EFFECT OF AUDIT QUALITY ON FINANCIAL PERFORMANCE OF SELECTED FIRMS IN NIGERIA

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Abstract
This study focuses on investigating the effect of audit quality on financial performance of selected firms in Nigeria. The study employs pooled ordinary least square regression analysis. From extant literature explored and analysis results, it was discovered that Audit Quality influences financial performance of selected firms in Nigeria. Therefore, the study concluded that Auditors' Independence (AUDIND) and Audit Size (AUFSZ) have significant positive effect on ROA (Return on Asset) while Audit tenure (AUDTEN) has significant negative impact on ROA. The study recommends that regulators should set a minimal standard for the degree of independence for auditors in order to improve audit quality and uphold auditor integrity, which will operate as a deterrent to fraudulent actions. It was also recommended that the tenure of office of external auditors should not be too long.
Keywords: Audit quality, Financial performance, Auditors, Audit tenure

1.0 Introduction

The intensified economic turmoil brought on by the current global financial crisis has demonstrated the urgent necessity for accurate, high-quality financial reporting systems. However, it is anticipated that external audit will play a substantial and important role in improving and/or achieving high quality financial reporting among businesses. Without a question, the accuracy of financial reporting and auditing has remained essential to numerous regulatory and supervisory thrusts over time. Firms, governments, and regulators are among those who place a premium on the accuracy of audited financial data (Odjaremu & Jeroh, 2019; Ivungu et al., 2019).

Expectedly, auditors have a great deal of independence in their judgements, even though the work done to acquire information and create a conclusion is substantially based on and anchored in clients' data. Studies have thoroughly explored the factors that influence audit quality within organisations due to the presumption of its relevance (Monye-Emina & Jeroh, 2022). As a result, the study notes that previous findings in the literature had clearly examined these factors, placing particular emphasis on corporate governance factors (size, diversity, and independence of boards, ownership structure, among others), audit attributes (audit fees, diligence, size, scope, and nature of audit, among others), and a number of other measures.

The foregoing analysis, thus, indicates a gap that needs empirical documentation, because past empirical attention was on the drivers of audit quality with less focus on whether audit quality predicts movements in financial measurements of organizations. In order to close this information gap, the study looks specifically at whether factors like audit tenure, auditor independence, and audit-firm size have an impact on performance (using ROA as a proxy). In order to achieve this objective, this study will answer the following research questions: Do audit tenure, auditors' independence, and Audit-firm size influence firms' financial performance? The remaining parts of this study cover the literature/conceptual clarifications, the design, data and other methodological procedures were highlighted in subsequent section. The fourth section covers data analysis whereas the last section covers conclusion and the recommendations.

2. Literature Review

2.1 Conceptual review

2.1. 1 Financial Performance

According to Amahalu et al. (2019), financial performance is a gauge of how well a company can employ resources from its main line of business to create income. The general assessment of a company's overall financial health during a specific time period is financial performance. A crucial prerequisite for future policy modifications is empirical performance

analysis. Financial performance refers to how well a company has performed throughout time in achieving its defined objectives. Despite the difficulties brought on by the global financial crisis and the failure of several domestically unlicensed institutions, some businesses in Nigeria have managed to stay strong and resilient. Financial statements reveal performance information. The first step in measuring a firm's performance should be to determine whether it has been successful in achieving the goals established by its stakeholders (Chinedu et al., 2020).

2.1.1.1 Return on Assets (ROA)

The Return on Assets (ROA) ratio is a key metric for assessing a company's profitability. It serves as a gauge of a company's profitability in relation to its overall asset base. It measures the revenue relative to total assets. It gauges the management team's capacity to turn a profit by making use of available resources. In other words, it demonstrates how effectively the company's resources are employed to generate revenue (Amahalu et al., 2019). This profitability ratio demonstrates the rate of returns and management effectiveness. Additionally, it shows how well a company's management uses all of its resources to produce net income. A greater ROA indicates that a corporation is utilising its resources more effectively (Horton, 2018). Return on Assets is computed as follows and is shown as a percentage: Return on Assets (ROA) = Net Income/Total Assets

2.1.2 Audit Quality

According to DeAngelo (1981), audit quality is the market-estimated joint chance that a particular auditor would find substantial inaccuracies in the client's financial statements and report those inaccuracies. Furthermore, DeAngelo (1981) uses a two-dimensional approach to characterise audit quality, first identifying substantial financial statement inaccuracies and errors and then disclosing them.

DeAngelo (1981) defined audit quality as being a function of the external auditor's technical capabilities (ability to identify substantial misstatements) and willingness (auditor independence) to disclose the errors. According to Houghton et al. (2010), the accounting literature on audit quality supports the idea that auditor competence and independence are two factors that contribute to audit quality. Any study examining the effects on audit quality (within nations) must take into account participants' perceptions of the independence and expertise of the auditor. Many people believe that auditor independence is the foundation of the auditing function, and this belief has served as the driving force behind numerous audit reforms worldwide since 2001 (Houghton et al., 2013 and Amodu, 2022).

2.1.2.1 Audit Independence and Financial Performance

The idea of independence comprises the mental condition of impartiality and lack of bias, according to Donatella et al. (2019). In light of this, the rules and practices of the audit firm as well as the attitudes of employees performing the assigned audit duties impact the level of independence of auditors (Geiger & Kumas, 2018). Audit independence, according to Amahalu and Beatrice (2017), describes the auditor's objectivity when performing his obligations as an auditor.

2.1.2.2 Audit Tenure and Financial Performance

The term "audit tenure" refers to the full time that an auditor has a customer. As the parties' personal relationships and familiarity build, it may become harder for the auditor to remain objective, which could lead to a lack of focus on the part of the investigator. This could happen when there are longer stretches between the auditors and their clients. In addition to endangering independence, if the audit appointment becomes routine over time, the auditor will have less time to look for weaknesses in internal controls and risk sources (Capkun et al., 2016).

2.1.2.3. Audit Firm Size and Financial Performance

Audit firms are service–driven professional and expertise-intensive organizations set up to uphold high-quality reporting among entities. Results from extant researches suggests that the size of audit firms have been used as proxy for audit quality, given that larger audit firms are known with a reputation of upholding and guaranteeing impartial and high-quality audit services (Chinedu et al., 2020). In comparison to smaller audit firms, the financial resources of large audit firms alongside their research facilities, technologies, and ability to attract talented workforce provides a platform for them to have larger client base and higher capacity to resist management pressure; thereby reducing their overall dependency level on a single or

group of clients when necessary. This is not the case for smaller audit (often referred to as non-big 4) firms whose focus is to offer more individualized services due to their smaller client bases which may compel them to give in to management demands where situations abound (Chen et al., 2021).

2.2 Theoretical Framework

2.2.1 Agency Theory

The interaction between the primary (shareholders) and the agents (business manager) was the focus of Jensen and Meckling's (1976) agency theory. The term "agency relationship" refers to a legal arrangement whereby one or more parties (referred to as the principal(s)) appoint another party (referred to as the agent(s)) to carry out specific tasks on their behalf. In order to make decisions on behalf of the principal (the business owner), this entails giving the agent some of their authority. If the agent refuses to follow the principal's instructions when making decisions, the principal may decide to limit deviations from his interest by giving the agent the right incentive and incurring costs for monitoring the agent's activities (Aliyu et al., 2015).

Understanding the role of an auditor in the creation of high-quality reports for the business requires an understanding of the principal-agent relationship as portrayed in agency theory. This is due to the fact that principals rely on their agents to work in their best interests, but information asymmetries between principals and agents lead to principals and agents acting with conflicting goals. In order to build up their agents' trust, principals may not have enough procedures or mechanisms in place. One such tool is the audit. The agency theory is a practical economic theory of accountability that sheds light on how audit quality has evolved generally.

2.3. Empirical Literature

Studies on audit quality, size, independence, tenure, and other topics are widely available. For instance, Egbunike and Abiahu (2017) looked into the audit entity report and operation of Nigerian banks. Data for 2010–2014 was gathered from yearly reports filed by banks in their corresponding databases and websites. The results of the multiple regression analysis led the study's authors to draw the conclusion that, while audit quality has a positive and significant influence on banks' returns on assets (ROA), audit fee and report latency do not appear to have a similarly significant impact on banks' performance indicators (ROA included).

In Nigerian listed manufacturing enterprises from 2006 to 2016, Chinedu et al. (2020) looked at the impact of audit quality on financial performance. Out of the 80 listed manufacturing companies in Nigeria, 24 companies were chosen using the stratified purposive sampling technique. The companies' public yearly financial statements were used to collect secondary data. The data analysis used the Ordinary Least Squares method of regression.

According to the study above, among other things, the independence of the auditor and the size of the firm have a favourable and significant impact on the financial performance of listed manufacturing firms.

For 10 years, from 2009 to 2018, Soyemi et al. (2021) evaluated the impact of audit quality on the financial performance of 40 listed non-financial enterprises in Nigeria. To estimate the model used in this study, ordinary least squares (OLS) was used. These companies' annual reports and audited financial statements were chosen using a stratified selection technique, and secondary data of a panel character were collected from them. Following that, the outcome showed a strong and favourable impact of audit tenure and audit firm size on operating cash-flow. Additionally, there were negligible and favourable correlations between audit fees, audit committee expertise, and operating cash-flow.

3.0 Research Methodology

3.1. Research Design and Sampling Procedure

A cause-and-effect link between correlates was established using the ex-post facto design. The rationale behind this decision was that it made sense given the retrospective nature of our data. All 21 quoted industrial products sector companies registered on the Nigerian Exchange (NGX) as of December 31, 2022 make up the study's population. Nevertheless, using the purposive sample approaches that have been used most frequently in earlier studies (Ezinando and Jeroh, 2017), the study was only limited to ten (10) of the listed industrial products sector enterprises.

3.2. Data and Analytical Procedure

The study made use of secondary source of data contained in the annual financial reports of the companies under investigation. These annual

reports were collected from the Nigerian Exchange with data spanning from 2012 to 2022.

3.3. Model Specification

This study expresses return on asset as a function of auditor's independence, audit-firm size and audit tenure. Accordingly, equation from the regression analysis is predicted as follows:

$ROA = \beta_0 + \beta_1 AUDIND + \beta_2 AUFSZ + \beta_3 AUDTEN + \varepsilon_{it}$ ……. (1);

Where:
ROA = Return on Asset;
AUDIND =Auditor's Independence;
AUFSZ = Audit-Firm Size;
AUDTEN = Audit Tenure;
βo = Intercept or Constant coefficients (the constant term);
β1-β3 = Regression Coefficients;
εit = Schocastic, disturbance error term (noisy variable).

Table 3.3: Operationalization of Variables

S/N	**Type of variable**	**Variable**	**Measurement**	***Apriori Expectation***
1	Dependent	Return on Asset	This is the ratio of net income to total asset.	
2	Independent	Auditor's Independence	This is the ratio of audit fee to the company's revenue	**+Ve**
3	Independent	Audit-Firm Size	A dummy variable, that is coded "1" if the firm is audited by a Big4 and "0" otherwise.	**+Ve**
4	Independent	Audit Tenure	Award number for years spent by audit firm to audit a client's company.	**-Ve**

Source: Authors' Compilation

4.0 Data Analysis

The data analysis covers pre-estimation test (unit root) and estimation of panel least square in order to analyze the effect of audit quality on firm financial performance.

4.1 Test of Unit Root (Stationarity)

The company financial performance variable and each of the audit quality variables under investigation were tested for the presence of unit root (lack of stationarity) using the Phillips-Perron (PP) test in this study. Due to its effectiveness in correcting correlated error through the calculation of the long run variance of the error process, the Phillips-Perron unit root test is chosen.

Comparing the crucial values with the Phillips-Perron t-statistics at the 1%, 5%, and 10% levels of significance is how the unit root test determines the correct answer. If the estimated P-P t-statistics value is greater than the critical value, the null hypothesis that a unit root exists cannot be accepted. If the P-P statistics are lower, the situation is the opposite.

Table 4.1 shows the summary of the results unit root test at levels and at first difference for each of the variables in the study. Premised on this summary of P-P t-statistics, panel least square (OLS) technique is appropriate since stationarity tests of all the variables used are stable at level.

Table 4.1: Summary of Phillps-Perron Unit Root Test

Variable	P-P Statistics	At Level 5% critical value	Prob.	P-P Statistics	At First Difference 5% critical value	Prob.	Stationarity Order
ROA	-8.243907	-2.875330	0.0000	-	-	-	1(0)
AUDIND	-7.941463	-2.875330	0.0000	-	-	-	1(0)
AUFSZ	-4.846440	-2.875330	0.0001	-	-	-	1(0)
AUDTEN	-7.948853	-2.875330	0.0000	-	-	-	1(0)

Source: Researchers' compilation, 2023

4.2: Estimation of Panel Least Square

Table 4.2: Estimation of Panel Least Square Results

Variable	Coefficient	Std. Error	t-Statistic	Prob.
AUFSZ	17.38635	6.047749	2.874842	0.0353
AUDTEN	-13.09796	5.040795	-2.598392	0.0208
AUDIND	14.57533	6.922284	2.105566	0.0160
C	0.597553	1136.735	0.000526	0.9990

R-squared	0.492417	Mean dependent var	11.35737
Adjusted R-squared	0.388119	S.D. dependent var	94.24364
S.E. of regression	73.72004	Akaike info criterion	11.59395
Sum squared resid	1983645.	Schwarz criterion	12.29864
Log likelihood	-2480.466	Hannan-Quinn criter.	11.87192
F-statistic	4.721253	Durbin-Watson stat	1.719337
Prob(F-statistic)	0.000000		

Source: Author's Computation, 2023.

Except for Audit tenure (AUDTEN), it is evident from the estimated model that the independent variables Auditors' Independence (AUDIND) and Audit Size (AUFSZ) in the model show a substantial positive association with the dependent variable ROA (Return on Asset) as shown in Table 4.0. The R^2 value of 0.49 indicates that the model accounts for 49% of the degree of return on asset variation, with the stochastic error term accounting for the remaining 51%. Additionally, while taking into account the importance of the Prob. (F-statistic) value (0.000), the estimated model is statistically significant in its overall evaluation.

The value of the Durbin Watson statistic of 1.719, which is roughly 2, indicates that there is no autocorrelation or serial correlation between the variables. The parameter estimates for the audit size (AUFSZ), audit tenure (AUDIND), and audit independence (AUDIND) variables are consistent with the a priori expectation of a favourable impact on financial performance (proxy ROA). The computed parameters agree with the a priori prediction. The work of Soyemi et al. (2021) and Chinedu et al. (2020) is consistent with this.

Based on the findings of the explanatory factors, AUDIND and Audit Size (AUFSZ) variables are positive and statistically significant at the 5% level of significance with T-Statistics of 2.106 and P-values of 0.016 and 0.035, respectively. This supports the claim that increased auditor independence and larger audit firms lead to higher ROA, hence its cause is predictable. At the 5% level of significance, however, AUDTEN of T-Statistics of -2.598 with P-value of 0.0208 is favourable and statistically significant. The cause of this is not surprising because it is consistent with the claim that a rise in AUDTEN causes a fall in ROA. This suggests that a unit rise in AUDTEN causes a drop in financial performance (ROA) of (-13.098). This is due to the fact that an external auditor's excessive familiarity may open the door to fraudulent operations, which may eventually lower the firm's financial performance.

5. Conclusion and Recommendations

This study looks into how audit quality affected a company's financial performance. The study, therefore, found that the AUDIND and Audit Size (AUFSZ) variables have a positive and statistically significant (at 5% level of significance) effect on ROA, based on the findings presented and discussed in the study. The effect of AUDTEN on ROA is, nevertheless, favourable and statistically significant (at the 5% level of significance). As a result, the study makes the following suggestions.

The country's Financial Reporting Council and other authorities should create policy guidelines to expressly monitor the length of an auditor's tenure in relation to compliance with the legal requirements for financial reporting that are already in place. Regulators should set a minimal standard for the degree of independence for auditors. This will effectively halt auditors' operations. In order to improve audit quality and uphold auditors' integrity, which will operate as a

deterrent to fraudulent actions, the term of external auditors should not be long.

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