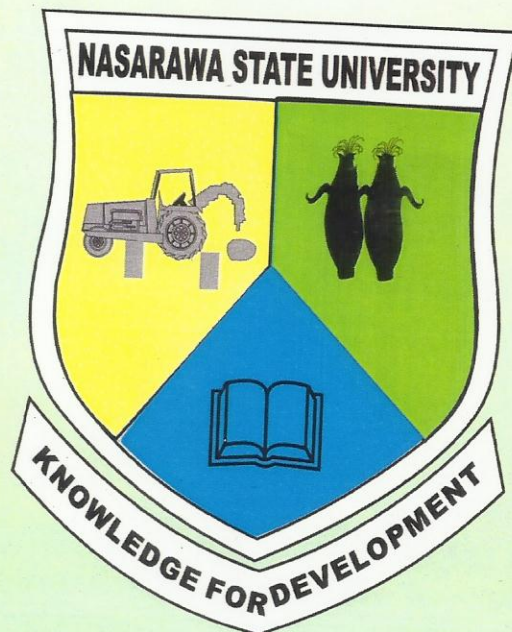


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CORPORATE GOVERNANCE AND AUDIT QUALITY OF QUOTED COMPANIES: EVIDENCE FROM NIGERIA

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Abstract

This study examined corporate governance and audit quality in Nigeria. Specifically it examined board diligence, managerial ownership and audit quality of Nigerian quoted companies. The ex-post facto research design was adopted in the methodology of the study. The population consists of all quoted companies in the Nigerian Stock Exchange; a sample of 25 companies was examined for the period 2007-2012 financial year using secondary data from annual reports of the sampled companies were used for the study. The data analysis technique used is Panel Estimated Generalized Least Squares (EGLS) regression with fixed effect. The study found that board diligence enhances audit quality and was statistically insignificant while managerial ownership determine audit quality and is significant. It is recommended that the 'corporate governance code of best practices of 2010 should be re-evaluated and frequency of board meeting increased statutorily so as to enhance top management monitoring process.

Keywords: Board diligence, managerial ownership, audit quality

Introduction

The collapse of quoted companies both in financial and non-financial sectors shortly after the audit report has continued to raise the concern of professionals and members of the general public in Nigeria and the world at large (Osamwonyi and Ogbeide, 2015). It has brought the need to strengthen the corporate governance structure of quoted companies with a view to enhancing audit quality in the financial reporting process. Basically, audit quality is enhanced through the effectiveness, objectivity and independence of the statutory auditors appointed by the corporate board of directors to audit the annual report prepared based on particular accounting standards and legal frameworks. Good corporate governance by board of directors is recognized

to influence the quality of financial reporting which in turn has an important impact on investors' confidence (Levitt, 1998; 2000). The quality of financial reporting is a function of audit quality which has the capacity to influence the investors' confidence. According to Adeyemi and Fagbemi (2010), the search for mechanisms to ensure reliable high quality financial reporting has largely focused on the structure of audit quality. They noted that the auditing profession has been proactive in attempting to improve audit quality by issuing standards that focus on discovery and independence. There is no doubt that user of financial statements perception of audit quality is linked to an effective audit quality. This is premised on the fact that investors' assessment of and confidence on the annual financial statements remains thwarted if thorough auditing is not done to provide the needed assurance geared towards encouraging investments.

Audit quality is becoming an issue of emphasis due to the major role of an audit in enhancing the quality and reliability of financial statement (Zureigat, 2011). Studies on audit quality and corporate governance mechanisms have captured the attention and imagination of researches especially in developed countries. This is unlike developing countries such as Nigeria where the study is yet to gain ascendancy in the empirical fronts. Corporate governance indicators that tend to affect audit quality have captured the attention of previous researchers like Carcello et al (1992); Lennox (1999); Li & Lin (2005); Knechel and Vanstraelen (2007); Atoeijeri and Annataabi, (2008); Chi et al (2009) and a host of others. However, the impact of the corporate governance mechanisms on audit quality has remained inconclusive. For instance, empirical researches remain inconclusive on the degree of effectiveness of board and the inclusion of outside direction on audit quality, and in the context of Nigeria, corporate governance in relation to audit quality has been a subject of some researches (Chukwunedo & Ogochukwu, 2014). Enofe, Mgbame, Aderin and Ehi-Oshio (2013) in Nigeria found an inverse relationship between directors' ownership and audit quality. In a related study, Chukwunedo and Ogochukwu (2014) ascertained that board diligence, proxied as frequency of board meeting was not linearly related to audit quality. Yatimi, Kent and Clarkson (2006) ascertained negative association between board of directors' diligence and audit quality. Shwu-jen, Yenn-ching and Yi-mien (2003), empirical study indicates that managerial ownership and audit quality are inversely associated. Against this back drop, this paper examines corporate governance and audit quality of quoted firms in Nigeria.

Review of Related Literature

Empirical Literature on Audit Quality

Audit quality and the measurement of audit quality have been studied widely. Kilgore (2007) indicated that a single generally accepted definition of audit quality has not emerged, nor has any single generally accepted measure been introduced. Reisch (2000) attributed the absence of a single measure of audit quality to the fact that it is a multidimensional latent construct and is therefore, somewhat difficult to measure. This was a reason that many researchers studied this area and have used different proxies for measuring the level of audit quality. Manry, Mock and Turner (2008) used estimated discretionary accruals to measure audit quality. Knechel and

Vanstraelan (2007) used the likelihood of an auditor issuing a going concern opinion as an indicator of audit quality. Li and Lin (2005) examined audit quality using non-audit fees. Chen, Sun and Wu (2010) used the propensity to issue modified audit opinion as a proxy for audit quality. Kilgore (2007) indicated that the most commonly used surrogate for audit quality is the size of the audit firm. Chang, Gygax, Oon and Zhang (2008) agreed because of the wide range of theoretical and empirical evidence that large audit firms may provide higher quality audits. DeAngelo (1981) proposed that the larger audit firms receive fee premiums because they have a greater reputation at stake and that reputation, together with their more substantial clients' base, provides them with the incentive to be more independent, leading to a higher level of audit quality. Gearemynck, Meulen, and Willeken (2008) indicated that audit quality is affected by expected future losses of audit firms, which trigger increased audit quality as they get larger. Furthermore, many studies found an evidence that clients audited by larger audit firms disclose more information voluntarily (Depoers, 2000; Chau, & Gray, 2002). Simunic and Stein (1987) asserted that larger audit firms are better than smaller audit firms at detecting errors because they have greater resources at their disposal and can attract employees with superior skills and experience. Despite the findings of some studies that have not supported the audit firm and audit quality association (simunic, 1980; Myer, White, & Janson, 1988), the weight of evidence supporting the association between audit quality and audit firm size is now generally accepted as norm when reviewing the audit quality literature (DeAngelo, 1981; Krishnan, & Schauer, 2000; Kim, Chung, & Firth, 2003; Kane, & Velury, 2004). Therefore, this research will base its empirical analysis on the premise that the auditor size is a surrogate for audit quality. Factors affecting the level of audit quality vary, many researches who have studied these factors have done so in order to support audit quality literature. A wide range of these studies were focused on variables related to the audit profession, auditors and audit firms. Other proxies used empirically encompass audit industry specialization (Beasley & Petroni, 2001), the amount of paid fees (O. Sullivan, 2000; Abbott, Parker, Peters & Raghunandan, 2003; Yatim, Kent & Clarson, 2006; Hay, Knechel, & Ling, 2008).

Board Diligence and Audit quality

Based on the work of DeZoort, Hermanson, Archambeault, and Reed (2002), the diligence of the directors' board within the Nigerian context is considered in relation to audit quality. They suggest that meetings are a good proxy of diligence. Board meetings give an idea about the time directors spend monitoring managerial performance (Adams, (2003) and to improve the effectiveness of the board (Lipton & Lorsch, 1992; Conger, Finegold, & Lawler, 1998). When boards hold frequent meetings, they spend more time monitoring top management and remain informed about the firm's situation and its sector's perspective, which ultimately make them more reactive in the decision-process (Abbott et al., 2003). Some researchers argue that boards that meet frequently are more often likely to perform their duties diligently (Byrne, 1996). Some other studies found an opposite relationship. For example, Carcello et al. (2002) found that board diligence is associated with higher fees in USA. They argued that a more diligent board of directors in carrying out its responsibilities requires a heightened level of monitoring process

regarding financial information and therefore requires a high level of external audit quality. More recently, Krishnan and Visvanathan (2009) showed that the two variables measuring the activity of the board of directors and audit committee (number of meetings conducted annually by the board and by the audit committee) are significant and associated positively with audit fees. However, in the Malaysian context, the result of Yatim et al. (2006) indicated that board diligence is not significantly associated with audit fees. This can be explained by the fact that the number of meetings is a bad proxy for the board activity since it does not indicate the effective work done by the members during their meetings (Menon & Williams, 1994).

Managerial Ownership and Audit Quality

The need to safeguard shareholders' interest and achieve goal congruence, often result to managers having investment in a company. It is one of the bases of reducing agency costs. Haugen and Senbet (1998) argued that monitoring and contractual constraints are always to reduce agency costs; but increase in managerial holdings of common stock is even more helpful in alleviating agency problems. Consequently, managerial ownership acts as a factor that limit management's manipulation of accounting numbers (Shwu-Jen, Yann-ching & Yi-Mien, 2003).

Holthausen and Verrechia (1988) posited that market reacts more to information of higher quality. Shwu-Jen, Yann-Ching and Yi-mien (2003), however were of the view that managerial ownership and audit quality are correlated to affect the quality of the reported accounting numbers. They noted that managerial ownership is an addition at source of information for investors. Kim and Lyn (1988) defined managerial ownership of over 25% as high insider ownership firms and less than 5% as low insider ownership firms. Lenox (2005) investigated the relation between audit quality and management ownership in the United Kingdom. He found a negative correlation between shares held by managers and audit quality. There is a considerable literature devoted to understanding the impact of managerial ownership on audit quality (e.g. Shwu-Jen, Yann-Chang and Yimien, 2003; Haugen and Senbet, 1987; Kim and Lyn, 1988). In those literatures, greater managerial ownership benefits shareholders because it increases managers' incentives to increase firm value and audit quality. But when managerial ownership becomes too large, it enables managers to entrench themselves so that firms value falls as managerial ownership increases beyond a certain point; and consequently the audit quality, owing to the inability to really monitor the top management. Mixed empirical evidence exists in literature study in link between managerial ownership and share price. The findings from this study are at variance with Lenox (2005) which investigated the relation between audit quality and managerial ownership in the United Kingdom and found a negative correlation. It is however in tandem with Shwu-Jen, Yann-Chung and Yi-Mien (2003) where they expressed their view based on empirical estimates that managerial ownership and audit quality are correlated to affect the quality of the reported accounting numbers.

METHODOLOGY

The study seeks to employ longitudinal and ex-post facto research designs. The population of the study consists of all the quoted companies on the Nigerian Stock Exchange. The study necessitated secondary data which covers 2007-2012 sample periods. A sample size of twenty five (25) companies was selected using the convenience sampling technique.

The model

The model employ in this study is based on the studies of Gana and Lajmi (2011) and Zuriegat (2011). To determine the empirical relationship between corporate governance and audit quality in this study, the following model was stated in stochastic form as:

$$AQ_{it} = \beta_0 + \beta_1 BDI_{it} + \beta_2 MGO_{it} + e_{it} \dots \dots \dots (1)$$

Where:

AQ_{it} = audit Quality.

$\beta_1 - \beta_2$ =Coefficient of the independent variables.

Mgo = Managerial ownership

Bdi =Board diligence. β_0 is the intercept while e_{it} is the error term. Apriori expectation in this study is of the form: β_1 and $\beta_2 > 0$

Given the measure of audit quality within the ontext of this study, it is expected that empirical substantiation would be made with a view to contributing to knowledge. Employing the econometric package of E-views version 7.0, the pooled and panel data estimates of the multiple regression models shall be obtained after some preliminary statistical analysis such as descriptive statistics and correlation matrix. The model is a linear regression model whose dependent variable is metric. Hausman testshall also be performed to determine preference for the choice of either the random or fixed effect. The above apriori signs connote that the explanatory variables were expected to significantly and positively influence the audit quality of the selected companies in the period under consideration.

Operationalization of Variables

Variables	Types of Variable	Operationalization
AQ	Dependent	This is operationalized using the amount of fees paid to external auditors
Board diligence	Independent	Using the frequency of meetings held by the directors

in a year.

Managerial ownership

Independent

Using the number of shares held by managers divided by the total shares in the company.

Data Analysis and discussion of findings

This section entails the preliminary analysis of the data using descriptive, correlation analyses and multiple regression analysis. The regression analysis was conducted using the pooled OLS and the panel Estimated Generated Least Square (EGLS) with effects. The results are presented and interpreted below.

Descriptive Statistics

Table A

	AQ	BDI	MGO
Mean	91396.46	5.133333	35.20644
Median	75000.00	5.000000	26.92500
Maximum	1401000.	8.000000	135.6400
Minimum	2500.000	2.000000	1.010000
Std. Dev.	177446.7	1.040564	31.85548
Skewness	5.991698	-0.411726	1.038849
Kurtosis	40.74872	2.993750	3.438314
Jarque-Bera	9803.550	4.238209	28.18094
Probability	0.000000	0.120139	0.000001
Sum	13709469	770.0000	5280.966
Sum Sq. Dev.	4.69E+12	161.3333	151201.0
Observations	150	150	150

Source: E-view 7.0

Table A above presents the summary statistics of audit quality and the independent variable, corporate governance of the firms. The descriptive statistics shows that the mean value (average value) of audit quality from the model in the period under investigation is 91396.46. This value is higher than the median value of 75000.00, an indication that there appears to be wide dissimilarities in audit quality for the individual quoted companies. The maximum and minimum value is 1401000 and 2500.00 respectively. This very wide obvious variation between the two values indicates the tendency for the audit quality of the sampled companies to nose-dive to extremely low values or reduce if there is a very low frequency of board meeting (board diligence) and managerial ownership (MGO) in the respective companies in this study. the standard deviation value of 177446.7 is also extremely high and shows variability or rapid

changes in the figures of audit quality, frequency of board meeting and managerial ownership either over time for the respective firms or cross-sectional basis in the quoted companies. The skewness value of 5.991698 is quite very low. The Jarque-Bera value of 9803.550 for the audit quality is very high. It passes the significant test at 99% level and simply indicates that the audit quality across the sampled firms is normally distributed. Moreover, board diligence has a mean value of approximately 5.13 which is higher than the median value of 5.00 which suggests that there appears to be wide differences in board diligence (number of meetings held by the board of directors on yearly basis) for the individual sample companies. The maximum and minimum mean value of board diligence (BDI) is approximately 8.00 and 2.00 respectively. The standard deviation of board diligence of the sample firms of 1.04 approximately is minimal suggesting that the deviation in board diligence (the frequency of board meeting) is very low. The Jarque-Bera value of 4.24 approximately for board diligence is quite low. It did not pass the significant test at 95% and 99% levels; and shows that the board diligence is very low and is not normally distributed across the sampled companies used in this study. It points out that the proportion of management having ownership in relation to the overall shareholding is below average; and may not be able to monitor the top management so as to enhance the audit quality.

In a similar manner, managerial ownership (MGO) has a mean value of 35.21 approximately which suggests that about 35.21% of the total shareholding is owned by management. This is higher than what was ascertained by Desender, Miguel and Rafel (2008) with the average of 12.5% using a sample of Spanish companies. The maximum and minimum values are 135.64% and 1.01% respectively of the sampled companies. The Jarque-Bera value of 28.78 is a bit high; and it passes the significant test and indicative of the normality of the MGO data distribution. The overall implication of all these analyses is that there is heterogeneity among the selected quoted firms in terms of audit quality. Endogeneity is thus expected in the model if the OLS technique is employed. This is a clear justification for the adoption of the panel data analysis technique for the estimation of the relationships among the variables and the impact of the explanatory variables, board diligence and managerial ownership on the dependent variable, audit quality. In a nutshell, the descriptive statistics show that the explanatory variables exhibit high variability, skewness and highly significant Jarque-Bera values across the sample companies.

Pearson Correlation Analysis

In econometric analysis, it is essential that the independent variables in the model specification do not have excessive correlation patterns. Similarly, it is essential to examine in a preliminary manner, the associations among the variables in the study. Thus, the correlation analysis is employed to conduct this investigation. The results of the correlation tests are reported in the table below:

TABLE B: Correlation matrix

	AQ	BDI	MGO
AQ	1	0.007601035 503814107	0.042485151 43019835
BDI	0.007601035 503814107	1	0.166600143 6200707
MGO	0.042485151 4 019835	-0.16660014 00707	1

Source: E- view 7.0

Where: AQ = Audit Quality, BDI = Board diligence, MGO = Managerial ownership.

From table B above, both board diligence and managerial ownership (MGO) are observed to be positively associated with audit quality (0.16) and (0.04) respectively, suggesting that the extent of managerial ownership and board diligence may be correlated with improvement in audit quality of the sampled firms. However, caution may be suggested in alluding strict causality using the correlation coefficients among the variables. This is because the correlation analysis does not necessarily imply the existence of functional relationship but a mere association. The analysis of the correlation coefficients among the independent variables is quite very low, and this suggests that the potential for multi-collinearity is reduced in the model. The overall implication of this is that all the variables tend to re-enforce each other in a positive mutual perspective towards enhancing the companies audit quality in the period evaluated.

Panel regression result

Under this section, we robustly present the results of the econometric analysis conducted to demonstrate the impact of board diligence (BDI) and managerial ownership (MGO) on audit quality of the sampled companies.

Correlated Random Effects – Hausman Test

Correlated Random Effects - Hausman Test

Equation: Untitled

Test cross-section random effects

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	7.228682	2	0.0269

Cross-section random effects test comparisons:

Variable	Fixed	Random	Var(Diff.)	Prob.
	16920.653	8878.91324	78174658.2	
BDI	177	9	35698	0.3631
	1860.6324		500860.363	
MGO	28	323.039827	665	0.0298

Cross-section random effects test equation:

Dependent Variable: AQ

Method: Panel Least Squares

Date: 11/25/14 Time: 17:42

Sample: 2007 2012

Periods included: 6

Cross-sections included: 25

Total panel (balanced) observations: 150

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-60969.14	92842.59	-0.656694	0.5126
BDI	16920.65	17221.07	0.982555	0.3278
MGO	1860.632	909.0137	2.046870	0.0428

Effects Specification

Cross-section fixed (dummy variables)

R-squared	0.365332	Mean dependent var	91396.46
Adjusted R-squared	0.231174	S.D. dependent var	177446.7
S.E. of regression	155590.1	Akaike info criterion	26.90939
Sum squared resid	2.98E+12	Schwarz criterion	27.45130
Log likelihood	-1991.204	Hannan-Quinn criter.	27.12955
F-statistic	2.723156	Durbin-Watson stat	2.244547
Prob(F-statistic)	0.000120		

From the table above, the Hausman test chi-square is 7.22 with a probability value of 0.02, ($p > 0.05$) indicating a significant difference. Thus, we reject the null hypothesis and conclude that the fixed effect estimator is preferable in this study. With the fixed effects panel estimation for the baseline model, the R^2 is 0.3653 which suggests that board diligence and managerial ownership explain about 36.53% of the systematic variations in audit quality with an adjusted

value of 23%. The F-statistic (2.72) and P-value (0.000) indicates that there is a significant linear relationship between the dependent variable (audit quality) and independent variables, board diligence and managerial ownership cannot be rejected at 1% level, while the D.W statistic value of 2.24 indicates that the presence of serial correlation in the residuals is unlikely. Commenting on the impacts of the variables, we observed that board diligence and managerial ownership appeared to positively improve audit quality with the value of 16920.65 and 1860.632 in the period under consideration. However board diligence is not statistically significant ($P=0.32$) at 5% level while managerial ownership is at 5% level. Evaluation of the regression result in tables above shows that board diligence has a positive slope coefficient and statistically insignificant at 5% ($P=0.32$) to determine audit quality; but displays a weak association ($r=0.07$) in the period under consideration of the sampled companies. Managerial ownership is significant (0.04) at 5% level, though it has a weak correlation (0.16) with audit quality. The non-significance of the influence of the board diligence in relation to audit quality can be intuitively said to be as a result of the variations and reduction in the frequency of board meetings in the quoted companies used in this study in the various years. This finding quite negates the finding of Yatimi et al (2006) who observed a negative relationship between board of directors' diligence and audit quality. On the other hand, this finding is consistent with Chukwunedo and Ogochukwu (2014) who found a negative relationship between board diligence and audit quality, and their study did not reveal the extent to which board diligence actually determines audit quality in Nigeria. However, the finding from the study is in tandem with DeZoort et al (2002) and Carcello (2002). It clearly suggests that the frequency of meeting by the board serves as a monitoring process and has the propensity to enhance audit quality of quoted firms in Nigeria.

Practical Implications of Findings

The findings made under this study are quite novel within the context of corporate board room squabbles and firms' collapse that has affected the business environment for sometimes now particularly in Nigeria. Managerial ownership leads to the efficient management and quality of audits exercise. Secondly, the fewer the board members, the tendency for unreserved commitment and day to day supervisions of the affairs of the companies, ensuring agency costs are kept at the lowest level.

Conclusion and Recommendation(s)

The spate of corporate insolvency shortly after the audited reports locally and in the international business world informs the need to actually ascertain how board diligence and managerial ownership possess the capacity to influence the quality of audit. High audit quality is one of the basis upon which investors, whether existing or potential investors' decision making depend on to an extent. This study therefore provides a robust perspective in this regard. This study found that board diligence proxy as frequency of board meeting has a positive association with audit quality; it positively determines audit quality and is statistically insignificant in the period considered. Managerial ownership positively determines audit quality and was significant. It is

therefore suggested the Security and Exchange Commission as well as the auditing profession make it mandatory for frequency of board meetings to be at least 10 to 15 times per annum. This will enable proper supervision and monitoring of the corporate organizations' affairs in pre and post-audit period. The percentage of managerial ownership in quoted companies should be readily defined or specified in the corporate governance code of best practices since a low managerial ownership may display low effect on the audit of audit firms. Furthermore, based on the findings of this study, we suggest that there is the need for future studies to examine more corporate governance variables and how they determine audit quality of quoted firms by elongating the time period; also further studies could also employed more advanced statistical methods not used in this study with a view to providing perhaps different empirical estimates that may serve the purpose of policy implications. And subsequent researchers in this area of study should make use of other proxies for board diligence with a view to ascertaining how it determines the audit quality of quoted firms in Nigeria.

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