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Environmental Determinants of Audit Quality and Regulatory Compliance among Small and Medium Enterprises in Osun State, Nigeria

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Abstract— This study examines the environmental determinants of audit quality and their implications for regulatory compliance among small and medium enterprises (SMEs) in Osun State, Nigeria, integrating accounting and political science perspectives by treating compliance as both a financial reporting obligation and an outcome of institutional capacity and regulatory legitimacy. A qualitative documentary design was adopted, drawing secondary data from legislation, regulatory notices, official reports, and peer-reviewed studies published mainly between 2010 and 2026, analysed through directed content analysis and thematic synthesis. Six connected determinants were identified: regulatory clarity and enforcement, professional competence and auditor independence, economic and compliance costs, accounting technology, administrative coordination, and trust in public institutions. Audit quality was found to improve compliance when it strengthens records, detects misstatement, clarifies obligations, and raises the perceived probability of detection, although this pathway is weakened by informality, limited accounting capacity, fragmented oversight, and the statutory audit exemption for qualifying small companies. The study concludes that a proportionate, graded assurance system supported by digital filing, registered practitioners, coordinated regulation, and targeted capacity building offers a more credible approach than uniform enforcement, and it proposes an integrated institutional model with specific policy relevance for Osun State.

Keywords: audit quality; environmental determinants; regulatory compliance; small and medium enterprises; institutional governance

1. Introduction

Small and medium enterprises (SMEs) are central to employment, local production, and household income in Nigeria, yet many operate within a demanding institutional environment marked by overlapping registration, reporting, and tax obligations. The national survey conducted by the Small and Medium Enterprises Development Agency of Nigeria and the National Bureau of Statistics documents the scale and diversity of the sector and confirms that a large share of enterprise activity remains micro and informal [1]. For Osun State, this context is particularly important because enterprise development is linked to agriculture, trade, services, artisanship, and a growing digital economy. Public policy therefore faces a dual task: it must encourage formalisation and investment while preserving credible mechanisms of financial accountability.

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Audit quality is commonly understood as the capacity of an audit to discover material misstatement and the willingness of the auditor to report it, with quality located in the joint probability of discovery and reporting [2]. Subsequent research shows that quality emerges from inputs, processes, professional judgement, incentives, institutions, and reporting outcomes [3], [4]. This wider conception is particularly suitable for SMEs, since the quality of an engagement cannot be reduced to the size of the audit firm; it also depends on competence, independence, access to records, technology, ethical culture, regulation, and the ability of the client to maintain auditable information.

Regulatory compliance is equally multidimensional. An enterprise may be expected to register correctly, maintain accounting records, submit annual returns, file accurate tax information, meet sector licences, and disclose relevant information to lenders or public authorities. The Companies and Allied Matters Act (CAMA) 2020 introduced a significant qualification by exempting companies that meet the statutory definition of a small company from audit in specified circumstances [5]. The exemption reduces cost, but it creates a policy boundary that must be interpreted carefully: it does not remove the need for proper records or other statutory obligations, and it does not cover every enterprise ordinarily described as an SME.

The political science dimension of this study arises because compliance is shaped by the authority, capacity, and legitimacy of public institutions. Rules that are clear, proportionate, and consistently enforced are more likely to influence behaviour than rules that are fragmented or perceived as arbitrary. Institutional theory explains how coercive, professional, and imitative pressures lead organisations towards accepted practices [6]. Applied to SMEs, these pressures operate through laws, professional norms, lender requirements, supply chain expectations, and the search for legitimacy.

Evidence from Nigeria suggests that reporting quality and statutory compliance are associated with enterprise performance and transparency [7], while proactive monitoring by regulators and auditors is associated with stronger disclosure compliance [8]. In Osun State and the wider South West, studies also point to the importance of technology, accounting services, and the business environment [9]–[12]. Yet the literature is dispersed across accounting, taxation, management, and public policy, and few studies connect the external environment of audit quality to the wider regulatory behaviour of SMEs in a specific state.

Audit quality is not directly observable and is therefore assessed through indicators such as audit firm size, tenure, industry specialisation, independence, fees, and the incidence of reporting failure. Nigerian evidence from listed firms shows that governance arrangements, auditor tenure, and firm resources can influence quality [13], [14], while more recent evidence warns that audit market competition may encourage opinion shopping, in which clients seek a favourable conclusion rather than a rigorous examination [15]. These findings cannot be transferred mechanically to SMEs, but they identify incentives that matter in smaller engagements. The International Auditing and Assurance Standards Board frames audit quality as an interaction among inputs, processes, outputs, key interactions, and contextual factors, in which context includes law, regulation, corporate governance, information systems, and the business environment [13]. This framework supports the premise that external conditions can strengthen or weaken professional work even where individual auditors possess technical knowledge.

The term SME must be treated with care, since the development classification used for enterprise support differs from the legal conditions used by CAMA to determine whether a company qualifies as small; a medium enterprise, a regulated entity, or a company that fails the statutory conditions may remain subject to audit, and even an exempt company may choose voluntary assurance where banks, investors, donors, or major customers require credible information [5]. The IFRS for SMEs Accounting Standard offers a simplified reporting framework for entities without public accountability, with its third edition effective for annual periods beginning on or after 1 January 2027 [17]; Nigerian literature nevertheless identifies capability, cost, and awareness as persistent implementation challenges [18].

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Regulatory compliance theory further distinguishes deterrence, which emphasises the probability of detection and the cost of non-compliance, from legitimacy, which emphasises fairness, clarity, trust, and acceptance of regulatory authority. Tax audit evidence in Nigeria supports the deterrence pathway, since desk and field audits are associated with stronger compliance [19], while digital systems and service quality support the legitimacy and capability pathway by making compliance easier [20]. The integrated model therefore treats the external environment as an antecedent of audit quality and audit quality as a mediator of compliance, with SME capability, informality, sector, and the audit exemption operating as boundary conditions.

Three gaps are evident in the existing literature. First, audit quality studies often emphasise firm-level attributes while treating regulation and administrative capacity as background conditions. Second, compliance studies often focus narrowly on tax rather than the connected corporate, reporting, and sector obligations faced by SMEs. Third, the legal consequence of the CAMA audit exemption is rarely incorporated into models of SME accountability. This paper addresses these gaps through a documentary analysis of the Nigerian regulatory architecture and relevant empirical evidence, asking four questions: which environmental factors shape audit quality for SMEs; through what mechanisms does audit quality affect regulatory compliance; how does the statutory audit exemption alter the relationship; and which policy measures can strengthen compliance without imposing disproportionate cost. The objectives are accordingly to identify the principal environmental determinants of audit quality, to explain their compliance pathways, to assess the institutional boundary created by CAMA 2020, and to develop a proportionate policy framework for Osun State, thereby contributing an integrated institutional model linking the audit environment, audit quality, and SME compliance.

2. Method

The study adopted a qualitative documentary research design using secondary data, which is appropriate given research questions concerned with rules, institutions, policy instruments, and recurring findings across existing studies. The unit of analysis was the substantive claim or provision relating to audit quality, SME capability, or regulatory compliance. The geographic focus was Osun State, while national legislation and evidence from Nigeria and the South West were included because corporate reporting and professional audit regulation are largely federal in character.

The review covered materials published mainly from 2010 to 2026, with seminal theoretical and audit quality studies retained where necessary. The final corpus comprised 27 documents, comprising legal, regulatory, and standards documents, official enterprise and state policy data, and peer-reviewed scholarly works, as summarised in Table 1. Materials were included where they addressed at least one of the following: audit quality, financial reporting by SMEs, corporate compliance, tax compliance, accounting technology, professional oversight, or the Osun business environment. News commentary, anonymous web material, and items without clear institutional or scholarly provenance were excluded.

A structured extraction sheet recorded the author or institution, year, jurisdiction, document type, stated obligation, determinant of audit quality, compliance outcome, and limitation. Directed content analysis began with categories derived from the IAASB framework and institutional theory — regulation, enforcement, professional competence, independence, economic conditions, technology, coordination, and legitimacy [13], [6] — after which open coding was used to capture additional themes, especially the audit exemption, informality, and accounting outsourcing.

Table 1. Documentary corpus and analytical use

Document group	Examples	Number
Legislation and regulation	CAMA 2020; FRC Audit Regulations; FRC amendment and audit-related rules	6

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Document group	Examples	Number
Standards and official guidance	IAASB audit quality framework; IFRS for SMEs	2
Official enterprise and state policy data	SMEDAN and NBS survey; Osun harmonised levies and investment portal	3
Peer-reviewed studies	Nigerian, South West, and Osun studies on audit, reporting, technology, and compliance	16

The analysis proceeded in three stages. First, legal and regulatory documents were read to establish the formal architecture. Second, empirical findings were compared for convergence, contradiction, and contextual limitation. Third, the themes were arranged into a causal pathway from the external environment to audit quality, and from audit quality to compliance. Claims were treated as stronger where supported by both an official provision and empirical evidence. The method supports analytical inference rather than statistical estimation of causal effects for the entire population of Osun SMEs.

Credibility was strengthened through source triangulation, preference for official documents, verification of digital object identifiers, and explicit separation of legal provisions from empirical findings. Dependability was supported by the documented inclusion criteria and coding categories. Because the study used public secondary materials and no personal data, direct participant consent was not required; the study nevertheless observes research integrity through accurate attribution and cautious interpretation.

3. Results and Discussion

Regulatory clarity, proportionality, and the audit exemption. Nigeria possesses a substantial architecture for corporate reporting and audit, including CAMA 2020, the Financial Reporting Council (FRC) Act as amended, the Audit Regulations 2020, and related audit rules [5], [21], [22]. The 2023 amendment strengthened enforcement powers and clarified aspects of public interest entity regulation [22], while in 2025 the Council reiterated mandatory compliance by statutory auditors with rules covering key audit matters, audit committees, transparency reporting, and non-compliance with laws and regulations [24]. These measures improve clarity for practitioners operating within the formal audit system; however, for SMEs, proportionality is decisive. CAMA exempts a qualifying small company from audit, but not all SMEs are qualifying small companies, producing a segmented compliance environment in which public interest and regulated entities face strong oversight, informal micro enterprises remain outside effective corporate reporting, and registered small and medium enterprises sit between the two with differing audit obligations and information needs. A uniform policy would either overburden the smallest firms or under-protect the users of higher-risk enterprises. The exemption also creates a possible assurance gap, since owners may incorrectly assume that no audit means no need for reliable records, whereas annual returns, taxation, loan applications, and management decisions still depend on credible information; reporting quality and compliance have indeed been linked to SME performance [7]. The policy implication is not automatic restoration of full audit for every small company, but access to proportionate services such as compilation, agreed procedures, limited assurance, or voluntary audit where risk and user need justify them.

Enforcement capacity and credible monitoring. Formal rules influence conduct when regulated actors expect that breaches can be detected and addressed. The FRC introduced Rule 14 to strengthen auditor responsibilities concerning actual or suspected non-compliance with laws and regulations [23], and in 2026 it made the National Audit and Assurance Firms Register operational, stating that only registered firms may undertake audit and assurance engagements in Nigeria [25]. This development can improve traceability, professional accountability, and public verification. Empirical evidence supports the monitoring mechanism: proactive regulatory monitoring and the use of large audit firms have been associated with stronger disclosure compliance [8], while desk and field tax audits positively influence

SME tax compliance [19]. Credible monitoring therefore changes the expected consequences of inaccurate reporting, although enforcement intensity alone is insufficient where regulators lack interoperable data, trained staff, or consistent procedures, since the formal probability of detection then remains low.

Professional competence, independence, and market incentives. Competence determines whether material errors are discovered, while independence determines whether they are reported. Larger audit firms may possess stronger methods, specialist staff, and quality control, but size is an imperfect proxy; evidence from Nigerian listed firms associates governance, tenure, and firm resources with audit quality [14], [15]. For SMEs, local knowledge and affordability are equally important, provided professional standards are maintained. Market pressure may weaken independence, and opinion shopping has been identified as a risk in a competitive Nigerian audit market [16], a risk that may be acute where an SME owner controls appointment, information, and fees and where no independent audit committee exists. Registration and inspection can reduce this vulnerability, but ethical culture, engagement quality control, and communication with lenders or other users remain necessary; the finding supports a professional environment that rewards credible reporting rather than client retention at any cost.

Economic conditions, capability, and accounting services. Audit quality depends on the quality of underlying records, and weak bookkeeping, cash-based transactions, owner dependence, and limited internal control increase the cost of obtaining evidence. Cost and implementation capability have been identified as central issues in SME financial reporting [18], while the business environment has been shown to influence SME success in Osun State [10], reinforcing the point that compliance decisions are made under economic constraint rather than in an institutional vacuum. Accounting outsourcing offers a partial response: evidence from Osogbo SMEs indicates that outsourcing can improve transparency but does not guarantee accountability without adequate supervision [12]. External accountants may create records that make assurance and compliance possible, yet owners must retain responsibility for completeness and accuracy, so the most appropriate policy response is capacity building linked to simple record systems, recognised practitioners, and clear engagement terms.

Technology and administrative coordination. Digital accounting systems can improve transaction trails, reduce arithmetic error, and make remote review possible. Accounting technology has been found to have a positive moderating effect on the technical and service dimensions of audit quality in South West Nigeria [11], and technology adoption similarly supports tax audit and compliance in Osun State [9]; electronic tax filing research also shows that performance expectancy, ease of use, and awareness influence SME compliance [20]. Technology is not automatically inclusive, however, since unreliable connectivity, fragmented portals, poor cyber security, and limited digital skills can merely transfer administrative burden to the enterprise; coordination is therefore as important as digitisation. Osun State has taken steps to simplify the business environment, including the harmonisation of levies into a single bill intended to reduce multiple taxation and improve payment convenience [26], and a subsequent investment portal that provides a single entry point for guidance on permits, incentives, and investment processes [27]. These initiatives can strengthen compliance if their data, service standards, and grievance procedures are integrated with broader formalisation support.

Trust, legitimacy, and compliance behaviour. SMEs are more likely to comply when obligations are understandable, service is accessible, and public revenue is perceived to support a fair business environment; multiple or unpredictable demands weaken legitimacy and may encourage informality. Harmonisation can therefore affect compliance not only by reducing cost but also by signalling procedural fairness, which is the political dimension of audit and accounting regulation: effective rules depend on the perceived competence and impartiality of the institutions that administer them. An independent auditor can act as an intermediary between the enterprise and the regulatory system by explaining obligations, correcting records, and reporting material problems, thereby converting abstract rules into operational behaviour; however, the auditor should not become a substitute regulator or assume

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management responsibility, and the value of this intermediary role depends on independence, clear professional boundaries, and the regulator's willingness to provide authoritative guidance.

These findings collectively support the proposition that audit quality is institutionally produced, as summarised in Table 2. The environment shapes who may practise, which standards apply, whether independence is protected, the quality of client records, and the consequences of non-compliance, which aligns with the IAASB framework [13] and extends the discovery-and-reporting logic proposed by DeAngelo [2]: discovery is more likely where records, technology, and competence are adequate, and reporting is more likely where independence, oversight, and legal protection are credible.

Institutional theory explains the interaction among these determinants [6]. Coercive pressure appears through CAMA, FRC regulation, and tax enforcement; normative pressure appears through professional standards, registration, and education; and imitative pressure appears when SMEs adopt credible practices to obtain credit, enter formal supply chains, or resemble successful peers. None of these pressures is sufficient alone: strong coercion without capability encourages avoidance, professional advice without enforcement may be ignored, and imitation without substantive records may become ceremonial compliance.

The audit exemption is the most important boundary condition identified in this study. It correctly recognises that a full statutory audit may impose disproportionate cost on a genuinely small company, yet it simultaneously removes a routine external verification point. The appropriate response is a graded assurance ladder rather than a binary choice between full audit and no accountability, in which low-risk small companies use supported bookkeeping and compilation, firms seeking credit or public contracts obtain limited assurance or agreed procedures, and medium, regulated, or public interest entities face stronger audit and oversight requirements.

The findings also demonstrate why accounting and political science perspectives must be combined. Accounting explains evidence, reporting quality, and professional judgement, while political science explains rule design, institutional capacity, coordination, incentives, and legitimacy; regulatory compliance occurs precisely where these two domains meet. A technically sound audit system cannot succeed if agencies issue conflicting demands, and a well-designed policy cannot succeed if enterprises lack records capable of verification.

For Osun State specifically, the policy opportunity lies in connecting current ease-of-doing-business reforms with financial capability and assurance. Harmonised levies and the investment portal [26], [27] can reduce transaction costs, but their compliance value will be greater if SMEs receive plain-language obligations, digital record templates, referral to registered practitioners, and a clear route for resolving inconsistent demands, thereby turning formalisation from a punitive event into a supported administrative transition. Based on these findings, a graded assurance framework, an integrated state-level compliance gateway linking levy, tax, and licensing obligations, simple digital record-keeping support, verification of registered practitioners, coordinated risk-based monitoring across agencies, and published service standards represent the most practicable measures for strengthening compliance without imposing disproportionate cost on genuinely small enterprises.

Table 2. Thematic synthesis of environmental determinants and compliance pathways

Environmental determinant	Effect on audit quality	Principal risk
Clear and proportionate regulation	Clarifies scope, evidence, and reporting duties	SMEs may confuse audit exemption with general exemption
Credible enforcement and oversight	Supports independence, registration, and quality control	Selective or weak enforcement produces symbolic compliance

Environmental determinant	Effect on audit quality	Principal risk
Professional capacity and ethics	Improves judgement, evidence, and truthful reporting	Opinion shopping and fee dependence
Economic capacity and accounting support	Improves the quality of records available for assurance	Poor records and owner dominance
Technology and interoperable systems	Creates audit trails and supports efficient procedures	Digital exclusion, fragmented portals, and cyber risk
Trust and administrative legitimacy	Supports candid engagement and acceptance of findings	Arbitrary demands and weak service reduce cooperation

4. Conclusion

This study concludes that the regulatory compliance of SMEs in Osun State is shaped not by audit quality in isolation but by the wider institutional environment that produces and uses that quality. Clear rules, credible enforcement, professional competence, independence, affordable accounting support, technology, coordination, and institutional trust form an interconnected system; where these conditions are present, audit and assurance improve records, detect misstatement, explain obligations, and increase the credibility of enterprise information. The study directly answers its four research questions by identifying six connected environmental determinants of audit quality, explaining the mechanisms through which they shape compliance, showing that the CAMA audit exemption creates a segmented compliance environment rather than a general release from accountability, and proposing a graded, proportionate assurance framework as the most defensible policy response.

The scientific contribution of this paper lies in its integration of accounting and political science perspectives into a single institutional model linking the audit environment, audit quality, and SME regulatory compliance, a linkage that has previously been addressed only partially and mostly at the national or firm level rather than for a specific sub-national jurisdiction. For Osun State and comparable Nigerian states, the study offers direct societal relevance by showing how ease-of-doing-business reforms can be connected to financial capability and assurance so that formalisation becomes a supported transition rather than a punitive event.

The study is limited by its documentary design and by the absence of a public longitudinal dataset linking audit engagements to corporate and tax compliance for Osun SMEs, so its findings are analytical rather than population estimates. Future research should construct a firm-level panel or conduct a mixed-methods study across Osun's senatorial districts, distinguishing micro enterprises, legally defined small companies, and medium enterprises, and comparing audit-exempt firms with firms that adopt voluntary assurance.

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