EFFECT OF AUDIT COMMITTEE EFFECTIVENESS AND AUDIT EVALUATION ON AUDIT QUALITY: A CRITICAL LITERATURE REVIEW

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Purpose - This paper focused on the critical review of literature on the effects of audit committee effectiveness and audit evaluation on audit quality and any research gaps in the area of audit quality and recommends any for future research.
Methodology – This is was a review of literature on audit committee effectiveness, audit evaluation and audit quality.
Findings – The study finds that audit committee effectiveness has a major effect on the audit quality in organizations. In addition, variations in different research methodologies used in the literature explain the inconsistencies in research findings by academicians. Further the study finds that independence of the audit committee, qualification of its members as reflected on the knowledge and expertise and the size of the committee is believed to improve the financial reporting quality which results in high audit quality.
Implication – The findings imply that there is no clearly agreeable audit quality framework and how audit committee effectiveness affects audit quality.
Value – The study recommends a further investigation on the effect of audit committee qualification on audit quality; the link between audit quality framework, audit quality indicators and audit quality using longitudinal and correlation approaches. The critical literature review points at a number of significant drivers of audit quality which are not fully identified in the expert role of audit committee including the roles of key players in the financial reporting chain viewed as improving financial reporting quality.

Key Words*: *audit committee effectiveness, audit evaluation, audit quality.

Introduction

The concepts of audit quality and governance structures in public organizations have come under sharp focus in the recent past (Abbott et al. 2000). The Audit Quality Forum (2005) posit 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 but major financial scandals in both developing and developed economies witnessed in the recent past have signaled corporate governance failures and the demand for audit quality has increased. International Auditing and Assurance Standards Board (IAASB, 2013) notes that recent financial conditions have highlighted critical importance of credible, high-quality financial reporting in all sectors of the world's economy including capital markets, small companies, government organizations and not-for-profit organizations and it emphasizes the need, in the public interest, for continual improvement to audit quality. This paper reviews literature on audit quality, audit committee effectiveness and audit evaluation relationships.

Audit Committee Effectiveness

Parker (1992) defines an audit committee as 'A committee appointed by a company as a liaison between the board of directors and the external auditors.' The committee has a majority of non-executive directors and is expected to view the company's affairs in a detached and dispassionate manner. IAASB (2013) identifies interactions between auditors and those charged with governance of the organization as one factor that may influence audit quality. The Audit Committee (AC) is charged with overseeing the financial reporting process in an organization and provides oversight role over the financial reporting chain, internal control system, risk management and governance processes within the organization. Collier and Gregory (1996) emphasize the important role audit committees have in improving financial aspects of corporate governance including financial reporting and auditing.

Magrane and Malthus (2010) say that AC is formed to improve organizational governance, regardless of whether the organization is private or the public sector. They emphasize that as subcommittee of the board, it aims to provide assurance through increased scrutiny, accountability, and efficient use of resources and serves as an advisory function aimed at performance improvement within the organization. Mohiuddin and Karbhari (2010) claim that many researchers have used the word 'effectiveness' to mean carrying out or fulfilling specific oversight responsibilities or duties. DeZoort et al (2002) as cited in Siti and Nazli (2012) explains that audit committee effectiveness is measured by a subset of audit committee effectiveness index. They provide analysis of the empirical audit committee literature and define an effective audit committee as a committee with qualified members with the authority and resources to protect stakeholder interests by ensuring reliable financial reporting, internal controls, and risk management through diligent oversight efforts.

Audit Evaluation

PCAOB defines audit evaluation as the periodic assessment of performance programs and initiatives that provide senior management with objective, timely and evidence-based information on the results of programs, policies and initiatives. AICPA (1997) note that auditors aim to obtain sufficient reliable evidence in accordance with the requirements of professional standards, while minimizing the cost of the evidence accumulation. Gillet and Peytchevance (2007) observe that an assessment of the sufficiency and strength of observed evidence influences decisions about what reliance should be placed on internal controls, what should be the extent of subsequent substantive testing of transactions, and what audit opinion is supported by the evidence leading to quality audits.

Public Company Accounting Oversight Board (PCAOB) Standard number four states that in forming an opinion on financial statements, in all material respects and conformity with the applicable financial reporting framework, the auditor should take into account all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements. The evaluation of audit results include evaluating the results of analytical procedures performed in the overall review of the financial statements; misstatements accumulated during the audit, including, in particular, uncorrected misstatements; the qualitative aspects of the company's accounting practices; conditions identified during the audit that relate to the assessment of the risk of material misstatement due to fraud; the presentation of the financial statements, including the disclosures; and the sufficiency and appropriateness of the audit evidence obtained, hence enhancing audit quality.

Audit Quality

while 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), Mehmet and Emin (2012) observe that audit quality is assumed to be a function of auditor's independence; however, the technical capability of auditors or the probability that the auditor will discover material misstatements and going concern breaches is usually assumed to be invariant across auditors. The United States Government Accountability Office (GAO 2003, 13) asserts that 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.''

International Auditing and Assurance Standards board (IAASB, 2013) assert that auditors are responsible for the quality of individual audits, and should aim to ensure that quality audits are consistently performed. It further states that, a quality audit is likely to be achieved when the auditor's opinion on the financial statements can be realized upon as it is based on sufficient appropriate audit evidence obtained by an engagement team that exhibited appropriate values, ethics and attitude.

Theoretical Literature Review

Agency Theory

Agency conflicts emanates from the separation of control and ownership of firms. Agency theory was first propagated by Stephen Rose and Barry Mitnick. In his delivered paper at the December 1972 economics meeting and published in the AER Proceedings issue in May 1973, Ross clearly identifies the agency problem as generic in society, not merely as a problem in the theory of the firm. Mitnick in his 1973 paper and 1974 dissertation presented detailed set of agency concepts and sorted them in typologies and identified types of agency relationships. Jensen and Meckling (1976) views 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. Watson and Head (2007) observe that agency problem occur when managers make decisions that are not consistent with the objective of shareholder wealth maximization and that managers are expected to make decisions that are consistent with the objective of maximizing shareholder wealth, whether this happens in practice is another matter.

Eisenhardt (1989) identified conflict of interest and different attitude towards risk between owner and management as the main cause of agency problem. 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 for 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. Dey (2008) concludes that the level and intense of agency problem is less in those organisations where AC is more effective in terms of composition and functioning resulting in quality audits.

The Audit Quality Forum, (2005) notes that agency theory is a useful economic theory of accountability which helps to explain the development of audit and it suggest that agents are untrustworthy. Jensen and Meckling (1976) argue that both the principal and 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. The forum criticizes the 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) suggest that predictions of agency theory are unsupported in cases where managerial interests are clearly in conflict with those of stakeholders.

Stakeholder Theory

The term "stakeholder" first appeared in the management literature in an internal memorandum at the Stanford Research Institute (SRI) in 1963 and was meant to generalize the notion of stockholder as the only group to whom management need be responsive. The concept is originally defined as "those groups without whose support the organization would cease to exist". SRI researchers further argued that unless executives understood the needs and concerns of the stakeholder groups, they could not formulate corporate objectives which would receive necessary support for the continued survival of the firm. Freeman in his book (1965) indicates that Ansoff advocated for the rejection of the theory and observed the objectives of the firm should be derived balancing the conflicting claims of the various "stakeholders" in the firm.

Evans and Freeman (1993) describe stakeholders as those groups who are vital to the survival and success of the corporation. The theory observes that the company is a separate organizational entity and it is 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 other (Jones and Wicks, 1999). Merrick Dodd, Jr. (1932) as cited in Donaldson and Preston (1995) posit 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 rather than attorneys for the stockholders. This confirms the nature of stakeholder theory compared to agency theory. Merrick argues that the theory establishes a framework for examining connections, if any, between practice of stakeholder management and achievement of various corporate performance goals.

Goodpaster (1993) criticizes Freeman's version of stakeholder theory and believes that stakeholder theory along the lines suggested by Freeman can be detrimental to both business and society. He describes Freeman's Stakeholder theory as a multi-fiduciary stakeholder conception. The theory is further criticized based on the non-dominance interest for various groups or persons who can affect or is affected by the policy of the organization. He further argues 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.

Empirical Studies

There are limited literature and relevant studies on audit quality in the public sector. Public sector spends huge sums of financial resources in pursuit of service delivery to the public performing key role in the economy and good governance structures are paramount in the control of the utilization of the financial resources. Picket (2003) describes AC as a governance body that is charged with oversight of the organization's audit and control functions. Institute of Internal Auditors (IIA) in its position paper considers the establishment of an AC in the public sector as an advisory body to the governing board, a valuable contribution in improving the governance, risk management and control practices. The institute observes that such committees can play an important role in examining organization's policies, processes neither the expertise nor the time to function as an effective alternative to an audit committee.

King III governance report issued by the South African Institute of Chartered Accountants (SAICA, 2009) states the provisions for an additional public sector AC's responsibility with regard to the oversight of management work and adequacy of monthly/quarterly reports submitted from the management in adherence to the Public Finance and Municipal Finance Management Act. Knechel et al (2013) in their study points out 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. DeAngelo (1981) developed a two-dimensional definition of audit quality that sets standards for addressing the issue. Audit quality has been critical and audit quality indicators have been under scrutiny in the recent past (Martin, 2013).

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 observed that audit quality is perceived, rather than directly observed trait since we can only learn about cases when quality is compromised. Casterella et al. (2009) observe that poor audit quality is observable with hindsight if engagement results in litigation or calm of malpractice against the audit firm while Francis (2011) notes that there are relatively few cases of detectable audit failures. They further 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 (Schwartzberg and Sevcik 1994; Beeler and Hunton 2002), and other client-related and engagement pressures (Hackenbrack and Nelson 1996: Haynes et al.).

Scholars have pointed out that good audit quality framework with clear audit quality drivers enhances audit quality. The U.K.'s Financial Reporting Council (FRC) 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. These observations are supported by Francis (2011) in his research that expands his view on audit quality framework. Francis (2011) proposes an audit quality framework where he observed that audit quality is a complex concept and he argues 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.

In a consultation paper, a Framework for Audit Quality, IAASB (2013) proposed 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. IFAC 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. Knechel et al. (2013) points out that various frameworks for audit quality highlights the evaluation of audit quality being a multi-dimensional challenge from both a theoretical and practical perspective.

Kathryn (2000) hypothesize that when consequences of audit failure are moderate, evaluation of auditors will be higher for high quality audits than for low quality audits; however, when consequences are severe, evaluations will be low irrespective of the level of audit quality. This implies that performing high quality audits is viewed to be protecting auditors against liabilities from audit failures when the consequences of audit failures are moderate, but may not provide protection when the consequences of audit failures are severe. Kathryn points out that the auditor's work will fall short and will receive low evaluations while auditors who perform higher quality audits in this situation will be rewarded with high evaluation. Zvi and You (2011) note that regulators have chosen to improve quality of audit of auditors' work by conducting quality control reviews on audit firms while Defond and Francis (2005) observes that researchers have shifted to analyze the quality of auditors' work in individual levels because they believe that auditors as performers of audit services, plays the main role in determining the quality of work.

Siti and Nazli (2012) in their study 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 argued 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 and notes that if audit committee is effective in performing its oversight duty of financial reporting process, it will affect the quality of financial reporting which may lead to timely presentation of financial information. 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. Mohiuddin and Karbhari (2010) concur that effective AC reduce financial frauds and disputes in the company and also ensures earning information to stakeholders. They conclude that AC effectiveness depends on the ability and scope of performing its oversight roles and responsibilities delegated by the Board.

Research Problem

Much have been written in theory about audit quality, however little is known in practice about audit quality in the public sector. A few of the studies have examined whether effective audit committee and audit evaluation improves audit quality in the public sector. Currently management theories have made a paradigm shift with a view to focusing on the value added strategy focusing on stakeholders. It is observed that stakeholders can influence the finance policy, structure and reporting of an organization and Freeman (1984) notes that the relative force of pressure exerted by various stakeholders is likely to influence the level of oversight provided on the expenditure of state resources.

Most public sector entities are failing to meet the expectation of their stakeholders, particularly the public in providing goods and services and providing oversight on the operations of the government agencies resulting to reduced cost of operations. There has been wanton misuse of public resources in the public sector due to inadequate oversight provided by the governing bodies in the public sector. As a sub-committee of the governing body, AC aims to provide assurance on the financial and compliance issues through increased scrutiny, accountability, and efficient use of resources and its effectiveness is critical in providing confidence to the public on the utilization of public resources. Audit quality is therefore, critical in the financial reporting chain of public sector organizations and the public and other audit stakeholders require assurance on the quality of audit reports, financial reporting disclosures and information on the performance of the public sector organizations. Through its oversight role, AC ensure that audit processes, procedures and internal control system are efficient and effective for high audit quality to be achieved.

Mohiuddin and Karbhari (2010) posit that inclusion of independent, knowledgeable and expert members and delegation of adequate authority make an AC effective playing a significant role in the financial reporting, internal auditing, risk management, external audit and compliance issues. They note that AC effectiveness has significant positive impact in minimizing agency conflicts, protecting stakeholders' interests and maximizing firm's value but fall short of revealing how AC effectiveness affects audit quality. From the global perspective, there is little coordinated information available about the impact effective AC and audit evaluation have on audit quality.
The study seeks to critically review effects the audit committee effectiveness and audit evaluation may have on audit quality in the public sector entities and answer the questions: how is audit committee effectiveness and audit evaluation affect audit quality in the public sector? How do audit committee effectiveness indicators contribute to the audit quality? And, what are some of the research gaps in the area of audit quality?

Research Objectives

The study reviews literature to establish the effects of AC effectiveness and audit evaluation on audit quality and to establish if any, research gaps in the area of audit quality and recommend any for future research.

Value of the Study

The study provides an opportunity to auditors, management of audit firms and other stakeholders to understand better the audit quality indicators, drivers and framework to enhance the financial reporting quality. The study also adds to the existing body of knowledge on the audit quality, audit quality indicators and framework and the audit committee effectiveness while providing an opportunity for possible future research by both academicians and the industry.

Summary and Recommendations

The findings on the effectiveness of audit committee and audit evaluation on audit quality reveal the need for extensive research on the area. Clear evaluation of audit procedures need to be adopted to enhance audit quality. Research on the relationship among audit quality, audit committee effectiveness and audit evaluation in public sector has been ongoing with inclusive findings on the actual nature of the audit quality framework, key drivers of audit quality and definition of audit quality. This has been furthered by the stakeholder and agency theories which require refocusing. 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 high audit quality.

The AC's frequency of meetings, informal relationships the committee has with audit stakeholders including internal auditors, external auditors, and senior management improves quality of audits in organizations. 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 including within firm pressures may influence the audit quality. Audit outcomes reflect on the nature of audit inputs that have been employed, the audit processes and tests that have been conducted, and audit staff employed on particular audit assignments. Audit reports being main audit output should capture facts and supported fully with evidence through audit documentation including audit work papers. The regulatory reviews of audit firms by regulators reveal deficiencies highlighted on audit quality procedures. The contextual framework under which audit is conducted may impact audit quality. The audit partner compensation and other audit staff remuneration may affect audit quality. The abnormal audit fees charged on clients and non-audit fees received by the audit firms may also affect the audit quality.

Conclusions

Research on the relationship among audit quality, audit committee effectiveness, audit evaluation and framework has been ongoing with inclusive findings on the actual nature of the audit quality framework, key drivers of audit quality and definition of audit quality. 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. A number of research conducted employs empirical tests on the large stock market capitalization determining relationship between audit quality and earnings management which may not be appropriate to the public sector and does not reveal any relationship that exist between audit quality and AC effectiveness. The empirical literature reviewed does reveal that independence of the directors and their qualifications improves AC effectiveness which is a contentious issue in the public sector. The review further doesn't link AC effectiveness with audit quality and reveals that there is no research done on critical audit attributes having greater impact on audit quality.

Public sector entities are complex as they are geared towards provision of services and huge financial resources are spent in operations. There is need to conduct research on the effects of audit committee members' qualification and the size of the committees on audit quality in the public sector. In addition, a further research can be conducted to find the link between audit quality framework, audit quality indicators and audit quality which will assist audit committees to set up the key audit quality indicators as one of their performance indicators at the beginning of each financial year.

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