



# The relationship between audit committees, compensation incentives and corporate audit fees in Pakistan

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## ABSTRACT

The objective of the study is to examine the association between audit committees, compensation incentives and corporate audit fees in Pakistan by using the data of fifty firms that are listed on the Karachi Stock Exchange (KSE), Pakistan during the years of 2007–2011. Panel data technique is used in this study, as the data set contains cross-sectional units over several time periods. Panel data control for cross sectional heterogeneity by observing individual firm and reduces the risk of biasness and collinearity among variables. The result of panel regression indicates that audit committee activity and committee member's independence are significantly associated to audit fee levels, consistent with the argument that audit committees complement the work of external auditors in monitoring management. In contrast, chief executive officers (CEO) pay incentives both short term and long term neither complement nor substitute for audit effort in disciplining Pakistan's firm management. Further results on the full sample of firms reveal significant differences in determinants of audit fees between the years examined. Finally, the results of control variables suggest a significant association between non-audit fee, board meetings, ROA (return on assets), sales and firm foreign operations with the audit fees in the selected market.

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## 1. Introduction

The problem of separation of ownership and control in a firm has given rise to the concept of corporate governance, which includes all measures, policies and procedures that align manager's interest and the interests of shareholders and all the other stakeholders of the firm. Auditing, as one measure of corporate governance, has received increased attention through the various corporate scandals such as Enron or WorldCom. In most of these corporate scandals, managers acted in their own self interest which results in collapse of those companies and destruction of shareholders' wealth. Coffee (2005) opines that auditors act as a gatekeeper that prevents these collapses from happening. In response to these scandals, the Sarbanes–Oxley act was passed in 2002, which had a severe impact on the audit fees charged by auditors thereafter.

Audit fees reflect an economic cost to the firm and determination of its determinants is important for two reasons. First, external auditing as a form of governance assures reliable financial reporting of the entity (Cohen et al., 2002a, 2002b). Second, audit fees paid to the auditors as a measure of governance results in an effective loss of profit to the shareholders. Audit fees research has identified a number of its determinants such as firm size, complexity, profitability, riskness and other characteristics of audited entity (Simunic and Stein, 1996; Gul and Tsui, 2001; Ferguson et al., 2003; Hay et al., 2008). Vafeas and Waeglein (2007)

suggest that effectiveness of audit committee and executive compensation incentives as determinants of audit fee partly drive the cost of corporate audit fee.

A brief glance at corporate governance guidelines formed in the wake of various corporate scandals suggests a significant role for the audit committees. According to Cadbury report (1992), audit committees as a governance mechanism protect the interests of shareholders, ensure transparent reporting and improve audit quality. This study focuses on the audit committee effectiveness as a determinant of audit fees in developing country like Pakistan. Following the enactment of Sarbanes–Oxley Act, the Securities and Exchange Commission of Pakistan (SECP) required audit committees to be directly responsible for the remuneration paid to external auditors. Pratt and Stice (1994) show that auditors charge higher audit fees from clients with greater earning manipulation risk to cover litigation risk. An unprecedented number of accounting and governance scandals have triggered an extensive research on use of incentive based compensations for corporate executives (Bedard and Johnstone, 2004). Prior studies in the accounting and finance literature suggest that incentive based compensation encourages executives to manage earnings for personal financial gains (Cheng and Warfield, 2005; Feng et al., (2011); Jiang et al., 2010).

The audit committee effectiveness and executive compensation incentives as determinants of audit fees is studied both in developed (US, Australia, Canada) and developing economies (Hong Kong, Malaysia, Singapore). However, much of the substantiation to date is from developed countries where corporate governance systems are mature and the role of audit committees is better defined in contrast to those in

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developing countries. In their studies, [Bushman and Piotroski \(2006\)](#) and [Gul \(2006\)](#) also acknowledged the differences in organizational and managerial incentives across different nations due to political economy, security laws, taxation regime and cultural factors. In addition, they also state that there can be systematic differences in developed and developing countries' implications for financial reporting quality and related assurance processes.

The above discussion confirms an association between audit committee effectiveness and executive compensation incentives as determinants of audit fees. In this study, an analysis has been carried out to find a statistical relationship between audit committee effectiveness, executive compensation incentives and audit fees in Pakistan using secondary data from fifty listed companies in Pakistan during the period of 2007–2011.

### 1.1. Objectives of the study

This study is conducted to investigate the relationship between measures of audit committee effectiveness, executive compensation incentives and corporate audit fees in Pakistan. More research objectives are:

- I. To review the developments in the roles and responsibilities of the audit committee as corporate governance mechanisms in Pakistan.
- II. To determine the type of relationship that exists between the measures of audit committee effectiveness, executive's compensation incentives and corporate audit fees in Pakistan.

### 1.2. Hypotheses of the study

The study used six hypotheses based on the literature. In this study, four empirical measures of audit committee effectiveness would be used i.e. committee independence, committee member expertise, committee size and committee meeting frequency. The study hypothesizes positive relationship between measures of audit committee effectiveness and external auditor's fee. The first four hypotheses of the study relevant for the association between audit committee effectiveness and corporate audit fees are given below i.e.,

**H1.** There exists a positive relationship between audit committee independence and audit fees

**H2.** There exists a positive relationship between audit committee size and audit fees

**H3.** There exists a positive relationship between committee meeting frequency and audit fees

**H4.** There exists a positive relationship between committee member expertise and audit fees

Prior studies provide evidence that bonuses based on annual earnings increase the possibility that managers would manage earnings to maximize the value of their bonus awards. So, a higher external audit effort is required to detect these earning manipulations. On the other hand, firms with long-term performance plans employ less earnings management than firms without that plans. The hypotheses related to CEO compensation incentives and audit fees are stated as i.e.,

**H5.** There exists a positive relationship between CEO compensation derived from bonuses and audit fees

**H6.** There exists a negative relationship between CEO long term pay for performance and audit fees.

### 1.3. Significance of the study

Since the introduction of corporate governance laws in Pakistan in 1998 by the Institute of Chartered Accountants of Pakistan (ICAP),

corporate governance is drawing much attention. The important purpose of studying audit fees and its determinants is that audit fees paid to the auditors as a measure of governance results in an effective loss of profit to the shareholders. Prior studies have shown inconsistent and mixed results on the relationship between audit committee effectiveness, executive compensation incentives and corporate audit fees. Furthermore, the study on audit fee determinants in developing countries like Pakistan has been given limited attention. So there is a need to find out the extent to which audit committee effectiveness and executive compensation incentives determine the amount of audit fees paid to external auditors. This study contributes to the growing literature by focusing on the associations between auditing, different elements of internal control and managerial incentives in developing countries like Pakistan.

The study is organized as follows: after the introduction which is provided in [Section 1](#) above, literature review is carried out in [Section 2](#). [Section 3](#) develops the hypothesis in the context of Pakistan. Data sources and the methodological framework are explained in [Section 4](#). The estimation and interpretation of results are mentioned in [Section 5](#). The final section concludes the study.

## 2. Literature review

### 2.1. Audit Fees

[Soltani \(2007\)](#) defined Audit fees as the costs associated with an auditor performing an audit to form an opinion on whether a client's overall financial statements are prepared, in all material respects, in accordance with generally accepted accounting principles (GAAP). [Simunic \(1980\)](#) defined audit fees as a product of unit price and the quantity of audit services provided by audit firms as demanded by the management of the audited company. [Chow \(1982\)](#) observed that the demand for audit services arises in a firm either due to contracting or institutional requirements. Earlier literature finds that managers desire to reduce agency cost as a main determinant of audit fees. [DeAngelo \(1981\)](#) and [Watts and Zimmerman \(1983\)](#) considered the provision of audited financial statements under contracting between management–shareholder as a cost effective contractual response to agency cost. However, the later literature suggests a number of variables that cover corporate needs, good corporate governance and litigation costs. The audit firms determine the audit fees of a firm based on different factors like the company size, complexity of the business and factors that contribute to different aspects of audit risk etc.

External auditors, being an important part of the corporate governance mechanism, are an important tool in providing assurance to protect investors' rights. External auditors assure that all shareholders are equally treated and that financial statements are in accordance with the contractual obligations. External auditors enhance the confidence of investors, assess the objective position of the firm and increase fund raising opportunities.

### 2.2. Corporate governance and audit fees

The information gap created as a result of the separation of corporate ownership from management necessitated the demand for forms of control and monitoring both internally and externally. Monitoring and control is done internally through the board of directors and externally through the report of the external auditors as well as through the market for control. [Soltani \(2007\)](#) states that corporate governance is related to the monitoring function of the board of directors and the audit committee. Corporate governance ensures reliable financial reporting of a firm by management. Various corporate governance measures related to auditing minimizes the chances of disclosure of financial restatements to protect the company against negative effects.

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