Audit Quality and Auditors Independence in Nigeria: An Empirical Evaluation

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Abstract
Many have argued that auditors' independence plays a pivotal role in enhancing the quality of the audit in an organization. This is the focus of this study, using Nigerian quoted companies as a reference point. This study empirically evaluates the relationship between audit quality and auditors independence. In pursuance of this, a cross sectional analysis of companies listed on the Nigerian Stock Exchange was carried out. The dependent variable was audit quality that was measured by the fees charged by the audit firms. The independent variables were the audit tenure, board independence, and ownership structure. The data collected for the variables were subjected to the ordinary least square (OLS) regression analysis. The results indicated that as auditors' independence increase, the quality of the audit also improves and as the independence of the board and the ownership structure increases, the quality of the audit reduces. It is therefore recommended that auditors should strive for independence in other to ensure quality audits.
Keywords: audit quality, auditors' independence, ownership structure.

1.Introduction

The quality of the audit services rendered by the auditor and the audit report issued are to a great extent affected by the independence of the auditor. Auditor independence is a cornerstone of the auditing profession, a crucial element in the statutory corporate reporting process and a key prerequisite for adding value to an audited financial statement (Mautz and Sharaf, 1961). The agency relationship that existed between the owner (shareholders) and the managers of the company necessitate the services of an auditor whose report on the financial statement has to be an unbiased and impartial view of the company's financial activities in other to be useful to users.

Companies like Xerox, Enron and WorldCom, amongst others, have disclosed improprieties in their financial statements amounting to billions of dollars. Xerox disclosed that it had incorrectly realized $6.4 billion in revenues and overstated its pretax income by $1.41 billion over five years from 1997 to 2001. In some of these high profile audit failures, auditor misconduct has been alleged. For example, according to the Wall Street Journal (2003), the SEC filed civil fraud charges against KPMG for its role in auditing Xerox. The accounting improprieties at Enron regarding related party transactions led not only to its demise but also the failure of its auditor, Arthur Andersen (Bajaj, Gunny, Sarin, 2003).

The probability that the auditor will uncover a breach and disclose such discovery is what DeAngelo (1981b) describes as audit quality. If the auditor's independence of mind and in appearance is compromised then the auditor is less likely to report the irregularities and this would result in the impairment of the audit quality.

In light of the ever present importance of the independence of auditors and in the aftermath of the global economic crises, which first made itself felt in 2008, several international bodies proposed new requirements to enhance audit quality as well as address market concentration of audit firms including revising auditors independence.

In recent times, the length of the audit tenure has become a cause for concern in relation to impairment of the auditor's independence. As a lengthy audit tenure could result in a close relationship between the auditor and the client, causing the auditor to act in favour of management thus reducing objectivity and audit quality.

1.1 Statement of the research problem

Several studies (Dopuch, King & Schwartz, 2001; Myers, Myers & Omer, 2003) have attempted to evaluate possible explanatory variables for the state of audit quality, focusing on the relationship between company specific and audit firm specific factors that could mediate audit quality. In light of these studies, auditor tenure has become the focus of much debate. Should a firm replace its auditors on a regular basis, or should the auditor be allowed to build a long-term relationship with the client?

The crux of the debate rests on how tenure affects auditor independence. Proponents of mandatory auditor rotation claim that lengthy auditor tenure erodes independence, which in turn impairs audit quality. Others argue that independence and audit quality increase with longer tenure because of improved auditor expertise from superior client-specific knowledge. Since independence is not observable, regulators, practitioners, and academics often rely on the appearance dimension to define auditor independence (Dopuch et al, 2003).

A considerable number of these studies (Healey & Kim, 2003; Carcello & Nagy, 2004) consider rotation of audit firms as a way strengthening the independence of the auditor and of improving audit quality. The Sarbanes-Oxley Act of 2002 consolidates this view as it requires rotation of the lead audit partner every five years so that the engagement can be viewed "with fresh and sceptical eyes." The argument basically is that longer auditor-tenure tends to result in an opportunity cost of auditor independence. Conversely, other studies (Defond & Francis, 2005; Jenkins & Velury, 2008) also argue that longer auditor tenure improves audit quality as auditors may need time to gain expertise in the business they audit and acquire client-specific knowledge over time. This implies that audit quality is lower during the early years of the Auditor- Client relationship, and audit quality increases with length of auditor-tenure due to the reduction in information asymmetry between auditor and client (Azizkhani, Monroe & Shailer, 2007).

However, in the Nigerian audit setting, the challenge of auditor tenure on auditors' independence and client relationship though still budding has not attracted much analytical attention and empirical studies beyond mere anecdotal opinions. Consequently, there has been a dearth of research in this area and inadequate empirical evidence from Nigeria. Hence the study attempts to analyze the significance of the interactive effects of the independence of the auditor on audit quality using a study sample from Nigeria.

In light of the above, the research questions for this study are:

1. What is the relationship between audit tenure and audit quality?
2. What is the relationship between board independence and audit quality?
3. What is the relationship between ownership structure and audit quality?

1.1.1 Objectives of the study

This study's main objective is to examine if audit tenure is an intervening variable in determining audit quality. The specific objectives are to:

1. Ascertain the relationship between audit tenure and audit quality
2. Find out the relationship between board independence and audit quality.
3. Examine the relationship between ownership structure and audit quality.

1.1.2 Hypothesis of the study

Hypothesis is a tentative answer to a research question. Therefore, the following hypotheses, stated in their alternate forms are been raised in light of our objectives.

HA: Audit tenure is positively related to audit quality in Nigeria.

HA: Board independence is positively related to audit quality in Nigeria.

HA: Ownership structure is positively related to audit quality in Nigeria.

1.1.3 Significance of the Study

The principal-agent relationship can be used in explaining the importance of the auditor. The directors (the agents) prepare the financial statements for use of interested parties one of which are the shareholders(principal), the demand for external audits is to ensure that the assertions of management are true. Therefore, this study is expected to provide useful insight into improving audit quality. This study contributes to the audit literature as it provides additional empirical evidence on the impact of auditors' independence on the level of audit quality. This study will be useful to stakeholders in the Nigerian Stock Exchange (NSE) as it provides evidence on the relationship between audit quality and the reforms instituted by the Sarbanes Oxley Act of 2002 demanding mandatory audit rotation every five years

1.1.4 Scope of the Study

This study is premised on the appraisal of audit quality in Nigeria. Therefore, data on corporate organisations in Nigeria were sought in providing answers to the problems and questions that have been raised in this research work. The study focuses on companies listed on the floor of the Nigerian Stock Exchange (NSE).

The remainder of this paper is organised as follows: Section II discusses the relevant literature including audit quality, audit committee and corporate governance, board structure, ownership structure, and CEO duality and audit quality. The methodology adopted to lend empirical weight to the findings was outlined in Section III. Section IV provides the results while Section V concludes the paper.

2. LITERATURE REVIEW

2.1 Audit quality

An audit is an independent examination of the financial statements of an enterprise as prepared by the management of that enterprise by an appointed person called the auditor in order to express a professional opinion whether or not those financial statements show a true and fair view of the position of the enterprise as at the end of the financial period in accordance with the relevant statutory and professional regulations (Izedonmi, 2000).

DeAngelo (1981) noted that audit quality consists of two components: auditor competence and auditor independence. Deterioration in audit quality in a short tenure audit may be due to either lack of competence or loss of independence, while a loss in quality in a long tenure audit is most likely due to a loss of independence (Knechel &Vanstraelen, 2007).

Moizer (1997) noted that the appraisal of the indices of measuring the quality of the audit service is not without its challenges since audit quality is typically unobservable (Francis, 2004). Thus, according to Hay and Knechel (2010), auditing could be categorized as a type of credence good and hence auditors add credibility to corporate financial reports by expressing an opinion about the true and fair representation but only in so far as the users of financial statements perceive that opinion as valuable. In this regards, Hardies, Breesh and Branson (2010) argued that audit quality is not simply a linear function of auditor competence and auditor independence, but also on the market's perception about the value of the auditor's report which is the result of the perceived competence and the perceived independence of the auditor. Seen from this perspective, audit quality refers in this case to credibility of the audit opinion which is a measurement for the degree of confidence users place upon the information provided by the auditor.

2.2 Auditor independence

Independent auditors are considered the "gatekeepers" of the public securities markets (SEC 2000).

The auditors' independence could be affected by the length of time the auditor works for a particular client. In particular, the familiarity developed from lengthy auditor tenure and the percentage of the total income of an audit firm which is accounted for by any particular client has been alleged to contribute to this erosion of auditor independence. In order to restore public confidence, policies such as mandatory audit firm rotation, prohibition/disclosure of certain non Audit Services have been initiated by regulators and accounting bodies in the US, Nigeria and elsewhere (Sarbanes Oxley Act, 2002).

There are two opposing views on the effects of auditor tenure on the audit quality. Auditor competence may increase as a result of long auditor tenure as the auditor can base audit decisions on extensive client knowledge that has developed over time, or it may hamper auditor independence as lengthy tenure encourages closeness and familiarity between management and the auditor (Knechel &Vanstraelen, 2007).

The first one suggests that as the auditor-client relationship lengthens, the auditor may develop close relationship with the client and become more likely to act in favour of management, thus reducing the audit quality. Therefore, imposing mandatory limits on auditor tenure is expected to improve audit quality by reducing client firms' influence over auditors (Mautz & Sharaf , 1961).

Barbadillo and Aguilar (2008) in a study of the relationship between the duration of audit engagement and audit quality specified a model to show the functional relationship between the dependent variable (value of audit quality) and the main explanatory factor (tenure). Using a sample of non-financial Spanish companies quoted on Madrid Stock Exchange, the study reveals an inverse relationship between auditor tenure and audit quality and suggest that auditors tend to be more dependent in the first years of the auditing engagement. The study concludes that the shorter the auditor's tenure, the more they behave in a dependent fashion.

The other view, on the other hand, indicates that as the auditors tenure becomes longer, the auditor develop their understanding of the business and also their expertise during the audit, resulting in higher audit quality.

Short auditor tenure may undermine auditor competence since the auditor knows less about a company in the early years of an audit, but it may also undermine auditor independence since auditors will wish to retain a new client long enough to recoup the costs of the initial audit setup or a lowball fee (Dye, 1991).

Shockley (1982) reports that auditors did not perceive tenure exceeding five years as reducing auditor independence. The opposing viewpoint holds that problem audits occur more frequently for newer clients because auditors have less information about these firms (AICPA 1992). Client-specific knowledge of items such as operations, accounting system, and internal control structure is crucial for auditors to detect material errors and misstatements.

Myers et al, (2003) apply the dispersion of accruals as a proxy. They report that as auditor tenure lengthens, the discretionary accruals and current accruals are less dispersed, suggesting higher earnings quality. Jenkins and Velury (2008) suggest that conservatism in reported earnings increases between short and medium tenure but does not change between medium and long tenure.

Apart from accruals, Stanley and DeZoort (2007) utilize restatement as a proxy for low quality of financial reports. Their test results also suggest that as the length of auditor-client relationship increased, the likelihood of restatement decreased, suggesting better financial reporting quality. Knechel and Vanstraelen (2007) find that longer auditor tenure neither increase nor reduce the likelihood of auditor's issuance of going concern report for a company that subsequently went bankrupt. However, the study involving going-concern report in the US suggest that audit reporting failures are significantly higher in the first few years of auditor-client relationship (Geiger & Raghunandan, 2002).

In the light of the positions of various studies as reviewed above, we can argue that the effects of auditors' independence (using audit tenure as a proxy) on audit quality are controversial. Moreover, few empirical studies use publicly available secondary data in order to determine whether perceived threats to auditor independence actually compromise auditor independence. Again, documentary evidence from Nigeria in this subject area is not readily available. Therefore, this study which was motivated by the lack of consensus in the literature on the impact of audit independence on audit quality will contribute to the debate by examining the relationship between auditor tenure and audit quality in Nigeria.

2.3.1 Board independence

Fama and Jensen (1983) have theorized that the board of directors is the best control mechanism to monitor actions of management. The study explored board independence based on the agency theory. The study of O'Sullivan (2000) found that the proportion of non-executive directors had a significant positive impact on audit quality. It suggests that non-executive directors encouraged more intensive audits as a complement to their own monitoring role while the reduction in agency costs expected through significant managerial ownership resulted in a reduced need for intensive auditing. We therefore control for the effects of board characteristics on audit quality in Nigeria.

2.3.2 Ownership Structure

The relationship between outside shareholders and managers is marked by moral hazard and opportunism, which result from information asymmetry. The social role of financial reporting increases with the separation of ownership and control.

3.METHODOLOGY

This study is a cross sectional study. The population of the study is made up of companies listed on the floor of the Nigerian Stock Exchange (NSE). A sample of twenty (20) audited financial reports of these companies for the period ending 2011 was selected using the simple random sampling technique. The regression model for this study takes the form:

AUDITQUAL = $\beta 0$ + $\beta 1$ ATEE + $\beta 2$ BIN + $\beta 3$ OSTR + ε..................................... (1)

Where:

AUDITQUAL= audit fee charged by audit firms which is used as a proxy for audit quality

ATEE= audit tenure which is used as a proxy for auditors independence

BIN= board independence

OSTR= ownership structure

ε = the error term

4.DATA ANALYSIS

4.1Descriptive Statistics

A study of table 1 below shows that the range of the fees paid by the observed companies for audit is 95,996,000 and on the average, a fee of 6,466,757 is paid for a financial audit. Furthermore, the table reveals that the mean average time an audit firm spends with client is 3years as inferred from the mean mark of 0.6. With respect to board independence, a good number of the companies observed can be said to be fairly independent as the average ratio of independence is approximately 60%. Lastly, a critical appraisal of the Jarque-Bera statistics reveals that all the observed variables are normally distributed with the exception of audit tenure and board independence.

Table 2 below examines the correlation between the various variables. A cursory look at the table shows that all the independent variables with the exception of audit tenure have a negative relationship with audit quality. Furthermore, looking at the magnitude of values, we can deduce that the relationship amongst these variables is weak as none is above 0.4. A critical analysis of the above table reveals the presence of first order autocorrelation as evidenced by the Durbin-Watson Statistics of 1.80. Hence, adjustments were made in an attempt to correct for the observed autocorrelation

4.2.Analysis Of Result

Having corrected for autocorrelation as best as possible; we observe the following, from table 3 and 4. The ($\boldsymbol{R^2}$) value of 0.384193 indicates that approximately 30% of the systematic variation in the dependent variable is

explained by the independent variables. A further adjustment for degree of freedom shows that approximately 19% of the systematic variation in the dependent variable is explained by the independent variables. This is evidenced by the adjusted (R^2).
The F-statistics which reveals the overall explanatory power of the model is 2.03 with probability of approximately 0.15. The implication of this is that the explanatory power of the model is weak as the independent variables taken holistically do not significantly explain our dependent variable.
The t-statistics value of audit tenure is 0.174459, which is an indication of a positive relationship between audit tenure and audit quality. The probability value of 0.8642 is an indication that audit tenure does not significantly affect audit quality at 5% significance level. We therefore accept the hypothesis that audit tenure is positively related to audit quality.
The t-statistics value of -1.836015 shows a negative relationship between board independence and audit quality. The probability value of 0.0893 indicates that the relationship between board independence and audit quality is not significant at 5% significance level but it is however significant at a 10 percent level of significance. We therefore reject the hypothesis that board independence is positively related to audit quality.
Ownership structure has a t-statistics value of -2.647092, which reveals a negative relationship with audit quality. The probability value of 0.0201 is an indication that the relationship between ownership structure and audit quality is significant. We therefore reject the hypothesis that ownership structure is positively related to audit quality.

4.3.Discussion Of Findings

The (R^2) value of 0.384193 indicates that approximately 30% of the dependent variable is explained by the independent variables. All the independent variables except ownership structure exhibited non significant relationships with audit quality; as a probability figure of less than 0.05 is deemed to be significant. This entails that shifts in the independent variables such as audit tenure and board independence would be accompanied by only slight changes in audit quality. The negative relationship between board independence and audit quality however, indicates that increases in board independence and ownership structure would be accompanied by decreases in audit quality and vice versa.
The findings of the study are in consonance with those of Shockley (1981), Tirole (1990), Geiger and Raghunandan (2002), Myers et al., (2003), Stanley and Dezoort (2007), our finding however contradicts that of O'Sullivan (2000), as we find a negative relationship between board independence and audit quality.

5.CONCLUSION

This paper is set out to ascertain the relationship between auditors' independence and audit quality. This stream of research quality has received considerable attention due to its significance to the auditing profession. Audit fee is used to proxy for audit quality based on previous research. It is observed that organizations that have been consistent with one audit firm for a period of at least 5 years are associated with high quality audits. This could be explained by the fact that auditors are more conversant with the clients business and are better able to carry out their functions.
Research concerning auditor independence and audit quality may benefit from cross-countries comparison. People in different countries are likely to have different attitude and culture. Finally, researchers can continue to generate future research questions around the requirements of the Sarbanes-Oxley Act, many of which aim towards auditor independence. The law has been in effect for over five years. This provides a good opportunity to perform related studies with less concern on limited sample size and more intense focus on the ability to generalize the findings.

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TABLE 1

DESCRIPTIVE STATISTICS

Parameter	AUDITQUAL	ATEE	BIN	OSTR
Mean	6466757	0.6	0.5915	6.340055
Median	167500	1	0.63	0.34105
Maximum	96000000	1	0.17	66.81
Minimum	4000	0	0.33	0
Std. Dev	21783625	0.502625	0.113845	16.81195
Skewnes	3.761508	-0.408248	-1.126479	2.844798
Kurtosis	15.84542	3.197279	3.197279	9.998983
Jarque-Bera	184.6672	4.262284	4.262284	67.79764
Probability	0	0.186702	0.118702	0
Sum	1.29+08	12	11.83	
Sum Sq.Dev	9.02E+15	4.8	0.246255	126.8011
				5370.189
Observations	20	20	20	20

TABLE 2

Dependent Variable: AUDQ Method: Least Squares

Sample: 1 – 20

Included observations: 20

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	55765569	31483909	1.77124	0.0956
ATEN	2132144	10064197	0.211854	0.8349
BIND	-81758868	48259235	-1.69416	0.1096
OSTR	-349796.3	326913.5	-1.069997	0.3005

R-squared	0.172303	Mean dependent var	6466757
Adjusted R-squared	0.01711	S.D. dependent var	21783625
S.E. of regression	21596463	Akaike info criterion	36.79081
Sum squared resid	7.46E+15	Schwarz criterion	36.98996
Log likelihood	-363.9081	F-statistic	36.82969
Durbin-Watson stat	0.374023	Prob(F-statistic)	1.808548

Source: E-Views 3.1 Output

TABLE 3

Dependent variable: AUDQ
Method: Least Squares
Sample: 1 – 20
Included observations: 20

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	58932362	34909377	1.688153	0.1152
ATEN	1812110	10387005	0.174459	0.8642
BIND	-92698133	50488753	-1.836015	0.0893
OSTR	-860296	324996.8	-2.647092	0.0201
AR(2)	0.583453	0.274253	2.127425	0.0531
R-squared	0.384193	Mean dependent var	7169275	
Adjusted R-squared	0.194714	S.D. dependent var	22915623	
S.E. of regression	20563960	Akaike info criterion	36.74611	
Sum squared resid	5.50E+15	Schwarz criterion	36.99344	
Log likelihood	2.027628	F-statistic	36.78021	
Durbin-Watson stat	0.149664	Prob(F-statistic)	1.818535	

Source: E-Views 3.1 Output

TABLE 4

Pearson's Correlation

	AUDQ	ATEN	BIND	OSTR
AUDQ	1.0000	0.1257	-0.3237	-0.1030
ATEN	0.1257	1.0000	-0.1085	-0.1117
BIND	-0.3237	-0.1085	1.0000	-0.4036
OSTR	-0.1030	-0.1117	-0.4036	1.0000

Source: E-Views 3.1 Output