CORPORATE GOVERNANCE AND AUDIT QUALITY

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Abstract

The study aims to examine the relationship between corporate governance and audit quality. The study used correlational and ex post facto research design. The population consists of all fifty-eight (58) insurance companies licensed to operate in Nigeria as of December 2023. Twenty-one (21) insurance companies were included in the study's sample using the purposive sampling technique. The audit firm type and audit fees were used as proxies for audit quality. The study revealed that board size, board independence, and board gender diversity improved audit quality. However, it was discovered that audit committee size had a negative effect on audit quality. According to the study, companies should prioritize maintaining or increasing board independence because it can improve the quality of audits. Companies should also recognize the potential benefits of having a more diverse representation of gender on their boards.

Keywords: Audit Quality, Corporate governance, Board size, Board gender diversity, Audit committee size, Board independence.

JEL Classification: G34, M42

1. INTRODUCTION

To handle the inherent conflicts of interest inside the company or corporate structure, stakeholders have created a set of processes, principles, rules, and a thorough definition of roles and duties that make up corporate governance. (Legal Information Institute, Cornell Law School, 2022). Corporate governance is simply a collection of guidelines, norms, and rules that control a company's administration and course. The Cadbury Report (1992) defined corporate governance as a framework for overseeing and directing organizations. The corporate governance system defines the roles, responsibilities, and obligations of a business, including

those of the board, management, and shareholders. One of its most crucial features is that corporate governance has a significant impact on the caliber of audits.

Omoye and Aronmwan (2013) described auditing as the process of verifying accounting data, such as financial statements, to ensure transparency and dependability. It involves an unbiased third party investigating to provide a report on the objectivity and fairness of the financial reports. Audit quality is the process by which an audit firm exposes material misstatements and mistakes in a company's financial transactions. The process includes planning, execution, and release of an audit opinion (Detzen & Gold, 2021; Wakil, Alifiah, & Teru 2020). According to Adams and Ferreira (2009) and Mallin (2013), efficient corporate governance is crucial for safeguarding the integrity of financial statements, ensuring responsibility to shareholders, and fostering sustainable organizational success. It provides a framework of principles and guidelines to manage businesses, reduce conflicts of interest, and promote transparency. Audit quality is determined by factors such as the efficiency of the external audit procedure (Bédard & Gendron, 2010; Hermalin & Weisbach, 2012).

Many nations, including Nigeria, have implemented corporate governance rules and legislation to address these issues and support good corporate governance practices (Mallin, 2016). The Nigerian Stock Exchange (2018) reports that changes were made to the Nigerian Corporate Governance Code in 2018 with the intention of improving moral behavior, accountability, and transparency in Nigerian businesses. It offers standards for stakeholder engagement, board supervision, leadership, and responsibility in businesses, all with the goal of improving corporate governance in Nigeria and fostering sustainable economic growth. Numerous studies have examined the link between corporate governance procedures and audit quality; this is demonstrated by the work of Soyemi et al. (2017), Aribaba and Ahmodu (2017), and Soyemi (2020), and their findings have been contradictory. This study aims to understand how factors like audit committee size, gender diversity, board independence, and board size affect audit quality, using audit fee and firm size as proxies for audit quality. The study will also examine the 2018 Nigerian corporate governance code's application and efficacy in response to company failures and international best practices.

Thus, this study will further corporate governance standards in Nigeria and foster a climate of business that is more open, moral, and responsible.

2. LITERATURE REVIEW

2.1. AUDIT QUALITY

An audit is a thorough study of a company's financial accounts to ensure that they are fair and accurate (PANE, 2021). Financial audits are increasingly necessary to ensure the integrity and accuracy of financial records, as well as to detect and prevent fraud (PANE, 2021). DeAngelo (1981) defined audit quality as the market evaluation of the auditor's likelihood of identifying material misstatements in the financial statements or the employer's accounting system and reporting those

misstatements to the appropriate authorities. The characteristics of detection show the auditor's skill, but their reports really highlight their independence, ethics, and honesty. The likelihood that there are no material misstatements in the financial accounts is known as the integrity of an audit report, and it raises the standard of audit reports (IFAC, 2009).

2.2. MEASUREMENT OF AUDIT QUALITY

Research on audit quality metrics has been extensive, with studies examining variables such as audit fee, auditor tenure, audit firm type, and auditor reputation. The Big 4 firms, such as Deloitte, KPMG, EY, and PwC, are renowned for their reputation, resources, and experience, leading to higher standards of audit delivery (Giroux & Jones, 2011). Benefits of engaging a Big 4 auditor include substantial investments in recruiting and retaining skilled professionals, maintaining rigorous quality control processes, and developing specialized industry knowledge (Gunn et al., 2019). Their larger client base exposes them to complex financial reporting requirements and regulatory environments, further contributing to their perceived expertise. The size of an accounting company can also determine audit quality, as larger firms are less reliant on any one client and offer better services (Al-Gammal, 2012). Research has shown that audit quality is often greater at Big 4 corporations than at non-Big 4 enterprises, with evidence of improved operational performance and better caliber audit reports (DeAngelo, 1981; Dopuch & Simunic 1980). Audit fees are the sums paid by an auditor to conduct an audit, which can vary depending on factors such as expertise, risk, intricacy of services, and the size of the business being audited (Stergiou, 2013).

2.3. CORPORATE GOVERNANCE

Establishing the links between corporate organizations and other stakeholders is a crucial function of corporate governance in modern business practices. Although there is not a single, accepted definition of corporate governance, many authors and experts have attempted to explain the idea from various angles, emphasizing its complexity. The Cadbury Committee states that corporate governance is predicated on a fundamental concept that aids companies in balancing their authority and accountability to shareholders and stakeholders (Soyemi, 2020; Hermawan et al., 2022).

Tricker (2022) highlights that corporate governance is essential in demonstrating trust, wielding power, and attaining accountability within corporate entities, all to benefit their members, stakeholders, and society. Obeten et al. (2014) defines corporate governance as the process of managing an organization's affairs in a balanced way by putting the values of accountability, transparency, and integrity to use. According to Oso and Semiu (2012), objectivity, dependability, trust, verifiability, responsibility, stakeholder welfare, ethics, quality management, honesty, respect for one another, and commitment to the company are crucial elements of corporate governance.

2.3.1. BOARD SIZE

Board size is the total number of directors on a company's board at any given time, and it is a significant factor influencing its effectiveness (Khudhair et al., 2019). The Cadbury Committee recommends a board with eight to ten members, equally divided between executive and non-executive directors. The 2014 CBN legislation sets a maximum limit of twenty directors, while the 2008 PENCOM regulation, the 2011 SEC code, and other corporate governance frameworks do not restrict the number of directors for pension operator companies. The 2009 NAICOM rule requires at least seven directors for insurance, reinsurance, and loss-adjusting organizations. The 2011 SEC code revision eliminated this restriction, mandating a minimum of five directors. A balance between executive and non-executive directors is necessary on the board. Research has found a positive link between board size and audit quality, but some argue that board size negatively impacts audit quality (Ejeabasi et al., 2015; Akhidime, 2015). The administration of a company depends on the board's organizational architecture being effective, and board sizes vary across nations due to cultural differences (Mustafa et al., 2017).

2.3.2. AUDIT COMMITTEE

The audit committee is a crucial part of corporate governance, overseeing a company's reporting procedures, audit procedures, and audit-related duties (DeZoort et al. 2017). Its primary role is to ensure the reliability and accuracy of financial statements. Menon and Williams (2016) emphasize that the committee acts as a mediator between management and outside auditors, ensuring moral business practices and improving transparency of financial reporting. In Nigeria, the FRCN Act of 2011 mandates every publicly traded firm to have an audit committee (Rainsbury et al., 2017; Braiotta et al. 2019). The committee is responsible for selecting outside auditors, setting fees, and ensuring accurate financial statements. The committee must be composed of an equal number of directors and shareholder representatives, as well as one individual with financial accounting or similar management accounting knowledge and abilities. According to Ofoegbu and Okoye (2016), the quality of audits is influenced by the independence and effectiveness of audit committees. An effective committee reduces the risk of audit failure and enhances audit quality.

2.3.3. BOARD GENDER DIVERSITY

Board diversity refers to the inclusion of individuals with diverse experiences, backgrounds, and personal qualities on a board of directors (Wang, 2015). This diversity is essential for improving corporate governance practices and encouraging better decision-making and creativity. The ideal board according to Sirnidi, Gul, and Tsai (2011), should include individuals with varying genders, ages, professional and educational backgrounds, industry knowledge, and nationality.

Diverse groups behave differently from homogenous ones, encouraging cognitive conflict and cohesion, leading to unbiased and improved decisions (Campbell & Minguez-Vera, 2008; Mustafa, et al., 2017). Female directors are more

dedicated to their governance roles, holding more frequent meetings and adhering to attendance mandates, which can enhance the detection and prevention of fraud and irregularities in financial statement preparation (Sonnenfeld, 2002; Adams & Ferreira, 2009).

2.3.4. BOARD INDEPENDENCE

According to Makani et al. (2012), independent directors are individuals who are not connected to the organization's upper management and have no familial relationships with executives. Independent directors hold less than 0.1% of the stock owned by shareholders and must not have a previous employment history or maintain any business or professional relationships with the organization (Aifuwa & Embele, 2019). Their main goal is to lower agency costs by supervising management activities that maximize shareholder wealth. Non-executive directors are recognized for their extensive engagement with diverse stakeholder groups. Having more independent members on a board can improve oversight effectiveness and provide more trustworthy financial statements (Hu & Loh, 2018; Ong, 2016). However, there are contradictions in the importance of independent directors, with some arguing that internal directors may add more to a firm due to their specific knowledge and skills, while others believe external directors perform better in increasing shareholder wealth (Ahmed & Che-Ahmad, 2016; Patelli & Prencipe, 2007; Akhidime, 2015). The percentage of independent board members is a crucial metric for determining board independence.

3. METHODOLOGY

This study employed an ex-post facto and correlational research approach. Ex post facto research design is a comprehensive, objective scientific study in which the researcher does not influence or alter the independent variables because the case being studied already exists or has occurred, in contrast to correlational design, which illustrates the relationships between independent and dependent variables.

All fifty-eight (58) insurance businesses that have licenses to operate in Nigeria as of December 2023 make up the study's population. The study's sample size is limited to twenty-one (21) insurance companies which were purposively chosen. The data was obtained from the NGX website. The required information was obtained from the yearly reports of insurance companies filed with the Nigerian Exchange Group. Both a probit model and an ordinary least squares regression model were used to analyze the data in this investigation. Diagnostic tests were then run, including the Ramsey RESET test for model specification and the Breusch-Godfrey serial correlation test for autocorrelation.

Following the framework, the study's model was adapted from the works of Saidu and Aifuwa (2020). Their model is specified below:

$$AUDQ = f(BIND, FGNB, BSZE, AUDIND, FSZE) \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots \quad (1)$$

In econometric form:

$$AUDQit = \beta0 + \beta1BINDit + \beta2FGNBit + \beta3BSZEit + \beta4AUDINDit + \beta5FSZEit + \varepsilon it \quad (2)$$

Using corporate governance variables like board size, board independence, audit committee size, and board gender diversity, along with principal component analysis on audit fee, audit firm size for audit quality, the study modifies its model in multiple ways. Considering this, the functional form of the modified model for this investigation is given below.

$$BIG4_{it} = f\,(BSIZ, BIND, BGD, ACS) \quad (3)$$

$$AUDFEE_{it} = f\,(BSIZ, BIND, BGD, ACS) \quad (4)$$

In its econometric version, the functional model mentioned above is represented as follows:

$$BIG4_{it} = \beta_0 + \beta_1 BSIZ_{it} + \beta_2 BIND_{it} + \beta_3 BGD_{it} + \beta_4 ACS_{it} + \varepsilon \quad (5)$$

$$AUDFEE_{it} = \beta_0 + \beta_1 BSIZ_{it} + \beta_2 BIND_{it} + \beta_3 BGD_{it} + \beta_4 ACS_{it} + \varepsilon \quad (6)$$

Where:

ε = Error term

i = Sampled population

t = Year/timeframe

$\beta_0 - \beta_4$ = Variable Coefficient

Dependent Variable

BIG4= Big 4 and non-big 4 firms

AUDFEE= Audit fee

Independent Variables

BSIZ = Board Size

BIND = Board Independence

BDIV = Board Gender Diversity

ACS = Audit Committee Size

Apriori Expectation $\beta_1, \beta_2, \beta_3, \beta_4 > 0$

4. FINDINGS AND DISCUSSIONS

4.1 DESCRIPTIVE STATISTICS

	ADQ	BSIZ	BIND	BGD	ACS
Mean	0.674603	9.031746	0.591277	0.202477	4.873016
Median	1.000000	9.000000	0.591667	0.166667	5.000000
Maximum	1.000000	18.00000	0.875000	0.500000	7.000000
Minimum	0.000000	3.000000	0.285714	0.000000	0.000000
Std. Dev.	0.470393	2.516939	0.127553	0.118588	1.277398
Skewness	-0.745335	0.517124	-0.306512	0.350164	-0.755415

Kurtosis	1.555524	3.838064	2.776431	2.314960	3.569711
Jarque-Bera	22.62018	9.303101	2.235357	5.038631	13.68769
Probability	0.000012	0.009547	0.327038	0.080515	0.001066

Source: Researchers Compilation (2024)

The audit quality score in the sample was 0.675, indicating a good result with most instances close to one. The distribution of ADQ values is left-skewed, with a skewness coefficient of -0.745, suggesting higher values. However, a smaller subset of observations with lower values has a leftward skew, indicating a higher level of audit quality. The distribution of board independence has a mean value of 0.51, indicating moderate independence. The variable is negatively skewed, with a skewness value of -0.30 and a slightly platykurtic curve. Skewness is significant in risk assessment and decision-making, as it signifies potential outliers or atypical occurrences in the lower tail of the distribution. The average board size was determined to be 9.03, with a standard deviation of 2.5 and a kurtosis value of 3.83.

4.2 CORRELATION RESULT

	ADQ	BSIZ	BIND	BGD	ACS
ADQ	1.000000				
BSIZ	0.029066	1.000000			
	0.7466	-----			
BIND	0.295480	0.193694	1.000000		
	0.0008	0.0298	-----		
BGD	0.082840	-0.356210	-0.271357	1.000000	
	0.3564	0.0000	0.0021	-----	
ACS	-0.016061	0.187881	0.355270	-0.103512	1.000000
	0.8583	0.0351	0.0000	0.2487	-----

Source: Researchers Compilation (2024)

ADQ and BSIZ show a small positive connection (0.029). This shows that there is little or no linear link between audit quality and board size. The correlation is zero, suggesting that changes in one variable do not have a significant linear influence on the other.

ADQ and BIND show a slight positive connection (0.295). This points to a minor positive linear link between audit quality and board independence. However,

the connection remains minimal, suggesting that other factors may impact audit quality.

ADQ and BGD show a small positive connection (0.083). This implies a minimally favorable linear link between audit quality and board gender diversity. The effect, like the other associations, is not substantial.

ADQ and ACS show a weak negative connection (-0.016). This is a very weak negative linear relationship between audit quality and audit committee size; however, the correlation is close to zero, indicating a weak association.

4.3 REGRESSION ANALYSIS

REGRESSION RESULT: PROBIT MODEL

Variable	Coefficient	Std. Error	z-Statistic	Prob.
C	-2.163274	0.933471	-2.317453	0.0205
BSIZ	0.034740	0.052676	0.659509	0.5096
BIND	4.808979	1.240549	3.876492	0.0001
BGD	2.503076	1.195964	2.092935	0.0364
ACS	-0.200089	0.117157	-1.707866	0.0877

McFadden R-squared	0.119364	Mean dependent var	0.674603
S.D. dependent var	0.470393	S.E. of regression	0.448349
Akaike info criterion	1.190500	Sum squared resid	24.32299
Schwarz criterion	1.303051	Log likelihood	-70.00148
Hannan-Quinn criter.	1.236226	Deviance	140.0030
Restr. deviance	158.9794	Restr. log likelihood	-79.48971
LR statistic	18.97646	Avg. log likelihood	-0.555567
Prob (LR statistic)	0.000794		

Source: EViews

Based on the regression analysis, the board size positively affects audit quality, as indicated by the positive coefficient value of 0.034. Thus, it was found to be statistically insignificant. Board independence was found to have a positive

impact on audit quality (4.80) and this impact was found to be statistically significant. Board Gender Diversity (BGD) has a positive and statistically significant coefficient (p-value < 0.05), with a value of 2.503076. This suggests that a higher likelihood of improved audit quality is favorably connected with a greater representation of gender diversity on board. The Audit Committee Size (ACS) coefficient was -0.200089. It was determined that the variable lacked statistical significance (p-value > 0.05). This suggests that there may be a connection between some outcomes and larger audit sizes.

MODEL 2: REGRESSION RESULT

Dependent Variable: LOG(AUDFEE)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	15.90699	0.408633	38.92736	0.0000
ACS	-0.051374	0.040374	-1.272446	0.2060
BGD	1.412531	0.470101	3.004742	0.0033
BIND	1.009518	0.403841	2.499791	0.0139
BSIZ	0.012827	0.021584	0.594293	0.5536
AR (1)	0.738821	0.065834	11.22252	0.0000

R-squared	0.568840	Mean dependent var	16.64458
Adjusted R-squared	0.548692	S.D. dependent var	0.658055
S.E. of regression	0.442078	Akaike info criterion	1.256974
Sum squared resid	20.91132	Schwarz criterion	1.401791
Log likelihood	-65.01906	Hannan-Quinn criter.	1.315740
F-statistic	28.23356	Durbin-Watson stat	2.123516
Prob(F-statistic)	0.000000		

Inverted AR Roots	.74

Source: EViews

The model's regression analysis where the audit fee was utilized as a gauge of audit quality is shown in the result above. Based on the results, it was found that the audit committee have a negative (-0.051) and insignificant impact on audit quality. It was discovered that board gender had a positive and significant effect on audit quality. When measured in terms of audit fees, board independence was found to have a positive and significant impact on audit quality. The board size was found to have a positive but insignificant effect on audit quality. The model is jointly statistically significant at the 5% level of significance, according to the F-statistics, which assesses the overall significance of the model. This value was 28.2 with a probability value of 0.00. There is no autocorrelation in the model, as indicated by the Durbin-Watson statistics, which measure its existence, which had a value of 2.12.

5. SUMMARY OF FINDINGS

1. Using the big four audit and audit fees as a proxy for audit quality, it was discovered that board size positively correlated with audit quality. However, when evaluated at the 5% level of significance, it was not statistically significant. This result is consistent with that of Aribaba and Ahmodu (2017).
2. Using the big four audit and audit fee as stand-ins for audit quality, it was discovered that board independence positively affected audit quality. At the 5% level of significance, this variable was shown to be statistically significant. This result differs from that of Al-Najjar (2018) but is consistent with that of Rose and Terry (2000).
3. Board Gender Diversity (BGD) positively impacts audit quality, as measured by the big four audits and audit fees. This shows that a higher chance of increased audit quality is associated with more gender diversity on board. This conclusion is similar with the findings of Chandren and Ahmad (2018).
4. The study found that Audit Committee Size (ACS) had a negative impact on audit quality, using the big four audits and audit fees as indicators. At 5%, it was concluded that the variable was not statistically significant. This result differs from that of Lennox et al. (2019) but is consistent with Knechel's (2020) findings.

5.1 CONCLUSION

Overall, the study's findings indicate a link between better audit quality and other characteristics of corporate governance, such as board independence and gender diversity. However, it does not appear that the size of the audit committee or board has a major influence on audit quality. Nonetheless, it is critical to consider the research limitations as well as the specific situations under which these findings apply.

5.2 RECOMMENDATION

1. Further study on the relationship between board size and audit quality is recommended in view of the lack of statistical significance. To have a more thorough grasp of the possible influence of board size on audit quality, this undertaking could need collecting a bigger dataset or using different approaches.

2. The investigation identified a favorable correlation between audit quality and board independence. Given empirical evidence that shows a positive and statistically significant relationship between board independence and audit quality, firms should prioritize preserving or improving board independence since it can improve audit quality.

3. The study found a positive relationship between board gender diversity and audit quality, indicating that higher levels of diversity on board lead to higher quality audits. Organizations must recognize the potential benefits of having gender diversity on their boards. This acknowledgment should go beyond justice and inclusion since gender diversity has been found to improve audit quality. The development and facilitation of gender diversity on boards has the potential to improve audit findings.

4. The data suggests a negative link between audit committee size and audit quality. It is important to note that this link was not statistically significant at the customary 5% level. Therefore, it is advised that corporations examine the size of their audit committees even in the absence of statistically significant outcomes. The size of a committee does not necessarily correlate with the quality of its audit. To assess if the audit committee is effective in managing the audit process, it is necessary to conduct a thorough evaluation of its functions and organization structure.

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