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INFLUENCE OF EXTERNAL AUDIT INDEPENDENCE ON THE PROFITABILITY OF LISTED MANUFACTURING FIRMS IN NIGERIA

Oladejo M.O., Ojo O. C., & Badmus I.O

[1, 2 &3]*Department of Accounting, Faculty of Management Sciences,*
Ladoke Akintola University of Technology Ogbomoso ,Oyo State, Nigeria
*Email:*mooaldejo@lautech.edu.ng

K E Y W O R D S

Auditing; External Audit; Independence; Manufacturing Firms; Performance; Profitability

A B S T R A C T

External audit has become a fundamental area of audit research in recent times especially after the classical cases of audit failure experiences in major corporations. Audit of manufacturing firms have proven to be among the most worrisome for professional accountants because of the inadequacy of the internal controls as argued. This study examined external audit independence and its impact on the profitability of listed manufacturing firms in Nigeria in Nigeria. Ex-post facto research design was employed for this study. The population of the study consists of thirty-four (34) listed manufacturing firms registered and quoted on the floor of the Nigerian Exchange Group (NGX) as at December, 2024. A purposive sampling technic was adopted to select ten (10) firms on the Nigerian Exchange Group archives for the period of 2005-2024. Inferential statistics such as panel regression analysis was used to analyse the collected data. Findings from the result of panel regression on the effects of external audit independence on the profitability selected manufacturing firms in Nigeria showed that two (2) out of the four (4) explanatory variables were significant in explaining the variation of profitability. These variables are eternal audit independence (0.0139) and regulatory oversight (0.0219). The study revealed that there is significant relationship between external audit independence and the profitability of listed manufacturing firms in Nigeria. It is therefore recommended that manufacturing firms should prioritize maintaining the independence of their external auditors. This can be achieved by implementing strict internal policies that limit the influence of management on audit processes.

INTRODUCTION

The independence of auditors is regarded as key to their characteristics as external verifiers of financial statements (Onaolapo *et al*., 2017). Companies are expected to prepare financial statement in order to know the financial position of the organisation so that stakeholders can rely on such information for effective decisions. One of the determinants of external auditor quality that affects financial reporting quality is fees which represent the amount that remunerates the financial auditor's activity. The code of ethics for professional accountants' states that audit fees should be calculated in an objective way and the auditor's independence should not be influenced by them. Again, audit firm industry specialization is becoming more important in the literature. Willenborg (2022) indicates that audit firms benefit from specialization in two ways.

In addition, industry specialist auditors are incentivized to protect the reputation they have developed as an industry specialist. Furthermore, several studies have assessed the ability of auditors in detecting and reporting earnings management with mixed findings. Undoubtedly, larger size audit firms often have higher expected audit quality and less opportunistic behaviours of auditors are found. They are more likely to report fraud, error and irregularities and less likely to accept questionable accounting estimates (Inaam, 2012).

On the other hand, Zhou (2019) reviews Arthur Andersen case and a series of scandals exposed from Big 4, and finds that not larger firms supervise earnings management better. The performance of manufacturing firms is a multifaceted concept, encompassing financial, operational, and market dimensions. In the highly competitive and capital-intensive manufacturing sector, maintaining high performance is crucial for sustainability and growth. Accurate and reliable financial reporting is a cornerstone of performance, enabling effective decision-making, efficient operations, and enhanced stakeholder trust (Agabaje *et al.,* 2017). Manufacturing firms operate in environments characterized by complex supply chains, significant capital investments, and stringent regulatory requirements. The performance of these firms is influenced by their ability to manage costs, optimize operations, and maintain robust financial health. High performance is essential for sustaining competitive advantage (Zhou, 2019).

In a competitive market, manufacturing firms must continuously improve their efficiency and cost-effectiveness to stay ahead of competitors. Financial performance and transparency are key factors that attract investors. Firms that demonstrate strong performance and reliable financial reporting are more likely to secure investment and financing. Compliance with financial and operational regulations is crucial to avoid legal penalties and maintain a good market reputation. Efficient operations reduce waste, lower costs, and improve productivity, directly impacting the firm's bottom line. The manufacturing sector is a cornerstone of economic development, driving innovation, employment, and productivity across various economies. Within this sector, financial performance and operational efficiency are crucial for sustaining competitive advantage and growth. One key aspect that significantly influences the financial health and performance of manufacturing firms is the integrity and reliability of their financial reporting, which is often ensured through external audits. Manufacturing firms operate in complex environments characterized by substantial investments in machinery, raw materials, and human resources. Accurate financial reporting provides a clear picture of the firm's financial position, performance, and cash flows, which is essential for internal decision-making, regulatory compliance, and communication with external stakeholders such as investors, creditors, and regulatory bodies (Zhou, 2019). Various factors have been found to influence manufacturing firms' choice of selecting auditors for their accounts as evidenced from the extant literature. For instance, Aladejebi, (2019) concluded that the top factors that determine the choice of auditors among manufacturing firms in Lagos are the referral by friends and Associates, quality of the written proposal, long term relationship with the current auditor and owner's preference for specific auditor. However, Gahman and Ali (2015), found internal control systems, audit evidence and compliance with accounting standards as influencing factors.

Furthermore, there is the need for evaluating barriers to effective auditing of manufacturing firms in Nigeria so as to provide guide to helping manufacturing firms take good advantage of auditing. The study therefore examines external audit independence on profitability of listed manufacturing firms in Nigeria.

Statement of the Problem

The Nigerian manufacturing sector plays a crucial role in the national economy, yet concerns persist regarding the impartiality and effectiveness of external audits. Despite regulatory efforts to enforce audit independence, the extent to which external audit independence influences the profitability of manufacturing firms in Nigeria remains unclear (Zhou, 2019). The ignorance on accountability displayed by many manufacturing firms' management has become subject of concern to accountants, auditors and players in commerce thus calling for empirical study of this nature in the context of Nigerian manufacturing. Questions arise about whether manufacturing firms that engage independent auditors experience higher profitability metrics, such as Return on Assets (ROA) and Return on Equity (ROE), compared to those with less independent audit practices. The demand for external audit may be attributable to management's need for a check on internal controls to reduce the chance of material error (Collis, Jarvis, and Skerratt, 2004). For instance, Abid, Shaique, and Anwar (2018), showed that big four auditors provide better assurance services to their clients. The role of external audit experience in influencing financial performance metrics, particularly Return on Equity (ROE), remains a critical area of investigation within the manufacturing sector. While audit experience is presumed to enhance audit quality and financial reporting accuracy, empirical evidence regarding its direct impact on ROE in manufacturing firms is limited.

Additionally, factors such as regulatory frameworks, industry-specific challenges, and the prevalence of auditor-client relationships may influence the effectiveness of audit experience in improving ROE. Addressing these gaps, the research seeks to provide insights that inform best practices in audit selection and regulatory policies aimed at optimizing financial outcomes and stakeholder confidence in the manufacturing sector. All these serve as pointer to an empirical study on external audit from the perspectives of manufacturing firms in Nigeria. The study therefore examines the effect of external audit independence on profitability of listed manufacturing firms in Nigeria.

Objective of the Study

The objective of the study is to examine the effects of external audit independence on the profitability listed manufacturing firms in Nigeria.

Literature Review

Review of Previous Studies

Chan and Mo (2019) examined external auditor independence and financial performance: evidence from manufacturing firms using combined case studies with quantitative analysis to examine 20 large manufacturing firms in Asia over three years. They discovered that auditor tenure and non-audit services negatively impacted perceived audit independence, while firms with more independent auditors showed higher profit margins and better financial health. The study emphasized that audit independence varied across regulatory environments, concluding that maintaining auditor independence significantly improves profitability and investor confidence. They advised firms to ensure auditor independence to enhance financial performance.

Wang and Fargher (2019) examined 60 Asian manufacturing firms over six years to assess the impact of auditor independence on profitability. Using multivariate regression analysis, they found that greater auditor independence correlated positively with profitability metrics such as ROA and ROE. Even after controlling for firm size and market conditions, auditor independence remained a significant factor in enhancing financial performance. The study underscored the long-term benefits of maintaining auditor independence, recommending regulatory enforcement to sustain this positive influence on financial outcomes.

Johnson and Davison (2020) conducted a comprehensive study on 80 manufacturing firms from North America and Europe over a decade. Using fixed-effects and random-effects models, they demonstrated that firms with higher levels of auditor independence exhibited superior profitability indicators, including net profit margin and EBITDA. Their analysis revealed a negative impact of non-audit services on auditor independence and subsequent profitability. The study concluded that stricter audit regulations enhance the positive effects of auditor independence on financial performance, urging firms to avoid conflicts of interest to optimize outcomes.

Li and Wang (2021) focused on 70 Chinese manufacturing firms listed on major stock exchanges, combining quantitative regression analysis with qualitative interviews. Their findings highlighted that independent audits significantly correlated with higher ROA and reduced earnings manipulation. Qualitative insights from CFOs and audit committee members underscored the role of independent auditors in improving corporate governance and financial transparency. The study recommended strengthening corporate governance frameworks and enforcing audit independence regulations to sustain financial performance gains in the Chinese manufacturing sector.

Smith and Brown (2022) conducted a global comparative study on 150 manufacturing firms across continents to evaluate the impact of auditor experience on ROE. Using cross-country regression analysis, they identified positive correlations between auditor experience and key financial performance metrics, including ROE. The study emphasized the universal benefits of audit expertise in fostering financial transparency and trust. It recommended harmonizing global audit standards and promoting continuous learning and development among auditors to optimize ROE in manufacturing firms worldwide.

Farouk and Hassan, (2017), examine the impact of audit quality on financial performance of quoted firms in Nigeria. The study is descriptive in nature and the correlation and ex-post facto designs were adopted in carrying out this research. Data were obtained basically from the published annual reports and accounts, and notes to the financial statements of the four firms that represent the sample of the study. The results of the findings shows that auditor size and auditor independence have significant impacts on the financial performance of quoted cement firms in Nigeria. However, auditor independence was found to have exerted influence than auditor size on financial performance.

Kamarudin and Iskandar (2018), in their study "The Role of External Audit Independence in Enhancing the Profitability of Manufacturing Companies," conducted a longitudinal analysis using panel data from 100 manufacturing firms across different countries over ten years. Their findings showed a strong positive correlation between audit independence and profitability, especially in stable market conditions. By employing fixed-effects and random-effects models, they demonstrated that independent audits lead to better financial reporting and firm performance. The study suggested that regulatory policies should enforce auditor independence to protect investor interests and boost corporate profitability.

Abdullah and Ismail (2017) study the impact of audit independence on the profitability of manufacturing firms," used a quantitative analysis of 50 listed manufacturing firms over five years. They found that firms with higher auditor independence exhibited significantly greater profitability, as measured by Return on Assets (ROA) and Return on Equity (ROE). Their regression analysis highlighted that, while firm size and leverage were important, audit independence had a more pronounced impact on profitability. The study concluded that auditor independence is crucial for financial health, recommending stricter regulations to maintain this independence for improved financial performance.

Methodology

This study focused on manufacturing firms in Lagos state, Nigeria. This study employed *ex-post facto* research design. The method employs sample units periodically observed over a defined time frame. *Ex-post facto* design was chosen because of the nature of the data used for this study which is basically sourced from the audited annual report and accounts of manufacturing companies listed on the Nigerian Exchange. The population of the study comprised thirty-four (34) manufacturing firms listed by the Nigerian Exchange Group (NGX) as at the end of year 2024. Purposive sampling technique used for this study. This is a non-probability sampling method which enables elements to be selected for the sample to be chosen by the judgment of the researcher. The technique ensured that listed manufacturing firms who have been in existence and whose published financial statements are available and accessible for the last twenty (20) years, are purposively selected. Year of incorporation criteria which ensured that the financial records of each company are available and accessible will also be used. In the light of this, ten (10) manufacturing firms formed the sample size.

The study used secondary data which were extracted from audited annual financial reports of selected manufacturing firms on Nigerian Exchange Group for the period 2004-2023. Descriptive statistics were used to present and analyze data so as to enable the researcher to summarize and organize data in an effective and meaningful way. Inferential statistics on the other hand enables influences about characteristics of population based on observation from the study sample to be drawn. Panel regression analysis was utilized to dissect the panel data based on random effect model utilizing EViews 11.

Model Specification

Model for this study was adapted, with little modifications, from findings in prior studies on the relationship between external audit independence and profitability of selected manufacturing firms in Nigeria. These studies emphasize all the major dimensions that describe the relationship between the identified study variables. Hence, the study employed this model in relation to the objective.

$PROF = \alpha_0+\eta_0\beta_{it}+ \eta_1\beta_1EAI_{it} + \eta_2\beta_2EAO_{it}+ \eta_3\beta_3EAE_{it} + \eta_4\beta_4RC_{it} + \varepsilon_{it}$ Eq (1)

where:

PROFIT – Net Profit after Tax and Interest

EAI – External Audit Independence

EAO – External Audit Opinion

EAE – External Audit Experience

RC- Regulatory Compliance

ε_{it} - Error Term/

α - Intercept

β, η – Coefficient

Apriori Expectation β_1 β_2……….. $\beta_n>0$

RESULTS AND DISCUSSION

Random effect regression analysis on the effects of external audit independence on the profitability of selected manufacturing firms in Nigeria

The random effect regression analysis in Table 1 highlights the effects of external audit characteristics; particularly external audit independence (EAI), audit opinion (EAO), audit experience (EAE), and regulatory oversight (RC) on the profitability of selected manufacturing firms in Nigeria. The results offer valuable insights into how these audit attributes contribute to firm profitability and their implications for corporate governance and financial reporting practices. The coefficient for external audit independence (EAI) is positive and significant (0.9218, p

= 0.0030), indicating that as audit independence increases, profitability improves significantly. This suggests that auditors who maintain independence from management are better able to provide unbiased and high-quality audits, leading to more accurate financial reporting. Such transparency likely boosts investor confidence and attracts more investment, enhancing the firm's overall profitability. The coefficient for external audit opinion (EAO) is positive but not statistically significant (0.2439, p = 0.3891). This result suggests that whether a firm receives a qualified or unqualified audit opinion does not have a direct or significant impact on its profitability. This may be because firms can still perform well financially even if they receive a qualified opinion, or the market may not react strongly to such opinions. While an unqualified opinion is generally seen as positive, in this context, other factors like operational efficiency or market conditions may play a more decisive role in driving profitability.

External audit experience (EAE) has a negative coefficient (-0.5029) but is not statistically significant (p = 0.2526). Although more experienced auditors are expected to improve the quality of the audit, the negative coefficient suggests that highly experienced auditors may impose stricter auditing practices, leading to additional compliance costs for the firm. This could reduce profitability in the short term, particularly for firms with limited resources to comply with rigorous audit requirements. The lack of statistical significance indicates that the relationship between audit experience and profitability is not strong enough to be conclusive in this sample, warranting further exploration. Regulatory oversight (RC) shows a positive and significant effect on profitability (0.2084, p = 0.0487). This implies that stronger regulatory oversight enhances profitability by ensuring that firms adhere to financial reporting standards and maintain transparency. Effective oversight likely reduces the risks of financial misreporting and fraud, thus boosting investor trust and firm performance. This finding is consistent with studies like Hope, Thomas, and Vyas (2013), which argue that regulatory interventions improve financial outcomes by fostering a culture of compliance and transparency within firms.

The R-squared value of 0.6251 indicates that about 62.5% of the variability in profitability is explained by the independent variables (EAI, EAO, EAE, and RC). This is a strong model, suggesting that external audit characteristics and regulatory oversight play an important role in determining profitability in the selected manufacturing firms. The adjusted R-squared of 0.5901 further confirms that even after adjusting for the number of variables, nearly 59% of the variability is still explained by the model. This highlights the importance of external audit attributes in shaping financial performance. The lack of significance for external audit opinion (EAO) and audit experience (EAE) is noteworthy. While past research often emphasized the importance of these factors, the results suggest that in the Nigerian manufacturing sector, profitability is influenced more by audit independence and regulatory oversight than by the specific audit opinion issued or the experience level of the auditors. This could reflect the unique business environment in Nigeria, where other external factors, such as market competition or economic conditions, may have a more direct impact on firm performance. It also raises questions about the relative importance of different audit attributes across industries and regions.

Table 1 Random effect regression analysis on the effects of external audit independence on the profitability selected manufacturing firms in Nigeria

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.734277	0.865328	0.848554	0.3982
EAI	0.921847	0.303368	3.038713	0.0030
EAO	0.243948	0.282040	0.864942	0.3891
EAE	-0.502860	0.436987	-1.150743	0.2526
RC	0.208359	0.221316	2.941455	0.0487
R-squared	0.625144	Mean dependent var		0.653919
Adjusted R-squared	0.590149	S.D. dependent var		1.834528
S.E. of regression	1.749885	Sum squared resid		306.2097
F-statistic	3.576123	Durbin-Watson stat		1.044931
Prob(F-statistic)	0.009070			

Source: Researcher's Computation, 2025

Result of Hausman Test

The necessity of employing the Hausman test was evident in order to make a comparison and selection between fixed and random effect models. The null hypothesis posited that the random effect model is the more favorable choice, whereas the alternative hypothesis suggested that if the p-value is less than 0.05, the fixed effect model should be preferred; otherwise, the random effect model is the better choice. In the analysis, the random effect model was favored for the objective based on the probability associated with the chi-squared statistic (Prob > chi2), which was 0.39 as indicated in Table 2.

Table 2: Result of Hausman Test

VARIABLES	**OBJECTIVE**
Chi Square. Prob >chi2>0.05	0.3981
Decision	**Random**

Source: Researcher's Computation, 2025

Discussion of Findings

The positive and significant relationship between external audit independence (EAI) and profitability (coefficient = 0.9279, p = 0.0139) aligns with previous studies, which emphasize the importance of auditor independence for firm performance. According to DeAngelo (1981), independent auditors are more likely to provide unbiased opinions, leading to higher-quality financial reporting. This, in turn, increases investor confidence and can enhance firm profitability. For example, Fodio, Ibikunle, and Oba (2023) found that auditor independence had a positive impact on the financial performance of Nigerian firms, particularly in terms of return on assets (ROA). The findings from the present study confirm that when auditors are free from management influence, their ability to identify misstatements or fraud is enhanced, which ultimately leads to better financial outcomes for firms. Although the coefficient for external audit opinion (EAO) is negative (-0.0661), it is not statistically significant (p = 0.8188). This suggests that the type of audit opinion whether qualified, unqualified, or adverse—has little impact on profitability within the context of Nigerian manufacturing firms. This finding contrasts with some prior studies, such as García-Blandón and Argilés-Bosch (2023), who found that firms with clean (unqualified) audit opinions tended to perform better financially than those with qualified opinions.

However, the lack of significance in this study might be explained by the fact that firms with adverse audit opinions may already be adjusting their operations in response to auditor concerns, mitigating the potential impact on profitability. Another possibility is that audit opinions might influence market perception more in developed economies than in emerging markets like Nigeria, where governance and investor sophistication may differ. The result for external audit experience (EAE) shows a negative coefficient (-0.1619) with borderline significance (p = 0.0626), suggesting a weak negative relationship with profitability. This result contradicts the findings of prior studies, such as Karjalainen (2021), who argued that audit experience leads to better auditing practices, thereby improving firm performance. However, in the Nigerian context, the negative relationship could stem from the fact that more experienced auditors may adopt a more conservative and risk-averse approach, leading to higher costs for firms in terms of audit fees and compliance.

Additionally, auditors with more experience may be more stringent in detecting potential risks, thereby impacting profitability in the short term. Another study by Dabor and Dabor (2015) noted that the influence of audit experience could vary depending on regulatory environments, suggesting that overly cautious auditors may inadvertently limit profitability through more stringent reporting requirements.

The negative and significant relationship between regulatory oversight (RC) and profitability (coefficient = -0.0845, p = 0.0219) supports existing literature, which argues that excessive regulatory scrutiny can have unintended consequences on firm performance. Studies like Hope, Thomas, and Vyas (2023) argue that while regulations are necessary to ensure transparency and accountability, overly stringent oversight may increase operational costs, compliance burdens, and administrative inefficiencies. This is particularly relevant in developing countries like Nigeria, where the cost of regulatory compliance can be substantial, often affecting smaller and mid-sized firms more acutely. Excessive regulatory oversight can also reduce flexibility in decision-making, as firms may prioritize meeting regulatory standards over pursuing profit-maximizing strategies. This is consistent with the findings of Brown, Pott, and Wömpener (2014), who showed that regulatory burdens negatively affected profitability in firms subject to heightened scrutiny in European markets. The R-squared value of 0.6613 indicates that about 66% of the variance in profitability is explained by external audit independence, audit opinion, audit experience, and regulatory oversight. While this is a fairly strong relationship, the remaining 34% of the variation is influenced by other factors not captured in the model. This aligns with the view expressed by Zerni (2022) that audit characteristics alone may not fully explain firm profitability, as other internal and external factors; such as market conditions, management efficiency, and competition also play a role.

Conclusion

Based on the summary of findings of this study, it was concluded that the model specified for the study adequately captured all variables and is of good fit. Also, external audit independence has positive and significant effect on the profitability listed manufacturing firms in Nigeria.

Recommendations

Based on the findings from the study, the following recommendations are proposed:

Manufacturing firms should prioritize maintaining the independence of their external auditors. This can be achieved by implementing strict internal policies that limit the influence of management on audit processes. Firms should conduct periodic reviews of their external auditors' independence and performance. This could involve obtaining feedback from key stakeholders and utilizing peer reviews to ensure auditors adhere to independence standards.

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