

The Impact of Audit Quality on Financial Reporting Quality: Evidence from Sri Lanka

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Abstract

The quality of the audit has been vital since accounting scandals like WorldCom, Enron, wire card scandals, and other risks have happened in the past. This is because auditors offer third-party assurance regarding the financial information of organizations. Then, Stakeholders mostly depend on the financial statements published by organizations when making decisions. As a result, stakeholders are becoming increasingly concerned regarding the accuracy of financial reporting. It is therefore necessary to examine every way in which audit quality affects the quality of financial reporting. Hence, this study mainly focuses on examining the impact of audit quality on the financial reporting quality of S&P Sri Lanka 20 index companies from 2013 to 2022. The sample of this study consisted of 15 non-financial companies, excluding the rest of the companies from the population due to their special nature. Further, this research used the data of companies' annual reports, which were extracted from the CSE website. Audit firm size, audit firm tenure, and audit fees are used as surrogates for audit quality (AQ). While earnings management is a surrogate for financial reporting quality (FRQ), which is the dependent variable, FRQ is measured through discretionary accruals. Then, the Results provided that audit firm size (AFS) has an insignificant impact on financial reporting quality (FRQ), as it was not supported by my first hypothesis. However, audit firm tenure (AFT) has a significant negative impact on financial reporting quality (FRQ). Moreover, it recommends that to raise the FRQ, the AFT should not be exceeded for longer than three years. On the other hand, audit fees (AF) showed a significant positive impact on financial reporting quality (FRQ). It indicates that higher audit fees result in improved FRQ. Then, the results of this study help to improve investor trust in the decision-making process and give authorities guidance on where rules and regulations need to be updated.

Keywords: Audit Quality, Financial Reporting Quality, Earnings Management, Discretionary Accruals, Modified Jones Model