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Impact of Audit Quality on Firm Performance: Evidence from Non-Financial Companies Listed in Colombo Stock Exchange

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ABSTRACT

Auditing is a crucial component of a firm's control system. However, in Sri Lanka, there is no standardized or mandatory code of best practices for audit quality. The purpose of this study is to investigate the impact of audit quality on the firm performance of non-financial companies listed on the Colombo Stock Exchange. In this study, audit fee, auditor expertise, auditor independence, and audit rotation are considered proxies for audit quality while firm performance is measured by ROA and Tobin's Q. A sample of 94 non-financial companies listed on the Colombo Stock Exchange was selected for the study comprising 470 observations. Secondary data were collected from the annual reports of these companies for the five-year period from 2017 to 2021. Descriptive and inferential statistics were employed to analyze the data. Correlation analysis was used to examine the relationship between audit quality and firm performance while panel data regression analysis was applied to assess the impact of audit quality on firm performance. The results of the correlation analysis indicate that audit fee and auditor expertise are positively correlated with ROA whereas auditor independence and audit rotation show no relationship with firm performance as measured by ROA and Tobin's Q. Furthermore, the panel data regression analysis reveals a significant positive impact of audit fees on firm performance while audit rotation positively influences only the ROA of listed companies in Sri Lanka. However, auditor independence and auditor expertise do not exhibit a significant impact on firm performance.This study is valuable for understanding the impact of audit quality on firm performance in the context of developing countries.

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1. Introduction

Any public or private company's principal goal is to maximize profits. As a result, increasing revenue is necessary, and it also depends on a company's business operations. This goal of profit maximization is consistent with the stakeholder's goal (Khan et al. 2021). Yet, stockholders do not engage in the basic

operations; instead, they rely only on the firm's management. The failure of well-known multinational firms has piqued the interest of academics, regulators, and investors alike. According to Srivastava (2009), these failures were mostly caused by flaws in corporate governance processes, such as poor external auditing and inefficient audit committees. Financial scandals and business collapses in Asian nations, like in the case of Satyam in India, Citic pacific in China and SK networks in South Korea, which serves as an exemplary illustration of poor corporate governance (Waleed, et al. 2021). In response to these unfortunate mishaps, a number of nations passed corporate governance focused laws intended to enhance the corporate disclosure, procedures and practices.

Users rely on financial statements to make investment decisions. Making sustainable decisions in corporate organizations necessitates the use of trustworthy and dependable financial statements. The financial statements are prepared by management and sent to all users for their various needs. Management may falsify the reports for their own advantages; because of the personal interest of management the veracity and dependability of these financial figures are always doubtful. The practice of auditing originated in the corporate sector because of the fraud caused by asset theft and misappropriation. The perceived value of auditing in spotting fraud, misstatements and inconsistencies in financial statements underlies its significance. Auditing increases the financial statement's credibility and confidence, which is necessary for performance improvement. By minimizing information asymmetry, financial statement audits are crucial instrument for preserving a competitive market environment.

According to Soltani (2014) one of the causes of financial and business scandals is poor audit quality. Even with the auditing procedure in place, there have been instances of failure of firms whose accounts were certified being very solvent and liquid. Example patisserie Valerie in the UK 2018, Steinhoff and KPMG in South Africa 2018, Kingdom bank Africa limited and Choppies limited in Botswana 2015, 2018 and crane band in Uganda 2018. These occurrences demonstrate the necessity of giving financial statement disclosures more careful examination.

Since these scandals showed that the audited financial accounts were inaccurate, external auditors and audit committees have come under public criticism. These incidents have led to a great deal of stakeholder debate on the efficiency of the audit committee and the level of service that the external auditors deliver. Several research projects have been carried out to investigate the potential relationship between audit quality and corporate performance. Contradictory results have been arrived at by other researchers; according to Wijaya (2020) firm value benefits from high-quality auditing. Shaique & Anwar (2018) found that, comparing the earning management of companies audited by Big 4 and non-Big 4 auditors, no discernible changes were found. Lestari & Aeni (2019) discovered that there is no correlation between audit quality and firm performance.

Auditing is a crucial part of a firm's control system, and the auditing is used by all organizations in Sri Lanka. But there is no standard or mandatory code of best practices on audit quality in Sri Lanka. As a result of this,

listed companies cannot give their best output in their financial performance. Sri Lanka, which is still developing, has already had a number of these controversies. Among notable incidents include the failure of Pramuka bank, Touchwood investments and Golden key plc. Regarding the auditors of Golden Key, auditors of such businesses have been publicly accused of acting unethically and carelessly and have even been sued and prisoned.

Although a few researchers have conducted studies on audit quality, including those in developing countries, the understanding of the level of audit quality and the factors that influence it remains unclear. Using information from Sri Lankan listed non-financial corporations, this study attempts to address the central query of whether audit quality influences firm performance. The research question is 'to what extent does audit quality impact on firm performance?' Examining how audit quality affects non-financial firms listed on the Colombo stock exchange in Sri Lanka is the primary objective of this study. The study thoroughly explores the idea of audit quality and the impact of the four primary audit quality proxies (Audit fees, auditor expertise, audit firm rotation and auditor independence). The remainder of this paper is organized as follows: Section 2 reviews the relevant literature and develops hypotheses; Section 3 outlines the research methodology; Section 4 presents the empirical results and discussion; and, finally, Section 5 concludes the study and offers implications.

2. Literature Review

Various empirical studies have been conducted on audit quality and firm performance in both developed and developing countries. Harianja & Sinaga (2022) investigated the effects of audit fees, audit delay, and auditor switching on audit quality. The data were obtained from the Indonesian Stock Exchange. Using Kasznik's methodology, discretionary accruals served as a proxy for audit quality. The data were analyzed using descriptive statistics, the coefficient of determination, the F-test, and the t-test. The study's findings revealed that while auditor changes had no discernible impact on audit quality, audit fees had a marginally significant effect.

Cahyonowati & Yolandita (2022) examined the impact of audit quality on the firm value of the Indonesian financial services sector. This study used audit firm size (Big 4 vs. Non-Big 4) as a measure of audit quality and Tobin's Q as a proxy for firm value. The study found that audit quality had a significantly negative effect on firm value. Furthermore, the findings suggested that companies and regulators view Big 4 and Non-Big 4 auditors as equally effective in terms of performance.

Meanwhile, Mehraan, et al. (2022) investigated the effects of audit quality and CEO remuneration on firm performance, using data from the Pakistan Stock Exchange. Measures of audit quality included audit fees, audit committee size, and audit firm rotation, while firm performance was measured by Return on Assets (ROA) and Earnings Per Share (EPS). The study, employing a fixed-effects model, found that audit fees and auditor rotation had no significant impact on ROA or EPS.

Martani,et al. (2021) studied the influence of audit tenure and audit rotation on audit quality, comparing Big 4 and Non-Big 4 firms. The findings indicated that audit quality was not significantly affected by an auditor's tenure but was positively influenced by audit firm rotation. Moreover, Rochmatilah, et al. (2021) explored the effects of audit fees, auditor rotation, auditor firm reputation, and auditor specialization on audit quality, using evidence from Indonesia. Multiple linear regression analysis was employed, with Kasznik's discretionary accruals serving as proxies for audit quality assessments. The results suggested that audit switching impacted audit quality, while audit fees and auditor specialization did not.

Altin (2024) indicated that audit committee independence, expertise, size and affiliation with the big four have a significant and positive effect on firm performance, while audit committee meetings have a non-significant effect using the Hunter–Schmidt method to conduct a meta-analysis of 39 previous studies published between 2012 and 2022. Rompotis & Balios (2023) accentuated that a positive relationship between financial performance and audit quality using the panel data of 75 companies listed in the Athens Exchange in Greece. Furthermore, Al-ahdal & Hashim (2022) demonstrated that external audit quality has a significant positive impact on the financial performance of firms as measured by Tobin's Q, while firm size and leverage were found to have a significant impact on the financial performance of firms as measured by return on assets and return on equity.

The effectiveness of an audit committee is dependent on the independence and quality of the audit committee chairman, who must be an independent director with professional accounting knowledge according to corporate governance codes (OECD, 2015). Independent directors in the audit committee can monitor managers' conduct and improve the reliability of financial reporting by preventing manipulative and self-centered activities (Cohen et al., 2011). Independent audit committees have been shown to improve the quality of audit reports and enhance firm performance in multiple studies (Arslan et al., 2014; Yasser et al., 2011). However, some researchers have found a negative relationship between the independence of the audit committee and firm performance (Leung et al., 2014; Mohammed, 2018), while others have found no significant relationship (Kota & Tomar, 2010; Hamdan et al., 2013).

The use of the Big 4 audit firms can improve a company's performance by enhancing the quality of audits and reducing information asymmetry, which signals financial markets about the firm's prospects (Detthamrong et al., 2017; Azizkhaniet al., 2010). Better investment and operational decisions are anticipated as a result of higher-quality audits. According to studies, firms with Big 4 auditors often perform better and have more financial leverage (Detthamrong et al., 2017; Caramanis & Lennox, 2008).

Despite a large body of research on audit quality, including studies conducted in developing countries, it remains unclear what constitutes high audit quality and which variables affect it. Different researchers have employed distinct dimensions, leading to disparate outcomes. As a result, it has been difficult to provide a coherent explanation for the phenomenon. To truly benefit both academics and business professionals, audit quality is a critical concept that requires further investigation. While audit quality has a significant impact on

business performance, few studies have explored its effect on company performance in-depth (Farouk & Hassan, 2014). Moreover, there is limited prior research in Sri Lanka linking audit quality to firm performance. Therefore, it is essential to examine this relationship within the Sri Lankan context.

Based on the literate review, the following research hypotheses were developed,
H_1: There is a significant impact of audit fee on firm performance.

H_2: There is a significant impact of audit expertise on firm performance.

H_3: There is a significant impact of auditor independence on firm performance.

H_4: There is a significant impact of audit rotation on firm performance.

3. Research Methodology

The quantitative technique is employed in this study to obtain results, as the study uses measurable numerical data to establish facts. Secondary data are also utilized in this research. A deductive approach has been applied to carry out the study.

Sample and Data

The study's goal is to investigate the impact of audit quality on firm performance of listed non-financial companies in Sri Lanka. The Colombo Stock Exchange comprises 296 companies representing 20 GICS industry groups as of 30th October 2021. The banking, finance, and insurance sectors are excluded due to their high volatility. Therefore, all 231 non-financial companies listed in the CSE are the population. The samples were selected using a stratified random sampling method. An industry with at least 10 companies was fully selected, while the remaining industries were chosen based on the proportion of companies to total assets. Consequently, 94 listed non-financial companies were selected as a sample from the following sectors: energy, materials, capital goods, commercial and professional services, transportation, automobiles and components, consumer durables and apparel, consumer services, retailing, food and staples retailing, food, beverage, and tobacco, household and personal products, health care equipment and services, telecommunication services, utilities, and real estate.

The data, including audit fees, the number of independent directors on the audit committee, audit rotation, and financial data, were obtained from the annual reports of non-financial companies listed on the CSE. Additionally, the data sources include the annual publications of the CSE, as well as the websites of the CSE and the companies.

Measurements

The proxies for audit quality include audit fee, auditor expertise, audit firm rotation, and auditor independence. Firm performance is measured by ROA and Tobin's Q, while the control variables are firm size, leverage, and firm age.

Audit fee refers to the amount paid by a firm to the auditor for auditing the company's financial statements. Auditor expertise is measured using a dummy variable: 1 if the company is audited by a Big Four firm (Deloitte, EY, KPMG, or PwC), and 0 otherwise. Auditor independence is the proportion of independent directors on the audit committee. Furthermore, audit rotation refers to the replacement of the audit firm providing general audit services, coded as 1 if the company rotates its audit firm, and 0 otherwise. Return on Assets (ROA) is measured by profit before tax divided by total assets. Tobin's Q is calculated by dividing market capitalization by total assets.

The control variables are as follows: firm size is the natural logarithm of total assets; firm age is the number of years the company has been listed on the CSE; and leverage is the proportion of long-term debt to total assets. Firm size often plays a significant role in firm performance because larger firms typically find it easier to secure financing, obtain better interest rates, and negotiate favorable discount rates due to the large quantities they purchase. Additionally, they possess greater market power, allowing them to charge higher prices and earn greater profits. Previous empirical studies indicate that firm size positively impacts corporate governance, which, in turn, enhances firm performance (Ahmed Haji,2014). Jensen (1986) stated that debt is an instrument to discipline managers and mitigate the negative impact of the agency conflict.

Regression Model

The following regression model was used by the researcher to find out the impact of audit quality on firm performance.

$$ROA = \beta_0 + \beta_1 AUF + \beta_2 AUEX + \beta_3 AUI + \beta_4 AUFR + \beta_5 FS + \beta_6 LEV + \beta_7 FA + e \text{ --(1)}$$

$$TQ = \beta_0 + \beta_1 AUF + \beta_2 AUEX + \beta_3 AUI + \beta_4 AUFR + \beta_5 FS + \beta_6 LEV + \beta_7 FA + e\text{---(2)}$$

Where: AUF = Audit fee; AUEX = Auditor expertise; AI = Auditor independence; AUFR = Audit firm rotation; FS = Firm size; LEV = Leverage; FA = Firm age; β_0, β_1, β_2, β_3, β_4, β_5, β_6, β_7 = Regression coefficients; e = Error term.

4. Analysis and Discussion

Descriptive Analysis

Table 1: Descriptive Statistics

Variable	Mean	Median	Max	Min	St. Deviation
Audit Fee	13.995	13.955	16.075	11.870	0.873
Auditor Expertise	0.923	1.000	1.000	0.000	0.266
Auditor Independence	0.805	0.750	1.000	0.000	0.173
Audit Rotation	0.068	0.000	1.000	0.000	0.252
ROA	0.046	0.037	0.782	-0.504	0.097
Tobin's Q	0.926	0.460	47.340	0.003	2.426
Firm Size	6.885	6.880	8.392	5.682	0.494
Leverage	0.147	0.109	0.704	0.000	1.100
Firm Age	30.03	27.00	93.00	3.00	17.60

Source: *Result from Eviews*

Table 1 portrays the descriptive statistics for the audit quality, firm performance and control variables that are utilized in this study. The overall mean of audit fee is 13.995 while the minimum value 11.870 and maximum 16.075 with the standard deviation of 0.873. These values refer to the natural log of audit fee that are paid to external auditors. The average value of auditor expertise in the sample is 0.923, with the minimum value of 0.000, maximum value of 1.000 and standard deviation of 0.266. Auditor independence shows an average value of 0.805, ranging from zero to full independence, with the standard deviation of 0.173. Audit rotation has an average value of 0.068, minimum value of 0 and maximum value of 1, with the standard deviation of 0.252. In respect to the firm performance, the result of descriptive statistics reveal that ROA has an average value of 0.046, minimum value of -0.504, maximum value of 0.782 with a standard deviation of 0.097. Tobin's Q has an average value of 0.926, minimum value of 0.003, and maximum value of 47.340 with a standard deviation of 2.426. While considering the control variables, firm size has a mean value of 6.885, minimum value of 5.682, and maximum value of 8.392 with a standard deviation of 0.494. As per the leverage, the mean value is 0.147, minimum value is 0, and maximum value is 0.704 with a standard deviation of 1.100. Furthermore, the average value of firm age is 30, minimum value is 3, maximum is 93, and median is 27 with a standard deviation of 17.6.

Correlation Analysis

As seen in the table 2, audit fee exhibits a significant positive correlation with ROA ($r=0.104$, $p<0.05$) at the significant level of 5%. This indicates that an increase in audit fee is associated with an increase in the ROA. Likewise, auditor expertise ($r=0.097$, $p<0.05$) demonstrates a significant positive correlation with ROA, at a significant level of 5%. Furthermore, auditor independence ($r=0.051$, $p>0.05$), and audit rotation ($r=0.075$, $p>0.05$) do not demonstrate significant relationship with ROA at significant level of 5%. Moreover, the control variables: firm size ($r=0.024$, $p>0.05$) and firm age ($r=0.080$, $p>0.05$) show an insignificant relationship with ROA. But, leverage is negatively correlated with ROA ($r=-0.263$, $p<0.01$) at significant level of 1%. On the

other hand, when examining the relationship with Tobin's Q, audit fee (r=0.086, p>0.05), auditor expertise (r=0.061, p>0.05), auditor independence (r=0.088, p>0.05) and audit rotation (r=-0.025, p>0.05) also do not exhibit significant correlation at 5% significant levels. In control variables, firm size (r=-0.002, p>0.05), leverage (r=-0.066, p>0.05) and firm age (r=0.042, p>0.05) show an insignificant relationship with Tobin's Q at 5% significant level.

Table 2: Correlation Matrix

Correlation Probability	Audit Fee	Auditor Expertise	Audit Independence	Audit Rotation	Firm Size	Leverage	Firm Age	ROA
Auditor Expertise	0.126 0.005							
Audit Independence	0.168 0.000	-0.033 0.470						
Audit Rotation	-0.033 0.468	0.014 0.756	-0.875 0.058					
Firm Size	0.557 0.000	0.190 0.000	0.063 0.173	0.020 0.680				
Leverage	0.272 0.000	-0.104 0.023	0.133 0.004	0.008 0.870	0.018 0.703			
Firm Age	-0.039 0.389	0.075 0.103	0.150 0.001	-0.044 0.340	0.019 0.980	-0.235 0.000		
ROA	0.104 0.023	0.097 0.033	0.051 0.280	0.075 0.103	0.024 0.670	-0.263 0.000	0.080 0.083	
Tobin's Q	0.086 0.062	0.061 0.185	0.088 0.057	-0.025 0.595	-0.002 0.970	-0.066 0.150	0.042 0.363	0.309 0.000

Source: Result from Eviews

Panel Data Regression Analysis

For the two regression models of this study, the fixed effects model is more suitable than the random effects model as the Hausman test is significant at 5%. (p<0.05).

Table 3 presents the result of panel data regression analysis. Accordingly, the model F statistic (p=0.000) is significant at the 1% level. This implies that the model is well-suited for this study. Adjusted R-squared value of 0.457 is noteworthy as it signifies that 45.7% of variation in ROA can be attributed to the combination of all independent variables, including audit fee, auditor expertise, auditor independence and audit rotation, and the control variables utilized in this study. Remaining 54.3% of variation is influenced by other unaccounted factors.

Table 3: Panel Data Regression Analysis of ROA

Variable	Fixed			Random		
	Coefficient	t-stats	P	Coefficient	t-stats	P
C	-1.424	-4.124	0.000	-0.295	-2.636	0.008
Audit fee	0.044	2.312	0.021	0.028	3.267	0.001
Auditor expertise	0.058	0.720	0.472	0.016	0.659	0.509
Audit independence	0.016	0.425	0.670	0.024	0.814	0.415
Audit Rotation	0.035	2.448	0.014	0.039	2.807	0.005
Firm size	0.121	2.771	0.006	-0.009	-0.640	0.522
Leverage	-0.244	-3.741	0.0002	-0.227	-5.140	0.000
Firm age	-0.0004	-0.145	0.884	0.00017	0.444	0.657
R-squared			0.573			0.086
Adj.R-squared			0.457			0.072
F-Stats			4.958			6.274
P(F-stats)			0.000			0.000
Durbin Watson			1.969			1.567

Source: Result from Eviews

The outcome of the regression shows, audit fee (ß=0.044, p<0.05) and audit rotation (ß=0.035, p<0.05) portrays a significant positive impact on ROA at 5% significant level. Companies paying higher audit fee may signal to the market that they are engaging auditors who provide higher audit quality, which, in turn, can enhance firm performance. Furthermore, auditor expertise (ß=0.058, p>0.05) and auditor independence (ß=0.016, p>0.05) shows insignificant impact on ROA. In control variables, firm size (ß=0.121, p<0.05) and leverage (ß=-0.244, p<0.05) demonstrates a significant impact on ROA while firm age (ß=-0.0004, p>0.05) shows insignificant impact on ROA at 5% of significant level. Based on the Durbin Watson-statistic, the autocorrelation is in the acceptable range.

Table 4 shows the panel data regression analysis of audit quality on Tobin's Q. Accordingly, the model F statistic (p=0.000) is significant at the 1% significance level. This implies that the model is correctly specified and well-suited for the study. The adjusted R-squared value of 0.256 indicates that 25.6% of the variation in Tobin's Q is explained by the combination of all independent variables, including audit fee, auditor expertise, auditor independence, and audit rotation, along with the control variables utilized in this study. The remaining 74.4% of the variation is attributed to other unaccounted factors. Based on the outcome, audit fee (ß=1.505, p<0.05) portrays a significant positive impact on Tobin's Q at 5% significant level. Auditor independence (ß=0.317, p>0.05), auditor expertise (ß=-0.206, p>0.05) and audit rotation (ß=-0.048, p>0.05) do not show significant impact on Tobin's Q at 5% significant level. Considering the control variables, firm size (ß = -0.433, p>0.05), leverage (ß = 3.58, p>0.05) and firm age (ß = 0.005, p>0.05) show an insignificant impact on Tobin's Q at 5% significant level.

Table 4: Panel Data Regression Analysis of Tobin's Q

Variable	Fixed			Random		
	Coefficient	t-stats	P	Coefficient	t-stats	P
C	-17.924	-1.775	0.076	-3.479	-1.316	0.188
Audit fee	1.505	2.701	0.007	0.472	2.216	0.027
Auditor expertise	-0.206	-0.087	0.930	0.466	0.791	0.428
Audit independence	0.317	0.271	0.786	0.765	0.969	0.332
Audit Rotation	-0.048	-0.114	0.908	-0.030	-0.075	0.939
Firm size	-0.433	-0.339	0.734	-0.474	-1.280	0.201
Leverage	3.588	1.880	0.060	-0.825	-0.733	0.463
Firm age	0.005	0.063	0.949	0.004	0.516	0.605
R-squared			0.415			0.016
Adj.R-squared			0.256			0.001
F-Stats			2.621			1.091
P(F-stats)			0.0000			0.367
Durbin Watson			1.050			0.810

Source: Result from Eviews

According to the table 3 and 4, it shows that audit fee has a positive impact on ROA (ß=0.044, p=0.02), and Tobin's Q (ß=1.505, p=0.007) which are significant at 5% level, which indicates there is significant impact of audit fee on ROA and Tobin's Q. Therefore, H_1 hypothesis is supported. This result aligns with signaling theory, which suggests that companies send signals to the market by engaging auditors with high audit quality, thereby enhancing their market value. These findings are also consistent with previous studies on the relationship between audit fee and firm performance (Martinez & De Jesus Moraes, 2014; Moutinho, Cerqueira & Brandão, 2012). H_2 hypothesis is not supported as there is no significant impact of auditor expertise on ROA and Tobin's Q. A lack of expertise within the audit committee can result in internal control weaknesses, which may ultimately have no significant impact on firm performance. H_3 hypothesis is not supported as there is no significant impact of auditor independence on ROA and Tobin's Q. Moreover, audit rotation has a positive impact on only ROA (ß=0.035, p<0.05). It suggests that companies engaging in audit firm rotation are more likely to achieve higher performance. Therefore, the hypothesis $H_{4\ is}$ supported in terms of ROA.

5. Conclusion

The impact of audit quality on firm performance has been the subject of considerable debate in the literature. Recent studies have emphasized the importance of audit quality from various perspectives, highlighting its implications for a firm's performance. Correlation analysis confirms that audit fees and auditor expertise have significant positive relationships with ROA. Panel regression analysis further demonstrates that audit fee has a significant positive impact on firm performance, as measured by ROA and Tobin's Q, while audit rotation positively impacts the ROA of listed companies in Sri Lanka.

Agency theory and investor confidence theories suggest that a higher audit fee leads to better audit quality, ultimately enhancing performance. This finding aligns with agency theory, which posits that audit rotation reduces agency costs and improves firm performance. However, other variables examined in the study showed no significant impact on firm performance. The results also indicate variability in performance among listed companies in Sri Lanka, partly due to the economic collapse during the COVID-19 pandemic, which contributed to the underperformance of some companies. This variability led to deviations in the findings among the companies.

This research provides valuable insights for management, particularly regarding the factors to consider when appointing auditors, such as audit fees, auditor expertise, auditor independence, and audit rotation, to improve firm performance and enhance financial reporting accuracy. The study also offers guidance to regulators and policymakers on ensuring the quality of financial reporting. Additionally, it serves as a foundation for future researchers interested in exploring the relationship between audit quality and firm performance. The practical implications for audit quality are substantial, underscoring its critical role in driving firm performance and maintaining robust financial reporting practices. This research recommends that future studies explore additional proxies for audit quality and investigate how firm performance may be influenced by factors such as industry-specialist auditors and the type of audit firm.

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