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The Impact of Audit Committee Effectiveness on Key Audit Matters

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According to the auditor's professional judgment Key Audit Matters (KAMs) are the most significant audit matters reported in the audit of financial statements in a particular accounting period. An effective audit committee is a key corporate governance mechanism which enhances the quality of financial reporting and reduces earnings management. An association between audit committee effectiveness and disclosure of KAMs can be predicted since KAMs are selected among the matters discussed with those charged with governance. Therefore, this study predicts that an effective audit committee interacts and resolves auditing issues with external auditors, and such a practice could probably reduce the number of KAMs. The effectiveness of the audit committee was measured using the audit committee's independence, financial expertise and the number of audit committee meetings. The number of KAMs was used to measure the KAMs. The study sample consists of 13 non-financial companies listed in S & P Sri Lanka 20 index. Data were collected from the annual reports for the period 2018-2023. A weighted least square regression analysis was used to analyze data. The results reveal that the audit committee's independence and the number of audit committee meetings have a positive insignificant association with KAMs disclosed. However, there is a negative insignificant relationship between audit committee expertise and KAMs. The study provided an important policy implication by showing that the act of imposing extreme criteria to strengthen the audit committee has limited impact on improving the quality of financial reporting and reducing earnings management.

Keywords: *Audit Committee Effectiveness, Corporate Governance, Key Audit Matters, S & P Sri Lanka 20 Index*

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1. INTRODUCTION

The audit reports play a remarkable role in providing information to users of financial statements. However, there were several criticisms of traditional audit reporting. Traditional audit reports were highly standardized and failed to provide adequate information (Bedard et al., 2016). Therefore, there is a gap between what is desired by users of financial statements and what is disclosed by the audit reports. Audit reports provide confined value and information on audit opinions are still unable to eliminate the audit expectation gap fully (Gutierrez et al., 2018). Traditional audit reports are weak in conveying sufficient information value and fail to adequately signal the users of financial statements in decision making (Suttipun, 2020).

During the global financial crisis, traditional auditors' reports failed to provide appropriate information on financial risks. To provide evidence on this fact, it is argued that most of the collapsed financial institutions were given unqualified opinions by auditors before collapsing (Doogar et al., 2015). These weaknesses in the traditional audit reporting led to the discussion on developing the communicative value of audit reports. To overcome this problem, regulators all over the world are in the process of introducing new requirements in the audit reports (Lawati and Hussainey, 2022). In 2003, French auditing standards decreed companies listed in the French stock market to disclose Justifications of Assessments, which are critical information existing in annual reports to ease off users understanding (Bedard et al., 2016). The introduction of ISA 701-Communicating Key Audit Matters (KAMs) by the International Auditing and Assurance Standards Board (IAASB) in 2016 is also an outcome of these reforms. Accordingly, CA Sri Lanka has converged SLAuS 701- Communicating Key Audit Matters in the Independent Auditors Report, as a new audit standard, which is effective for audits of financial statements for periods ending on or after 31st March 2018 in Sri Lanka. The main objectives of introducing the new standard were to enhance the informative value of the audit report, transparency of auditors' work and focus more on auditors' responsibilities. According to the auditor's professional judgment (SLAuS 701), KAMs are the significant audit matters in the audit of financial statements in the current accounting period. KAMs are selected among the matters communicated with those charged with governance. According to SLAuS 701, in determining KAMs, the auditor shall consider areas of higher assessed risk of material misstatement, significant auditor judgments relating to areas in the financial statements that involved significant management judgment and the effect on the audit of significant events or transactions that occurred during the period. KAMs assist the users by enhancing the communicative value and transparency of the audit, providing extra information to realize auditors' professional judgment, assisting in understanding critical management judgments and motivating users to actively engage with the audit committee and management (SLAuS 701).

An effective audit committee is a key corporate governance mechanism, which enhances the quality of financial reporting, reduces earnings management, identifies and responds to risks, ensures compliance with rules, regulations and ethical standards and enhances the effectiveness of internal controls (Al-Baidhani, 2014). As stated earlier, KAMs may contain areas of high risk of material misstatements. Those KAMs can reveal issues which reduce the quality of financial reporting and attempts at earnings management. Most importantly, KAMs are selected among the matters discussed with those charged with governance. In conflict, audit committee members are elected among those charged with governance. Therefore, a relationship between audit committee effectiveness and disclosure of KAMs can be predicted (Abu and

Jaffar, 2020). On the other hand, audit committee members are the persons who discuss financial reporting issues, which are having a high probability to become KAMs with external auditors. Also, the American Institute of Certified Public Accountants (AICPA, 1981) encourages external auditors to discuss internal earnings management attempts with the audit committee. When many of these unclear areas are discussed with the audit committee and clarified by external auditors, the significant matters to disclose as KAMs might be reduced Gold and Heiliman (2019).

SLAuS 701- Communicating Key Audit Matters in the Independent Auditors Report is a recent development to auditing standards which offers a wide range of substantial benefits to stakeholders. Thus, this standard is an important domain to study. According to SLAuS 701, KAMs help to enhance communication between auditors and those charged with governance. After referring to the KAMs paragraph, stakeholders will have a clear and transparent idea of the audit process and auditors' professional judgments. KAMs induce preparers of financial statements to revisit financial reporting and disclosures highlighted by auditors with KAMs. Also, the additional information provided by KAMs assists stakeholders in identifying areas associated with significant judgments made by management (SLAuS 701).

Further, the literature about assessing the impact of KAMs on audit committee effectiveness in the international context concludes contradictory findings. For instance, Abu and Jaffar (2020) have found that audit committee independence and financial expertise do not have significant impact on reducing KAM disclosures. In contrast, Gold and Heilmann (2019) have found that more audit committee meetings cause disclosing fewer number of KAMs. Most importantly, there is a dearth of research available on this topic in the Sri Lankan context, which can be identified as the research gap. Hence, the researchers attempt to address the following research question whilst providing evidence from the Sri Lankan context in this study.

How does the audit committee's effectiveness impact Key Audit Matters in non-financial listed companies in S & P Sri Lanka 20 index?

2. LITRATURE REVIEW

2.1 Theoretical foundation – Agency Theory

Agency theory explains the two-party relationship between principals (shareholders) and agents (management). Generally, agents are recruited by principals to perform the company tasks on behalf of principals. Yet, the problem arises when the goals of principals and agents are not aligned. In most cases, the principals are inspired by profits or wealth maximization, whereas agents are inspired to maximize their benefits. Therefore, there always will be a conflict between agents and principals. Audit committee members are members of the board as well. When a board contains effective audit committee members, they tend to be involved in active communication in meetings to clarify their doubts by asking critical questions and ultimately it will reduce the restrictive over information dissemination (Lawati and Hussainey, 2022). Further, one of the main responsibilities of the audit committee is to provide recommendations on external independent auditors to those charge with governance. Depending on the admonitions provided by the audit committee, those charge with governance tend to share more relevant information with external auditors (Lawati and Hussainey, 2022). Eventually, it will lead the external auditors to disclose more precise KAMs to meet the information needs of the users of financial statements.

2.2 Empirical Literature

The vitality of an effective audit committee is elaborated by many of the mandatory and voluntary corporate governance codes in Sri Lanka such as Companies Act No 7 of 2007, Colombo Stock Exchange (CSE) Continued Listing Rules and Code of Best Practice on Corporate Governance issued by the Institute of Chartered Accountants of Sri Lanka. The literature suggests that there is an association between the extent of risk disclosures and audit committee effectiveness (Oliveira et al., 2011).

Khamsi et al. (2015) carried out a study in Malasiya to determine the impact of audit committee independence and financial understanding on non-compliance with financial disclosure. Their results proved that, even if the audit committee comprises independent and financially knowledgeable members, still there can be instances where the company is not complying with financial regulations. Due to those non-compliances, the companies have to make negative disclosures such as late submission of quarterly reports, audited reports and annual reports, inaccurate announcements on financial matters, failure to make announcements on material information and breaches. Following such an initiative, in order to examine the audit committee's effectiveness on KAMs in its first year of implementation in Malaysia, Abu and Jaffar (2020) have carried out a study. They revealed that audit committee independence and financial expertise do not have significant impact on reducing KAM disclosures. Further, their results proved that there is a significant impact of audit committee meetings on reducing the KAM disclosures., A recent study by Lawati and Hussainey (2022) have used two models to investigate the determinants and the impact of KAMs disclosure in the auditor's report in Omani context. Model 1 examined the impact of overlapping audit committee membership with other board committees on KAMs disclosures. Model 2 examined the impact of KAMs on audit quality. The corporate governance variables:

audit committee size, and audit committee meetings were controlled in their study. Their findings revealed a positive relationship between overlapping audit committee members and KAMs since audit committee members become more knowledgeable when serving in multiple committees. They have also found a positive relationship between KAMs and audit quality, since disclosing more KAMs enhance the communicative value of audit reports and provide a better understanding of auditors' roles and responsibilities for users. The main objective of the study conducted by Mah'd and Mardini (2022) was to investigate the extent of the KAMs disclosures and factors affecting the level of KAMs disclosures in audit reports. Their empirical findings show that auditors of high geared companies disclose more KAMs to reduce their liability. Further, the regression results revealed that there is a significant positive relationship between audit committee financial expertise and audit committee female representation with KAMs disclosures. However, the audit committee size and the number of audit committee meetings were not found to have significant impact on KAMs disclosures. Moreover, they have found a positive relationship between industry type and KAMs disclosures. Eriksson and Thunell (2023) have carried out a recent study in this research area to explore the relationship between KAMs and Audit Committees in Sweden. They have measured audit committee characteristics using six dimensions namely; meeting frequency, independence in the audit committee, size of the audit committee, diversity in the audit committee, separate remuneration for the work in the audit committee, and diligence. However, their results conclude a positive significant relationship only between audit committee meetings and KAMs and remuneration and KAMs. None of the other variables have depicted a significant relationship with KAMs. Meantime, Hussin et al., (2023) have observed the association between audit firm attributes and key audit matters readability. They have measured audit firm attributes using five dimensions namely; Big 4, audit fees, busy season, audit firm tenure and female partner involvement. Their findings depict that only Big 4, audit fees and female partner involvement are positively influencing KAMs. The above literature shows that the findings in this area of research are contradictory and inconclusive. Therefore, further research is necessary to examine how the effectiveness of the audit committee impact on the disclosure of KAMs.

3. METHODOLOGY

The population of the study was all 290 listed companies in CSE. The study's sample consists of 13 non-financial listed companies in S & P Sri Lanka 20 index. There are 14 non-financial listed companies in S & P Sri Lanka 20 index and one company is removed from the sample due to the unavailability of data. The S & P Sri Lanka 20 index consists of the uppermost companies listed in CSE with the highest market capitalization, financial viability, and liquidity. S & P Sri Lanka 20 index was identified as the most suitable list of companies since it represents companies in different GICS industry categories and so, the results can be generalized over a wider population.

The sample excludes banking, financial and insurance companies since those companies have different and non-routine operations than companies in other industry groups. Financial service, insurance industries, and leasehold property companies' total asset base and financial structure are not comparable with other selected companies in sample (Chirakool, 2021).

This study covers six annual reporting periods from 2018 to 2023 since SLAuS 701 became effective in Sri Lanka in 2018. Therefore, all the 13 non-financial listed companies in S & P Sri Lanka 20 index have six years of observations. Table 3.1 shows the industry composition and number of observations of 13 sample companies.

A panel data regression using the Weighted Least Squares (WLS) regression method applied to analyze the relationship between audit committee effectiveness and KAMs using the statistical software STATA.

Table 3.1 – Industry composition

Industry	**Number of companies**	**Observations**
Food Beverage and Tobacco	2	12
Materials	3	18
Transportation	1	6
Capital goods	5	30
Energy	1	6
Telecommunication services	1	6
Total	**13**	**78**

Source: Author developed based on independent auditors' reports included in annual reports of S & P Sri Lanka 20 companies from 2018 to 2023

This study uses audit committee effectiveness as the independent variable. Audit committee independence is measured using three constructs namely audit committee independence, audit committee financial expertise and audit committee meetings. These three corporate governance characteristics were used by Abu and Jaffar (2020) in developing an audit committee index to measure audit committee effectiveness.

The study uses seven control variables namely company size, leverage, profitability, liquidity, big 4, audit fees and financial period end. Market capitalization has an effect on first time disclosure of KAMs since auditors tend to disclose more KAMs for large companies (Bedard et al., 2016). Relatively, more complex and large firms disclose more risks than smaller firms (Gutierrez et al., 2018). Contradictorily, Yang (2021) has stated that large companies typically have good governance structures and effective control systems which will lead to high audit quality. Thus, auditors may find less significant matters to disclose as KAMs when the audit quality is sound. At the same time, Bedard et al. (2016) argue that the company size has a positive effect on audit fees. Accordingly, the audit fees are low when companies earn low profits and audit fees are low for companies which have accounting periods not ending from 31st December (Bedard et al., 2016). Further, it is argued that the management of companies with high debt to assets ratios has motives to whitewash financial statements (Yang, 2021). These malpractices of management will be disclosed as KAMs by auditors. On the contrary, when a company has stable profitability, management has a low requirement for earnings management and manipulates returns (Yang, 2021).

Table 3.2 – Mapping the variables

Variable	**Definition**	**Reference**
Dependent Variable		
KAMs	The total number of Key Audit Matters disclosed in the audit report.	Abu and Jaffar (2020) Lawati and Hussainey (2022)
Independent Variables		
Acind	Audit committee independence – the proportion of independent directors in the audit committee.	Abu and Jaffar (2020)
Acexpert	Audit committee financial acumen – the proportion of audit committee members with a financial background.	Abu and Jaffar (2020)
Acmeeting	Audit committee meetings – Number of audit committee meetings held during the year.	Abu and Jaffar (2020) Hussin et al. (2023) Lawati and Hussainey (2022)
Control variables		
Size	Total assets base of the company – The natural logarithm of total assets.	Abu and Jaffar (2020) Hussin et al. (2023) Lawati and Hussainey (2022)

Liquidity	Short-term liquidity position of the company – current ratio (current assets/ current liabilities).	Abu and Jaffar (2020)
Profitability	Company's profitability – Return on Equity (Net profit attributable to ordinary shareholders/ stated capital).	Abu and Jaffar (2020) Hussin et al. (2023) Lawati and Hussainey (2022)
Leverage	Long-term solvency of the company – Leverage ratio (Total debt/ total assets).	Abu and Jaffar (2020) Hussin et al. (2023) Lawati and Hussainey (2022)
Big 4	Whether the company's statutory audit is performed by one of the big four audit firms – Dummy variable equal to 1 if the company's external auditor is one of the big 4 audit firms, 0 otherwise.	Abu and Jaffar (2020) Hussin et al. (2023)
Audit fee	Audit fee paid to the external auditor – The natural logarithm of audit fees.	Abu and Jaffar (2020) Hussin et al. (2023)
Busy	Whether the company's financial year ends on 31st December or 31st March. – Dummy variable equal to 1 if the company's financial year ends on 31st March, 0 otherwise.	Abu and Jaffar (2020) Hussin et al. (2023)

The following model is used to test the relationship between KAMs and audit committee effectiveness.

Formula 1

$$\text{KAMs} = \beta_o + \beta_1\text{Acind} + \beta_2\text{Acexpert} + \beta_3\text{Acmeeting} + \beta_4\text{Size} + \beta_5\text{Leverage} + \beta_6\text{Profitability} + \beta_7\text{Liquidity} + \beta_8\text{Big 4} + \beta_9\text{Auditfees} + \beta_{10}\text{Busy} + \varepsilon\ it$$

3.1 Conceptual Framework

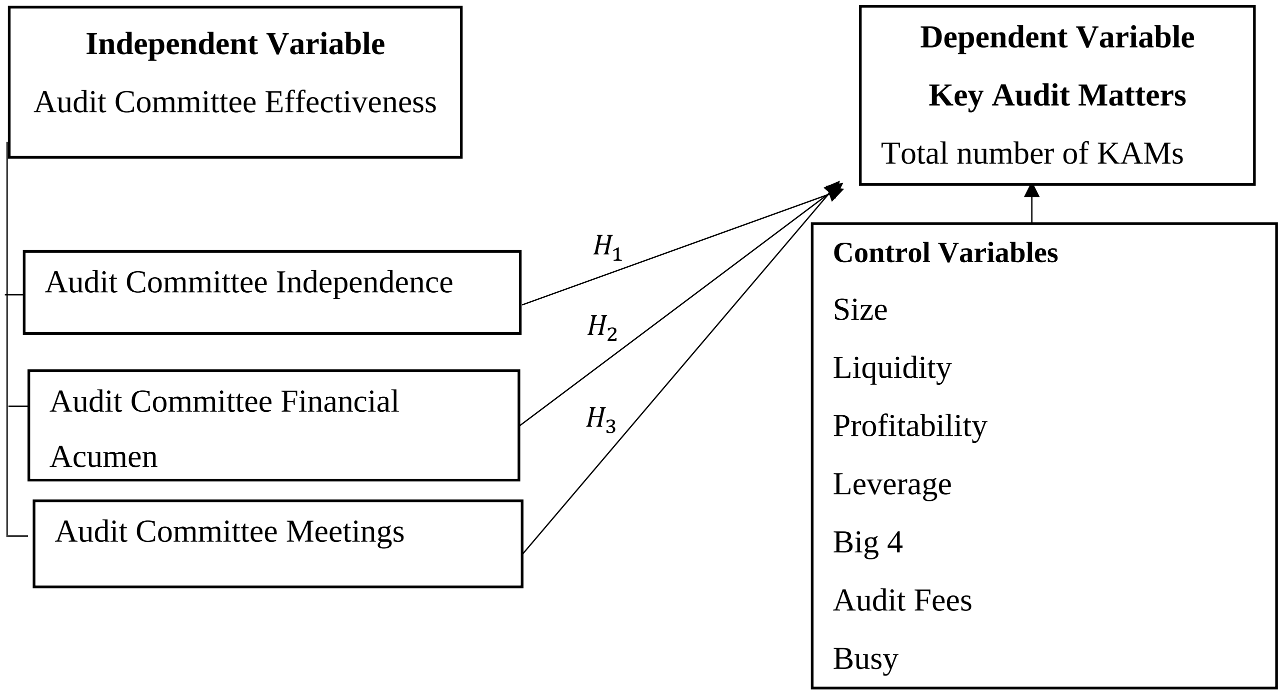

Figure 1 – Conceptual Framework (*Source: Abu and Jaffar (2020)*)

3.2 Hypotheses Development

The audit committee is a corporate governance mechanism which protects shareholders by securing the quality of financial statements and revealing necessary disclosures (Akhtaruddin and Haron, 2010). According to Bedard et al. (2004), an independent audit committee is a mechanism of controlling earnings management. The audit committee is considered independent when the audit committee members are not affiliated persons of the company and do not receive consulting, advisory, or any other compensatory fee from the company other than his/ her capacity as a member of the audit committee, the board of directors, or any other board committee (Sarbanes and Oxley Act, 2002). Abbott et al. (2000) argue that there is a negative relationship between audit committee independence and misstatements. As per Oliveira et al. (2011), an audit committee comprises of many independent directors who strongly monitor the entire board, which will ultimately result in strong compliance with accounting standards and regulations. Therefore, hypothesis one can be stated as follows.

H_1: There is a negative association between audit committee independence and the number of KAMs disclosed in audit reports.

According to Krishnan and Visvanathan (2008) having more financially expertized audit committee members enhances the earnings quality. Financially literate audit committee members mitigate the risk of accounting restatements (Cohen et al., 2010). Further, Goh and Hooper (2009) has stated that when there are financial experts in an audit committee, they can take immediate corrective actions against internal control weaknesses promptly. Mustafa and Youssef (2010) have found that independent and financially literate audit committee members can reduce the misappropriation of assets. The audit committee members who have obtained accounting expertise by serving as public accountants can enhance the timeliness of financial reporting (Abernathy et al., 2014). According to Yasin and Nelson (2012), audit committee members having a thorough understanding on financial reporting requirements encourage the company to comply with International Financial Reporting Standards (IFRS). Rainsbury et al. (2024) have found a negative relationship between audit committee financial expertise and number of KAMs as financially acumen board members better understand accounting complexities leading to less significant areas requiring emphasis by auditors. Therefore, hypothesis two can be stated as follows.

H_2: There is a negative association between audit committee financial expertise and the number of KAMs disclosed in audit reports.

Al- Matari et al. (2014) have stated that the mix of audit committee size, financial expertise and audit committee meetings acts as a good corporate governance structure, and it enhance the firm's performance. A good governance structure leads to disclose a lesser number of KAMs (Fera et al., 2021). Further, Gold and Heilmann (2019) also have stated that more audit committee meetings lead to disclose less number of KAMs. Therefore, hypothesis three can be stated as follows.

H_3: There is a negative association between audit committee meetings and the number of KAMs disclosed in audit reports.

4. DISCUSSION

The number of KAMs recorded by 13 sample companies in each industry are represented in Table 4.1.

Table 4.1: Number of KAMs

INDUSTRY	**NUMBER OF KAMS**					
	0	**1**	**2**	**3**	**4**	**Total**
Food beverage and tobacco	-	-	3	6	3	12
Materials	1	5	4	8	-	18
Transportation	-	1	-	4	1	6
Capital goods	-	-	11	10	9	30
Energy	-	6	-	-	-	6
Telecommunication services	1	-	5	-	-	6
Total observations	**2**	**12**	**23**	**28**	**13**	**78**

Source: Author developed based on independent auditor's reports included in annual reports of S & P Sri Lanka 20 companies from 2018 to 2023

As per the findings, the maximum number of KAMs found from an audit report is four and companies operate in the food, beverage and tobacco, transport and capital goods industries have recorded four KAMs in audit reports. The lowest number of KAMs were found from an annual report is zero and companies operate in materials and telecommunication industries have recorded zero KAMs. Overall, the capital goods industry is the industry group which has disclosed the highest number of KAMs, which is 30 out of the total number of KAMs observations.

Table 4.2 shows the types of issues recorded in the KAMs section in annual reports.

Table 4.2 – KAMs Issues in sample companies

KAMs Issue	Frequency
Goodwill and intangible assets impairment	32
Subsidiaries and equity accounted investees	12
Biological assets	20
Business combinations and acquisitions	6
Leases	3
PPE and investment property	30
Performance incentives and discounts to customers	5
Inventory	14
Impairment of Trade receivables, loans and hire purchase receivables	22
Retirement benefit obligation	5
Revenue	30
Interest bearing borrowings	3
Insurance contract liabilities	6
Other	6
Total KAMs	**194**

Source: Author developed based on independent auditors’ reports included in annual reports of S & P Sri Lanka 20 companies from 2018 to 2023

According to the findings, KAMs on goodwill and intangible assets impairment is identified as the highest reported KAMs. It appears 32 times among the total identified KAMs. It is reasonable to consider impairment as the top KAM because it involves lots of management judgments on estimating the carrying value. Since companies need to assess impairment annually, it is frequently subjected to auditors' attention (Abu and Jaffar, 2020). Xiao et al. (2020) has also stated that auditors spent more time and effort and use more professional judgment on areas like goodwill impairment and financial instruments valuation.

Secondly, KAMs issues regarding PPE and investment property and revenue have obtained the same significance and they have been recorded 30 times among the total identified KAMs issues. The institute of CA Sri Lanka has published SLFRS 15 – Revenue from contracts with customers, effective as of 1st January 2018. The KAMs on revenue recognition may be influenced by the new accounting standard since its first implementation.

In 2018, the first year of implementation of SLAuS 701 in Sri Lanka, KPMG audit firm conducted an experimental study on KAMs disclosure of listed companies in the CSE. Accordingly, in 2018 there were 290 listed entities in CSE and 510 KAMs were found from all the companies. Out of 510 total KAMs, 92 were regarding impairment of financial instruments, 70 were regarding the valuation of property plant and equipment (PPE) and 44 were regarding inventory (KPMG, 2019). Those issues were the top three KAMs in 2018. In the same way, KAMs issues on PPE have obtained the same significance in this study as well.

4.1 Descriptive Statistics

A summary of descriptive statistics is shown in Table 4.3.

Table 4.3 – Descriptive Statistics

Variable	Mean	Std. Dev.	Min	Max
Acind	0.8504274	0.1668608	0.5	1
Acexpert	0.6997863	0.2760065	0.25	1
Acmeeting	5.025641	1.423133	1	9

Size	10.93396	0.4913174	9.747872	11.87187
Leverage	0.5849774	0.264734	0.2551929	1.516765
Profitability	0.1504342	0.1800244	0.0782683	0.7854394
Liquidity	1.418642	0.6679837	0.2483608	3.56027
Audit fee	7.25343	0.5151616	6.176091	8.798166
Busy	0.1538462	0.3631365	0	1

Source: STATA output

According to descriptive statistics, the mean values of audit committee independence (Acind), audit committee financial expertise (Acexpert) and audit committee meetings (Acmeeting) are 0.850 (St. Dev. = 0.167), 0.699 (St. Dev. = 0.276) and 5.026 (St. Dev. = 1.423) respectively. It indicates that an audit committee of a sample company consists of 85% of independent non-executive directors and 70% of members in an audit committee possess financial acumen on average. Also, the results depict that a sample company holds around 5 audit committee meetings per annum.

4.2 Weighted Least Squares (WLS) Regression

WLS regression is an alternative method of dealing with violation of regression assumptions: homoscedasticity and Non–Serial correlation (University of California, Los Angeles – Statistical Methods and Data Analytics). The researcher performed the following tests to check the validity of regression assumptions.

4.3 Regression Assumptions

Regression Assumption 1 – Homoscedasticity (White's Test)

White's test for Ho: homoscedasticity against Ha: unrestricted heteroscedasticity chi2(53) = 44.61	To test the Homoscedasticity, the "White's test" was used and results contained a p value of 0.7872 which

Prob > chi2 = 0.7872	is greater than 0.05. The null hypothesis of "White's test" is the panel is subjected to homoscedasticity. Here the null hypothesis can be accepted since the p value of White's test is greater than 0.05. Which means there is no issue of heteroscedasticity in the data set.

Regression Assumption 2 – Non–Serial correlation (Wooldridge Test)

Wooldridge test for autocorrelation in panel data H0: no first-order autocorrelation F (1, 12) = 4.874 Prob > F = 0.0475	Secondly, the data set was checked for the panel data regression assumption "Non–Serial correlation". In order to check serial correlation, the "Wooldridge test" was performed. According to the results, the P value was 0.0475 which is below 0.05 and we cannot accept the null hypothesis: the residuals across time are not correlated. Therefore, the data set was subjected to the violation of non-serial correlation.

Since the second regression assumption of non-serial correlation is violated, an Ordinary Least Squared regression model cannot be utilized. Therefore, the researcher used a WLS regression model for this study. The results of WLS regression are explained in Table 4.4.

Table 4.4 – Results of WLS regression analysis

Number of obs	= 78	R-squared	= 0.5735
F (9, 68)	= 10.16	Adj R-squared	= 0.5170
Prob > F	= 0.0000	Root MSE	= 0.74062

KAM	Coef.	Std. Err.	T	P > [t]	[95% conf.	Interval]
Acind	.4584735	.6839452	0.67	0.505	-0.9205715	1.648484
Acexpert	-.0849069	.4524188	-0.19	0.852	-1.088875	0.6611461
Acmeeting	.0146629	.065955	0.22	0.825	-0.0798808	0.1800771
Size	.2422269	.2718038	0.89	0.376	-0.0706543	0.8904752
Leverage	.0377367	.4469249	0.08	0.933	-0.7173017	0.9199184
Profitability	1.040079	.7358504	1.41	0.162	-0.5049593	2.161865
Liquidity	-.458605	.204577	-2.24	0.028	-0.7485598	-0.0282424
Auditfees	.8904365	.2756395	3.23	0.002	0.2316661	1.27171
Busy	-1.147862	.3300735	-3.48	0.001	-1.675057	-0.3069975
_cons	-6.333194	2.743155	-2.31	0.024	-12.24473	-2.358819

Source: STATA output

The above summary shows that control variables explain 52% of changes in the reporting of KAMs (Adjusted $R^2 = 0.517$, F = 10.16, prob > F = 0.0000). Results of the regression model reveal that audit committee independence (p>0.505, Coef. = 0.458) and audit committee meetings (p>0.825, Coef. = 0.0147) are positively and insignificantly associated with disclosure of KAMs. Therefore, H_1 and H_3 cannot be supported. Eriksson & Thunell (2023) also conclude a positive insignificant relationship between audit committee independence and KAMs. Gold & Heilmann (2019) as well as Mah'd and Mardini (2022) have evident that higher frequency of audit committee meetings is not related with KAMs' disclosures. According to Lawati and Hussainey (2022), when an audit committee is meeting regularly, the likelihood of communicating financial reporting issues with external auditors is high and it will cause to disclose more KAMs in audit reports. As per the agency theory, companies which are having more audit committee meetings reveal more readable KAMs (Hussin, 2023). Further, Bullay and Ajmi (2019) also revealed the same findings and concluded that the audit committee members' independence and meeting frequency play a positive role in deciding the degree of disclosure. Yet, as per the results of preset study, those two relationships are statistically insignificant. In the contrary, a negative insignificant relationship is detected between audit committee expertise ($p>0.852$, Coef. -0.0849) and KAMs. However, H_2 also cannot be supported since the association is statistically insignificant. This finding is also in line with the results of Khamsi et al. (2015). According to Khamsi et al. (2015), even though the companies are complying with minimum corporate governance requirements in terms of audit committee independence and financial expertise, there still can be failures in financial reporting disclosures.

Profitability and KAMs depict a positive significant association ($p>0.162$, Coef. = 1.04). Audit fees also positively and significantly impact on KAMs ($p> 0.002$, Coef. = 0.890). Lawati and Hussainey (2022) who observed the impact of KAMs on Audit Quality, by using the natural logarithm of audit fees to measure audit quality, found a positive significant association between audit quality and KAMs. According to Lawati and Hussainey (2022) disclosing a higher number of KAMs will incur additional cost and time. Thus, the audit quality which is explained by the natural logarithm of audit fees will be increased. Whereas, results revealed that the liquidity ($p>0.028$, Coef. = -0.459) and busy ($p>0.001$, Coef. = -1.148) variables are negatively but significantly associated with KAMs. The other two variables, size and leverage are insignificantly associated with KAMs.

5. CONCLUSIONS

It has been several years since the implementation of the SLAuS 701 in Sri Lanka. Even though KAMs reveal critical issues of a company that influence shareholders' investment decisions, there is an insufficiency of published studies which address the KAMs in Sri Lanka. Further, audit committee effectiveness is identified as a major corporate governance characteristic which is thoroughly emphasizes by both voluntary and mandatory corporate governance codes in Sri Lanka. Therefore, the objective of this study is to examine whether audit committee effectiveness has an impact on reducing the number of KAMs in audit report. Most of the non-financial listed companies in S & P Sri Lanka 20 index have recoded three KAMs during the period 2018-2023 and impairment of goodwill, intangible assets, valuation of PPE and revenue recognition were identified as the most reported KAMs issues. The results of the study reveal that audit committee independence and meetings have a positive insignificant association with KAMs and audit committee financial expertise has a negative insignificant association with KAMs. Hence it can be concluded that none of the three audit committee characteristics contribute to reducing the number of KAMs disclosures in independent audit reports. These findings were complying with the studies of Lawati and Hussainey (2022) and Khamsi et al. (2015).

This paper contributes to the literature on corporate governance by showing how audit committees' characteristics affect the disclosure of KAMs. These results may provide important policy implications. According to the objectives of SLAuS 701, KAMs are immensely beneficial to the users of financial statements because KAMs enhance the communicative value of audit reports, provide better transparency on the audit, assist the users in understanding auditor's professional judgments and management judgments, encourage users to further engage with audit committee by using the information provided by KAMs. Therefore, when referring to the results of this study, it is questionable whether imposing unnecessary criteria on audit committee independence, meetings and financial expertise is practically worthwhile. According to the results of the study, fulfilling the criteria on audit committee independence, meetings and financial expertise do not assist in improving the informative value of audit reports. Thus, audit practitioners have a sound role to play in enhancing the communicative value of the audit reports, whereas the role of the company is limited. Practitioners and audit standard setters can be suggested to seek other methods to enhance the informative value of audit reports. For instance, auditors can be suggested to avoid standardized and technical audit terms in KAMs paragraphs and replace them with simplified and layman's words in order to avoid misinterpretations among users. Also, audit practitioners can be advised to employ their professional skepticism in a superior way and decide what matters should be brought to shareholders' attention and the quality of KAMs disclosures. Accordingly, practitioners may understand the KAMs are primarily based upon professional judgement and audit risk with limited impact from audit committee. Since the audit committee does not provide sufficient inputs, practitioners need to engage in meaningful communications with audit committee when determining KAMs.

This study contains several limitations. The researcher has measured the audit committee effectiveness on KAMs using only the quantitative measurements. Therefore, future researchers are suggested to incorporate qualitative aspects also to measure audit committee effectiveness on KAMs and consider more audit committee characteristics other than independence, financial expertise and number of meetings. Further, the sample of the study consist of largest and most liquid top 20 companies in Sri Lanka which has similar characteristics. The limited and similar nature of the sample may affect the generalization of empirical findings. Future studies can develop this research area by extending the sample size to different types of companies. The WLS regression model is adopted in this study and it is supported by previous scholarly articles. However, the empirical findings of this study could be sensitive to various model selections. Other data analysis models could reveal different relationships which are not captured by the WLS regression model. Therefore, the insignificant relationships between audit committee effectiveness criteria and number of KAMs should be interpreted within the scope of the selected regression model.

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