

Effect Of Independent Of External Auditors On Accounting Quality Of Selected Nigerian Firms

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This study examined the effect of independent of external auditors on accounting quality of three selected nigerian firms. Specifically, the study ascertained the effect of audit firm size and audit degree of competition on discretionary accruals of quoted Nigerian firms. Ex-post facto research design was adopted. The sample of three selected Nigerian firms were used for the study. The data were analysed and tested using Ordinary Least Square with aid of E-View 9.0. The result revealed that there is a significant positive effect of audit firm size significantly on discretionary accruals of quoted manufacturing firms in Nigeria: and, that the degree of competition has a non-significant positive effect on audit discretionary accruals of quoted manufacturing firms in Nigeria. Based on this, it was recommended that the firms management should be wary of the degree of competition during choice of audit firm: This is particularly important during the bargaining process, as firms enjoying a monopolistic status may charge abnormally high audit fees.

Keywords: External auditors independence, Audit firm size, Audit degree of competition and Accounting quality

INTRODUCTION

There has been a growing emphasis on the perceived independence of external auditors (O'Sullivan, 2000). The independence of the external auditor is a fundamental pre-requisite for an objective audit in order to boost confidence in the quality of the audited financial statements. Changes in the economic environment and growth of corporate structure have brought about the need to separate business ownership from management. In the past, the nature and size of businesses made it possible for owners to manage their firms hence self-accountability was prominent. Separation of owners (principals) from managers (agents) has necessitated owners and managers rapport such that managers have the responsibility of handling the business activities of the firm on behalf of their principals (Otuya, 2019). The quality of financial

reporting is jointly determined by the company's management and the audit firm (Hamilton, Ruddock, Stokes, & Taylor, 2005). According to the IOSCO Technical Committee (2002) the public's perception of the credibility of financial reporting is influenced "significantly by the perceived effectiveness of external auditors in examining and reporting on financial statements". Thus, any perceived influence on the auditor's independence directly affects the quality of financial reporting (Kramer, Georgakopoulos, Sotiropoulos, & Vasileiou, 2011).

To discharge their duties objectively, external auditors are expected to be independent and objective (Adelaja, 2009); in order to ensure the reliability of auditors' reports (Rittenberg, Schwieger, & Johnstone, 2008). They should be independent of parties that have a financial interest in the business, and free from any obligation or interest in the client, its management, or its owners (Au sec. 220, cited in Harris, 2011). The independence factor is essential because of the separation of ownership and control in modern corporations (Salehi, Mansoury, & Azary, 2009).

Recent studies on financial crises and corporate failures (Igbekoyi & Agbaje, 2018; Ilaboya & Ohiokha, 2014; Manukaji, 2018; Odia, 2015; Oyewole & Adegoke, 2018) have raised public concerns regarding independence of auditors. Several corporate collapses, audit failures, and the global financial crisis have threatened the credibility of the audit function (ACCA & IGAP, 2014). They were mainly attributed to managerial opportunistic behaviours and unethical accounting practices (Shen & Chih, 2007). These practices undermined the quality of reported accounting numbers which is of prime importance to several stakeholders and investors inclusive. This has driven the debate among financial statement users, regulatory bodies, and practitioners on how to safeguard the audit profession by assuring the highest levels of independence (Houque, van Zijl, Dunstan, & Karim, 2012).

Studies have been conducted by previously using either selected firms quoted on the Nigerian Stock Exchange or only a particular activity. However, some of these studies were conducted in time periods before the adoption of IFRS by firms in the country; thus, may not provide an accurate picture of the status quo. Against this backdrop, this study thereby ascertain the effect of external auditor's independence on accounting quality of quoted firms in Nigeria. Specifically to determine:

1. *The effect of audit firm size on discretionary accruals of quoted Nigerian firms.*
2. *The effect of audit degree of competition on discretionary accruals of quoted Nigerian firms.*

REVIEW OF RELATED LITERATURE

Auditor Independence

Independence of the auditor implies the capacity of an auditor to sustain a dispassionate and neutral mental attitude in the process of carrying out an audit. DeAngelo (1981) defines auditor independence as the balanced mental assertiveness of an auditor in making judgments in the course of carrying out an audit and disclosing the outcome of such audit. Whenever independence of the auditor is under any threat, there is likelihood of an auditor being seen as lacking objectivity. The implication is that the auditor will be viewed as not having the independence to report any discovered breach. Arens, Elder and Beasley (2014) explain that independence entails an attitude of a sense of obligation distinct from the client's interest. Saputra (2015) maintains that quality of an audit report is influenced by how independent minded the auditor is as it enables him to conduct his assignment in agreement with generally acceptable auditing standards. Independence makes it possible for an external auditor to report any material misstatements - due to error or fraud - in the company's books of account when detected (Otuya, 2019).

The International Federation of Accountants (IFAC) (2012) identifies five potential threats to auditor independence: Self-interest threats: According to IFAC (2012; 200.4) self-interest threats result from circumstances which make the auditor have a stake or personal interest in the audit client. Such instances include having a direct or indirect material financial interest in client, loan to or from client, contingent fees or unpaid fees, business relations with client among others (Tahir, Idris, & Ariffin, 2014).

Familiarity threats: These emanate from circumstances such as having close family ties with client employees, family members occupying an influential position in client company, influential client officer was formerly a partner, lengthy audit tenures or acceptance of gift and hospitality from client (IFAC, 2012; 200.7); and, Intimidation threats: These emanate from threatened auditor dismissal, threatened litigation, client pressure to reduce the extent of audit

work to reduce fees, greater client expertise in matters or partner promotion depending on acceptance of client policies (IFAC, 2012; 200.8).

Self-review threats: These emanate from circumstances which place the auditor in a position to review their own work (e.g. by providing joint assurance and certain non-audit services) or were former client employees (IFAC, 2012; 200.5);

Audit Firm Size

The size of an audit firm has been identified as one crucial factor affecting the auditor independence (Al-Ajmi & Saudagaran, 2011). The big four audit firm comprise Klynveld Peat Marwick Goerdeler (KPMG), Price Waterhouse Cooper (PWC), Ernst & Young (E&Y), and Deloitte Touche Tohmatsu (Deloitte). Studies have shown that large and internationally affiliated firms perform audit engagements faster than smaller firms (Al-Ajmi, 2008; Skinner & Srinivasan, 2012). The study by Okere, Ogundipe, Oyedeji, Eluyela, and Ogundipe (2018) showed evidence that listed companies in Nigeria that had more equity than debt preferred Big-4 to non-Big 4 auditors. For instance, Francis, Maydew, and Sparks (1999) opined that Big 4 audit firms have shown to have higher accrual quality (Financial reporting quality) as measured by lower absolute values of discretionary accruals, and their clients are less likely to manage earnings. Another instance, recently the study by Rusmin and Evans (2017) using a sample of firms from Indonesia showed that Big-4 auditors conduct faster audits than their non-Big 4 counterparts.

Audit Degree of Competition

Managers in competitive industries face intense pressure in beating their peers, or at least not falling behind (Balakrishnan & Cohen, 2011). Thus, it is highly likely that firms in highly competitive environments are mostly dependent on their clients because such clients can easily switch to the services of another (Alleyne, Devonish, & Alleyne, 2006). The literature has shown that audit firms compete by specializing in certain areas or industries relative to non-specialist auditors (Casterella, Francis, Lewis, & Walker, 2004; Numan & Willekens, 2012).

However, there is evidence that a higher level of competition lowers the auditor independence. For instance studies by Knapp (1985) show that a high level of competition decreases auditor

independence. In contrast, Shleifer and Vishny (1997) found support that competition is the most important driving force towards economic efficiency. Thus the tendency to achieve earnings benchmarks may cause managers to manipulate disclosures in financial statements (Hermalin & Weisbach, 2007). Karuna (2007) found evidence that firms in highly competitive industries monitor their CEOs more closely; thus, further compounding the career concerns. The literature documents mixed findings on the link between competition and accounting quality. The first stream argues that product market competition provides an incentive for managers to be more efficient and more closely aligned with shareholders' interests (Giroud & Mueller, 2007; Grullon & Michaely, 2007).

Accounting Quality

Accounting quality is a product of the accounting system which reflects unobservable construct that inherently involves estimations and judgment, and thus has the potential for unintentional errors and intentional bias (Ewert & Wagenhofer, 2010). The value of financial accounting is determined largely by its quality. The central concept of accounting quality is that some accounting information is better than other accounting information at communicating what it purports to communicate. For that reason, accounting quality is of great interest to participants in the financial reporting supply chain. For example, to a reporting entity, better accounting quality can translate into a lower cost of capital. To an investor, better accounting quality can translate into a more-profitable allocation of capital.

Many different approaches have been used to measure accounting quality, and new approaches are continually being developed. Accounting professionals usually expect measures of accounting quality to be determined directly from the financial information that entities report, as many measures are. For example, one measure of accounting quality is the Beneish model's "M-Score," which is computed from eight variables that are based on quantitative accounting metrics such as days' sales in receivables. The M-Score quantifies the degree to which an entity's reported earnings are likely to have been manipulated by management. But measures of accounting quality may be based on information other than the financial information that an entity reports. One such measure is based on the fees that companies pay their external auditors. Analysis of the scientific literature has allowed concluding that accounting quality related research is gaining interest but, to the author's opinion, is still incomplete and fragmented. To

start with, all the reviewed scientific papers analysed the situation of listed companies. No studies related to accounting quality assessment in small and medium entities or public sector organisations have been found (Renata, 2016). Based on the efficient market hypothesis and signalling theory, the listed companies have an interest and incentives to disclose their information to increase stock prices and to improve market liquidity. Unlisted companies should also be interested in financial reporting quality in order to signal their value to various stakeholders, but such arguments do not always work in real life.

The overview of the aims and the context of the accounting quality analysis has revealed that in the majority of the papers accounting quality is analysed along with adoption of IFRS or transition from one set to another set of accounting standards (Morais & Curto, 2008; Barth, Landsman & Lang, 2008; Soderstorm & Sun, 2007; Armstrong, 2010, Brochet, Jagolinzer & Riedl, 2013). Assessment of quality changes moving from national to international standards (i.e. IFRS) is mixed: Barth *et al.* (2008) found that the adoption of high quality accounting standards in general improved accounting quality, while Daske, Hail, Leuz and Verdi (2008) concluded that the adoption of IFRS limited a role in determining accounting quality (Renata, 2016).

Empirical Studies

Yip and Pang (2017) evaluated investors' perceptions of auditor independence: Evidence from Hong Kong'. The study adopts the survey research design. The data were analysed using multiple regression and factor analysis. The results revealed that audit firm size, high level of competition, strict regulation and severe, and auditor tenure of 5 years or more influence auditor independence. Okolie (2014) ascertained audit quality and earnings response coefficients of quoted companies in Nigeria, with sample of fifty-seven (57) non-financial firms quoted on the Nigerian Stock Exchange. The study employs panel data regression techniques to validate the hypotheses. The results showed that audit firm size had a significant negative effect in fixed effects model; while, audit fees, and audit tenure were positive but non-significant in the pooled and random-effects models. Alleyne, Devonish, and Alleyne (2006) determined the perceptions of auditor independence in Barbados'. They conducted a survey of auditors and financial statement users in Barbados. The sample included sixty-six auditors and one hundred and forty-eight users. Independent samples t-test was used to analyse differences between the two groups.

The results showed that factors such as economic dependence of auditor on the client, the provision of non-audit service, competition, small firm size, long tenure and the size and closeness of Barbadian society negatively affect perceived auditor independence. Ilaboya and Ohiokha (2014) determined the nexus of audit firm characteristics and audit quality in Nigerian food and beverages sector of the Nigerian Stock Exchange. Data collected were analysed using the panel Logit and Probit regression techniques. The results showed a positive relationship between firm size, board independence, and audit quality; whereas, a negative relationship exists between auditor's independence, audit firm size, audit tenure, and audit quality. Akpom and Dimkpah (2013) examined the determinants of auditor independence: A comparison of the perceptions of auditors and non-auditors in Lagos, Nigeria'. A survey of auditors and non-auditor professionals in Lagos State, Nigeria. It was revealed that the provision of non-audit services, regulatory risk, auditor-client relationship, long-tenure, and the extent of audit market competition all posed threats to auditor's independence. Al-Ajmi and Saudagaran (2011) ascertained the perceptions of auditors and financial-statement users regarding auditor independence in Bahrain'. a survey of auditors, bank-loan officers, and financial analysts on factors that enhance or threaten auditor independence in Bahrain was conducted. The study showed that among the three groups economic dependence on the client, provision of non-audit service, competition, and long tenure were rated highest independence threatening factors. Abu Bakar and Ahmad (2009) evaluated auditor independence: Malaysian accountants' perceptions'. The conducted a survey of accountants in Malaysia. Data were analysed using descriptive statistics. It was showed that the size of audit fees, followed by competition, size of audit firm, tenure, provision of management advisory service and finally audit committee were among the determinants of auditor independence as perceived by Malaysian accountants. Babatolu, Aigienohuwa and Uniamikogbo (2016) ascertained the effect of auditor's independence on audit quality of selected deposit money banks in Nigeria. The Data analysis techniques that were adopted for this study consisted of descriptive statistics, correlation and ordinary least square (OLS) regression. The study revealed that there is a positive relationship between audit fee, audit firm rotation and audit quality. The correlation between audit quality and company size is strong, positive and statistically significant. Otuya (2019) examined the relationship between auditors' independence and quality of corporate financial reporting in Nigeria. The study adopted the content analysis research design. Data were collected from annual reports of

listed manufacturing companies for the period 2013 to 2017. Regressions were used to examine the relationship between the variables highlighted in the study. Findings of the study revealed that audit incentives, audit tenure and audit client size have a significant positive relationship with quality of financial reporting. The study also finds that audit reporting lag has a positive but insignificant correlation with financial reporting quality whereas auditor's status such as being one of the big 4 audit firms has a significant negative relationship with quality of financial reporting.

Studies have been conducted by previously using either selected companies quoted on the Nigerian Stock Exchange or only a particular activity. However, some of these studies were conducted in time periods before the adoption of IFRS by manufacturing firms in the country; thus, may not provide a accurate picture of the status quo.

METHODOLOGY

The study used the *ex post facto* research design. This design is considered suitable because the researcher does not have direct control of independent variables because their manifestations have already occurred.

The sample for the study was purposively drawn as three firms; selected based on the scope of the study. The three selected Nigerian firms are Conglomerates; Industrial Goods and Oil & Gas.

Methods of Data Analysis

Ordinary Least Square was used to test the independent variables and the dependent variable. This was done with aids of the E-View 9.9 was used at 95% confidence at five degree of freedom (df).

Decision Rule

The decision for the hypotheses is to accept the alternative hypotheses if the p-value of the test statistic is less or equal than the alpha and to reject the alternative hypotheses if the p-value of the test statistic is greater than alpha at 5% significance level.

Model Specification

The specified simple regression estimated model takes the following form:

$$ACQTY_{it} = a_0 + \mu_i + \beta_1AUDFSZ_{it} + \beta_2FRMAG_{it}\sum_{it} \dots\dots\dots(i)$$

$$ACQTY_{it} = a_0 + \mu_i + \beta_2DECOM_{it} + \beta_2FRMAG_{it}\sum_{it} \dots\dots\dots(ii)$$

Where:

The independent variables:

AUDFSZ = Audit firm size show that it is audited by one of the “big 4” audit firms (Price-water house coopers; Akintola Williams Deloitte; KPMG Professional service and Ernst and Young, otherwise zero (0).

DECOM= degree of competition

AUDFSZ= Firm age

The dependent variable:

ACQTY = Total accrual (TA) is computed using the balance sheet approach (Jones, 1991):

$$TA_{it} = \Delta CA_{it} - \Delta CASH_{it} - \Delta CL_{it} + \Delta STDEBT_{it} - DEPTN_{it}$$

$$TA_{ijt} / A_{ijt-1} = \alpha (1 / A_{ijt-1}) + \beta_1 (\Delta REV_{ijt} / A_{ijt-1}) + \beta_2 (PPE_{ijt} / A_{ijt-1}) + e_{ijt} \quad (2)$$

a_0 = Slope of the model

$\beta_1, \beta_2,$ = Coefficient of parameter.

β_0 = Constant term (intercept)

β_{it} = Coefficients to be estimated for bank i in period t

μ_{it} = Error term/Stochastic term for bank i in period t

DATA ANALYSIS AND INTERPRETATION

The table presents the summary statistics of the external auditor’s independence proxies. The Table shows the Mean, Median, Minimum and Maximum values, Standard Deviation, Skewness, Kurtosis, and Jarque-Bera statistics.

Table 1: Descriptive statistics of independent variables

	AUDSZ	DECOM	FRMAG
Mean	0.857143	0.017073	46.04167
Median	1.000000	0.015625	51.00000
Maximum	1.000000	0.173339	95.00000
Minimum	0.000000	0.000820	5.000000
Std. Dev.	0.350973	0.014395	20.51007
Skewness	-2.041241	7.808373	-0.227688
Kurtosis	5.166667	84.10652	2.959323
Jarque-Bera	149.5278	47755.06	1.463159
Probability	0.000000	0.000000	0.481148
Sum	144.0000	2.868207	7735.000
Sum Sq. Dev.	20.57143	0.034603	70250.71
Observations	168	168	168

Source: E-Views 9

The mean of audit firm size was 0.857143, thus we infer that approximately eighty six (86%) percent of the sampled firms engaged the services of the Big 4 audit firms within the study

period. The standard deviation value was 0.351; therefore, the observed values in the data set are close to the mean of the data set, on average. The average value of degree of competition measured using the HHI was 0.017073, this translates to a value of 1.7073. The standard deviation value was 0.014; therefore, the observed values in the data set are close to the mean of the data set, on average.

Test of Hypotheses

Hypothesis 1

H₁: Audit firm size significantly affect discretionary accruals of quoted firms in Nigeria.

Table 2: Panel Least Squares output for hypothesis one

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.243124	0.094841	-2.563491	0.0113
AUDSZ	0.350231	0.095953	3.650044	0.0004
FRMAG	0.000963	0.001529	0.630139	0.5295
Effects Specification				
Period fixed (dummy variables)				
R-squared	0.244464	Mean dependent var		0.068089
Adjusted R-squared	0.178229	S.D. dependent var		0.389126
S.E. of regression	0.373596	Akaike info criterion		0.942938
Sum squared resid	21.63394	Schwarz criterion		1.184673
Log likelihood	-66.20680	Hannan-Quinn criter.		1.041046
F-statistic	2.181078	Durbin-Watson stat		1.392160
Prob(F-statistic)	0.015069			

Source: E-Views 9

The Table 2 above shows the regression result to test hypothesis one. The R-squared (R^2) is a statistical measure that represents the proportion of variance in the dependent variable due to changes in the independent variables in a regression model. The R^2 value is 0.224; i.e., 22.4% variation is explained by the predictor variables. The Adjusted R-squared has been adjusted for the number of predictors in the model; the Adjusted R-squared was 0.178; i.e., the explanatory variables account for 17.8% variation of the dependent variable, discretionary accruals. The F statistic used to check the statistical significance of the model showed a value of 2.181; p value $<.05$; therefore the hypothesis that all the regression coefficients are zero is rejected. However to validate the hypothesis, the p-value of Audit Firm Size is 0.0004; which is less than the chosen critical value @ 5% significance level. Therefore, there is a significant positive

relationship between audit firm size and discretionary accruals, hence, H_0 is rejected and H_1 is accepted.

Hypothesis 2

H_1 : The degree of competition has a significant effect on discretionary accruals of quoted firms in Nigeria.

Table 3: Panel Least Squares output for hypothesis two

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.076283	0.087755	-0.869271	0.3860
DoC	2.457143	2.150331	1.142682	0.2549
FRMAG	0.002686	0.001528	1.757646	0.0808
Effects Specification				
Period fixed (dummy variables)				
R-squared	0.178688	Mean dependent var		0.068089
Adjusted R-squared	0.107361	S.D. dependent var		0.389126
S.E. of regression	0.387691	Akaike info criterion		1.017008
Sum squared resid	23.29720	Schwarz criterion		1.258743
Log likelihood	-72.42867	Hannan-Quinn criter.		1.115116
F-statistic	2.103202	Durbin-Watson stat		1.304594
Prob(F-statistic)	0.036128			

Source: E-Views 9

The Table 3 above shows the multiple regression result to test hypothesis two. The R-squared (R^2) is a statistical measure that represents the proportion of variance in the dependent variable due to changes in the independent variables in a regression model. The R^2 value is 0.178; i.e., 17.8% variation is explained by the predictor variables. The Adjusted R-squared has been adjusted for the number of predictors in the model; the Adjusted R-squared was 0.107; i.e., the explanatory variables account for 10.7% variation of the dependent variable, discretionary accruals. The F statistic used to check the statistical significance of the model showed a value of 2.103; p value $<.05$; therefore the hypothesis that all the regression coefficients are zero is rejected. However to validate the hypothesis, the p-value of Degree of Competition is 0.2549; which is greater than the chosen critical value @ 5% significance level. Therefore, there is a non-significant positive relationship between degree of competition and discretionary accruals, hence, H_0 is accepted and H_1 is rejected.

Discussion of Findings

The one hypothesis showed a significant positive effect of audit firm size on discretionary accruals of quoted consumer goods manufacturing firms. This was supported in the survey conducted by ACCA & IGAP (2014) of Australian CFOs that showed that audit firm size was the most significant driver of audit quality. A similar survey conducted by Akpom and Dimkpah (2013) in Lagos, Nigeria support the fact that large audit firms were perceived as to enhance auditor independence. The results are in contrast with the study by Okolie (2014b) in Nigeria. Similarly, Ilaboya and Ohiokha (2014) showed a negative between audit firm size, audit tenure, and audit quality. The survey by Yip and Pang (2017) in Hong Kong showed that audit firm size is significantly negatively related to auditor independence.

The two hypothesis showed that degree of competition has a non-significant positive effect on discretionary accruals of quoted consumer goods manufacturing firms in Nigeria. The result is in contrast with the study by Yip and Pang (2017) in Hong Kong high level of competition influence auditor independence. Previously, Alleyne, Devonish, and Alleyne (2006) showed that factors such as economic dependence on the client, provision of non-audit service, competition, small firm size, long tenure and the size and closeness of Barbadian society negatively affect perceived auditor independence.

CONCLUSION AND RECCOMENDATIONS

Conclusion

The study evaluates the effect of external auditor's independence on accounting quality of selected manufacturing firms in Nigeria. Auditors' are responsible for certifying the true and fairness of financial statements. However, studies note that the degree to which they perform this task is dependent on their perceived level of independence. The present study investigates the effect of audit firm size, and degree of competition on the level of discretionary accruals as proxied for accounting quality. The results showed mixed findings. The audit firm size showed a significant positive effect; degree of competition showed non-significant positive effect.

This may be to the fact that larger sized firms has the capacity paying auditors better which in turn implies that such auditors are likely to do more qualitative job, hence for huge audit fee and the need to protect the interest of the stakeholder in such large firms.

Recommendations

Based on the empirical results above, the study makes the following recommendations:

1. Shareholders are advised to monitor such fee setting via the audit committees as low audit fees may signal low quality while too high audit fees may pose a threat to independence, integrity and objectivity.
2. The firms management should be wary of the degree of competition during choice of audit firm: This is particularly important during the bargaining process, as firms enjoying a monopolistic status may charge abnormally high audit fees.

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