

EFFECT OF AUDIT QUALITY ON FIRM PERFORMANCE: A REVIEW OF LITERATURE

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Abstract

The main objective of this paper is to review extant literature on concepts, theories and empirical studies that relate to audit quality and firm performance. The study found different ways of measuring audit quality in literature. This include audit firm size, audit firm rotation, audit opinion, audit fees, audit tenure and auditor independence while firm performance is measured in terms of financial and market performance of the firm. Findings from past studies revealed that audit quality affect firm performance either positively or negatively. Some studies documented positive relationship between certain audit quality proxies and firm performance measures; others show negative relationship between these variables. Also, majority of the works reviewed are outside the Nigerian business environment, even those in Nigeria did not assess the effect of audit quality on performance generally but examined them in terms of either financial performance or market performance. This review therefore suggests a quantitative research into this area to fill the gap in literature.

Keywords: Audit quality, performance, audit firm size, market performance, financial performance.

I. Introduction

The needs for trustworthy and reliable financial statements are imperative for making sustainable decisions in corporate organisations. This is because both current and potential investors, government and all other stakeholders rely on the financial statements for investment decisions and any other contractual relationship with the reporting entity. However, these financial statements are prepared by management and presented to the entire users for their varying needs. The authenticity and reliability of these financial statements is always doubtful and questionable, hence management may manipulate the reports for their personal interests. With regards to lack of confidence in the reported financial statements, the demand for the services of an external auditor becomes necessary to monitor, prevent, detect, and report fraud and other illegal acts and errors if found in the financial reports.

Even with this mechanism in place, there have been cases of failure (Enron scandal of 2001; Parmalat in 2003) of companies whose accounts were audited by external auditors and were certified as been highly solvent and/or liquid when in reality they were not. Owing to these incidences and considering the fact that users of financial statements need reliable financial information on which to base their resource allocation decisions, attention shifted from mere auditing to quality audit with the sole aim of restoring stakeholders' confidence in companies' financial statements. According to Farouk and Hassan (2014), when the providers of finance have confidence and trust in the audited financial statements of an entity, they are motivated to increase their holdings in the organization. This increase in investment in turn leads to better performance hence the need for quality financial reporting.

The onus of achieving quality financial reporting to a large extent lies on the external auditor. Audit quality has become an essential issue in audit practice today because, both internal and external stakeholders have interest in the quality of audited financial reports of entities (IAASB, 2014; Heil, 2012). Conceptually, DeAngelo (1981) defines audit quality (AQ) as the market-assessed joint probability that an auditor discovers a breach in the client's accounting system and is able to report the breach. Researchers have therefore used these two dimensional approaches of audit quality definition to define audit quality. In 2004, the European Supreme Audit Institution (EUROSAI) captured audit quality to include the degree to which a set of inherent characteristics of an audit fulfills its requirements. Many researchers used one or a combination of proxies such as audit tenure, audit fees, audit client importance, litigation effect, audit firm size, audit opinion, expertise and so on to measure audit quality and compare its relationship with firms' performance (Eshitemi, & Omwenga 2016, Farouk and Hassan, 2014).

The increase in corporate failure (Enron scandal of 2001; Parmalat in 2003; Cadbury Nigeria Plc in 2006 and Afriland First Bank Nigeria Plc in 2009) globally has created a need for audit quality in recent times. As vital as financial reports are to its users who rely on them to make economic decisions simply because the auditor has expressed an opinion and assurance on their fairness, the financial distress, bankruptcy and finally the collapse of such organizations that were given a going concern opinion and a healthy status is worrisome and thus questions the

quality of audit performed by the auditors on those financial statements. However, one reoccurring problem in the research on the quality of audit report is that the perceived reliability of audited financial information has declined while the perceived relevance of audited financial information has been on increase. It therefore, becomes imperative for one to question the relevance of audit quality and if audit quality affects the performance of companies.

It is against this background that this paper therefore seeks to undertake an empirical review on the effect of audit quality on firm's performance with a view to identify the existing research gap(s) from past studies for future research.

II. Review of Related Literature

To achieve the objective of this paper, this section reviews extant literature on the effect of audit quality on firm performance. It is structured into the following sub-heads; conceptual framework, theoretical framework and review of empirical studies.

2.1 Conceptual Clarifications

The concepts reviewed in this study are; audit quality, and firm performance.

2.1.1 Audit Quality (AQ)

It is on record that several efforts have been made to conceptualize "audit quality" in the past, however, none has achieved recognition and acceptance on a universal basis (International Auditing and Assurance Standards Board, 2014). The starting point in defining audit quality that is cited by most audit researchers is that of DeAngelo (1981) who defines audit quality as the market-assessed joint probability that an auditor will (i) discover a breach in the client's accounting system and (ii) be able to report the breach. The definition emphasises two important aspects of audit quality viz: the professional competence of the auditor firm that determines the likelihood of detecting misstatement and (b) the independence and objectivity of the auditor that determines the decision about a detected misstatement. Audit quality, in this context, is perceived as a function of both auditor competence and auditor independence. That is, discovering misstatements and reporting them.

Davidson, Stening and Wai (1984) assert that audit quality connotes the accuracy of auditor's information reporting while Wallace (1987) posits that audit quality is a measure of the auditor's capability to minimise bias and diligently improve accounting data. In addition, Davidson and Neu (1993) maintained that, an audit quality definition depends on the auditor's capability to detect and eliminate material manipulations and misstatements in reported profit. All these definitions have given good insight into what audit quality entails.

In another parlance, audit quality is defined with emphasis on the accuracy of the auditor's opinion. Titman and Trueman (1986) opined that, for financial statement information to be reliable and serve the purposes to which they are intended to, high quality audit must be maintained. This enables investors to make more precise estimate of the firm's value in order to take informed decisions. Schauer (2002) also posits that, a higher quality audit increases

the probability that the financial statements reflect the financial position and results of operations of the entity more accurately. Other researchers of audit consider audit quality in the perspective of perceived audit quality and actual audit quality which are two different concepts, because actual audit quality cannot be observed but can be evaluated at the end of an audit exercise. To measure actual audit quality in the public sector, Deis and Giroux (1992) analyzed quality control reviews while Palmrose (1988) measured actual audit quality using auditor's litigation activities. Krishnan and Schauer (2000) measured actual audit quality on compliance of audited financial statements with certain specific GAAP reporting requirements.

In a broader context, factors that moderate audit quality include sound corporate governance; Law and regulation, regulatory oversight and the quality of the applicable financial reporting framework (DeFond & Zhang, 2013). In simple terms, audit quality refers to both the audit firm's attributes, the attributes of the audit team, corporate governance practices and the techniques used in carrying out audit work that result in a perceived satisfaction by different stakeholders. Although, to determine the level of satisfaction by different stakeholders depends largely on their information needs.

Despite the fact that audit quality is no longer a new concept under the scope of auditing, till date it appears to have no measurement construct that is generally agreed upon (Knechel 2009 and IAASB, 2014). Two views on how audit quality should be measured include: By using direct measures like bankruptcy, financial reporting compliance with GAAP, desk review, quality control review and SEC performance. The second perspective is via indirect measures like audit fees, auditor tenure, audit size, industry expertise, economic dependence, reputation and cost of capital.

2.1.2 Firm Performance

The offer of information on a firm's performance is one of the important objectives of the financial statements in order to meet the requirements of a wide range of users in making economic decisions. The financial health of an entity is depicted by its ability to use assets to generate revenue from its operations. To Demsetz and Lehn (1985), firm performance connotes measuring an entity's policies and operations in monetary terms as shown by return on investment, return on assets, value added, among others. In other words, firm performance is the measurement of an entity's worth which is done in two broad ways: accounting measures and market measures of performance. Understanding the overall performance of an entity entails a proper financial statement analysis which according to Mirza and Javed, (2013) is a process of evaluating the relationship between component parts of the financial statements to get a better understanding of the entity's financial position and performance and also the relevance of the company's shares in the market.

An entity's stakeholders (managers, shareholders, creditors, tax authorities, and others) seek to know the financial performance of the firm over a given period of time, its financial position at a given point in time, its cash flows and other relevant information so as to take informed decisions. Afza and Nasir (2014) maintained that, investors believe quality of

external audit improves a firm's performance. They believe that companies that are audited by reputable audit firms are likely to disclose reliable, proper, and authentic information than their counterparts that are audited by small audit firms. This reliable information is capable of wooing investors and customers to the firm leading to better performance which is reflected in the firm's sales growth, increase in profit, investment and share capital.

III. Theoretical Framework

Agency theory, stakeholder theory, auditors' theory of inspired confidence and signaling theory, justify the key function of auditing as a mechanism for reducing information asymmetries among related parties (Gerayli, Yanesari, and Ma'atoofi, 2011). These theories are discussed thus;

3.1 Agency Theory

Agency theory rooted in economic theory and championed by Jensen and Meckling (1976) dominates the auditing, accounting and finance literature. According to Jensen and Meckling (1976), the principal's ability to monitor whether his interest is served or not is highly affected by information asymmetry. This is because, the agents have more information than principals. The principal-agent relationship as captured in agency theory is crucial in understanding the need for an auditor. Principals (shareholders) appoint agents (managers) and bestow decision making authority in them. By so doing, the principals place their trust in their agents to act in their best interests. However, information asymmetries that exist between principals and agents give room for conflict of interest which betrays the trust the principals have on their agents. To re-enforce this trust, mechanisms such as audit quality, need to be put in place. Agency theory therefore, is a useful economic theory of accountability, which helps to explain audit quality.

3.2 Stakeholder Theory

Stakeholder theory as propounded by Freeman (1984) holds that, a firm has varying stakeholders who are interested in the activities of the firm. A Stakeholder is any individual or group of individuals who are affected or can affect the achievement of an entity's objectives. The main assumption of this theory is that, values are necessary and explicitly a part of doing business. It requires firms through their managers to articulate the shared sense of the value they create and what brings its core stakeholders together. It also tasks managers to be certain about how they want to do business, specifically what kind of relationships they want and need to create with their stakeholders to deliver on their purpose.

The proponents of stakeholder theory suggest that managers in organizations have a network of relationships to serve which include suppliers, employees, lenders and other business partners. Therefore, the auditor is obliged to be accountable to these varying stakeholders since they (stakeholders) rely on his opinion on financial statements for their decisions. Stakeholder theory has been praised for overcoming the narrow view that the company's sole purpose is to maximize economic value for shareholders (Eshitemi and Omwenga 2016). Since stakeholders directly or indirectly affect the performance of an organization, audit

quality provides information about how well or not the interest of these stakeholders is represented. Therefore, the decisions made by these stakeholders basing on the quality of audit provided to some great extent affect firm performance.

3.3 Auditors' Theory of Inspired Confidence

Developed in Netherlands by the Limperg Institute in 1985, the theory of inspired confidence recognises the auditor as a confidential agent who derives his function from the need for expert and independent examination as well as the need for an expert judgment supported by the audit work. This theory offers a connection between the users' needs for reliable financial reports and the ability of the audit work to meet those needs. Thus, auditors are required to know that the public expects a low rate of audit failure. Therefore, auditors are required to plan and perform their audit in a manner that will reduce to the barest minimum the risk of undetected material misstatements. The auditor is under obligation to conduct his work in a manner that does not betray his confidence (Limperg Institute, 1985).

The main importance of this theory is that, the duties and responsibilities of the auditors are derived from the confidence and trust that the public bestowed on the success of the audit and the assurance given by the auditor. According to Carmichael (2004), the confidence that the society has in audited financial statements is misplaced when the audit process fails to address the societal expectations giving rise to a loss in the value relevance of even the audit.

IV. Review of Empirical Studies

A lot of researches have been done on the effect of audit quality on firm performance. Some of which are reviewed thus:

Ugwunta, Ugwuanyi and Ngwa (2018) assess the effect of audit quality on share prices in Nigerian oil and gas sector using regression and covariance analyses. Findings show that audit committee composition and auditor type has significant effect on market prices of quoted firms. The covariance analysis suggests that while auditor type, auditor independence, and composition of the audit committee have significant relationship with market price of shares, audit tenure has a negative relationship with the market price per shares. This study is timely but it focused only on aspect of performance hence the need for a study that will study the effect of audit quality on performance generally.

Egbunike and Abiahu, (2017) investigate audit firm report and financial performance of Money Deposit Banks in Nigeria with the aim of determining the effect of audit firm characteristics on financial performance of money deposit banks in Nigeria. The study adopted the ex post facto and correlational research design, with a study population that comprises all money deposit banks in existence as at 2015 financial year end covering a period of 5 years from 2010-2014. The study finds that audit quality has a significant effect on return on assets of Nigerian banks; Audit fee and audit report lag had no significant effect on return on assets, earnings per share and net profit margin of Nigerian banks. This study is also timely but if it had used a combination of both market and financial measure of performance, its result would have either been different or better and more reliable.

Al-Attar (2017) explores the impact of auditing on stock prices of Amman stock market. Impact of audit is indicated in terms of audit quality and its effect on financial performance measured by stock prices. Primary data were collected from finance managers of listed companies of Amman stock market, about audit and its impact on stock prices. Descriptive analysis, factor analysis and structural equation models were implemented to find out the results. It was found that audit has a direct impact on stock prices of firms in Amman stock market while improved audit quality results in improved financial performance of the firms indicated in their stock prices. Al-Attar's study uses questionnaires whereas results obtained from questionnaires are generally not relied upon for the fact that, the questionnaire is highly abused by researchers.

Hua, Hla, and Isa (2016) examine the impact of audit quality and financial reporting standard practices of firms on their financial success in Malaysia. The study Sampled firms listed on Malaysian stock market from the construction sector for the period of 2010 to 2013. Data for the study was collected from published annual reports. Firm's engagement with established audit firm is used as a proxy for audit quality, and return on assets is used as a measure of firm performance. Ordinary Least Square Regression Model was developed to test the relationship between variables of interest in the study. Results of the study reveal that, compliance with financial reporting standard's relevant disclosure requirements and audit quality assurance of the firms are positively and significantly related with financial performance. The study examines audit quality in terms of firm size and financial performance in terms of return on asset and return on equity which is in line with other studies.

Eshitemi and Omwenga (2016) examine the relationship between auditor's independence, size of the audit firm, attributes of the audit team and experience of the auditor and Financial Performance of Listed Parastatals in NSE. Primary data was collected by the use of semi-structured questionnaire. Multiple linear regression analyses were used in the study. Findings reveal a positive relationship between audit quality proxies (audit firm size, independence, qualification of the audit team and auditor's experience) and financial performance measures of Return on Assets (ROA) and Return on Equity (ROE). Despite the claim by the authors to use both primary and secondary data, no part of the work has shown evidence of secondary data usage, only views of respondents were analysed and conclusions drawn from. Also, the use of a non-parametric tool like ANOVA instead of regression would have given a better result since the data used was primary.

Ching, The, San and Hoe (2015) investigate the relationship between audit quality, earnings management, and financial performance of public listed companies in Malaysia during the period of 2008 to 2013 with a total of 100 sampled companies. Data was analysed using multiple regression analyses and the result indicates that high audit quality can contribute to better company financial performance, since large scale audit firms are always perceived to have higher audit quality that can increase the confidence of investors. However, this study used Sobel test to examine the indirect effect of audit quality on financial performance

without any empirical support but rather made conclusions as if it were the direct effect of audit quality on financial performance that were examined.

Sayyar, basiruddin, Rasid and Elhabib (2015) assess the impact of audit quality on firm performance using a sample of 542 listed Malaysian companies, the study uses audit fees and audit firm rotation as proxies for audit quality, return on assets (ROA) and Tobin's Q were used as measures of firm performance. Data was analysed using regression analysis. Results show that audit quality (audit fee and audit firm rotation) is significantly and negatively related to ROA (performance). This study made use of audit fees as a proxy for audit quality which is in line with Egbunike and Abiahu, (2017).

Aryan (2015) examines the relationship between audit committee characteristics, audit firm quality and company's profitability in Jordan. The study made use of 69 companies in the industrial sector for the period 2009-2014. Multiple regression was used to analyze the data, the result reveals a positive relationship between audit committee meeting, audit committee size and company's profitability. No significant relationship was found between audit quality and company's profitability.

Almomani (2015) investigate the impact of external audit quality features on enhancing the quality of accounting profit of listed manufacturing firms at Amman stock exchange. Indicators of quality of audit, audit office size, auditors' fees, period of customer retention, type of auditor's opinion, and the specialization in client's industry, were used to measure audit quality, where continuity of profit was used as proxy variable to express the quality of earnings. Using a sample of 45 firms and data covering the period of 2009-2013, the study adopted a multiple linear regression method from which the results show that auditor's fees has the most significant effect on earning quality and in turn enhances the quality of accounting profits which is a measure of financial performance.

Aledwan, Yaseen, and Alkubisi (2015) examine the impact of audit quality on financial performance of quoted firms in Jordan. The study was descriptive in nature and the correlational and ex-post facto designs were adopted in carrying out the research. Multiple regression analysis using the SPSS (Version 15.0) was employed in analyzing the data and testing the stated hypotheses. The results of their findings show that auditor size and auditor independence have significant impacts on the financial performance of quoted cement firms in Jordan. However, auditor independence has more influence than auditor size on financial performance.

Reza and Quraishi (2015) assess the impact of auditor ethics and auditor independence on share price. The audited financial statements of thirty listed banks and their share prices have been considered in the study while audit report, loan outstanding and loan provision data were used to measure audit quality. Results from findings show that auditors of three banks compromise their independence and ethics by reporting that those banks' financial statements present true and fair view of their financial position rather than reporting the violation, and this violation lowers investors' confidence resulting to low share price. Despite the fact that conclusions were made from the findings, the researchers did not identify any specific model

used to measure the relationship between dependent and independent variables without stating whether it is a review. This might have affected their conclusion because the researchers made conclusions based on the inferences.

Omid, (2015) examines the relationship between qualified audit opinions and earnings management, as measured by discretionary accruals (accounting earnings management) and abnormal production cost (real earnings management), for listed firms on the Tehran Stock Exchange (TSE). Using multiple regressions and sample of 2818 firm-years observations, results show that qualified opinions are related to accounting earnings management but are not related to real earnings management.

Slaheddine (2015) examines the impact of audit quality on earnings quality. The study measured audit quality using the Big 4 and non-big 4 audit firm criteria while earnings quality was measured by the predictability power of time series of earnings for firm financial statement audited by one of the Big 4 auditing firms and those audited by non-Big 4 auditing firms. Based on a sample of 4030 firms-year observations in the French and US market during ten years (2004-2013) and multiple regressions was used as a technique for data analysis, findings show that earnings quality is better when financial statements are audited by one of the Big 4 auditing firms. Nevertheless, earnings quality of US companies is more associated with audit quality than those of French companies. This study is situated in the developed countries where economic activities are more matured than in developing countries and thus create a vacuum for new research to be conducted.

Rahimi, and Amini (2015) examine the relationship between audit quality and profitability in the companies on Tehran's Exchange Market. Auditor size and the audit tenure were used to measure audit quality. The study surveyed a total number of 52 companies accepted in Tehran's securities exchange market. Using correlation analysis, findings show that there is a positive and weak relationship between auditor size and auditor's tenure and the profitability ratios. Also, there is a positive but non-significant relationship between profitability and auditor size, while a positive and significant relationship between audit tenure and profitability was reported.

Santos, Cerqueira, and Brandão (2015) examine Audit Fees, Non-Audit Fees and Corporate Performance in United States of America (USA). The study obtains data from Thomson Data Stream which comprise of 416 companies and covers the period of 2002 to 2014. Using least square regression, findings show a significant negative relationship between corporate performance variables of Tobin's Q, EP, ROA and ROE and non-audit fees, suggesting that the increase (decrease) in corporate performance is related to the decrease (increase) in non-audit fees. The research demonstrates an interaction between corporate performance measure and audit quality surrogates (audit fees and non-audit fees) but fail to incorporate the ratios that analyse the performance of the stock in the market which have created a gap to be filled in literature.

Okolie (2014) investigates audit firm size and market price per share of quoted companies in Nigeria with the aim to ascertain the influence which audit firm exerts on the market value

per share of companies in Nigeria. With a sample of 342 companies – year observations from the NSE and applying audit firm size as a measure, comprehensive multivariate analyses were conducted on archival data covering 2006 to 2011. The result shows that audit firm size has a significant relationship and significantly influences market price per share of the companies in the sample.

V. Summary and Suggestion for Further Research

The quality of audit is critical for making informed economic decisions but the perceived reliability of audit quality has declined amidst increased relevance of audit quality. To this end, the study reviewed extant literature on the effect of audit quality on firm performance. Various proxies for measuring audit quality such as audit size, audit tenure, audit fees, client's importance, the provision of non-audit services, audit firm experience, communication between the audit team and client's management, the audit partner's knowledge of the client's industry, auditor independence among others were identified. Also, the concept of firm performance and its measures are discussed in this paper. The most notable of these performance measures relating to financial performance include; return on assets (ROA), return on equity (ROE) and profit margin (PM) while those relating to market performance include market price per share (MPS) and Tobin's Q. The empirical studies reviewed show similar view on the relationship between audit quality and market performance but also a mixed view among other audit quality proxies and financial performance measures. Also, some of the studies used fewer or single audit quality measures making it difficult to generalize conclusions. More so, majority of the works are outside the Nigerian business environment, even those in Nigeria did not ponder directly on the effect of audit quality on firm performance generally but either on financial performance or market performance. With respect to these problems, this study therefore suggests a quantitative investigation into the effect of audit quality and firm performance especially in emerging economies such as Nigeria.

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