

# **Audit Quality, Audit Committee Effectiveness and Audit Evaluation: A Critical Literature Review**

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## **Abstract**

There have been growing academic research and literature on audit quality in corporate organisations but increase in financial and accounting scandals has brought the integrity of financial reporting and audit quality in disrepute. Questions have arisen on the independence of the auditor and quality of audits conducted for public interest organisations. Audit quality is critical in the financial reporting chain and investors and other audit stakeholders require assurance on the quality of the audit reports, financial reporting disclosures and information on the performance of firms. This paper seeks to review literature on audit quality to establish how audit quality is affected by audit committee effectiveness and audit evaluation. The study involves critical review of academic literature and research on audit quality, audit committee effectiveness and audit evaluation including related theories and empirical studies which investigates the relationship among audit quality, audit committee effectiveness, and audit evaluation. Review findings reveal that there is no agreeable audit quality framework, definition of audit quality and information on how audit committee effectiveness affects audit quality. Independence of the AC, qualification of members reflected on the knowledge and expertise possessed and size of the committee are believed to improve financial reporting quality resulting in high audit quality. AC's frequency of meetings, contributions reflected in committee minutes, informal relationships between the committee and stakeholders such as internal and external auditors; and senior management improves audit quality in organizations.

**Keywords:** *Audit Quality, Audit Committee Effectiveness, Audit Evaluation*

## **Introduction**

The concepts of audit quality and the governance structures in public organisations have come under sharp focus in the recent past. Audit committee (AC) being one of the governance structures in organisations depends on its effectiveness to provide assurance to stakeholders on the effectiveness of the internal control system and the risk management processes in an organisation. The Audit Quality Forum (2005) observe that audits serve a vital economic purpose and play an important role in serving the public interest to strengthen accountability and reinforce trust and confidence in financial reporting. However, major financial scandals in both developed and developing economies witnessed in the recent past have signaled corporate governance failures in the corporate world and the demand for improvements in audit quality has increased.

## **Audit Quality**

DeAngelo (1981) defines audit quality as a function of the auditor's ability; first; to detect material misstatements and errors in financial statements (technical capabilities); and secondly, to report these material misstatements and errors (Auditor independence) while the United States Government Accountability Office (GAO 2003, 13) defines audit quality as one performed "in accordance with Generally Accepted Auditing Standards (GAAS) to provide reasonable assurance that the audited financial statements and related disclosures are presented in accordance with Generally Accepted Accounting Principles (GAAP), and are not materially misstated whether due to errors or fraud." DeAngelo (1981) further explains that a quality audit does in fact, take place when a competent and independent audit firm is able to identify accounting misstatements and exert pressure on the client to correct those misstatements.

Knechel et al. (2013) further assert that "the perception of audit quality can depend very much on whose eyes one looks through. Users, auditors, regulators, and society—all stakeholders in the financial reporting process—may have very different views as to what constitutes audit quality, which influences the type of indicators one might use to assess audit quality". They further argue that if in any case an outcome of audit is considered to be unobservable, it is difficult to define audit quality in terms of an achieved outcome. Karjalainen (2011) posit that audit quality obscurity implies that audit quality in fact (i.e., actual audit quality) can be quite different from audit quality in appearance (i.e., perceived audit quality).

## **Literature Review**

### **Agency Theory**

Agency conflicts emanates from the separation of control and ownership of firms. Agency problem is said to occur when managers make decisions that are not consistent with the objective of shareholder wealth maximization (Watson and Head, 2007). Watson and Head (2007) further argue that while managers are expected to make decisions that are consistent with the objective of maximizing shareholder wealth, whether this happens in practice is another matter. Jensen and Meckling (1976) defined agency relationship as "*a contract under which one person (the principal) engages another person (the agent) to perform some services on his/her (the principal's) behalf*". Agency relationship can also be defined as a contractual process whereby owners delegate some of their authorities and responsibilities to a team consisting of expert member(s) and expect them to exercise their expertise in best interest of firm's operational success.

Mohiuddin and Karbhari (2010) points out that AC is appointed by the Board in order to protect stakeholders' best interest by its fair and neutral views and judgment regarding different issues of the firm. They further observe that AC plays role not only as a bridge between board and management but also as a safeguard of the stakeholders. Muth and Donaldson (1998) described agency relationship as delegation of power by owner to management. The agency theory indicates that there exist conflict of interest between owner and management. Eisenhardt (1989) discussed two main causes of agency problems namely, conflict of interests, and different attitude towards

risk between owner and management. Berle and Means (1932) argued that when shareholders are not able to monitor management properly, the company assets might be used for the welfare of management instead of maximizing shareholders' wealth. Chrisman et al. (2004) noted that this conflict arises from information asymmetry between owners' and managers and there exists a gap between them.

Chen et al. (2008) studied non US companies trading shares in US market and argued that effective AC can resolve agency problems of foreign companies no matter which CG model is being followed in the company's home country. Dey (2008) found that the level and intensity of agency problem is less in those firms where AC is more effective in terms of composition and functioning. Greiling (2006) states that agency theory assumes that the actors are motivated by rational self-interest and that mainly the agent uses gaps in contracts to his or her advantage. Greiling further contends that agency problem arises not just from a conflict of interests but also from the agent's privileged access to information and that the agent will tend to use his or her superior knowledge to divert benefits in his or her direction. Jacobides and Croson (2001) posit that the primary challenge is to achieve the full gains from exploiting comparative advantages in order to achieve joint agency value. Due to information asymmetry Greiling argues that hidden characteristics occur before the contract is signed and that the agent has private information about his or her ability and skills which may lead to information quality insecurity. Agency theory is a useful economic theory of accountability, which helps to explain the development of the audit (The Audit Quality Forum, 2005). The forum argues that agency theory suggests that agents are untrustworthy. Jensen and Meckling (1976) argue that both the principal and the agent benefit from the relationship, and therefore, there is no good reason to believe that the agent will not always act in the best interest of the principal. Eisenhardt (1989) posits that incentive schemes for managers which reward them financially may reduce agency losses.

The Audit Quality Forum (2005) criticizes agency theory's assumption that no agents are trustworthy and if an agent can make himself better off at the expense of a principal then he will. This assumption ignores the likelihood that some agents will in fact be trustworthy and will work in their principals' interest whether or not their performance is monitored and output measured. Lane et al. (1998) observe that predictions of agency theory are unsupported in cases where managerial interests are clearly in conflict with those of stakeholders.

## **Stakeholder Theory**

Penguin Dictionary of Accounting (2006, p.280) defines stakeholders as persons with an interest in an organization, such as its owners, employees and creditors. Freeman (1984) defines a stakeholder as "*any individual or group who can affect or is affected by achievement of the organization's objectives*". Stakeholder theory argues that the company is a separate organizational entity connected to different parties in achieving wide range of purposes (Donaldson and Preston, 1995). The theory highlights interests of different groups and argues on the possibility of favoring one group's interest over that of another (Jones and Wicks, 1999).

Donaldson and Preston (1995) pointed out that managers are responsible to deploy their wise decisions and best efforts in obtaining benefits for all stakeholders. The board of directors (BoDs) cannot ignore its responsibilities in safeguarding stakeholders' interests (Wang and Dudley, 1992). Hillman et al. (2001) found that inclusion of stakeholders' in the board merely improves their relation and performance. Cole (2004) considers group effectiveness in terms of satisfaction of group members and task accomplishment. He further contends that the official organization view of effectiveness is more concerned with output, efficiency and other benefits, than with satisfying the needs of individuals while individual view on effectiveness is concerned with personal success in the individual's role and personal satisfaction from being a member of a team. Cole asserts that effectiveness is achieved when the needs and expectations of the organization are one and the same as those of individuals.

Merrick Dodd, Jr. (1932) as cited in Donaldson and Preston (1995) posits that if the unity of the corporate body is real, then there is reality and not simply legal fiction in the proposition that the managers of the unit are fiduciaries for it and not merely for its individual members, that they are trustees for an institution with multiple constituents rather than attorneys for the stockholders. This confirms the nature of the stakeholder theory as compared to the agency theory. They argue that

stakeholder theory establishes a framework for examining the connections, if any, between the practice of stakeholder management and the achievement of various corporate performance goals; it describes the corporation as a constellation of co-operative and competitive interests possessing intrinsic value; that stakeholders are identified by their interests in the corporation, whether the corporation has any corresponding functional interest in them; that the interests of all stakeholders are of intrinsic value and that each group of stakeholders merits consideration for its own sake and not merely because of its ability to further the interests of some other group, such as the share owners; and it does not simply describe existing situations or predict causal relationships; it also recommends attitudes, structures, and practices that, taken together, constitute stakeholder management.

Stakeholder theory is criticized based on the non-dominance interest for various groups or persons who can affect or is affected by the policy of the organization. They argue that the proponents of the theory decline to specify how to make tradeoffs among competing interests and they leave managers with a dilemma in making management decisions.

### **Audit Quality and Audit Quality Indicators**

Audit quality has been critical and in the recent past, audit quality indicators have been under much scrutiny (Martin, 2013). Knechel et al (2013) argue that the problem of audit quality being in the eye of the beholder, has been reflected in the broader range of diverse, and sometimes divergent, definitions that have been offered by numerous authorities and individuals over the past 20 years.

Knechel et al. (2013) in their research concludes that good audit is one where there is execution of a well-designed audit process by properly motivated and trained auditors who understand the inherent uncertainty of the audit and appropriately adjust to the unique conditions of the client. They further observe that audit quality is perceived, rather than directly observed trait since we can only learn about cases when quality is compromised. Some researchers define audit quality in terms of failure which is appealing because it is easy to operationalize the definition. Casterella et al. (2009) observe that poor audit quality is observable with hindsight if engagement results in litigation or claim of malpractice against the audit firm while Francis (2011) notes that there are relatively few cases of detectable audit failures.

Knechel et al (2013) organized their discussion of audit quality indicators around balanced scorecard parameters by categorizing audit inputs, process, outcomes and context which allowed them to link general attributes of audit quality of incentives, uncertainty, uniqueness, process, and judgment to the existing research. They observe that the ability to make sound judgments directly influences the quality of the audit, so the better the personnel; the better the outcome of the audit is likely to be. The quality of auditor judgments has been found to adversely impacted by the perceived risk of client loss (Farmer et al. 1987; Bay 2005), fee pressure (Houston 1999; Grambling 1999), client retention incentives (Lord 1992; Trompeter 1994); Chang and Hwang 2003), economic benefits contingent on specific actions (Schartzberg and Sevcik 1994; Beeler and Hunton 2002), and other client-related and engagement pressures (Hackenbrack and Nelson 1996; Haynes et al.). However, Nelson (2009) observe that there are several countervailing incentives in place, such as concerns for regulatory enforcement, potential litigation costs, and potential reputation losses, promoting high audit quality.

Chen et al. (2009) posit that there is positive relationship between professional skepticism and audit quality. Shaub and Lawrence (1996) note that auditors with high level of professional skepticism are more likely to confront a client or perform additional procedures when the high risk irregularities arise are more likely to detect fraud (Bernali 1994), exhibit high-quality assessments of evidence (Hurtt et al. 2008), and are less trusting of a client and more likely to invest in high levels of audit effort (Bowlin et al. 2012).Knechel et al. (2013)

argues that auditor knowledge and expertise have a direct bearing on the quality of the audit. They observe that domain-specific knowledge accumulated through client, task, and industry experience is associated with higher-quality auditor judgment and is necessary for developing audit expertise. Bedard (1989) explains that auditors with more domain-specific knowledge make decisions that are more consistent with professional standards and have higher consensus. Beck and Wu (2006) posit that the level of auditors' client specific knowledge has been found to be positively related to auditor performance over time and that an auditor's industry expertise is positively related to the quality audits. Knechel et al. (2013) indicate that quality of an auditor's judgment is also influenced by pressures emanating from the firm itself and that these pressures can arise from immediate supervisors on the audit team or the overall evaluation process used by the audit firm. They explain that audit managers who perceive audit partners to value efficiency as compared to effectiveness may rely on questionable work by internal auditor to a great extent while engaging in less skeptical behaviors during audit testing. DeZoort and Lord (1997) in their study observe that time-budget and time-deadline pressures adversely impact the quality of audits. McDaniel (1990) indicate that time-budget pressures result in tradeoffs of audit effectiveness for audit efficiency and to increase the likelihood of engaging in reduced audit quality acts such as under reporting of time (Lightner et al. 1982; Kelley and Margheim 1990; Ponemon 1992) and prematurely signing off on audit work papers (Alderman and Deitrick 1982; Kelley and Margheim 1990; Reckers et al. 1997).

### **Audit Quality and Audit Committee Effectiveness**

Mohiuddin and Karbhari (2010) observes that the ongoing global financial distress and recession has necessitated the discussion on the governance mechanism especially touching on corporate governance (CG) practices of big companies and roles of special committees are being closely reviewed. They point out that Audit Committee (AC) has become more common mechanism for ensuring good corporate governance in firms. Audit committee is appointed by the board in order to protect stakeholders' interest by its fair and neutral judgment regarding different issues of the firm (Mohiuddin and Karbhari, 2010).

Chang and Li (2008) contend that effective AC provides a sound monitoring of the financial reporting process. While Campbell (1990) and Vicknair et al. (1993) claim that lack of effective AC practice is a factor behind rigorous financial problems for companies, Mohiuddin and Karbhari (2010) contend that effectiveness is an elusive concept that can be approached through several models, none of which is appropriate in all circumstances. DeZoort et al. (1998) defines effectiveness as a committee's ability to meet its oversight objectives. They further define effective AC as a committee with qualified members with authority and resources to protect shareholders' interests by ensuring reliable financial reporting, internal controls, and risk management through its diligent oversight efforts.

Siti and Nazli (2012) in their study examined the association between audit committee effectiveness and timeliness of reporting with a view of establishing whether there was any relationship between effectiveness of an audit committee

and submission of audited financial statements to the Indonesian Stock Exchange (IDX). They found that timeliness of reporting is associated with audit committee effectiveness which suggested that audit committee effectiveness is likely to reduce the financial reporting lead time. They further argue that the existence of AC is to protect shareholders' interests through its oversight responsibility in the area of financial reporting, internal control, and external auditing activity. Siti and Nazli (2012) assert that a well functioning AC system leads to the improvement of corporate financial reporting and the decrease of earnings management or financial frauds, as well as the increase of unqualified

auditor report. Garcia-Meca and Sanchez-Ballesta (2009) noted that existence of AC reduces errors and irregularities in financial statements and enhances the credibility of financial reporting which is consistent with conclusion of McMullen (1996). Mohiuddin and Karbhari (2010) concur that effective AC reduces financial frauds and disputes in the company and also ensures earning information to stakeholders. Mohiuddin and Karbhari further observe that an effective AC minimizes agency problem by reducing information asymmetry between owners and management and also acts as safeguard of stakeholders' interest.

### **Audit Quality, Audit Evaluation and Audit Quality Framework**

Audit firms evaluate audit quality control processes and procedures to enhance audit quality. The U.K.'s Financial Reporting Council (FRC; 2008) developed and published Audit Quality Framework in 2008 where it identified five drivers of audit quality namely: (1) the culture within an audit firm; (2) the skills and personal qualities of audit partners and staff; (3) the effectiveness of the audit process; (4) the reliability and usefulness of audit reporting; and (5) factors outside the control of auditors affecting audit quality. Knechel et al. (2013) points out that various frameworks for audit quality highlight that the evaluation of audit quality is a multi-dimensional challenge from both a theoretical and practical perspective.

In his research, "a framework for understanding and researching audit quality", Francis (2011) proposed an audit quality framework where he observed that audit quality is a complex concept and he argued that audit quality is influenced by six levels of analysis that range from a granular view of the audit process to a very broad view of the outcomes of the audit, including (1) audit inputs, (2) audit process, (3) accounting firms, (4) audit industry and audit markets, (5) institutions, and (6) economic consequences of audit outcomes. The different levels of analysis illustrate how audit quality reflects the cascading of conditions at different levels of the overall system.

In a consultation paper, a Framework for Audit Quality, IAASB (2013) proposes audit quality framework to consist of input factors, output factors, key interactions among audit stakeholders, contextual factors and special considerations specific to public sector audits and audits of smaller entities. International Federation of Accountants (IFAC, 2008) describes the financial reporting supply chain as "the people and processes involved in the preparation, approval, audit, analysis and use of financial reports." IFAC observes that all links in the chain need to be of high-quality and closely connected to supply high-quality financial reporting. It notes that while each separate link in the supply chain plays an important role in supporting high-quality financial reporting, the nature of the connects, or interactions, between the links can have a particular impact on audit quality.

### **Results and Discussions**

Various reasons reveal the divergent relationships that exist between audit quality, audit committee effectiveness and audit evaluation framework due to various empirical methods applied in determining the key drivers of audit quality. Burnett et al. (2012) used multivariate analysis and sensitivity tests to examine whether audit quality affects managers' choices between accrual-based earning management and accretive stock repurchase. They argue that firms with high quality auditors are more likely to use accretive stock purchases and less likely to manage accruals to meet or beat consensus analysts' focus. The study does not include the AC effectiveness as one of the variables that drive audit quality. The study also confirms that the firms choose high quality audits to indicate earning quality and corporate governance effectiveness.

Junaidi, Miharjo and Hartadi (2012) in their study to determine the effect of auditor tenure on audit quality found that client's relationships with auditor arranged by the management can reduce the independence of auditors. The research also reveal that the length of relationship between auditors and clients has significant negative effect on the propensity to issue going-concern opinions. The research model does not include the audit quality drivers which form audit quality framework. Skinner and Srinivasan (2012) used events study analysis method to determine whether there was any relationship between audit quality and auditor reputation in the Japanese companies due to clients switches from ChuoAoyama in large numbers due to fraud in Kanebo, large Japanese cosmetic firm. The researchers assert that even though there were undeniable signal of audit

quality problems at ChuoAoyama due to large clients switches, they cannot confirm what drove the client switches from the firm.

Memis and Cetenak (2012) in their study investigated the relationship between earnings management-audit quality and earnings management-legal system quality and used management related variables such as size of the firms, leverage, lagged return on assets of the firms which have loss in the previous year and Tobin Q as control variables. The research reveal that Brazilian and Mexican companies exhibit significant relationship between discretionary accruals and audit quality.

## **Conclusions and Recommendations**

The AC effectiveness has major effect on the audit quality in organizations. The independence of the AC, the qualification of members as reflected on the knowledge and expertise they possess and the size of the committee is believed to improve the financial reporting quality which results in the high audit quality. The AC's frequency of meetings, contributions as captured in the committee minutes, the informal relationships that the committee has with audit stakeholders such as internal auditors, external auditors, senior management improves audit quality in organizations. The audit quality indicators reignite the focus on the audit processes which contributes in the quality of audits realized in firms. The judgment made by auditor in the audit process may influence the outcome of the audit. The assessment of audit and business risks, analytical procedures undertaken by the auditor, obtaining and evaluation of audit evidence in aiding in forming an audit opinion, auditor-client negotiations on the audit assignment may all affect the audit quality. In addition, review and quality procedures undertaken by audit firms through employing audit seniors, supervisor and managers ensures that all quality objectives are achieved while audit inputs such as incentives and motivation, professional skepticism among auditors, the knowledge and expertise of the audit staff, audit partners, audit managers coupled with the training and experience over the years of service, and within firm pressures also may have effect on the audit quality. The contextual framework under which is conducted; audit partner compensation and other audit staff remuneration; abnormal audit fees charged on clients and non-audit fees received by the audit firms; audit tenure with clients; and audit fee premiums charged by the Big 4 auditors, industry specialists and market perception of audit quality may also affect audit quality. Even though limited evidence is available to support these assertions. The research will contribute to the already existing body of knowledge on audit quality, and the academic research in the area. A lot of research have been conducted in the area of audit quality and this provides an opportunity for future research in the same area. Such research may focus on the effects of AC qualifications on audit quality, the link between audit quality framework, audit quality indicators and audit quality. Audit staff behaves in a different way and are influenced by various factors which provides a good research area to establish how behavioral aspects between audit staff including the audit partner and clients may affect audit quality.

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