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IMPACT OF AUDIT COMMITTEE CHARACTERISTIC ON FIRM PERFORMANCE: LISTED COMPANIES IN SRI LANKA

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Abstract

The Audit Committee plays a vital role in overseeing the audit process, the company's system of internal controls, financial risk management, and compliance with laws and regulations. This study explores the impact of audit committee characteristics on firm performance, based on an empirical analysis of companies in Sri Lanka. Firm performance was measured using Tobin's Q, Return on Assets (ROA), and Return on Equity (ROE). The characteristics of audit committees were assessed through three proxies: Audit Committee Size (ACS), Audit Committee Independence (ACI), and Audit Committee Meetings (ACM). The study utilized data from 49 listed companies in Sri Lanka, covering the year from 2019 to 2023. A quantitative research method was employed, with data collected from annual reports of the selected companies. The results indicate that Audit Committee Independence (ACI) has a positive impact on both ROA and Tobin's Q, suggesting that greater independence within audit committees enhances oversight and improves firm performance. In contrast, Audit Committee Size (ACS) shows a negative relationship with both ROA and Tobin's Q. Additionally, Audit Committee Meetings (ACM) are negatively associated with ROE and ROA, while showing an insignificant effect on Tobin's Q. These findings have important implications for policymakers, providing valuable insights for strategic policy formulation and implementation aimed at enhancing corporate governance practices, thereby contributing to income and wealth maximization.

Keywords: Audit Committee Meeting, Audit Committee Size, ROA and ROE.

Introduction

The audit committee was established for fostering greater confidence in the reliability of internal control systems and corporate reporting procedures, especially financial reporting. The Audit Committee (AC) provides the Board of Directors a sense of independence through its role in oversight and monitoring. The effectiveness of domestic and outside audit functions, the strength of internal audit and internal control systems, the efficacy of prevent fraud, ethics, and compliance systems, and the review of the whistleblower system or immoral activities are just a few of the various duties that the boards have entrusted to the Audit Committee. It's possible that the AC is directing the company's risk organization activities and procedures. This study seeks to navigate the intricacies of how audit committee attributes influence the performance of companies listed on the Colombo stock Exchange. By examining key attributes such as audit committee meetings, committee size and audit committee independence. The Institute of Chartered Accountants of Sri Lanka and the Securities and Exchange Commission of Sri Lanka in march 2013 developed by the guidelines on the formation of the audit committee.

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Theoretical underpinnings rooted in stewardship theory and agency theory provides a conceptual framework for investigating this relationship. The impact of AC attributes on firm performance was exposed using numerous actions of firm performance (Kallamu & Saat, 2015 and Malik & Makhdoom, 2016). Although many Sri Lankan listed companies, like many Asian countries, has established an audit committee (OCDE white paper 2003), a transparent system for deciding directors' compensation was lacking (Gunaratne, 2008).

According to the available research, the audit committee's size, independence, expertise, and frequency of meetings are analyzed in relation to organizational performance. Recent years have seen an enlarge in the amount of AC literature due to rising concerns about corporate governance and the importance of AC in ornamental the luster of financial reporting (DeZoort, 2023).

Saseela and velnampy (2018) explained that audit committee is one of the key elements in the corporate governance structure that helps to control and monitor management in the organization. Anojan (2023) said that Policymakers should consider some code of best practices regarding the number of audit committee meetings and audit committee expertise.

The majority of factors, including capital structure, working capital management, inventory management, and others, have an impact on an entity's success in Sri Lanka. These effects have been thoroughly investigated in Sri Lanka over a long period of time by numerous researchers. But in additions, the performance of business is also impacted by the audit committee. However, a few researches on this topic were conducted globally as well as in Sri Lanka. So, this attempt to investigate and find out whether there is an association amid the audit committee and firm performance. A research effort was started to find the answer to the following study confront in order to address this issue: How much does the AC influence on firm performance?

Research question

The following research question was identified before to the formation of this study, so we examine it in this study.

- Do AC characteristics impact on firm performance?

Research objectives

This study's primary goal is to study the impact of AC Characteristics on firm performance of CSE listed companies in Sri Lanka. Sub-objective of this research is identifying the association amid Audit committee characteristics and firm performance.

Research method

The research to examine the impact of audit committee (AC) components—specifically independence**,** meeting frequency**,** and size**—**on firm performance indicators such as Return on Assets (ROA)**,** Return on Equity (ROE)**,** and Tobin's Q (TQ)**,** several statistical techniques were employed. The data analysis was conducted using EViews 10, and included descriptive statistics**,** correlation analysis**,** and multiple regression analysis**.** These methods were used to identify patterns, relationships, and the extent to which AC characteristics influence firm performance. The multiple regression model allows for a comprehensive evaluation of how each independent variable (audit committee attributes) affects the dependent variables (firm performance measures). The study is based on a sample of 49 listed companies in Sri Lanka**,**

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observed over a five-year period from 2019 to 2023**.** This time frame provides a sufficient range of data to ensure meaningful and reliable results, capturing both short-term fluctuations and longer-term trends in corporate governance and performance.

Hypothesis

H_1: There is a significant association amid AC characteristic and firm performance.

H_2: There is a significant impact of AC characteristic on firm performance.

Table 1: Descriptive Statistics for AC characteristics and Firm Performance

Variables	ACS	ACI	ACM	ROA	ROE	TOBIN_S_Q
Mean	3.4122	2.657143	6.2448	0.0479	0.1064	1.3854
Median	3	3	4	0.0370	0.0972	1.0641
Maximum	7	5	19	0.1769	0.3275	5.4728
Minimum	2	1	3	-0.0414	-0.0484	0.0350
Std. Dev.	0.7876	0.7443	3.4931	0.0416	0.0726	0.8215
Observation	245					

Source: Result from the panel data analysis

Table 1 illustrate the descriptive statistics provide an overview of the audit committee characteristics and firm performance among the 49 listed companies in Sri Lanka from 2019 to 2023, totaling 245 observations. The average Audit Committee Size (ACS) is 3.41 members, with a minimum of 2 and a maximum of 7, indicating that most companies maintain relatively small audit committees. Audit Committee Independence (ACI) has a mean value of 2.66, suggesting that, on average, there are about 2 to 3 independent members in the audit committees, with values ranging between 1 and 5. Audit Committee Meetings (ACM) were held an average of 6.24 times per year, but the high standard deviation of 3.49 and a maximum of 19 meetings suggest significant variation in meeting frequency among firms.

Regarding firm performance, the average Return on Assets (ROA) is 4.79%, with a maximum of 17.69% and a minimum of -4.14%, reflecting moderate profitability with some firms experiencing losses. Return on Equity (ROE) averages at 10.64%, with a wider range between -4.84% and 32.75%, indicating variability in returns to shareholders. Tobin's Q, a measure of market performance, has a mean value of 1.3854, implying that, on average, the market value of firms slightly exceeds their asset value. However, the wide range—from 0.0350 to 5.4728—and a standard deviation of 0.82 suggest considerable disparity in market valuation across the sample.

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Correlation Analysis

Table 2: Correlation Analysis

Variables	ACS	ACI	ACM	ROA	ROE	TOBINS'Q
ACS	1					

ACI	0.6405	1				
	0.0000	-----				
ACM	0.2893	0.09547	1			
	0.0000	0.1362	-----			
ROA	-0.0247	0.2190	-0.2757	1		
	0.7000	0.0006	0.0000	-----		
ROE	-0.0517	0.0523	-0.1669	0.6774	1	
	0.4204	0.4150	0.0088	0.0000	-----	
TOBINS'Q	-0.0073	0.1859	-0.0228	0.2305	0.0822	1
	0.9087	0.0035	0.7218	0.0003	0.1994	-----

Source: Result from the panel data analysis

The correlation matrix reveals the relationships between audit committee characteristics (ACS, ACI, ACM) and firm performance indicators (ROA, ROE, Tobin's Q). The strength and direction of the relationships are measured using Pearson correlation coefficients, and their statistical significance is reported through p-values (shown beneath each coefficient).

Audit Committee Size (ACS) **is** positively and significantly correlated with Audit Committee Independence (ACI) ($r = 0.6405$, $p = 0.0000$), indicating that larger committees tend to include more independent members. ACS also shows **a** positive correlation with Audit Committee Meetings (ACM) ($r = 0.2893$, $p = 0.0000$), suggesting that larger committees may meet more frequently. However, ACS has a weak and statistically insignificant negative correlation with ROA ($r = -0.0247$, $p = 0.7000$), ROE ($r = -0.0517$, $p = 0.4204$), and Tobin's Q ($r = -0.0073$, $p = 0.9087$), indicating that committee size does not have a meaningful direct impact on firm performance in this dataset.

Audit Committee Independence (ACI) shows a positive and statistically significant correlation with ROA ($r = 0.2190$, $p = 0.0006$) and Tobin's Q ($r = 0.1859$, $p = 0.0035$), implying that greater independence in audit committees is associated with improved asset efficiency and market valuation. However, the correlation between ACI and ROE is weak and not statistically significant ($r = 0.0523$, $p = 0.4150$).Audit Committee Meetings (ACM) has a significant negative correlation with both ROA ($r = -0.2757$, $p = 0.0000$) and ROE ($r = -0.1669$, $p = 0.0088$), indicating that more frequent meetings are associated with lower profitability. The correlation between ACM and Tobin's Q is negligible and not significant ($r = -0.0228$, $p = 0.7218$).

Among the firm performance measures, ROA and ROE are strongly and positively correlated ($r = 0.6774$, $p = 0.0000$), as expected, since both measure profitability. Tobin's Q shows a moderate positive correlation with ROA ($r = 0.2305$, $p = 0.0003$) and a weak, insignificant correlation with ROE ($r = 0.0822$, $p = 0.1994$).

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Overall, the findings highlight that Audit Committee Independence (ACI) is positively associated with firm performance, while frequent meetings (ACM) may be linked to lower profitability, and committee size (ACS) does not show a strong or significant relationship with performance indicators.

Multicollinearity and Variance Factor Test

Table 3: Variance Inflation Factors Test

Variable	Coefficient Variance	Un centered VIF	Centered VIF
C	0.00013	21.3989	NA
ACS	1.83E-05	36.9463	1.8616
ACI	1.89E-05	23.7458	1.7214
ACM	5.54E-07	4.6636	1.1079

To identify the multicollinearity between the autonomous variables of ACS, ACI and ACM the researcher uses VIF test.

All the VIF values are well below the commonly accepted threshold of 10**,** and even below the more conservative cutoff of 5. This indicates that multicollinearity is not a concern in this model. The variables are not excessively correlated with each other, and the regression coefficients can be considered reliable and stable.

Regression Analysis

Linear regression is used to learn the impact of AC on FP of companies in Sri Lanka.

Table 4: Regression Model Summary of AC on ROA, ROE and Tobins'Q

	ROA		ROE		Tobins'Q	
Vari	Coeff	Pro	Coeff	Pro	Coeff	Pro
C	0.0462	0.0001	0.1216	0.0000	1.1956	0.0000
ACS	-0.0095	0.0268	-0.0078	0.3260	-0.2274	0.0110
ACI	0.0201	0.0000	0.0118	0.1447	0.3584	0.0001
ACM	-0.0030	0.0000	-0.0032	0.0216	0.0021	0.8883
	R-sq	0.1542	R-sq	0.0364	R-sq	0.0618
	Ad R-s	0.1437	Ad R-s	0.0244	Ad R-s	0.0501
	F-st	14.649	F-st	3.038	F-st	5.2900
	Pro (F)	0.0000	Pro (F)	0.0300	Pro (F)	0.0020
	S.D. devar	0.0416	S.D. devar	0.0726	S.D. devar	0.8215
	DurWatstat	0.7011	DurWatstat	0.7081	DurWatstat	0.3373
	Log likeli	451.926	Log likeli	299.924	Log likeli	-291.173

Source: Result from the panel data analysis

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Table 4 shows that regression results examine the influence of audit committee characteristics ACS), ACI, and ACM on firm performance, measured by ROA, ROE, and Tobin's Q. For ROA, the model shows that ACS has a pessimistic and statistically major impact (coefficient = -0.0095, p = 0.0268), suggesting that larger audit committees are associated with reduced asset efficiency. In contrast, ACI has a positive and highly significant effect (coefficient = 0.0201, p < 0.0001), indicating that greater independence among audit committee members improves firm profitability. ACM is also negatively significant (coefficient = -0.0030, p < 0.0001), implying that frequent meetings may not enhance asset returns. The ROA model explains about 15.4% of the variation in performance (R^2 = 0.1542), with an F-statistic of 14.649 (p < 0.0000), indicating strong overall significance.

For ROE, ACS and ACI have insignificant effects (p = 0.3260 and 0.1447, respectively), while ACM shows a significant negative relationship (coefficient = -0.0032, p = 0.0216), suggesting that more frequent meetings are linked to lower returns to shareholders. However, the explanatory power of the model is weak (R^2 = 0.0364), and although the F-statistic (3.038) is statistically significant (p = 0.0300), the model explains only a small portion of ROE variation.

In the Tobin's Q model, ACS has a negative and significant impact (coefficient = -0.2274, p = 0.0110), implying that larger committees may reduce market valuation. ACI continues to have a positive and highly significant effect (coefficient = 0.3584, p = 0.0001), reflecting a strong relationship between independence and market performance. However, ACM has no significant effect on Tobin's Q (p = 0.8883). The model explains 6.18% of the variation (R^2 = 0.0618) and is statistically significant overall (F-statistic = 5.290, p = 0.0020).

These findings highlight the consistent positive role of audit committee independence (ACI) across performance measures,

Conclusion

This paper has examined the impact of the audit committee on firm performance. The results indicate that Audit Committee Size (ACS) has a negative and significant effect on both Return on Assets (ROA**)** and Tobin's Q**,** suggesting that larger audit committees may not enhance firm performance**.** The negative relationship with ROA implies that having more members on the committee could lead to coordination difficulties and reduced efficiency by Jethusan, J., & Premi(2024.These findings are in line with previous studies by Ahdal & Hashim (2023), Hassan Bazhair (2022), Abeygunasekera et al. (2021), and De Silva et al. (2022).

Similarly, the study found **a** negative and significant association between ACS and Tobin's Q**,** reinforcing the idea that a larger audit committee may not positively influence market valuation. This outcome is consistent with the findings of R.S. Yardav et al. (2024), Fariha et al. (2022), and Dao et al. (2022). Additionally, ACS shows a negative but statistically insignificant relationship with Return on Equity (ROE)**,** aligning with the studies of Romano et al. (2012), Zraiq and Fadzil (2018), and Bouaine and Hrichi (2019).

In contrast, Audit Committee Independence (ACI) shows a positive and significant impact on both ROA and Tobin's Q. This implies that having independent members within the audit committee enhances firm oversight**,** supports better profitability**,** and strengthens market valuation by ensuring more objective and unbiased monitoring.

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Overall, the study's findings suggest that specific characteristics of audit committees particularly in Sri Lankan firms play a critical role in influencing firm performance. These insights can also benefit regulators in other countries who are looking to improve audit committee effectiveness, strengthen corporate governance, and build greater investor confidence.

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