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EFFECT OF AUDITORS' INDEPENDENCE ON FINANCIAL REPORTING QUALITY OF NIGERIAN DEPOSIT MONEY BANK

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Abstract

This study examined the effect of auditor independence on financial reporting quality of deposit money banks in Nigeria with Financial Reporting Quality as the dependent variable; Audit Fee, Audit Firm Size and Audit Meeting as independent variables, Debt Ratio as control variable. The sample period covered six (6) years (2013 to 2018) and data were extracted from the audited annual reports of ten (10) selected deposit money banks. The results of this study revealed that Audit Fee, Audit Meeting and Debt Ratio are positive but have insignificant impact on financial reporting quality; Audit Firm Size is negative and has insignificant impact on financial reporting quality. The study recommends orientation and reorientation of audit committee members to guarantee significant influences on financial reporting quality.

JEL classification: E4, E5, E6
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Introduction

According to Fielder (2011), auditing is the accumulation and evaluation of evidence about information to determine and report on the degree of correspondences between the information and the established criteria. Auditor independence as an essential platform for a quality audit is indisputable. The past decade has witnessed a growing interest in research on auditor independence (Bahram, 2007). Izedonmi (2000) stated that independence is of the mind, characterized by objectivity and integrity on the part of the auditor; hence independence is fundamental to the reliability of the auditor's report. Financial reporting quality is of tremendous concern not only to the final users, but to the entire economy as it affects economic decisions which may have significant impact (Ahmed 2018). However, managerial opportunistic behaviours as well as unethical accounting practices are identified as major challenge to the quality of accounting earnings and financial reporting quality (Shen & Hsiang-Lin, 2007). The decline in the confidence in financial reporting and auditing arising from corporate collapses and audit failures in a number of countries including Nigeria is the background of reforms in audit independence and quality control.

Literature Review

Auditor independence is the foundation of the auditing profession (Abu Bakar & Ahmad, 2009). Auditor independence may be defined as an auditor's unbiased mental attitude in making decisions throughout the audit and financial reporting process. An auditor's lack of independence increases the possibility of being perceived as not being objective. This means that the auditor will not likely report a discovered breach (DeAngelo, 1981). Auditor independence also refers to the ability of the external auditor to act with integrity and impartiality during his auditing functions (Akpom & Dimkpah, 2013). Independence, in this context, represents the means by which an auditor demonstrates that he can perform his task in an objective manner (Aliu, 2018).

DeAngelo (1981) defined financial reporting quality as the market-assessed joint probability that the auditor discovers an anomaly in the financial statements, and reveals it. Financial reporting quality according to Dandago and Rufai (2014) is obtained by a process of identifying and administering the activities needed to achieve the quality objectives of audit work. Users, auditors, regulators and other stakeholders in the audit report process may have very different views as to what constitutes financial reporting quality, which will influence the type of indicators one might use to assess financial reporting quality (Enofe, Mgbame, Adeyemi & Ehi-Oshio, 2013).

Theoretical Review

Jensen and Meckling (1967) define agency relationship as a contractual relationship under which one or more persons (the principals) engage the services of another person (the agent) to perform some services on their behalf which involves delegating some decision-making authority to the agent. Agency theory is considered to be a contract between shareholders (principals) and external auditors to control the work of other agents (management). Shareholders (principals) delegate tasks to be performed by management (agents). Tasks mainly cover operating the organization on behalf of shareholders to meet their objectives. Auditors exercise an intermediary role between shareholders and management to validate financial statements prepared by management. The most important basis of agency theory is that the managers are usually motivated by their own personal gains and work to their own personal interests rather than considering shareholders' interests and maximizing shareholder value.

Empirical Review

Okolie (2014) examines the effect of auditors' independence on earnings management. A sample of fifty seven (57) listed companies in Nigeria for the period ranging between 2006 and 2011 was used. Findings of the study indicate that audit fee has a negative but significant association with discretionary accruals. This is affirmed by Abdul-Malik (2016) who explored the impact of audit fees on financial reporting quality in Nigeria. Data were sourced from the annual reports of eighty-nine (89) listed companies for the period of 2008 to 2013. The result revealed that audit fees have a negative but significant influence on discretionary accruals.

Mgbame, Eragbhe and Osazuwa (2012) note that an audit firm's tenure can result in a loss of an auditor's independence. A long audit-client relationship could lead to an alignment of the auditor's interest and that of its client which makes truly independent behaviour of the auditorless of aprobability. They added that audit firm rotation does not necessarily enhance audit independence in Nigeria. This could be due to the unity of professional attitude among auditors and similarity in cultural bias and orientation. They buttress that belief with the idea that as the auditor-client relationship lengthens, there is the tendency that auditors may develop a "learned confidence" in the client which may result in the auditor not performing religiously the required testing of financial reports. This learned confidence results in the auditor making assumptions about outcomes and using less rigorous audit procedures or static audit programs. Potentially, a loophole for a decline in financial reporting quality has been created.

Ilaboya and Ohiokha (2014) empirically examine the impact of audit firms' characteristics on financial reporting quality. They proxy the dependent variable (Financial reporting quality) using the usual dichotomous variable of 1 if big 4 audit firm and 0 if otherwise. Data for the study were sourced from the financial statements of 18 food and beverage companies listed on the Nigerian Stock Exchange within the period studied (2007-2012). They adopted multivariate regression technique with emphasis on Logit and Probit methods in analyzing their data. Their study revealed there is a positive relationship between firm size, board independence and financial reporting quality whereas there is a negative relationship between auditor's independence, audit firm size, audit tenure and financial reporting quality.

Methodology

The population of this study consists of ten (Access Bank PLC, FCMB, Fidelity Bank PLC, Guaranty Trust Bank PLC, Stanbic IBTC, Sterling Bank PLC, UBA PLC, Zenith Bank PLC, First Bank PLC, Wema Bank) of the fifteen (15) deposit money banks quoted on the Nigerian Stock Exchange for the period of six years (2013–2018).

Model Specification

The model for this study is stated in econometric form below:

$$FRQ_{it} = \beta_0 + \beta_1 AUDFE_{it} + \beta_2 AUDSIZE_{it} + \beta_3 AUDM_{it} + \beta_4 DR_{it} + Ut$$

Where:

FRQ = Financial reporting quality

AudFe = Audit fee

AudSize = Audit Firm Size

AudM = Audit Meeting

DR = Debt Ratio

Table 1: Variable Definitions

S/N	Variable	Variable Acronym	Measurement
1.	Financial reporting quality	FRQ	This was taken as total accrual: net income – cashflow from ope ating activities.
2.	Audit FEE	AudFE	Measured by the Natural Log of total fee paid to an auditor
3.	Audit Firm Size	AudSize	This was measured as 1 if the company audit firm is one of the big 4, and as 0 if otherwise.
4.	Audit Meeting	AudM	It is the total number of meetings held by the audit committee.
5.	Debt Ratio	DR	Measured by Total liabilities divided by Total Assets

Source: Authors' Compilation, 2020.

Data Presentation and Interpretation

This shows the relationship between variables. From the table above, the correlation between Financial Reporting Quality (FRQ), Audit Fee (AUDFE), Audit Firm Size (AUDSIZE), Audit Meeting (AUDM) and Debt Ratio (DR) shows that FRQ is positively correlated to AUDFE, ADM and DR, it is negatively (weak) correlated to AUDSIZE. It shows that ADFEE is negatively (weak) correlated to AUDFSIZE, AUDM and DR. AUDSIZE is positively correlated to AUDM and DR. AUDM is positively correlated to DR. DR is positively correlated to AUDM.

Table 2: Correlation Matrix Table

	FRQ	AUDFE	AUDSIZE	AUDM	DR
FRQ	1.000000				
AUDFE	0.035231	1.000000			
AUDSIZE	-0.137901	-0.031999	1.000000		
AUDM	0.224301	-0.079372	0.129837	1.000000	
DR	0.001871	-0.374920	0.091673	0.078353	1.000000

Source: Author's computation, 2020.

Table 3: Regression Result (Fixed and Radom Effect)

Dependent Variable: NPM						
	Fixed Effect			Random Effect		
Variable	Coefficient	Std. Error	T-Statistic	Coefficient	Std. Error	T-Statistic
C	-2.134235	18.48523	-0.115456	-4.351111	13.90773	-0.312856
AudFe	0.868887	2.124716	0.408943	0.665293	1.631290	0.407833
AudSize	-1.036431	0.536459	-1.931985*	-0.466362	0.357363	-1.305012
AudM	0.275227	0.470851	0.584531	0.692187	0.362140	1.911382*
DR	0.022090	0.571090	0.038680	0.051372	0.373208	0.137651
R-Squared	0.235798			0.281453		
Adj.R^2	0.219829			0.254650		
F-Statistic	1.091810			1.219295		
DW	1.601216			1.279687		

Source: Author's computation (2020).

Table 4: Hausman Test

HAUSMAN TEST			
Correlated Random Effects - Hausman Test			
Equation: Untitled			
Test cross-section random effects			
Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	5.333198	4	0.2548

Source: Authors' computation (2020).

This Test is carried out to determine which of the results is adequate for discussion of its findings. The decision rule under this test is when the p-value is greater than the level of significance we will accept the fixed effect result but if the p-value is less than the level of significance, we accept the random effect result. Here, our p-value is 0.2548 which is greater than 0.05. This research work accepts the random effect specification.

Random effect result

From the regression result, all variables i.e AUDFE, AUDSIZE, AUDM and DR are seen to be statistically insignificant (according to the p-value of the regression) at 5% level of significance. Since all variables are greater than 5% level of significance, we can say it is highly statistically insignificant.

From the regression result for the co-efficient, the constant (α) in the model is -4. 351111.This means that holding other variables (AUDFE, AUDSIZE, AUDM and DR) constant, FRQ is equal to -4.351111. From the equation, β1 co-efficient is 0.665293 which shows that a positive and insignificant relationship exists. β2 co-efficient is -0.466362 which shows that a negative and significant relationship exists. β3 co-efficient is 0.692187 which shows that a positive and insignificant relationship exists. β4 co-efficient is 0.051372 which shows that a positive and insignificant relationship exists.

Under the T-stat, to know if the variables are statistically significant, for each variable we need to find t (α/2, n-k) and we tend to reject the null hypothesis if only t-stat > t(α/2, n-k). To calculate t(α/2, n-k), this would be equal to t(0.05/2,60-5); t(0.025, 55) = 2.00.

The F-stat is used to test for joint hypothesis. Under the F-Stat, H0 is rejected if F-stat > Fcal (Fα (k-1, n-k)) but if not, we do not reject the null hypothesis. In our regression, F-statistics is 1.219295 and F-Cal is F0.05 (5-1, 60 -5) when α = 5% (0.05), k = 5 (number of parameters) and n = 60 (number of observations); this gives F0.05 (4,55) which equal to 2.53.

Thus, since the F-stat > F0.05 (4,55) (1.219295 < 2.53) we tend to accept the null hypothesis and conclude that FRQ depends on AUDFE, AUDSIZE, AUDM, DR for the deposit money banks quoted on the Nigerian stock exchange and given sample since the regression explains a significant amount in the model.

Using the probability value for F-stat (p-value (F-stat)) to test for joint hypothesis which states that the null hypothesis should be rejected if p-value (F-Stat) is < level of significance. In our regression result, the value for the p-value (F-stat) is 0.313204 which is not lesser than the level of significance (0.313204 > 0.05), thus we do not reject the null hypothesis. The R-squared is a goodness of fit measure for a linear regression model. It measures the strength of the relationship between the model and dependent variable on a scale of 0-100%. An R-squared of 1 indicates that regression is perfect. In our regression result, R-squared is 0.281453 which shows that about 28.14% of variation in the dependent variable is explained by the explanatory variable. This indicates a weak fit since 71.86% (100-28.14) % of the variables are attributable to the error term and the closer the R-squared to 1 the better the regression model. Adjusted R-squared is simply the modification of R-squared and it adjusts the explanatory variable in terms of the model which tends to increase only if variables improve the model more than expected. The Adjusted R-squared is 0.254650 (25.46%) as shown in the regression result table.

Discussion of findings

The study adopted the random effect regression results based on the Hausman test which showed that it is the most suitable in testing the hypothesis. From the random effect result: it was revealed that FRQ is positively related to Audit Fee (AUDFE). The result shows a p-value of 0.6850 which is $\geq$ 5% LOS; this indicates that AUDFE has no significant impact on FRQ. The finding is in line with the result of Ibrahim maltan fali (2019).

FRQ is negatively related to Audit Firm Size (AUDSIZE). The result shows a p-value of 0.1973 which is > 5% LOS; this indicates that AUDSIZE has no significant impact on FRQ. The finding is in line with the result of Mahmud (2018).

FRQ is positively related to Audit Meeting (AUDM). The result shows a p-value of 0.0612 which is $\geq$ 5% LOS; this indicates that AUDM has no significant impact on FRQ.

Lastly, FRQ is positively related to Debt Ratio (DR). The result shows a p-value of 0.8910which is >5% LOS; this indicates that DR has no significant impact on FRQ.

Summary

The study developed four hypotheses in order to test the effect of auditor's independence on financial reporting quality of Nigerian deposit money banks. 10 deposit money banks were selected based on availability and accessibility of annual reports and existence within the period of this research work (2013-2018) on the Nigerian Stock Exchange (NSE). Data were collected from financial statements and analyzed using the panel data regression analysis to establish the relationship between financial reporting quality and auditor's independence of Nigerian deposit money banks. FRQ is the dependent variable. AUDFE, AUDFSIZE, AUDM are the independent variables in the model. DR is used as control variable. The result shows the following: FRQ is negatively related to Audit Firm Size; FRQ is positively related to Audit Meeting.

Conclusion

Some research studies have shown that auditors' independence has a positive relationship with the financial reporting quality of Nigerian deposit money banks and some indicated otherwise. This study concludes as follows; there is a positive insignificant relationship between (AUDFE, AUDM, and DR) and financial reporting quality (FRQ). Managers need to be cautioned about the size of the audit committee since it has a negative insignificant relationship with the variable which represents financial reporting quality.

Recommendations

In line with the critical evaluation of the findings, the following recommendations were made. The study recommends orientation and reorientation of audit committee members to guarantee significant influences on financial reporting quality.

Audit Committee members should be able to adequately comprehend the bank's financial statement as this is very fundamental. With a view to significantly improving upon their level of profitability, Nigerian banks should largely depend upon audit quality.

Regulatory agencies around the world should increase surveillance on audit practices particularly statutory audits with regards to audit fees. The regulators should emphasize the use of large reputable audit firms by the deposit money banks, so as to avoid possible instances of low audit quality and poor financial reporting.

Managers of deposit money banks in Nigeria should subscribe to acceptable ethical standards in discharging their duties and responsibilities.

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