

Impact of Audit Quality on Firm Performance with the Mediation of Ethical Climate and Moderation of Ethical Leadership

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Abstract

Purpose:

The current research intends to measure the impact of audit quality on firm performance with the mediation of ethical climate and moderation of ethical leadership.

Research Method:

This research study undertakes quantitative research technique and collected data cross-sectionally using deductive approach and convenience sampling method and analyzed results using SMART PLS 3.3.

Findings/Implications: Audit quality is found to have full mediation with firm performance as dependent variable and ethical climate as mediator. Moderation of ethical leadership is insignificant i.e., not enhancing the relationship of audit quality and ethical climate. This paper holds theoretical implications by providing novel relationships to literature and positive implications of audit quality for policy makers to implement in retail organizations.

Originality:

Current research study investigates the impact of audit quality on firm performance with the mediation of ethical climate and moderation of ethical leadership. Keeping in view the prior research studies, both mediation and moderation adds novelty to the current research. Moreover, the current study is conducted in retail sector which is a novel contribution to literature.

Introduction

The need for trustworthy and reliable financial statements are imperative for making sustainable decisions in business organizations (Ivungu, Anande, & Ogirah, 2019). It is because of the fact that both current and potential investors, government and all other stakeholders rely on the financial statements for investment decisions and any other contractual relationship with the reporting entity (Ivungu et al., 2019). Auditing has its roots in the private sector where there is a concern of fraud through theft and misappropriation of assets (Monametsi & Agasha, 2020). The importance of auditing lies in its perceived role of detecting fraud, errors and irregularities in financial statements (Monametsi

& Agasha, 2020). The prime area of concern that motivated are fraudulent practices and a deficiency of transparency are major problems in the firms of developing economies, like Pakistan (Iqbal, 2012). Furthermore, in the Pakistani context, few studies investigated the association between the audit quality and firm performance using secondary data (Al Ani & Mohammed, 2015; Arshad, Satar, Hussain, & Naseem, 2011).

Further, Monametsi and Agasha (2020) observed audit quality to be an effective predictor of firm performance. They used secondary data to evaluate the results in 27 companies of Uganda. Most of the previous research studies have used secondary data or dummy variable to measure the audit quality which poses certain limitations regarding the reliability of data. Current investigation covers the limitations and intends to study the impact of audit quality on firm performance using primary data. Leaders are the role models in an organization (Gandolfi & Stone, 2018). Their ethical standards can highly effect the auditing quality. Sattar, Javeed, and Latief (2020) investigated the impact of audit quality on performance and suggested future researchers to evaluate the role of leadership in raising or reducing the firm performance in regards to audit quality. Ethical leadership has gained great interest both from academicians and practitioners in the last two decades due to the apparent decline in public's trust in corporate governance and the decrease of perception of leadership legitimacy (Kelemen & Peltonen, 2001; Lins, Servaes, & Tamayo, 2017). The current research thus undertakes ethical leadership as an enhancing moderator to be impacting the relationship of audit quality and firm performance. The better the audit quality in a firm, the better is the ethical sensitivity of its employees (Badera & Jati, 2020) and a better ethical sense can lead to an enhanced ethical climate.

Audit quality is a serious problem when it comes to retail sector (departmental stores) in Pakistan. A poor audit quality leads the retail sector performance to be the poorest in the supply chain. Previously, studies have been conducted to evaluate audit quality in manufacturing (Bello, Ahmad, & Yusof, 2018) and banking sectors (Alhababsah, 2019; HAZAEA, TABASH, KHATIB, ZHU, & AL-KUHALI, 2020; Kamran, Omran, & Mohamed-Arshad, 2019) etc. The current research analyzes audit quality in retail sector of Pakistan to be studied and its impact on firm performance with the mediation of ethical climate and moderation of ethical leadership.

This study has multiple recommendations for governments, policymakers, owners, investors, and shareholders. The government can play a significant role to enhance the audit quality for retail firms. An independent audit creates a good social image of the firm in the market. Policymakers of the firms can consider the audit quality and firm performance as important corporate governance factors for improved outcomes. This study is a beacon light for countries that have the same capital and financial market who can implement these findings for positive outcomes. According to the acquired knowledge, this is a purely new study for equally developing and developed economies.

1. Literature Review

2.1 Audit Quality and Firm Performance

Audit quality is defined as per the utility of different stakeholders. For instance, some define audit quality as the high quality of audit that can identify the inaccurate figures in the financial statements (Monametsi & Agasha, 2020). On the contrary firms themselves or the society define high audit quality in firms where firms can hold out against unlawful financial acts (Monametsi & Agasha, 2020). Audit quality has no proper statement to define it as a standard measure to evaluate performance as per the Financial Reporting Council (FRC). Their exist differences in the opinions of stakeholders regarding the definition of audit quality as per the International Organization of Securities Commission (IOSO, 2009) report. A firm's stakeholders (chiefs, investors, banks, charge specialists, and others) look to know the financial performance of the firm throughout a given time frame, its monetary situation at a given

moment, its cash flows and other significant data to take better financial decisions.

Understanding the performance of an organization involves an appropriate financial assertion examination which as per Mirza and Javed (2013) is an assessment of the book and market values of resources. A profitable firm is the one which exhibits good financial performance. Since profit is a number game i.e., it depends upon the revenues and expenses of a business organization. The managers use discretionary power to manipulate revenues and expenses if their perks and benefits are associated with the financial performance. This opportunistic behaviour of managers can be detrimental to the business organization as the self-interest may lead to agency problem. Therefore, the role of external auditors become very crucial to restrict the opportunistic behaviour of managers, improve the financial performance. Afza and Nazir (2014) also suggest that external audit work has a significant impact on firm's performance. This leads to our first hypothesis:

H₁: Audit quality has a significant positive impact on firm performance.

Audit Quality and Ethical Climate

Audit quality is quite significant in determining the possible risks that can be associated with that particular organization (Chae, NAKANO, & FUJITANI, 2020). The better the audit quality the less is the expected risk (Chae et al., 2020). Training of auditors can lead to more standardized audits with fewer loops in it (HAZAEA et al., 2020). A high-quality audit leads to less or few malpractices within organizations. Audit is conducted to prevent any financial loops in the organization. As per the agency theory agents for shareholders can be more interested in their self-goals than in stakeholders and organizations best interest. This self-interest of agents may lead them to malpractices in organization practicing unethical acts in the organization. A high-quality audit identifies these loops by addressing these potential risks that might result from unethical practices of an agent.

All the formal and informal rules and processes that are shared within the members of an organization that shape up ethical behavior is called ethical climate (Victor & Cullen, 1988). It can also be referred as psychological processes that address ethical issues (Martin and Cullen, 2006). An ethical climate is established when the individuals are able to distinguish between the right and the wrong. In his book Contemporary Auditing, Gupta, Kamal (2004) defined audit to be a process of financial inspection of organization. An audit refers to identify any financial malpractices by agents or other stakeholders in the organization. A quality financial inspection thus can prevent an organization's members to act unethically for the sake of self-interest, thus, formulating an ethical climate in the organization. It leads to our second hypothesis:

H₂: Audit Quality have a significant positive impact on Ethical Climate.

Mediating Role of Ethical Climate

The quality of audit is supported by the evidences it holds at its back. A high-quality audit can be result of strong evidences behind it (Augustine, Mgbame, Efayena, & Edegware, 2014). Auditors try and look for the loop holes in the management systems and procedures and try and look for the strength of the organizational systems to be able to cope with these loop holes and potential risks. Precisely, auditors not only work to improve the public image of an organization but also work to fully rectify any unethical practices that might leads to potential risks to an organization and its performance. To prove their notion, and highlight the unethical practices in the organization, auditors use evidences to raise the quality of their audits. (Johnstone Karla, Gramling, & Rittenberg, 2013).

Ethical work climate characterizes the ethical behavior of the employees or stakeholders of that organization (Victor & Cullen, 1988). Recently, researchers have discovered that an unethical environment can affect both the individual and collective (organizational) outcomes (Newman &

Newman, 2017). Precisely, ethical climate is related to positive work outcomes (Briggs, Jaramillo, & Weeks, 2012; Ehrhart & Raver, 2014; Mayer, 2014; Pagliaro, Lo Presti, Barattucci, Giannella, & Barreto, 2018; Peterson, 2002). Therefore, an ethical climate can raise the overall organizational effectiveness and outcomes (Pagliaro et al., 2018).

Successful firms represent a key ingredient for developing nations (Taouab & Issor, 2019). Many economists consider them similar to an engine in determining their economic, social, and political development (Taouab & Issor, 2019). To survive in a competitive business environment, every firm should operate in conditions of overall organizational performance. Firm performance is referred to be as the ability of firms to utilize their material and human resources to achieve an organization's goals. So, an ethical climate in organizations can help improve firm outputs (Pagliaro et al., 2018) raising its overall performance. This drives us to third hypothesis:

H₃: Ethical Climate mediates the relationship between audit quality and firm performance.

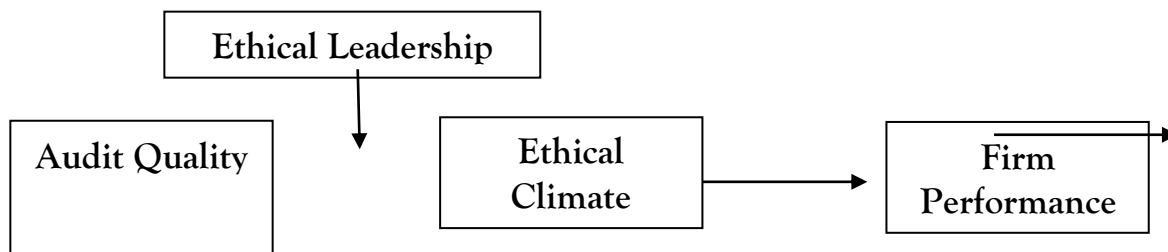
Moderating Role of Ethical Leadership

Ethical leadership is a dynamic conceptualization with no definite statement or concept to define it (Ahmad and Gao, 2018). However, Brown et al., (2005) defined ethical leadership as the show of normatively proper lead through individual activities and relational connections, and the advancement of such direct to subordinates through two-way correspondence, support, and navigation. An organizations ethical climate is led by often its ethical leader (Elçi, Şener, & Alpkan, 2013). The level of ethics of leader defines the level of ethical climate within that organization (Elçi et al., 2013). This notion is in harmony with the investigation of Elçi et al. (2013); Mayer, Kuenzi, and Greenbaum (2009); Neubert, Carlson, Kacmar, Roberts, and Chonko (2009). Ethical climate emphasizes employees on the collective practice of ethical procedures, rules and norms (Mayer et al., 2009; Victor & Cullen, 1988). Mayer et al. (2009) also stated that an ethical leaders will ensure the reduction of unethical and malpractices within an organization.

Audit quality is defined as per the utility of different stakeholders. For instance, some define audit quality as the high quality of audit that can identify the inaccurate figures in the financial statements (Monametsi & Agasha, 2020). On the contrary firms themselves or the society define high audit quality in firms where firms can hold out against unlawful financial acts (Monametsi & Agasha, 2020). When leaders prevent any malpractices by emphasizing ethical rules and procedures, with high level of financial inspection of the firm in the form audit quality, an ethical climate is formed in the organization. From there, we can state the fourth hypothesis as below:

H₄: Ethical Leadership moderates the relationship between Audit Quality and Ethical Climate.

2. Conceptual Framework



3. Methodology

4.1 Procedure and Sample

The study is rather causal and focused to explore the impact of audit quality on firm performance. The moderating role of ethical leadership is tested between the relationship of audit quality and ethical climate.

Impact of Audit Quality on Firm Performance with the Mediation of Ethical Climate and Moderation of Ethical Leadership

For this purpose, the retail sector of Pakistan has been focused to get the required data importantly to get accurate results. The data was collected in one span of time; therefore, the study is a cross-sectional and single field. Initially, 300 questionnaires were set as a target but 200 genuine responses were collected with a 66.66% response rate using convenience sampling method. The sample that was selected for this study is assumed to represent the entire retail sector organization's employees of Pakistan.

This research follows a deductive research method based on determinism. Previous research and existing theories have been used to test the hypothesis. And then we perform an empirical test of the hypothesis to verify the proposed hypothesis. General quantitative methods have been used that are of great value and can be integrated into a wide range of population sizes. Therefore, the data was analyzed quantitatively. Quantitative technique refers to empirically or numerically measuring something (Bryman, 2016). As per Rasinger (2013), this technique refers to how much of something or how many or to what limit.

The advantage to using this technique for the current research is that it quantifies the problem being researched in form of empirically represented items called variables. The technique is also useful in generalizing the results for sample data on the entire population making the results truth-worthy (Powers D. and Powers A., 2015). Moreover, this technique is less time-consuming in comparison to qualitative and can easily be analyzed using statistical software (Connolly, 2007) like SMART PLS.

4.2 Instruments

All constructs are measured on a 5-point Likert scale, ranging from Strongly Disagree at 1, Neutrality at 3 to Strongly Agree at 5. Table 1 represents the instruments utilized in the study with their references of adoption.

Variable Type	Variable Name	Reference	No. of Items	Reliability (α)
Independent Variable	Audit Quality	Jalil Ibrahim Saliha, Hakeem Hammood Flayyihb, 2020	12	0.79
Dependent Variable	Firm Performance	JW Dean Jr. SA Snell, 1996	6	0.791
Mediator	Ethical Climate	Victor & Cullen, 1993	12	0.86
Moderator	Ethical Leadership	(ME Brown, LK Treviño, DA Harrison, 2005	6	0.78

Table 1: Instruments

4. Results

Results were analyzed using SMART PLS. Both the measurement model and structural model are analyzed of the sample data.

Measurement Model

	Cronbach's Alpha	rho_A	Composite Reliability	Average Variance Extracted (AVE)
AQ	0.937	0.945	0.907	0.602
EC	0.937	0.946	0.906	0.603
EL	0.911	0.914	0.901	0.694
FP	0.859	0.871	0.896	0.591

Table 2: Measurement Model

The above table 2 depicts the results for the measurement model of the sample data using SMART PLS. All constructs are reliable and valid. Audit Quality (AQ) measure of convergent validity is 0.602 which is greater

than 0.5, thus, declaring it a valid measure. Ethical Climate (EC) measure of convergent validity is 0.603 which is greater than 0.5, thus, declaring it a valid measure. Ethical Leadership (EP) measure of convergent validity is 0.694 which is greater than 0.5, thus, declaring it a valid measure. Firm Performance (FP) measure of convergent validity is 0.591 which is greater than 0.5, thus, declaring it a valid measure. Audit Quality (AQ) measure of reliability is 0.907 which is greater than 0.7, thus, declaring it a reliable measure. Ethical Climate (EC) measure of reliability is 0.906 which is greater than 0.7, thus, declaring it a reliable measure. Ethical Leadership (EL) measure of reliability is 0.901 which is greater than 0.7, thus, declaring it a reliable measure. Firm Performance (FP) measure of reliability is 0.896 which is greater than 0.7, thus, declaring it a reliable measure.

Structural Model

Direct Effects

	Original Sample (O)	Sample Mean (M)	Standard Deviation	T Statistics	P Values
AQ → EC	0.985	0.984	0.008	123.201	0
AQ → FP	0.35	0.365	0.303	1.154	0.249
EC → FP	0.625	0.61	0.303	2.063	0.04
EL → EC	0.015	0.016	0.008	1.828	0.068
Moderating Effect 1 → EC	-0.004	-0.004	0.004	1.062	0.289

Table 3: Direct Effects

The above-mentioned table 3 depicts the direct results of the study. Audit quality (AQ) have insignificant impact on Firm Performance (FP) with p value 0.256 ($p > 0.05$) and t value 1.154 ($t < 1.96$). Thus, rejecting our first hypothesis. In contrast, Audit quality (AQ) have positive significant impact on Ethical Climate (EC) with p value 0.000 ($p < 0.05$) and t value 123.20 ($t > 1.96$). Thus, accepting our second hypothesis. Moderating effect of Ethical Leadership (EL) is found to be insignificant between the relationship of Audit Quality (AQ) and Ethical Climate (EC). Thus, rejecting our fourth hypothesis.

Indirect Effects

	Original Sample (O)	Sample Mean (M)	Standard Deviation	T Statistics	P Values
AQ → EC → FP	0.616	0.601	0.301	2.048	0.041

Table 4: Indirect Effects

The above table 4 shows the indirect effects of the study i.e., the mediation model. The results show the mediation of Ethical Climate (EC) to be significant between the relationship of Audit Quality (AQ) and Firm Performance (FP) with a p value 0.041 ($p < 0.05$) and t value 2.048 ($t > 1.96$). Results show a full mediation model i.e., there exists only an indirect relationship between Audit Quality (AQ) and Firm Performance (FP) with the bridging effect of Ethical Climate (EC).

5. Discussion

First hypothesis is not supported by the results that audit quality have a significant impact on firm performance. Egbunike and Abiahu (2017) in their study reported an insignificant impact of audit quality on firm performance. The possible reason for the insignificance they quoted is that a combine measure of market and financial performance could provide a better understanding of impact of audit quality. The current study uses primary data and Ivungu et al. (2019) states that primary data can highly alter the results of audit quality on firm performance as the data is not based on facts but on respondents which is easily abused by them.

Our second hypothesis gets its support from the results that audit quality have a significant positive impact on ethical climate. Audit is conducted to prevent any financial loops in the organization. As per the agency theory agents for shareholders can be more interested in their self-goals than in stakeholders and organizations best interest. This self-interest of agents may lead them to malpractices in organization practicing unethical acts in the organization. An ethical climate is established when the individuals are able to distinguish between the right and the wrong. In his book *Contemporary Auditing*, Gupta, Kamal (2004) defined audit to be a process of financial inspection of organization. An audit refers to identify any financial malpractices by agents or other stakeholders in the organization. A quality financial inspection thus can prevent an organization's members to act unethically for the sake of self-interest, thus, formulating an ethical climate in the organization.

Our third hypothesis also gets its support from the results that ethical climate mediates the relationship between audit quality and firm performance. A high-quality audit can be result of strong evidences behind it (Augustine et al., 2014). Auditors not only work to improve the public image of an organization but also work to fully rectify any unethical practices that might leads to potential risks to an organization and its performance. To prove their notion, and highlight the unethical practices in the organization, auditors use evidences to raise the quality of their audits. (Johnstone Karla et al., 2013). Highlighting such practices creates ethical climate. Ethical climate is related to positive work outcomes (Pagliaro et al., 2018). So, an ethical climate in organizations can help improve firm outputs (Pagliaro et al., 2018) raising its overall performance.

Our fourth hypothesis is not supported by the results that ethical leadership moderates the relationship between audit quality and ethical climate. Wang, Xing, Xu, and Hannah (2021) in their study investigated impact of ethical leadership on unethical behaviors. Surprisingly they found a positive significant impact of ethical leadership on unethical behaviors in the organization. In their study they stated in the presence of low morality ethical leadership evokes unethical behaviors at work leading to an unethical work environment.

6. Implications

The current study has both theoretical and practical implications. The current study firstly adds on to the literature of investigated variables such as audit quality, firm performance, ethical climate and ethical leadership. Secondly, this study shows that firm performance in retail sector of Pakistan is not affected by the quality of its audits. However, audit quality that raises ethical climate within organizations can raise the overall firm performance. Also, ethical leadership was not found to be enhancing ethical climate by raising audit qualities at firms.

Policy makers in retail sector of Pakistan should focus on raising the audit quality to develop ethical climates and improve firm performance. Retail firms should use high level audit firms to perform audit for them. Audit provides the financial inspection of the firm. A high-quality audit would help firm better look at the financial loops and inaccuracies leading less unethical behaviors and raised firm performances.

7. Limitations and Future Research

The current research is a cross sectional study conducted in the retail sector of Pakistan using primary data. Primary data can easily be mistreated by respondents. Future researchers can conduct the same study using secondary data like using data from GovData360 to evaluate the ethical standing of firms. Moreover, the same study can be conducted in the retail sector of India, China, and Bangladesh etc. The current model can also be tested in other sectors of Pakistan like manufacturing, pharmaceutical, food sector etc. A time-series data can eradicate any potential factor that might have affected the results in the current time frame. The current study has utilized ethical leadership as moderator between audit quality and ethical climate. Future researchers can test other moderators with the model like unethical behaviors, unethical leadership etc. Similarly, mediators other than ethical climate can be tested in the current model like audit processes, earning quality etc.

8. Conclusion

The current study investigated the impact of audit quality on firm performance with the mediation of ethical climate and moderation of ethical leadership in the retail sector of Pakistan. Primary data was collected cross-sectionally using convenience sampling method and quantitative technique. The results depicted an insignificant direct relationship of firm performance on audit quality. In contrast, their relation with the mediation of ethical climate was found to be significant. However, moderation of ethical leadership between audit quality and ethical climate was found to be insignificant as sometimes ethical leaders evoke unethical behaviors in the presence of low morality. This study added on to the literature of constructs utilized and emphasizes on raising audit quality in retail sector to enhance firm performance by developing ethical climate.

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Impact of Audit Quality on Firm Performance with the Mediation of Ethical Climate and Moderation of Ethical Leadership

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