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Title: The Power of Assurance: External Audit Quality and Its Influence on Corporate Financial Performance

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The Power of Assurance: External Audit Quality and Its Influence on Corporate Financial Performance

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Abstract

This paper probes the impact of external audit quality on firm performance. External audits function as a critical tool to improve stakeholder confidence and mitigate financial irregularities. This study utilizes a dataset comprising 37 companies for the years 2021 to 2023 across various industries extracted from their financial statements. This research employs quantitative methodologies including correlation and regression analysis to assess the impact of audit quality on firm performance. The results indicate a positive effect that suggests that better quality external audit can improve profitability indicating that companies audited by reputable and independent firms exhibit stronger financial performance. These results highlight the critical role of rigorous external audits in improving financial health providing valuable insights for stakeholders including regulators, and corporate management. Companies can strengthen their policies when appointing the external auditor. On the other hand, regulators can make policies that can best serve the need of the shareholders. This research adds to the present literature by offering an insight on the intersection of external audit practices and profitability with implications for developing regulatory frameworks.

Keywords: *Quality, Firm Performance, Pakistan, Stock Exchange, Profitability, Audit.*

1. Introduction

Firm performance is an essential notion that refers to how financial resources provided to an organization are wisely employed to fulfill the firm's overarching corporate aim, which maintains the company in business and increases the likelihood of future opportunities. Corporate governance has a wide range of effects on company performance. One prominent element of corporate governance is the quality of audit. In the framework of agency theory, as presented by Jensen and Meckling (1976), auditing is acknowledged as a prominent supervisory mechanism aimed at alleviating the challenge of information asymmetry and enhancing the financial performance of firms (Agyei-Mensah, 2019; Chung et al., 2005; Habbash & Alghamdi, 2017; Mohapatra et al., 2021). External audit quality is of utmost importance in the business sector. It is the degree of effectiveness to which financial statements of a company are assessed by the external auditor. Audit quality is a complex concept that includes ensuring compliance with applicable standards and the ability of an auditor to identify material misstatements. Audit represents that financial position, financial performance and the position of cash flows are giving true and fair view. Such reliability is necessary for investors, regulators, creditors and other stakeholders' confidence in a corporate setting (Farouk & Hassan, 2014).

Quality audits build confidence of the investors on the financial statements and such financial statements are perceived to be trustworthy and transparent (Farouk & Hassan, 2014). Investors'

confidence is of prime importance for attracting the investments in the capital market and maintaining the stability of capital markets. Auditors play a crucial role in detecting fraud, errors, and mismanagement within an organization. A good quality audit helps in ensuring the compliance with relevant laws, regulations, and accounting standards. This compliance is necessary for evading legal and financial penalties and maintaining the reputation of the company. Hence, the quality of external audit can be of utmost significance for improving the profitability of a company (Cenciarelli et al., 2018).

A high quality audit process evaluates different risks that could impact an organization's financial health. By recognizing these risks, organization can take pre-emptive measures to mitigate them, improving the overall risk management strategy of the company. High-quality audits promote transparency in financial reporting. Clear and accurate disclosures help stakeholders understand a company's financial health, strategic decisions, and potential challenges. Lenders and creditors rely on audited financial statements to evaluate a company's creditworthiness (Farouk & Hassan, 2014). Accurate and reliable financial information helps companies secure loans and credit on favorable terms. Many industries are subject to regulatory oversight, and audit quality ensures that companies meet these regulatory requirements. Proper audits help prevent financial irregularities and non-compliance issues. Reliable financial information, enabled by high-quality audits, contributes to market efficiency by facilitating well-informed investment decisions. This efficiency benefits both companies and investors.

This research is conducted to study the impact of external audit quality on the firm's financial performance in the context of Pakistan. This study enhances the literature filling the contextual gap in the market of Pakistan. According to Phan et al. (2020), limited literature exists on the role of audit quality on company specific variables in the developing countries. Audit quality can be of prime importance for all the stakeholders as reliance on financial statements depend on the quality of audit (Kausar et al., 2016). This research is therefore focusing on studying the impact of audit quality on firm performance.

2. Literature Review

DeAngelo (1981) described audit quality as the likelihood or probability that auditors will detect and report significant errors. Belkaoui (2004) provided an alternative perspective, describing it as the low probability that financial statements will be misinterpreted, contain errors, or involve misconduct. Audit quality entails the assurance that auditors offer an appropriate audit opinion (Dewi & Monalisa, 2016). DeAngelo's (1981) definition of audit quality implies that auditors of higher quality are capable of producing financial reports that are more reliable. Defond and Zhang (2014) put forth a definition of audit quality as "providing greater assurance of high financial reporting quality". Higher-quality audit is one of the factors that lead to better firm performance (Balsam et al., 2003; Nguyen & Nguyen, 2024). While the primary focus of audit quality is to ensure accurate and reliable financial reporting, it indirectly contributes to improving firm profitability. High-quality audits are designed to uncover errors, irregularities, and potential instances of fraud within a company's financial records (Zahid et al., 2022). Higher quality of financial statements is associated with quality of audit (Watkins et al., 2004). Audit quality is also expected to bring credibility in the information depicted in the financial statements (Esplin et al., 2018). It also reduces the opportunistic behavior. Many studies have found a positive link between audit quality and company performance indicators such as profitability, market value, and stock returns (e.g. Balsam et al., 2003; Cenciarelli et al., 2018). These studies propose that higher audit quality is connected with better financial reporting accuracy and

transparency, which in turn can enhance investor confidence, attract investment, and positively impact firm performance (Farouk & Hassan, 2014). High-quality audits are associated with more accurate and reliable financial reporting, discouraging aggressive earnings management strategies. This can lead to improved firm performance as investors' value transparency and accurate reporting. Identifying and rectifying these issues can prevent financial losses and potential legal liabilities, leading to improved profitability. A thorough audit process often involves evaluating a company's internal controls. Implementing effective internal controls helps prevent financial mismanagement, reduces the likelihood of errors, and safeguards company assets, positively impacting profitability. Previous studies have demonstrated that companies audited by specialized auditors exhibit lower levels of earnings management when contrasted with those audited by non-specialized auditors. Specifically, reduced discretionary accruals are found in the clients of auditors specializing in particular industries (Krishnan, 2003). High quality audit improves profitability and reduces a probability of financial fraud (Carcello & Nagy, 2004; Balsam et al., 2003; Nejad et al., 2024).

Audit helps in identifying areas of wastages and inefficiency in company's operations. A company can optimize its operational process and allocation of resources by addressing these issues, leading to reduced cost and improved profitability. Companies having reputation of upholding high audit quality have an increased chance of securing funding on favorable terms by attracting more investors. Increased investor confidence as a result of accurate financial reporting can lead to increased stock prices contributing to improved financial performance. High-quality audits enhance the credibility of the financial statements (Watkins et al., 2004) making it easier for companies to raise capital at lower interest rates positively impacting profitability. Previous studies have confirmed that superior auditing practices are linked with reduced earnings manipulation, subsequently leading to greater earnings quality (Becker et al., 1998). Audits involve a detailed review of a internal controls and financial processes of a company. Companies can therefore improve its operations, streamline their processes, and reduce cost by addressing the recommendations of the audit, all of which contribute to improved profitability. Audits also assess risks faced by a company. A company can minimize potential losses by identifying these risks, which in turn can lead to more profitability.

High quality attributes to accurate financial reporting that help companies avoid regulatory fines pertaining to inaccurate financial statements. Financial penalties can significantly affect profitability. Management are able to make well-informed strategic decisions on the basis of reliable financial information backed by high-quality audits. This includes investment, expansion, cost management and product development decision which can lead to improved long term profitability. Similarly, companies build a reputation of integrity and ethical business practices by consistently disseminating accurate and transparent financial information. This reputation can attract partners, customers and suppliers making a positive impact on profitability. Information asymmetry between external stakeholders and management is reduced as a result of high-quality audits (Mohapatra et al., 2021). Due to increased investor trust, companies with high-quality audits are able to lower their cost of capital through better access to external financing (Sjam et al., 2020). Auditors perform three distinctive functions, namely, assurance, insurance and information provision (Wallace, 1980). The assurance function entails their responsibility to corroborate the credibility of financial information prepared by the company's internal personnel. Audit quality is often linked to the effectiveness of a company's internal controls and corporate governance mechanisms (Bawuah, 2024). Effective audits help identify

weaknesses in internal controls, which, when addressed, can enhance operational efficiency, reduce fraud risk, and improve overall firm performance.

Within the realm of accounting literature, there is a widely accepted viewpoint that audit fees serve as a reflection of auditors' exerted efforts. This perspective is rooted in the highly regulated nature of the audit market, which constrains the ability to extract excessive rents (Monametsi & Agasha, 2020). In anticipation of increased audit workload, audit firms levy higher fees in proportion to the magnitude of work entailed in the audit process (Krishnan et al., 2013). Consequently, audit fees function as a market signal denoting the augmented credibility of financial information, consequently augmenting the overall value of the firm. Within this context, conflicting evidence emerges. Various researches argued that audit fees are indicative of higher quality audit practices (e.g. Asthana & Boon, 2012; Blankley et al., 2013; Eshlemen & Guo, 2014).

Company's financial performance improves with the existence of an experienced expert external auditor (Al-ahdal & Hashim, 2022). Enekwe et al. (2020) conducted their study in the contextual environment of Nigeria. To measure audit quality, audit committee composition, audit independence and audit fee were used as proxies. Their findings indicated a positive impact of auditor independence on profitability. Similarly, Rahman et al. (2019) explored the influence of audit characteristics on profitability of Vietnamese companies. Positive impact of external audit quality and audit committee size was revealed on firm performance. Moreover, Sayyar et al. (2015) find a positive link between audit fees and profitability in Malaysia. Al-Mamun et al. (2014) studied the link between audit committee attributes, external audit quality and the profitability of Malaysian listed companies. The outcome of their research revealed that the external auditors had a negative impact on firm performance. Martinez and Moraes (2014) evaluated the link between audit fees and firm performance of Brazilian public companies. Their study determined that firm value increase due high quality audit. The association between audit quality and firm performance may vary across industries and regulatory environments. Many industries e.g. financial sector, have greater reliance on audit quality due to the complexities of their operations. Moreover, stricter regulatory environments may lead to higher audit quality, which can positively influence firm performance. Some studies explore the long-term implications of audit quality on firm performance and sustainability.

H₁: Audit quality positively impacts profitability of the firm.

H_{1a}: Remuneration of the audit positively impacts the profitability of the firm.

H_{1b}: Big4 audit firms as external auditor affects the profitability of the firm positively.

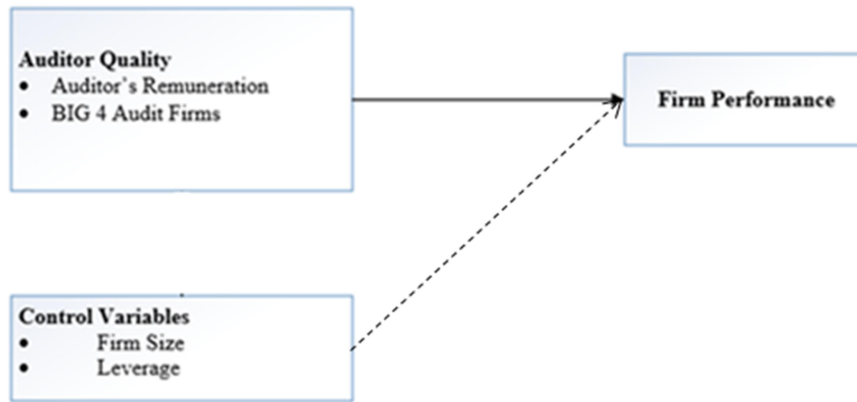


Figure 2.1: Research Model

3. Research Methodology

3.1 Audit Quality

3.1.1 Auditor Remuneration

The cost of auditing is typically linked to the level of audit quality. Audit firms that are renowned for their commitment to high-quality auditing practices often levy a higher audit fee (Zahid et al., 2022). It is observed that top auditors charge a premium in terms of their fees (Crawswell et al., 1995), and their presence exerts a favorable influence on various firm-related phenomena, including firm performance (Balsam et al., 2003). In line with agency theory, which theorizes that performance-based incentives can mitigate agency conflicts, audit remuneration has been employed as a proxy measure for assessing audit quality.

3.1.2 Big 4 Firms

Second variable used as a proxy of audit quality is audit firm ranking (Achour & Boukattaya, 2021). Dummy variable is used as a measure. Previous studies have confirmed that auditors with specialized expertise deliver audits of higher quality when compared to auditors without specialization (e.g. Krishnan, 2003). The value “1” is assigned if auditor is among the Big 4 firms and otherwise value is “0”.

3.2 Firm Performance

Profitability is measured by the ratio ‘ROA’ calculated by the formula given as follows:

$$\text{ROA} = \text{Net Profit} / \text{Total Assets}$$

Measurement of variables used in the study is precisely given in the table as follows:

Table 1. Measurement of Variable

Variable	Symbol	Measurement
Audit Remuneration	AUD_REM	Natural Log of Audit Remuneration for the year particular year
Audit Firm Quality	BIG4	Dummy variable is used having value “1” if audit firm is among the top four audit firms, otherwise value is “0”
Firm Size	F_SIZE	Natural log of the value of total assets of the firm
Leverage	LEV	Debt to Equity Ratio = Total Debt/ Total Equity
Firm Performance	FP	Return of Asset = Net Profit/ Total Assets

3.3 Econometric Model

The econometric model tested in the study is shown below:

$$FP_{it} = \alpha + \beta_1(AUD_REM)_{it} + \beta_2(BIG4)_{it} + \beta_3(F_SIZE)_{it} + \beta_4(LEV)_{it} + \varepsilon_{it}$$

4. Results

4.1 Descriptive Statistics

Mean value of ROA which is the measure of profitability is 0.266 which implies that average profitability of the companies in the sample is 26% of their total assets. Big_4 represents the auditor of the company. Maximum value is 1 which is given when the auditor is one of the big 4 firms. "0" value is given when auditor is other than the big 4 firms. Audit remuneration represents the log value of audit fee received by the audit firm. Mean value is 5.643. Firm size represents the logarithm value of total assets of the company. Mean of the variable is 14.585. Leverage represents the proportion of debt in the financing of total assets. Mean value of the variable is 0.379. Table 4.1 provides descriptive results of the study:

Table 2. Descriptive Statistics

	FP	BIG_4	AUD_REM	F_SIZE	LEV
Mean	0.266	0.378	5.643	14.585	0.379
Median	0.229	0.000	5.593	14.331	0.350
Maximum	2.400	1.000	6.311	18.156	0.750
Minimum	-1.200	0.000	5.090	10.345	0.100
Std. Dev.	0.306	0.487	0.294	1.679	0.117
Observations	111	111	111	111	111

4.2 Correlation Matrix

One of the fundamental reasons to calculate the correlation matrix is that it gives an initial idea about the direction of the relationship between the variable. Secondly, if relationship among the independent variables is high, it gives an indication about the existence of multicollinearity in the model. The above given statistics show that relationship between independent variables is weak and hence the possibility of multicollinearity is ruled out. All the independent variables are showing positive relationship with the profitability. The correlation between the variables is given in the table 4.2 shown as follows:

Table 3. Correlation Matrix

	FP	BIG_4	AUD_REM	F_SIZE	LEV
FP	1				
BIG_4	0.372**	1			
AUD_REM	0.389*	0.076**	1		
F_SIZE	0.323	0.168*	0.022*	1	
LEV	0.072**	0.071	0.603	0.018	1

*p < 0.05, **p < 0.01

4.3 Regression Results

The Hausman test indicates whether to use fixed-effects or random-effects model in a panel data analysis. As the p-value is less than 0.05, this suggests that the fixed-effects model is appropriate to use in the given data.

Table 4. Hausman Test

Test Summary	χ^2	Degree of Freedom	Prob.
Cross-section random	12.751644	4	0.0126

As suggested by the results of Hausman test, fixed effect model is applied for the analysis. The results of fixed effect model are shown in the table below:

Table 5. Fixed Effect Model

Variable	B	S.E	t-stats	p-value
Constant	-2.327	1.036	-2.247	0.028
AUD_REM	0.304	0.184	1.655	0.042
BIG_4	0.187	0.042	4.449	0.000
F_SIZE	-0.002	0.006	-0.366	0.715
LEV	2.221	0.313	7.105	0.000
R ²	0.283	Prob (F-statistic)		0.000
Adj. R ²	0.273	Durbin-Watson stat		2.190

The above results show that choice of audit firm positively affects the profitability of the firm. The β of the variable “Big_4” is 0.187 and is significant at p-value 0.000 (less than 0.05). This implies that choosing big 4 audit firm as the auditor leads to better profitability. Similarly, remuneration of the auditor has a slope of 0.304 (p-value = 0.0042) shows that impact of auditor remuneration is significant on the firm profitability. Often the remuneration represents the extent of work auditor is performing during the audit and hence it can be said higher audit fee mean better quality of audit which leads to more reliance on the financial statement leading to increased profitability. F_SIZE has a beta-value of -0.002 and is insignificant (p-value = 0.715). This implies that size of the firm does not effect profitability. On the other hand, leverage has a beta-value of 2.221 (p-value = 0.000). The results depict that use of debt option for financing increase profitability of the firm possibly because of the tax benefit they get as a result of interest being a deductible expense when calculation income for payment of tax.

5. Conclusion

The findings of study in hand revealed a positive impact of audit quality on financial performance. The results of the study are consistent with Farouk & Hassan (2014). Prior studies also showed a significant impact of audit quality measured by BIG 4 and firm performance (e.g. Khan, et al., 2021). The study shows that when quality of the audit is high, the stakeholder reliance on such financial statement is high and financiers show positive attitude in financing to such companies. Similarly, investors feel confident in investing in such companies. Tax authorities rely on these financial statement leading to lesser tax penalties. For all the mentioned reasons the performance of the companies increase in result of the high quality audit.

The results of the study also showed that there is no impact of the firm size on the performance of the firm. It can be interpreted that the impact of firm size on profitability varies across different firm types, industries and operational environments leading to an overall insignificant effect. Moreover, only an increase in the firm size does not enhance profitability. Firm’s operational efficiency, innovation and strategic investments are the factors that are prominent when size of the firm increase. In contrast, the study underpinned that use of debt in the capital structure leads to increase in the profitability. Interest expenses on debt are tax-deductible that

can reduce the company's tax liability leading to improved profitability. Moreover, financing through debt enables the company to invest in lucrative projects that could not have been possible if debt financing option is not available. Hence, this leads to increase in overall profitability.

5.1 Recommendations

In the end, it is recommended that it is the duty of the directors to main a system of transparency in the external auditor selection and facilitate them in the course of audit to enhance the quality of the audit. Quality of audit can be one of the underlying factors in the sustained profitability of the company as the company's image can improved in the eye of the stakeholders. Hence, it is recommended that company may opt for better quality audit so that their profitability can be increased in long term.

5.2 Limitations of the study

The research is constrained to a specific number of companies or industries within a particular geographic region or time frame, which may limit the generalizability of the findings to other contexts. Audit quality is inherently difficult to measure objectively. Profitability is measured using ROA which may not reflect the full spectrum of a company's financial performance due to accounting practices or non-financial factors.

5.3 Future Research Directions

Further researches could explore how the relationship between audit quality and profitability varies across different industries. Comparative studies across countries with varying regulatory environments and auditing standards could shed light on the role of institutional factors in shaping the relationship between audit quality and profitability.

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