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IMPACT OF CORPORATE GOVERNANCE ON AUDIT QUALITY OF QUOTED FIRMS IN NIGERIA

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ABSTRACT

This study focused on the impact of corporate governance on audit quality of quoted firms in Nigeria. The study looked at the effects of board size, board independence and audit committee independence on audit quality with firm size and firm age as control variables. The sample of the study consists of forty (40) non-financial quoted firms on the Nigerian Stock Exchange Market. Secondary data on audit quality, board size, audit committee independence, board independence were sourced from the annual financial statements reports of the listed non – financial firms on Nigerian Stock Exchange from the period 2010 – 2017. Ordinary Least Square regression with the aid of E-view 9.0 was used to test the formulated hypotheses. The findings of the study revealed that board size exhibit positive significant effect on audit quality. Also board independence shows positive significant effect on audit quality, while audit committee independence shows significant effect on audit quality. Based on the findings of the study, the researchers recommended that regulatory bodies such as the Financial Reporting Council of Nigeria and other regulatory bodies in line with best global practices should take a thorough look at corporate governance practices and its impact on audit quality. Also there is need for regulatory bodies such as Security and Exchange Commission (SEC) to mandate corporate governance practices that affect positive audit quality in Nigeria.

Keywords: Corporate Governance, Audit Quality, Board Size, Board Independence, Audit Committee Independence.

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1. Introduction

Corporate governance issues took centre stage after the collapse of Enron and WorldCom in the United States of America and the subsequent enactment of the Sarbanes-Oxley (SOX) Act of July 2002 (Okoye, Maimako, Jugu, & Jat, 2017). In response to the failure of Enron corporation in 2001, seventh largest company in America at the time, Senator Paul Spyros Sarbanes, the chairman of the Senate Banking, Housing and Urban Affairs Committee in collaboration with Congressman Michael Oxley, held a series of hearings that resulted in the passage of a bipartisan bill designed to reform the accounting industry and restore the investor confidence that had been eroded following the collapse of Enron. The Public Company Accounting Reform and Investor Protection Act also called the Sarbanes – Oxley Act (SOX) was signed into law on July 30, 2002 (Osaze, 2007). This legislation laid the groundwork for other similar legislations around the world on good corporate governance, created a strong and independent oversight board to oversee the auditors of public companies and enable the board to set accounting standards, investigate and discipline accountants.

It addresses conflicts of interest, ensures auditor independence, strengthens corporate governance by requiring corporate leaders to be personally responsible for the accuracy of their company's financial statements reports, and establishes safeguards to protect against investment analysts' conflicts (Osaze, 2007). There is consensus in the governance literature that controlling shareholders rely on external monitoring by high quality external auditors to restrict management expropriation through improving the quality of financial reporting (Fan & Wong, 2005). According to Jensen and Meckling (1976) the cost of external audits is part of the bonding costs that owners must bear in order to mitigate agency problems. The auditing function reduces information asymmetry between management and outsiders, as well as management and subordinates (Chaney, Faccio, & Parsley, 2011).

Although vast majority of the corporate governance and audit quality literature abounds in both developed and developing countries, especially Nigeria, such as Enofe, Mgbame, and Edegware (2014); Almomani (2015); Ilaboya and Iyafekhe (2014); Nwanyanwu (2017); Dennis, Michael, and Nicole (2013). However there is still much to be desired because most of the studies had methodological weakness such as inadequate sample size and this could undermine the estimation result. To address this gap in the literature, this study examined the impact of corporate governance on audit quality in Nigeria. The motivation for undertaking this study is because most of the studies that explore the relationship between corporate governance and audit quality has methodological weakness, hence the need to improve on these existing literature. The study formulates the following hypotheses in the null form as follows:

Ho_1: Board Size has no significant effect on Audit Quality of quoted manufacturing firms in Nigeria.

Ho_2: Board Independence has no significant effect on Audit Quality of quoted manufacturing firms in Nigeria.

Ho_3: Audit Committee Independence has no significant effect on Audit Quality of quoted manufacturing firms in Nigeria.

2. Review of Related Literature

2.1 Conceptual Review

2.1.1 Corporate Governance

Corporate governance is concerned with ways in which all parties interested in the wellbeing of the firms ensure that managers and other insiders take measures or adopt mechanisms that promote accountability (Ejeagbasi, Nweze, Ezeh, & Nze, 2015). Corporate governance act as a set of incentive mechanisms that are designed to ensure management efficiency. The four drivers of corporate governance are accountability, fairness, transparency and independence according to (Okaro, Okafor, & Okoye, 2015). An essential feature of modern business organizations is the divorce of ownership from management. This separation of ownership from control implies a loss of effective control by shareholders over managerial decisions. The primary objective of corporate governance is to try and align managerial incentives with that of stakeholders so that managers work in the best interest of the stakeholders (Al-Qadasi & Abidin, 2018; Okaro, Okafor, & Okoye, 2015).

Corporate governance enhances transparency and fairness between management and stakeholders (Ogula & Emini, 2012). Corporate governance mechanisms vary widely across countries and firms. The nature of a country's characteristics such as cultural, financial and economic factors and regulations development play an important role in firms' decisions to implement certain governance mechanisms (Doidge, Karolyi, & Stuls, 2007). The inability to comply with corporate governance codes in firms have been responsible for the collapse of many business firms through abuse of power, recklessness in handling of finances leading to financial misappropriation, inability to follow laid down internal control systems leading to lack of credible organizational leadership especially as it affects hiring of manpower, flouting of laid down policies that should act as a guide in achieving organizational goals or corporate objectives. Empirical evidence shows that poor corporate governance often decreases the quality of financial reporting and causes changes in and overstating the profits and fraud in financial statements (Mahdi, Mahdi, & Paiydarmanesh, 2015).

Corporate governance is also all about the way firms are directed and controlled. It is concerned with the work of the board as the body which bears ultimate responsibility for the performance of a firm (Gacar, 2016). According to Olawoyin (2014) corporate governance seeks to ensure a balance between economic and social goals of a firm and also between individual and communal goals. Its' framework also seeks to encourage efficient use of resources and equally require accountability for the stewardship of those resources.

2.1.2 Audit Quality

Management renders their stewardship by preparing financial reports for stakeholders. It is the responsibility of auditors to express their opinion on the financial report audited. Davidson and Neu (1993) described audit quality as a function of the auditor's ability to detect and prevent material misstatements and manipulations in reported net incomes of corporate organizations. Moreover, Farouk and Hassan (2014) noted that audit quality gives credibility and integrity to financial statements. Engaging a higher quality external auditor is expected to be associated with higher quality financial report, the rationale of employing a higher quality external auditor is to mitigate the problem of information asymmetry between owners and managers by improving the quality of reported financial information (Johnson, Schnatterly, Johnson, & Chiu, 2010). The objective of the external audit function is recognized by the American Institute of Certified Public Accountants and the International Auditing and Assurance Standards Board as obtaining reasonable assurance regarding whether reported financial statements are free of material misstatements and communicating results to interested parties (Rittenberg, Johnstone, & Gramling, 2010).

2.2 Theoretical Framework

2.2.1 Agency Theory

The study is anchored on the 'agency theory'. The researchers anchored this study on Agency theory because the moral hazards caused by the conflicting interest between managers and owners could be mitigated by corporate governance framework. The primary users of financial statement reports are the owners and as such the quality of the audited financial statement reports is germane to them to make informed economic decision.

3. Design and Methodology

The study adopts the *ex post facto* research design. This design is considered suitable, in order to establish the meaningful relationship between corporate governance and audit quality. This study is treated as ex-post facto research since it relied on historical data. The population of the study consists of all 76 non-financial quoted firms on the floor of the Nigerian Stock Exchange (NSE) as at Dec 2017. The study used the purposive sampling method in selecting sampled companies. Non-financial firms quoted on the Nigerian Stock Exchange Market for eight (8) year period spanning from 2010-2017 who filed their annual reports without missing any year were selected for this study, thus we arrived at a sample size of 40. The study is based on secondary data; such as data on audit quality, board size, audit committee independence, board independence, firm size, firm age, were sourced from the annual reports of selected companies for the period 2010 to 2017. This data collected from annual reports and accounts of the selected firms were analyzed using simple regression technique with the aid of *E-view 9.* Both the dependent and the independent variables were computed from the data extracted from publications of the Nigerian stock exchange.

4. Data Presentation and Results

4.1 Descriptive Statistics

The Table below shows the combined operational variable for the selected manufacturing firms. This shows the merged data of the forty (40) sampled manufacturing firms. It represents the average data for the variables of this study calculated annually for the period of eight (8) years. The results are presented and analyzed below:

Table 1: Summary statistics of combined operational variables

	AUDQ	BSIZE	AUDITCOMI	BINDC	FMSIZE	FMAGE
2010	0	10	0.5	0.6	17.32	25
2011	0	10	0.5	0.6	17.51	26
2012	1	10	0.5	0.6	17.61	27
2013	1	10	0.5	0.6	17.75	28
2014	1	10	0.5	0.6	17.84	29
2015	1	11	0.5	0.81	18.03	30
2016	1	11	0.5	0.81	18.03	31
2017	1	11	0.67	0.91	18.28	32

Source: Annual Reports and Accounts Various Issues

Table 2: Descriptive statistics of combined operational variables

	AUQ	BSIZE	BINDC	AUDITCOMI	FMSIZE	FMAGE
Mean	0.750000	10.37500	0.691250	0.521250	17.79625	28.50000
Median	1.000000	10.00000	0.600000	0.500000	17.79500	28.50000
Maximum	1.000000	11.00000	0.910000	0.670000	18.28000	32.00000
Minimum	0.000000	10.00000	0.600000	0.500000	17.32000	25.00000
Std. Dev.	0.462910	0.517549	0.129663	0.060104	0.314140	2.449490
Skewness	-1.154701	0.516398	0.701804	2.267787	0.003925	5.22E-17
Kurtosis	2.333333	1.266667	1.752527	6.142857	2.013526	1.761905
Jarque-Bera	1.005926	1.007037	1.005434	0.014966	0.004398	0.000960
Probability	0.001260	0.000268	0.001194	0.001052	0.000272	0.000545
Sum	6.000000	83.00000	5.530000	4.170000	142.3700	228.0000
Sum Sq. Dev.	1.500000	1.875000	0.117688	0.025288	0.690788	42.00000
Observations	8	8	8	8	8	8

Source: E-Views 9.0

4.2 Test of Hypotheses

4.2.1 Hypothesis One

Ho: Board Size has no significant effect on Audit Quality of quoted manufacturing firms in Nigeria.

Table 3: Regression output showing the effect of Board Size on AUDQ

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	4.976279	37.94535	0.131143	0.9020
BSIZE	-0.499947	0.381824	-1.309367	0.0006
FMSIZE	-0.095309	2.673178	-0.035654	0.9733
FMAGE	0.262099	0.346932	0.755476	0.4920

R-squared	0.800064	Mean dependent var	10.37500
Adjusted R-squared	0.650111	S.D. dependent var	0.517549
S.E. of regression	0.306138	Akaike info criterion	0.777289
Sum squared resid	0.374881	Schwarz criterion	0.817009
Log likelihood	0.890846	Hannan-Quinn criter.	0.509388
F-statistic	5.335452	Durbin-Watson stat	2.517866
Prob(F-statistic)	0.000053		

Source: Researchers' Computation with aid of E-view 9

The Adjusted R squared, i.e., coefficient of determination, tells us the variation in the dependent variable due to changes in the independent variable. From the findings in the table above, the value of adjusted R squared was 0.800, an indication that there was variation of 80% on the audit quality of quoted firms in Nigeria due to changes in BSIZE. This shows that only 80% changes in audit quality of quoted firms in Nigeria could be accounted for by the predictor variables.

The Durbin-Watson Statistic of 2.517866 suggested that the model does not contain serial correlation problem. The F-statistic of the AUDQ regression is equal to 5.335452 and the associated F-statistic probability is equal to 0.000053, so reject the null hypothesis and accept the alternate hypothesis. As a result, there is linear relationship of AUDQ to the independent variables.

Decision

Since the result of the Prob (F-statistic) of 0.000053 is less than the critical value of 5% significance level, leading to the conclusion that there is a significant positive link between board size and audit quality at 5% significant level, hence alternate hypothesis is accepted.

4.2.2 Hypothesis Two

Ho: Board Independence has no significant effect on Audit Quality of quoted manufacturing firms in Nigeria.

Table 4: Regression output showing the effect of Board Independence on AUDQ

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.279863	10.60818	-0.026382	0.9802
BINDC	0.599535	0.661855	0.905841	0.0163
FMSIZE	-0.028610	0.750374	-0.038128	0.9714
FMAGE	0.040974	0.092267	0.444083	0.6799

R-squared	0.799329	Mean dependent var	0.691250
Adjusted R-squared	0.648827	S.D. dependent var	0.129663
S.E. of regression	0.076838	Akaike info criterion	-1.987378
Sum squared resid	0.023616	Schwarz criterion	-1.947657
Log likelihood	11.94951	Hannan-Quinn criter.	-2.255278
F-statistic	5.311056	Durbin-Watson stat	1.649280
Prob(F-statistic)	0.010246		

Source: Researchers' Computation with aid of E-view 9

The Adjusted R squared, i.e., coefficient of determination, tells us the variation in the dependent variable due to changes in the independent variable. From the findings in the table above, the value of adjusted R squared was 0.648, an indication that there was variation of 64.8% on the audit quality of quoted firms in Nigeria due to changes in BINDC. This shows that only 79.9% changes in audit quality of quoted firms in Nigeria could be accounted for by the predictor variables.

The Durbin-Watson Statistic of 1.649280 suggested that the model does not contain serial correlation problem. The F-statistic of the AUDQ regression is equal to 5.311056 and the associated F-statistic probability is equal to 0.010246, so reject the null hypothesis and accept the alternate hypothesis. As a result, there is linear relationship of AUDQ to the independent variables.

Decision

Since the result of the Prob (F-statistic) of 0.010246 is less than the critical value of 5% significance level, leading to the conclusion that there is a significant positive link between board independence and audit quality at 5% significant level, hence alternate hypothesis is accepted.

4.2.3 Hypothesis Three

Ho: Audit Committee Independence has no significant effect on Audit Quality of quoted manufacturing firms in Nigeria.

Table 5: Regression output showing the effect of Audit Committee Independence on AUDQ

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-7.325419	6.393971	-1.145676	0.3158
AUDITCOMI	-0.066394	0.064339	-1.031941	0.0004
FMSIZE	0.509478	0.450443	1.131059	0.3212
FMAGE	-0.041064	0.058460	-0.702438	0.5211

R-squared	0.579068	Mean dependent var	0.521250
Adjusted R-squared	0.263370	S.D. dependent var	0.060104
S.E. of regression	0.051586	Akaike info criterion	-2.784294
Sum squared resid	0.010644	Schwarz criterion	-2.744574
Log likelihood	15.13718	Hannan-Quinn criter.	-3.052195
F-statistic	1.834244	Durbin-Watson stat	1.788414
Prob(F-statistic)	0.001123		

Source: Researchers' Computation with aid of E-view 9

The Adjusted R squared, i.e., coefficient of determination, tells us the variation in the dependent variable due to changes in the independent variable. From the findings in the table above, the value of adjusted R squared was 0.263, an indication that there was variation of 26.3% on the audit quality of quoted firms in Nigeria due to changes in AUDITCOMI. This shows that only 26.3% changes in audit quality of quoted firms in Nigeria could be accounted for by the predictor variables.

The Durbin-Watson Statistic of 1.788414 suggested that the model does not contain serial correlation problem. The F-statistic of the AUDQ regression is equal to 1.834244 and the associated F-statistic probability is equal to 0.001123, so reject the null hypothesis and accept the alternate hypothesis. As a result, there is linear relationship of AUDQ to the independent variables.

Decision

Since the result of the Prob (F-statistic) of 0.001123 is less than the critical value of 5% significance level, leading to the conclusion that there is a significant positive link between audit committee independence and audit quality at 5% significant level, hence alternate hypothesis is accepted.

5. Conclusion and Recommendations

The series of well-publicized cases of accounting improprieties in Nigeria and around the world have raised doubts about the quality of audited financial statement. This has stirred a number of professional and regulatory organizations to recommend reforms that will improve auditor independence and thereby increase audit quality. The aim of this study was to examine the corporate governance on audit quality in listed firms in Nigeria. Specifically, the study looked at the effects of board size, board independence and audit committee independence on audit quality, with firm size and firm age as control variables. The three hypothesis tested were all significant. Based, on these the study makes the following recommendations:

1. The regulatory bodies such as the Financial Reporting Council of Nigeria should strengthen its role in ensuring higher quality financial reporting in Nigeria. This is necessary as audit quality has always been an important dimension of corporate

reporting because not only is financial reports useful to the owners of a company, they are also useful sources of information for other stakeholders. The importance of audit quality for corporate existence is germane. In recent times the quality of financial reporting has also become a basis for investment flows across countries with countries perceived to have higher reporting quality receiving significant investment flows

2. The Financial Reporting Council of Nigeria and other regulatory bodies in line with best global practices should take a thorough look at corporate governance practices and its effect on audit quality.
3. There is need for regulatory bodies, such as Securities and Exchange Commission (SEC) to mandate corporate governance practices that affect positive audit quality in Nigeria. Noncompliance with corporate governance codes should be met with severe sanctions as currently contained in SEC (2014) code of corporate governance.

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