

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.

Keywords: Independence, fees, report, qualified and unqualified

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 and 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 and 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; and 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 appear 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 behavior 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.

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:

$$AI = \alpha(NAR)$$

where,

$$AI = AF$$

$$AI = \text{Auditor}$$

Independence

$$TAF = \text{Total audit fees}$$

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.

Conclusion and recommendations

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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