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Effect of Corporate Governance on Audit Quality in Nigerian Banks

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ABSTRACT: This paper examined the effect of corporate governance on audit quality in deposit money banks (DMBs) in Nigeria. This research also examined and determined the impact that the gender diversity, size of the board, Non-Executive in the Board, foreign directorship and board composition have on the audit quality in Nigeria IDMBs. Secondary data were gathered from fifteen (15) listed banks covered the duration of twelve years (2007 - 2018). The data were processed using panel data estimator which was based on pooled regression model, fixed effect model and random effect model while the hausman test were used to choose the better model. The result showed that gender diversity ethnic diversity, board composition and board size are significant variables that can explicate on audit quality of the deposit money banks in Nigeria, but foreign diversity cannot significantly explicate on audit quality. Surge in ethnic representation on the board of directors will have substantial effect on the audit assurance of the Banks in the country.

KEYWORDS: corporate governance, audit Quality, Banks, Board, diversity

I. INTRODUCTION

Board of directors' responsibility is to render service on how the economic resources of the shareholders were used. The shareholders thereafter, used an external auditor to provide assurance service to confirm that the financial reports put together by Management show a true and fair view of financial dealings of the organization for the indicated duration. One of the major responsibilities of auditors is that, they assure confidence to financial statements users about the reported information. Audit services have been crucial to the quality of financial reporting since industrial revolution. Lin & Liu (2009) asserted that high-quality auditing services bolster the confidence of investors in financial reporting and boost fundraising chances. Thus, top-notch auditing is especially crucial for firms that are usually involved in fund mobilization, such as financial firms. Audit quality employ some methodologies to identify wrong claims in customer's accounting system and report the discrepancies. Audit quality is an argumentative matter in the recent decades and most previous evidence states that poor audit quality is a key factor for financial and corporate scandals (Sayyar et al, 2015). Audit quality refers to the state of an audit activity to discover material error and fraud culminating in errors in the financial documents where such occured.

De Angelo (1981) in Akhalumeh et al (2017) asserted that audit quality as an evaluation by the market of the combined likelihood that an auditor will discover a significant disparity in the client company accounting system and publish this abnormality. It is therefore reasonable to see it in the same light as Palmrose (1988) who views audit quality as a level of assurance. The goal of an audit is to give an assurance on the financial documents, the quality of audit is hence the extent of such assurance that there are no material irregularities in the financial documents. Prior studies showed that audit quality as external corporate governance monitoring can bolster firm's performance. Therefore, Auditing is a kind of governance system, as auditors perform the gatekeeper responsibility of verifying information from firms (Coffee, 2002). Beisland, Strøm and Mersland (2013) stated that corporate governance should be set up in a way that fits the business conditions of a company. Hay (2006) described two views in the literature regarding the connection between corporate governance and audit quality. One of these views is that better control will reduce the need for top-notch auditing, whereas the other perception opines that governance mechanisms are complements; thus, improved control mechanisms will engender auditing and greater audit quality. This paper is motivated by the interest around the need of reforms instituted by corporate governance code in Nigerian banks in response to the corporate failures, global best practice and their implied efficiency as relates to implementation and audit quality of banks in Nigeria.

Statement of the Problem: The reality facing stakeholders of financial reporting is that there has been a surge in corporate financial reporting failure especially in the past decades, window dressed accounts generated concerns in the USA with the collapse of the energy corporation (ENRON) in 2001. The company filed for bankruptcy after adjusting its accounts. WorldCom, Global Crossing and Rank Xerox are other companies in the USA with similar problems. In Italy, parmalat failed in 2003 when it engaged in accounting scandals worth eight billion Euros (Demaki, 2011 and Norwani, et al., 2011) cited in (Hassaini & Gugong, 2015). Nigeria has had its own share of financial reporting failure with the problems in Cadbury Nigeria Plc in 2009, Afribank Nigeria Plc faced problem of financial reporting in 2009, and Intercontinental Bank Plc in 2009. With this development, most countries all over the world decided to set codes of best practice to address governance and financial reporting issues. In Nigeria, the regulatory bodies have responded by compelling companies to comply with stringent corporate governance codes. Idornigie (2010) opined that Nigeria has multiplicity of code of corporate governance with distinctive dissimilarities namely; Security and Exchange Commission (SEC) code of corporate governance 2003 to guide the operation of public companies listed in the Nigerian Stock Exchange, which was reviewed in 2011, Central Bank of Nigeria (CBN) code of 2006, National Insurance Commission (NAICOM) code of 2009. In Nigeria, a set of well-publicized cases of accounting anomalies in Nigeria has captured the attention of investors and regulators alike. Hence, there has been a joint effort to create ways of enhancing independence (Corporate Governance Code of Nigeria 2005; Blue Ribbon Committee 1999). Further, studies in corporate governance and audit quality have been carried out internationally including Alghamdi (2012) who examined investigation into quality of audit practices and the role of corporate governance and external audit in emerging markets from Saudi listed companies. Many of the authors focus on board size, board composition, CEO duality, but to the best knowledge of the researcher, empirical evidence linking corporate board diversity to audit quality in Nigeria banks is scanty. This will be chief contribution of this paper. Hence, gap ready to be filled will be to study the nexus between corporate board diversity and audit quality. In essence, the paper attempts to answer the following research questions:

- What significant effect does corporate governance practices has on audit quality of listed DMBs in Nigeria?
- What impact does gender diversity has on the audit quality of Nigeria DMBs?
- What impact does ethnic diversity has on the audit quality of Nigeria DMBs?
- What is the impact that the proportion of Non-Executive/outside Directors in the Board has on audit quality of DMBs? (v) What significant impact does foreign directorship have on the Audit quality of Nigerian DMBs?
- What relationship exists between board composition and audit quality of DMBs in Nigerian?

EMPIRICAL LITERATURE REVIEW AND THEORETICAL UNDERPINNING The idea of corporate governance has been defined different by various scholars. According to Adebayo, Ayeni & Oyewole (2013), corporate governance has been described as one of the most vital yardsticks that impact company performance. It bothers on ways in which all parties interested in the welfare of the company tried to ensure that managers and other insiders are always taking appropriate measures that protect the concerns of the shareholders (Waseem, Saleh & Fares 2011). Magdi & Nadereh (2002) in Adebayo et al (2013) asserted that corporate governance focuses on quality of management of a business to ensure that investors get a good return. Corporate governance stipulates the allocation of rights among various participants in the corporate and states the regulations for making decisions on corporate affairs (Adebayo et al, 2013). Waseem, Saleh & Fares (2011), opined that corporate governance focuses on the ways in which suppliers of finance corporations assures them of getting a return on their investment and is about promoting corporate fairness, transparency and accountability. Danoshana and Ravivathani, (2013) views corporate governance as the mechanism by which firms are controlled. Danoshana and Ravivathani (2013) added that corporate governance is not of domestic concern only, but also a matter that requires international co-operation, especially at this time of economic and financial globalization which are very crucial for a developing country. Babatunde & Okezie (2014) observed that corporate governance practices are seen to have a huge influence on maximization of shareholder wealth and to the growth opportunities of an economy. They added further that, they are practices considered as critical to management of constraint, such as the issue of reducing risk for investors, attracting investment capital, and improving the performance of firms. Kajola (2008) in Yimka et al (2014) claim that corporate governance guarantees that business is well ran and shareholders' interest is protected at all times.

Principles of Corporate Governance According to Lai & Bellow (2012), the following have been ascertained as principles of corporate governance; rights and equitable treatment of shareholders, interest of stakeholders, role and responsibility of the board of directors, integrity and ethical behaviour as well as disclosure and transparency. Rights and Equitable Treatment of Shareholders: Organizations are duty bound to give interpretation of these rights for better understanding by the shareholders as well as ensuring stakeholders' involvement in the running of the organization through general meetings. Interest of Stakeholders: Firms are obliged to identify, in their policies and other aspect of operations, their legitimate stakeholders as having legal and other obligations which should be fulfilled at all time. Role of the Board of Directors: Board members should be chosen to include persons with expertise with the needed knowledge. The size of the board should be sufficient enough. Integrity and Ethical Behaviour: This is key to the practice of good governance. It bothers on ethical and responsible decision making which is crucial to mitigating risk and avoiding lawsuits. Companies should evolve a transparent code of conduct to guide the affairs of their directors and executives. This improves their sense of commitment to work which will be to the benefit of all stakeholders.

CEO Duality and Audit Quality This study also intended to discover the relationship between the CEO duality and audit quality. The CEO duality refers to non-separation of roles between Chief Executive Officer (CEO) and the Chairman of the board. In the normal situation, boards with CEO duality are perceived ineffective because a conflict of interest may arise. This is often attributed to the nature of family owned business in developing countries. Yemark (1996) posits that large companies that have separate persons for both functions normally trade at higher price and have higher return on assets and cost efficiency ratios (Pi & Timme, 1993).

THEORETICAL REVIEW Mechanisms and theories associated with the development of corporate governance are quite varied. The exposition of some of these mechanisms and theories will help provide insight to the framework, see the interaction, (this study adopts the agency theory) thereby providing the underlining of the current study.

Agency Theory Agency theory discusses the separation of ownership from control in the modern enterprise, the agent-principal relationship and the consequential conflict of interest has emerged. Ideally, managers as agents are expected to monitor corporate affairs in a most profitable manner so as to maximize the value of the owners as principals and protect the interest of other stakeholders. Under the theory, managers are responsible for managing the business profitably and are also responsible for preparing financial statement of the organization at the end of the period. While the control and the running of the day-to-day affairs of corporate entities is with the managers, there are two major factors that usually give rise to agency problem; self-serving interest and incentives/managerial discretions. For instance, the interest of management usually conflicts with the interest of the owners, in which the managers try to meet their goals at the expense of the firm, and this can affect the performance in many ways. On the other hand, managers are usually given incentives to meet or to beat earnings target and hence receive bonuses that are tied to the firm's earnings (i.e. performance related). Considering the influence of managers and possibilities of information asymmetry between managers and owners, the managers are likely to use the discretion they have on accruals and manipulate firm performance through accounting earnings.

Efficiency Contracting Theory In an effort to provide the policy makers and business owners with logical input to address the problems of corporate failures and defaults, a plethora of empirical works have examined audit committees. For example, Carcello & Neal, (2003), Felo et al., (2003); Abbott et al., (2003); Bédard, et al., (2004); Mangena & Tauringana, (2008); Mangena Pike, (2005); Klein (2002), using quantitative methods to document a positive correlation between audit committee and performance and financial reporting quality. Rainsbury, Bradbury & Cahan (2009) examined the association between the quality of audit committees and performance, financial reporting quality and external audit fees. The study uses a sample of 87 New Zealand firms in 2001 when no regulations or listing rules existed for audit committees. Their results show no significant association between the quality of an audit committee and the quality of financial reporting and performance. Further, Baxter (2007) investigated whether the formation of audit committees and their characteristics are associated with improved performance and financial reporting quality using both a modified version of the traditional Jones (1991) discretionary accruals model and the more recently developed accrual estimation error model from Dechow & Dichev (2002) to estimate proxies for financial reporting quality and performance. They reviewed that earnings quality measured using the modified Jones (1991) model significantly reduced in the year following the audit committee formation, thus providing some support for the notion that the formation of audit committees improves performance and financial reporting quality.

EMPIRICAL LITERATURE The empirical literature is arranged in line with developed countries, developing countries and Nigeria evidence:

Evidence from Developed Countries Paul & Mathew (2010) in their study impact of corporate governance on performance of firms: A case study of Cement industry in Swaziland. They described corporate governance as the as the framework by which the interests of various stakeholders are balanced. It shows a set of relationships between a company's management, its board, its shareholders and other stakeholders. It provide the mechanism by which the problems of corporation stakeholders, which include the shareholders, creditors, management, employees, consumers and the public at large are framed and resolved. Their study gives attention to three variables which include board size, family controlled firms, and CEO duality. A panel data was set in their study to covered data of fifteen companies of the cement industries of Pakistan spanning the period of 2007 to 2011. A regression analysis was used in analyzing the data generated. Findings from their analysis affirmed CEO duality is negatively and significantly related to cement industry performance, as the performance indicator for firm is Earning Per Share and non family firms has also impact on cement firm's performance.

II. METHODOLOGY

This paper used the ex-post facto research design employing panel data analyses of financial information gotten from Financial Statements for the years 2007 to 2018 of fifteen (15) banks listed under financial institutions on the Nigerian Stock Exchange. Ex-post facto research technique is a quasi-experimental technique which is used to investigate how an independent variable, present before the research, impacts a dependent variable. It is also a kind in which the examination begins after the fact has occurred without interference from the researcher and test hypotheses about cause-and-effect scenarios (Awotumilusi, 2015). Inferential statistics was employed to process the results. Findings from the data analysis were shown in tables. This is to enable the researcher explain the physical attributes of the data collected while the hypotheses were tested at 5% significance level by means of both t-statistics and F-statistics. E-view statistical package was employed for data analysis.

The Model

The functional nexus existing between variables from the hypotheses are:

Functions:

$Y = f(X)$

$Y = y1$ (Dependent variable)

$X = x1 + x2 + x3 + x4 + x5$ (Independent variables)

Dependent Variables

Y = Big four auditors as commonly used indicator of audit quality (ADQ)

The proposition that the use of a Big Four auditor is related to high-quality auditing (Francis, 2004; Barnes, 2008; Dechow 2010).

Independent Variables

$X = f(X_1, X_2, X_3, X_4, X_5, X_6\ \mu)$ (Independent variables)

$X = (X_1+X_2+X_3+X_4+ X_5+ X_6\ \mu)$ Corporate Governance Mechanisms (CGM)

Where:

X_1= **GSTY =** Gender diversity

X_2 = **FSTY** = Foreign directorship

X_3=**ESTY** = Ethic diversity

X_4 **=BCOM =** Board composition

X_5 = ***BSIZE*** **=** the numbers of board members during that year.

f = functional dependency of the relationship

Functional Relationships The regression takes the form of:

ADQ = β_0 + β_1GSFY + β_2 FSTY + β_3 ESFY

+ β_4 BCOM + β_5 BSIZE + ε.................. (1) Where:

ADQ = Big four auditors as commonly used indicator of audit quality

GSTY = Gender diversity, measured as the percentage of female directors on a board. FSTY = Foreign directorship, measured as the percentage of foreign directors on a board.

ESTY = Ethic diversity, measured as a dummy variable taking the value of 1 if the board consists of both Northerners and Southerners, and 0 otherwise.
BCOM = Board composition, measured by taking the number of non-executive directors as a proportion of board size.

BSIZE = the numbers of board members during the year

f = functional dependency of the relationship α0 - 5, are intercepts

μ = are the errors or disturbing terms that absorb the influence of omitted variables in the proxies used.

III. FINDINGS AND DISCUSSION

This paper studied the impact of corporate governance on audit quality with a focus on the banking industry in Nigeria, from 2007 to 2018. The goal of the paper was to examine the association between board diversity as a mechanism for corporate governance and audit quality of banks in Nigeria, with allusion to how gender diversity, board composition, ethnic diversity, and foreign directorship impact audit quality of listed deposit money banks. This paper chose 15 listed banks using non-probability sampling technique specifically the availability sampling technique for a span of 12 years i.e. 2007 to 2018. Using big four audit firm measures of audit quality and applying panel least square estimators, the paper showed the followings:

- that gender diversity and foreign directorship have negative and significant impact on audit quality at 5% level under fixed and random effects models.

- that board composition has positive and insignificant influence on audit quality at 5% level under the two models

- that board composition and board size have a positive but significant influence on audit quality at 5% level under fixed effect model.

- that the appropriate model for forecasting is the fixed effect as the Hausman statistic with p-value of 0.0000 shows the rejection of the null hypothesis of random effects. Hence, we accept the estimation of fixed effect for forecasting.

- The overall model is significant using the f-stat and showed that the results of analysis propose a rejection of the null hypothesis and accepts that gender diversity (GSTY) has significant impact on audit quality; this means that gender diversity (GSTY), ethnic diversity (FSTY), board composition (BCOM) and board size (BSIZE) are significant variables that can explain audit quality of the deposit money banks in Nigeria, but foreign directorship (FSTY) cannot significantly explain audit quality (ADQ).

IV. RECOMMENDATIONS AND CONCLUSION

On the premise of the findings of this study it is instructive to state that a surge in gender diversity on the board improves audit quality. Thus, even though the ratio of female directors on corporate boards in Nigeria is miniscule, an increase in female enlistment on the board may improve audit quality. Increase in ethnic presence on the board of directors will boost the audit assurance of the banks. A significant increase in the ratio of female directors on the board will enhance the audit quality in Banking sector in Nigeria. Appointing foreign directors has significant influence on the audit quality of the chosen banks, but any increase in this factor may promote banks audit quality in Nigeria.

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