducting a research based on this problem will enlighten the managers and the shareholders of the firm of how to overcome some of the issues related to AC and performance. To address this issue the study was undertaken to explore the answer to the following research question: To what extent AC impacts on firm performance?

## **2. LITERATURE REVIEW**

According to the agency theory, the AC has a significant role in implementing the principles of corporate governance and in increasing firm value. The AC improves

firm performance through enhancing information quality. It validates the sufficiency and integrity of information supplied by management and disseminated to shareholders and stakeholders in order to diminish information asymmetry and alleviate interest conflicts (Anderson et al., 2004; Agyemang-Mintah & Schadewitz, 2018).

Karamanou and Vefas (2005) identified a positive association between presence of AC and firm performance. Mangena et al. (2012) found that the existence of AC in a company helps to enhance compliance with the regulatory requirements thereby reducing the possibility of the suspension of the firm from the South African stock exchange. AC may be unable to perform the monitoring role effectively due to lack of independence from management, expertise and because of the additional responsibilities imposed on the committee by the regulatory bodies (Yatim, 2009).

Wan Ismail et al. (2009) supposed that independent AC functions better than less independent committee. AC composed of majority independent directors is likely to provide more monitoring due to its ability to resist pressure from the management. In a review conducted by Ghafran and O'Sullivan (2013), they found that high-audit coverage is associated positively with independent ACs. They also reported that independent AC preserves the independence of the external audit by purchasing less non-audit services from their external auditor. Bronson et al. (2009) argued that independent AC will ensure effective monitoring only when the committee is fully independent but not when there is a majority of independent directors. Chan and Li (2008) found performance of companies to be positively related with the presence of expert independent directors (expert independent directors defined as top executive of other listed firms) on AC.

The need for expert directors on the AC was emphasized as a result of prior financial crises and previous corporate scandals (Güner et al., 2008). Davidson et al. (2004) report that market valuation of a firm is positively related with appointment of a director with finance expertise on AC. Ghafran and O'Sullivan (2013) documented that investors value the presence of AC and they perceive the appointment of expert director on AC positively. The presence of accounting or finance expert on AC will enhance the quality of financial reporting (Abbott et al., 2004) and internal control oversight (Krishnan and Lee, 2009).

Furthermore, the presence of accounting or finance expert will help a company to prevent the incidence of accounting misstatement, help reduce possibility of litigation against the company and reduce the attention of regulators on the company. The effectiveness of members of the AC in discharging their functions

depends on their level of expertise in accounting and finance (Raber, 2003). The various scandals, the nature of operations and assets of finance companies make the appointment of accounting or finance expert very important to finance companies. The presence of expert directors on AC enhances the effectiveness of AC in performing its monitoring function (Carcello et al., 2011).

Although the presence of expert is associated with enhanced controls and reduced chances of accounting manipulations (Krishnan, 2005; Dhaliwal et al., 2006), the ability of a company to attract accounting or finance experts depends on the quality of governance arrangements in a particular company (Krishnan and Lee, 2009). In addition, the effect of expertise of directors on AC may not be significant for all types of companies and may vary with company's lifecycle stage (Carcello et al., 2011). The complexity of accounting and auditing issues facing companies requires the AC to have members that have expertise in accounting and finance (Abbott et al., 2004). Expertise is required so that the directors will be able to understand audit risk and measures to prevent and detect those risks, understand financial statements and financial reporting issues including issues that involve management's judgment and in case of dispute between external auditor and management, the directors will be able to understand the basis of the disagreement and reconcile between the parties (Dezort, 1998).

Ravindran et al., (2018) found that AC size and AC meeting have a significant negative relationship with share price of banking and finance companies while board size and company age is significant and positively related with share price. The AC independence is non-significant and negatively related with share price. Further the study revealed that there is negative and non-significant relationship between firm size and share price. Balagobei and Velnampy (2018) documented that AC characteristics such as AC independence, AC experts and AC meetings have a significant impact on organizational performance of listed hotels and travels in Sri Lanka. Further AC size is not found to have a significant impact on the organizational performance.

### **Hypotheses Development**

Based on the above discussion, the following hypotheses are developed:

**H<sub>1</sub>: Audit committee size significantly impacts firm performance**

**H<sub>2</sub>: Audit committee independence significantly impacts firm performance.**

**H<sub>3</sub>: Audit committee meetings significantly impact firm performance.**

**H<sub>4</sub>: Audit committee financial expertise significantly impacts firm performance.**

### **3. RESEARCH METHODOLOGY**

Research methodology is the roadmap that deals with the manners in which data is collected, analysed and interpreted in order to achieve research objectives. This study focuses on AC characteristics and its impact on the performance in Sri Lankan listed hotels and travels companies.

#### **3.1. Sample and Data**

The population of the study comprises firms listed under hotel and travels sector in Colombo Stock Exchange (CSE). The Colombo Stock Exchange (CSE) has 299 companies representing 20 business sectors as at 29<sup>th</sup> March 2018, with a Market Capitalization of Rs. 3,032.7 Bn. The samples of the study are taken from the listed companies of the Hotels and Travels sector in Sri Lanka and choose 16 companies out of 38 companies listed in Colombo Stock Exchange using convenience sampling technique. The data is collected for the period of 6 years from 2012 to 2017.

In order to meet the objectives of the study, data is collected from secondary sources mainly from company's annual reports of Listed Companies of the Hotels and Travels sector in Sri Lanka and magazines of the listed Companies of the Hotels and Travels sector in Sri Lanka. Sri Lanka is one of the well-known holiday destinations for its remarkable natural tourism resources and authentic food culture. Even though tourists enjoy the tourism experience in Sri Lanka, the hotel industry has faced issues with limited resources.

The hotel sector of Sri Lanka has become competitive by nature after the cessation of the 30-year civil war since peace has prevailed, and the country is experiencing considerable growth in the arrivals in international tourism. However, prior to 2009, the country faced a long and dormant period where the tourism industry came virtually to a standstill. The hotel sector of the country requires to be well equipped to be competitive; since the tourism sector of the country is faced with considerable competition from the East Asian nations where they also offer certain interesting tourism destinations. Further, it is important to note that the hotel sector of the country needs to be capable of withstanding future fluctuations in the tourism sector, irrespective of the conditions of the local economy. Therefore, this study focuses on hotels and travels sector listed in Colombo Stock Exchange.

#### **3.2. Model specification**

The multiple regression analysis is carried out in order to investigate the simultaneous impacts of all the independent variable having on the dependent

variable. The regression model is used to examine the influence of audit committee attributes on firm performance.

$$ROA_{it} = \beta_0 + \beta_1 ACS_{it} + \beta_2 ACI_{it} + \beta_3 ACM_{it} + \beta_4 ACFE_{it} + \beta_5 FS_{it} + \beta_6 FL_{it} + \varepsilon_{it} \quad (1)$$

$$TQ_{it} = \beta_0 + \beta_1 ACS_{it} + \beta_2 ACI_{it} + \beta_3 ACM_{it} + \beta_4 ACFE_{it} + \beta_5 FS_{it} + \beta_6 FL_{it} + \varepsilon_{it} \quad (2)$$

Where:

$\beta_0, \beta_1, \beta_2, \beta_3, \beta_4, \beta_5, \beta_6$	- Regression coefficient
ROA	- Return on Assets
TQ	- Tobin's Q
ACS	- Audit committee size
ACI	- Audit committee independence
ACM	- Audit committee meeting
ACFE	- Audit financial expertise
FS	- Firm size
FL	- Financial leverage
$\varepsilon$	- Error term
i	- Firms
t	- Years

### 3.3. Operationalization

The measurements for the variables of the study are as follows.

**Table 01: Operationalization**

Concepts	Variables	Measurement
<b>Firm Performance</b>	Tobin's Q	[Market Capitalization + Total Assets – Shareholders Fund] / Total Assets
	Returns on Assets	Net Income / Total Assets
<b>Audit Committee</b>	Audit Committee Size	Number of audit committee members
	Audit Committee Independence	Proportion of independent directors to audit committee size
	Audit Committee Meetings	Number of meetings held in financial year
	Audit Committee Financial Expertize	Proportion of audit committee members with financial expertise to the total number of audit committee members
<b>Control Variable</b>	Firm Size	The log of book value of the total assets
	Financial Leverage	Debt / Equity

## 4. EMPIRICAL RESULTS

### 4.1. Descriptive Analysis

Descriptive analysis represents the mean, median, maximum, minimum and other characteristics of audit committee variables and firm performance measured by ROA and Tobin's Q in Sri Lanka during the period of 2012 to 2017.

**Table 02: Descriptive statistics**

	ACS	ACI	ACM	ACFE	FS	FL	ROA	TQ
Mean	3.1770	0.7500	4.2187	0.5512	6.3124	0.2575	0.0722	1.5207
Median	3.0000	0.6666	4.0000	0.6666	6.2688	0.1532	0.0666	1.3244
Maximum	4.0000	1.0000	9.0000	1.0000	7.5100	1.2397	0.2223	3.7500
Minimum	2.0000	0.5000	2.0000	0.0000	5.0823	0.0015	-0.0081	0.4408
Std. Dev.	0.4587	0.1524	0.9646	0.2330	0.5348	0.2751	0.0459	0.7734
Skewness	0.6410	0.7878	1.8857	0.0257	0.1154	1.8231	0.7894	0.7861
Kurtosis	3.6043	2.2840	9.8683	2.5467	2.4123	5.5273	3.4605	3.1178

Table 02 presents the descriptive statistics of all variables employed in this study. On average companies have the audit committee size of 3. The maximum available audit members on the board in the sample are 4. The standard deviation is only 0.459 (aprox.) audit members. Profile analysis shows that companies have the audit independence of 75% on average. This table also shows that the average audit committee experts of 55 % (aprox.) with a standard deviation of 0.233 and has a wide range from 1 to 0. Audit meeting has the average of 4.218 held per year with the standard deviation of 0.964. Average firm size is 6.312 with standard deviation of 0.534. Average of ROA and Tobin's Q are 0.072 and 1.521 respectively. There is a highest standard deviation of Tobin's Q and lower ROA.

### 4.2 Correlation Analysis

The Pearson's correlation co-efficient analysis is to measure the liner relationship between two variables. The table 3 shows the association between audit committee variables and firm performance variables.

According to the table 03 the value of correlation between audit committee size and Tobin's Q is 0.5839 which is significant at 0.01 levels; indicates that there is a moderate positive association between audit committee size and Tobin's Q while the value of correlation between audit committee independence and Tobin's Q is 0.5661 which is significant at 0.01 levels, represents positive moderate association between audit committee independence and Tobin's Q. Other AC variables such as audit



committee meeting, audit committee financial expertise and control variables of firm size and firm leverage have an insignificant association with Tobin's Q. Among audit committee variables and control variables, only audit committee independence has positive moderate association with ROA. This is indicated by the correlation value 0.5548 which is significant at 0.01.

**Table 03: Correlation Matrix**

	ACS	ACI	ACM	ACFE	FS	FL	ROA	TQ
ACS	1.0000							
ACI	0.5345	1.0000						
	0.0000	-----						
ACM	0.1018	0.2262	1.0000					
	0.3235	0.0267	-----					
ACFE	-0.3073	0.1810	0.0542	1.0000				
	0.0023	0.0776	0.5995	-----				
FS	0.1241	0.3140	0.3582	0.0942	1.0000			
	0.2283	0.0018	0.0003	0.3612	-----			
FL	0.5064	0.0035	0.2279	0.1662	0.3844	1.0000		
	0.0000	0.9728	0.0255	0.1055	0.0001	-----		
ROA	0.0899	0.5548	0.0576	0.1529	0.0053	0.0294	1.0000	
	0.3835	0.0000	0.5769	0.1368	0.9586	0.7758	-----	
TQ	0.5839	0.5661	0.1055	0.2029	0.1391	0.2867	0.4352	1.0000
	0.0000	0.0000	0.3063	0.0474	0.1765	0.0046	0.0000	-----

### 4.3 Regression Analysis

In order to examine the impact of audit committee on firm performance measured by ROA and Tobin's Q, Least Squares method by using E-views is performed in this study.

According to the table 04, coefficient of determination for audit committee variables (Adjusted R<sup>2</sup>) is 0.3966 which denotes that 39.66% of the observed variability in ROA can be explained by the differences in the variables such as audit committee size, audit committee independence, audit committee meetings, audit committee financial expertise, firm size and financial leverage. The remaining 60.34% of the variances is related to the other variables which are not depicted in this model. In this analysis, F statistic is 11.40793, p < 0.01, indicated that the model is significant. It means that the regression results are acceptable for this analysis and all variables (audit committee size, audit committee independence, audit committee meeting,

audit committee financial expertise, firm size and financial leverage) jointly in the model significantly affect the ROA at 1% significant levels.

**Table 04: Multiple Regression analysis for ROA**

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.128536	0.051169	2.511973	0.0138
ACS	-0.047640	0.012562	-3.792262	0.0003
ACI	0.064586	0.008067	8.006462	0.0000
ACM	-4.16E-05	0.004163	-0.009994	0.9920
ACFE	-0.020878	0.016793	-1.243211	0.2171
FS	-0.008826	0.008490	-1.039516	0.3014
FL	0.035091	0.019022	1.844709	0.0684
R-squared	0.434732	Mean dependent var		0.072215
Adjusted R-squared	0.396625	S.D. dependent var		0.045993
S.E. of regression	0.035726	Akaike info criterion		-3.755742
Sum squared resid	0.113596	Schwarz criterion		-3.568758
Log likelihood	187.2756	Hannan-Quinn criter.		-3.680160
F-statistic	11.40793	Durbin-Watson stat		1.391359
Prob(F-statistic)	0.000000			

Among the all four audit committee variables considered in the analysis, only two audit committee variables have a significant impact on ROA which are audit committee size and audit committee independence. Audit committee size has a significant negative influences on ROA ( $\beta = -0.047640$ ,  $p < 0.01$ ), while audit committee independence has a significant positive influences on ROA ( $\beta = 0.064586$ ,  $p < 0.01$ ) at 1% significant level. The coefficients of other variables show that audit committee variables which are audit committee meeting and audit committee independence and control variables (firm size and financial leverage) have no significant impact on ROA.

According to the table 05, coefficient of determination for AC variables (Adjusted  $R^2$ ) is 0.4068 which denotes that 40.68% of the observed variability in Tobin's Q can be explained by the differences in the variables such as AC size, AC independence, AC meeting, AC financial expertise, firm size and financial leverage. The remaining 59.32% of the variances is related to the other variables which are not depicted in this model. In this analysis, F statistic is 11.85948,  $p < 0.01$ , indicated that the model is significant. It means that the regression results are acceptable for this analysis and all variables AC size, AC independence, AC meetings, AC financial expertise, firm

size and financial leverage) jointly in the model significantly affect the Tobin's Q at 1% significant levels.

**Table 05: Multiple regression analysis for Tobin's Q**

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-1.680489	0.853179	-1.969678	0.0520
ACS	0.469898	0.209460	2.243379	0.0274
ACI	0.527101	0.134503	3.918881	0.0002
ACM	0.006066	0.069415	0.087393	0.9306
ACFE	-0.073918	0.280009	-0.263984	0.7924
FS	0.056682	0.141563	0.400398	0.6898
FL	0.442165	0.317174	1.394076	0.1668
R-squared	0.444295	Mean dependent var		1.520798
Adjusted R-squared	0.406832	S.D. dependent var		0.773445
S.E. of regression	0.595688	Akaike info criterion		1.871920
Sum squared resid	31.58108	Schwarz criterion		2.058904
Log likelihood	-82.85218	Hannan-Quinn criter.		1.947502
F-statistic	11.85948	Durbin-Watson stat		0.842709
Prob(F-statistic)	0.000000			

Among the all four AC variables considered in the analysis, only two AC variables have a significant impact on Tobin's Q which are AC size and AC independence. AC size has a significant positive influences on Tobin's Q ( $\beta = -0.469898$ ,  $P < 0.05$ ), similar pattern is observed in audit committee independence that has a significant positive impact on  $\beta$  ( $\beta = 0.527101$ ,  $P < 0.01$ ). The coefficients of other variables show that AC variables which are AC meeting and AC independence and control variables (firm size and financial leverage) have no significant impact on Tobin's Q.

Hypothesis ( $H_1$ ) states that AC size significantly impact firm performance. According to the table 04 and table 05 there is a significant impact of AC size on firm performance measured by ROA ( $P = 0.0003 < 0.05$ ) and significant positive impact of audit committee size on firm performance measured by Tobin's Q ( $P = 0.0274 < 0.05$ ), as a result  $H_1$  is supported. This finding is collaborated with previous studies such as Karamanou and Vefas (2005) and Mangena et al. (2012). Hypothesis ( $H_2$ ) states that AC independence significantly impact firm performance. According to the table 04 and table 05 there is a significant positive impact of AC independence on firm performance measured by ROA ( $P = 0.0000 < 0.05$ ) and TQ ( $P = 0.0002 < 0.05$ ), as a result  $H_2$  is supported. This is collaborated with studies of Ghafran and O'Sullivan (2013), Bronson et al. (2009) and Chan and Li (2008)

Hypothesis (H<sub>3</sub>) states that AC meeting significantly impact firm performance. According to the table 04 and table 05 there isn't a significant impact of AC independence on firm performance measured by ROA ( $P=0.9920 < 0.05$ ) and Tobin's Q ( $P=0.9306 < 0.05$ ), as a result H<sub>3</sub> is not supported. Hypothesis (H<sub>4</sub>) states that AC financial expertise significantly impact firm performance. According to the table 04 and table 05 there isn't a significant impact of AC independence on firm performance measured by ROA ( $P=0.2171 < 0.05$ ) and Tobin's Q ( $P=0.7924 < 0.05$ ), as a result H<sub>4</sub> is not supported.

## 5. CONCLUSION

The overall goal of this study is to investigate the impact of various AC attributes, such as the AC size, AC independence, AC meetings and AC financial expertise on the firm performance measured by ROA and TQ for the listed hotels and travels firms in Sri Lanka. Audit committee attributes such as AC size and AC independence have a significant impact on both ROA and TQ of listed hotels and travels firm in Sri Lanka. The results of the study suggest that some features of audit committees in Sri Lanka are relevant with firm performance in term of ROA and TQ.

The findings could be useful to regulators in other jurisdiction who are looking at ways to enhance the effectiveness of AC, overall firm governance and enhance investors' confidence in the firms. Future studies could examine other committee attributes such as size, individual characteristics of the directors on the committee and the internal processes of the committee.

Furthermore, the study used secondary data; future studies could use primary data or a combination of primary and secondary data. Finally, future studies could consider taking a qualitative approach to examine the impact of AC attributes on value relevance of accounting information.

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