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Corporate Governance and Audit Quality: Evidence from Pakistan

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Abstract:
The thought that producing an excellent audit report will boost issuers' trust in financial reports is the driving force for this study. The main focus of the study is how corporate governance affects how well business audits are performed. 71 non-financial firms took part in the study between 2008 and 2015. A fake variable with the values "1" and "0" was used to evaluate the audit quality; a value of "1" meant the company used one of the "big four" auditors, while a value of "0" meant it did not. Board independence was calculated using the ratio of non-executive directors to total directors as a measure of corporate governance. Binary regression analysis was used to examine the data that was gathered. The findings show that board independence and audit quality are negatively correlated. The study emphasizes how important it is to make sure that the board has a suitable balance of expertise. The analysis suggests that the current makeup of the board should be preserved and enhanced with regard to the number of non-executive directors.
Keywords- Corporate Governance and Audit Quality: Evidence from Nigeria

Introduction

Financial crimes, including fraud and excessive earnings management, are rampant throughout the country and have severely damaged the credibility of financial statements and their capacity to fulfill their mandates. The serious financial repercussions connected to these illegal acts have made it necessary to create strategies for identifying and perhaps preventing commercial fraud (Akinjobi & Omowumi, 2010). Stories of dishonesty point to a destructive route that is more imagined than real. Some people have become suspicious and even hostile toward the vestment because of their traumatic experiences with phony dealing tables. While the perpetrators' accomplices are happy to go on to more complex plans of deception if the action goes unpunished and retire with satisfaction. Unfortunately, even in the micro, small, and medium-sized firm sector, owners are unable to oversee every area of their companies' operations due to the present economic structure. Employees are therefore required to supervise different aspects of the project. The human predicament of greed coexists with the previously described delegation, which is the cornerstone of the stewardship theory paradigm. Every stakeholder in the globe is concerned about how urgent it is to handle this sickness in order to completely stop it from occurring. Within the larger scope of institutional reform, corporate governance (CG) is an endeavor designed to ensure appropriate administration of economic institutions and reduce agency costs. The fact that various nations have published research and national corporate governance rules attests to the framework's international recognition (Rossouw, 2005). CG is the way that organizations are managed and controlled. Due to the costs involved in keeping an eye on management behavior, one important concern is the possibility of conflicts of interest developing between corporate managers and shareholders (O'Sullivan, 2000). The board of directors is in charge of managing corporate operations and is a crucial component of the company's internal CG system (Fama, 1980). Emerging economies prioritize the board of directors because they have relatively weak governance processes and institutions, including as financial markets, regulators, control markets, oversight, and the legal system (Ujunwa, Salami, & Umar, 2013). It is evident that the majority of areas have seen significant gains in the management of corporate operations as a consequence of the use of CG technology. Meanwhile, both before and after the emphasis on CG, audit has been and still is relied upon as a testimony to the reliability of stated outcomes. The audit information gateway is used by third parties to confirm the accuracy of earnings reports. However, the scandals that followed raised serious questions about the veracity of the audit reports and brought attention to the matter of quality. Academics in the auditing field argue that producing a high-caliber report is an audit assignment's main goal. They claim that rigorous adherence to the requirements of high audit quality is required in order to accomplish this (DeAngelo, 1981). In a landmark study in the industry, DeAngelo (1981) defined audit quality as the likelihood—as judged by the market—that a certain auditor would find and reveal major misstatements in the client's financial statements. This conclusion is influenced by the auditor's professional behavior, which includes aspects like impartiality, acceptable professionalism, and lack of prejudice (Mgbame, Eragbhe, & Osazuwa, 2012). This emphasizes the need of auditing even more since it gives investors—who rely only on audited financial statements to judge the success of the company—the necessary trust. Auditing, according to Adeyemi and Fagbemi (2010), removes residual loss brought on by managerial opportunism in the financial reporting process and lessens information asymmetry in accounting numbers. The rationale behind this study stems from the belief that improving the caliber of audit reports increases the trust that investors have in financial statements. Because of the assurance that important investment choices may be made based on the substance of the audited financial statements—which is further bolstered by the auditor's alleged independence—investors have more faith in audited financial statements (Onwuchekwa, Erah, & Izedonmi, 2012). The heightened confidence of these groups of financial consumers usually draws capital inflows, which in turn promotes business growth and development (Adeyemi & Fagbemi, 2010). Managerial inefficiencies may therefore lead to poor financial reporting. Potential investors' trust in the organization's assessments is put at risk since the financial statements generated by the aforementioned approach do not fairly depict the organization's actual financial situation.

2. Review of Literature

2.1. The audit summary's quality

An auditor who performs an audit examines accounting data in order to determine the reliability and integrity of financial statements and to provide a report detailing his findings (Omoye & Aronmwan, 2013). In essence, financial auditing is the work of an unbiased third party to comment on the accuracy and integrity of financial accounts (Millichamp, 1994). A rigorous process for gathering and evaluating information related to statements made regarding economic events and activities is involved in financial statement auditing. Its goal is to establish how closely these claims match predefined criteria and to disseminate the results to relevant parties (Rittenberg, Johnstone, & Gramling, 2012). Essentially, the purpose of auditing is to give consumers of financial statements—who rely on audited financial statements—the required level of reasonable assurance. The topic of audit quality has been extensively discussed in audit market research. The scientific community still hasn't come to a consensus on an appropriate definition or even an optimum measurement for the notion. Stakeholders in a company, including investors, regulators, and auditors, have differing perspectives on what constitutes an audit quality. The definition of audit quality given by DeAngelo (1981), a pioneer in the field of audit quality indicators, is the auditor's capacity to identify and report a major abnormality in the financial statements that the market has determined to exist. It is possible for a financial report user to mistakenly believe that a high audit quality is shown by the lack of material misstatements. High audit quality can be described by the auditing firm's auditor as having satisfactorily fulfilled all obligations as stipulated by the audit methodology. According to Chan and Wong (2002), audit quality affects the likelihood of correctly detecting differences between the organization's good report and the real quality of the project, even when these differences are undetectable. Users have opinions on what they believe an audit should cover. There are two parts to this expectation: the objective quality and the subjective quality. Both perceived and actual quality have been shown to be essential components in the definition of audit quality. Actual audit quality is defined by Palmrose (1988) as the likelihood of reducing the risk of revealing a major misstatement in a financial statement. The trust that users of financial accounts have in the auditor's capacity to reduce serious misstatements is known as perceived quality. An example of improved perceived audit quality might lead to improvements in audited customers' investment procedures. According to Jackson, Moldrich, and Roebuck (2007), an audit is considered to be of genuine quality if there are no type I errors (which indicate a failing firm receiving an unqualified report) or type II errors (which indicate a non-failing company receiving a qualified report) during the audit.

2.2. Previous Analysis of the Literature

The evaluation of auditor-related criteria has taken up much of the literature on audit quality. These studies were conducted in developed and developing nations alike. Research by Hosseinniakani, Inacio, and Mota (2014) found that the following factors had a substantial impact on audit quality: size, industry knowledge, auditor tenure, audit fees, non-audit services, auditor reputation, and auditor fees. Barbara et al. (2006) carried out an experimental investigation in developed nations to investigate if audit job quality is impacted by auditor rotation. Researchers looked at whether, in the case that a customer departed from generally accepted accounting standards, public accountants would amend their annual report. The findings imply that when their reports are rotated, auditors who hope for a long-term partnership are less likely to make changes in response to a disparity. In 2013 research, Enofe et al. examined the factors that influence audit quality in Nigeria's business environment, particularly from the standpoint of a developing country.

The study looked at participation as well as business-related factors such ownership structure, board independence, audit tenure, and audit firm size. A regression model was used to determine the variables' relevance. The results showed a relationship between board independence and audit quality. There were just a few observations made, and the only statistical technique used was basic least square regression, which may not have been appropriate given the dependent variable's binary form. Adeyemi, Okpala, and Dabor (2012) looked at audit quality characteristics in Nigeria. The analysis of the study included both primary and secondary data. The results of the study showed that the availability of non-audit services and the presence of several directors had a major impact on the caliber of audits conducted in Nigeria. To improve the quality of financial reporting, the study recommends techniques to support audit quality. The study also suggested that regulatory agencies verify that one company does not provide audit and management consulting services in the same company at the same time. Furthermore, Omoye and Aronmwan (2013) investigated the connection between audit firm rotation and audit quality using cross-sectional pool data collected from 15 Nigerian institutions between 2005 and 2011. The results of the study showed that the quality of audits is severely harmed by audit companies' turnover. According to the review's summary, the majority of research on audit quality in Nigeria has focused on issues related to auditors, with very few studies looking at governance procedures.

3. Developing Hypothesis

The difficulties experienced by auditing bodies as a result of the division of ownership and control inside businesses give rise to the necessity for external audit services (Jensen & Meckling, 1976). Firm owners seem to be physically and functionally separated from the companies they own. Expert managers, who could or might not be major shareholders in the business, have control over the day-to-day activities and projects of the establishment (Fama, 1980). According to Securities and Exchange Commission (2000), this suggests that a part of the company's resources are set aside for the benefit of its shareholders, and that the managers of the company have a duty to report to them on how they are managing those resources. Usually, this is done through a regular release of financial statements. It is normal for organizations to designate auditors to certify financial statements in order to ensure their correctness and credibility for users (Enofe et al., 2013). An auditor is a disinterested, thorough outsider who performs unbiased, independent audits that provide credibility to financial accounts.

3. The approach

In addition to the Securities and Exchange Code of Corporate Governance, financial organizations are also governed by other laws issued by the Central Bank, such as the Code of Corporate Governance for Financial Services Companies. Consequently, the sample was limited to non-financial companies. In addition, there are a lot of reporting requirements and government rules that apply to this industry (Gupta & Newberry, 1997; Richardson et al., 2015; Richardson & Lanis, 2007). The principal factor that guided the decision was the unavailability of particular annual reports from the websites of the individual firms as well as the libraries of the Nigerian Stock Exchange. From 2008 to 2015, 71 firms were the subject of the investigation. The time frame was chosen in response to the 2011 amendment to the publicly listed businesses' code of corporate governance.

3.1. Research Framework

The empirical investigation includes an estimation of the relationship between corporate governance and audit quality. A number of characteristics that have been connected in the literature to audit quality—such as company size, profitability, and leverage—were incorporated as controls into the Audit quality: (corporate governance + control variables) model.

3.2. Quantification of Variables

The study has a causal and descriptive underpinning. While the descriptive component outlines the properties of the variables, the causal relationship shows how the interactions between the variables affect the data. The econometric program Stata 13.0 was used for the study's binary regression analysis, in which the dependent variable was assessed by a dummy variable with two potential values: "1" and "0."

4. An explanation of findings

By include both big four and non-big four auditors in the audit quality evaluation process, the audit quality model is calculated. Table 4 displays the binary model's estimation results. Table 1 displays the results of the robust binary regression. Heteroskedasticity and data autocorrelation are taken into consideration by the robust regression approach. The variable under consideration is audit quality, as stated. With a corrected R2 value of 0.06, the explanatory variable appears to be able to explain 6% of the variability in the dependent variable. The adjusted R2 is comparable to earlier research findings. The Wald Chi2 value of 29.70 supports the statistical significance of the whole model.

Table 1: Binary Regression Result

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AUDQ	Coef.	Std.err	T	$p > t$
CG	−0.79	0.59	−1.33	0.09
LEV	0.02	0.46	0.05	0.96
FSIZE	0.76	0.15	5.02	0.00
PROF	1.29	0.97	1.33	0.09
CONS	−4.40	1.08	−4.08	0.00

Notes: Adjusted R^2 = 0.06; *Wald* Chi^2 = 29.70; p = 0.00. *Significant at 10%; **significant at 5%; ***significant at 1% (1-tail).

The binary regression result (= 0.79, p 0.10) indicates the importance and negative association between board independence and audit quality, implying that a rise in board independence is linked to a fall in audit quality. Corporate governance and audit quality have been found to positively correlate in earlier research (Adeyemi & Fagbemi, 2010; O'Sullivan, 2000). Our results are compatible with the agency hypothesis, even if they might not match those of previous studies. According to this argument, because ownership and control are separated, management will put their own interests ahead of shareholders' when the chance arises (Jensen & Meckling, 1976). Non-executive directors can therefore examine managers' opportunistic behavior (Fama & Jensen, 1983). According to Abidin et al., independent non-executive directors have a variety of traits, attributes, and abilities (2009). The enhancement of board procedures and decision-making processes is facilitated by diversity, which may have a noteworthy impact on the organization's sustainability. Furthermore, as per Ajibolade and Uwuigbe (2013), it is anticipated that external directors will be mindful of their public image and reputation, which will encourage them to ensure precise financial disclosure. Furthermore, a reasonable explanation is that the board's independence, which is a sign of robust corporate governance, functions as a control mechanism in the company, ensuring accurate financial disclosures and eliminating the requirement for a top-notch audit proxy by hiring a major four auditor.

5. Conclusion

This study uses agency theory and data from earlier studies to investigate the relationship between audit quality and corporate governance in Nigeria. Our results show that, when used as a proxy for corporate governance, audit quality is not positively connected with board independence, in contrast to a number of previous studies. This result is in line with the agency theory's central thesis, which holds that the necessity for a big four auditor—which we use as a stand-in for the firm's audit quality—can be replaced by an independent board, which is equivalent to strong corporate governance. The study's conclusions have significance for a wide range of stakeholders in companies, such as researchers, administrators, investors, policymakers, and shareholders. It highlights how crucial it is to have a board with a diverse variety of skills. This is also something that policymakers need to give top priority if they are interested in developing a robust corporate governance environment. The analysis suggests that the current makeup of the board should be preserved and enhanced with regard to the number of non-executive directors. Furthermore, the outcome has research implications. This adds to the body of knowledge already available on Nigerian corporate governance and audit quality. This study has limitations despite its significant contributions in several disciplines. One such disadvantage is its dependence on a single corporate governance statistic. It is recommended that future studies make use of a range of corporate governance tools or create an index of several aspects that influence audit quality.

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