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Audit Independence and Financial Statements Quality in Nigeria Listed Banks

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Abstract

The primary aim of this study was to examine the impact of audit independence on the financial statement quality of commercial banks listed in Nigeria. The study was conducted using a twelve-year scope (2010 to 2021). Four independent variables—audit fee, joint audit, audit tenure, and audit opinion—as proxies for measuring audit independence were employed while twelve (12) commercial banks that consistently submitted their annual financial reports throughout the entire period of investigation were used as the sample size. This study conducted pre-regression analyses, including descriptive statistics, correlation analysis, and data normality analysis. The regression result revealed a significant influence of audit fees on financial statement quality while auditor tenure, joint audit and auditors' opinion showed no statistically significant influence on the financial statement quality of the sampled banks. In line with the outcome, the study recommends strengthening the oversight and regulation of auditing practices in the Nigerian banking sector. This could involve closer collaboration between regulatory authorities and audit firms to ensure that audit fees are commensurate with the quality of audits conducted.

Keywords

Audit Independence, Financial Statement Quality, Regression Analysis, Auditor Opinion, Audit Fee, Audit Tenure, Joint Audit

1. Introduction

The financial statements of any organization represent a fundamental tool not only for measuring the performance of an organization in operational terms but also for allowing the general world of business and interested stakeholders to assess the profitability and going concern status of an establishment. The financial statements issued by business entities must provide objective and reliable information that third parties and other concerned entities will rely on in making critical decisions such as investment and divestment of shareholding in target companies. According to Ivungu et al. (2019), it is necessary for corporate organizations to have trustworthy and reliable financial accounts to be able to make sustainable decisions. This assertion underscores how crucial it is to have trustworthy and reliable financial statements. Financial statements serve as the primary instrument to assist users in making investments and other business-related choices. If financial statements are ambiguous and inefficient, they can negatively influence how users perceive a company's current financial position (Simon, 2018). Stakeholders' views on the quality, integrity, and dependability of a company's financial statements are often significantly impacted by the evaluations conducted by external auditors. The Companies and Allied Matters Act (as amended), along with the Statement of Accounting Standards that includes the International Financial Reporting Standards and the guidelines from regulatory bodies in Nigeria, such as the Securities and Exchange Commission, Central Bank of Nigeria, and Financial Reporting Council of Nigeria, all consider external auditors to be independent entities distinct from the ownership and management of the companies they audit. The independence of auditors is expected to influence the quality of the financial statements they assess (Daniels & Booker, 2011). As a result, the auditor's independence plays a crucial role in establishing the credibility, integrity, and overall quality of financial statements, particularly in a developing country like Nigeria.

Inefficiencies on the part of management and the fact that financial statements do not show the true situation and financial position of the organization have been jeopardizing the decisions of prospective investors. This is one serious challenge facing organizations, imply that the sanctity of financial statement as well as the confidence of stakeholders, rest on the auditors, who are saddled with responsibilities of addressing these issues through efficient and effective execution of their audit assignment, to produce quality reports. Complaints about dishonest and deceptive audited financial statements are now common, causing unanticipated financial system distress such as the Enron Scandal in 2002, the collapse of Lehman Brothers in the United States, and the global financial crises of 2008. Many of these crises were blamed in part, if not entirely, on misleading audited financial statements issued by those companies. In the Nigerian context, there is the case of Akintola William's Accounting Firm and the Federal Republic of Nigeria on the Nigeria National Petroleum Corporation (NNPC) Probe and accounting failure labeled as Cadbury Nigeria Plc saga after been audited by the well-known audit firm "Akintola Williams Delloite" (Okaro, Okafor & Ofoegbu, 2018). Accounting scandals and lack of audit quality in Nigeria make financial reports distrustful (Adeyemi & Akinniyi, 2011). The most worrying aspect of the narrative is that many failed companies have been audited by external auditors and received a clear report. This anomaly has led to the need to strengthen regulations, standards and modify corporate governance mechanisms (Umobong & Ibanichuka, 2017).

Extant related studies show mixed results while investigating the effect of auditors' independence on audit quality. Salehi and Kangarlouei (2010) document the existence of more accrual stability coefficient in audit firms with higher audit quality than those with lower audit quality. Similarly, Al-Khaddash, Nawas, and Ramadan (2013) revealed a positive significant association between audit quality (the reputation of auditing office, the size of audit firm and the proficiency of the auditor) and audit independence. Empirical evidence from the Nigerian context such as those of Okoh (2015), Okolie (2014), Ndubuisi and Ezechukwu (2017), and Wan Mohammad, Wassiuzaman, and Nik Salleh, (2016) document significant positive effect of auditor's independence on audit quality. Okolie, Izedonmi and Enofe (2013); Umobong and Ibanichuka (2017) and Aliyu, Musa and Zachariah (2015), document a significant negative effect of audit firm size on auditor's independence.

However, with respect to the Nigeria environment, empirical investigation reveals that studies on the effect of auditor's independence on audit quality are still sparse, while such novel idea has been mostly conducted in developed nations. Further, this study employs audit independence proxies to include audit opinion, audit tenure, joint audit, and audit fee as predictors of audit quality. To the best of the researchers' knowledge no extant related study in the Nigerian context has modeled all the above-mentioned audit quality proxies in a study of this nature, hence the outcome of this study will go a long way to expand relevant literature on the area of financial statement quality. Against this backdrop, this study investigates the effect of auditors' independence on audit quality of listed commercial banks in Nigeria. The study proceeds with the review of literature which first captures key concepts which the study is anchored upon then proceed to the theoretical framework followed by review of empirical literature. Section three provides the methodology of the study while section four and five addresses discussion of findings and provides conclusion with possible recommendations for policy makers.

2. Literature Review

2.1. Conceptual Literature

2.1.1. Auditors' Independence

Following Okolie (2014), auditor independence is defined as the unbiased mental attitude of the auditor in providing decisions all through the audit and financial reporting process. However, independence connotes the quality of freedom from influence, persuasion, or bias, which will greatly impair the value of the audit service and consequently the audit report. Auditors' lack of independence increases the possibility of being perceived as not being objective (DeAngelo, 1981). The value of the independence in the auditors work according to Pricewaterhouse Coopers (2012) is very well identified particularly during the financial crisis where the question of independence of an auditor has been intensified; therefore, putting in place extensive safeguards of the systems to protect and enhance this independence becomes paramount.

2.1.2. Audit Quality

The Institute of Chartered Accountants of Nigeria (ICAN) defined an audit as a systematic process of objectively obtaining and evaluating evidence in respect of certain assertions about economic actions and events to determine the degree of correspondence between those assertions and established criteria and reporting the results to interested parties over a specific period. The International Accounting Standard Board (IASB) emphasized that audit quality is critical to achieving high-quality financial reporting. Accordingly, high quality reporting contributes to global financial stability, and can help foster trust in the quality of reporting through audit quality. The IASB developed the framework for audit quality, which describes the various elements that create the environment for audit quality at the engagement, firm, and national levels, as well as relevant interactions and contextual factors, in a holistic manner. The framework for audit quality aims to raise awareness of the key elements of audit quality, encourage key stakeholders to investigate ways to improve audit quality, and facilitate greater dialogue between key stakeholders on the topic (IASB, 2013).

2.2. Theoretical Framework

2.2.1. Economic Bonding Theory

Economic rents associated with audit fees, is argued to create an economic bond between the auditor and the client, which can jeopardize the auditor's independence (DeAngelo 1981). According to the theory of economic bonds, an economic bond forms between an audit firm and its client when the audit firm's economic reliance on the client reduces the auditor's independence, making the auditor less willing to resist management pressure (Kim & Yi, 2009). According to Svanström (2013), "this type of bonding is inherent and already present when the auditor is appointed, but it is amplified if lucrative consulting opportunities are apparent." Economic bonding theory, suggest that higher audit fees are indicative of potential independence issues; auditors who receive higher fees may be less inclined to modify the standard audit report. Auditors have been required in a variety of contexts to identify and evaluate threats to their independence and reduce them to an acceptable level.

2.2.2. Empirical Review

Fossung and Verges (2022) conducted a study to verify the link between external audit quality and value creation while controlling for exogenous factors (the size and age of the firm). The audit quality was captured by the competence and the independence of the auditor while the creation of value is measured by the evolution of turnover and net income. Using the logistic regression analysis on data collected on a sample of 97 public limited companies in Cameroon, it is proved that audit quality has a positive significant influence on value creation. Belonging to the Big Four, providing services other than external audit and the evolution of audit fees have no significant impact on value creation.

Ogoun and Perelayefa (2020) examine specifically the role of corporate governance in determining the audit quality of firms by utilizing 71 non-financial firms for the periods 2008 to 2015. Audit quality was measured using a dummy variable of "1" and "0", with 1 representing the use of a big four auditor by the firm and 0 otherwise. Corporate governance was proxy with board independence measured using the ratio of non-executive directors to total directors. The data collected was analyzed using the binary regression analysis which reveals that board independence is negatively related to audit quality.

Shakhatreh, Alsmadi and Alkhataybeh (2020) conducted a study to explore the influence of audit fees, audit firm size, and audit opinion on the quality of financial statements. The main emphasis of the study centered on a particular set of financial statements from Jordan characterized as low-quality and had been reported as violations by the Jordanian Securities Commission (JSC). The data utilized for analysis were extracted from the financial statements of manufacturing and services companies listed on the Amman Stock Exchange (ASE) during the period 2009 to 2016. The findings of the logistic regression analysis revealed that audit fees had a positive statistically significant impact on financial statement quality, while audit opinion had a negative statistically significant effect on financial statement quality.

Sunday (2019) conducted a study in Nigeria to examine the association between auditors' independence and the quality of corporate financial statements. The research was grounded on the Agency Theory and data were collected from the annual reports of listed manufacturing companies, covering the period 2013 to 2017. Descriptive and correlation statistics were used as analytical tools, and regressions were applied to investigate the relationship between the dependent and variables of interest. The study reported a positive relationship between audit incentives, audit tenure, audit client size and the quality of financial reporting. Also, a significant negative relationship was found between the auditor's status, especially when affiliated with one of the big four audit firms, and the quality of financial reporting. The study notes that longer auditor tenure and increased incentives play a role in strengthening auditors' independence, resulting in an overall improvement in the quality of financial reporting.

Stella and Uchenna (2019) conducted a study to investigate the impact of audit independence on financial statement quality. The study utilized ex-post facto research design and collected data from four (4) banks listed on the Nigerian Exchange Group covering a period of five years (2014 to 2018) for analysis. The findings of the study revealed a significant effect of audit independence on the financial statement quality and conclude that maintaining audit independence plays a crucial role in improving the quality and reliability of financial statements for commercial banks.

Amahalu, Okeke and Chinyere (2018) sought to know the determinants of financial statement quality with a focus on healthcare firms listed on the floor of Nigerian Stock Exchange for the period 2010-2016. The study made use of secondary data obtained from fact books, annual reports and account of healthcare firms. The data were subjected to statistical analysis using Pearson correlation analysis, Ordinary Least Square and Granger causality test with the aid of E-view 9.0 econometric software. The study's findings showed a positive statistically significant correlation between audit independence, audit tenure, audit firm size, and the financial statement quality.

3. Methodology

In this study, *ex-post facto* research design is employed over a population made up of all commercial banks that are listed on the floor of the Nigerian Exchange Group (NGX) for the period between 2010 and 2021. As of 31st December 2021, the total number of listed commercial banks were 15 (NGX Website, 2021). To obtain a sample size from the population, this study employed the sampling filtering non-probability technique which requires that a set of criteria must be fulfilled to allow a given firm into the sample pool. Therefore, only commercial banks that have complete financial data during the 2010 to 2021 period and have been consistently listed over the same period are included in the sample size. Further, the twelve (12) sampled banks that were chosen showed strong similarities in operating and reporting activities during the period under review.

Model Specification

The model for this study was adopted from the study conducted by Wan Mohammad, Wassiuzaman and Nik Salleh (2016) and expressed in the econometric equation below as:

$$\mathrm{JOSA}_{it} = \beta_0 + \beta_1 \mathrm{AUDF}_{it} + \beta_2 \mathrm{JOTA}_{it} + \beta_3 \mathrm{AUDT}_{it} + \beta_4 \mathrm{AUDO}_{it} + \beta_5 C\mathrm{FAO}_{it} + e_{it}$$

where:

JOSA = Jones Discretionary Accrual;

AUDF = Auditors' Fee;

JOTA = Joint Auditor;

AUDT = Auditors' Tenure;

AUDO = Auditor's Opinion;

CFOA = Cash Flow Operating Activities;

"{*i*}" = Cross Section "*t*" = Time Frame;

e_{it} = Stochastic error Term.

4. Data Analysis and Discussion of Result

In this study, audit independence and financial statement quality nexus in Nigeria was analyzed with data drawn from commercial banks listed on the Nigerian Exchange Group. This study included a control variable, cash flow from operations in a model with independent variables to include audit fee, audit tenure, audit opinion and joint audit. This study adopted Jones discretionary accrual as a proxy for financial statement quality while descriptive statistics, correlation analysis and regression analysis were conducted. The researcher used correlation analyses to ascertain the association between the variables of interest while regression analysis was employed to evaluate the hypotheses.

From Table 1, it was observed that the value of audit quality (Jones discretionary accrual) averaged at −0.07 with a standard deviation of 0.13 during the period under consideration. Further, the maximum and minimum values of Jones discretionary accrual are seen to be 0.25 and −0.78 respectively. A cursory look at the variable of joint audit reveals that only about 9% of the observations had their accounts jointly audited. On average, audit fee was seen to be 5.42 with standard deviation of 0.33 while about 72% of the observations in the sample complied with audit tenure system which allowed a particular auditor to be engaged with a client for 3 years and, thereafter, disengaged his services for another

Table 1. Operationalization of variables.

VARIABLES	MEASUREMENT	SOURCE	APRIORI SIGN
AUDIT QUALITY	Modified Jones Discretionary Accruals	Wassiuzaman, and Salleh, (2016)	
AUDITORS' OPINION	Audit Opinion in Dummy (1,0) is computed as "1" for Companies received qualified opinion statement or modified it going concern opinion on the audit report and "0" otherwise	Wassiuzaman, and Salleh, (2016)	+
JOINT AUDIT	Joint Audit in Dummy (1, 0) is computed as "1" for Companies that use more than one external auditor in a particular year and "0" otherwise	Wassiuzaman, and Salleh, (2016)	-
AUDITORS' FEE	Auditor's fee is the amount paid to external auditors divided by revenue.	Wassiuzaman, and Salleh, (2016)	+
AUDITORS' TENURE	Auditors Tenure in Dummy (1,0) is computed as "1" for Companies that engage external auditor for only 3 years and "0" for firms that engage external auditors for less or more than 3 years	Wassiuzaman, and Salleh, (2016)	-
CASH FLOW OPERATIONS	Computed as Net cash flow from operations divided by Total asset	Ni, Huang, Chiang, and Liao (2019)	-

Source: Researcher's compilation 2023.

auditor. Particularly, it is observed from **Table 2** that the average value of the control variable (cash flow from operations) is 0.40 with standard deviation of 0.097 during the period under review.

A cursory look at **Table 3** show that the probability of the z-statistics was significant at 1%, indicating that the dependent variable of the Big4 auditors was not normally distributed (Prob> z = 0.000). The result also showed that the control variable return on capital employed, had a non-normal distribution (Prob> z = 0.000), as did the independent variables, audit opinion (Prob> z = 0.000), joint audit (Prob> z = 0.000) and auditor's fees (Prob> z = 0.007). However, the independent variable of audit tenure followed a normal distribution due to the low probability values of the z-statistics (Prob> z = 0.360). All results were interpreted based on Bera and Jarque (1982) study.

Specifically, the analysis from the Spearman rank correlation analysis showed that the independent variables of audit opinion (−0.019) and joint audit (−0.671) negatively correlated with the audit firm size of the listed commercial banks in Nigeria. However, the independent variables of audit fee (0.437) and audit tenure (0.089) and the control variable of return on capital employed (0.201) positively correlated with audit firm size during the period under consideration. Furthermore, the associations were seen to be weak since no strength of association was seen to exceed 0.70. Therefore, there was no room to suspect the presence of multicollinearity in the estimated model (**Table 4**).

Table 2. Shapiro-Wilk test for data normality.

Variable	Obs	W	V	z	Prob > z
josa	144	0.90692	10.459	5.310	0.00000
audo	144	0.70593	33.042	7.913	0.00000
jota	144	0.88106	13.364	5.865	0.00000
audf	144	0.97072	3.290	2.694	0.00353
audt	144	0.98529	1.653	1.137	0.12778
cfoa	144	0.94795	5.849	3.995	0.00003

Author's Computation, 2023.

Table 3. Shapiro-Wilk test for data normality.

Variable	**W**	**V**	**z**	**Prob > z**
Afz	0.942	5.554	3.841	0.000
audito	0.709	28.035	7.468	0.000
jaudit	0.876	11.950	5.558	0.000
audfee	0.969	3.014	2.471	0.007
audten	0.988	1.173	0.358	0.360
roce	0.827	16.677	6.305	0.000

Author's Computation, 2022.

5. Discussion of Findings

In Table 5, the results of a binary logistic model for audit firm sizes were reported, including the model's coefficient, t statistics and the probability of the t statistics. A pseudo R^2 value of 0.651 indicated that the model's independent variables accounted for approximately 65% of the variation in the dependent variable, implying that approximately 35% of the variation in the dependent variable was left unexplained but had been captured in the error term. Furthermore, the likelihood ratio statistics provided the model's goodness of fit and its corresponding probability value (0.000) revealed that the entire model was fit at 1% statistically significant level. Pearson chi2 (6) = 7.54 and the corresponding probability value of 0.9997 from the goodness-of-fit confirmatory test showed that the model was well-fitted. The regression result indicates that except for the variable of audit fee, all other independent variables revealed insignificant effect on audit quality during the period under consideration. The statistical significance of audit fee suggest that higher audit fee reduces the likelihood of receiving

Table 4. Spearman's rank correlation coefficients.

Variables	(1)	(2)	(3)	(4)	(5)	(6)
(1) afz	1.000					
(2) audito	-0.019	1.000				
(3) jaudit	-0.671	0.070	1.000			
(4) audfee	0.437	0.039	-0.188	1.000		
(5) audten	0.089	-0.132	-0.078	0.264	1.000	
(6) roce	0.201	0.128	-0.126	0.458	0.075	1.000

Author's Computation, 2022.

Table 5. Binary logistic regression result.

Big4	Coef.	St.Err.	t-value	p-value	[95% Conf	Interval]	Sig
Audo	1.695	10.297	0.16	0.869	−18.487	21.877	
Jota	−7.638	2.195	−3.48	0.001	−11.94	−3.336	***
Audf	10.404	3.165	3.29	0.001	4.201	16.607	***
Audt	−0.518	0.88	−0.59	0.557	−2.243	1.208	
Roce	0.027	0.135	0.20	0.842	−0.238	0.292	
Constant	−50.631	15.712	−3.22	0.001	−81.427	−19.836	***
Mean dependent var		0.833		SD dependent var		0.374	
Pseudo r-squared		0.651		Number of obs		120.000	
Chi-square		70.379		Prob > chi2		0.000	
Akaike crit. (AIC)		49.755		Bayesian crit. (BIC)		66.480	

*** $p < 0.01$, ** $p < 0.05$. Author's computation, 2022.

higher quality report which translate to poorer financial statement quality. This result is inconsistent with the conclusions reached by Hussein and Hanefah (2013), and Babatolu & Akinnubi (2016). However, this result on audit fee is consistent with that of Karsemeijer (2012) who argue that "higher audit fees make the client more valuable to the audit firm; hence, independence and the need for improved audit quality may be compromised." Similarly, this finding is buttresses the pays higher audit fees comparable to what other companies in the same industry pay, there is a high probability that the client would become loyal to the audit firm and that could lead to the auditor overlooking material misstatements and/or permitting management to engage in aggressive income smoothing.

6. Conclusion and Recommendations

As Nigeria battles and struggles to come out from its excruciating economic recession, maintaining investors' confidence in the capital market through high-quality auditing and transparent financial reporting becomes paramount. Several investors in Nigeria have lost confidence in the audit function due to incessant accounting scandals linked to poor audit quality and a perceived lack of auditor independence. Increased reliability of financial statement may restore investors' confidence during economic crisis. Hence, this study examined the impact of audit independence on financial statement quality of listed Nigerian commercial banks. Empirical evidence obtained from this research work is consistent with the economic bonding theory to indicate that higher audit fees significantly lower the quality of financial statements presented by external auditors. Accordingly, this study recommends strengthening the oversight and regulation of auditing practices in the Nigerian banking sector. This could involve closer collaboration between regulatory authorities and audit firms to ensure that audit fees are commensurate with the quality of audits conducted. Also, this study recommends that audit firms should adopt a risk-based approach to audit planning. This approach may involve tailoring audit procedures to address the specific risks faced by each bank of which could lead to more effective and efficient audits, potentially reducing the need for higher fees.

Conflicts of Interest

The authors declare no conflicts of interest regarding the publication of this paper.

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