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EFFECT OF AUDIT REPORT QUALITY ON FINANCIAL DISTRESS AMONG INSURANCE COMPANIES LISTED ON THE NIGERIAN EXCHANGE GROUP

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ABSTRACT:

To achieve better financial condition, an objective quality audit is needed which forms the basis for investors' confidence on the integrity and reliability of financial reports. Financial reports are statements used to provide important information to the users so as to enable them assess the financial conditions and performance of related companies. This study examines the effect of audit quality on financial distress among insurance firms listed on the Nigerian Exchange Group. Specifically, the study examines the effect of audit fee, audit report lag and auditors' independence on financial distress among insurance firms listed on the Nigerian Exchange Group. Financial distress was measured using the Altman Z-score ratios to determine the financial health status of twelve (12) Insurance companies listed on the Nigerian Exchange Group. The study adopts Ex-post Facto research design and the Linear Regression Analytical technique which was used to analyze data generated from 2013 – 2019 annual reports of insurance firms sampled. This was done with the aid of SPSS version 22. The study revealed that audit report lag has no significant effect on financial distress while audit independence and audit fee have positive and significant effect on financial distress. This study concludes that the financial condition of a firm is affected when there is lack of auditor independence. Based on the findings, the study recommends that the executives of Insurance companies should engage audit firms with an audit team that have more integrity and reputable character. Also, it is recommended that the firm should engage the services of auditors with the necessary technical and interpersonal skills to improve audit quality.

Key words: *Audit fee, Audit Independence, Audit Quality, Audit Report Lag, Financial Distress*

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1. INTRODUCTION

Financial statements are used to provide important information for the users as they use the statements to assess the financial conditions and performance of related companies (Ahmed & Hossain, 2010). This gives rise to the need to improve the information quality as disclosed in the financial statements thereby, safeguarding the interests of the shareholders. An independent check or examination of the financial affairs of the company becomes necessary especially in the case of public firms. This role is carried out by the external auditor usually appointed based on the decisions

of the board (Egbunike & Abiahu, 2017). This enhances the confidence of the investors and increases the rate of acceptance of the financial statements report audited. This can be easily trusted in the capital market. This trust, however, is based on audit quality (Taoying & Zhaodong, 2014). Audit quality is the ability to detect and report important falsification of financial statements during the audit process as well as to reduce asymmetry of information between managers and stakeholders that are relevant to the level of quality of information in the financial statements (Issa & Velte, 2019). Financial statements with high audit quality guide the company managers to know the actual financial status of the company and also aid in making financial and investment decisions. Financial statement audit is a monitoring mechanism that helps reduce information asymmetry and protect the interests of the various stakeholders by providing reasonable assurance that the management's financial statements are free from material misstatements (Farouk & Hassan, 2014). Insurance companies offer financial protection as compensation for premium or consideration paid for life, health and other financial interests to individuals and companies for the risk of expected events such as death, loss, illness or damage. Any reason why this cannot be achieved should be nipped in the bud as best as possible to avoid financial insolvency or distress.

Financial distress can be defined as having no ability to cover current obligations, for example, unpaid debts (Lu & Ma, 2016). To achieve better financial condition and enhance the investor confidence, a higher quality audit is needed. Audit quality in the present Nigerian environment has been of great concern to stakeholders due to the collapse of several companies emanating from inefficient audit quality practice measures. Over the years, companies like Cadbury Nigeria Plc. in 2006, Intercontinental Bank in 2009, Afribank Nigeria Plc in 2009 and Diamond bank as of recent, in 2019 have found themselves in this category. Some of the reasons thought to be responsible for bankruptcy and financial distress of companies include lack of auditor independence and audit quality inefficiency which has been a recurring issue and a real concern to investors in the Nigerian capital market. One common phenomenon in the majority of these bankruptcy cases is that most of the corporations had clean auditor's reports prior to their eventual collapse (Dabor & Dabor, 2015). Ensuring higher audit quality and auditor independence may do the magic of restoring investors' confidence at this critical economic situation the country is facing (Aliu & Okpanachi, 2017). This can be achieved by reducing the period it takes to make the audited financial report available to the current and potential investors thereby reducing the audit report lag, thereby reducing information asymmetry. This study is motivated by the recent effect of COVID -19 lockdown in the Nigerian economy and on companies and the possibility that the production of quality reports on the financial statements audited could help in determining those companies that are actually financially healthy.
In Nigeria, most prior research works as observed by the researcher studied audit quality, measuring its effect on corporate governance, shareholders' earnings and auditor independence focusing on industrial goods' firms, real sector, oil companies and insurance companies. Also, it was observed that financial distress was reviewed in relation to different variables like capital structure and leverage (Ikpesu & Eboiyehi, 2018; Abdullahi, Norfadzilah, Umar and Lateef, 2020; Lucky & Michael, 2019) in other financial institutions but to the best of our knowledge none has treated the effect of audit quality on financial distress among insurance firms listed on the Nigerian Exchange Group. This constitutes the research gap that this study fills. This study creates awareness to investors and other insurance firms' stakeholders on the use of Altman Z score ratios to predict and assess the company's volatility and financial robustness. It also enriches the literature and provides valuable information to policy makers.

1.1 Objectives of the Study

The main objective of this research work is to ascertain the effect of audit report quality on financial distress among insurance companies listed on the Nigerian Exchange Group. The specific objectives are:

a. to determine the effect of audit fee on financial distress among Insurance companies listed on the Nigerian Exchange Group.

b. to ascertain the effect of audit report lag on financial distress among Insurance companies listed on the Nigerian Exchange Group
c. to assess the effect of audit independence on financial distress among Insurance companies listed on the Nigerian Exchange Group.

1.2 Hypotheses

H_{O1}: Audit fee has no significant effect on financial distress among Insurance companies listed on the Nigerian Exchange Group.
H_{O2}: Audit report lag has no significant effect on financial distress among Insurance companies listed on the Nigerian Exchange Group.
H_{O3}: Audit independence has no significant effect on financial distress among Insurance companies listed on the Nigerian Exchange Group.

2. LITERATURE REVIEW

2.1 Conceptual review

2.1.1 Audit Report Quality

Audit quality is seen as how well an audit detects and reports material misstatements in financial statements, the detection aspects are a reflection of auditor competence, while reporting is a reflection of ethics or auditor integrity, particularly independence. However, an auditor may likely lack the independence and integrity to report the breach in financial reporting practice, thereby, impairing the audit quality**.** Audit quality is one of the significant issues that influence the audit profession (Vanstraelen, 2000). The preparation of the financial information should be done in such a way that it becomes reliable and accurate, playing the fundamental role of ensuring the quality of auditing. High quality auditing could enhance investor's protection and firm value (Black, 2001). Audit quality is about the fair representation of financial information and it is a significant determinant of financial distress.

2.1.2 Financial distress

Financial distress can be defined as the inability of an organization to meet up with its necessary obligations. The problems of financial distress arise when the companies have difficulties to pay the financial commitment (Khaliq, Altarturi, Thaker, Harun & Nahar 2014). There is higher probability that a company facing financial difficulties can end up in bankruptcy and this can bring bad reputation to the company. It is expected that a company in distress will experience high cost due to one reason or the other. These costs can be their employees turning out to be less productive because of their deteriorating self-confidence and their fear of job loss. It becomes a disaster when the current and prospective investors withdraw or refuse to invest in the company thereby reducing capital. Presumably, the chances of a financially distressed firm heading to bankruptcy are higher due to difficulties of getting new funding to maintain their operations (Senbent & Wang, 2010).

2.1.3 Audit Fees

Audit fee is the economic remuneration for auditors who provide audit services, which are an agency fee according to certain standards (Liu, 2017). It represents the amount charged by the auditor for an audit process performed for the accounts of an enterprise (Walid, 2012). It is the total audit cost and it includes the total audit labour hours worked, the audit risk compensation and the profit desired. Companies are required statutorily to have their accounts independently examined by an external auditor without compromising the quality of the audit. For this purpose, it is expected that an audit client pay an amount of audit fees that is in relation to the total audit services rendered which should reflect the level of audit work carried out in the auditing process.
Audit fees do not in any way undermine auditor objectivity, which is normally being seen to lessen an auditor's will to dispute management attempts to take full benefit of the information irregularities in the agent-principal relationship (Abdullahi, Norfadzilah, Umar & Lateef (2020). In this study,

audit fee is related with financial distress to determine whether its increase or decrease is a determinant to financial distress in insurance companies.

2.1.4 Audit Report Lag

Audit report lag (ARL) is the time between the company's end of the fiscal year and the audit report date (Chukwu & Nwabochi, 2019). It is the period between a fiscal year of a reporting entity and the date of audit report and provides that barometer with which the efficiency of an audit is gauged (Hassan, 2016). It is of note that different sub-sectors of the Nigerian financial services sector have different filing dates and it can be as large as 90 days. Audit report lag is arguably one of the very few variables that is associated with audit efficiency that is externally observable. In Nigeria, audited annual accounts shall be filed with the Exchange not later than ninety (90) calendar days after the relevant year end, and published in at least two (2) national daily newspapers not later than twenty-one (21) calendar days before the date of the Annual General Meeting, and posted on the company's website with the web address disclosed in the newspaper publications (Rule book of the Nigerian Stock Exchange).

2.1.5 Audit Independence

The most important element to company financial reporting is the audit quality and auditor independence helps to build that quality. Audit Independence refers to the independence of both the internal and external auditor from parties and /or any relationship that may have financial interest in the firm being audited. It means that auditors should have no financial interest in the firms being audited. Audit independence requires integrity and also an objective approach to the audit process. The possibility of being perceived of not being objective is on the increase when an auditor lacks independence (Arens, Elder, Beasley & Fielder, 2011). Auditor independence is commonly referred to as the cornerstone of the auditing profession since it is the foundation of the public's trust in the accounting profession (Lindberg & Beck, 2004).

2.2 Theoretical Review

2.2.1 Agency Theory

This study is anchored on the Agency theory. Agency theory is defined as the relationship between the agents such as the company executives and the principals such as the shareholders. A company consists of a set of linked contracts between the owners of economic resources (the principals) and the managers (agents) who are hired by the principals and are charged with using and controlling these resources (Sarens & Abdolmohammadi, 2007). Jensen and Meckling (1976) cited in Matoke and Omwenga (2016) states that in Agency theory, agents have more information than principals and this information asymmetry adversely affects the principal's ability to monitor whether or not their interests are being properly served by the agents. The agents are given an authority to make decisions on the principals' behalf, thereby, leaving the principals no choice but to place their trust in the agents to act in their best interests. This may increase moral hazard which is constituted in a situation where agents, in order to increase their own wealth, may be faced with the problem of indecision of acting against the principals' interests. To reduce the likelihood of the moral hazard, principals and agents engage in contracting to achieve optimality, including the establishment of monitoring processes such as auditing (Matoke & Omwenga, 2016). Therefore it can be said that the development of audit quality is explained using the agency theory.

2.3 Empirical Review

Abdullahi, (2020) examined the impact of audit quality on the financial performance of listed companies in Nigeria. They employed 84 companies listed on the Nigerian Stock Exchange with 756 samples for the period of nine years from 2010 to 2018. Secondary data was used to collect data from the Thompson Reuters DataStream. The results from the multiple regression analysis revealed that the auditor size and auditor independence showed positive and significant relationship with financial performance while audit fee showed a positive but insignificant relationship with financial

performance. This means that the firms that are audited by the Big 4 audit firms have an increased audit quality because the audit firms have a reputation to protect. Also auditor independence improves audit quality.

Kamalludin, Ishak and Mohammed (2019) examined the relationship of cash flow ratios in predicting financial distress. Secondary data was collected from 80 companies operating in Malaysia for the period 2014-2015. Using Multiple Regression technique, the result revealed a negative significant relationship between profitability ratio and financial distress, whilst efficiency ratio has no relationship with the financial distress. Also, there is no relationship between firms' size with financial distress.

Lucky and Michael (2019) examined the effect of leverage on corporate financial distress in Nigeria. Cross-sectional data was sourced from financial statements of ten (10) quoted manufacturing firms and panel data regression analysis was used to test the hypotheses. Findings revealed that financial leverage has positive effect on financial distress measured by Z-Score. Total debt and debt equity ratio have positive effect on financial distress measured by changes in operating profits while short term and long term debt have negative effect on operating profits.

Aliu, Okpanachi and Mohammed (2018) examined the relationship between audit fees and audit quality of listed companies in the downstream sector of the Nigerian petroleum industry. Cross-sectional data was collected from nine (9) listed companies in the downstream sector of the Nigerian petroleum industry for the period 2007-2014. Using regression analysis, the results show that audit fees have a negative significant relationship with audit quality while leverage has an inverse relationship but not significant.

Ikpesu and Eboiyehi (2018) investigated the effect of capital structure on corporate financial distress of manufacturing firms in Nigeria. Data was sourced from the audited financial statements of 58 listed manufacturing firms in the Nigerian Stock Exchange for the period 2010-2016. Using multiple regression, the outcome of the analysis showed that capital structure affects corporate financial distress negatively while company revealed that firm growth and firm size affects financial distress negatively. It was recommended that managers have to be cautious when designing their capital structure, age, profitability and asset tangibility affects corporate financial distress positively. The result further revealed that firm growth and firm size affects financial distress negatively. It was recommended that managers have to be cautious when designing their capital structure.

3. MATERIAL AND METHOD

The study adopted the Ex-post facto research design. The Ex-post facto is a type of design in which information is collected without alterations to the source data. The researcher used the data from the readily available financial statements of the companies which could not be manipulated. The researcher employed the secondary source of data from 2013-2019. The period chosen represents a year after the inception of IFRS adoption in preparation of financial statements introduced in 2012. The population of the study includes all the insurance companies listed on the Nigerian Exchange Group as at 2019 financial year. The sample was derived using the purposive sampling method influenced mainly by the availability of annual reports. Twelve companies were selected. In this study, in line with some financial distress determinant studies such as Lu and Ma (2016), accounting based tools were employed to analyze the data due to the need to provide a guideline as to the financial status of companies. The popular accounting–based tool is the Altman (1993) Z-Scores. The Linear regression technique was used in the study to analyse and test the hypotheses with the aid of SPSS version 22 at 5% level of significance.

The linear regression model used in this study was adopted from Lu and Ma (2016). Firm size was also used as a control variable. The model takes the following form:

Financial Distress = f (Audit report quality) ……Equ (1)
Infusing the proxy variables as independent variables and the control variables, we have: Financial Distress = f(Audit fee, Audit report lag, Audit independence, Firm size)…Equ (2)
In econometric form, we have:
$FD_i = \beta_0 + \beta_1 AUDFEE_{it} + \beta_2 ARLit + \beta_3 AUDINDit + \beta_4 FSit + e_t$ .....Equ (3)
Where,
FD = Financial Distress, (the dependent variable) was measured using the Altman Z-Score ratios (Kamalludin et al, 2019)
AUDFEE = Audit fee, was measured using the logarithmic transformation of ₦ value remunerated to the auditor for the audit services.(Hanlon, Krishnan & Mills, 2012)
ARL = No of days from fiscal year end to audit report date. (Chukwu & Nwabochi, 2019).
AUDIND = Audit Independence, measured using the natural log of audit fees is employed as the reverse measure of audit independence. (Gerayli, Yanesari & Maatoofi, 2011)
FS = Firm Size, measured using the natural log of total assets. (Isa & Farouk, 2017)
β = Constant,
β_{1-4} = Unknown Coefficients,
e_t = error term

4. RESULT AND DISCUSSIONS

4.1Data Analysis

4.1.1 Correlations

The correlation matrix is used to determine the correlation between the dependent and independent variables of the study. Joseph (2010) proposed also that the correlation value of 0 indicates there is no relationship while the correlation ±1.0 means an excellent relationship. The sample observations are represented in the table below.
The correlation analysis from the table 2 below display that the AUDFEE and ARL possess negative correlation coefficients (-0.281, -.147) with the FD. AUDIND (0.273) revealed a positive correlation coefficient with FD of listed Insurance companies in Nigeria during the period investigated.

Table 1: Summary of Correlation Matrix

Variable	FD	AUDFEE	ARL	AUDINP	FSIZE
FD	1				
AUDFEE	-.281	1			
ARL	-.147	-.096	1		
AUDINP	.273	-.886	.081	1	
FSIZE	-.262	-.878	-.178	-.804	1

Source: Extract from SPSS 22.0 Printout result

4.2 Hypotheses Testing

4.2.1 Hypothesis One.

H_{O1} Audit fee has no significant effect on financial distress among Insurance companies listed on the Nigerian Exchange Group.

The linear regression analysis in this study is being employed as a statistical procedure to explore the relationships that arise amongst a particular dependent variable and a group of three independent variables involving audit fee, audit report lag, audit independence and the control variable which is the firm size for 12 companies listed on the Nigerian Exchange Group. The two measures generally agreed by most authors as being good for determining multi co linearity between the independent variables of a study are the tolerance values and the variance inflation factor (VIF) (Aledwan, Yaseen & Alkubisi, 2015). If the variance inflation factors of all the independent variables are less than 10, multi co linearity does not exist and the model is said to fit. Also, a tolerance value of 1 or

above signifies multi co linearity, while tolerance values of less than 1.00 in all the observed variables signifies the absence of multi co linearity (Cassey et.al. (1999) in Aledwan et al (2015).
Table 2 below discloses the analysis of results for linear regression model:

Table 2: Analysis output for linear regression model:1

Variables	Coefficient	t-values	P-values	Tolerance/VIF
Constant	2.021	6.076	.000	
AUDFEE	-.052	-2.156	.034	0.308/3.247
FIRMSIZE	0.004	0.824	.412	0.308/3.247
R	.295			
R^2	.087			
Adj. R^2	.064			
Durbin-Watson	.317			

Source: Extract from SPSS 22.0 Analysis Results 2021

4.2.1.1 Discussion of Result

In Table 2 above, it shows an R^2 of 0.087 which indicates that 8.7 percent of the variation in financial distress can be explained by variability in audit fee. This implies that financial distress changes by 8.7% when the independent variable changes. AUDFEE is statistically significant with financial distress predictor variable (as being measured using Z-Score). The result for the test of hypothesis I showed that AUDFEE show a negative (β = -0.052) but statistically significant (p = 0.034) effect on financial distress.

4.2.1.2 Decision: The p-value is significant if it is less than 5% significance level. These, therefore produced evidence of rejecting the null hypothesis that audit fee has no significant effect on the financial distress among Insurance firms in Nigeria. Thus this implies that *Audit fee has significant effect on financial distress among Insurance companies in Nigeria*.
In other words, increase in audit fee increases the possibility of financial distress. Increase in firm problems increases the need for more audit fees. This supports the findings of Lu & Ma (2016) who found that audit fee is negatively and significantly related to Z-Score, a proxy of financial distress. Their results show that a high audit fee relates to a bad financial condition. The variance inflation factors and tolerance values are 3.247 and 0.308. It also shows the complete absence of multi co linearity between the independent variable and the control variable and the model is said to be fit. The Durbin-Watson test checks the auto-correlation among the variables studied. Its value of 0.317 which is less than 2 means there is no auto-correlation among the variables.

4.2.2 Hypothesis Two.

H_{O2} Audit report lag has no significant effect on financial distress among Insurance companies listed on the Nigerian Exchange Group

Table 3: Analysis output for linear regression model:2

Variables	Coefficient	t-values	P-values	Tolerance/VIF
Constant	2.147	4.059	.000	
ARL	-0.006	-1.383	.171	0.996/1.004
FIRMSIZE	-0.005	-1.805	.075	0.996/1.004
R	.238			
R^2	.057			
Adj. R^2	.033			
Durbin-Watson	.290			

Source: Extract from SPSS 22.0 Analysis Results 2021

4.2.2.1 Discussion of Result

The analysis output of test of hypothesis II as in Table 3 above demonstrates an insignificant and negative effect of audit report lag on financial distress (β = -0.006, t = -1.383, p = 0.171).

4.2.2.2 Decision: The calculated p-value of audit report lag is 0.171 which is greater than 5 percent (0.05) thereby being insignificant at 5 percent. This, therefore implies that *audit report lag has no significant effect on financial distress among Insurance firms in Nigeria*.

This means that the number of days it takes the auditors to present the audited financial report after the financial year end does not lead to financial distress. However, it supports that of Ahmed (2003) and Tanyi (2011) who found that audit report lag has no significant influence on a firm's financial condition. The Durbin-Watson value of 0.290 is less than 2 which means there is no auto-correlation among the variables. Also, the tolerance value (0.996) and the VIF (1.004) show the complete absence of multi co linearity between the independent variable and the control variable and the model is said to be fit.

4.2.3 Hypothesis Three

H_{O3} Audit independence has no significant effect on financial distress among Insurance companies listed on the Nigerian Exchange Group.

Table 4: Analysis output for linear regression model:3

Variables	Coefficient	t-values	P-values	Tolerance/VIF
Constant	12.180	2.253	.027	
AUDINDP	-1.529	-1.980	.051	0.573/1.744
FIRMSIZE	-9.325E-5	-0.024	.981	0.573/1.744
R	.281			
R^2	.079			
Adj. R^2	.056			
Durbin-Watson	.291			

Source: Extract from SPSS 22.0 Analysis Results 2021

4.2.3.1 Discussion of Result

From table 4 above, the result for the test of hypothesis III demonstrates that AUDINDP shows a negative but statistically significant effect on financial distress (β = -1.529, p = 0.05).

4.2.3.2 Decision: The calculated p-value of audit independence is 0.05 which is significant at 5 percent. This, therefore implies that *audit independence has significant effect on financial distress among Insurance firms in Nigeria*.

This means that increase in lack of audit independence increases the possibility of financial distress. However, this study is in line with Farouk and Hassan (2014) who found positive and significant relationship between audit independence and firm performance in their study. The tolerance value (0.573) and the VIF (1.744) show the complete absence of multi co linearity between the independent variable and the control variable and the model is said to be fit.

For the control variable, Firm Size was found to have no significant effect on financial distress as shown in Tables 2, 3 and 4 (0.412, 0.075 and 0.981). This is to say that the size of a firm does not determine the extent of its financial condition. This is in line with Lu and Ma (2016) whose results suggest that size does not influence the relation between Audit quality and financial distress.

CONCLUSION AND RECOMMENDATIONS

This study concludes that audit independence as an important factor in determining the quality of the financial statements of a company (Abdullahi et al, 2020), has a significant effect on financial distress. Empirical studies show that audit independence boosts the confidence that investors have

on the financial statements being audited (Farouk & Hassan, 2014). This suggests that companies are likely to perform better if they engage the services of audit firms that work with qualified and trust-worthy audit partners. Besides, the significant effect of audit fee on financial distress implies that payment of high fee in audit does not reduce effectively the possibility of a bad financial condition. Also, audit report lag should not be a major concern in Insurance companies in Nigeria as they were not found to be a significant factor affecting their financial status. The study therefore recommends that the regulatory bodies should enforce compliance where necessary, concerning the period it takes to present the audited financial reports and auditor independence. It further recommends that firms should engage the services of audit firms that have audit team members with more integrity and reputable character.

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