Does Corporate Governance Matter for Audit Quality? Evidence from Sri Lanka

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ABSTRACT

This study aimed to investigate the effects of corporate governance on audit quality. Using a sample of 100 Sri Lankan listed companies from 2016 to 2020, this study used the ordinary least squares method. The results of this study overall suggests that there is a significant relationship between board size, board independence, audit committee independence and audit quality proxies. However, CEO duality and audit committee financial literacy are only significantly associated with BIG4. This study demonstrates the need of taking the institutional context into account in governance studies. This research focused on companies in Sri Lanka. Future studies should look into this issue in other contexts and time periods. This study is significant for practitioners and academics, legislators, and professional accounting organisations because it demonstrates how legislative reforms might encourage corporations in emerging markets to adopt good governance practices. The findings are also valuable for investors in examining the impact of corporate governance on audit quality. The study adds to the body of knowledge by demonstrating that there is a substantial association between corporate governance and audit quality in Sri Lankan listed companies.

Keywords: Corporate Governance, Audit Quality, Sri Lanka

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INTRODUCTION

This study investigated the impact of corporate governance on audit quality in Sri Lanka. The ultimate goal of corporate governance is to maximize long-term shareholder value, and companies that follow optimal corporate governance practices are more likely to outperform their competitors (Khanchel, 2007). Corporate governance, when viewed from the perspective of the traditional accounting and finance paradigms, as expressed in the Agency Theory, "deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment" (Shleifer & Vishny, 1997, pp.737). Corporate governance refers to the methods and systems by which persons concerned with the firm's overall well-being take actions to protect the interests of stakeholders (Aljifri & Moustafa, 2007). Good corporate governance is built on the values of accountability, transparency, fairness, and responsibility in the management of a firm (Ehikioya, 2009). A well-defined and well-functioning corporate governance framework aids a firm's ability to attract investment, raise capital, and build its foundation.

Corporate governance protects a firm from future financial difficulties. Members of the board of directors represent the shareholders in publicly traded companies. Managers are in charge of overseeing the firm's operations (Kyereboah-Coleman & Biekpe, 2006). The agency problems associated with the separation of ownership and control, along with information asymmetry between management and absentee owners, create the demand for audit. The intention of financial reporting is for users to be able to use the information to make economic decisions, with investors, lenders, and creditors, being the primary users. Audited financial reports, according to the Agency Theory (Bansal & Sharma, 2016), play an important role in supporting relationships with principals who are disconnected from management's actions and cannot verify the information. Auditing is a type of governance mechnism, as auditors perform the gatekeeper role of certifying information from companies (Coffee, 2002). The aim of an audit is to offer assurance about financial statements. Davidson and Neu (1993) defined audit quality as the auditor's ability to discover and remove major misstatements and manipulations in the financial statements provided. In this context, audit services are seen to play a key role in reducing information asymmetry (Beatty, 1989; Willenborg, 1999), as well as resolving agency

issues between managers and shareholders, as well as between shareholders and creditors (Jensen & Meckling, 1976). Therefore, owners hire auditors to produce information used in contracting with managers (Watts & Zimmerman, 1986).

Audit quality is a concept that different people define differently. Donaldson and Davis (1991) proposed a two-dimensional definition of audit quality that has become the industry standard for dealing with the issue. A material misstatement must first be identified, and then it must be reported. Audit quality is becoming a more important function of an auditor's ability to detect accounting misstatements, and it is related to the degree of auditor independence. DeFond and Francis (2005) stated that the demand for audits and audit quality rises as the degree of conflict among stakeholders rises. Audit quality is critical to completing these two goals. While audit quality is an important aspect of corporate governance, DeFond and Francis (2005) argued that it is unclear whether audit quality and other aspects of corporate governance are essentially complements or substitutes. Corporate governnace, according to Demsetz (1983) and Fama and Jensen (1983), should be established in a manner that fits the business conditions of a firm. When discussing the theoritical framework for services and other governace strcutures, Knechel and Willekens (2006, p.1346) contended that 'prior research has generally argued that there should be a trade-off between sources of control (i.e., more of one leads to less of another)'. However, they feel that the empirical findings are plagued with inconsistencies and oddities.

Corporate governance is a well-researched topic in the accounting literature from an academic standpoint (Cohen, Krishnamoorthy, & Wright, 2004). On the other hand, the impact of corporate governance on the audit quality has yet to be explored. There are a very few studies that investigated the impact of corporate governance on audit quality. Chang, Chi, Hwang, and Shiue, 2011) tested the relationships between corporate governance and audit quality by collecting data from Taiwan. Beisland, Mersland, and Strøm (2015) investigated audit quality and corpoarte governance in microfinance institutions from 70 developing countries. The present study extends these studies using data from Sri Lankan companies as an emeraging country.

Sri Lanka is an emerging economy 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. The aim of this study was to see how corporate governance affects audit quality. It's logical to expect that companies that follow the code's rules will outperform their rivals since corporate governance includes managing a firm's operations and affairs in order to promote commercial success and accountability. The research question is as follows:

RQ. What is the relatiosnhip between corpoarte governance and audit quality of these companies?

The structure of the paper is as follows. The following section provides a brief summary of the Code of Best Practice on Corporate Governance in Sri Lanka. Section 3 offers a brief literature review on the relationship between corpaorte governance and audit quality. Section 4 describes the data collection and research methodology. Section 5 presents the research findings. The final section provides conclusions of the study, its implications, and suggestions for future research.

OVERVIEW OF CORPORATE GOVERNANCE IN SRI LANKA

Corporate governance refers to a collection of laws, practices, rules, conventions, and institutions that influence how an institution's business is done by management, based on values such as transparency, accountability, and integrity (Nanayakkara, 2021). Sri Lanka's economic policies have been open since 1977. As a result of these policies, the government has privatised a number of state-owned businesses, and the private corporate sector has grown into a significant component of the economy.

From 141 in 1977 to 285 in 2021, the number of listed companies has more than tripled. Corporate governance is a relatively new idea in the nation, with attempts beginning in 1997 (Guo & Kga, 2012). With effect from the financial year beginning 1 April 2008, businesses must comply with the corporate governance requirements that were formerly part of the Colombo Stock Exchange (CSE's) listing regulations, according to a circular published by the CSE. Chartered Accountants of Sri Lanka has pioneered the development of Corporate Governance Codes in Sri Lanka. The first

code was issued in 1997 and was titled "Code of Best Practice on Financial Aspects of Corporate Governance."

Following that, in 2003, 2008, and 2013, the codes were examined and modified as part of a collaborative effort. The 2017 code expanded on prior codes to enhance optimal governance practices in the context of global events affecting Sri Lanka, developing contemporary governance issues, and difficulties affecting the Sri Lankan capital market. Corporate governance procedures of Sri Lankan listed companies are currently regulated by the mandatory corporate governance standards included in the CSE listing rules (Lakshan & Wijekoon, 2012). Companies listed on the CSE Sri Lanka must also follow the requirements of the Companies Act No.07 of 2007 regarding the appointment and removal of directors and auditors, as well as the Central Bank Direction on Corporate Governance for listed regulated commercial banks (Senaratne, 2011).

Many economic changes have been enacted in recent years, most notably in the areas of trade, taxation, privatization, and increasing labor market flexibility. Sri Lanka has attained human development levels that are comparable to those of high-income nations. With the continuous expansion of Sri Lanka's commercial sector, there has been a rise in interest in corporate governance in the country.

LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

Researchers have linked many corporate governance proxies such as board size, independent directors, CEO duality and ownership structure. We will review below the empirical evidence on the linkage between five main corporate governance proxies including board size, independent directors, CEO duality, audit committee independence and audit committee financial literacy to audit quality as a basis of a research question.

Board Size

Higher audit quality, according to Bansal and Sharma (2016), results in more credible and reliable financial information, improves the accuracy

of a firm's earnings, and reduces information risk, lowering the conflict of interest among stkeholders. Every public firm should have an effective board of directors that directs, leads, and controls the firm (CA, 2017). Ruigrok, Peck, and Keller (2006) suggested that the other major responsibilities of the board include strategy formulation and implementation, as well as encouraging links between the firm and its external environment. Several empirical research across countries look into the relationship between board size and various business endeavors. Florackis and Ozkan (2009) claimed that seven or eight board members have a propensity to be inefficient. Big boards, they claim, are less well-coordinated, have poor communication, take longer to make decisions, and are more susceptible to the chief excutive officer's influence. Jensen (1993) claims that small boards are more effective at regulating managers than bigger boards because they have less communication issues, can easily coordinate their actions and bureaucracy, and have fewer free-rider concerns among directors. The size of the board of directors has a positive influence on corporate performance, according to Kutum (2015) and Bansal and Sharma (2016). Beasley, Carcello, Hermanson, and Lapides, (2000) mentioned that the argument that a larger board size results in a more effective control environment is commonly applied to audit quality. Audit quality is a function of how well an audit team functions, and presumably firms perform best based on the availability of adequate resources: However, Husaini (2018) and Yermack (1996) believe that board size has a negative influence on corporate performance. Thus, it was hypothesized that:

H_1: Board size is significantly related to audit quality.

Independent Directors

Independent directors, according to Jensen and Meckling (1976), are more effective in monitoring diectors and improving firm performance. As a result, companies with more independent directors are able to lower agency costs between managers and stakeholders, resulting in improved firm performance (Ang, Cole, & Lin, 2000). Baysinger and Butler (1985) noted that companies appoint independent directors to oversee management on behalf of shareholders. Bhagat and Black (1999) argued that companies with low profitability obtain board independence, whereas companies with board independence appear to underperform other companies. They also proposed

that the supermajority independent board may be flawed, and that an ideal board would have a mix of independent, inside, and associated directors with a variety of skills and experience. According to Abidin, Kamal, and Jusoff (2009), having a larger percentage of independent boards improves corporate performance because they may bring a variety of backgrounds, traits, qualities, and skills to the board process and decision-making. However, Board independence has insignificant impact on firm performance (Abdullah, Shah, & Hassan, 2008; Bansal and Sharma, 2016). In terms of the audit process, it is expected that increased independent representation will improve the quality of the audit process in a variety of ways. Auditors, in particular, have the ability to discuss issues arising from the audit process with independent members who are not influenced by management. Hence, it was hypothesized that:

H_2: Independent directors in the board is significantly related to audit quality.

CEO Duality

Two alternative perspectives on CEO duality emerge from the Stewardship Theory and th Aency Theory. The chairperson of the board has a number of responsibilities, including running board meetings and overseeing the process of recruiting, assessing, dismissing, and paying the CEO, therefore distinguishing between the two responsibilities of a CEO is based on the Agency Theory (Fama & Jensen, 1983). According to Jensen (1993), the CEO serving as the board chair and performing the supervision job linked to this procedure constitutes a conflict of interest. He argued that it is important to separate the CEO and the chairperson positions for the board to provide effective monitoring. When CEOs have complete control over the firm, Davis, Schoorman, and Donaldson (1997) believe that it can lower agency costs and increase corporate performance. Advocates of the Stewardship Theory, on the other hand, claim that managers are naturally trustworthy, act as excellent stewards of company resources, and seek to improve performance (Donaldson & Davis, 1991). Hence, it was hypothesized that:

H_3: CEO dulaity is significantly related to audit quality.

Audit Committee Independence

In Sri Lanka, the CA (2017) recommends that audit committees have at least three directors, with at least two of them being independent. If the company has multiple boards of directors, the majority of them should be independent. Prior research in the audit committee literature has had mixed outcomes. According to the literature, independent board directors are able to provide more freed opinions to the firm's management since they promise to act more freely than non-independent board directors (Vicnair, Hickman, & Carnes, 1993; Weisbach, 1988). As a result, the likelihood of corporate reporting problems would be reduced by independent directors (McMullen & Raghunandan, 1996). Financial statement fraud is more likely to occur in companies with a poor audit committee, according to prior studies (Beasley, Carcello, Hermanson, & Lapides, 2000). Troubled companies with an independent audit committee are more likely to receive a going concern qualifying report, according to Carcello and Neal (2000). The results in Klein (2002) showed that there is a negative relationship between independent audit committee and earnings management. An effective independent audit committee is regarded as one of the determinants of audit quality (Beasley, Carcello, Hermanson, & Lapides, 2000). Audit committee generally recommends external auditors and manages the relationship between them and the company. The firms with an ineffective audit committee are more likely to have an internal control weakness identified. Hence, it was hypothesized that:

H_4: Audit committee independence is significantly related to audit quality.

Audit committee financial literacy

CA (2017) requires that every audit committee have at least one member with financial knowledge. The financial competence of the audit committee, according to DeZoort and Salterio (2001), improves the chance that major misstatements will be notified to the audit committee and remedied in a timely manner. Abbott, Parker, and Peters (2004) reported a negative association between the audit committee's financial expertise and occurrence of earnings restatement. Hence, it is hypothesized that:

H_5: Audit committee financial literacy is significantly related to audit quality.

RESEARCH METHODOLOGY

The study's population consisted of the 285 CSE-listed companies as of March 2020. The financial industry was excluded from this study because its sole financial features, high levels of regulations, and/or extensive use of leverage which are likely to skew the results. Similarly, by excluding companies that were not listed at any point throughout the sample period, the chance of missing data was decreased. Following the deletions, a 100-firm sample was randomly selected from the CSE's listed businesses and analysed. The financial statements from 2016 to 2020 were used as data source. Financial reports were chosen for two reasons: they are seen as a key source of business information by external users, and the degree of transparency in financial reports is directly proportional to the quantity of firm information conveyed to the market and to investors via other media.

Variable measures

As suggested by Abbott, Parker, and Peters (2004), Abidin, Kamal, and Jusoff (2009), Baysinger and Butler (1985), Ehikioya (2009), McMullen and Raghunandan, (1996), Weisbach (1988), board size, independent directors, CEO duality, audit committee independence and audit committee financial literacy were used to measure corporate governance. As recommended in prior literature, the impact of corporate governance on audit quality was discovered using many measures of quality (i.e. BIG4, auditor tenure, auditor specialisation auditor size and internal auditor (Kusumawati & Syamsuddin, 218; Jackson, Moldrich, & Roebuck, 2008; Al-Thuneibat, Al Issa, & Baker, 2011). This research measured audit quality using a BIG4 and auditor tenure. The control variables such as firm size and firm age were included in the study. These variables have been used in many prior studies (Jackson, Moldrich, & Roebuck, 2008; Lin & Hwang, 2010) and are correlated with audit quality.

Table 1: Variable Measurement

Variables	Measures	Label
Board Size	Number of board directors on board	BS
Independent directors	Number of independence directors divided by total directors	BID
CEO duality	Dummy variable, taking a value of 1 for firm with the CEO as Chairman and 0 otherwise	CEOD
Audit committee independence	Number of independence members on audit committee divided by total audit committee members	ACI
Audit committee financial literacy	Dummy variables, taking a value 1 for if one or more for audit committee members who have financial literacy and 0 otherwise	ACFL
BIG4	Dummy variables, taking a value 1 if a firm is audited by one of the Big Four auditors and 0 otherwise	BIG4
Auditor tenure	The consecutive number of years of the auditor-client relationship	AT
Firm size	The natural logarithm of total assets in company	FS
Firm age	The natural logarithm of company age, as companies are listed on Colombo Stock Exchange	FA

To explore the impact of corporate governance on audit quality, regression models were generated using the panel generalised least squares (GLS) method. It was used to replace ordinary least squares (OLS), which has two flaws: autocorrelation and heteroskedasticity. The Eview statistical program was used to investigate a panel GLS estimated equation in order to solve these problems. As a consequence, the estimated model was as follows:

$$Big4 = \beta o + \beta 1\ BS + \beta 2BID + \beta 3CEOD + \beta 4ACI + \beta 5ACFL + \beta 6\ FS + \beta 7\ FA + \varepsilon \quad \text{(Eq 1)}$$

$$Audit\ tenure = \beta o + \beta 1\ BS + \beta 2BID + \beta 3CEOD + \beta 4ACI + \beta 5ACFL + \beta 6\ FS + \beta 7\ FA + \varepsilon \quad \text{(Eq 2)}$$

RESULTS AND DISCUSSION

Table 2 shows the descriptive statistics results for all variables used in this study. The average value of auditor tenure as a measure of audit quality for Sri Lankan listed companies was 3.8480, which is lower than the average estimate of 11.954 reported for a sample of Indian companies by Jadiyappa, Hickman, Kakani, and Abidi (2021), but higher than the average value of

2.54 reported for a sample of Indonesian listed companies by Simamora and Hendar (2019). It was also revealed that 47.20 percent of the Sri Lankan companies utilised the Big Four auditors, which is a higher proportion than in the samples of Tunisian companies (Zgarni, 2016). It is also obvious from the Table 2 regarding corporate governance variables that the mean value was 8.2260 reported for board size with median (standard deviation) values of eight (2.1624), which reflected that most companies on the Sri Lankan stock exchange had more than eight directors on their board, while across the companies an average of 57.3681 percent of the directors were classified as independent. This proportion of board independence is consistent with the criteria set by the CA Sri Lanka for good corporate governance practices (CA, 2017). A little over one-quarter of the companies (0.3620) had separated the chairman and CEO positions. The mean (median) of audit committee independence is 75.6740, implying high independence of audit committees in Sri Lankan companies when performing their duties. In addition, about 0.6860 percent of audit committee members were financial experts. As a result, Sri Lankan companies are more likely to meet regulatory governance requirements. According to the natural logarithm of total assets, the average firm size was 5.2100, with a standard deviation of 0.6943. The companies were 7.6240 years old on average, with a standard deviation of 3.1683.

Table 2: Descriptive analysis

Variables	Lable	Minimum	Median	Maximum	Mean	Std.Dev
Auditor tenure	AT	0.0000	4.0000	7.0000	3.8480	1.8449
BIG4	BIG4	0.0000	1.0000	1.0000	0.4720	0.3344
Board Size	BS	4.0000	8.0000	17.0000	8.2260	2.1624
Independent directors	BID	11.1100	39.9300	87.5000	57.3681	12.2223
CEO duality	CEOD	0.0000	0.0000	1.0000	0.3620	0.4810
AC independence	ACI	0.0000	75.0000	100.000	75.6740	24.2496
AC financial literacy	ACFL	0.0000	1.0000	1.0000	0.6860	0.4645
Firm size	FS	6.7800	9.6950	11.2300	5.2100	0.6943
Firm age	FA	3.0000	8.0000	16.0000	7.6240	3.1683

Table 3 presents findings of regression analysis with information on the impact of an independent variable on the dependent variable. The model R2 value of two audit quality proxies indicated that 42-58 percent of the observed variability in audit quality can be explained by corporate governance. The F-statistics and significance levels (Table 3) show that both Auditor tenure and BIG4 models generate statistically significant outcomes.

The results showed that board size was positively and significantly related to audit quality. Thus, the hypothesis (H1) is supported. The result indicated that large board size can reduce agency costs and leads to arise audit quality because larger board size represents greater resources and talents to rely on in overseeing the auditing process. Board independence had a positive and significant effect on audit quality proxies, thus hypothesis (H2) was supported. The results indicated that improved board independence contributes to increasing audit quality, and hence avoiding agency conflicts and asymmetric information problems. The results of this study, in line with the previous findings of Carcello et al. (2002), indicated that companies having a higher proportion of independent directors on the board are associated with a higher quality audit being demanded and it is also supporting the finding of Guizani and Abdalkrim (2021). The results suggested that CEO duality had a insignificant effect on auditor tenure but there was a signficant effect on BIG4 audit companies, thus hypothesis (H3) was supported.

The result indicated that when the CEO and chairman of the board are the same person, the ability of directors on boards to seek an audit quality may be harmed. It supports the finding of Tsui, Jaggi, and Gul (2001) who found that audit companies perceive higher inherent risk associated with CEO duality companies. There was a positive and significant relationship between AC independence and audit quality. Thus H4 was supported. A higher proportion of independent directors on the audit committee is expected to demand that the audit firm perform more audit work, resulting in a higher quality audit. This is consistent with the findings of Lin and Hwang (2010). There was a positive and significant relationship between AC financial literacy and BIG4 but there is no significant relationship between AC financial literacy and auditor tenure. Thus H5 was supported. AC with financial literacy are valuable because they demonstrate support for auditors. This finding is consistent with Salehi and Shirazi (2016).

Table 3: Regression Analysis

Variables	Auditor tenure		BIG4	
	Coefficient values	***p*-value**	**Coefficient values**	***p*-value**
Const	13.939	0.001***	7.348	0.000***
BS	0.160	0.050*	0.223	0.001***
BID (%)	0.172	0.046*	0.179	0.046*
CEOD	0.452	0.334	0.754	0.073*
ACI (%)	0. 611	0.082*	0.653	0.031**
financial literacy	0.309	0.175	0.465	0.015**
Firm age	0.025	0.755	-0.048	0.904
Firm size	1.685	0.000***	5.703	0.000***
R^2	0.419		0.582	
Adjusted R^2	0.262		0.469	
F-statistic	2.674		5.170	
p-value(F)	0.000		0.000	
DWT	1.889		1.888	

Notes: *Significant at the 0.1 level; **significant at the 0.05 level; ***significant at 0.01 level; for the definition of variables refer to Table 1

CONCLUDING REMARKS

Corporate stakeholders are very concerned about audit quality. Despite its popularity, empirical evidence on the effect of corporate governance on audit quality is inconclusive. The current study examined the relationship between corporate governance (board size, independent directors, CEO duality, audit committee independence, audit committee financial literacy) and the audit quality measured by BIG4 and auditor tenure. The data used consisted of 100 companies that were listed on the CSE2016-2020. The results of this study overall suggest that there is a significant relationship between board size, board independence, audit committee independence and audit quality proxies. However, CEO duality and audit committee financial literacy were only significantly associated with BIG4.

The primary goal of corporate governance is to assure the quality of a financial reports. Companies must assure the quality of the audit if the financial reports are to be of high quality. This is critical to a firm's success. The issue of corporate governance has important implications on the audit quality of Sri Lankan companies. A comparatively bigger

board size puts pressure on management to pursue high quality concerns in order to improve audit quality through strict monitoring and regulatory mechanisms. However, beyond a certain point, increasing board size may have unfavorable consequences. An increase in board size should be accompanied by an increase in the number of independent directors. Given that independent board members may have strong knowledge/useful information on audit quality, the presence of independent directors may lead to better audit choices and assist businesses in recruiting better resources. The outcome emphasises the significance of avoiding confrontation between a CEO and a board chairman, especially when the two personalities are diametrically opposed.

In a one-tier structure, the lack of this conflict allows the CEO to follow an effective audit strategy based on board recommendations. A greater share of independent directors on the audit committee is intended to put pressure on the audit firm to undertake more audit work, resulting in a higher-quality audit. The presence of financial literacy on AC will improve internal control audit monitoring which leads audit quality. Furthermore, the existence of financial literacy on AC will assist a business in reducing the frequency of accounting misstatement, reducing the likelihood of litigation against the firm. It gives policymakers a better understanding of the various features of corporate governance that should be included in future policy formulation in order to protect shareholders' investments, protect the interests of various stakeholders, and increase the flow of investment into listed companies and the economy in general.

The findings might be beneficial to regulators in other jurisdictions searching for methods to improve the efficacy of corporate governance and increase investor trust in businesses. The study was confined to listed companies in Sri Lanka; future research might look at the influence of corporate governance on audit quality in unlisted companies.

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