

1 Effect of Audit on Profitability: A Study of Cement Listed 2 Firms, Pakistan

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6 **Abstract**

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

15 **Index terms**— organization, audited

16 **1 I. INTRODUCTION**

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

28 **2 II.**

29 **3 LITERATURE REVIEW**

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

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

39 In addition, audit committees could play a role in selecting auditors, determining their remuneration and in
40 the dismissal/retention of auditors. Goldman and Barlev (1974) pointed out that audit committees could observe
41 the financial reporting process and provide recommendations in the selection of auditors, negotiation of fees and
42 termination of external auditors, which would ultimately reduce management's power over the auditor. An audit

4 III. METHODOLOGY

43 committee is expected to ensure that a business organization has adequate internal controls, proper accounting
44 policies, and independent external auditors that will stop the incidence of fraud and promote high quality and
45 timely financial statements.

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

54 In addition, the formation of an audit committee would improve the credibility and reliability of financial
55 statements through providing an guarantee of the objectivity of financial statements to shareholders (Auerbach,
56 1973; ??CCG, 1999). However, in Malaysia, the Finance Committee on Corporate Governance (FCCG) (1999) is
57 interested in the effectiveness of audit committees, and has noted, "We have very real experience in Malaysia in
58 the form of audit committees, where Companies just abide by in form by setting up L such committees without
59 giving attention to the spirit of the requirement by ensuring, for example, the quality of the people within the
60 committee" (p. 64). In This respect, Mohamad et al. ??2001) found that a large majority of companies listed on
61 the BMB tend to abide by all regulations imposed on them, such as the requirement to disclose audit committee
62 reports, without concern for the quality of these reports.

63 An active audit committee would improve their role to follow the terms of reference and objectives ??FCCG,
64 1999; ??readway Commission, 1987). The frequency of audit committee meetings would indicate whether the
65 committee was active or not. Although the presence of non-executive directors was linked with audit committee
66 effectiveness, it is not certain.

67 Menon and Williams (1994) pointed out that audit committee independence did not guarantee effectiveness
68 unless the committee was active. In addition, Kalbers and Forgarty (1993) supported this argument and indicated
69 that audit committee effectiveness would only materialise if the members were committed to pursue their roles and
70 duties. The BMB listing requirements (2001), BRC (1999) and the Treadway Commission (1987) suggested that
71 audit committees should meet at least four times a year. To effectively pursue their objective, audit committees
72 need clear, practical and flexible terms of reference, sometimes referred to as the charter (Mohamad and Sori,
73 2001). This charter should be considered on and accepted by the board of directors that govern the firm's
74 operations. The charter should be re-evaluated periodically, sufficiently flexible to include a changing business
75 environment and clearly explain the responsibilities of the audit committee.

76 Preferably, the charter should be disclosed in the financial statements to help shareholders assess the
77 performance of the committee in communicating their responsibilities. Prior studies have documented the various
78 roles of audit committees. Vanasco (1994) contended, "there seems to be a consensus among researchers in the
79 field and the various national and international organizations that audit committees provide significant benefits to
80 the corporation, public, investors and regulatory agencies" (p.38). He further provided the most cited functions of
81 audit committees, as follows: "strengthening the internal and external audit functions", co-coordinating the work
82 of the external and internal auditors", strengthening the position of nonexecutive directors", and assisting the
83 board of directors to fulfill their legal responsibilities" (p. 38). Furthermore, audit committees are also expected
84 to regularly assess a company's risk and management's responses to significant financial and non-financial risks
85 facing the organization. Duncan (1991) argued that audit committees must take into account the following audit
86 risk assessment: (i) the major risks facing the organization; (ii) the auditor examines the company's efforts to
87 control these risks through contingency plans, security measures and other means; (iii) the auditor compares the
88 risks and company responses to determine adequacies; (iv) the auditor recommends improvements in company
89 activities in the identification, control and financing of critical risks. Cowan (2004) argued that risk management
90 is crucial to corporate governance and it has became the main component of' effective modern management'.
91 He further pointed out that the complexity of today's business environment necessitates the committee and the
92 entire organization to understand the importance of risk management. Mohammad and Sori (2001) summarized
93 an audit committee's responsibilities to include ensuring quality accounting policies, internal controls, and the
94 independent and effective role of outside auditors to International Research Journal of Finance and Economics
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96 In a review of the literature, DeZoort et al. (2002) concluded that: (i) audit committee responsibilities
97 are diverse and seem to be intensifying; (ii) the main areas of audit committee oversight include oversight of
98 financial reporting, auditing and controls; (iii) audit committee authority is associated with written authority
99 and management support. However, they pointed out several limitations of prior studies: (i) none of the prior
100 studies focus on the ultimate source of the audit committee's authority (i.e. board of directors) or aspects
101 linked with variations in such authority; (ii) there is a lack or absence of empirical research that addresses the
102 relationship between audit committee effectiveness and audit committee authority.

103 4 III. METHODOLOGY

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

110 Purposed Model : $EPS = ? + ?1 BS + ?2 AC + Ui$? 1 $PM = ? + ? AC + Ui$? 2 $EPS = ? + ? AC + Ui$?3

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

113 5 CONCLUSION

114 We conclude from model #1, there is negative & significant effect of BS on EPS; there is positive& significant
115 effect of Independent Audit Committee on EPS. In model#2 there is positive & significant effect of Independent
116 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. ^{1 2 3}



Figure 1:

117

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5 CONCLUSION

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