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CORPORATE GOVERNANCE AND AUDIT QUALIFICATIONS IN SRI LANKA: DOES CORPORATE GOVERNANCE MATTER?

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ABSTRACT

The aim of this study is to investigate the corporate governance role of external audits in Sri Lanka as an emerging market context. Using a sample of Sri Lankan firms, the paper uses regression analysis techniques to test the corporate governance (i.e., block ownership, family ownership, insider ownership, board size) and qualified opinion (indicating whether the firm receives qualified opinion). The empirical evidence indicates that ownership concentration (i.e., block ownership, family ownership, insider ownership) provides better corporate governance leading to higher quality financial reporting and therefore, less likelihood of receiving qualified audit reports. Whilst, board size is insignificantly positively related to audit qualifications implying that possibility of receiving an audit qualification. These findings provide Sri Lankan listed firms with an insight on how to improve/practice their financial reporting quality and audit mechanisms. These results can also serve as a useful reference for firms and the academics concerning future strategies and decision making.

Keywords: Corporate governance, audit report, audit qualification, Sri Lanka

1. INTRODUCTION

Cadbury (1992) defines corporate governance (CG) as the system by which firms are directed and controlled. CG is the mechanism, by which firms are rationalized, directed, controlled and monitored (Dissabandara, 2006). It is concerned with the duties and responsibilities of a firm's board of directors to successfully lead the firm, and their relationship with its shareholders and other stakeholder groups. It affects the development and functioning of capital markets and experts a strong influence on resource allocation due to it reduces shareholders' monitoring and auditing cost (Pedro-Sánchez-Ballesta & Garcia-Meca, 2005). Prior studies predominantly using data from the USA, the UK and Australia have investigated the association between governance mechanisms and the financial reporting process. Nevertheless, CG characteristics and the legal system of investor protection may also influence the role of statutory auditors and the demand for audit quality (Piot, 2001). DeFond, (1992) states that the demand for audit quality is a function of the agency conflict caused by the disparity between management and ownership incentives. The study is motivated by the dearth of literature on corporate governance and audit qualifications in the developing world despite the increasing interests in the topic in both the developed and the developing world. Whereas, some prior studies have investigated whether well-governed firms receive more non-qualified audit reports than the rest. As explained by Pedro-Sánchez-Ballesta and Garcia-Meca (2005), this study focuses explicitly on the end result of the audit decision process: the presence or absence of a qualification, which is the central concern of the financial statement user. The difficulty of the qualified report decision may render the auditor susceptible to management pressure. A good CG could help the auditor mitigate such pressure, so that this study expects that under certain governance characteristics auditors are more likely to mitigate any management pressure to issue a clean opinion. This study extends this line of research and examines the relation between CG and audit qualification in emerging markets such as Sri Lanka. The examination of the association between CG and audit qualification in Sri Lanka is motivated by specific reasons. Sri Lanka is an emerging economy and it is still considered developing. Since the conclusion of the civil war in 2009, Sri Lanka has witnessed considerable economic progress despite some ongoing political issues. Post war recovery reform of the financial system has been pivotal in accelerating economic growth, with Sri Lanka recently adopting several economic reforms (e.g., infrastructure development, deregulation and fostering integration into international markets). Accordingly, Sri Lanka is an appealing case to study because it is likely that CG practices used by Sri Lankan listed firms are different from those practiced in developed markets. While the empirical results provide evidence from a strong and sophisticated capital market (Piot, 2001), very little research has been conducted in countries where capital markets are less developed and where CG are still developing. Moreover, this study would hopefully benefit academics, researchers, policy-makers and practitioners of Sri Lanka and other similar countries through exploring the relationship between GC and audit qualifications, and pursuing strategies to improve the current status of it.

This paper is organized as follows: Section 1.2 presents a review of the empirical studies that investigate the association between CG and audit qualifications; Section 1.3 addresses research methods; Section 1.4 reports the results and discussion; and Section 1.5 summarizes the conclusion.

1.1 Literature Review and Hypotheses Development

Corporate governance refers to a set of internal and external control mechanisms looking to protect public shareholders' interests (John & Senbet, 1998; Engel, Gordon, & Hayes, 2002). These mechanisms allow fund providers to guarantee the return of their financial investments (Shleifer & Vishny, 1986). Whilst, the way in which corporate governance is organized differs between countries, depending on the economic, political and social contexts. Since corporate governance varies significantly from country to country, it is likely to play an important role in determining the severity of agency problems arising between managers and shareholders. Quality financial reporting can only be achieved through open and candid communication and close working relationships among the firm's board of directors, management, internal and external audit (Rezaee, Olibe, & Minmier, 2003). Accordingly, some studies have examined the influence of corporate governance variables in the likelihood that a firm obtains an audit qualification. Keasey, Watson, and Wynarczyk (1988) examined in UK the extent to which a number of variables are able to explain the receipt of a small audit qualification. The main empirical findings showed that companies audited by large audit practices, firms which had a prior year qualification, a secured loan, declining earnings, large audit lags and few non-director shareholders were more likely to receive an audit qualification than other companies. Citron and Taffler (1992) explored the value of the audit report in the context of the going concern qualification (GCQ) decision along the joint dimensions of auditor competence and independence with a large sample of UK quoted firms. The results revealed a positive relationship between the objective likelihood of company failure and the probability of a going concern opinion, although it only happens when the probability of failure is very high. In addition, the findings showed that smaller UK audit firms do not appear to exhibit lower going concern opinion rates than do large firms. An audit qualification can be modelled as an economic decision by the auditor (Antle, 1982; Smith, Schatzberg, & Waller, 1987). Chow (1982) argues that in the presence of costly contracting the probability that a firm will voluntarily engage an auditor increases as managerial ownership decreases. The argument, which is developed from Jensen and Meckling (1976), implicitly holds the leverage of the firm constant. Chow (1982) subsequently develops a leverage hypothesis which predicts that auditors will be used more firequently when debt levels increase. As the percentage of shares held by the management of a firm increases, the potential cost of an adverse audit opinion falls because the accounting reports (prepared by managers and directed to shareholders) increasingly become management reports to owner-management. The stewardship function is less important for a firm where managers own a larger proportion of the equity capital (Chan & Walter, 1996). Large audit firms may have greater synergies in conducting audits and detecting reporting abnormalities compared with small firms. Large firms achieve higher audit accuracy compared with small firms (Francis & Stokes, 1986; Nelson, Ronen, & White, 1988). Large firms are more likely to qualify an audit report to protect their reputation. On the other hand, litigation losses are likely to be more important in small audit firm decision-making because first, they carry lower professional indemnity insurance and second, they command access to a smaller asset structure. This argument suggests that small firms are more likely to issue qualified opinions compared with large firms (Chan & Walter, 1996). Another study by Shevlin and Whittred (1984) examined the stock market's reaction to qualified audit reports. There is no substantive evidence that qualifications affect equity prices in the month of their announcement. However, there is evidence that firms that receive certain types of qualification experience negative abnormal returns in the twelve months preceding this event. Salehi and Alinya (2017) note that there is a weak relationship between corporate governance auditors switching which indicates that there are some other effective factors on which selecting and switching auditors in studied companies are more dependent. The another study provides supporting evidence for the complementary association between a company’s governance and audit fees (AlQadasi & Abidin, 2018). Al-Najjar (2018) notes that corporate governance mechanisms are important in determining audit fees. Accordingly, this research seeks to reduce a gap in the extant literature on the relationship between corporate governance and audit qualifications. The research into the relationship between corporate governance and audit qualifications has also been frequently conducted in previous years (Chan & Walter, 1996). The studies conducted in this area, have been inconclusive (i.e. mixed results). The mixed outcomes of that research suggest that a significant gap exists in understanding the nature, intensity and direction of the relationship between corporate governance and audit qualifications.

2. METHODOLOGY

Initially, the population of interest in this study was 290 Colombo-Stock-Exchange (CSE) listed firms, as at February 2018. In selecting the study population, this study excludes financial, investment and securities-sector firms, because their unique financial attributes, intensity of regulation, and/or intensive use of leverage are likely to confuse and/or foul the outcomes being studied. Also, the risk of missing data was reduced by excluding firms that were not listed throughout the review period. After the eliminations, the remaining population was 150 Sri Lankan CSE-listed firms. Secondary data were obtained 2016-18, CSE's database.

2.1 Measurement of variables

The general model used to determine which factors influence the receipt of an audit qualification is as follows:

$$AO = \beta_0 + \beta_1 Block + \beta_2 Family + \beta_3 Insown + \beta_4 Boardsize + \beta_5 ROA + \beta_7 Lev + \varepsilon$$

Variable	Description	Abbreviation
Audit opinion	Dummy variable (it takes the value of one if the opinion is qualified)	AO
Block	Proportion common shares held by significant shareholders (>5 percent)	Block
Family	Dummy variable (it takes the value of one if there are family members on board)	Family
Ins_ownership	Proportion common shares held by members of the board of directors.	Insownership
Board size	Number of directors of the board	BS
ROA	Operating income before interests and taxes over total assets	ROA
Leverage	Long-term debt/total assets	Lev

where Audit opinion (AO) is the dependent variable measured as dummy variable (it takes the value of one if the opinion is qualified); Block is proportion common shares held by significant shareholders (>5 percent); Family is dummy variable (it takes the value of one if there are family members on board); Insownership is proportion common shares held by members of the board of directors.; BS is the number of directors of the board; BSize is number of directors on the board; ROA is the operating income before interests and taxes over total assets; Lev is a the long-term debt/total assets; and ε is the error term.

3. FINDINGS & DISCUSSION

Table 1 contains descriptive statistics for the independent variables of the total sample of 150 are drawn from a range of industrial sectors. The average proportion of shares held by significant shareholders is 48.4 percent, revealing that the ownership in Sri Lanka is considerably concentrated. The mean of family and insider ownership is about 26 and 14.3, percent respectively, suggesting that all firms in the analysis had some family and insider involvement. It is also observed that the firms in the sample are characterized by a poorly concentrated level of family ownership and are dominated by a significant investor with the participation of national and international investors. The board size averaged eight and ranged from five to 12 members. There is no precisely recommended size for a board, most previous studies and regulatory requirements seem to suggest three to five members. Relating the control variables, the mean long-term debt to total assets is of 18.6 percent while the ROA is of 4.3 percent. The results also reveal that the values for the skewness and kurtosis show that sample is normally distributed since they are within the acceptable range of normality for both skewness and kurtosis. According to Brooks (2014), the normality of data can be achieved if standard kurtosis is within ±3 and standard skewness ±1.96.

Table 1 - Descriptive analysis

	Minimum	Maximum	Mean	Std.dev	Skewness	Kurtosis
Block	0.000	0.975	0.484	0.285	-0.03	-0.076
Family	0.000	1.000	0.260	0.501	0.144	-1.021
Ins_ownership	0.000	0.890	0.143	0.257	1.211	0.481
Board size	5.000	12.000	8.100	4.0220	0.243	0.151
ROA	-0.210	0.213	0.043	0.006	-0.533	2.822
Leverage	0.000	0.546	0.186	0.288	0.819	0.266

Table 2 shows the results of the regression analysis. It can be seen from Table 2 that the regression model which incorporates four independent and two control variables results in an adjusted R^2 of 16.5 percent. This means that the variables tested were able to explain 16.5 percent of the variation in audit qualification among Sri Lankan listed companies investigated in this study. The F-statistics and significance levels (sig) show that this model generates statistically significant outcomes. Block as substantial shareholders, family ownership and insider ownership variables were statistically significant and positively associated with audit qualifications. However, board size was statistically insignificant in explaining audit qualifications. The two control variables included in the analysis were statistically insignificant.

Table 2 – Regression analysis

	Model AQ
Constant	1.862 *(0.05)*
Block	2.791 *(0.031)*
Family	2.331 *(0.022)*
Ins_ownership	-3.636 *(0.000)*
Board size	1.636 *(0.122)*
ROA	-1.333 *(0.152)*
Leverage	*1.402* *(0.164)*
R	0.465
Adjusted R Square	0.165
F	4.220
Sig	0.001

4. CONCLUSION

This paper has examined the impact of corporate governance on audit qualifications. There is a significant and positive association between block-holders and audit qualifications. This result suggests that block ownership provides entrancement and self-aggrandizing behavior. As a result, it reduces minority owner's ability to monitor and control behavior of the firm's leadership which might reduce the value of the firm that incurs high agency costs for lack of transparency. The empirical results show statistically significant and negative associations between insider ownership and audit qualifications, revealing that, in Sri Lankan firms, the likelihood to receive and audit qualification decreases as insider ownership increases. As explained by Pedro-Sánchez-Ballesta and Garcia-Meca (2005), acquiring more ownership give directors more power and control over the auditing process, decreasing the probability to obtain a qualified audit report. Dominant directors may exert more pressure on auditors to issue clean opinions compared to boards where control is exercised democratically. Family ownership significantly positively influences on the audit qualifications, the presence of family members on the board can result in higher liquidity for these firms, which allows them to undertake more marginally acceptable investments lowering their average profitability and increasing the likelihood of qualifications whilst board size is insignificantly positively related to audit qualifications implying that possibility of receiving an audit qualification. The most significant findings are that the probability to obtain a clean audit report is related to the insider ownership and the presence of family members on the board. The findings have different recommendations for policymakers and managers. First, policymakers need to provide compulsory rules, and legislations of corporate governance practices for listed firms to enhance the role of good audit reports in such emerging markets. In addition, firms are encouraged to adopt proper governance tools as such tools are proved to improve audit services and audit quality. It is indeed important for firms to have large boards, to ensure more discussions about strategic decisions, and hence large boards are seen to be active in firm's auditing process. The results are consistent with the theory that states that when the managers are owners they act in the interest of the firm and prepare financial statements that are less likely to attract audit qualifications.

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