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Propensity of Unqualified Audit Reports and Auditors' Independence in Nigeria

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Abstract

The need for auditors' independence is very crucial for the success of audit process. Independence of the auditors manifests in technical, investigative and reporting forms. For the audit report to be publicly accepted as reflecting the true and fair view the auditors must be seen to be indeed truly independent. One way the auditor's independence manifests is in the nature of audit report issued by the auditors. This study therefore examines the nexus between the auditor's independence and the nature of audit report issued. Using audit fees as a measure of audit independence we examined the relationship between the audit fees and the nature of audit reports of Twenty-

Seven (27) publicly quoted companies in Nigerian Stock Exchange between 2002 and 2006 period. The results of the analysis show that there is a positive but insignificant relationship between the auditor independence (measured by audit fees) and the nature of the audit reports issued by the auditors. Most of the companies under investigations issued unqualified audit reports. Since audit fee is used to estimate independence it therefore means that the higher the audit fee the lower the auditor independence and the higher the incidence of issuing unqualified audit reports.

Key words: Auditor independence, audit fees, audit report, qualified audit report, and unqualified audit report.

Introduction

Auditor independence is the cornerstone of the auditing profession since it is the foundation of the public's trust in the accounting profession (Lindberg & Beck, 2004). Auditor independence is a crucial element in the statutory corporate reporting process and a key prerequisite for the adding of value to audited financial statements (Mautz & Saharraf, 1961:16). Baker (2005:11) identifies auditor independence as the independence from the parties that have an interest in the financial statements of a reporting entity. Auditor independence is an attitude of mind characterized by integrity and an objective approach to the audit process. The purpose of an audit is to enhance the credibility of financial statements by providing written reasonable assurance from independent sources that the financial statements present a true and fair view in accordance with the accounting standards. This objective will not be met if users of the audit report believe that the auditor may have been influenced by other parties, more specifically the enterprise managers/directors or by conflicting interests (e.g. if the auditor owns shares in the company to be audited). In addition to technical competence, auditor independence appears to be the most important factor in establishing the credibility of the audit opinion. Since 2000, a wave of high profile accounting scandals (such as Enron in the United States of America and HIH Insurance in Australia) have cast the profession into the limelight, negatively affecting the public perception of auditor independence and the overall value of auditing.

There are three main ways in which the auditor's independence can manifest itself: Programming independence, investigative independence and reporting independence (Mautz & Sharaf, 1961; & Dunn, 1996). While programming independence protects auditors' ability to select appropriate strategies,

investigative independence protects the auditor's ability to implement the strategies in whatever manner they consider necessary. Reporting independence protects the auditors' ability to choose to reveal to the public any information they believe should be disclosed.

There are two important aspects of independence which must be distinguished from each other: independence in fact (real independence) and independence in appearance (perceived independence). Together, both forms are essential to achieve the goals of independence. For the public to conclude that the audit report represents a true and fair view the auditor must not only act independently but appears independent too. Thus, how the public would receive the audit reports depends on how they perceive the auditors in terms of independence. The threat to auditors' independence stems from two main sources: the auditors' relationship with the company and the nature of the accountancy profession. The economic bonding between the auditors and the clients as the auditors obtain their income from audit service may make auditors to be subservient and not be to stand independent to confront the directors who negotiate audit contracts with the auditors. Hence, so long as the client determines audit appointments and fees an auditor will never be able to have complete economic independence. If auditors feel that the income from a specific client is important than their responsibilities to shareholders they may not perform the audit with the shareholders' interests in mind. The larger the fee income the more likely the auditor is to shirk his responsibilities and perform the audit without independence. Again, audit firms may on some occasions quote low prices to directors to ensure repeat business, or to get new clients. By doing so the firm may not be able to perform the audit fully as they do not have enough income to pay for a thorough investigation. Cutting corners could mean the audit team would be reporting without all the evidence required which will affect the quality of the report. This would bring into question their independence. How do we then measure audit independence if high audit fees or low audit fees could jeopardize auditor's independence? How does audit report relate to the auditor's independence? These are the questions for investigation in this study.

The Audit report is the final outcome of the audit process and is the only external communication of what the auditor has done and concluded during the audit (McGrath, Siegel, Dunfee, Glazer and Jaenicke, 2004:39). The audit report communicates the auditor's findings to outsiders and plays a crucial role in warning financial statements users of impending problems with the

firm's financial reporting or internal controls, including going concern problems. However, for the audit opinion to play a credible role as a warning signal, the auditor must be able to objectively evaluate the firm's performance and withstand any client pressure to issue a clean opinion.

The decision on what type of audit report to render to the clients is the final cumulative audit decision and is subject to a considerable amount of professional judgment and negotiation with the clients. As such, it captures the possible influence that close auditor- client relationships might have on the auditor's personal judgment and their behaviour in the negotiation. Thus, if auditors are independent, it will be seen from the nature of audit reports issued by the auditors. The audit report will have no value unless auditors can programme their work in the most appropriate manner, conduct investigations without restrictions and report their findings clearly and objectively. The appearance of independence is at least as important as the auditor's attitude, although it may well be that readers or users of the audit reports are forced to rely on the auditor's integrity to a greater extent than they would wish.

The questions then arise as follows:

- i) Does auditor independence affect the nature of audit report?
- ii) Will increased auditor independence lead to a true and fair audit report?
- iii) Will audit fees affect auditor independence?

Going by the above research questions, the study aims at examining the relationship between auditor independence and the nature of audit report and, assessing the impact of auditor's independence on the nature of audit report.

Review of literature

A fairly large volume of literature has accumulated on the relationship between auditor's independence and the nature of audit report. Several models have been developed in the literature that try to give some direction on the relationship between auditor's independence and the nature of audit report as well as the effect of auditor's independence on the nature of audit report (Salehi, 2008 & 2010).

Prior research provides mixed evidences on the relationship between fees and (qualified) audit opinions. It has been observed that the more economically dependent the auditor is on the client, the more likely the auditor is to

succumb to client pressure (Nelson, Elliot & Tarpley, 2002; Trompeter, 1994). Mautz and Sharaf (1961:18) recognize the auditor's financial dependence on clients as a built-in-anti-independence factor. They further observe that since auditors are financially dependent on the client, their independence as regards the financial reports might be reduced. DeAngelo (1981:82) argues that future economic interest in a client reduces the auditor's independence towards the client. In other words, the greater the client-specific quasi-rent stream, the less likely the auditor is to report a discovered breach.

Wines (1994) suggests that high audit fees would impair auditor independence. Using a sample of 76 large Australian public firms over 1980 - 1989 period, he finds that non-audit fee dependence is related to a reduced likelihood of qualification. Trumpeter (1994:56) in his study on auditor's independence and audit partner judgment observed that in instances where auditor's independence is compromised, auditors are less likely to require downward adjustments for important clients than for relatively unimportant clients. He suggests that partners with compensation more closely tied to client retention are less likely to require downward adjustments to income than partners with compensation less closely tied to client retention.

Similarly, Basioudis, Papakonstantinou, and Geiger (2006) using a sample of 29 financially distressed U.K. firms find out that firms with high audit fees are more likely to receive a going concern modified audit opinion, whereas firms with high non-audit fees are less likely to receive a going concern modified opinion.

Wallman (2006) posits that auditor independence should be examined at the office level where the important audit decisions regarding individual clients are made. He stated that when auditors of a company are in conflict with the directors, it is important this conflict should be resolved without losing any of their independence. He also explained that this can prove to be difficult as auditors earn fees from providing a service, which is how they earn a living. The audit fees are paid by the board of directors leaving them with the power in the auditors-clients relationships. The question often asked is how can the audit teams please the directors without losing any of their independence but keep the directors happy to ensure and maintain repeat business?

There are some studies which show no auditor's independence impairment as a result of high audit fees. Some prior research suggests that client fee dependence does not appear to compromise auditor objectivity for publicly

listed companies in the United States and Australia (DeFond et al. 2002; Craswell et al. 2002) and for private firms in Norway (Hope and Langli, 2007).

DeFond, Raghunadan, and Subramanyam (2002) examine the relation between audit and non-audit fees and the issuance of a going concern audit opinion. Using a sample of 1,158 financially distressed publicly listed U.S. firms in 2001–2002, they find no association between fees and impaired auditor independence because of the auditors' concern for loss of reputation and litigation costs. Craswell, Stokes, and Laughton (2002) also find similar results from a sample of Australian firms. Hope and Langli (2007) analysed the relationship between auditor fees and auditors' propensity to issue a going concern opinion. Contrary to the regulators' concern, the study provides no evidence that auditors compromise their objectivity through fee dependence.

In summary, it is evident that there is a close nexus between the independence of auditors and the propensity to qualify or not qualify audit reports. We know that audit reports will lack credibility if auditors appear to lack professional independence. However, the results from the empirical studies from the developed countries appear inconclusive and very little is known in the developing countries such as Nigeria and this is what necessitates the need for this present study.

Research methodology

In this study, auditor's independence and audit reports which are the two main issues discussed have to be analysed and measured so that the relationship between both can be established. Auditor's independence, which is the independence of the auditor from parties that have interests in the financial statements of an entity, is proxied by audit fee, which is the dependent variable while the explanatory variable is the nature of audit report. The auditor's independence function is therefore expressed as follows:

$$AI = f(NAR)$$

where,

$$AI = AF$$

$$AI = \text{Auditor Independence}$$

TAF	=	Total audit fees
NAR	=	Nature of Audit report
AF	=	Audit Fees

However, other extraneous variables that impact on auditor's independence are: personal relationship with the client, non-audit services (NAS), audit firm tenure, audit partner tenure and alumni affiliation. These factors reduce the propensity of issuing an unqualified audit report (Mikol and Standish, 2008:72). The data used in this study were obtained from the reports of twenty seven quoted companies in Nigeria between 2004 and 2008, which is a period of five years.

Data analysis and interpretation of results

The empirical relationships between auditor's independence (proxied by audit fees) and the nature of audit report were examined. The activities of twenty-seven quoted firms, the representative sample of study in the period 2002 – 2006, has witnessed significant variations brought about by the impact of the determinants of audit reports presented by auditors. In this study, the determinants are audit report and audit fees of each company respectively. A careful analysis of the variations in the nature of audit report, verified that audit report varied positively with these determinants between 2002 and 2006 but had no significant relationship.

It is observed that between year 2002 and year 2006, audit reports were mostly unqualified implying that the financial statements brought before the auditors presented true and fair view of the states of affairs of the companies. The results obtained using the Prise-Winsten estimation method is presented in a tabular form below:

Table 1: Results of Regression Analysis

Regressor	Coefficient	T-ratio
Constant	1.016	16.230
Audit fees	7.98	1.686
$R^2 =$	0.021	Adjusted $R^2 =$ 0.006
F =	2.8391	DW-Statistic = 1.984

Source: Authors (2010)

Before interpreting the regression results, it is imperative that the following diagnostics are examined. The R^2 value of 0.021 indicates that about 2% of the systematic variation in the nature of audit reports is explained by the changes in audit fees. This is not a good fit as about 98% systematic variation in the nature of audit reports is left unaccountable for by the model.

The value of adjusted R^2 which equals 0.006 indicates that the model explains about 0.6% systematic variation in the nature of audit report.

In support of the above, the F-statistic measures the overall significance of the model, that is, whether $R^2 = 0.021$ is different from zero. The R^2 value of 0.021 is different from zero and it is not statistically significant at 5% and 1% levels of significance. This shows that the slope coefficient is not statistically significant, which implies that there is no linear relationship between the independent variable (audit fees) and the dependent variable (the nature of audit report). The Durbin-Watson statistic was also employed as a model to test for auto-correlation and partial auto-correlation. The regression results shows $DW = 1.984$, which indicates the absence of first order serial correlation.

The sign of the estimated coefficient for the audit fee is correct. The t-statistics of the slope coefficient of audit fees computed is 1.686 and it has observed that it is not significant at 5% and 1% levels of significance. In particular, a percentage point increase in the audit fees improves the nature of audit reports by 7.98 percentage points. It could be observed from the findings of this study that there exist a positive but not significant relationship between audit fees and the nature of audit reports during the period under review.

It is however true that other factors may impact on the nature of audit reports, though they are not within the model specified. Lengthy audit firm tenure, audit-client relationship, provision of non-audit services (NAS), and alumni affiliation, all affect the nature of audit reports issued by the auditor.

Summary, recommendations and conclusion

We have empirically investigated and attempted to ascertain the impact of audit fees on the nature of audit report of public quoted companies in Nigeria. In this study, data were collected from the firms' Annual Reports and Accounts for the period 2002 – 2006 to obtain various auditor's opinions and audit fees for the period under study.

From the findings, it was observed that the financial statements of public quoted companies in Nigeria is premised on several factors, which determines the nature of audit reports given by the auditors. We observed that audit fee (AF) has a positive but insignificant correlation with the nature of audit report.

This study shows that there is a positive relationship between the nature of audit report and the audit fees over the period under study. Drawing from the research findings, the under-mentioned recommendations have been developed to serve as measures for improving the nature of audit reports. Our study reveals that there is a positive but insignificant relationship between auditor's independence and the nature of audit reports. While suggesting that this research work expresses a highly intelligent guide to determining the nature of audit reports of public quoted companies in Nigeria, interested parties are hereby advised to conduct more research on this area, as improvement will be highly appreciated.

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Table1: Companies and Audit Fees Paid (2002- 2006)

S/N	NAME OF COMPANIES	2002 ₦	2003 ₦	2004 ₦	2005 ₦	2006 ₦
1	Nigerian Bottling company	14,500,000	15,400,000	16,700,000	18,400,000	19,500,000
2	Berger Paints Nig. Plc	2,250,000	3,420,000	4,250,000	4,900,000	5,155,000
3	West African Portland Cement	12,000,000	16,000,000	18,000,000	22,000,000	31,500,000
4	Ashaka Cement plc	4,200,000	6,000,000	6,000,000	8,200,000	11,500,000
5	Presco Plc	1,700,000	2,000,000	2,000,000	3,100,000	5,800,000
6	African Petroleum Plc	7,000,000	10,000,000	12,500,000	10,000,000	14,250,000
7	May and Baker Nigeria Plc	2,000,000	2,100,000	3,600,000	5,700,000	8,000,000
8	First Bank of Nigeria Plc	8,500,000	11,000,000	14,500,000	17,000,000	19,200,000
9	United Bank for Africa (UBA) Plc	11,000,000	16,000,000	20,000,000	20,000,000	23,000,000
10	Afribank plc	18,000,000	17,000,000	15,000,000	18,000,000	29,000,000
11	Union bank plc	27,000,000	30,000,000	30,000,000	35,000,000	40,000,000
12	Dunlop Nigeria Plc	5,000,000	4,790,000	5,200,000	7,300,000	9,150,000
13	Oando plc	7,000,000	10,000,000	14,000,000	17,500,000	28,000,000
14	Mobil Oil Plc	5,500,000	7,618,000	9,003,000	8,418,000	9,200,000
15	Texaco Nigeria Plc	4,427,000	6,799,000	7,128,000	11,200,000	13,450,000
16	Glaxomithkline	4,300,000	6,000,000	7,200,000	9,000,000	11,500,000

17	Evans medical Plc	3,500,000	3,500,000	4,000,000	6,200,000	7,500,000
18	Unilever Nigeria Plc	8,500,000	9,500,000	10,192,000	13,700,000	14,100,000
19	Japaul oil	650,000	650,000	500,000	720,000	1,200,000
20	Jos International Breweries Plc	1,150,000	1,150,000	3,700,000	5,720,000	6,000,000
21	Wema Bank Plc	8,500,000	11,000,000	14,500,000	17,000,000	19,200,000
22	Guinness Nigeria Plc	5,850,000	9,000,000	10,000,000	12,500,000	14,375,000
23	Total Fina Elf	6,200,000	8,500,000	10,800,000	13,300,000	15,400,000
24	Nestle Foods	6,300,000	8,700,000	10,700,000	12,800,000	14,800,000
25	Okomu oil	1,400,000	1,600,000	2,500,000	3,200,000	4,000,000
26	Seven Up Bolting company	5,500,000	6,000,000	5,500,000	6,500,000	7,500,000
27	University Press	750,000	1,000,000	1,000,000	1,200,000	1,600,000

Table 2: Companies, Their Auditors and Types of Audit Reports

S/N	Name Of Companies	Auditors	2002	2003	2004	2005	2006
1	Nigerian Bottling company	Akintola Williams Deloitte	1	1	1	1	1
2	Berger Paints Nig. Plc	Akintola Williams Deloitte	1	1	1	1	1
3	West African Portland Cement	Akintola Williams Deloitte	1	1	1	1	1
4	Ashaka Cement plc	Akintola Williams Deloitte	1	1	1	1	1
5	Presco Plc	Akintola Williams Deloitte	1	1	1	1	1
6	African Petroleum Plc	Akintola Williams Deloitte	3	3	3	1	1
7	May and Baker Nigeria Plc	Akintola Williams Deloitte	1	1	1	1	1
8	First Bank of Nigeria Plc	Akintola Williams Deloitte	1	1	1	1	1
9	United Bank for Africa (UBA) Plc	Akintola Williams Deloitte	1	1	1	1	1

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10	Afribank plc	Akintola Williams Deloitte	1	3	3	1	1
11	Union bank plc	Akintola Williams Deloitte	1	1	3	1	1
12	Dunlop Nigeria Plc	Ernest and Young	1	1	1	1	1
13	Oando plc	PriceWater House Coopers	1	2	1	1	1
14	Mobil Oil Plc	PriceWater House Coopers	1	1	1	1	1
15	Texaco Nigeria Plc	PriceWater House Coopers	1	1	1	1	1
16	Glaxomithkline	PriceWater House Coopers	1	1	1	1	1
17	Evans medical Plc	PriceWater House Coopers	1	1	1	1	1
18	Unilever Nigeria Plc	PriceWater House Coopers	1	1	1	1	1
19	Japaul oil	Ugboaja, Martins and Co	1	1	1	1	1
20	Jos International Breweries Plc	Pannel Kerr Forster	1	1	1	1	1
21	Wema Bank Plc	KPMG Audit	1	1	1	1	1
22	Guinness Nigeria Plc	KPMG Audit	1	1	1	1	1
23	Total Fina Elf	KPMG Audit	1	1	1	1	1
24	Nestle Foods	KPMG Audit	1	1	1	1	1
25	Okomu oil	Spiropoulos Adiele, Okpara & Co	1	1	1	1	1
26	Seven Up Bolting company	Egunjobi, Adegbite and Co	1	1	1	1	1
27	University Press	Oyediran Faleye Oke and co	1	1	1	1	1