Corporate Governance, Audit Quality and Audit Expectation Gap: Theoretical and Conceptual Perspectives

*Adeniyi Alao**

*Richard Akingunola***

*Ishola Akintoye****

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Abstract:

The main focus of this study is to create a discourse as to the extent to which corporate governance practices and audit quality are predictor variables for the audit expectation gap based on the premise that upholding external auditors' independence factor would assist in narrowing the expectation gap in society. The theory of inspired confidence and stakeholders' theory underpins the framework concerning the nexus among corporate governance practices, audit quality and audit expectation gap. Research has been conducted on the nexus between corporate governance practices and the audit expectation gap however, there are fewer research efforts on the mediating effect of audit quality between the two variables. Hence, this study recommended the need to develop the body of knowledge in this regard as the present review has conceptualised the incorporation of corporate governance practices and audit quality as mechanisms for narrowing the audit expectation gap in our society.

Originality: The research focuses on the mediating role of audit quality on the nexus between corporate governance practices and audit expectation gap. The conceptual framework was built on SmartPLS modelling.

JEL Classification Code: M41, M42

Keywords: Corporate governance, Audit quality, Audit expectation gap, SmartPLS modelling

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*Olabisi Onabanjo University, Ago-Iwoye, Nigeria; alao.adeniyi@oouagoiwoye.edu.ng; https://orcid.org/0000-0003-1710-9734

** Olabisi Onabanjo University, Ago-Iwoye, Nigeria; richakingunola@oouagoiwoye.edu.ng; https://orcid.org/00000002-6503-9147

*** Babcock University, Ilishan-Remo, Nigeria; irakintoye@yahoo.com; https://orcid.org/0000-0003-4165-5612

1. Introduction

The need for organisations to operate on a large scale as well as the desire for expansion and growth has brought about the separation of ownership from the management. The management is burdened with the responsibility of directing the affairs of the company on a day-to-day basis. Also, the management is responsible for rendering the stewardship report to the owners. This is expected to give appropriate accounts to the owners and update the owners on how far they have gone with the entrusted resources. Meanwhile, to give credibility to the stewardship report, the owners are mandated to appoint an independent person, auditor(s) to examine and report on the true and fair view of the financial reports. Hence, section 377 of the Companies and Allied Matters Act (CAMA) of 2020, mandates those responsible for governance to prepare financial statements for every company annually while section 401 mandates every corporate entity to appoint an auditor(s) at an annual general meeting (AGM) to review the financial statements of the company to lend credibility to the stewardship report.

The auditors intend to reduce the audit risk while carrying out the audit assignment and the stakeholders have the desire to make decisions based on the audited financial statements with minimal errors (Nguyen, Pham & Nguyen, 2020). However, anytime there is any occurrence of fraud or the failure of any corporate entity, stakeholders always attribute such to the failure of auditors' responsibility, hence the occurrence of an audit expectation gap (AEG). AEG is seen as the difference between the opinion of auditors and stakeholders on auditors' duties. Moreover, studies like that of Kamau, Kavure and Lokuta (2023); Fotoh, Lorentzon and Fossung (2021); Olojede, Erin, Asiriuwa and Usman (2020) and Nguyen and Nguyen (2020) have lent credence to the fact that the general public believe that the main responsibility of auditors is to uncover frauds and other irregularities. Subsequently, the audit career has paid momentous devotion to the AEG because it destroys the suitability of the profession (Fijabi, 2020).

The two essential practices that motivate financial reporting processes and the correctness of the accounting information are corporate governance (CG) and audit quality (AQ) (Soyemi, Afolabi and Obigbemi, 2021). Alao, Okewale and Sanyaolu (2020) conceptualised corporate governance as the nexus between shareholders and the management of corporate entities concerning how those entities are managed. On the other hand, Baah and Fogarty (2018) described audit quality as the level to which auditors' attributes affect their opinion on the quality of financial statements. Furthermore, Amole, Muo and Lawal (2021) regarded corporate governance as a modern phenomenon that needs the attention of individuals and groups in society. Therefore, CG and AQ are the two apparatuses for enhancing stakeholders' confidence in corporate entities thereby narrowing the AEG.

The proxies for corporate governance in this paper are board financial expertise, employees' shareholding, engagement of Big-four audit firms and audit firm tenure. These are linked to the principles of the NCCG (2018) while the proxies for the audit expectation gap include the going concern, responsibility, independence and reliability factors. Meanwhile, audit quality served as the mediator. The mediating role would be considered based on the SmartPLS 4 modelling theory. Above all, this paper covered the following aspects – a conceptual framework built on theoretical substance with emphasis on the concepts of AEG, CG and AQ. Also, the paper considered the development of propositions concerning the conceptual framework regarding the nexus among CG and AEG; CG and AQ; AQ and AEG and the mediating effect of AQ between CG and AEG. These are followed by contributions and implications while the last aspect deals with the conclusion and recommendations for future studies.

2. Conceptual Framework Based on Theoretical Foundation

This study is developed to provide a strong discerning of the justification and foundation for the nexus among corporate governance, audit expectation gap and audit quality. The discussions would be based on the theories of inspired confidence, stakeholders' theory and the theory of SmartPLS. The nexus between corporate governance and audit expectation gap would be discussed around the theories of inspired confidence and stakeholders' theory while the mediating role of audit quality would be shown via the theory of SmartPLS modelling. The theory of inspired confidence according to Limperg (1932) is based on the demand and supply for audit assignments. Limperg's viewpoint centres around achieving the highest degree of contentment among primary users of financial statements about the efforts of auditors. In pursuit of this goal, auditors are anticipated to conduct sufficient work to fulfil the expectations they have generated within society. Therefore, concerning the audit expectation gap, the theory of inspired confidence explains the extent to which auditors perform their duties as expected thereby enhancing stakeholders' confidence to narrow the expectation gap.

Similarly, the stakeholders' theory according to Freeman (1984) was based on two groups – internal and external stakeholders. Furthermore, the theory was an extension of the agency theory which only focused on the relationship between the principal and agent. Furthermore, the theory posits that a company's success hinges on the effective management of all the interactions it maintains with its stakeholders According to Awotundun, Kehinde and Somoye (2011), the stakeholder theory centres on a range of diverse groups or individuals whose interests are directly impacted by the activities of a corporate entity. Therefore, with corporate governance, stakeholders' theory explains the extent to which corporate governance practices assist in upholding the independence of external auditors thereby enhancing stakeholders' confidence to narrow the expectation gap.

Furthermore, the SmartPLS modelling theory explains the intervention of a mediator (audit quality) on the nexus between the independent variable (corporate governance practice) and the dependent variable (audit expectation gap). Therefore, the conceptual framework which explains the relationships is shown thus;

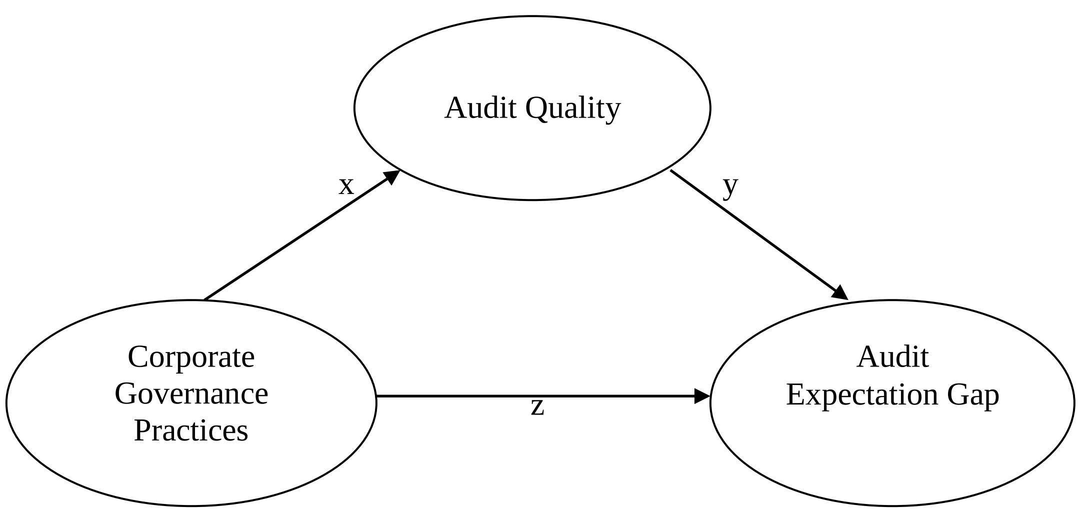

Figure 2.1: The Conceptual Framework of the Study

The conceptual framework aligns with the SmartPLS modelling theory, illustrating both the direct correlation between corporate governance practices and the audit expectation gap and the indirect influence of audit quality on the connection between corporate governance practices and the audit expectation gap. From the diagram, *z* shows the direct relationship while *x* and *y* show the indirect relationship.

2.1 Audit Expectation Gap

The term "audit" finds its origins in the Latin word "audire," which translates to "to hear," and the term "auditor" refers to a "hearer." In the initial stages of the accounting profession's evolution, auditors were tasked with assuring fraudulent activities and intentional mismanagement. This was particularly relevant due to the relatively modest size of firms during that era (Epstein & Geiger, 1994). The Audit Expectation Gap (AEG) came to light following instances of corporate scandals, notably the McKesson & Robbins fraud case in 1937 (McEnroe & Martens, 2001). Consequently, Lee (1969), as cited by Porter (1990) in the UK, appears to have been among the first to investigate the public's perceptions of auditors through an inquiry into the nature of objectives relevant to the external auditors of UK Limited companies while the research of Beck (1973, 1974) in Australia disclosed that the public had high expectations of auditors. However, it was not until 1974, that Liggio appeared to provide the first recognised definition of the term (Porter, 1990).

Azagaku and Aku (2018) formulated the concept of AEG as the variance between the general anticipation of the public concerning the role of audits and what the auditing profession defines as the fundamental purpose of the audit process. According to Humphrey, Moizer, and Turley (1992), AEG can be described as a scenario in which auditors behave in a manner that deviates from the preferences of the parties for whom the audit is intended to provide advantages. Soyemi (2014) characterised AEG as the distinction between the perception held by the general public and financial statement users regarding the purpose of an audit and the assertions made by audit professionals about their anticipated responsibilities throughout the audit process. Elad (2017) defined the AEG as the disparities in opinions and preferences between auditors and the general public concerning the obligations and roles assigned to auditors.

The AEG in the literature has been divided into different components following various authors and scholars. For instance, Porter (1993) to launch the causes of the expectation gap in New Zealand, classified the audit expectation gap into two (2) thus – the reasonableness and the performance gaps. In his work, Salehi (2016) classified the components into three (3) - the reasonableness, the deficient standards, and deficient performance gaps. Boterenbrood (2017) added a materiality gap to the components of the audit expectation gap. In another classification, Oluyombo and Okunola (2018) described the AEG as the combination of knowledge, reasonable expectation, regulation, performance and skill gaps.

According to Jabbar (2018), the elements of the AEG which can be linked to external auditing comprise six (6) items which consist of independence, performance, reporting, reasonableness, deficient standards and legal liability gaps. Therefore, of all the classifications reviewed, this study focused on the reasonableness gap. The logic behind the choice of reasonableness gap is that of all the various classifications of AEG considered so far, the reasonableness gap needs more attention as it relates to society. The reason is that society is volatile as it comprises people with different behavioural and cultural differences, educational backgrounds and information needs.

Furthermore, in terms of the factors (elements) of the audit expectation gap, scholars have come up with different classifications. For instance, Jannat (2022) categorised the elements into four distinct groups, namely: internal control, fraud detection, appropriateness in the utilisation of accounting figures and dependability. Akther and Xu (2020) structured the components into a comprehensive set of ten (10), which encompass: auditors' responsibility for fraud detection, the significance and value of audit reports, the offering of non-audit services, the anticipation of evaluations related to going concern reporting, the anticipation of diverse assurance services, limitations on furnishing non-audit services, obligatory auditors' rotation, interaction with the engaged audit committee, enlargement of audit report and assurance of adequate audit education. In contrast, Best, Buckby and Tan (2001) organised the elements into two distinct categories, namely: responsibility and reliability. On the other hand, Schelluch and Gay (2006) exclusively focused on the aspect encompassing the nature and meaning of audit report messages. Furthermore, Enyi, Ifurueze and Enyi (2012), in their exploration of AEG, introduced an additional component labelled as the independence factor to the established classifications. In a more recent study, Alao, Akingunola and Akintoye (2022) condensed the various factors into four distinct groups: going concern, independence, responsibility and reliability factors. Above all, the audit expectation gap is conceptualised in this study as the variance in the opinion of the general public and the auditors as regards auditors' duties.

2.2 Corporate Governance

Corporate governance (CG) has been observed by different intellectuals in their various studies. However, Almansour, Asad and Shahzad (2016) stated that CG has no generally accepted definition. However, researchers have made attempts to define the term. For instance, Ali (2016) conceptualised CG as the relationship between corporate entities' board, management, shareholders and other stakeholders. Igbekoyi and Agbaje (2018) characterised CG as a regulatory mechanism utilised to ensure the efficient safeguarding of stakeholders' interests. In a more recent study, Soyemi *et al.* (2021) formulated a hypothesis defining CG as the framework through which a company's goals are established, the methods for attaining them are defined and the oversight of performance is established.

Almansour *et al* (2016) referred to CG as how organisations should conduct their operations, guided by the principles of confidence, sincerity and answerability. Therefore, Eugen (2013) opined that the need for the global competitiveness of corporate organisations as well as the increase in business challenges has increased the need for good corporate governance. Corporate governance codes, principles and standards flourished around the world after the collapse of major corporations in 2001. Therefore, CG is about the creation of trustworthiness, ensuring openness and culpability, and the maintenance of an effective network of information flow that would bring about good business performance (Acharya, Gottschalg, Hahn & Kehoe (2013). Hence, the calibre of a nation's CG framework holds substantial significance for the vibrancy and competitiveness of its business sector, as highlighted by the Organisation for Economic Co-operation and Development (OECD) in 2019. Recently, Amole, *et al.* (2021) viewed corporate governance as a contemporary discourse that needs the consideration of individuals and groups in society.

Corporate governance has been conceptualised by various researchers (Soyemi *et al.* 2021; Almansour *et al.* 2016; Akingunola, Adekunle and Adedipe 2013; Awotundun *et al.* 2011) and institutions (NCCG, 2018; OECD, 2019) in their different studies. The definitions and descriptions as reported in the previous paragraph of this study can be divided into two (2) thus – those that portray CG as a mechanism through which an organisation is best directed and controlled, and those that depict CG as a set of rules and principles that aid decision-making process in an organisation. Above all, corporate governance is conceptualised in this study as those practices through which corporate entities are handled in the best interest of the investors.

2.3 Audit Quality

The term audit quality (AQ) according to Knechel (2016) is barely observable but may be measured. Corroborating the point, Soyemi *et al.* (2021) posited that audit quality has no exact definition but may be generally applied in all circumstances. Despite the submissions of Knechel (2016) and Soyemi *et al.* (2021), De Angelo (1981), as cited in Knechel, Krishnan, Pevzner, Shefchik, and Velury (2013), initially formulated AQ as the combined likelihood evaluated by the market that an auditor will detect irregularities within a client's accounting system while also disclosing these irregularities. Therefore, AQ is the capability of auditors to perceive misstatements and their preparedness to report such anomalies discovered during the audit exercise.

The above definition according to Knechel (2016) has two rudiments – auditors' expertise and objectivity. Auditors' expertise means the ability of the auditor to discover an error in a client's financial records. Auditors' objectivity is the likelihood of the auditor revealing the error uncovered. Audit quality according to Ogungbade, Adekoya and Olugbodi (2021) comprises two (2) fundamentals – audit and quality. Audit means the expression of view on the status of the financial records while quality means complete responsibility for making sound judgements. Baah and Fogarty (2018) described AQ as the extent to which an auditor's freedom, honesty and neutrality affect the auditor's opinion on the quality of financial records. AQ has been perceived differently by different individuals. For instance, users of financial information are with the expectation that a high AQ means the absence of material misstatement while auditors see a high AQ as a satisfactory completion of the audit assignment. Above all, audit quality is conceptualised in this study as the capacity of the auditor to see and report any misstatements in the financial statements.

3. Hypotheses Development

AEG has been seen in the literature as a menace to the accounting profession. However, two (2) strategies have been identified to address the menace. These are the defensive and constructive approaches. The defensive approach deals with the use of audit education in narrowing AEG while the constructive approach involves the use of corporate governance practices and principles in narrowing AEG. The focus of this study is on the constructive approach because the literature is replete in terms of studies on the defensive approach. Therefore, the hypotheses developed in this study are based on four (4) proxies of corporate governance – "board financial expertise, employees' shareholding, engagement of Big-four audit firms and audit firm tenure" while the proxy for AEG is the independence factor of the external auditor. Audit quality served as the mediator. Consequently, the following hypotheses are developed thus;

3.1 Board Financial Expertise and Audit Expectation Gap

The board is important in corporate entities as it directs the actions of the management and defends shareholders' benefits (Ali, 2016). Hence, the proficiency in financial matters possessed by the board is crucial, enabling them to effectively oversee current circumstances and make informed decisions as needed. As a result, it becomes imperative for the board to be sufficiently equipped with a strong foundation in financial knowledge. Board financial expertise is the ability of the board members to have sound knowledge of financial-related matters. The financial expertise of the board assists them to act in the entities' optimal interests and that of the shareholders. Board financial expertise is defined in this study as the presence of board members with finance/accounting expertise.

On the other hand, the audit expectation gap is conceptualised in this study as the change in the opinion of the general public and the auditors as regards auditors' duties. However, AEG has been established in the previous works as a menace to the accounting profession hence, the need for those practices that can assist in narrowing/reducing the effect of the menace in our corporate entities. One of such likely practices is board financial expertise which is considered in this sub-section as the independent variable. Therefore, the following is the hypothesis;

Ho_1: "Board financial expertise has no significant influence on the independence factor of the external auditor".

3.2 Employees' Shareholding and Audit Expectation Gap

One of the constructs of employees' shareholding that has gained lots of discussion in the literature is managerial ownership. For instance, Saidu and Gidado (2018) defined managerial ownership as the amount (in naira value or units) of shares held by those individuals (agents) who are in charge of business affairs on behalf of the shareholders. According to Azim, Ahmed and Zia u-Din (2015) corporate managers that have an ownership interest in an entity work more resourcefully to increase the entity's value.

However, two contradictory theories (managerial entrenchment and interest alignment) have been established in the literature concerning the reduction of the battle of concentration between managers and shareholders (Khafid & Arief, 2017). The managerial entrenchment hypothesis argues that managers use their opportunity for selfish interest at the expense of other shareholders while the interest alignment hypothesis postulates that managers use their opportunity as motivation for excellent performance (Khafid & Arief, 2017). Therefore, from the angle of the interest alignment hypothesis, managerial ownership is capable of providing the link through which managers engage in active monitoring thereby aligning ownership and control via managers' stock ownership (Saidu & Gidado, 2018).

Employees' shareholding in this study measures the level of participation of the employees in the ownership structure of quoted firms in Nigeria. They serve as employees and at the same time organisation's shareholders. Consequently, another likely practice for narrowing the audit expectation gap in our corporate entities as mentioned in sub-section 3.1 of this study is employees' shareholding. Employees' shareholding is employed as one of the independent variables in this study. Based on the above discussions, the hypothesis is;

Ho_2: "Employees' shareholding has no significant effect on the independence factor of the external auditor".

3.3 Engagement of Big-four Audit Firms and Audit Expectation Gap

There is no doubt that auditing lends credibility to the financial statements of corporate entities. More so, it makes the information therein more reliable. There are over a million audit firms all over the world. The audit market in Nigeria comprises large, medium and small audit firms and the composition is made up of the Big Four and non-Big-Four audit firms (Soyemi, 2020). However, the four internationally recognised audit firms (the Big Four) are Deloitte, Ernst and Young (EY), Klynveld Peat Marwick Goerdeler (KPMG) and Price Waterhouse Coopers (PWC). The combined market share of these firms all over the world is above 85% (Che, Hope & Langli, 2020). Consequently, the Big-Four Effect has been established among quoted firms. The Big-Four Effect simply means that the audit service of the Big-Four audit firms is of higher quality than the audit service of the non-Big-Four audit firms (Che, *et al.* 2020).

Subsequently, engagement of big-four audit firms is another likely practice for narrowing the audit expectation gap in our corporate entities as mentioned in sub-section 3.1 of this study. The engagement of big-four audit firms is employed as one of the independent variables in this study. In line with the above submission, the hypothesis is;

Ho$_3$: "Engagement of Big-four audit firms has no significant impact on the independence factor of the external auditor".

3.4 Audit Firm Tenure and Audit Expectation Gap

Audit firm tenure has been explained in the literature via two propositions – auditor independence proposition where it was argued that longer audit firm tenure reduces financial reporting and audit quality due to the auditor's independence impairment. On the other hand, the proponents of the expertise proposition argued that longer audit firm tenure enhances audit quality via learning and experience (Odia, 2015). Also, audit firm tenure can be seen from two perspectives – the tenure of the office of the audit firm and the tenure of the individual audit engagement partner (NCCG, 2018).

The NCCG (2018) put tenure of office of the audit firm at the maximum of ten (10) years continuously while that of the individual audit engagement partner is fixed for five (5) years to preserve independence. However, this study focused on the tenure of the office of the audit firm because it may be difficult to determine that of the individual audit engagement partner. Audit firm tenure is measured as the average number of years spent by each external auditor. Therefore, audit firm tenure is another likely practice for narrowing the audit expectation gap in our corporate entities as highlighted in sub-section 3.1 of this study. Audit firm tenure is employed as one of the independent variables in this study. Based on the above submission, the hypothesis is;

Ho$_4$: "Audit firm tenure has no significant influence on the independence factor of the external auditor".

3.5 Corporate Governance Practices, Audit Expectation Gap and Audit Quality

As earlier expressed, AEG has been established in the extant research works as a menace to the accounting profession hence, the need for those practices that can assist in narrowing/reducing the effect of the menace in our corporate entities. Besides, audit quality is another vital practice that can assist in narrowing/reducing the effect of the menace in our corporate entities. Hence, audit quality is introduced as a mediator in this sub-section while corporate governance practices remain the independent variables. Therefore, the following is the hypothesis;

Ho$_5$: "Audit quality has no significant mediating effect on the nexus between corporate governance practices and the independence factor of the external auditor".

4. Contributions and Implications

The subsistence of AEG as well as the nexus between corporate governance principles and audit expectation gap have been researched and discussed among scholars from the developed and developing economies. However, to the best of our knowledge, much has not been done on the nexus between CG practices and AEG, especially concerning Nigerian quoted firms. Furthermore, the mediating role of AQ in the connection between CG practices and AEG has not been addressed. Hence, this study considered it relevant to discuss the conceptual and theoretical issues relating to the mediating effect of AQ on the nexus between CG practices and AEG.

5. Conclusion and Recommendations

The subsistence and danger of AEG as a menace have been established in the literature all over the world. Consequently, the literature came up with two (2) approaches for narrowing the menace. These are the defensive and constructive approaches. The present study considered the constructive approach by explaining the conceptual and theoretical foundations involved in employing AQ as a mediator for the nexus between CG and AEG based on SmartPLS modelling theory. Sequel to the above submission, further empirical analysis is recommended and encouraged on the nexus between CG practices and AEG as well as the mediating role of audit quality on the relationship between the two variables. Besides, further studies are required from both developed and developing economies on the subject matter using both quantitative and qualitative approaches.

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