IIARD International Journal of Economics and Business Management E-ISSN 2489-0065 P-ISSN 2695-1878, Vol 5. No. 3 2019 www.iiardpub.org

Audit Independence and Reliability of Financial Reports: Empirical Evidence from Nigerian Banks

OKEZIE STELLA O. (PhD)[1], EGEOLU DANIEL UCHENNA[2]
[1,2]Department of Accounting,
Michael Okpara University of Agriculture, Umudike
nwanekem@gmail.com

Abstract

The study examined the effect of audit independence on reliability of financial reports in the banking sector. Ex-post facto research design was employed and data elicited from four (4) banks listed on the he Nigerian Stock exchange and also operates within the African region. The data spanning across 5years from 2014-2018, were analysed using multivariate linear regression. Findings revealed that audit independence had a significant effect on the value relevance of the financial reports of the banks under study. This was reflected in how the amount spent on audit fee had no significant effect on the reported earnings per share(proxy for reliance on financial reports by investors). Further findings reveal that audit independence has an insignificant effect on the timeliness of the financial reports. It was recommended that banks and other firms alike should negotiate for reasonable audit fees that would ensure engagement of an independent audit firm; in order to enhance the degree of confidence in the reported financial statement and thus create a high level of reliability on the financial reports. Furthermore managers are also enjoined to corporate with auditors in an independent manner to ensure timely production of financial reports which could point to reliability.

1. Introduction

Auditing is the accumulation and evaluation of evidence about information to determine and report on the degree of correspondences between the information and the establish criteria (Arens, Alvin, Shailer and Fielder, 2011). Messier (2008) in his own view asserts that auditing is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between assertion and established criteria and communicating the results to interested user. The audit of accounts in the corporate sector by an independent auditor is obligatory by statutes which define the duties, rights and powers. This is essential because of the separation of ownership from the management in the corporate sector. The owner needs someone who can keep a professional watch on the management and to whom they can trust for the reliability of the accounts since the prerogative of preparing the financial statement is that of the management.

In order for users of the financial statement to gain assurance that the financial statement data are being reported and measured properly and also fairly presented, independent certified auditors audit the financial statement and express an opinion on the statements. Thus the reliability of the financial reports is premised on the assumption that the certified auditor is not influenced by their clients or other bodies. Where financial reports are not credible, investors and creditors would have little or no confidence in them. Auditors must therefore be independent both in fact and appearance. Auditor's independence is seen as the backbone of the audit profession. It forms an integral part of the financial reporting process and a necessity for adding value to all audited financial reports. Audit independence is an important ingredient in audit practice. Izedonmi (2000) stated that independence is of the mind, characterised by Objectivity and Integrity on the part of the auditor, hence independence is fundamental to the reliability of auditors' reports.

The issue of auditor's independence as an essential platform for quality audit is not disputable. The past decade has witnessed a growing interest in research bothering on auditor‘s independence. This is not unconnected to the very many corporate collapses and scandals that hit the world's business environment and has kept corporate managers, business owners and investors of all type on the edge in ensuring adherence to standard accounting and management practices. Nigeria is not left out in the drive towards compliance to acceptable norms and practices hence the need to ascertain what drives reliability of financial reports. This has made firms in Nigeria to adopt standard accounting practices that have increased the preservation of auditor's independence and enhance credibility of financial reports.

1.2 Statement of the Problem

To carry out an audit in a manner that meets the reasonable expectations of users of audited financial statements, it is essential that the work is performed with due regard for audit independence (Bahram, 2007). The audit firm and the auditor must not be compromised and they must not compromise quality to achieve financial or non-financial benefits. 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. The consequence of this has been greater regulation of the profession in an attempt to restore public and investor confidence in corporate financial reporting.

1.3 **Objectives of the Study**

The main objective of the study is to examine the effect of audit independence on reliability of bank's financial report but specifically the study seeks to

i. Examine the effect of audit independence on the timeliness of listed commercial banks financial reports in Nigeria
ii. Ascertain the effect of audit independence on the value relevance of listed commercial banks' financial report in Nigeria

2 Literature Review

2.1 Concept of Audit Independence

Bahram (2007) describes the concept of auditors' independence as the ability to maintain an objective and impartial mental attitude throughout an audit. Rick, Roger, Arnold and Philip (2004) defines the independence of the auditor as having a position to take an unbiased viewpoint in the performance of audit tests, analyses of result, and attestation in the audit report of an entity. Furthermore Arens et al (2011) explains that audit independence requires an attitude of responsibility separate from the client's interest. The auditor must maintain an attitude of healthy professional skepticism. Auditor's independence can therefore be summarised as the auditors' ability to maintain mental attitude objectively and impartially in the interest of the client in conducting the audit, analysing the results and attesting to the the audit report without influence. Arens et al (2011) observed that independence of the auditor can be explained from two perspectives; Independence in mind and independence in appearance. Independence in mind reflects the auditor's state of mind that permits the audit to be performed with an unbiased attitude. It reflects a long standing requirement that members be independent in fact. While independence in appearance is the result of others' interpretation of what independence should actually be. If auditors are independent in fact but users believe them to be advocates for client, then most of the value of audit function will be lost.

2.2 Audit Independence and Reliability of Financial Reports

The audit report is the primary medium of communication between auditors and the company stakeholders. The growing interest about financial reports and the extent to which they could be trusted by investors and stakeholders suggests that they should be prepared objectively and audited by an independent and neutral body, this body normally being the independent external auditors. Reliability of audit report refers to a condition, in which investors and all those interested in a company's business affairs, consistently find the audit reports and opinion about a company's financial statements and position to be dependable and credible. Reliable audit reports also reveal whether accounting reports are reasonably free from error and bias and whether the accountants are justified in making a 'going concern' assumption. It therefore implies that for the audit report to be reliable it must give investors adequate information about the quality and accuracy of the accounting reports so that they can decide the extent to which to place reliance on the report in making investment decisions.

Ndubuisi and Ezechukwu (2017) opined that the immediate role of audit independence is to serve the audit by making it more effective in providing assurance that the auditor will plan and execute the audit objectively. Hence the larger purpose of audit independence and its objective must be sought. Mitra, Deis and Hossain (2009) on the other hand assert that the immediate objective of an audit is to improve the reliability of information. Improvement in the reliability of corporate disclosure reduces the risk that an investor or creditor will make a poor decision because the information is inaccurate or otherwise wanting in quality. It must be noted that risk information is present every time an investor or creditor uses information to assess the economic risk of a potential investment, so care should be taken in carrying out an audit assignment.

The better the quality of information investors and creditors use for the assessment of economic risk, the better their chances of making sound decisions. In other-words their information risk is lower. This information risk perceived by investors and creditors is reflected in the cost of capital of the firms. Both suppliers and users of capital benefit from reliable corporate disclosure. Knechel, Krishman, Pevzner, Shechik and Velury (2012) acknowledge the fact that the way in which audit independence improve the reliability of information used for investment and credit decision is well understood in theory and practice. Audit work by deterrence, detection and verification. Knowing that auditors will do their work, management is deterred from distorting the financial results. However, auditors often detect the vast majority of distortions that nevertheless occur and verification of undistorted information by selective tests provides evidence of its reliability. Asthana, Khurana and Raman (2018) showed that auditing improves the reliability of the financial information investors' use for decision making. More reliable information affects the earnings reported which is of value relevance to the investors. Also earnings per share is more likely to reflect corporate earning power if figures used more closely reflect the substance of financial performance of the bank. Investors are likely to invest their capital in the most productive enterprises if financial reports reflect corporate earning power than if they do not.

The auditors' independence is sometimes described as adding credibility to the timeliness of financial report which is an important ingredient of auditing though management's corporation is also needed (Carmona, Momparler & Lassala, 2015). Audit quality when considered with auditor independence impact the confidence level which users of financial statements have in financial reports (Al Khaddash et al, 2013). Without improved reliability there would be no valid basis for investor confidence in the information made available and earnings will have less of a relationship with firms earning power and report timeliness.

2.3 Theoretical Framework

This study anchors on the Signalling theory. This theory refers to a situation where one party (termed the agent) credibly conveys information to another party (the principal). This theory was originally developed by Michael Spence in 1973 based on observed knowledge gaps between organizations and prospective employees and later extended to other domains. Signalling theory posits that firms with good performance tend to make voluntary disclosures more readily as doing so is regarded as an easy means of distinguishing themselves from others in the marketplace. Hence we conjecture that auditors' independence is positively related to reliability of financial reports. Scott (2009) suggest that manipulative accounting may be used for signalling as managers will try to window dress the report in a manner that it will transmit their desired information to users.

2.4 Review of Empirical Studies

Several studies have been conducted on the effect of audit independence on reliability of financial report from both developed and emerging economies. Okolie (2014) examine the effect of auditors' independence on earnings management. A sample of fifty seven (57) listed companies in Nigeria for the period ranging between 2006 to 2011. Findings of the study indicate that audit fee has a negative but significant association with discretionary accruals. This is affirmed by Abdul-Malik et al (2016) who explored the impact of audit fees on financial reporting quality in Nigeria. Data was 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. In addition a recent study by Abdul – Rahman et al (2017) examined the relationship between of audit fees and quality of audit in Nigeria reveals that audit fee is positive and significantly related to audit quality. Kabiru and Abdullahi (2012), they carried out an empirical investigation into the quality of audited financial statements of deposit money banks in Nigeria, using both primary and secondary data and from the population of 21 banks they select a sample of 5 banks comprises of First Bank, Zenith Bank, Union Bank, United Bank for Africa and Access Bank, all publicly quoted companies in Nigeria. They found that Independence of an auditor does significantly improve the quality of audited financial statements of money deposit banks in Nigeria. Compliance to auditing guidelines has positive and significant effect on the quality of audited financial statement of money deposit banks in Nigeria. Material misstatement does significantly affect the quality of audited financial statements of money deposit banks in Nigeria. They also found

that audited financial statements of Nigerian money deposit banks, if re-audited by other independent auditors, will give the same result and conclusion.
Asthana *et al.,* (2018) examine fees competition amongst Big 4 auditors and audit quality in US. They show that fees competitions are valued as essential mechanism for enhancing audit quality in the vastly concentrated US audit market. In the same vain, Knechel *et al.,* (2018) examine the impacts of widespread trust and community cooperation on audit fees amongst different countries in the world. They reveal that countries with higher trust and community cooperation have high likelihood to expense on a strong audit job to request higher auditing services. They argue that countries with greater trust and community cooperation reimburse higher audit fees to demand greater assurance. This indorses that countries with higher extensive trust or greater public cooperation pay higher price on auditing services and hence are prepared to pay higher audit fees.

Al-Dhamari*et al.,* (2018) explore the link between related party transactions and audit fees in Malaysia. They indicate that audit fees are high for firms that engage in related party transactions including the acquisition and sale of assets, goods, and services. This validates the finding of Al-Rassas*et al.,* (2015) who study the influence of external audit quality and audit committee characteristics in Malaysia. They show that audit fee has a negative and significant relationship with discretionary accruals. This suggests that higher audit fees is associated to lower discretionary and higher financial reporting quality in Malaysia.

2. METHODOLOGY

This study basically seeks to investigate the effect of audit independence on reliability of firms' financial report in Nigeria specifically the listed commercial banks in Nigeria. The study adopts ex post facto research design and employed Multi-variant ordinary least square (OLS) regression in analyzing the data collected from the annual financial statement of 4 out of 17 listed commercial banks (First Bank PLC, Guarantee Trust Bank PLC, Eko Bank PLC & United Bank for Africa PLC) on the Nigerian stock exchange market from 2013-2017 a period 5 years; reasons being they are banks who operate within the African borders not just Nigeria.

Model Specification

This study formulates the following model to be used by the researcher in the investigation.

$$VR_{it} = \alpha + \beta_1 AI_{it} + U_{it}$$

$$TM_{it} = \alpha + \beta_1 AI_{it} + U_{it}$$

Where;

α = Constant

AI = Audit Independence (Log of audit fee; proxy for audit independence)

VR = Value Relevance (Reported Earnings per share of the firm at a time as proxy for value relevance of firms financial statement)

TM = Timeliness of Financial report (Reported number of days between when the auditor sign the financial report and when it is published)

it= Cross-sectional ($_i$) at time ($_t$)

U = Error term used in the model.

β_1= Beta coefficient of the independent variable.

Decision Rule: Accept the null hypothesis if the calculated value is greater than the significant level of 0.05.

3. DATA PRESENTATION AND ANALYSIS

Data Validity Test

In order to ensure that the results are robust, the Pure Error statistic was computed as shown in table 2 below. The Pure Error statistic for the two models specified stood between at 0.00 which is not above the standard of 0.05 indicating the absence of auto-correlation (Gujaratti, 2004); this substantiates the absence of auto-correlation problem among the explanatory variable thus enabled us to go ahead with the regression analysis.

Table 1: **Descriptive Statistics of Variables**

Descriptive Statistics

	N	Minimum	Maximum	Mean		Std. Deviation
	Statistic	Statistic	Statistic	Statistic	Std. Error	Statistic
AI	20	7.40	8.70	8.2594	.09732	.43521
VR	20	.16	5.67	1.7055	.38061	1.70213
TM	20	1.70	2.00	1.8727	.02440	.10910
Valid N (listwise)	20					

Table1 presents the descriptive statistics of all the variables. N represents the number of observations and therefore the number of observations for the study is 20.

Audit Independence (AI) reflects a mean of 8.2594 and a standard deviation of 0.0.43521, it has a minimum value of 7.40 and a maximum value of 8.70. Value Relevance (VR) reflects a mean of 1.7055 and a standard deviation of 1.70213, it has a minimum value of 0.16 and a maximum value of 5.67. Timeliness (TM) of financial reports reflects a mean and deviation of 1.8727 and 0.10910 respectively. It also shows a minimum and maximum value of 1.70 and 2.00. This various means and deviation shown by the variables shows the level of variation amongst the variables in the industry.

Regression of the Estimated Model Summary

This section of the work presents the results produced by the model summaries for further analysis. Thus:

Univariate Tests

Dependent Variable	Source	Sum of Squares	df	Mean Square	F	Sig.
VR	Lack of Fit	41.634	17	2.449	.	.
	Pure Error	.000	1	.000		
TM	Lack of Fit	.203	17	.012	.	.
	Pure Error	.000	1	.000		

Tests of Between-Subjects Effects

Source	Dependent Variable	Type III Sum of Squares	Df	Mean Square	F	Sig.
Corrected Model	VR	13.414[a]	1	13.414	5.800	.027
	TM	.023[b]	1	.023	2.014	.173
Intercept	VR	10.670	1	10.670	4.613	.046
	TM	.337	1	.337	29.793	.000
AI	VR	13.414	1	13.414	5.800	.027
	TM	.023	1	.023	2.014	.173
Error	VR	41.634	18	2.313		
	TM	.203	18	.011		
Total	VR	113.222	20			
	TM	70.366	20			
Corrected Total	VR	55.048	19			
	TM	.226	19			

a. R Squared = .244 (Adjusted R Squared = .202)
b. R Squared = .101 (Adjusted R Squared = .051)

Table 2, presents the regression result between AI and VR, TM. From the model summary table above, the following information can be distilled.

***Ho$_1$:** Audit Independence has no significant effect on the value relevance of listed banks financial reports in Nigeria.*

The R^2 value stood at 0.244. The R^2 otherwise known as the coefficient of determination shows the percentage of the total variation of the dependent variable (VR) that can be explained by the independent or explanatory variable (AI). Thus the R^2 value of 0.244 indicates that 24.4% of the variation in Value Relevance (Reliability of financial report) of the listed firms can be explained by a variation in the independent variable AI (Audit Independence) while, the remaining 75.6% (i.e. 100-R^2) could be accounted for by other variables not included in this model.

The adjusted R^2 of 0.202 indicates that if the entire population is considered for this study, this result will deviate from it by only 0.042 (i.e. 0.244 – 0.202). This result shows that there is a deviation of the sample examined and the total population by 4.4%. The table further shows the F of 5.800.

Given the stated null hypothesis above for model 1 and considering the outcome of the regression result carried out in line with the decision rule earlier stated. The study accepts the alternative hypothesis and rejects the null hypothesis since the calculated significant level of 0.0.027 (AI) is less than the accepted significant level of 0.05.

***Ho$_2$:** Audit Independence has no significant effect on the Timeliness of listed banks financial reports in Nigeria.*

The R^2 value stood at 0.101.The R^2 otherwise known as the coefficient of determination shows the percentage of the total variation of the dependent variable (TM) that can be explained by the independent or explanatory variable (AI). Thus the R^2 value of 0.101 indicates that 10.1% of the variation in Timeliness (Reliability of financial report) of the listed firms can be explained by a variation in the independent variable AI (Audit Independence) while, the remaining 89.9% (i.e. 100-R^2) could be accounted by other variables not included in this model.

The adjusted R^2 of 0.051 indicates that if the entire population is considered for this study, this result will deviate from it by only 0.050 (i.e. 0.101 – 0.051). This result shows that there is a deviation of the sample examined and the total population by 5.0%. The table further shows the F of 2.014.

Given the stated null hypothesis above for model 2 and considering the outcome of the regression result carried out in line with the decision rule earlier stated. The study rejects the alternative hypothesis and accepts the null hypothesis since the calculated significant level of 0.173 (AI) is greater than the accepted significant level of 0.05.

5.0 Conclusions

The correlation between audit independence and reliability of financial statements is positive and significant. This implies that reliability of financial reports to a great extent is a function of the auditors' independence as measured in this paper using the audit fees. The researcher from the empirical results strongly concludes that auditor's independence cannot be divulged from the credibility of the financial reports of the firm; this is reflected in how the amount spent on audit fee by these firms is seen not to have affected significantly the reported earnings per share which is a proxy for reliance on the financial report by investors. Further findings revealed an insignificant effect of audit independence on the timeliness of the financial reports of the firms.

Thus**,** it is recommended that: Firms in Nigeria should endeavour to pay the right audit fee required in other to enable the engagement of audit firm that is independent from influence. This will enhance the degree of confidence in the reported financial statement and in turn create a high level of reliability on the financial reports by investors. Furthermore, managers should corporate with auditors in an independent manner so as to ensure the publication of financial reports of the firm on time which will enhance and facilitate prompt investment decision as these investors look at timely reports to be reliable.

References

Abdul-Rahman, O.A., Benjamin, O.A., & Olayinka, O. H. (2017). Effect of audit fees on audit quality: Evidence from cement manufacturing companies in Nigeria. *European Journal of Accounting, Auditing and Finance Research*, 5(1), 6–17.

AbdulMalik, S., & Ahmad, A. C. (2016).Audit fees, corporate governance mechanisms and financial reporting quality in Nigeria.*DLSU Business & Economics Review*, 26(1), 1–14.

AICPA, Statement on Auditing Standards No. 122. "Statements on Auditing Standards: Clarification and Recodification." October 2011

Arens, R., Alvin A., Shailer, G. & Fielder, B. (2011) *Auditing, Assurance Service and Ethics in Australia.* 8th Edition. Pearson Australia

Asien, E. N. (2014). Exploring the state of the audit market in Nigeria.*African Journal of Accounting, Auditing and Finance*, 3(4), 287–307.

Asthana, S., Khurana, I., & Raman, K. K. (2018).Fee competition among Big 4 auditors and audit quality. *Review of Quantitative Finance and Accounting*, 50, 1–36.

Bahram, S. (2007) *Auditing_ An International Approach* -Trans-Atlantic Publications, Inc.

Bartov, E., Givoly, D., & Hayn, C. (2002).The rewards to meeting or beating earnings expectations. *Journal of Accounting and Economics*, 33(2), 173–204.

Carmona, P., Momparler, A., &Lassala, C. (2015). The relationship between non-audit fees and audit quality: dealing with the endogeneity issue. *Journal of Service Theory and Practice*, 25(6), 777–795.

David N. (2006) *Auditing*, 8th edition, Thomson, South-Western, Printed in the United States of America

Enofe, D., Nbgame, C., Okunega, E. &Ediae, O. (2013) Audit Quality and Auditors Independence in Nigeria: An Empirical Evaluation. *Research Journal of Finance and Accounting*, 4 (11) 23-35

Eko, S. (2012) Determinant Factors Affecting The Audit Quality : An Indonesian Perspective. *Global Review of Accounting and Finance*, 3(2) 42 – 57

Eriabie, S., &Dabor, E. L. (2017). Corporate governance and audit quality in Nigeria: Evidence from the banking industry. *Journal of Accounting, Finance and Auditing Studies*, 3(1), 1–16.

Gujarati, D. N. (2004). Basic econometrics - Economic series McGraw-Hill international editions: Economic series. …

Herath, K. S., &Albarqi, N. (2017). Financial reporting quality : A literature review School. *International Journal of Business Management and Commerce*, 2(2), 1–14.

International Auditing and Assurance Standards Board (IAASB) (2015) A Framework For Audit Quality.

Jensen, M. &Meckling, W. (1976) Theory of the Firm: Managerial Behaviour, Agency Cost and Ownership Structure. *Journal of Financial Economics*, 3(1)305-360.

Knechel, W. R., Krishnan, G. V., Pevzner, M., Shefchik, L. B., &Velury, U. K. (2012). Audit quality: Insights from the academic literature. *Auditing: A Journal of Practice & Theory*, 32(1), 385421

Linda, E. &DeAngelo, C. (1981) Auditor Size And Audit Quality. *Journal of Accounting and Economics* , 3 (1981) 183-199.

Mautz, H. & Hussein, A. (1993) *The Philosophy of Auditing*. American Accounting Association Seventeenth Printing

Messier, C. (2008) *Auditing and Assurance Services_ A Systematic Approach*, Edition 6 - McGraw-Hill Companies

Mitra, S., Deis, D. R., &Hossain, M. (2009). The association between audit fees and reported earnings quality in pre- and post- Sarbanes-Oxley regimes.*Review of Accounting and Finance*, 8(3), 232–252.

Ndubuisi, A. N., &Ezechukwu, B. O. (2017). Determinants of audit quality : Evidence from deposit money banks listed on Nigeria stock exchange. *International Journal of Academic Research in Accounting, Finance and Management Sciences*, 7(2), 117–130.

Nelson, S. P., & Devi, S. (2013). Audit committee experts and earnings quality. *Corporate Governance*, 13(4), 335–351.

Novie, S. (2013) An empirical analysis of auditor independence and audit fees on audit quality. *International Journal of Management and Business*, 3(3)13-27

Okolie, A. O. (2014). Auditor tenure, auditor independence and accrual – based earnings management of quoted companies in Nigeria. *European Journal of Accounting Auditing and Finance Research*, 2(2), 63–90.

PCAOB Auditing Standard No. 12.“Identifying and Assessing Risks of Material Misstatement.”Release 2010-004. August 2010

Public Company Accounting Oversight Board (PCAOB) (2013) Standing Advisory Group Meeting Discussion – Audit Quality Indicators.

Rick, H., Roger, D., Arnold, S. & Philip, W. (2004) *Principles of Auditing_ An Introduction to International Standards on Auditing* (2nd Edition)

Scott, W. (2009) *Financial Accounting Theory* (5ed), New Jersey: Prentice-Hall International, Inc.

Turpen, R. A. (1995). Audit fees - what research tells us. (Auditing).The CPA Journal Online. Retrieved from http://archives.cpajournal.com/old/16349305.htm

Zhou, S. & Liu, X. (2006) The analysis of Chinese auditing market. *Northern Economy Journal*, 2(1)52.