Research Journal of Finance and Accounting
ISSN 2222-1697 (Paper) ISSN 2222-2847 (Online)
Vol.4, No.4, 2013
www.iiste.org

Determinants of Audit Quality in the Nigerian Business Environment

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Abstract
The objective of this study was to analyze the determinants of audit quality in the Nigerian business environment. The research empirically examined the relationship between audit quality, engagement and firm related characteristics such as audit tenure, audit firm size, board independence and ownership structure. A regression model was used to analyze the existence of significant relationships between audit quality and the firm/audit related characteristics. Audit firm size, board independence and ownership structure were found to be positively related to audit quality; however, only board independence exhibited a significant relationship with audit quality. Audit tenure exhibited a negative relationship with audit quality which was also not significant. The study recommends the sustenance and possible improvements on the non-executive board composition of organizations.
Keywords: Audit Quality, Audit Tenure, Audit Firm Size, Board Independence, Ownership Structure.

Introduction

The Nigerian business environment has been perceived in some quarters as not too conducive to investors; both local and foreign. Adjudged reasons for this assertion include the inability of financial reports to meet the needs of this group of users. The prevalence of fraud, excessive earnings management and other financial crimes in the country has reduced the level of confidence reposed in these financial statements; and in the ability of these statements to perform their requisite functions. In light of the cost of frauds to the business and the offender, it is important to develop strategies to prevent or detect business fraud, taking a cursory look at the risk factors associated with business, giving due attention to the motives attached with it, and establishing how to effectively manage it on a daily basis (Akinjobi & Omowumi, 2010). Hence, the auditors are looked upon as ‘messiahs’ in correcting this anomaly, and thereby directly, or indirectly creating a balance in the functioning of the business environment.

The demand for external audit services originated from the agency issues which arise out of the separation of ownership and control of firms. Firms are invariably owned by disparate shareholders, but the daily operations of the firms are controlled by professional managers; who may or may not hold significant shareholdings in the firm. This means that the shareholders of the firm have a residual claim on the firm’s resources and that the managers of the firm will have to communicate their stewardship of the firm’s resources to shareholders; normally through the periodic issue of a set of financial statements (Securities and Exchange Commission, 2000). In order to ensure that the financial information published by firms are reliable for users, it is normally required that the statements are certified by an auditor - an objective and rigorous third party who performs independent examinations that give financial statements credibility with users.

It has been advocated by auditing scholars that the main aim of an audit assignment is to produce a quality report. The emphasis here is on ‘quality report’, hence, it is presumed that the major role of the auditor is the production of a quality report; achieved through strict adherence to the principles of high audit quality. DeAngelo defined audit quality as the market-assessed joint probability that a given auditor will both detect material misstatements in the client’s financial statements and report the material misstatements (as cited in Chadegani, 2011). This probability depends upon the broad concept of an auditor’s professional conduct, which includes factors such as objectivity, due professionalism and conflict of interest (Mgbame, Eragbhe & Osazuwa, 2012).

In essence, auditing is used to provide the needed assurance for investors when relying on audited financial statements. More precisely, the role of auditing is to reduce information asymmetry on accounting numbers, and to minimize the residual loss resulting from managers’ opportunism in financial reporting (Adeyemi & Fagbemi, 2010). Effective and perceived qualities (usually designated as apparent quality) are necessary for auditing to produce beneficial effects as a monitoring device.

It is therefore, based on these tenets, that this study aims to analyze the possible relationship between audit report and the effectiveness of financial reporting in particular (positive or otherwise); and the workings of the business environment in general. Having established that the contribution of the auditor is basically through the production of a quality report, we investigate the factors that could influence the achievement of high audit quality and determine the existence of relationships and correlation among these factors.

Statement of the Research Problem

The production of a quality audit report is perceived to foster engendered confidence in financial reports by the users of those reports. Investors in particular tend to place better trust in financial statements that are audited; as the expected independence of the auditor boosts the assurance that important investment decisions can be made on the thrust of those statements. The increased confidence of these set of financial users tend to attract the inflow of capital which has the long-run effect of creating growth and development in the business environment (Adeyemi & Fagbemi, 2010). However, inefficiencies on the part of management could lead to 'structured financial statements'. These financial statements ordinarily do not show the true state of affairs and financial position of the organization and hence, could jeopardize the decisions of prospective investors. Adverse results on investment would reduce the credibility of the financial statements; which would in turn reduce the level of capital flow, thereby deteriorating the state of the business environment (Securities and Exchange Commission, 2000).

The onus therefore rests on the auditors to address these issues through efficient and effective execution of the audit assignment, and the resultant production of a quality report. The study therefore investigates the factors that could affect the quality of the audit assignment, and analyzes the existence and degree of relationships between these factors and the achievement of high audit quality in the Nigerian business environment. The following research questions were therefore proposed:

1. Is there a relationship between auditor tenure and audit quality?
2. Is there a relationship between auditor size and audit quality?
3. Is there a relationship between board independence and audit quality?
4. Is there a relationship between ownership structure and audit quality?

Objectives of the Study

The objectives of the study are to:

1. Analyze the relationship between auditor tenure and audit quality.
2. Analyze the relationship between auditor size and audit quality.
3. Analyze the relationship between board independence and audit quality.
4. Analyze the relationship between ownership structure and audit quality.

Hypotheses

H_1: There is no significant relationship between auditor tenure and audit quality.
H_2: There is no significant relationship between auditor size and audit quality.
H_3: There is no significant relationship between board independence and audit quality.
H_4: There is no significant relationship between ownership structure and audit quality.

Review of Relevant Literature

Overview of Audit Quality

Audit quality is much debated but little understood; and despite the diversity of the concept, there remains little consensus about how to define, let alone measure, audit quality. Perception of audit quality can depend very much on whose eyes one looks through. Users, auditors, regulators and other stakeholders in the financial reporting process may have very different views as to what constitutes audit quality, which will influence the type of indicators one might use to assess audit quality.

DeAngelo (1981) defined audit quality as the market-assessed joint probability that the auditor discovers an anomaly in the financial statements, and reveals it. The user of financial reports may believe that high audit quality means the absence of material misstatements. The auditor conducting the audit may define high audit quality as satisfactorily completing all tasks required by the firm's audit methodology. The audit firm may evaluate a high audit quality as one for which the work can be defended against challenge in an inspection or court of law. Regulators may view a high quality audit as one that is in compliance with professional standards. Finally, society may consider a high quality audit to be one that avoids economic problems for a company or the market. In the end, different views suggest different metrics.

Chan and Wong (2002) note that audit quality, though unobservable, impacts the probability of successful detection of discrepancies between the firms' favorable report and the true quality of the project. The implicit common link in all these statements is the auditor's ability to satisfy their professional obligation to find material misstatements through the execution of the audit process.

Auditor Tenure and Audit Quality

The question of whether audit firm tenure impacts audit quality has long been one of the major issues concerning auditing regulations. Some believe that lengthy auditor tenure undermines independence and objectivity, while others believe that long tenure increases auditor knowledge and competence.

Mgbame, Eragbhe and Osazuwa (2012) carried out an empirical study on the relationship between audit tenure and audit quality. They utilized the Binary Logistic Model estimation technique in analyzing the perceived relationship between the tenure of an auditor and the quality of the audit. Other explanatory variables like the Returns on Asset (ROA), Board Independence, Director Ownership and Board Size were also considered in the study. Their findings revealed a negative relationship between auditor tenure and audit quality; though the variable was not significant. The other explanatory variables considered alongside auditor tenure were found to be inversely related to audit quality; with the exception of Returns on Assets which exhibited a positive effect.

Onwuchekwa, Erah and Izedonmi (2012) investigated the relationship between mandatory audit rotation and audit quality. The data used were extracted through the distribution of questionnaires to investors, lecturers, consultants, accountants and auditors in Southern Nigeria. The extracted data was analyzed using percentage analysis, while the specified model was estimated using binary logistic regression technique. They tested the hypothesis that mandatory audit rotation had no significant relationship on audit quality in Nigeria. Their binary logistic ordered regression revealed a negative relationship between mandatory audit rotation and audit quality. They emphasized on other ways of improving audit quality; such as through strengthening the board of audit committee and encouraging joint audit to avoid monopoly of audit opinion.

Siregar, Amarullah, Wibowo and Anggraita (2012) carried out their research in the Indonesian environment where regulators had made it compulsory to rotate the appointments of public accountants every three (3) years and the appointment of public accounting firms every five (5) years. The purpose of their study was to investigate the effects of auditor rotation and audit tenure of the public accountant and the public accounting firm, on audit quality (before and after the implementation of the mandatory auditor regulation). Their results showed that mandatory auditor rotation did not increase audit quality; and that shorter audit tenure (both partner and firm level) did not also increase audit quality.

Al-Thuneibat, Al-Issa and Ata-Baker (2011) analyzed the effect of the length of the audit firm-client relationship and the size of the audit firm on audit quality in Jordan. In order to test their hypotheses, the authors use the quadratic form approach, with some modifications. The population of the study encompassed all firms whose stock was publicly traded on the Amman Stock Exchange throughout the years (2002-2006). Their statistical analysis of data showed that audit firm tenure affects the audit quality adversely (negatively). Audit quality deteriorated when audit firm tenure was extended as a result of the growth in the magnitude of discretionary accruals. Meanwhile, their data analysis did not reveal that the audit firm size had any significant impact on the correlation between audit firm tenure and audit quality.

Using data obtained from actual audits by multiple Taiwanese offices of four large international audit firms, Hsieh (2011) examined the existence of a relationship between evidence of reduced audit quality; measured by estimated discretionary accruals, and audit partner tenure with a specific client. He utilized the Jones' cross sectional model for his analysis, and found estimated discretionary accruals to be significantly and negatively associated with the lead audit partner's tenure; in consideration with a specific client. Thus, he perceived audit quality to increase with increased partner tenure. His results relating to audit partner tenure were consistent with the conclusions about audit firm tenure by Geiger and Raghunandan (2002); Johnson, Khurana, and Reynolds (2002); Myers, Myers, and Omer (2003); and Nagy (2005) and he further extended the ambit of their findings by focusing on individual audit partners rather than on audit firms.

Audit Firm Size and Audit Quality

Yuniarti (2011) examined the determinant factors of audit quality by proposing the hypothesis that the audit firm size and audit fees have an effect on audit quality. She utilized a CPA firm in Bandung, West Java, Indonesia as her unit of analysis. She carried out a descriptive verification research by describing the variables and observing the correlation of these variables from the hypothesis that has been made, systematically through statistical testing. She examined the hypothesis; through simultaneous test and individual test, using the t-test and f-test. Her empirical results showed that the CPA firm size does not significantly affect the audit quality, whereas audit fees significantly affect the quality of audit. However, simultaneously, firm size and audit fees do not significantly affect audit quality.

Dehkordi and Makarem (2011) investigated the influence of audit firm size (Big auditors vs. non-Big auditors) and auditor type (governmental vs. private auditors) on audit quality. A sample of 224 firms was observed from the Tehran Stock Exchange (TSE) companies during the period 2002 to 2007. Discretionary accruals (DAC) were employed as representative of audit quality. A modified, cross-sectional version of the Jones' model was applied to measure DAC. Their results showed that the size of non-governmental audit firms does not affect their audit quality, and changes within private audit firms does not lead to changes in the level of discretionary accruals. Their empirical results imply that in some settings such as that of Iran, factors such as auditor type, intense competition, audit committee, and litigation risk are of greater importance than audit firm size.
Al-Ajmi (2009) documented the perceptions of credit and financial analysts with regard to the relationships between effectiveness of audit committee, size of the auditing firm and audit quality in the context of Bahrain. He conducted a survey of 300 credit and financial analysts; which revealed that analysts considered auditors' opinion useful. Both credit and financial analysts see the credibility of financial statements to be a function of the size of the auditing firm. Both groups assume that the characteristics of Big-Four firms allow them to produce better-quality reports than non-Big firms. Non-audit services were found to affect auditor's independence and hence impair audit quality.

Board Independence and Audit Quality

Abdullah, Ismail and Jamaluddin (2008) examined effective components of corporate governance in Malaysian listed companies and their relationship with audit quality. A total of 655 companies were selected as the sample; representing 73.84% of the total number of companies across industries in the year 2003. The analysis of logistic regression was used to investigate the relationship between dependent and independent variables. Their results showed that two independent variables had a significant relationship with audit firm size. They were board independence and nonfinancial institutional ownership. The executive directors' ownership and CEO duality had a negative relationship; but not significant with audit quality, whereas non-executive directors' ownership and financial institutional ownership showed a positive relationship with audit quality; though not significant. Their findings posit that both board independence and institutional ownership are important factors to the listed companies in improving their decision making processes, and in being more transparent and objective.
Salleh, Stewart and Manson (2006) examined the effect of board composition and ethnicity on audit quality using a sample of 100 companies under the Industrial Product Sector listed on the Bursa Malaysia Main Board in 2002. The study used audit fees as a proxy for audit quality and examined the proportion to which independent directors, CEO duality and ethnicity factors are associated with audit fees. They found that the proportion of independent directors was significantly related to audit fees. However, they did not find any evidence of association of CEO duality and ethnicity factors with audit fees. Overall, their results suggested that independent directors encourage the appointment of higher quality auditors to give greater assurance to investors that company financial statements are fairly presented.

Ownership Structure and Audit Quality

Zureigat (2011) investigated the effect of ownership structure among Jordanian listed firms based on their audit quality. His study sample consisted of one hundred and ninety eight (198) companies, out of the two hundred sixty two (262) listed companies on the Amman Stock Exchange (ASE). The analysis of logistic regression was used to investigate the relationship between the audit quality; measured based on the audit firms size as a dependent variable, and ownership structure as independent variables. His results showed a significant, positive relationship between foreign and institutional ownership and audit quality. Whereas ownership concentration was shown to have a negative relationship with audit quality, that relationship was not significant.
Adeyemi and Fagbemi (2010) provided evidence on corporate governance, audit quality, and firm related attributes from Nigeria. Logistic regression was used in investigating the questions that were raised in the study. Their findings showed that ownership by non-executive directors had the possibility of increasing the quality of auditing. Evidence from the study also indicated that company size and business leverage are important factors of audit quality for companies quoted on the Nigerian Stock Exchange.

Research Methodology

The research utilized primary data source in the form of questionnaires. The questionnaires were constructed using the likert scale, and were distributed randomly to a cross-section of financial report users; consisting mainly of investors, financial analysts and credit institutions. A sample size of one hundred (100) was selected for the study, and the geographical population was restricted to the South-South geopolitical zone. The questionnaires were designed to elicit information from respondents on their perception of auditors' contributions to the Nigerian business environment; in relation to the quality of audit engagements. The data collected were analyzed using dummy variables (1 for SA; 2 for A; 3 for U; 4 for D; 5 for SD) based on the respondent's response. The model specified was estimated using the OLS Regression technique with the aid of SPSS software; in order to test the following hypothesis:

Model Specification

$AUDQ = \beta_0 + \beta_1 AUDTEN + \beta_2 AUDSIZE + \beta_3 BIND + \beta_4 OWNSTR + \mathcal{E}_t$

An explanation of the variables is as follows:

AUDQ = Audit Quality
AUDTEN = Audit Tenure
AUDSIZE = Auditor Size
BIND = Board Independence
OWNSTR = Ownership Structure

The dependent variable is audit quality. Auditor independence was utilized as a direct proxy for audit quality. For the purpose of the regression, the variables are captured using responses from the questionnaires; with specific questions assigned for the measurement of each variable.

Analysis and Discussion of Results

A correlation co-efficient of -0.499 indicates a negative relationship between audit tenure and audit quality. The magnitude of the relationship is however not significant. A co-efficient of variation (R^2) of 0.249 (Appendix 1) indicates that only about 25% of variations in audit quality can be explained by audit tenure. We therefore accept the null hypothesis which states that there is no significant relationship between audit tenure and audit quality.

The relationship between audit firm size and audit quality is seen to be a positive one; however, it falls below the acceptable level of significance. The co-efficient of variation (R^2) of 0.383 (Appendix 2) indicates that only about 38% (which is not a substantive measure) of variations in audit quality can be explained by audit firm size. The hypothesis which states that there is no significant relationship between audit firm size and audit quality is therefore accepted.

Board Independence exhibits a strong relationship with audit quality. The co-efficient of variation (R^2) of 0.797 (Appendix 3) further buttresses this point by indicating that approximately 80% of the variance in audit quality can be explained by board independence. This relationship passes the significance test hence, the null hypothesis which states that there is no significant relationship between board independence and audit quality is rejected, while the alternative is accepted.

A correlation co-efficient of 0.263 indicates a positive relationship between audit tenure and audit quality. The magnitude of the relationship is however not significant. A co-efficient of variation (R^2) of 0.069 (Appendix 4) indicates that only about 7% of variations in audit quality can be explained by audit tenure. We therefore accept the null hypothesis which states that there is no significant relationship between audit tenure and audit quality.

The co-efficient tables (Appendix 1-4) serve as a check on the test of significance; as a score of less than 0.05 serves as an indication of strong significance.

Conclusion and Recommendation

The study empirically examined the relationship between audit quality and engagement related factors such as audit tenure, auditor size and board independence. The model was regressed to analyze the existence of significant relationships between the dependent and independent variables. Audit quality was found to be significantly related to board independence with a positive relationship. Audit firm size exhibited a non-significant positive relationship with audit quality; audit tenure exhibited a non-significant negative relationship with audit quality, while ownership structure exhibited a positive non-significant relationship with audit quality. The findings of the study are consistent with the works of Mgbame, Eragbhe and Osazuwa, 2012; Onwuchekwa, Erah and Izedonmi, 2012; Yuniarti, 2011; Dehkordi and Makarem, 2011; Abdullah, Ismail and Jamaluddin, 2008; and Salleh, Stewart and Manson, 2006.

An understanding of the factors that could significantly affect audit quality, and strict adherence to the rules governing those factors, would inadvertently increase the possibility of a quality audit assignment. This would in turn boost the confidence of users of the financial statements; while at the same time enhancing the discovery and reporting of material misstatements in the financial reports. This leads to an improved role of the auditors, and their possible impact to the business environment is enhanced.

The study recommends that the composition of non-executive directors as members of the board should be sustained and improved upon. The relationship between board independence and audit quality could be perceived to be borne out of the expectation that the higher the proportion of non-executive directors, the higher the degree of the board independence which invariably affects the probability of the board trying to influence the contents of the financial statements; and directly or indirectly, the outcome of the audit assignment. Furthermore, this study may be improved upon by including more variables of significance to audit quality.

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APPENDIX 1: Audit Quality and Audit Tenure

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.499[a]	.249	-.001	40.42604

Predictors: (Constant), AUDTEN

Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	42.142	28.633		1.472	.237
	AUDTEN	-1.107	1.110	-.499	-.997	.392

Dependent Variable: AUDQ

APPENDIX 2: Audit Quality and Auditor Size

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.619[a]	.383	.177	36.64965

Predictors: (Constant), AUDSIZE

Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-18.795	32.830		-.573	.607
	AUDSIZE	1.940	1.422	.619	1.364	.266

Dependent Variable: AUDQ

APPENDIX 3: Audit Quality and Board Independence

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.893[a]	.797	.729	21.03855

Predictors: (Constant), BIND

Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-14.846	13.852		-1.072	.362
	BIND	1.675	.489	.893	3.428	.042

Dependent Variable: AUDQ

APPENDIX 4: Audit Quality and Ownership Structure

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.263[a]	.069	-.241	45.00840

Predictors: (Constant), OWNSTR

Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	8.383	31.807		.264	.809
	OWNSTR	.581	1.231	.263	.472	.669

Dependent Variable: AUDQ