**Chapter 1: Introduction.**

* 1. **Background of the study:**

The word “audit” comes from the Latin word audire, meaning “to hear” “to listen”. (Ajao, Olamide and Temitope, 2016). audit is a social phenomenon which serves no purpose or value except of its practical usefulness and its existence is wholly utilitarian. (Ajao, Olamide and Temitope, 2016). Auditing refers to a systematic and independent examination of books, accounts, documents and vouchers of an organization to ascertain how far the financial statements present a true and fair view of the concern. (Ajao, Olamide and Temitope, 2016). Auditing is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users (Ajao, Olamide and Temitope, 2016).

External auditing, as external monitoring mechanism, has become a fundamental requirement in the business environment and has been established as a regulated activity in most industrialized countries due to its important role in offering more confidence and transparency in financial reporting. (SALIM ALI ALGHAMDI, 2012) Recent financial scandals have increased the question of whether an external audit is effective in constraining earnings management and the wave of audit failure in the capital market has also increased concerns about audit quality. (SALIM ALI ALGHAMDI, 2012).

Corporate governance became a pressing issue following the serious corporate scandals that occurred in different countries all over the world. (Hassan, Hijazi and Naser,2017).

To react to such scandals, sets of corporate governance regulations and codes have been established in different developed and emerging countries to improve corporate governance practices. (Hassan, Hijazi and Naser,2017).

Series of corporate scandals around the world eroded the trust in the financial statement, and placed a doubt in the mind of investors, which resulted to the loss of confidence by investors worldwide. (Miko and Kamardin 2016) For example, Enron, WorldCom, and Xeronx in developed nations (Fodio, Ibikunle and Oba, 2013), in Nigeria, Cadbury Nigerian plc, Lever Brothers plc (Ajibolade, 2008), called attentions for the investors, because, they suffered loss of their investments. (Miko and Kamardin 2016)

Corporate Governance attracted the considerable attention after some of the prominent and famous scandals or the collapse of the big organizations like Enron, WorldCom, Arthur Andersen etc. (Leventis, Dimitropoulos ,2018). Which raised concerns about the reliability of financial reporting and the efficiency of the monitoring mechanisms. (Leventis, Dimitropoulos ,2018). And because of this investor lost the confidence in the corporate disclosures of and the efficiency of capital markets deteriorated. (Leventis, Dimitropoulos ,2018).

Corporate governance is the system by which companies are directed and controlled. (Leventis, Dimitropoulos ,2018). Boards of directors are responsible for the governance of their companies. (Leventis, Dimitropoulos ,2018). The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. (Leventis, Dimitropoulos ,2018).

Better governance is supposed to lead to better corporate performance by preventing the

expropriation of controlling shareholders and ensuring better decision-making. (Ali Shah, Ali Butt, Hasan, 2006) This expropriation may be due to the result of smoothening of earning intention which is known as earnings management. (Ali Shah, Ali Butt, Hasan, 2006) This study attempts to assess that whether corporate governance creates any impact on earnings management or not. (Ali Shah, Ali Butt, Hasan, 2006)

Good governance means little expropriation of corporate resources by managers or controlling

shareholders, which contributes to better allocation of resources and better performance. (Ali Shah, Ali Butt, Hasan, 2006) As investors and lenders will be more willing to put their money in firms with good governance, they will face lower costs of capital, another source of better firm performance. (Ali Shah, Ali Butt, Hasan, 2006) Other stakeholders, including employees and suppliers, will also be associated with and enter into business relationships with such firms, as the relationships are likely to be more prosperous, fairer, and longer lasting than those with firms with less effective governance. (Ali Shah, Ali Butt, Hasan, 2006)

All the business concerns are established to earn profits. The foremost duty of an enterprise is economic performance, which means the preservation and increase in the value of economic resources entrusted to it. To achieve this object, the enterprise must earn profits at a certain minimum rate.

Earning Management occurs when managers use judgement in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company, or to influence contractual outcomes that depend on reported accounting numbers (Healy, Wahlen, 1998). (S. Abbadi, F. Hijazi, and S. Al-Rahahleh, 2016)

Earnings management (EM), as a phenomenon of previous scandals (Goncharov, 2005) which has received considerable attention, is one of the most important challenges confronting corporate governance (CG) mechanisms which endeavor to resolve the negative impact of earnings management on financial reporting. (SALIM ALI AL GHAMDI,2012) (Jaggi and Tsui, 2007).

Whatever the motivation, it is documented that earnings management harms earnings quality (SALIM ALI AL GHAMDI,2012) (Jaggi and Tsui, 2007). and misleads financial reporting users. (SALIM ALI AL GHAMDI,2012) (Jaggi and Tsui, 2007). Even in developed countries the practice of adopting international accounting and auditing standards has failed to provide sufficient assurances that financial reports are free from earnings management. (Pornupatham, 2006). (SALIM ALI AL GHAMDI,2012) EM has many victims such as equity investors, creditors, suppliers, regulators and customers. (SALIM ALI AL GHAMDI,2012)

Investors’ confidence depends mainly on the strength of the capital market associated with different monitoring mechanisms such as internal corporate governance (CG) which has recently received significant attention in numerous developing countries. (SALIM ALI AL GHAMDI,2012) The significance of internal CG ensues from the vital role it can play in helping firms and economies to attract investment and provide reasonable credibility in financial reporting. (SALIM ALI AL GHAMDI,2012)

Accordingly, prior studies have concluded that internal CG mechanisms have a substantial effect on earnings management practices. The impact of internal CG varies from country to country according to the nature of the ownership structure and various factors. In other words, concentrated ownership may offer extra monitoring mechanisms by affecting the formation of the board of directors and its committees. (SALIM ALI ALGHAMDI, 2012).

The rate of profit is regarded as an indicator of the progress of the enterprise and of the direction in which the company’s resources are utilized. Profit must also provide economic growth and development.

According to Peter Drucker’, the profits of a concern should be sufficient to cover. (i) Current costs of business, (ii) the future costs of staying in the business due to certain risks, that is, the risk of replacement, obsolescence, and uncertainty; (iii) to fill dry holes, as the productive well must compensate the loss of the pipe and labor wasted in a dry hole.

**1.2 Problem Statement:**

**What?**

In the previous articles, researches were done on impact of Corporate Governance (Internal Audit and BOD quality) and on Earning Management whereas, this research focus is on external audit impact on Earning Management and Corporate governance.

**Why?**

The reason why I am carrying this topic is, I have experience in the field of accounting and auditing and therefore it’s a better way to utilize my knowledge and skills regarding the same in a practical manner and also to check the impact of External Audit on Corporate governance and on earning management as there are many corporate scandals has already happened in the history and In order to avoid such scandals and corporate disasters in future I am doing my research on the said topic.

**How?**

This study will fulfill the gap as it’s on external audit impact on corporate governance and earning management and previous articles are been on internal audit impact on corporate governance (Internal Audit Function and BOD Quality) and on earning management whereas in my research I will be targeting the external audit’s impact on the same with some modifications in different sectors of the industry.

**1.3 Research Objective:**

The objective of this research/study is to find out the role, impact / effect of external audit on corporate governance and earning management in Pakistan.

**1.4 Research Question:**

Why it’s necessary for every public listed company to have their annual audit done by external auditors?

What is earning management? And why its important and what relation or role does it play with regards to internal and external auditing and corporate governance?

What were the factors behind incorporating corporate governance for every company?

What were the reason corporate governance comes into existence?

Who will be benefitted by this and how?

How it (corporate governance) can be improved

**1.5 Significance of the study:**

**Who will be benefitted by this study?**

Accounting and Finance professionals, audit professionals such as CA’s, ACCA’s, ICAEW’S, CIA’S, Finance Managers, Accountants, Compliance Officers / Executives, Audit Managers, Audit Partners, Director Finance, Director Compliance and corporate affairs etc. in their respective field with respect to the market / industry practices in the field of Finance and Accounts, taxation, Compliance etc. Will be benefitted by this study.

**Which area or domain will be most benefitted by this study**

People who are working in the Accounts, Finance, Funds Management, Audit, Taxation, Compliance, Legal and Corporate Affairs departments in any of the industrial sectors of the economy will be benefitted by the study.

**Contribution to the study?**

My contribution to the study is that I am utilizing my skills, knowledge and experience which I have gained in the field of external audit. This research will help to those who have no experience of auditing or audit related work.

**1.6 Limitations and Delimitations:**

Improvement on a regular basis and strict laws, rules and regulations has been made and implemented time to time and therefore its not in the control to monitor each and every improvement which has been made either in general or with regards to any industrial sector nor they are publicly available for general use and if its publicly available then the time when it was needed or required is lapsed and its of no use in particular.

Technical language has been used in the laws which is not easy for a layman to understand and it’s not in control to teach every single word or sentence written in the law and there is no such guarantee that every single person who is prone to this will easily understand this.

Financial and non-financial both the sectors of the economy have been targeted and impact has been checked but all the KSE-100 index organization has not been checked and if they checked then there are possibilities that the result mentioned in this research will be changed.

Literature related to Future contracts and organizations which are in this business or the nature of work involves around future contracts and its related study are not part of the research nor they have been studied, because they operate in a different working environment, different capital structure, different nature of business and most importantly different rules have been followed and its commonly in financial and banking sector where it has been widely used as compared to non-financial sector and other companies.

The banking sectors, foreign exchange teller and people who are trading in forex are not part of the study being a small part of the sample and thus they are not being incorporated in this study.

**Future Recommendations:**

**1.7 Organizations of the study:**

The rest of the paper is as follows.

Literature review is reported in chapter 2.

Chapter 3 discusses the methodology used in the research

Chapter 4 consists of results of the tests applied in the research, there discussions and conclusion.

Limitations of the study are described in chapter 5 of the paper.

**Chapter 2: Literature Review:**

**2.1. Theoretical Background:**

Auditing has its history to a large extent determined by the history of accounting, as the latter metamorphosed and culminated with the development of the world economy.

“Corporate governance” first came into vogue in the 1970s in the United States. Within 25 years corporate governance had become the subject of debate worldwide by academics, regulators, executives and investors. (Brian R Cheffins, 2012)

Earnings management directly affects the overall integrity of financial reporting and significantly influences resource allocation in an economy. (Subhrendu Rath and Lan Sun)

The practice of earnings management (hereafter EM) has attracted academic research attention since at least the 1960s. Early literature focus in this area was primarily on the impact of accounting choices on the capital markets. Both the Mechanistic Hypothesis and the dominant paradigm for financial accounting research in the 1970s, the Efficient Market Hypothesis were used to test the impact of accounting choices on the capital markets. However, the implications were contradictory. (Subhrendu Rath and Lan Sun)

**2.2. Empirical Studies**

**1.** Akhtar Uddin, Haron (2010) Board ownership, audit committee’s effectiveness and corporate voluntary disclosures.

….. has been used as the dependent variables and ,…………………………………………………………….. are used as the independent variables. The data was collected from 124 Malaysian firms listed on the main board of Bursa Malaysia. (it excludes Banks, Financial Institutions and Insurance companies). Descriptive Statistics and Univariate Analysis, Multi variate tests, Sensitivity Analysis, Variance inflation factors, Regression analysis etc. techniques have been used to analyze this relationship. Result shows consistent relation of independent variable with dependent variable, . It has been suggested that if the sample drawn have included the financial firms along with the non-financial firms and have data / information for more than one year, the results would be different and better.

**2.** Siagian, V. Siregar, Rahadian (2013) Corporate Governance, reporting Quality and firm value: evidence from Indonesia.

Are used as dependent variable

Reporting Quality Index (RQI) and Corporate Governance Index (CGI) are used as the independent variables.

The data was collected from 125 firms that were traded on JSX in 2003-2004 (Total firms or Observations with RQI data 411, Firms or Observations with CGI data 267, firms or observations with both data 248, observations with incomplete financial data (20), observations with negative book value (25), observations that are considered as outliers (15) Final 188 firms)

Pearson’s Correlation, this shows the positive co relation in their model. Descriptive Statistics, Regression, Sensitivity Analysis, Multivariate Regression Analysis tests has been performed during the research of the study.

It has been suggested that firms having higher value seems to incorporate low or less information as compared to those organizations who have low value and they consider it as an opportunity to have a good market image and value which in turn can have a positive impact in the market regarding compliance with all the relevant laws prevailing in the country.

**3.** W.lin, F.li and S. Yang (2014), The effect of audit committee performance on earnings quality

Characteristics of audit committees (size, independence, financial expertise, activity and stock ownership) has been used as the dependent variables and, earning restatement (a direct measure of earnings management) is used as the independent variables.

The initial sample was collected from 267 publicly held corporations in USA for the fiscal year 2000. (Restatement sample includes106 firms after, 106 companies were deleted due to incomplete financial data,44 due to missing auditor fee data and 11 dues to missing of audit committees). Each restatement sample firm was matched with non-restatement firm which was based on a four (4) digit SIC code and firm size. All the control sample firms were screened for earning restatement (or lack of) This results in a final sample of 212 firms.

Firms restating earnings for the fiscal year 2000 identified from

Lexis-Nexis 267

Less: financial data not available from research insight (106)

Less: auditor fee data not available from the proxy statements (44)

Less: audit committee data not available from the proxy statements (11)

Final sample

Restatement firms: 106

Control firms: 106

Total firms: 212

Univariate correlations and multivariate statistical analyses and multivariate logistic regression model were used in the research.

Result shows negative relation / association of size of audit committees and the occurrence of earning restatement. The remaining characteristics have not found to have any significant or high impact on the quality of reported earnings.

Former US Securities and Exchange Commission (SEC) Chairman Levitt in his famous speech” the Numbers Game” calls for a corporate culture change in management and strengthening corporate governance, improving the effectiveness of audit committee and also expresses his serious concerns over earning management.

It has been suggested that the data used in this research paper is only of year 2000, if more years’ data would be used then the results would have been different and better.

Also noted that in this research study as per the result shown informs that the larger audit committee provide more oversight on financial statements as compared to low or few audit committee members therefore as the number of persons increases in the audit committee the more are the chances of oversighting on the financial statements and there will be low chance that the financials are needed to be restated.

It is recommended that annual external audit and voluntary disclosure of relevant information in the financials must be made public and corporate governance report must be separately issued and published and not with the annual report.

**4.** Hassan, Hijazi and Naser (2017), Does audit committee substitute or complement other corporate governance mechanisms Evidence from an emerging economy

Audit committee effectiveness is used as a dependent variable while Audit committee size, independence, financial expertise and diligence, board characteristics, CEO duality and board size, ownership concentration, government ownership, major shareholders, institutional ownership are taken as independent variable. Along with dependent and independent variables, the researcher also used control variables which are: Firm size, Auditor type, Industry Type and Firms Profitability.

The data was collected from a panel data of 48 non-financial companies. listed on the UAE stock exchanges (Abu Dhabi Stock Exchange and Dubai Financial Market) from 2011 to 2013 has been used in the article.

Financial companies (Insurance and banking) were excluded as the nature of these companies, capital structure, regulatory environment is different as compared to non-financial companies. And seven (7) non-financial companies were excluded because of missing data related to variables in the study.

Result shows the positive relation between dependent, independent and control variable. Negative relationship between CEO duality and AC (Audit Committee) effectiveness. Institutional ownership is negatively and significantly corelated with AC effectiveness.

AC effectiveness is positively related with control variable Firm size, Auditor type and profitability, however firm size is statistically significant.

Multiple logistic regression model and ACE model were used in the study.

It has been suggested that this study contains certain set of corporate governance mechanisms on the effectiveness of Audit Committees whereas Corporate governance is not limited or confined to AC only and other factors or variable can be considered and then the results will be different.

Sample size is relatively small and therefore UAE government should make some flexible rules and regulations regarding corporate governance and registration of companies in stock exchanges and should gave some subsidy wherever possible for them to do so which will boost not only their economy but will create employment opportunities in the region.

**5.** Y. Nugroho, and Umanto Eko (2011) Board Characteristics and Earning Management.

Earning Management has been used as the dependent variables and board characteristics (independent board of directors, dual leadership/CEO duality, board size, managerial ownership, board composition /multiple directorships, board tenure, audit committee, and board interlock) are used as the independent variables.

The data was collected from 212 companies listed on Indonesian Stock Exchange from 2004-2008 period.

Non-probability sampling technique and purposive sampling method were used in this research.

Results between dependent variable (Earning Management) with Board Characteristics (independent board of directors, dual leadership/CEO duality, board size, managerial ownership, board composition /multiple directorships, board tenure, audit committee, and board interlock) Independent Variable is as follows:

Independent board of directors is negatively linked with earning management

Dual leadership/CEO duality is positively linked with earning management

Board Size is negatively associated with earning management

Managerial ownership is negatively associated with earning management.

Board Composition/multiple directorships is negatively linked with earning management

Board Tenure is negatively linked with earning management

Audit Committee is negatively linked to earning management.

Board interlock is positively linked with earning management.

Multivariate Testing, Discretionary Accrual Values, NOVA tests has been performed on Microsoft Excel and on e-views software.

It has been suggested that Audit Committees needs to be added as a classification criterion for those companies which are taking services of big 4 Auditors and non-big 4 auditors.

The data available for this research was from 2004-2008 if more year’s data would be available along with other independent variables, then the results would have been different. Also noted that in this research the companies selected were manufacturers, non-manufacturers, companies that use audit committee services or the companies in general. If financial sector companies (example. Banks, Insurance companies) data was used then the results would be different.

**6.**