Determinant of Audit Quality of Quoted Industrial Goods Sector in Nigeria

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Abstract
External auditing is a key component of a well-functioning capital markets. This is based on the assertion that companies with a reputation for credible financial reporting are likely to change auditors when their audit quality is questioned to avoid capital market consequences of unreliable financial reporting. This study empirically ascertained the relationship between audit quality attributes and financial reporting quality of listed consumer goods companies in Nigeria. The study adopted a correlational research design and adopted 12 out of the entire population of 17 quoted companies in the industrial goods sector using purposive sampling technique to determine sample size. The result of the panel regression with the aid of STATA indicated that audit firm size has a negative significant relationship, auditor tenure has a positive insignificant relationship while audit fees has a negative insignificant relationship with financial reporting quality of quoted industrial goods companies in Nigeria. The study recommended that consumer goods companies should not rely on audit fees paid to auditors as a guarantee of qualitative financial reporting since audit fees contributes negatively and insignificantly to financial reporting quality. Consumer goods companies should not emphasis on elongated tenure of auditors and should reasonably consider the size of audit firms before engaging them.
Keywords: Audit Fees, Audit Tenure, Financial reporting, Firm size, audit quality, Industrial goods sector.

1. INTRODUCTION

High-quality external auditing is a central component of a well-functioning capital markets. Companies with a reputation for credible financial reporting are likely to change auditors when their audit quality is questioned to avoid capital market consequences of unreliable financial reporting (Hennes, Leone & Miller, 2012). The performance of independent auditors is deemed fundamental to the functioning of the financial and capital markets based on the assumption that, by issuing an opinion on the reliability of accounting information, it contributes to a business environment characterized by trust and credibility (Newman, Patterson & Smith, 2005; Ojo, 2008; Zagonov, 2011). However, with the corporate scandals at the start of the century, characterized by fraud and accounting manipulation, much has been discussed about the scope of responsibilities of auditors, given that the opinion on financial statements has not changed.

Further, the economic crisis is the latest event to raise interest globally in audit quality, the integrity of financial reporting and corporate governance. The scale of the problem has also raised expectations of further regulation in the economy which have well impacted on reporting, auditing and governance. National regulatory systems are increasingly interconnected with supranational private sector standard setting bodies, such as the International Accounting Standards Board (IASB), the International Federation of Accountants (IFAC) and governmental bodies such as the European Union (EU).

Again, the Enron and other notable scandals however, prompted a global shift to re-regulation (Kinney, 2005). In the US, the Sarbanes Oxley Act (SOX) (2002) introduced major modifications to the US audit, financial reporting and corporate governance regimes. Similar regulatory changes subsequently occurred in the UK and many other countries (Lennox, 2009). In Nigeria, the Regulatory authorities also responded by compelling companies to comply with stringent corporate governance codes. Idornigie (2010) reported that Nigeria have multiplicity of codes of corporate governance with distinctive dissimilarities namely: Security and Exchange Commission (SEC) code of corporate governance (2003) addressed to public companies listed in the Nigeria Stock Exchange (NSE). The code was reviewed in 2011; Central Bank of Nigeria (CBN) Code (2006) for banks established under the provision of the Bank and Other Financial Institutions Act (BOFIA); National Insurance Commission (NAICOM) Code (2009), directed at all insurance, reinsurance, broking and loss adjusting companies in Nigeria; and Pension Commission (PENCOM) Code (2008), for all licensed pension fund operators. Scandal and regulatory change has brought attendant changes in the conceptualization of practice. For example, Khalifa, Sharma, Humphrey and Robson (2007) present evidence that the dominant audit discourse shifted from one of 'business value' to one of 'audit quality'.

The loss of Enron's audit firm, Andersons, left only four major firms dominating the global audit market and led to an overall loss of confidence in audit quality which affected the remaining firms and created concerns about competition and choice for major companies using audit services in the market (e.g. General Accounting

Office (GAO), 2003; US Treasury, 2007; FRC, 2007; EC, 2008).Sadly, this avalanche of regulation has not prevented the meltdown in the banking sector that western economies have recently experienced. Some observers have questioned whether audit quality failures contributed to the crisis (e.g., Holmes and Sukhraj, 2008; Sikka, 2009).

Despite the interventions of the regulatory authorities, the challenges of ensuring credibility in financial reporting and auditing are still prevalent. It therefore, becomes pertinent to investigate the factors affecting audit quality in order to enhance the relevance of audit and assurance functions. Nigeria is currently experiencing a paucity of research in this direction. Even the very few studies conducted have advanced mixed reactions concerning which factors are pertinent to contributing to enhanced audit quality. This study is expected to broaden extant literature and provide essential findings to assist stakeholders of financial reporting and auditing in the country in formulating and administering relevant and pragmatic policies to enhance corporate financial reporting.

Theoretically, the auditor is expected to be independent of the management staff of the company being audited. However, a number of factors like familiarity, threat of replacement of an auditor and the provision of management advisory services appear to impair auditor's independence. Concerns have been expressed about the conflict of interest between the statutory role of the auditor and the other services it may undertake for a client (UK House of Common Treasury Committee, 2008). The spate of audit failures in the world has brought a great deal of disappointment to investors and other corporate financial reporting stakeholders. Longevity of audit firm tenure, audit firm size and audit fees has also been frequently linked with fraudulent financial reporting. If empirical studies are not carried out with respect to specific environmental factors the problem of poor audit quality may be exacerbated with likely grave consequences for the nascent Nigerian Capital Market.

Given the significance of this problem combined with the factors discussed, this study seeks to ascertain the determinants of audit quality of quoted industrial goods sector in Nigeria. Specifically, the study will investigate audit fees, audit firm size and auditor tenure as the main determinants of audit quality.

2. LITERATURE REVIEW

According to International Auditing and Assurance Standards Board (IAASB, 2011), there has been a number of attempts to conceptualize "audit quality" in the past. However, none has resulted in a definition that has achieved universal recognition and acceptance. Audit quality is, in essence, a complex and multi-faceted concept. The classic definition of audit quality that is cited by most audit researchers is that of DeAngelo (1981) which states that audit quality is the market-assessed joint probability that a given auditor will both (a) discover a breach in the client's accounting system and (b) report the breach. The definition highlights two important aspects of audit quality: (1) the competence of the audit firm that determines how likely it is that a misstatement will be detected and (2) the independence and objectivity of the auditor that determines what the auditor is likely to do about a detected misstatement. This definition has been quite useful to audit quality studies.

The import of DeAngelo (1981) definition is that audit quality is a probability that an auditor will discover and truthfully report material errors, misrepresentations, or omissions in the client's financial statements. Davidson, Stening and Wai (1984) simply posit that audit quality is the accuracy of auditor's information reporting while Wallace (1987) shows that audit quality is a measure of the auditor's ability to reduce noise and bias and meticulously improve accounting data.

Audit quality has to do with a display of professionalism, diligence and care by auditor in audit process which should lead to a true and fair view of financial statement (Arrunada, 2000). Arens*et. al* (2011) defines the quality of the audit to mean how well an audit detects and report material misstatements in financial statements, the detection aspects are a reflection of auditor competence, while reporting is a reflection of ethics or auditor integrity, particularly independence". Davidson and Neu (1993) define audit quality as the ability of auditors to discover and reveal light material misstatements and manipulations in net income reported. This is corroborated by findings from Salehi and Azary (2008) who stressed that the capability of an auditor in the protection of the interest of users of financial statement through the detection and reporting of material misstatements and diminution of information asymmetry between the users of financial statement and management explains audit quality. They further opined that the existence of audit quality is validated when a financial statement is free from information asymmetry. According to Palmrose (1988), in defining audit quality, actual quality and perceived quality have been contended as essential issues. While actual quality is regarded as the likelihood of reducing the associated risk of reporting a material misstatement in financial statement, perceived quality has to do with what the users of financial statement believe about the ability of auditor to reduce material misstatement.

Moreover, there are certain fundamental characteristics to watch out for when audit quality is a subject of discussion. This according to Yuniarti (2011) include Reliability (which has to do with how dependable are the auditor's findings and to what extent do the findings reflect a true and fair view of audited entity's financial statement), Significance (what value is tied to the audit?), Scope (which has to do with whether the entire aspects of the audit is properly addressed), Objectivity (what level of independence was exhibited in the audit process?), Clarity (was the audit outcome well communicated and recommendations made?), Timeliness (was the duration of the audit work too long, too short or just normal before the audit report was submitted?), Effectiveness (does the audit actually achieved its objective?) and Efficiency (was the cost of the audit outweighed by the associated benefit?). According to him, the integration of these characteristics as a whole gives quality to the audit. This implies that audit quality is prominent where these characteristics can be identified.

Audit fee therefore, can be explained to be the amount charged by the auditor for an audit assignment carried out. That is, the amount charged by the auditor for any work done in order to express opinion on the true and fair state of affairs or position of the client's enterprise. Iskak (1999 in Suharli & Nurlaelah, 2008) described audit fee as the fee charged by a public accountant to the client for the financial audit services. This is in accordance with the opinion of The Securities and Exchange Commission, Final Rule (in Yuniarti, 2011) that the audit fee is the fees paid for annual audits and reviews of financial statements for the most recent fiscal year. The amount of audit fee can vary depending on the complexity of services, assignment risk, the cost structure of Public Accountants Firm, the required level of expertise, and other professional considerations.

Moreover, Hoitash et al. (2005) opined that the aggregate of audit fees is the amount of all costs covered for auditor. There is variation in the amount of the fee, depending on auditee size and how complex the auditing process is (Lyon and Maher, 2005). This is further corroborated by Turley et al. (2008) who states that there are three composite factors which contribute to the establishment of audit fees, which include complexity, Client size and associated risk. Audit fees are the fees paid to the auditors that reflect the cost of the effort conducted by the public editors and litigation risks (Choi, 2009).

Similarly, Audit tenure is the agreed period of engagement between the auditor and client (Hartadi, 2009). The issue of audit tenure is usually linked to auditor independence. Research conducted by Ghosh and Moon (2003) shows that audit quality increases as audit tenure increases. This result is however contrary to the results of a research conducted by Indah (2010) which reveals that as thelength of auditor-client relationship increases; there could be decrease in the level of audit quality, because too long auditor-client relationship impairs auditor's independence. Furthermore, the audit quality decreases as the auditor-client relationship lengthen (Deis and Giroux, 1992). However, the study involving going-concern report in the US suggest that audit reporting failures are significantly higher in the first few years of auditor-client relationship (Geiger and Raghunandan, 2002). According to Chen (2008), audit firm tenure as well as audit partner tenure, affects financial reporting quality.

Empirically, 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. Their findings revealed a negative relationship between auditor tenure and audit quality; though the variable was not significant.

Onwuchekwa, Erah and Izedonmi (2015) investigated the relationship between mandatory audit rotation and audit quality using selected stakeholders in southern Nigeria. The data used were extracted through the distribution of questionnaires to investors, lecturers, consultants, accountants and auditors in Southern Nigeria. Their binary logistic ordered regression revealed a negative relationship between mandatory audit rotation and audit quality.

Siregar, Amarullah, Wibowo and Anggraita (2016) investigated 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 (2014) analyzed the effect of the length of the audit firm-client relationship and the size of the audit firm on audit quality in Jordan. 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.

Yuniarti (2017) 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 (2013) investigated the influence of audit firm size (Big auditors vs. non-Big auditors) and auditor type (governmental vs. private auditors) on 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. 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.

Yuniarti (2017) explained that the complexity of services provided, expertise, risk of assignment, and other professional considerations determine audit fee charged by auditor. The study further reveals that higher audit fee enhances a higher quality audit. However, a contrary opinion is observed in Supriyono (1988 in Wati & Subroto, 2003); which shows that a high amount of audit fee can impair the independence of public accountants, this he attributed to the fact that the big fee can inhibit reluctance of audit firms to controvert the will of the client, while small fee has the tendency to limit the cost and time to carry out complete audit procedures.

Ilaboya and Ohiokha (2014) empirically examined the impact of audit firms’ characteristics on audit quality. The study revealed that a negative relationship exists between auditor’s independence, audit firm size, audit tenure and audit quality. Examining the relationship between audit partner tenure and audit quality, Chijoke (2012) found that there is existence of negative but insignificant relationship between auditor tenure and audit quality. On the contrary, by applying the dispersion of accruals as a proxy for audit quality, Myers et al, (2003) report that as tenure of auditor lengthens, the discretionary accruals and current accruals are less dispersed, thereby suggesting higher earnings quality. Apart from accruals, Stanley and DeZoort (2007) used restatement as a surrogate for low quality of financial reports. Their findings also suggest that as the auditor-client relationship lengthens, there is corresponding decreased in the likelihood of restatement, implying better financial reporting quality. Findings from Knechel and Vanstraelen (2007) reveals neutral effect of auditors’ tenure on audit quality as they find that longer auditor tenure neither reduce nor increase possibility of auditor’s issuance of going concern report for a company that went bankrupt thereafter.

Theoretically, agency theory and auditors’ theory of inspired confidence justify the key function of auditing as a mechanism for mitigating information asymmetries among related parties. The demand for audit of companies’ accounts is created by the agency problems which are related to the separation of corporate ownership from control (Eilifsen & Messier, 2000; Gerayli, 2011). The agency problem arises from the existence of asymmetric information in the principal – agent contracts (Jenson and Messier, 2000). Some studies (Trueman & Titman, 1988; Dye, 1988; Schipper, 1989; Warfield, Wild & Wild, 1995) have shown that the existence of information asymmetry between corporate management and company shareholders is a necessary condition for and easy perpetration of earnings misreporting and financial statements manipulations. The audit of a company’s accounts is a monitoring or control mechanism that diminishes information asymmetry and protects the interests of the principal.

The auditors’ theory of inspired confidence offers a linkage between the users’ requirement for credible and reliable financial reports and the capacity of the audit processes to meet those needs. It sees through the development of these needs of the public (stakeholders) and the audit processes over time. Developed by the Limperg Institute in Netherlands in 1985, the theory of inspired confidence states that the auditor, as a confidential agent, derives his broad function in society from the need for expert and independent examination as well as the need for an expert and independent judgement supported by the examinations. Thus, accountants and auditors are expected to know and realize that the public continues to expect a low rate of audit failures. This requires that the auditors must plan and perform their audit in a manner that will minimize the risk of undetected material misstatements. The accountant is under a duty to conduct his work in a manner that does not betray the confidence which he commands (Limperg Institute, 1985).

3. METHODOLOGY

A correlational research design was adopted due to the fact that the study measures relationships between audit quality and financial reporting of listed industrial goods firms in Nigeria. Secondary data obtained from a sample of 12 quoted industrial goods companies are studied out of the 17 quoted on the NSE over a period of six years from 2012 to 2017 via purposive sampling technique. Given a total of one hundred and two financial year examination. Panel regression was adopted as techniques for data analysis.

Model Specification

$FRQit = \beta it0 + \beta it1AUFEEit + \beta 2ACTENit + \beta 3FSIZit + \varepsilon it$

Where:

FRQ= Financial Reporting Quality

$\beta 0$ =Constant

AUFEE=Audit Fee

AUTEN= Audit Tenure

Control variable

Firm Size

$\beta 1$, $\beta 2$, $\beta 3$, are parameters estimates; $\beta 0$ intercept

ε = Residuals

it= cross-sectional time series

Variable Measurement

Dependent variable

$(TAcci,t/ATi,t\text{-}1) = \alpha 0 + \alpha 1\ (1/\ ATi,t\text{-}1) + \alpha 2\ (\Delta\ REVi,t\ /\ ATi,t\text{-}1) + \alpha 3\ (PPEi,t\ /\ AT\ i,t\text{-}1) + \alpha 4ROAi,t\text{-}1 + \varepsilon i,t$

TAcci, t=Total Accruals of the company; PPEit = Property, plant and equipments of the company; Δ REVi, t= Change in Revenue of the company; ATi, t-t= Assets total of the company in year t-1; ROA i,t-1= Return On Assets of the company in year t-1; ε = random error term

Independent variables

Audit Fee= measured as total audit fees as reported at the end of accounting period

Audit Tenure=Measured by dichotomous variable, 1 for all the times spent by the same audit firm and 0 for the year of auditor change.

4. RESULTS AND FINDINGS

Table 1. Descriptive Statistics

Stats	AQA	AUFEE	AUTEN	FSZ
Mean	.4687349	1.694379	.6388889	4.604708
Min.	.6001882	.60206	0	4.025552
Max.	2.942672	2.444045	1	5.004205
SD	.5602351	.4690511	.4836934	.2868101

Source: Stata V13 Result (2018)

The table above presents the result of the descriptive statistics conducted on the variables. The result indicated that Audit Quality has a mean of .4687349. The mean values stood at 1.694379, .6388889, and 4.604708 for Audit Fee, Audit Tenure and Firm size respectively. The standard deviation values stood at .5602351 and .4690511 for Audit Quality and Audit Fees respectively while Audit tenure and Firm size have SD values of .4836934 and .2868101.

Pre- Diagnostic Test

Multicollinearity Test

Multicollinearity is a statistical situation where some independent variables in a multiple regression are highly correlated. In order to identify if there were multicollinearity among independent variables in this study, a Variance Inflation Factor (VIF) measure was used. The table below shows the result.

VIF and Tolerance of Audit quality and Control Variables

Table two (2)

Variables	VIF	1/VIF
AUTEN	1.05	0.9488
AUFEE	1.03	0.9687
FSZ	1.02	0.9778
Mean VIF	1.04	

Source: Stata V13 Result, (2018)

The current study indicates that the result of VIF and its inverse show absence of multicollinearity. Table above shows that VIF and tolerance value for all the variables had VIF of less than 10 and tolerance of higher than 0.5 it therefore implies that there was no multicollinearity among the independent variables.

Breusch-pagan/Cook-weisberg test for Heteroskedasticity

Table 3. Variables: fitted values of the Model

Ho: Constant Variance

37.72	4	0.0000
Test – Statistics	**Df**	**sig**

Source: Stata V13 Result, (2018)

The result of the test as shown above indicate that the test- statistics is 37.72 (p-value =0.0000). since the test- statistic is lower than 0.05, the null hypothesis is rejected and concluded that there was presence of heteroscedasticity in the data (that the data is heterosgeneous in variance), which violates the assumption of multiple regression.

Table 4. Correlation Coefficient Matrix

The table below show the pearson correlation coefficients between all combinations of dependent and independent variables. The correlation matrix is used to determine the relationship between the dependent and independent variable of the study.

	AQA	AUFEE	AUTEN	FSZ
AQA	1.0000			
AUFEE	-0.1807	1.0000		
AUTEN	0.1170	0.1763	1.0000	
FSZ	-0.6810	-0.0391	-0.1484	1.0000

Source: Regression Result Using STATA

The table above reveals that there is positive correlation between the dependent variable and all the independent variables.

Table 5. Summary of Regression Result for the Study using Fixed Effect Model

Variables	Statistics	P-values
R Square: within	0.2872	
Between	0.7456	
overall	0.5081	
F-Statistics	17.93	0.0000
Prob>F	0.0000	

Source: Stata V13 Result, (2018)

Table 6. Regression Coefficients of the Study using Fixed Effect Model

Variables	Coefficient	P-value
Audit Fees	-0.2180225	0.061
Audit Tenure	0.0832987	0.461
Firm Size	-1.308968	0.000

Source: Stata V13 Result, (2018)

Discussion of Findings

The table above presented the summary of the result for the model of the study. This is used to predict the relationship between the dependent and independent variables and to further test the strength of the relationship. The overall R=Square indicated 0.5081 representing 51% which evidences a statistically strong relationship. The result of the adjusted R Squared indicates 0.4833, this means financial reporting quality can be predicted using these variables). The table also shows that the model is fitted as evidenced by the F-Statistics of 17.93 which is significant at 1% level of confidence (P-value 0.0000).

However, based on the evaluation effects of the explanatory variables on the financial reporting quality. Accordingly, coefficient slope of AUDIT FEES appeared negative (-0.2180) and insignificant at 5% (p=0.061). This suggests that the linear function specified in the model might be the case. This shows that there is a negative insignificant relationship between AUDIT FEES and AUDIT QUALITY in the sector covered by the study. Again, the result indicate that AUDIT TENURE has a positive coefficient of 0.0832 and a p=value of 0.461 which is insignificant 5% level of confidence. It means AUDIT TENURE has a positive but insignificant impact on the AUDIT QUALITY of companies in the area covered by the study. The study also found that FIRM SIZE has a negative coefficient but positive p=value of -1.3089 and 0.000 respectively. This means that FIRM SIZE has negative but significant impact on the AUDIT QUALITY of companies in the area covered by the study. These findings are consistent with those of Mgbame et al (2012); Onwuchekwa et al (2012); Ilaboga et al (2014);

Chijioke (2012).

5. CONCLUSION AND RECOMMENDATIONS

Based on the findings it was concluded that Audit Fees has an insignificant negative impact on the financial reporting quality of quoted industrial goods companies. Audit Tenure has an insignificant positive impact while Firm Size has a significant negative impact on the financial reporting quality of quoted industrial goods companies in Nigeria. Based on the findings and recommendations, it was concluded that;

Industrial goods companies should not rely on audit fees paid to auditors as a guarantee of their audit qualitysince audit fees contributes negatively and insignificantly to financial reporting quality.

Although Audit Tenure can contribute positively to financial reporting quality it has a statistically insignificant impact so company should not put much emphasis on auditors' tenure as a guarantee of audit quality.

Companies can also reasonably consider the size of the audit firms while hiring audit partner as it has significant impact on their audit quality, although not very strong.

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