



---

## **Compliance difference of audit committee attributes and financial distress of listed companies in the Colombo Stock Exchange in Sri Lanka**

T.K.G. Sameera and P.R. Weerathunga

*Department of Accountancy and Finance,  
Faculty of Management Studies, Rajarata University of Sri Lanka,  
Mihintale, Sri Lanka*

*Corresponding author: [tksameera@gmail.com](mailto:tksameera@gmail.com)*

### **Abstract**

*The effectiveness of the audit committee is one of the significant themes in corporate governance debates. This study contributes to the debate by examining compliance difference of audit committee attributes and its impact on financial distress of listed companies in Sri Lanka. Three attributes of the audit committee, size, composition and frequency of meeting, were examined. The study was based on the secondary data which were obtained from Colombo Stock Exchange archives and annual reports of the respective companies. Altman Z-score model was employed to identify 32 distress and 32 non-distress companies during the period spanning from 2011 to 2015. The t-test was employed to examine audit committee practices of distress and non-distress companies. The results show that the level of compliance with audit committee practices of distress companies is significantly lower than that of non-distress companies. Moreover, this study revealed that the composition and meeting frequency of the audit committee have a negative and significant effect on financial distress of a company. The result suggests that the majority representation of independent non-executive directors in the committee and meeting frequency of audit committee members are important factors for resolution of financial distress of the company. The participation of independent non-executive members in a greater proportion improves the independence of the audit committee and increases the capacity of corporate boards to effectively advice, monitor and consequently, reduces the likelihood of financial problems. Meeting frequency plays an important role to ensure the integrity of financial reporting and provide better monitoring and review the operations effectively.*

**Keywords:** *Audit committee attributes, distress and non-distressed companies, financial distress.*

## 1. Introduction

Recently, the World has witnessed dramatic financial scandals which put the public to the research in corporate governance systems. Consequently, government's put forwarded new regulations to enhance boards' committees and to improve the efficiency of corporate governance systems (Cadbury, 1992). In this context, the boards of directors play a major role in management control through its committees in order to enhance corporate governance efficiency. According to Blue Ribbon Committee (BRC) good corporate governance can enhance the accountability relations between companies' participants in order to protect stakeholders' interests. Consequently, the board of directors delegates their authorizes to the audit committee to overseeing company's internal control process and financial reporting. In this context, audit committee should assist the board of directors in effective management and monitoring with the aim of protecting the interest of the shareholders.

An audit committee in a firm works as an internal corporate governance mechanism and reduces agency costs (Forker, 1992). Collier and Gregory (1999) state that, "*the presence of an audit committee in a firm helps directors in meeting their statutory and fiduciary responsibilities such as accounting records, annual audit and ensures the quality of the financial reporting and control system*". According to Hicks and Goo (2008) the audit committee enables the non-executive directors to contribute an independent judgment and play a positive role in the matters of the firm (Miglani, Ahmed & Henry, 2010). Similarly, Calleja (1999) reported that companies with audit committee tend to perform better than the companies without an audit committee. Miglani et al. (2010) also identified a negative association between the existence of an audit committee in a firm and financial distress probability.

In recent past, Sri Lanka has experienced a number of corporate failures (Sirmanna, 2011). In this evolving context the Central Bank of Sri Lanka stated that there were several common issues behind the collapse of these companies, such as lapses of directors and managers, imprudent related party transactions and investments, unauthorized deposit taking by related companies, weak risk management systems, unethical business practices, mismanagement, and corruption negative capital and accumulated losses (Sirmanna, 2011). Therefore a great deal of attention should be devoted to an early recognition of distress condition and to seek promptly actions of turnaround. Therefore, identification of those companies impending distress condition is an important prerequisite in the quest of rescuing them. In this light, many academics suggested that corporate governance attributes are leading factors for success or failure of a corporation (Parker, Peter & Turetsky, 2002; Gilson, 1990; Daily & Dalton, 1994).

This contemporary interest follows colselly on recent initiatives to improve the performance of the audit commitee. In this context many studies examined the relationships between effectiveness of audit committee and entity performance (Adams, 1997; Rahmat & Iskandar, 2009; Dalton, Daily, Johnson & Ellstrand, 1998). Adams (1997) found that effective audit committee could increase the financial statement credibility and objectivity. Further Rahmat and Iskandar (2009) found that the audit committee effectiveness depends on the prosperity or financial distress of companies such as financially literate of the audit committee members increase the company performance and prevent its financial distress. Hence evidence of competence between members enhances company performance and reduces the likelihood of financial problems. Charbel, Salloum, Azzi and Gebrayel (2014) foud that the meeting frequency of audit

committee members is an important factor as it helps the audit committee to hinder the financial distress. Moreover, it is expected that the domination of independent non-executive members helps the company to enhance its performance and to avoid any financial distress.

According to Senaratne and Gunaratne (2012), the compliance with corporate governance practices of Sri Lankan firms is closely associated with ownership structure and better governance seems to associate with higher financial performance of the firms. Therefore existing literature in Sri Lankan context generally focused the structure of the corporate governance and their relationship over the financial performance of the company. In this context, it is observed that the use of bankruptcy model for predicting financial distress of Sri Lankan companies and impact of audit committee attributes of corporate governance on financial distress of a company has not been completely addressed by previous studies in Sri Lanka. Therefore, this study attempts to fill this persistent gap in the literature.

## **2. Literature and hypotheses**

Collier (1993) found that the presence of an audit committee in a firm helps directors to meet their statutory and fiduciary responsibilities such as accounting records, annual audit and ensures the quality of the financial reporting and control system. Audit committee is playing a vital role as a board subcommittee and therefore governance codes contain extensive requirements for audit committee. As per Code of Best Practices of Chartered Accountants of Sri Lanka (CASL) an audit committee should have written terms of reference indicating the purpose, duties, and responsibilities of the committee. Further, it requires an audit committee to have two independent non-executive directors (NED) or exclusively NEDs with a majority of independent directors. Effectiveness of the audit committee depends upon the composition of the committee, and its processes. Composition concerns the number of independent directors, having accounting and finance professionals in the committee and having an independent chairman. Processes deal with the role of selecting auditors and maintaining a working relationship with them, procedures regarding minutes, remuneration of committee members and written terms of reference for committee proceedings. Moreover some studies have examined the effect of audit committee attributes on firm performance. Gan, Saleh, Abessi and Huang (2013) suggested that there is a negative relationship between size of audit committee and financial performance. Further Salloum et al. (2014) found that there is a negative and significant relationship between meeting frequency of audit committee members and financial distress of the firm.

Anderson, Deli and Gillan (2003) found that large size audit committee improves financial reporting quality as its effectiveness increases with the existence of experienced and knowledgeable members. This is evident that the right-sized committees can use their experience to help the committee in monitoring. On the other hand, Pincus, Rusbarsky and Wong (1989) found that a weak association between the size of audit committee and company performance. Therefore, the large audit committee loses concentration and becomes less participative than the smaller one. However, Rahmat and Iskandar (2009) suggested that there is a negative relationship between size of audit committee and financial distress. Thus, this study suggests that;

*Hypothesis I (H<sub>1</sub>): There is a negative relationship between size of an audit committee and financial distress of the firm.*

Audit committee composition focuses on independence aspect. It is defined by the ratio of independent non-executive directors to total number of directors in audit committee. When higher the proportion of independent non-executive directors, the audit committee is considered independent. However, executive members can impair the effectiveness of audit committee by influencing the decision making process of the board (Ruiz, Biedma & Gomez, 2007). High presence of executive directors limits the amount of information held by board members. Thus, a large proportion of independent directors enhances management monitoring (Xie & Dadalt, 2003), which evidences that more independent audit committee has a high level of audit coverage (Ghafran & Sullivan, 2013). There is evident that more independent audit committees are seeking to preserve the independence of the external audit process. The participation of independent non-executive members in large proportion improves the audit committee independence. This enhancement of audit committee independence should facilitate decision and assure information objectivity (Vinteen & Lee, 1993). For this reason, the audit committee should maintain the monitoring role delegated by the board with aim to provide better reliability of information. Consequently, the presence of independent board committees increases the capacity of effective advice and monitoring of corporate boards (Ntim, 2013). Carcello and Neal (2000) found a negative association between the audit committee independence and the going-concern of financially distressed companies. In other words, they found that the greater the proportion of affiliated directors in the audit committee, the lower the likelihood the auditor will issue a going-concern reports. McMullen and Raghunandan (1996) stated that the presence of independent non-executive directors in audit committee reduces the likelihood of financial problem. Thus, this study postulates that;

*Hypothesis II (H<sub>2</sub>): There is a negative relationship between the composition of non-executive directors in audit committee and financial distress.*

Abbott, Parker and Peter (2004) suggested that frequent meetings of audit committee provide a better monitoring of financial environment and reduce financial reporting problems. Further McMullen and Raghunandan (1996) argue that by meeting regularly, audit committee provides its effectiveness and ensures the integrity of financial reporting process. Hence this implies that audit committees in companies with financial reporting problem do not hold frequent meetings compared with audit committees in companies with no such financial reporting problems. Therefore these studies found a positive relationship between frequency meetings and audit committee effectiveness. In this light frequency of audit committee meeting plays an essential role in effectiveness of audit committee with respect to reduce any perceived audit and controls risk. Moreover Charbel et al. (2014) found that the meeting frequency of audit committee members is an important factor as it helps the audit committee to hinder the financial distress. Thus, third hypothesis of the study is developed as follows.

*Hypothesis III (H<sub>3</sub>): There is a significant negative relationship between the frequency of audit committee meeting and financial distress.*

### **3. Methods and materials**

In order to accomplish the objectives of the study, secondary data were obtained from Colombo Stock Exchange (CSE) archrivals and annual reports of respective companies

of the period spanning from 2011 to 2015. The working sample was achieved after screening the sample firms for missing information. This process reduced sample to 168 listed companies. The classification of financial distress and non-distress was then performed based on the calculated Altman Z values of these companies. If the computed Z value of the company falls below 1.81, it was classified as “Distress” and if Z value equal or greater than 1.81 it was classified as “Non distress firm”. It left the final sample with 64 companies which consists of 32 financially distressed and 32 financially non-distressed companies. Thus, analysis was performed with 320 firm-year observations. The relative levels of compliance with audit committee practices were assessed based on a scores of index that was constructed referring the Code of Best Practice, Listing Rules of CSE and the prior research studies. The impact of audit committee attributes on financial distress was examined through binary logistic regression model. The binary regression model is specified as follows:

$$\text{Financial distress} = \alpha_0 + \beta_1 \text{AS}_{it} + \beta_2 \text{AC}_{it} + \beta_3 \text{AMF}_{it} + \beta_4 \text{SF}_{it} + \beta_5 \text{FR}_{it} + \varepsilon$$

Where, for sample firm  $i$  and year  $t$ , Financial Distress $_{it}$  = 1, when firm is classified as being in financial distress, and 0 otherwise, Audit committee size (AS), Audit committee composition (AC), Meeting frequency of Audit firm (AMF), Size of the Firm (SF), Financial Risk (Leverage) (FR),  $\varepsilon$  - Error term

#### 4. Results and discussion

It is interesting to note that more than 75 percent of sampled firms have an audit committee irrespective of the category into which they fall. It was also revealed that the majority of distress companies have no clearly defined written terms of reference and is lack in conducting of recommended frequency of audit committee meetings compared to non-distress companies. The lack of independence and the relatively low level of activities carried out by audit committees of distress companies compared to non-distress companies suggests that even the boards have control over the functions of audit committees, they are meant to be independent from the executives and owners. Non-distress companies demonstrate greater concern for the independence of the committees and relationship with the external auditors.

As shown in Table 1, non-distress companies obtained higher mean values for audit committee attributes than that of distress companies. This result indicates that compliance levels of distress companies are relatively lower than that of no distress companies. Results of Independent Samples t-test also reveal that there is a significant difference between distress companies and non-distress companies in terms of audit committee size ( $t=-5.897$ ,  $p<0.05$ ), audit committee composition ( $t=-12.525$ ,  $p<0.05$ ) and frequency of audit committee meetings ( $t=-14.648$ ,  $p<0.05$ ). The higher frequency of committee meetings of non-distress companies indicates the active functioning of these committees by securing the independence and efficiency of audit committees. These results therefore confirm that level of compliance with audit committee practices of corporate governance of distress companies is significantly lower than the non-distress companies in Sri Lanka. This tendency raises a question, whether compliance with audit committee practices may have impact over financial distress condition of a firm. Thus, it warrants further analysis to find out whether the compliance with these audit committee practices have created diverse impacts on financial distress condition in Sri Lankan companies.

Table 1  
Descriptive statistics of audit committee attributes

Variables	Distress			Non-Distress			t
	Mean	Std. Deviation	Skewness	Mean	Std. Deviation	Skewness	
AS	2.00	1.594	-0.174	3.00	0.858	-0.523	-5.897
AC	0.46	0.382	-0.105	0.89	0.200	-2.434	-12.525
AMF	2.00	1.726	0.400	5.00	1.693	0.653	-14.648

AS: Audit committee size, AC: Audit committee composition and AMF: Frequency of Audit Committee Meetings

The binary logistic regression analysis was performed to examine the impact of audit committee attributes on financial distress of the firm. Binary logistic regression is appropriate as logistical regression provides significance tests on the parameter estimates and enables researcher to generate probabilities for financial distress for each firm to examine the classification accuracy. Moreover the binary logistical regression analysis was widely employed by the studies carried out in the field of financial distress for prediction purposes (Miglani et al., 2010). Table 2 presents results of the analysis.

Table 2  
Results of Logistic Regression

Nagelkerke R Square	0.641	Classification Performances 85%			
Omnibus Tests of Model Coefficients		Chi-square 209.779 (Sig 0.000)			
Hosmer and Lemeshow Test		Chi-square 14.963 ( Sig 0.060)			
Variable	B	Std. Error	Wald	Sig.	Exp(B)
AS	-0.810	0.219	3.673	0.071	2.247
AC	-3.073	0.746	16.961	0.000**	0.046
AMF	-0.984	0.157	39.534	0.000**	0.374
SF	-0.421	0.386	1.194	0.275	0.656
FR	2.102	0.731	8.275	0.004**	8.184
Constant	6.089	3.451	3.112	0.078	440.808

Notes-\*\* Statistically Significant at 0.05 level Audit committee size (AS), Audit committee composition (AC), Frequency of Audit Committee Meetings (AMF), Size of the firm (SF), Financial Risk (Leverage) (FR)

The result of the Omnibus test of model coefficients in Table 2 indicates that the model is statistically significant (Chi-square= 209.779,  $p < .05$ ). Nagelkerke R Square value (0.641) reveals that the predictor variables have ability to explain 64.1 percent of variation in financial distress the sampled firms. In addition Classification Performances (85%) indicates the number of observations in the sample that an estimated equation classified correctly and the model performs well in distinguishing between financially distressed and non-distress firms. Furthermore Hosmer and Lemeshow test (Chi-square=14.963,  $p > .05$ ) shows the better model fit. It implies that the model's estimates are in acceptable level. In other words the model predictions are not significantly different from observed values. A closer look at the individual coefficients in Table 2 reveals that composition of an audit committee and frequency of audit committee meetings ( $B_{AC} = -3.073$ ,  $p < .05$ ;  $B_{AMF} = -0.984$ ,  $p < .05$ ) have significant and negative effect on finance distress of the firm. Therefore Hypothesis II and Hypothesis III are supported by these results. However coefficients associated to the size of audit committee ( $B_{AS} = -0.810$ ,  $p > .05$ ) is negative as expected, but not significant. Hence, Hypothesis I is rejected at 0.05 level of significance.

With respect to the control variables, size of the firm (SF) is not statistically significant at any confidence (1% and 5%) level. Financial Risk (Leverage), on the other hand, is positive and statistically significant ( $p < 0.05$ ), which suggests that higher leverage companies are more likely to experience financial distressed than lower firms. These findings are consistent with the argument of Chan and Chen in 1991.

## 5. Conclusion

The audit committee is arguably the most important of the board subcommittees. An audit committee is required to assist the board over matters such as accounting and financial statements, compliance with regulations, internal control, going concern assessment and external auditor's independence and performance. This study found a significant difference between distress and non-distress companies in relation to the compliance requirements of audit committee. In particular, majority of distress companies have no clearly defined written terms of reference and lack in conducting of recommended frequency of audit committee meetings, while non-distress companies demonstrate greater concern on them. It indicates that relatively low activities carried out by the audit committees of distress companies. The lack of independence and the relatively low level of activities carried out by audit committees of distress companies compared to non-distress companies suggest that the board even have control over the functions of audit committees, although they are meant to be independent from the executives and owners.

The results of the study further revealed that composition and frequency of meeting of audit committee members have negative effect on financial distress of the firm. This implies participation of independent non-executive members in large proportion improves the independence of the audit committee and increases the capacity of corporate boards to effectively advice, monitor and consequently, reduces the likelihood of financial problems. Moreover frequent meetings of the audit committee are able to help audit committee members to fulfill their responsibilities. In other words, audit committee is able to ensure the integrity of financial reporting, to provide better monitoring and to review effectively the operations.

It was further found that the listed companies in Sri Lanka meet the minimum requirements of code of best practice of corporate governance in terms of existence and size of audit committee. This is a clear evidence that Sri Lankan listed companies comply with basic principles of code of best practice of corporate governance. However, complying with these requirements is not enough to enhance performance of the audit committee and avoid the financial distress of the company. Other qualitative factors may have influence on audit committee performance (Rahmat & Iskandar, 2009), such as quality of discussion during meetings, level of commitment of audit committee members and organizational work environment. Finally, study infers that if the distress companies can strengthen their performance of audit committee in terms of increasing the proportion of independent non-executive directors and frequency of meetings may have a positive contribution towards the resolution of their financial distress. Further studies are required to validate the findings of the present study.

## References

- .Abbott, L. J., Parker, S., & Peters, G. F. (2004). Audit committee characteristics and restatements. *Auditing: A Journal of Practice & Theory*, 23(1), 69-87.
- Adams, M. (1997). Determinants of audit committee formation in the life insurance industry: New Zealand evidence. *Journal of Business Research*, 38(2), 123-129.
- Anderson, K. L., Deli, D.N. and Gillan, S.L.(2003), “ Boards of Directors, Audit Committees, and the Information Content of Earnings”. Delaware: University of Delaware Weinberg Center for Corporate Governance.
- Cadbury, A. (1992). The code of best practice. *Report of the Committee on the Financial Aspects of Corporate Governance, Gee and Co Ltd*, 27.
- Calleja, N. (1999). To Delegate or Not to Delegate: Board Committees and Corporate Performance in Australia's Top 100 Companies. *Sydney L. Rev.*, 21, 5.
- Carcello, J. V., & Neal, T. L. (2000). Audit committee composition and auditor reporting. *The Accounting Review*, 75(4), 453-467.
- Collier, P. (1993). Factors affecting the formation of audit committees in major UK listed companies. *Accounting and Business Research*, 23(sup1), 421-430.
- Collier, P. and Gregory, A. (1999), “Audit Committee in Large UK Companies. London”: The Institute of Chartered Accountants. London.
- Daily, C. M., & Dalton, D. R. (1994). Corporate governance and the bankrupt firm: An empirical assessment. *Strategic Management Journal*, 15(8), 643-654.
- Dalton, D. R., Daily, C. M., Ellstrand, A. E., & Johnson, J. L. (1998). Meta-analytic reviews of board composition, leadership structure, and financial performance. *Strategic Management Journal*, 19(3), 269-290.
- Forker, J. J. (1992). Corporate governance and disclosure quality. *Accounting and Business research*, 22(86), 111-124.
- Gan, K., Saleh, Z., Abessi, M., & Huang, C. C. (2013). Intellectual capital disclosure in the context of corporate governance. *International Journal of Learning and Intellectual Capital*, 10(1), 52-70.
- Ghafran, C., & O'Sullivan, N. (2013). The governance role of audit committees: reviewing a decade of evidence. *International Journal of Management Reviews*, 15(4), 381-407.
- Gilson, S. C. (1990). Bankruptcy, boards, banks, and blockholders: Evidence on changes in corporate ownership and control when firms default. *Journal of Financial Economics*, 27(2), 355-387.
- Hicks, A., & Goo, S. H. (2008). *Cases and materials on company law*. Oxford university press.
- McMullen, D. A., & Raghunandan, K. (1996). Enhancing audit committee effectiveness. *Journal of Accountancy*, 182(2), 79.
- Miglani, S., Ahmed, K., Henry, D. (2010), “Corporate Governance and Financial Distress: Evidence from Australia” Paper presented at the Accounting and



Finance Association of Australia and New Zealand (AFAANZ) Conference,  
Christchurch, New Zealand, pp. 1-55.

- Ntim, C. G. (2013). Monitoring board committee structure and market valuation in large publicly listed South African corporations. *International Journal of Managerial and Financial Accounting*, 5(3), 310-325.
- Parker, S., Peters, G. F., & Turetsky, H. F. (2002). Corporate governance and corporate failure: a survival analysis. *Corporate Governance: The International Journal of Business in Society*, 2(2), 4-12.
- Pincus, K., Rusbarsky, M., & Wong, J. (1989). Voluntary formation of corporate audit committees among NASDAQ firms. *Journal of accounting and public policy*, 8(4), 239-265.
- Rahmat, M. and Iskandar, T., (2009), "Audit Committee Attributes in Financially Distressed and Non-Distressed Companies", *Managerial Auditing Journal*, vol. 24, no.07, pp. 624-638.
- Ruiz-Barbadillo, E., Biedma-López, E., & Gómez-Aguilar, N. (2007). Managerial dominance and audit committee independence in Spanish corporate governance. *Journal of Management & Governance*, 11(4), 311.
- Salloum, C., Azzi, G., & Gebrayel, E. (2014). Audit committee and financial distress in the Middle East context: evidence of the Lebanese financial institutions. *International Strategic Management Review*, 2(1), 39-45.
- Senaratne, S., & Guneratne, P. S. M. (2012, December). Ownership structure and corporate governance of Sri Lankan listed companies. In *Proceedings of International Conference on Business Management* (Vol. 4). Faculty of Management Studies and Commerce, University of Sri Jayewardenepura Sri Lanka.
- Sirimanna, B. (2011), 'Central Bank Rescues three Crisis hit Finance Companies'. The Sunday Times, 2011 /03 /27, pp. 12.
- Vinten, G., & Lee, C. (1993). Audit committees and corporate control. *Managerial Auditing Journal*, 8(3), 11-24.
- Xie B. D. W. and Dadalt P., (2003), "Earnings Management and Corporate Governance: The Role of the Board and the Audit Committee", *Journal of Corporate Finance*, vol. 09, pp. 295-316.
- Xie, B., Davidson, W. N., & DaDalt, P. J. (2003). Earnings management and corporate governance: the role of the board and the audit committee. *Journal of Corporate Finance*, 9(3), 295-316.