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Effect of Audit on Profitability: A Study of Cement Listed Firms, Pakistan

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Abstract - An audit is an independent examination of financial information of an organization. Audit helps us to detect errors and frauds at early stage and gives true views about financial information. This study is based on secondary data which is collected from annual audited reports of the firms. Regression method is used for analysis; SPSS & MS Excel is tools of analysis. Conclusion of the study is, there is positive effect of an audit committee on firm's profitability ratio and on firm's performance.

I. INTRODUCTION

Late Middle English: from Latin *auditus* 'hearing', from *audire* 'hear', in Medieval Latin *auditus* (compoti) 'audit (of an account)', an audit originally being presented orally, is the history of audit. Oxford Dictionary defines an audit as "an official inspection of an organization's accounts, typically by an independent body." Internal and External are two types of audit. The objectives of an audit are effectiveness and efficiency of operations. Reliability and integrity of financial and operational information. Safeguarding of assets. Compliance with laws, regulations, and contracts. Auditing helps us to detect error and fraud at an early stage and also helps management to improve with better strategies to quality management system. The audit committee is a critical link between a firm's financial reporting function and its external shareholders. When this link is compromised, it can lead to even larger corporate governance failures. Proper alignment of the interests of the audit committee with the interests of the firm and its external shareholders should be a key element of corporate governance. This study focuses on the effect of audit committee on firm's profit.

II. LITERATURE REVIEW

Audit committee's works as a link in the communication network between internal and external Auditors and the board of directors, and their activities include analysis of nominated auditors, overall Range of the audit, results of the audit, internal financial controls and financial information for Publication (FCCG, 1999). In fact, the existence of an audit committee in a company would provide a Analytical control of the company's financial reporting and auditing processes (FCCG, 1999; Walker, 2004).

Audit committee could also increase auditor independence. Knapp (1987) discovered that an Audit committee is more likely to assist the auditor rather than management in audit disputes and the level of assistance is uniform across members of the committee, irrespective of whether the member is in a full-time or part-time position, such as corporate managers, academicians and retired partners of CPA firms.

In addition, audit committees could play a role in selecting auditors, determining their remuneration and in the dismissal/retention of auditors. Goldman and Barlev (1974) pointed out that audit committees could observe the financial reporting process and provide recommendations in the selection of auditors, negotiation of fees and termination of external auditors, which would ultimately reduce management's power over the auditor. An audit committee is expected to ensure that a business organization has adequate internal controls, proper accounting policies, and independent external auditors that will stop the incidence of fraud and promote high quality and timely financial statements.

Moreover, the existence of an audit committee was found to have an association with the trend to change from less credible to more credible auditors (Kunitake, 1983; Eicheneher and Shields, 1985). Kunitake (1981) believed that independent directors of audit committees might have 43 International Research Journal of Finance and Economics - Issue 8 (2007) exposure to larger and better-known CPA firms rather than to local or regional firms, through their involvement as officers or directors of other public corporations. In addition, Kunitake (1983) found that there was less frequent auditor switching in companies that had audit committees than companies that did not have audit committees. These results indicate that the audit committee acts as a promoter to enhance good financial reporting and support the role of auditors.

In addition, the formation of an audit committee would improve the credibility and reliability of financial statements through providing an guarantee of the objectivity of financial statements to shareholders (Auerbach, 1973; FCCG, 1999). However, in Malaysia, the Finance Committee on Corporate Governance (FCCG) (1999) is interested in the effectiveness of audit committees, and has noted, "We have very real experience in Malaysia in the form of audit committees, where Companies just abide by in form by setting up

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such committees without giving attention to the spirit of the requirement by ensuring, for example, the quality of the people within the committee" (p. 64). In This respect, Mohamad et al. (2001) found that a large majority of companies listed on the BMB tend to abide by all regulations imposed on them, such as the requirement to disclose audit committee reports, without concern for the quality of these reports.

An active audit committee would improve their role to follow the terms of reference and objectives (FCCG, 1999; Treadway Commission, 1987). The frequency of audit committee meetings would indicate whether the committee was active or not. Although the presence of non-executive directors was linked with audit committee effectiveness, it is not certain.

Menon and Williams (1994) pointed out that audit committee independence did not guarantee effectiveness unless the committee was active. In addition, Kalbers and Forgarty (1993) supported this argument and indicated that audit committee effectiveness would only materialise if the members were committed to pursue their roles and duties. The BMB listing requirements (2001), BRC (1999) and the Treadway Commission (1987) suggested that audit committees should meet at least four times a year. To effectively pursue their objective, audit committees need clear, practical and flexible terms of reference, sometimes referred to as the charter (Mohamad and Sori, 2001). This charter should be considered on and accepted by the board of directors that govern the firm's operations. The charter should be re-evaluated periodically, sufficiently flexible to include a changing business environment and clearly explain the responsibilities of the audit committee.

Preferably, the charter should be disclosed in the financial statements to help shareholders assess the performance of the committee in communicating their responsibilities. Prior studies have documented the various roles of audit committees. Vanasco (1994) contended, "there seems to be a consensus among researchers in the field and the various national and international organizations that audit committees provide significant benefits to the corporation, public, investors and regulatory agencies"(p.38). He further provided the most cited functions of audit committees, as follows: "strengthening the internal and external audit functions", co-coordinating the work of the external and internal auditors", strengthening the position of non-executive directors", and assisting the board of directors to fulfill their legal responsibilities" (p. 38). Furthermore, audit committees are also expected to regularly assess a company's risk and management's responses to significant financial and non-financial risks facing the organization. Duncan (1991) argued that audit committees must take into account the following audit risk assessment: (i) the major risks facing the organization; (ii) the auditor examines the company's

efforts to control these risks through contingency plans, security measures and other means; (iii) the auditor compares the risks and company responses to determine adequacies; (iv) the auditor recommends improvements in company activities in the identification, control and financing of critical risks.

Cowan (2004) argued that risk management is crucial to corporate governance and it has become the main component of 'effective modern management'. He further pointed out that the complexity of today's business environment necessitates the committee and the entire organization to understand the importance of risk management. Mohammad and Sori (2001) summarized an audit committee's responsibilities to include ensuring quality accounting policies, internal controls, and the independent and effective role of outside auditors to International Research Journal of Finance and Economics - Issue 8 (2007) 44

In a review of the literature, DeZoort et al. (2002) concluded that: (i) audit committee responsibilities are diverse and seem to be intensifying; (ii) the main areas of audit committee oversight include oversight of financial reporting, auditing and controls; (iii) audit committee authority is associated with written authority and management support. However, they pointed out several limitations of prior studies: (i) none of the prior studies focus on the ultimate source of the audit committee's authority (i.e. board of directors) or aspects linked with variations in such authority; (ii) there is a lack or absence of empirical research that addresses the relationship between audit committee effectiveness and audit committee authority.

III. METHODOLOGY

The data used for this study taken from the audited annual reports of the firms listed on the Karachi Stock Exchange (KSE). The data is Panel. There are nineteen listed cement firms on KSE and we take a sample of seventeen (89%) firms. For analysis SPSS & MS Excel 2007 is used as a tool. In this study regression method is used for analysis. Profit Margin (P.M) and Earning per Share (EPS) taken as dependent variables and Board Size (B.S), Audit Committee (A.C) taken as independent variables. In this study Eleven Years (1999 – 2009) data is taken.

Purposed Model :

$$EPS = \alpha + \beta_1 BS + \beta_2 AC + U_i \rightarrow 1$$

$$PM = \alpha + \beta AC + U_i \rightarrow 2$$

$$EPS = \alpha + \beta AC + U_i \rightarrow 3$$

Model 1 is considered as multiple regressions whereas model 2 & 3 are simple regression models. In all above models we assume U_i normal distribution with zero mean and constant variance.

Expected signs

For model 1 $\beta_1 < 0$ & $\beta_2 > 0$

For model 2: $\beta > 0$

For model 3: $\beta > 0$

Analysis

OLS regression analysis is performed on panel data by assuming all intercepts and slope coefficients are constant for individuals and for different time periods.

Estimated form of model 1

EPS = -1.82 - 1.55 BS + 3.48 AC ----- R² = 0.16

T-stat -0.672 -2.962 5.849

P-value : (0.00) (0.00)

Estimated form of model 2

PM = -24.26 + 7.15 AC ----- R² = 0.06

T-stat -3.850 3.656

P-value (0.00)

Estimated form of model 3

EPS = -8.28 + 2.56 AC ----- R² = 0.118

T-stat -4.957 4.491

P-value (0.00)

IV. CONCLUSION

We conclude from model #1, there is negative & significant effect of BS on EPS; there is positive & significant effect of Independent Audit Committee on EPS. In model#2 there is positive & significant effect of Independent Audit Committee on PM. In model#3 there is positive and significant effect of Independent Audit Committee on EPS. Therefore conclusion of the study is, there is positive effect of an audit committee on firm's profit.

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