

Mediating Effect of Audit Committee on the Connection Linking Auditor Attributes and Financial Reporting Quality: A Conceptual Framework

Saifullahi Abdullahi¹, Muhammad Law², Hussaini Bala³ & Haruna Daddau⁴

¹Department of Accounting, Faculty of Management Science, Kaduna State University

²Department of Accountancy, Abba Gusau Polytechnic, Talata Mafara, Zamfara, Zamfara State.

³Department of Accounting, Faculty of Administrative Sciences and Economics

Tishk International University, Erbil, Kurdistan Region, Iraq

⁴Department of Accounting, Faculty of Management Science, Kaduna State University
Kaduna, Nigeria

Correspondence: hanan4dad@gmail.com - lawalbawa82@gmail.com

hussainumi2013@gmail.com - harunadaddau@gmail.com

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Abstract

Earlier research has shown that auditor attributes (AAT) complementary functions regarding audit committee (ACs) are complicated and go beyond a straight relationship. This research's goal is to present a steady framework with the corresponding hypothesis and demonstrate the mediating influence of ACs on the connection involving AAT features and financial reporting quality (FRQ). To do so, we looked at the extant literature using conceptual approach on AAT, ACs, and FRQ and discovered that studies on AAT and FRQ had diverse outcomes. We also discovered there was minimal indication of non-audit service fees, industry experience, audit firm age, audit firm tangibility, responsiveness, reliability and assurance impacting FRQ.

It was set up that more investigation is needed on the potential possible mediating effect of ACs on AAT and FRQ. Future research is needed to evaluate our proposed framework in greater depth empirically.

Keywords: Auditor Attributes, Financial Reporting Quality, Audit Committee Attributes

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1. Introduction

Financial statements are the primary means through which firms convey valuable information about their operations to their shareholders and other stakeholders, such as creditors, the government, and proper agencies (Bala, Amran & Shaari, 2019). Annual financial reports are one of the most important documents used by third parties to make informed investment decisions (Younis et al., 2016). These publicly available annual financial statements report clearly provides the user with a foundation for making decisions among available options and evaluating the company's growth and results. Investors can compare companies within or across time periods using audited financial statements as a common ground (Zandi, Sadiq & Mohamad, 2019).

The accounting numbers stated in a company's published annual report and accounts have a significant impact on investors, current shareholders, creditors, and other financial statement users. However, directors of a company who handle the preparation and presentation of financial statements are expected to act diligently in order to avoid frightening shareholders and investors through aggressive earnings management, implying that accounting earnings reported in a company's published financial reports are expected to be faithful, prompt, and reliable to various stakeholders for a prudent economic decision.

Therefore, audit quality is critical for ensuring trustworthy and high-quality financial statements. The external auditor's role is complementary to the board of directors' and audit committee's monitoring and supervision roles in improving financial reporting quality (FRQ) and protecting the company's public image. Earlier research has found that auditor attributes (AAT) can help firms enhance their financial reporting quality (Bala & Ibrahim, 2015). This is due to auditor independence, which protects auditors from outside influence and biased auditing, resulting in better financial reporting quality FRQ (Al-Najjar, 2018).

Despite the importance of financial statements and the role of auditors in confirming their authenticity and trustworthiness, shareholders are, however, concerned about their quality. This was a product of a string of corporate failures around the world, including the Enron Corporation incident in 2001, the Cadbury Nigeria crisis in 2009, Tyco, A.P., Xerox, and Health South. The

recent Sky and Diamond Bank catastrophe, in which the Central Bank of Nigeria ordered the termination of the bank's top management employment, is a case in point (Al-sraheen, Saleh & Alsmadi, 2019; Zandi, Sadiq & Mohamad, 2019). This entire incident stemmed from an accounting issue that continues to jeopardize financial reporting's accuracy, therefore misleading concerned stakeholders. Furthermore, these current widespread manifestations of fraudulent or deceptive financial reporting can be argued to be accountable for business distress, causing damage to the integrity of the financial reporting process and the obligations of those who certify the financial reports (Umar et al., 2016).

However, owing to paired opposing belief; demand-based and risk-based, it is hard to forecast if the AAT is associated to financial ability audit committee member. Those companies with solid governance are more inclined to appoint financial expert in the mix of their audit committee members and thus likely to have larger audit committee size (ACS), (Cohen et al., 2013; Eriandani & Kurniawan, 2020). The complementing functions of ACs in relation to AAT are also proven from a demand-based perspective. Consequently, it is envisaged that a successful ACs would require premium audit services from an outside auditor in order to improve financial reporting systems, in line with the demand-based perspective (Kim, Lee & Chung, 2015).

Accordingly, this research adds to the agency theory of (Jensen & Meckling, 1976), by showing how the complimentary impacts of ACs and AAT can control agency dispute and improve FRQ. The text on the ACs, AAT and FRQ link needs to be re-evaluated. This, therefore, leads to a general question on what is the proposed framework that is steady with the corresponding hypothesis and proving the mediating influence of ACs on the association relating AAT features and financial reporting quality (FRQ)? We supply a framework based on the complementing proposition and show how ACs can intercede the relationship involving AAT features and FRQ based on this review. This is a study area that has gotten little attention in the past. Our optional framework will be put to the test using mediation analysis, which has been used in earlier research in the field of societal psychology (Baron & Kenny, 1986).

Based on the above discussions, the study is set to address the of how auditor attributes mediate the link between audit committee attributes and financial reporting quality. Therefore, the main aim of this investigation is to present a framework that is steady with the corresponding hypothesis and proves the mediating influence of ACs on the link between AAT features and financial

reporting quality (FRQ). This study will supply insight on the possible mediation role of ACs on AAT and FRQ, which has limited empirical study. Specifically, the study will add to the existing body of conceptual literature and by extension empirical literature on the possible mediation effect of ACs on AAT and FRQ.

2. Theory and Evidence

(Pfeffer & Salancik, 1978) and (Pfeffer, 1987) set up resource dependence theory in their famous paper 'The outside control of organizations: A resource dependency standpoint.' Since then, resource dependency theory has become one of the most widely accepted suppositions in organizational theory and tactical management. The theory has been used to explain why companies merge and get one another (Pfeffer and Salancik, 1978), as well as to explain joint ventures and other inter-organizational interactions, strategic alliances, R&D partnerships, research consortia, and buyer-supplier ties.

(Pfeffer & Salancik, 1978) proposed that enterprises that rely on the environment can employ a variety of tactics to deal with unexpected events. The theory of resource dependency has been widely used in research to illustrate how organizations reduce ecological interdependence and uncertainty (Pfeffer, 1987). The theory's core theme is the concept of power and resource control. The behavioral characteristics of boards and governance in enterprises are the subject of resource dependency theory. The consequences of the paired ideas for the design of effective board governance are different. While both agency theory and resource dependency theory emphasize the importance of having outside board members, the fundamental rationales for this proposal differ. Thus, resource dependency theory focuses on how the management team controls external actors to access vital resources.

Resource dependency theory acknowledges the constant fight for power and influence over an organization's resource allocation decisions among various stakeholder coalitions, while agency theory mostly ignores it. As previously stated, this study uses resource dependence theory (RDT) to protect minority interests and other stakeholders by using external environmental resources to aid in the protection of corporation resources with auditor attributes, audit committee and financial reporting quality. On the other hand, (Jensen and Meckling, 1976) advanced agency theory, which was based on (Berle & Means, 1932) research which has been universally used, and it appears to be the dominating model in various elements of corporate governance studies (Davies, 2000). Prior

research has used agency theory to link Auditor attributes (AAT) and FRQ, as well as ACs and FRQ (DeFond et al., 2014; Williams & Ellis, 2002). According to agency theory, the AC's principal responsibility is ensuring managers operation conform the shareholder's best concern. According to (DeFond, Mark & Zhang., 2014), having a superior AQ ensures a healthier FRQ.

External auditors are believed to have taken part and imperative function in corporate governance, which acts as a harmonizing tool for increasing shareholder legal protection (Lin & Hwang, 2010). Because shareholders rely substantially on external auditors' monitoring efforts, this will limit agency and complicity between management and stakeholders. A complementary premise proposes that individual is tired to those who are most probable to proffer them with utmost fulfillment, implying that, workers paucity or need is compensated by the company's strength, or vice versa (Mishra & Malhotra, 2016). This study proposes that successful ACs search for enhanced audit assurance from external auditors to deliver superior FRQ, which is consistent with the complementary hypothesis of AQ. Independent ACs and AQ, according to proponents of the complementary hypothesis, are two complementing monitoring systems (Shan, 2014; Dabbous et al., 2015; Richard et al., 2016; Rafique et al., 2017). Meanwhile, effective ACs may seek more FRQ assurance since they are more concerned about their reputation and legal threats (Al-khaddash et al., 2013; Asthana et al., 2018). According to (Richard et al., 2016) a successful ACs serves a complimentary role for AQ. They did, however, emphasize that the link is complicated and that more research is needed.

2.1 Auditor Attributes and Financial Reporting Quality

One of the most momentous tools used by a board of directors to supervise management activities and choices as regards financial reporting has long been renowned as auditor qualities (Abubakar et al., 2020; Bala et al., 2018; Ihsan et al., 2016). Earlier research on AAT and FRQ has yielded conflicting results (Hay, 2012; Trotman, 2013; Aswadi et al., 2014; Tepalagul & Lin, 2015; Kamolsakulchai, 2015; Lin et al., 2017; Ndubuisi & Ezechukwu, 2017; Badawy & Aly, 2018; Abubakar et al., 2020; Afifa et al., 2020; Akono, 2020; Suleiman et al., 2020). These mixed results could be attributable to variances in the setting and the procedures used in these investigations. These studies have primarily focused on direct correlations, even when using similar approaches. As a result, a more advanced method, such as mediation, should be used to explore the direct and indirect influence of AAT on FRQ.

Furthermore, the relationship between AAT and FRQ has been investigated in previous studies using a variety of proxies such as auditor independence (Abubakar et al., 2020; Ihsan et al., 2016), established a positive connection amid AI and FRQ, audit fees AF and FRQ (Huang & Hsiao, 2011; Wuchun et al., 2014; Al Dabbous et al., 2015; Al-rassas & Kamardin, 2015; Habbash & Alghamdi, 2016; Kuntari et al., 2017; Reguera-alvarado et al., 2019; Scott, 2020), auditor tenure AT (Jorjani & Gerayeli, 2018; Olufemi & Patrick, 2018; Özcan, 2018; Sarun et al., 2019; Cameran et al., 2020) and joint audit JA (Zerni et al., 2014; Al Dabbous et al., 2015; André et al., 2015; El Assy, 2015; Velte & Azibi, 2015; Haak et al., 2018; Sabah et al., 2019).

On the other hand, extraordinarily little evidence was set up between auditor size AS and FRQ (Hay, 2012; Umaru, 2014; Lin et al., 2017; Afifa et al., 2020), none-audit service fees NASF, (Mgbame, Izedonmi et al., 2012; Patrick et al., 2017; Ugwunta et al., 2018), suggesting more investigation is needed in this area of study. As a result, other attributes of auditors' such as auditor firm age, auditor tangibility, auditor responsiveness, auditor reliability, auditor assurance, auditor empathy and client financial health (Gaynor et al., 2016), need to be studied and re-evaluated further for better inspection of FRQ.

2.2 Audit Committee and Financial Reporting Quality

Several studies have investigated the influence of audit committee attributes (ACs) and financial reporting quality (FRQ) and reported divergent views. It was reported that audit committee size (ACS), audit committee financial ability (ACFE) and audit committee gender (ACG) reduces the possibility of fraudulent financial reporting by managers of a firms thereby improving financial reporting quality (Oluoch et al., 2017; Mansour et al., 2018; Bala et al., 2019; Marzuki et al., 2019; Ibrahim et al., 2020). Other stream of studies linking ACs and FRQ argued on the opposite direction (Majiyebo et al., 2018; Abdulrahman et al., 2019; Alkilani et al., 2019; Lajmi et al., 2019; Suleiman & Saleem, 2019). These studies looked at principally direct relationships yet applying similar approaches. This suggests proposing a more sophisticated method, such as mediation, to explore the direct and indirect influence of AAT on FRQ using ACs as mediator.

2.3 Mediating Effect of AC on the Connection Between AAT and FRQ

Audit Committee Financial Expertise (ACFE) complements the AAT effort on ensuring top level of assurance that financial reporting is of high quality. (SEC, 2003) conceptualized ACFE as a financially literate person who can read and understand the information in an entity's financial

statement. Accordingly, it is provided by the code that at least one among the members of the audit committee should be knowledgeable in accounting and or finance. Therefore, AAT increases Financial Reporting Quality by boosting the financial reports' trustworthiness (Bala et al., 2019). So, AAT and FRQ appear to be commonly noticeable outcomes. As a result, several proxies have been used as measures of AAT in various research. However, there are conflicting opinions about which metrics are better; as a result, there is little precise guidance on how to compare one proxy to another (Gaynor et al., 2016).

On the other hand, AAT metrics can be viewed from good three perspective as suggested by (DeFond et al., 2014); Big N auditors, earning base response, non-audit service fees and stock market reactions can be grouped into belief base metrics. Other proxies such as audit firm size and audit fees are input-based metrics and finally, audit opinion, accruals quality, accounting conservatism and market reactions are examples of output-based metrics. However, several of these aspects, such as restatement, have been critiqued for not capturing properly FRQ. Consequently, Big 4 auditors show up in all three classes, audit reward and Big 4 auditors are proposed as AAT substitutes. Because larger auditors are regarded to be more encourage and skilled for delivering high-quality auditing, audit firm size, as assessed by Big 4 membership, is a dependable proxy for AAT (DeAngelo et al., 1981). The audit fee is a useful proxy since it considers audit activities clearly tied to AAT (DeFond et al., 2014; Gaynor et al., 2016). Audit fees are also an excellent substitute since they are the result of both demand and supply-based assumption, i.e., an auditor cannot increase audit fees for other work with no equal increase in AQ (DeFond et al., 2014). Most prior research on AAT and FRQ has found that soaring audit reward and hiring Big N auditors are linked to less aggressive earnings management and greater FRQ (Ihsan et al., 2016; Mohammad & Ahmed, 2017; Alqadasi & Abidin, 2018; Bala et al., 2018; Abubakar et al., 2020). In essence, firms that hire either of the Big 4 auditors and priced greater audit costs are less prone to take part in aggressive earning manipulations.

By overseeing audit quality and management activities, audit committee ACs maintains a critical position in corporate governance. Thus, effective ACs with relevant financial experience is expected to improve audit procedures, which will improve the audit quality and, in turn, improve FRQ (Suleiman & Saleem, 2019; Suleiman et al., 2020). Meanwhile, audit committee financial ability ACFE is essential for the financial reports' trustworthiness and are thought to defend the

concern of investors and other stockholders (Kibiya, et al., 2016; Bala et al., 2019). Internal governance mechanisms and external audit can only partly replace for each other, according to earlier literature, implying that improved internal control such as strong audit committee with relevant financial ability will result in lower audit fees (Al Dabbous, et al., 2015; Kusnadi et al., 2015; Alkilani et al., 2019) has refuted this claim. Earlier research on the causative impacts of internal governance and external audit has consistently proven to be substitute, meanwhile, improving internal governance procedures is linked to greater external audit exercise (Dobija, 2015; Mwangi, 2018; Nawafly et al., 2019).

Effective ACs have been said to improve monitoring, which leads to increased audit costs and expanded audit coverage. This is in line with the alternative theory. This proves that bigger ACs, made up of independent directors and at least one member with financial literacy, require more audit work by employing Big 4 auditors and paying higher audit cost (Al-rassas, 2015; Aifuwa & Embele, 2019; Alkilani et al., 2019). This is owing to the increased audit oversight function that such ACs are obligated to supply to improve statutory audit quality. As the ACs complements the statutory audit assignment, there is a chance that both monitoring instruments will work together to prevent aggressive earnings adjustment and increase FRQ (Reguera-alvarado, et al., 2019). To protect its reputation, better engaged, expert, and standalone board may require a more thorough audit. This gives investors more confidence, reduces legal liability, and encourages them to invest (Masliza et al., 2018; Mwangi, 2018).

Given the prior considerations concerning the supporting functions of ACs with respect to AAT in improving FRQ, we thereby, expect that ACs to act as intermediary variable (mediator) that can be changed by AAT, in improving FRQ. This is because a mediator variable is an intermediate variable that denotes the useful instrument via which the explanatory variable can account for the explained variable (Baron & Kenny, 1986). When the explanatory variable is considered to influence the mediator, and the mediator, in turn, influences the result variable, a simple mediation model is assumed (Afifa et al., 2020). This means that changing the AAT causes a change in the ACs and changing the ACs causes a change in the FRQ. Our proposed paradigm clearly proves this. It is built on a series of relationships that describe mediation circumstances. Before mediation to take place, the following conditions must be met, according to (Baron & Kenny, 1986): firstly, the explanatory variable Y must be notably associated with the determinant construct X; secondly,

the conciliator variable M must be notably linked with the determinant variable X; thirdly, the outcome variable Y must be notably related with the conciliator variable M; fourthly, the consequence of the determinant variable X (the parameter) on the outcome variable Y must be fewer in perfect terms than the consequence in relative terms; (v) the consequence of the mediator variable M on the outcome variable first order. As indicated in Figure 1 below, these conditions underpin the study's recommended structure.

3. Study Strategy

The study employed conceptual strategy with the following proposed framework as under.

Independent Variables

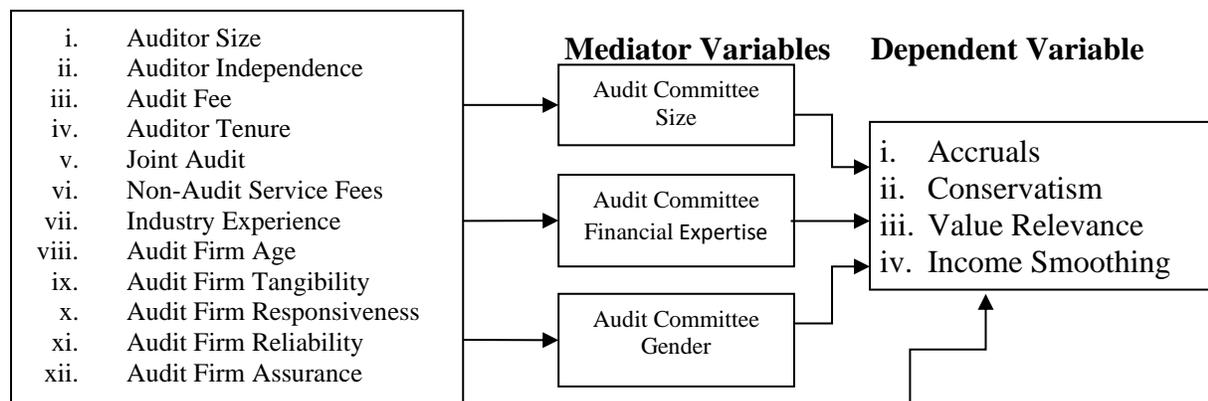


Figure 1: Propose Study Framework

Source: Author, 2022

A mediation study aids in determining if ACs on FRQ supplement (supportive hypothesis) the oversight task of ACs. An incomplete mediation (supportive mediation) or comprehensive mediation may be the outcome of the mediation (Baron & Kenny, 1986). Note that where the power of the mediator ends the independent variable's influence on explain variable, it is called full mediation. Incomplete (Partial) mediation, on the other hand, occurs when a mediator causes a notable decline in the independent variable's ability to predict the dependent variable (Complementary mediation) as suggested by (Baron & Kenny, 1986).

As a result, ACs partial mediation could imply that ACs perform a supporting duty in AAT consequence on FRQ. This premise, however, can only be tested using a mediation inquiry rather than a moderation analysis, considering a moderator clarify when a predictor variable most firmly or fragile, engender an outcome variable, while a mediator clarifies the procedure of why and how

a cause-and-effect relationship transpire (Baron & Kenny, 1986; Bala et al., 2019; Ibrahim, Mansor, 2019; Ibrahim et al., 2020).

4. Conclusions and Suggestion for Further Studies

Extant literature on ACs, AAT, and FRQ was evaluated in this study. We provided advance study groundwork to show how ACs can conciliate (mediate) the affair linking AAT and FRQ, which is in line with the complementary hypothesis. The study looked at the most recent and groundbreaking research on AAT and FRQ, as well as ACs and FRQ. We found several vacuums in the literature and offered suggestions for filling them. The investigations on AAT and FRQ yielded inconsistent findings, according to our review. The study also discovered that there is little sign of female representation on ACs. Similarly, our examination through the review of extant literature also showed a little evidence on non-audit service fees, industry experience, audit firm age, audit firm tangibility, audit firm responsiveness, audit firm reliability and audit firm assurance having an impact on ACs and FRQ. Based on the above it is concluded that more investigation is necessary to focus on the identified areas by future researchers. In addition, future research is hereby advice to focus attention on the empirical side of the study by studying the mediating effect of ACs, AAT and FRQ empirically.

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