EFFECT OF AUDITORS' INDEPENDENCE ON FINANCIAL REPORTING QUALITY OF LISTED DEPOSIT MONEY BANKS IN NIGERIA

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Abstract

This paper examines the effect of auditors' independence on financial reporting quality of listed deposit money banks in Nigeria from 2015-2020. Data for the study were collected from the annual reports and accounts of the ten (10) sampled deposit banks and panel regression analysis was used as a technique for data analysis. The study finds that there is an insignificant negative relationship between audit tenure (AUDTEN), firm size (FSIZE) and financial reporting quality using earning management as a measure. Audit fee (AFEE) and leverage (EBLLA) however exhibits a positive insignificant relationship with earning management (EMGT). The study recommends that regulatory authorities should regulate how much firms pay as audit fees in order to ensure a better earnings management for money deposit money banks in Nigeria, money deposit banks in Nigeria should always strengthen their auditors' independence according to lay down policies, Security and Exchange Commission should continue to uphold the policy of ensuring that tenure of auditors be more stable. Money deposit banks in Nigeria should continue to maximize opportunities and advantages that align to firms operating in the market for better improvement in operations and increase in earning management, since some firms are able to enjoy larger economic of scales.

Keywords: Auditor, Independence, Auditors' independence, Quality, Financial report

Introduction

Independence in the auditing profession reduces corporate scandals like error failure confirmed the importance of credibility of audits. Audit independence refers to the ability of the external auditor to act with integrity and impartiality during his/her auditing functions (Akpom & Dimkpah, 2013). Auditor independence may be impaired by auditor tenure. As the relationship between the auditor and client lengthens, the auditor may develop close relationship with the client and may likely act in favor of the management such like, impair objectivity and audit quality (Babatolu, Aigienohuwa & Uniamikogbo, 2016). Audit quality in recent times has become a source of worry globally as most auditors seem not to be discharging their duties independently (Zayol, Kukeng & Iortule, 2017).

Audit fees popularly defined as an amount required by the auditor to conduct a proper audit agreed upon by an audit firm and its client (Yao *et al*., 2015). In China, Mao, Qi, and Xu, (2017) and Chen, Krishnan, and Yu (2018) examined the association between audit fee and audit quality and independent of an auditor. The authors found that member firms charged high audit fees than non-member firms, but could not conclude whether it has an impact on audit quality.

The length of time an audit firm spends with a particular client is considered as a form of threat to auditor's independence as a result of familiarity threats, (Ghosh & Moon, 2015), reported on the influence of the increase in future earnings as auditor tenure increases. Familiarity threat to auditor's independence occurs when an audit firm has a particularly close or long-standing relationship with a client's directors, officers and employees. Meanwhile, Zhang *et al.,* (2016) found no evidence of loss of independence for lengthy tenure. Providing an independent verification of financial statements, auditors lend credibility to accounting information and enhance its integrity. There is the belief that auditing report issued by an auditor should be of reputable quality. Seen from this perspective, audit quality refers to credibility of the audit opinion which is a measurement of the degree of confidence users place upon the information provided by the auditor. However, these external parties cannot be expected to trust reported financial information without confidence in the Auditors‟ Independence.

Recently, there is an increasing concern by regulators, investors and the general public regarding the quality and reliability of audited financial statements, because auditors compromise independence and thus diminish the quality of earnings reported, by either providing non-audit services to clients or collecting abnormal audit fees from the clients (Siriyama & Tori, 2018).

The major challenges to auditor independence are the fees perceived by the auditor for audit services and the length of relationship between the auditor and client. Erode independence of an auditor leads to poor audit quality and the consequence include greater earnings management and lower earnings quality (Okolie, 2014).

In Nigeria, banking industry witnessed different factors that slow the desired level of economic growth and development, the Central Bank of Nigeria (CBN) Code of Corporate Governance for Banks in Nigeria Post Consolidation of 2019 identified weak internal controls, non-compliance with laid-down internal controls and operations procedures; poor risk management practices resulting in large quantum of nonperforming credits,

Auditor independence is critical to the reliability of financial statements as well as investors‟ confidence due to the psychological belief in the auditors‟ role. The value of an audit depends on independence (objectivity). The Institute of Chartered Accountants' of Nigeria (ICAN, 2018) define independence as a state of not being controlled by other people or things, such as financial benefits. In an effort to ensure independence of mind and in appearance, the International Standard on Auditing (ISA) No. 200 (objective and general principles of audit) states that "in the conduct of any audit of financial statements, auditors should comply with the ethical guidance issued by their relevant professional bodies". These ethical rules govern auditors‟ responsibilities and guide the audit and non-audit functions performed by auditors.

Therefore, this study will examine the effect of auditors' independence on financial reporting quality of listed deposit money banks in Nigeria.

Independence in fact is a state that allows auditors to perform audits with objectivity, honesty and skepticism while independence in appearance requires avoiding situations that may cause users of the audit reports to suspect that the auditor may give an unbiased opinion. So, in fact, auditors need to be independent of any client they provide audit services and must show to third parties that the auditor can maintain impartiality in judgment and resist pressure from managers at client companies (Chrystelle, 2016).

Auditor fees are the compensation to auditor for the services he rendered to a client, such audit services include statutory audit and non-statutory services also known as management consultancy services. Audit fees popularly defined as an amount required by the auditor to conduct a proper audit agreed upon by an audit firm and its client (Yao et al., 2015). Chen,

Krishnan, and Yu (2018) In China, Mao, Qi, and Xu, (2017) examined the association between audit firm membership on audit fees and audit quality. The authors found that member firms charged high audit fees than non-member firms, but could not conclude whether it has an impact on audit quality. However, their findings are in line with Bills, (Cunningham, &Myers ,2015).

The length of time an audit firm spends with a particular client is considered as a form of threat to auditor's independence as a result of familiarity threats, (Ghosh & Moon,2015) reported a more likely influence of the increase in future earnings as auditor tenure increases. Familiarity threat to auditor's independence occurs when an audit firm has a particularly close or long-standing relationship with a client's directors, officers and employees. Meanwhile, Zhang et al. (2016) found no evidence of loss of independence for lengthy tenure.

Bello (2014) viewed Earnings management as attempt to cook/doctor or tailor financial accounting reports to a given desired level and regarded as ethical misconduct of accountants and relates it to the recent times corporate failures and loss of investors" confidence on both financial reports and auditors. Definition by Schipper (2019) as a purposeful intervention in the external financial reporting process, with the objective of obtaining some private gain. While Healy and Wahlen (2014) state that "earnings management occurs when managers use judgment in financial reporting and in structuring transaction to alter financial reports to either mislead some stakeholders about the underlying economic performance of a company, or to influence outcomes that depends on reported earnings".

Motivator

Some of the attributes of audit that could affect the audit quality positively and increase the chances of discovering and reporting intentional errors and misstatements in the financial statements include the size and experience of the auditor, auditor remuneration and the joint audit services. In Nigeria however, there are no significant researches on these factors in the banking sector, particularly in the deposit money banks. This constitutes the problem that this study investigated.

Objectives

The objective of this study was to examine the effect of auditor's independence on the earning management of deposit money banks in Nigeria through

i. Examining the impact of audit fees in earnings management of deposit money banks in Nigeria.
ii. Investigating the consequences of audit firm tenure on earnings management of deposit money banks in Nigeria.
iii. Evaluating how audit services are effective in earning management of deposit money banks in Nigeria.

Literature Review

This chapter reviews relevant literatures on the theoretical background relating to the title under study. In order to understand the direction of the study, there is need to identify the variables of the study and how they connect to each other. This will aid in identifying and describing the variables of the study and serves as a guide that helps in understanding the research. This chapter reviews and explains the relevant concepts as they are being used in the study, the review of empirical studies (i.e review of prior studies) as well as theories relevant to the study. The review is to serve as the basis for the research findings and also the basis upon which the analysis of the study will be made.

Theoretical Framework

There are several theories that can be used to explain the effects of auditor's independence on financial reporting quality of listed money banks in Nigeria. Therefore, this study is anchored on agency theory, theory of inspired confidence and the credibility theory.

The agency theory as the underpinning theory of this study emphasizes that audit services are employed in both the interests of third parties and management. An agency relationship exists between the agent (management) and principals (shareholders, employees, banks etc.); where the authority of decision-making is delegated to the agent. Agency theory is the most widely used audit theory. The audit theories demonstrate the need of accountability in modern society and the role of audit in providing reasonable assurance and unbiased opinion to users of financial statements, about an organization.

The theory of inspired confidence focuses on both the demand and supply of audit services. The relationship of accountability is realized with financial statements; however, as outside parties cannot monitor any material misstatement or bias in financial reports, the demand for an independent reliable audit arises. The supply of audit services should satisfy the public confidence that arises from the audit and fulfill community expectations, as the general function of audit is derived from the need for independent examination and an expert opinion based on findings; due to the confidence society places in an independent auditors' opinion.

Method and Materials

This study employed correlation research design in assessing the effect of auditor independence (through fees, tenure and large audit firms) on the earnings management of deposit money banks in Nigeria. In correlational research design, the aim is to investigate the relationships between variables (and to observe the impact on the dependent variable, so as to establish the causal relationship or otherwise among the variables).

The study is designed in two parts. In the first part, abnormal loan loss provision portion which is highly susceptible to management manipulation, and thus the proxy of earnings management is estimated from total Loan Loss Provision (LLP) using modified LLP model of estimation in line with (Kanagaretnam*et al.*, 2018). The second part covers the analysis of the relationship between abnormal or discretionary loan loss provision, audit firm tenure and the total audit fees.

The population of the study comprises of all the nineteen (19) banks listed on the Nigerian Stock Exchange Market as at 30th July, 2021.

The study basically makes used of secondary sources of data, while the method of data collection involved financial statements; income statement and the statements of financial position of the ten (10) sampled banks, for the period of five years (2015 – 2020). This was because the nature of the data warrants using quantitative data and quantitative methods of analysis. This investigation utilized Panel Regression Techniques followed by a descriptive statistic for both preliminary tests and post estimation tests.

Measurements of the variables of the study

S/N	Variables	Definition	Types	Measurement
1	EMGT	Earning Management	Dependent	discretionary loan loss provision (measure of earnings management) of bank I in year t. (Cheng et al., 2011)
2	AFEE	Total Audit Fee	Independent	Total audit fees scaled by book value of bank I in year t. Fiecher Meryer (2011)
3	AUDTEN	Audit Firm Tenure	Independent	Audit firm tenure of bank I, 1 if there is no change of auditor and 0 otherwise.
4	EBLLA	Leverage	Control	Net earnings before loan loss allowances for bank I in year t, controlling for bank performance.

5	FSIZE	Firm Size	Control	Natural log of Firm Total Assets. Hamid and Abubakar (2019)

Source: Field work 2021

Data Analysis

Table 1: Correlation Matrix Result

Variables	EMGT	AFEE	AUDTEN	EBLLA	FSIZE
EMGT	1.000000				
AFEE	0.161427	1.00000			
AUDTEN	-0.123787	-0.039627	1.00000		
EBLLA	0.020755	0.246419	-0.054456	1.00000	
FSIZE	-0.074841	0.195199	-0.034648	-0.109838	1.00000

Source: Author's Computation using EVIEWS 12.

The correlation coefficients of all the variables are presented in Table 1 above. Pearson's Correlation coefficient (r) is a measure of the strength of the relationship between the variables. The results of the correlation matrix show to what extent variables correlate with each other. The correlation matrix is one of the instruments to address the issue of multicollinearity. Evidence of Correlation between EMGT and all the independent variables exist but with relationship exhibiting a positive correlation while others exhibit negative correlation. All the results of the correlation coefficients are statistically insignificant at all levels of significance. In other words, AFEE and EBLLA are all positively correlated with earning management but at an insignificantly statistical level, while AUDTEN and FSIZE are negatively correlated but at an insignificantly statistical level too.

Table 2: Fixed effect panel regression result

Dependent Variable: EMGT
Method: Panel Least Squares
Date: 11/30/21 Time: 23:16
Sample: 2016 -2020
Periods included: 5
Cross-sections included: 10
Total panel (balanced) observations: 50

Variable	Coefficient	Std. Error	t-Statistic	Prob.
LOG(AFEE)	**-0.010112**	**0.004005**	**-2.524979**	**0.0161**
AUDTEN	**0.015639**	**0.013506**	**1.157927**	**0.2545**
EBLLA	**-1.08E-05**	**9.46E-05**	**-0.114630**	**0.9094**
LOG(FSIZE)	**0.000310**	**0.001194**	**0.259953**	**0.7964**
C	**0.211092**	**0.074465**	**2.834793**	**0.0075**

Effects Specification

Cross-section fixed (dummy variables)

R-squared	0.538416	Mean dependent var	0.035821
Adjusted R-squared	0.371733	S.D. dependent var	0.015157
S.E. of regression	0.012014	Akaike info criterion	-5.774060
Sum squared resid	0.005196	Schwarz criterion	-5.238693
Log likelihood	158.3515	Hannan-Quinn criter.	-5.570189
F-statistic	3.230183	Durbin-Watson stat	2.513976
Prob(F-statistic)	0.002677		

Source: Author's computation on Eviews 12.

From the first panel of the fixed panel regression model, it is obvious that only two of the variables are significant. The logarithm of audit fees (AFEE) was significant at the 5% level of significance while the constant, that is, the earnings management variable when holding all other variables or everything else constant is also significant but at the 1% level of significance. The relationships that subsist between the dependent and independent variables can be seen from the sign and magnitude on the coefficients on the first part of the result for the fixed effects model. Audit fees have a significant but indirect relationship with the earnings management holding other factors constant. In other words, there is a negative relationship between audit fees and earning management. This means that for every increase in audit fees of the auditors by the money bank, there is decrease in earning management by 0.0101 everything else constant. Audit tenure affects earning management positively. Meaning that there is a direct and proportional effect that audit tenure exert on earning management. This finding disagrees with the findings by Jayeola, O. et al (2017) in a study of Nigerian listed deposit money banks. In other words, keeping the auditors to continue as the auditors of the banks increases the earnings management of the bank by 0.015. This effect is not significant. Also, the leverage ratio of the money banks shows what kind of relationship exists. For every 1% increase in the leverage ratio, there is a corresponding decrease in earning management ceteris paribus. Leverage is an indication of the profit that management earns for every one naira they invested in the shares of a company. Lastly, the size of the firm also has an effect on the earnings management of the banks under review. Firm size exerts a positive effect on the earning management of the banks but at an insignificant level.

The second panel of the fixed effect model tells more about the model and how robust the model used is. The results of testing the coefficient of determination (adjusted R^2) produces a value of 0.538416 indicating that the dependent variable accruals earnings management is explained by all the explanatory variables in the model - firm size audit fees, leverage, and audit tenure. While the remaining unexplained variation of about 47% are explained by factors outside the model. The R^2 indicates that about 53% of the variables in the model are explained by the explanatory variables. While, the Durbin Watson statistic of 2.5 shows the absence of serial autocorrelation. With this observation, there is no need for testing for the existence of autocorrelation. The probability value that is near zero (0.002677) shows that the model is of best fit. These insignificant results when compared to results in the literature, is opposite of some results considered. Take for instance, result of Beck et al. (1988) and Lys and Watts (1994) argue that longer auditor tenure leads to an impairment of independence allowing for higher magnitudes of earnings management.

Discussion of Findings

In this section of the study, the findings of this research were discussed in line with expectations of the study and in comparison, with the findings of past researches.

From fixed effect model (FE), the expectation is a positive significant impact that is, as audit fee increases there should be a corresponding increase in EMGT. But it was a contrary result from this study. Audit fee has a negative insignificant impact on EMGT. This means that, an increase in the audit fee of a firm leads to decrease in EMGT, but statistically insignificant and as such not a good determinant of performance. This is in line with Frankel et al. (2014), Ashbaugh et al., (2016) but in disagreement with findings by Koh et al., (2018), Brown et al., (2019) who revealed positive significant.

Audit tenure affects earning management positively. Meaning that there is a direct and proportional effect that audit tenure exerts on earning management, in other words, keeping the auditors to continue as the auditors of the banks increases the earnings management of the bank. This finding is consistent with Beck et al. (1988) and Lys and Watts (1994) who argued that longer auditor tenure leads to an impairment of independence allowing for higher magnitudes of earnings management but disagrees with the findings by Jayeola, O. et al (2017), Carey and Simnett (2017) as well as Carcello and Nagy (2020) in a study of Nigerian listed deposit money banks.

The result reveals that leverage is a determinant of earning management as it has a negative significant impact on earning management, though contradicts our expectation of a positive significant impact on return EMGT. Since it is believed that when extra funds (leverage) are sourced, they should be invested to produce high profit to meet creditors' expectations (interest) and likewise that of the shareholders. However, this study is in line with the findings of Lorpev and Kwanum (2012); Tih (2008) but not in line with the findings from the studies of Humera et al (2011); Laurent (2000) that found a positive significant impact of leverage on earning management. But the findings on the overall, confirm that leverage cannot not be strictly considered as a variable that explains profitability since profitability is a source of internal financing. Consequently, higher profit means a reduction in the need for external financing such as financial leverage (Laurent, 2000), that is internal source of financing is preferable to meet firms' long-term investment. Thus, investment decision should be used by considering size, tangibility and growth factor (Lorpev and Kwanum, 2012).

Lastly, the expectation is a positive significant impact that is, as FS increases there should be a corresponding increase in EMGT and it was a confirmed result from this study. Firm size has a positive significant impact on EMGT. This means that, an increase in the FS of a firm leads to increase in EMGT, statistically significant and as such a determinant of earning management. The findings of Bala et al (2005); Abdullahi et al (2011); Gray and Birger (1989); Pawan and Shuangi (2014) contradicts the finding of this study as they found that firm size has a negative significant impact on firm earning management. But, the studies of Yana (2010); Agustinus and Rachmadi (2008); Pavlos (2008); Owen and Paul (2003); are in line with the finding of this study as they found a positive significant impact of firm size on firm management. The variation in findings of this study from others could be explained as possible where the use of earning management of a firm were not maximized. This is so because, if the EMGT of listed deposit banks were effectively used, it would have led to a significant increase in EMGT which is the proxy for firm performance in this study. Similarly, the previous researches that contradict the findings of this work are all foreign based researches which could be the reason for the differences. Another reason for the contradiction of the findings of this study from other works could be as a result of the time frame, geographical location, number of firms studied and economic stability as at the time these studies were conducted.

Conclusion

This paper has empirically provided evidence on the relationship between auditor's independence and earnings management of listed money deposit banks in Nigeria. Based on the findings, it is concluded that auditor's fees and leverage have an inverse relationship with earnings management. However, study concludes that auditor's independence has negative insignificant impact on earning management of listed money deposit banks in Nigeria for the period under review.

Earnings management is an opportunistic action carried out by managers to achieve certain desired profit figures. The research sample used in this study is that of listed money deposit banks on the Nigeria Stock Exchange from 2016 to 2020 selected based on a purposive sampling method. Empirically this study found that accrual earnings management did not affect the value of the firm. Real earnings management has a negative impact on firm value. Leverage and audit quality have no effect on firm value. Firm sizes were found to have a positive impact on earnings management. This study reveals that managers use earnings management techniques such as accrual earnings management and real earnings management simultaneously to obtain profit targets.

Recommendations

Since an increase in audit fee leads to a decrease in earnings management, it is then, imperative that the regulatory authorities should regulate how much firms pay as audit fees in order to ensure a better earnings management for money deposit banks in Nigeria

The paper recommends that the Security and Exchange Commission should continue to uphold the policy of ensuring that tenure of auditors be more stable. The Commission has already signified a time span for any serving auditor before they can be changed.

This paper used accruals quality as indicator of financial reporting quality. It is proposed that following research should use other indicator different from what this study employ in order to have a different perspective.

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