

AUDITING | RESEARCH ARTICLE

# Audit Quality and its Effect on the Financial Performance of the Firm: A Case Study of Pakistan

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## ARTICLE HISTORY

Received: December 05, 2025

Revised: February 01, 2026

Accepted: February 07, 2026

## DOI

<https://doi.org/10.52970/grar.v6i2.1922>

## ABSTRACT

The paper investigates the role of audit committee characteristics in a firm's financial performance. During the ongoing economic recession and the world financial crisis, the corporate governance systems are quite notorious. The audit committee represents one of the most important aspects of efficient corporate governance in companies. In Pakistan, little evidence exists on the effects of audit committees and their attributes on firm performance in the Pakistani literature. Four key characteristics of the audit committee were defined to examine their influence on the company's financial performance: independence, activity, size, and quality of the external audit. The researchers used Tobin's Q to quantify the market and ROA to quantify the accounting business. The panel data analysis showed that the size of the audit committee and the quality of the external audit positively and statistically significantly affect Return on Assets (ROA) and Tobin's Q. Two more variables, including audit committee independence and AC activity, also do not lead to any significant effect, and this can also be seen through the results of the jurisdiction studies that have been conducted in different countries. Essentially, the study has provided valuable information to regulators, policymakers, and stakeholders in Pakistan regarding the adoption of specific audit committee qualities. Incorporating these qualities can improve firms' financial performance. To determine whether the corporation's performance has improved, the audit committee's skills can be used to gather information at the company's administrative level.

**Keywords:** Activity, Audit Committee, External Audit Quality, Independence, ROA, Size, Tobin's Q.

**JEL Code:** G34, M42, G32, C23.

## I. Introduction

In the current globalized and dynamic business world, the credibility of financial statements has become a key factor in shaping investor confidence and stakeholder decisions. Good auditing addresses the relevance of financial reporting, entry, and the corporation's good governance. As the dynamics of financial markets have changed, greater emphasis has been placed on the role of external auditors, particularly in emerging economies like Pakistan, which have yet to develop their institutional frameworks fully. The



expansion of businesses is crucial to the health of economies, as is the expansion of related industries. In any business, owners or shareholders are looking for a healthy return on their investment. The primary purpose of a company's board of directors is to ensure that both management and shareholders are satisfied with their interests, thereby enabling the business to run smoothly and efficiently, ultimately benefiting the owners.

The failure of corporations to repay money was another way in which the global financial crisis of 1997, compared to 1998, rattled the confidence of shareholders and investors (Foster & Magdoff, 2009). In light of this serious problem, good corporate governance is essential for companies seeking to regain the trust of shareholders, investors, and other key constituencies. The term "corporate governance" has recently surpassed all others in usage within the international business community. During this time of a worldwide financial crisis and an economic slump, there has been much talk about corporate governance and the mechanisms by which it operates. In addition to the fact that all listed organizations must follow a code of corporate governance based on their norms and regulations, good corporate governance is essential because it enhances a company's value. According to Brickley, Coles, & Terry (1994), Brickley & James (1987), Lee, Rosenstein, Rangan, & Davidson III (1992), Yermack (1996), and Hossain, Cahan, & Adams (2000) are among the many studies that have found that effective corporate governance improves a company's success. Various authors have examined the impact of corporate governance on a business's value. When looking at metrics such as Tobin's Q, return on assets (ROA), Return on Equity (ROE), etc., their study found that strong corporate governance helps companies perform better. In situations where principles are not actively monitoring their agents, corporate governance measures step in to help. Because of the many financial challenges agents face, governance systems are put in place to ensure agents always act in their owners' best interests (Hill, 2004). Audit committees are required to enhance the reputation of the financial reporting and audit practices, which the Public Oversight recognized (Board, 1993) and (Committees, 1999).

In light of this, the company's board has entrusted the audit committee with oversight of the financial reporting process. To reduce the likelihood of corporate financial failures and increase public trust, it is necessary to ensure the audit committee operates effectively. It is observed that auditors frequently identify abnormalities, fraudulent activities, and pinpoint faults within organizations. Furthermore, Krishnan (2005) noted that the audit committee typically oversees internal control systems within companies. Also, the audit committee may be able to fulfill all of its roles in this vein, with the help of many, including the board, with the cooperation of the involved management and the employees of the firms (Haron, Jantan, & Pheng, 2005). Therefore, Chambers (2005) outlined the four fundamental obligations of the audit committees. First and foremost, the AC provides guidance to the board regarding the credibility and dependability of financial data. In addition, the AC offers guidance to the board on matters related to internal control and risk management.

Additionally, the AC advises the board on the credibility and reliability of financial information. Additionally, the AC provides the board with guidance on risk management and internal control issues. A company's overall performance can be improved by establishing an audit committee to oversee internal and external auditing processes. Given the importance of audit committees in Pakistani corporations, this topic has been researched because the Pakistani literature provides limited data on how audit committees affect company performance. The existence of financial transparency, data integrity, anti-fraud measures, and error detection is a key research area concerning the role of audit committees. This paper discusses empirical evidence supporting the notion that audit committee size, independence, activity, and the quality of external audits influence a firm's financial performance. With the strong foundation provided by this study, further studies in this area can be conducted.

## II. Literature Review and Hypothesis Development

Earlier research indicates that the formation of an audit committee plays a vital role in enhancing internal and external audit processes, risk oversight, and financial reporting quality. A strong audit committee helps reduce agency problems, protects the interests of shareholders and other stakeholders, and ultimately drives greater firm value. Recent studies have also shown that specific audit committee characteristics can

improve overall corporate performance. These features are essential for preserving shareholder rights, protecting stakeholder interests, and fostering long-term value creation. Emerging empirical evidence further supports the link between audit committee attributes—such as size, independence, expertise, and meeting frequency—and better governance and financial outcomes (Kamran, Shami, Khan, & Hussain, 2023; Nawaz et al., 2023; Roziqin, 2025). This underscores the increasing importance of audit committee effectiveness as a key factor in promoting corporate accountability and sustainable firm success.

## 2.1. Audit Committee Size

Research has shown that the size of the audit committee plays a critical role in its effectiveness within organizations (Pincus, Rusbarsky, & Wong, 1989). However, empirical findings on audit committee size remain mixed. Some studies have shown a positive impact on financial performance, with Qin (2007) finding that companies with larger audit committees tend to produce higher earnings returns. Similarly, (Pucheta-Martínez & De Fuentes, 2007) suggested that larger audit committees enhance financial reporting quality, a view also supported by (Felo, Krishnamurthy, & Solieri, 2003), who noted that an increased number of committee members improves reporting accuracy. On the other hand, there is contrasting evidence. For example, (Xie, Davidson III, & DaDalt, 2003) found only a weak connection between audit committee size and earnings management, while (Lin & Hwang, 2010) observed a negative relationship between committee size and earnings manipulation. Furthermore, research by Abbott, Parker, & Peters (2004) and Bédard, Chtourou, & Courteau (2004) indicated no significant link between audit committee size and the occurrence of financial restatements. Despite these varied conclusions, resource dependence theory (Pearce & Zahra, 1992) posits that larger audit committees can improve financial performance by enabling them to address complex business challenges more effectively. Recent evidence from Pakistan supports this argument, demonstrating a significant, positive relationship between audit committee size and firm financial indicators such as ROA and EPS (Mehran, Zubair, & Ahmed, 2022). Hence, as the committee expands, its ability to enhance firm performance improves. Drawing on this rationale, the following hypothesis is proposed:

H1: There is a statistically significant positive relationship between audit committee size and firm performance.

## 2.2. Audit Committee Independence

Audit committee independence is characterized by a larger proportion of non-executive directors than executive directors. This level of independence reflects a firm's strong commitment to sound corporate governance practices (Sommer Jr, 1991). Existing research indicates that independent audit committees are more effective at preventing financial misreporting and fraud (Beasley, 1996; Williams, Fadil, & Armstrong, 2005). In line with this, studies have shown a negative association between audit committee independence and earnings management, as observed by Lin and Hwang (2010) and Bradbury, Mak, and Tan (2006). Similarly, Abbott et al. (2004) concluded that fully independent audit committees tend to reduce instances of earnings manipulation. Moreover, the independence and expertise of audit committees have been found to significantly improve firm performance, particularly in Pakistan's manufacturing and banking sectors (Javed & Qazi, 2024). Furthermore, Chan and Li (2008) highlighted that having independent, qualified specialists on the audit committee enhances firm value.

H2: There is a significant positive relationship between audit committee independence and firm performance.

### 2.3. Audit Committee Activity

Previous research has often measured the number of audit committee meetings as an indicator of the committee's diligence and overall effectiveness (Menon & Williams, 1994). However, findings on the impact of audit committee activity have been mixed. Some studies suggest that frequent meetings can enhance transparency in financial reporting and improve earnings quality, as Xie et al. (2003) indicated. Likewise, Lin and Hwang (2010) observed that more active audit committees help reduce earnings management. On the other hand, other studies have failed to establish any significant link between meeting frequency and earnings manipulation (Bédard et al., 2004; Yang & Krishnan, 2005). Abbott et al. (2004) also reported no evidence that the number of audit committee meetings reduces instances of fraud. Moreover, audit committees with independent and financially literate members are often better equipped to challenge management decisions, leading to more transparent and credible disclosures (Akbar, Zeb, & Zada, 2024). According to the Corporate Governance Code (2002), audit committees should hold at least 4 meetings per year. In light of these findings and requirements, the following hypothesis is proposed:

H3: There is a strong positive relationship between audit committee activity and firm performance.

### 2.4. External audit Quality

Having reputable external auditors on the audit committee is important, as their expertise enhances audit quality. Prior research indicates that larger audit firms allocate more resources to engagements, charge higher fees, and face fewer legal claims, suggesting they generally produce better audit outcomes than smaller firms (Palmrose, 1988). Studies by Francis (2004) and Francis, Maydew, and Sparks (1999) further reveal that companies audited by Big Four affiliates earn higher profits than those audited by non-Big Four firms. This is mainly because Big Four auditors enhance the credibility of financial disclosures, making companies more trustworthy to investors. However, findings from Bangladesh (Humayun Kabir, Sharma, Islam, & Salat, 2011) report no significant differences in earnings quality between Big Four and non-Big Four clients. In practice, Big Four audit firms employ highly trained professionals with advanced technological and financial expertise, allowing them to serve larger clients more effectively. In contrast, smaller audit firms, with fewer staff and limited resources, often offer more customized services to their clients' management teams (Zahid, Khan, Anwar, & Maqsood, 2022). Similar conclusions were reached by Jeong and Rho (2004) in Korea, who found that a firm's membership in the Big Six did not necessarily affect audit quality. Although empirical evidence on the direct relationship between audit firm size and earnings is mixed, prior research by Becker, DeFond, Jiambalvo, and Subramanyam (1998) and Francis (2004) provides a basis for the following hypothesis:

H4: There is a significant positive relationship between external audit quality and firm performance.

## III. Research Method

The study's final sample comprised 124 companies. The selection process took place in two stages. In the first stage, 75 top non-financial companies were selected from the KSE-100 index based on their market capitalization as of December 31, 2011. The list was compiled using data from the KSE and company websites. In the second stage, Shariah-compliant companies were included to create a more representative sample of market capitalization, in line with the screening criteria provided by Meezan Bank on the KSE website. This Shariah-compliant set initially contained 100 firms, 44 of which already overlapped with the 75 selected companies. Among the remaining 56 Shariah-compliant firms, two were banks and therefore excluded as per the criteria. The remaining 54 non-financial firms were added to the existing 75 companies, bringing the total to 129. However, due to incomplete data for five companies, they were dropped, leaving a final sample of 124 companies.

The data for the study were sourced from secondary, publicly available materials on various websites. Company annual reports were reviewed to obtain information on the variables of interest. The audit committee data were gathered in accordance with corporate governance requirements. Moreover, the accounting and market data for the companies were extracted from their annual reports. The empirical model is constructed based on the reviewed literature and the formulated hypotheses.

$$ROA = \alpha + \beta_1 AC\ Size_{it} + \beta_2 AC\ Ind_{it} + \beta_3 AC\ Activity_{it} + \beta_4 EAQ_{it} + \beta_5 Firm\ Size_{it} + \beta_6 Lev_{it}$$
$$Tobin\ Q = \alpha + \beta_1 AC\ Size_{it} + \beta_2 AC\ Ind_{it} + \beta_3 AC\ Activity_{it} + \beta_4 EAQ_{it} + \beta_5 Firm\ Size_{it} + \beta_6 Lev_{it}$$

ROA denotes the return on assets for the *i*th company, calculated at time *t* as net income divided by total assets. Tobin's *Q* is measured as the market value of firm *i* relative to its book value of assets for a given period (*t*). AC Size refers to the total number of members serving on the audit committee or board of directors of company *i* at time *t*. Audit committee independence is calculated as the proportion of non-executive directors on company *i*'s audit committee at time *t*. AC activity indicates the level of audit committee engagement for company *i* in period *t*, measured by the number of audit committee meetings held during the financial year. EAQ<sub>*it*</sub> denotes the quality of the company's external audit at time *t*, using a binary indicator—1 if audited by one of the Big Four audit firms and 0 otherwise. Firm size is the company's scale at time *t*, represented by the natural logarithm of its total assets. Lev is the leverage of company *i* at time *t*, computed as the ratio of its total debt to total assets, expressed as a percentage. The data for this research span the period 2004–2011 and comprise 992 observations across 124 companies. Panel data were applied to examine the link between audit committee characteristics and firm performance. Statistical analysis was carried out using SPSS software.

## IV. Results and Discussion

### 4.1. Descriptive Statistics

The descriptive findings for the research variables, treated as independent variables in the regression model, examine the relationship between audit committee attributes and firm performance. The summary statistics reveal that audit committee sizes range from 3 to 8 members, with an average committee size of approximately 3.37 and a standard deviation of 0.723. This indicates that most companies in the sample use committees of 3 or 4 members. Regarding composition, audit committees in Pakistani firms consist of non-executive directors ranging from 0 to 8, with a mean of 2.73 and a standard deviation of 0.963. In practice, most companies have about 8 non-executive directors serving on their audit committees. The companies also hold 3 to 8 committee meetings annually, with an average of 4. According to the Institute of Chartered Accountants of Pakistan, approximately 61% of the sample companies appoint one of the Big Four audit firms as their external auditor. These findings demonstrate that most companies comply with Pakistan's 2002 corporate governance regulations. Typically, audit committees consist of 3 members and hold about 4 meetings per year, with their financial accounts audited by independent directors and reputable external audit firms. Additionally, the average Return on Assets (ROA) for the companies was 7.22%, with a standard deviation of 0.100. The average Tobin's *Q* of 1.3173 indicates that investors tend to value the firm's assets at a premium over their book value, reflecting a preference for total assets as an investment base rather than just their accounting value.

**Table 1. Descriptive statistics**

Variables	Min.	Max.	Mean	S.D.
AC size	3	8	3.3700	0.7230
AC non-Ex	0	8	2.7300	0.9630
AC Indp	0	1	0.8000	0.1930
AC activity	3	8	4.1100	0.5050
Big 4 auditor	0	1	0.6100	0.4870
ROA	-1.2139	0.7836	0.6122	0.1004
Tobin's Q	0.1000	7.1053	1.3173	0.7996
Assets	31.1860	262673.4060	13898.1240	29914.4620
Total debt	0	171223.6320	1552.3110	6930.0310
Net profit	-16071.7070	63527.2700	1212.8630	5163.5490

#### 4.2. Correlation Matrix

The table presents the correlations among the independent, dependent, and control variables. The size of the audit committee and its independence exhibit a positive and significant relationship. Specifically, the correlation coefficient of 0.149 for audit committee independence is statistically significant at the 1% level, suggesting that independence tends to grow as the committee size increases. Similarly, audit committee activity is positively correlated with both size and independence, with coefficients of 0.285 and 0.064, respectively. These findings indicate that larger audit committees tend to be more independent and active. As audit committee size and activity increase, the company's monitoring capacity improves, which can enhance overall firm performance (Raghunandan & Rama, 2007). Importantly, all three audit committee characteristics—size, independence, and activity—are positively associated with higher external audit quality. This implies that adhering to best practices in audit committee structure and operations, as outlined in governance codes, enhances the quality of the external audit. This relationship is significant at the 1% level. Furthermore, return on Assets (ROA) is the performance measure that shows a significant positive correlation with the quality of the external audit. This suggests that companies with larger, more independent, and more active audit committees tend to achieve better financial performance, as reflected by higher ROA.

**Table 2. Pearson Correlation**

Variables	Ac size	Ac Indp	Ac activity	Big 4 auditor	ROA	Tobin's Q	Size	Leverage
Ac size	1							
Ac Indp	0.149**	1						
Ac activity	0.285**	.064*	1					
Big 4 auditor	0.287**	0.212**	0.152**	1				
ROA	0.122**	0.037	0.068*	0.213**	1			
Tobin's Q	0.186**	0.083*	0.092**	0.251**	0.465**	1		
Size	0.381**	0.144*	0.193*	0.397*	0.092*	0.063*	1	
Leverage	-0.032	-0.058	-0.012	-0.012	0.086*	0.023	0.019	1

The finding that all audit committee characteristics are positively and significantly correlated with Tobin's Q implies that investors assign greater value to a firm's assets when the audit committee complies with corporate governance standards. This enhances the company's credibility and reputation in the marketplace. Furthermore, all audit committee attributes show a significant positive correlation with firm size at the 1% level. The correlation between firm size and return on assets (ROA) is 0.092 (p-value = 1%), demonstrating a positive relationship.

Although leverage and ROA do not have a significant direct correlation, leverage is negatively associated with all audit committee variables. Specifically, the Pearson correlation between leverage and ROA is -0.086 at the 1% level, indicating a strong inverse relationship. Moreover, the audit committee variables do not pose substantial multicollinearity concerns in the regression, as the highest intercorrelation is approximately 0.621

#### 4.3. Regression Analysis

Regression analysis is conducted in this research to evaluate the hypotheses outlined in Table 3. The study examines the influence of audit committee characteristics on two key performance metrics, return on assets (ROA) and Tobin's Q. Control variables like firm size and leverage are also incorporated into the regression model because they play an important role in explaining the impact of audit committee attributes on firm performance. The adjusted R-squared values for ROA and Tobin's Q are 0.053 and 0.080, respectively, as reported in Table 3. Both models are significant at the 1% level, with F-values of 19.492 and 29.528 and corresponding p-values of 0.000. After controlling for firm size, audit committee size, and Big Four audit affiliation, the results indicate that the independent variables account for approximately 5.3% of the variance in ROA and 8% of the variance in Tobin's Q. These relatively low adjusted R-squared values are shared in governance-related research (Rahmat & Iskandar, 2009). In addition, the Durbin-Watson statistic was calculated to check for autocorrelation in the regression model. The Durbin-Watson values are 1.104 for ROA and 1.700 for Tobin's Q, indicating no significant autocorrelation among the variables.

**Table 3. Regression Analysis of AC Characteristics and the Firm's Performance**

Variables	ROA	Tobin's Q
Big 4 auditors	0.194** (5.994)**	0.243** (7.125)**
AC size	0.064* (1.976)*	0.150** (4.474)**
Leverage	-0.082* (-2.463)*	-0.013* (-0.437)*
Firm size	-0.010 (-0.277)	-0.089 (-2.549)*
Adj. R <sup>2</sup>	0.053	0.080
F	19.492**	29.528**
D-W	1.104	1.700
AC activity	0.021 (0.649)	0.033 (0.021)
AC Indp	-0.019 (-0.588)	0.022 (0.707)

The findings reveal that external audit quality significantly and positively influences both performance measures. The beta coefficient for ROA is 0.194, and for Tobin's Q it is 0.243, both significant at the 1% level. These results imply that selecting one of the Big Four audit firms enhances the firm's accounting performance by 19.4%, as measured by ROA. Similarly, Tobin's Q rises by 24.3%, suggesting improved market valuation. These conclusions align with earlier research (Becker et al., 1998; Francis et al., 1999; Francis, 2004), which also found that companies audited by Big Four affiliates outperform their non-Big Four counterparts. Partnering with a top-tier audit firm enhances credibility in capital markets, as investors perceive stronger financial disclosures and greater transparency, thereby improving investor confidence and leading to higher asset prices relative to book value. Moreover, Rahmat and Iskandar (2009) show that audit quality is negatively associated with financial distress, supporting the argument that audit quality bolsters firm performance.

Additionally, Audit committee size has a positive impact on both ROA and Tobin's Q. The regression coefficients for ROA and Tobin's Q are 0.064 and 0.150, significant at 5% and 1%, indicating that an extra

member on the audit committee can enhance ROA by 6.4% and Tobin's Q by 15%. This aligns with the findings of Felo et al. (2003) and Pucheta-Martínez & De Fuentes (2007), who also note that larger committees promote stronger financial reporting and better overall business results. Moreover, according to resource dependence theory (Pearce & Zahra, 1992), larger committees provide greater expertise and resources to manage corporate challenges effectively. Investors recognize larger audit committees as capable and well-equipped to tackle financial and accounting matters. Kalbers and Fogarty (1993) similarly note that audit committees with more members act as a substantial counterpart to the Board of Directors, earning respect from internal and external auditors.

In short, the results confirm that audit committee size and the quality of the external audit significantly enhance firm performance, supporting H1 and H4. Furthermore, additional audit committee characteristics — namely, AC activity and independence — were tested but proved insignificant and were excluded. This negligible impact is attributed to the uniformity of audit committee meeting frequency across most sampled firms, where about 91% hold at least four meetings per year. Due to minimal variation, committee activity displayed little predictive power and was thus omitted from the regression model.

**Table 4. Summary Results For AC Characteristics and The Firm's Performance**

Independent variables	Expected sign	Actual sign	Hypothesis accepted/rejected
AC size	+	+*	Accepted
AC Indp	+	?	Rejected
AC activity	+	?	Rejected
EA quality	+	+*	Accepted

\*: Represents a significant positive relationship

The results are consistent with Abbott et al (2004), who also found no significant link between audit committee (AC) activity and fraudulent practices or earnings management. Similar conclusions have been reported in Australia by Baxter and Cotter (2009) and Davidson, Goodwin-Stewart, and Kent (2005), who observed that the frequency of AC meetings was not associated with better firm performance or reduced earnings manipulation. Likewise, this study indicates that AC independence does not have a significant effect on company performance. These findings support Bhagat and Black (2001), who also noted that independent directors showed no substantial relationship with firm success. Other research, including Lin, Li, and Yang (2006) and Yang and Krishnan (2005), similarly reported that audit committee independence had little influence on earnings management and restatement outcomes. One possible reason for the lack of significant impact of AC independence in Pakistan is that management dominance over the board may hinder committees from fulfilling their monitoring role (Rahman & Ali, 2006). Hence, audit committee independence does not appear to improve company performance. In light of the empirical findings, H2 and H3 are not supported and thus rejected. The analysis reveals no meaningful connection between AC activity or independence with either accounting performance (ROA) or market performance (Tobin's Q). Table 4 summarizes these results. Two of the four hypotheses are supported, suggesting a strong, positive relationship between audit committee size, audit quality, and firm performance. However, the findings do not establish a significant link between company performance and audit committee activity or independence.

## V. Conclusion

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#### 5.1. Conflict of Interest

The authors declare that there is no conflict of interest regarding the publication of this manuscript.

#### 5.2. Funding Declaration

This research received no specific grant from any funding agency in the public, private, or not-for-profit sectors or organizations.

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