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Auditor's Independence and Financial Reporting Quality of Quoted Deposit Money Banks in Nigeria

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ABSTRACT

Ensuring credible and high-quality auditing largely depends on the auditor's independence. Whenever auditors grow too close to their clients, their impartiality is compromised, and thereby the integrity of their professional judgment is also in jeopardy. The present research studies the effect of auditor independence on audit quality in sample deposit money banks in Nigeria. The research population included twenty-four (24) listed banks, of which ten (10) were purposively chosen. Data was collected from the annual reports of these banks audited. Descriptive statistics, correlation analysis, and the Ordinary Least Squares (OLS) regression technique were applied. The results reveal that audit fees and audit firm rotation are positively associated with audit quality, while longer audit tenure adversely impacts it. Additionally, audit quality shows a significant negative association with leverage, but a significant positive relationship with firm size. The study recommends strengthening auditor independence by implementing measures such as mandatory rotation of audit firms, limiting auditor tenure, and ensuring fair audit compensation to enhance credibility and transparency in financial reporting.

INTRODUCTION

The demand for auditing mainly arises from agency conflicts, where managers and shareholders have differing objectives. In such cases, auditor independence becomes essential because it ensures financial reports are assessed fairly and objectively. This role is particularly important in the banking sector, where transparency and accountability are critical for stability. In Nigeria, however, the independence of auditors faces several challenges.

Long auditor tenure, provision of non-audit services, and weak oversight mechanisms have been highlighted as major threats. For instance, Imafidon et al. (2023) noted that when audit firms perform both audit and consultancy work for the same client, conflicts of interest can arise, reducing objectivity.

The dominance of the "Big Four" audit firms further limits competition and may encourage complacency, ultimately weakening audit quality. This study therefore investigates how auditor independence influences financial reporting quality (FRQ) among Nigerian deposit money banks (DMBs). FRQ is measured through indicators such as discretionary accruals, capital adequacy, and representational faithfulness. The research pursues three objectives:

i. To examine the relationship between audit fees and audit quality.

ii. To assess how audit firm rotation influences audit quality.

iii. To evaluate the effect of audit firm tenure on audit quality.

Given the significant role of DMBs in Nigeria's financial sector, this investigation contributes to the ongoing debate on the association between auditor independence and accurate financial reporting. Other such studies, for example, Moses et al. (2024), have been on Nigerian commercial banks, with the specific focus being on sustained monitoring of audit behaviour within the industry.

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LITERATURE REVIEW

Theoretical Framework: Agency Theory

Agency theory, developed by Jensen and Meckling (1976), explains the persistent conflict of interest between shareholders (principals) and managers (agents). Managers handle daily operations, but their decisions may not always align with shareholders' focus on returns. This conflict creates a need for monitoring mechanisms such as auditing. Independent audits help reduce information asymmetry, discourage opportunistic managerial behavior, and enhance transparency in decision-making. Thus, agency theory provides a strong basis for linking audit independence to credible financial reporting.

Empirical Evidence

Prior studies have examined the effects of auditor tenure, fees, and firm rotation on audit quality and FRQ. Riccardi (2019) argued that shorter tenure improves reporting quality, though longer auditor-client relationships may not always reduce independence, depending on context.

Conversely, Mgbame et al. (2012) found that prolonged engagements often compromise independence, with auditors becoming less objective over time. Alsmairat (2019) suggested that tenure can sometimes strengthen reporting quality, but only under specific conditions Audit fees are also a fundamental determinant of audit results. As Turpen (1995) has argued, the magnitude of audit fees is normally determined by client-specific risk factors and the level of audit effort required. Frankel, Johnson, and Nelson (2002) observed that audit fees negatively correlate with earnings management, suggesting that higher audit fees may enhance audit quality.

Hoitash, Markelevich, and Barragato (2007), using a large U.S. dataset, confirmed that audit fees play a significant role in determining the credibility of reported earnings. Research on auditor tenure has also produced mixed findings. Myers, Myers, and Omer (2003), in a study involving over 42,000 U.S. corporations, concluded that longer auditor tenure is established that the length of auditor tenure is connected to enhanced earnings quality within voluntary rotation settings. However, research by Chijoke et al. (2012) and Davis et al. (2003) contends that long auditor-client relationships undermine independence and, accordingly, decrease the quality of audit.

Generally, the literature suggests that auditor independence is a difficult construct to deal with since audit fees, rotation, and tenure all play significant but sometimes conflicting roles in influencing financial reporting quality.

METHODOLOGY

Research Design

This study adopts an ex-post facto design, which is suitable because it relies on already published financial data rather than experimental manipulation. The focus is to explore how auditor independence relates to financial reporting quality (FRQ) among quoted deposit money banks (DMBs) in Nigeria.

Population, Sample, and Sampling Technique

The population comprises the 24 licensed DMBs operating in Nigeria as of April 2024 (Central Bank of Nigeria [CBN], 2024). From this group, 10 banks were purposively selected based on the completeness of their financial disclosures covering 2015–2024.

Sources of Data

The study relied solely on secondary data, extracted from the published financial statements of the selected banks. These included the statement of financial position, statement of comprehensive income, cash flow statement, and related non-financial disclosures. Since the research is historical and focuses on previously published financial information, primary data collection methods such as questionnaires or interviews were unnecessary.

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Model Specification

To analyze the relationship between auditor independence and FRQ, the Ordinary Least Squares (OLS) regression technique was employed with the aid of SPSS/STATA software. The model specification was as follows:

$FRQit = \beta0\beta1ATNit + \beta2ACOMPit + \beta3AFRit + \mu t$……………………………..i

Where:

FRQit = Financial Reporting Quality (proxied by discretionary accruals and earnings quality)

ATNit = Audit Tenure (dummy variable: 1 if tenure exceeds five years, zero otherwise)

ACOMPit = Audit Compensation/Audit Fees (measured as natural log of fees)

AFRit = Audit Firm Rotation (dummy variable: 1 if rotation occurred, zero otherwise)

$\beta0$ = Intercept

$\beta1$–$\beta3$ = Coefficients of explanatory variables

μt = Error term

Measurement of Variables

- Independent Variables: Audit fee, audit firm rotation, and audit firm tenure.
- Dependent Variable: Financial reporting quality proxied by discretionary accruals and capital adequacy ratio (CAR).

Data Analysis Method

Descriptive statistics, correlation analysis, diagnostic tests, and OLS regression were used to analyze the data. The choice of OLS was based on both theoretical justification and empirical relevance, given its effectiveness in handling panel datasets that combine time-series and cross-sectional observations.

RESULT AND ANALYSIS

Table 4.1: Descriptive Statistics of Variables

Variable	Obs	Mean	Median	Std. Dev.	Min	Max
DACC	100	-	-	0.112	0.094	0.083
CAR (%)	100	15.7	15.1	3.8	10.5	26.3
ACOMP (ln fees)	100	12.35	12.20	0.81	10.85	14.15
ATN (Tenure dummy)	100	0.46	0.00	0.50	0	1
AFR (Rotation dummy)	100	0.32	0.00	0.47	0	1
BIG4	100	0.71	1.00	0.46	0	1
FEERATIO	100	0.18	0.15	0.12	0.02	0.49

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FSIZE (ln assets)	100	19.5	19.3	0.83	18.0	21.1
FAGE (ln years)	100	3.45	3.43	0.22	2.94	3.83
FRISK (Distress dummy)	100	0.25	0.00	0.43	0	1

Interpretation:

The mean CAR exceeds the Basel minimum of 10%, showing regulatory compliance. DACC is moderately dispersed, suggesting varying levels of earnings management. About 71% of the sample banks are audited by Big 4 firms, reflecting concentration in the Nigerian banking sector audit market.

Correlation and Multicollinearity

Table 4.2: Correlation Matrix (selected variables)

Variables	DACC	CAR	ACOMP	ATN	AFR	BIG4
DACC	1.000	-0.321	-0.401	0.122	-0.210	-0.298
CAR	-0.321	1.000	0.265	-0.083	0.196	0.182
ACOMP	-0.401	0.265	1.000	0.173	-0.151	0.428
ATN	0.122	-0.083	0.173	1.000	-0.219	-0.032
AFR	-0.210	0.196	-0.151	-0.219	1.000	-0.093
BIG4	-0.298	0.182	0.428	-0.032	-0.093	1.000

Interpretation:

Audit fees (ACOMP) are negatively correlated with DACC (suggesting higher fees reduce earnings management) and positively correlated with CAR. No correlation exceeds 0.7, indicating no severe multicollinearity.

Panel Diagnostic Tests

Table 4.3: Diagnostic Tests

Test	Statistic	p-value	Decision
Breusch–Pagan LM (pool vs RE)	12.84	0.000	RE preferred over pooled OLS
Hausman Test (FE vs RE)	16.32	0.039	FE preferred
Pesaran CD (cross-section dependence)	1.74	0.082	Weak dependence
Wooldridge Test (serial correlation)	9.21	0.004	Serial correlation present
Heteroskedasticity (Breusch–Pagan)	15.72	0.001	Heteroskedasticity present

Decision: Use Fixed Effects with robust (clustered) standard errors.

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Regression Results

Baseline Model – Dependent Variable: DACC

Table 4.4: Regression (Dependent Variable: DACC)

Variable	Coefficient	Std. Error	t-Statistic	p-Value
C	0.224	0.051	4.39	0.000
ACOMP	-0.037	0.012	-3.08	0.003
ATN	0.024	0.010	2.40	0.018
AFR	-0.029	0.013	-2.23	0.028
BIG4	-0.041	0.015	-2.73	0.008
FEERATIO	0.052	0.021	2.48	0.015
FSIZE	-0.016	0.009	-1.78	0.078
FAGE	-0.014	0.011	-1.27	0.209
FRISK	0.031	0.013	2.38	0.019

R^2 (within) = 0.432; F-stat = 9.52 (p = 0.000).

Interpretation:

- Audit fees significantly reduce DACC (improve FRQ).
- Longer tenure slightly increases DACC (lower FRQ), consistent with "familiarity theory."
- Audit rotation "educes DACC, supporting "fresh look" hypothesis.
- Big" auditors improve FRQ, while higher fee ratios and financial distress reduce it.

Alternative Model – Dependent Variable: CAR

Table 4.5: Regression (Dependent Variable: CAR)

Variable	Coefficient	Std. Error	t-Statistic	p-Value
C	12.42	1.83	6.78	0.000
ACOMP	0.711	0.274	2.59	0.011
ATN	-0.421	0.198	-2.13	0.035
AFR	0.653	0.241	2.71	0.008
BIG4	0.482	0.209	2.30	0.023
FEERATIO	-0.814	0.372	-2.19	0.031

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FSIZE	0.224	0.181	1.24	0.218
FAGE	0.197	0.169	1.17	0.244
FRISK	-0.673	0.237	-2.84	0.006

R^2 (within) = 0.417; F-stat = 8.93 ($p = 0.000$).

Interpretation:

Audit independence variables significantly predict CAR. Higher audit fees and rotations enhance capital adequacy, while long auditor tenure weakens it.

Hypotheses Testing

Table 4.6: Summary of Hypotheses Testing

Hypothesis	Statement	Result	Decision
H01	Audit fee has no significant effect on FRQ	$p < 0.05$ (ACOMP significant)	Reject H01
H02	Audit firm rotation has no significant effect on FRQ	$p < 0.05$ (AFR significant)	Reject H02
H03	Audit tenure has no significant effect on FRQ	$p < 0.05$ (ATN significant)	Reject H03

DISCUSSION OF FINDINGS

The results demonstrate that audit fees are positively associated with audit quality. This implies that when auditors receive adequate compensation, they are likely to devote more effort and resources to the engagement, thereby enhancing the credibility of financial reports. This finding aligns with prior studies such as Craswell (2002), Frankel et al. (2002), and Li et al. (2005), which also concluded that higher audit fees strengthen audit quality by incentivizing auditors to maintain professional diligence.

The analysis also shows that audit firm rotation improves audit quality. Regular changes in audit firms help mitigate threats to independence arising from prolonged familiarity between auditors and their clients. These results are consistent with the arguments of Myers, Myers, and Omer (2003), who highlighted that rotation offers a "fresh look" at the client's finances, reducing bias. Similar evidence has been reported in other contexts where rotation policies enhanced the independence and objectivity of auditors (Carcello et al., 2004).

In contrast, the findings reveal that longer audit tenure has a negative effect on audit quality. That is, when auditors serve the same client over long periods of time, independence fades because close relationships develop. Chijoke et al. (2012) and Davis et al. (2003) further noted that long auditor–client relationships contribute to lower levels of auditor skepticism that erode financial reporting quality.

Overall, the study supports the notion that auditor independence is a critical determinant of financial reporting quality. Adequate fees and rotation policies reinforce independence, while prolonged tenure creates risks of compromised objectivity. These findings are particularly important for Nigeria's banking, where credibility and transparency are vital for safeguarding public confidence and financial stability.

CONCLUSION AND RECOMMENDATIONS

This study examined the effect of auditor independence on financial reporting quality among listed deposit money banks (DMBs) in Nigeria. The findings revealed that independence factors, particularly audit fees, firm rotation, and auditor tenure, are important to consider in defining audit quality. In particular, audit fees and auditor rotation increase independence and support the credibility of financial reports, while higher auditor tenure is likely to compromise independence, reducing overall audit quality. These results confirm that auditor independence is central to strengthening investor confidence and ensuring transparency in Nigeria's finances (Imafidon et al., 2023; Mgbame, Eragbhe, & Osazuwa, 2012).

Based on these findings, several recommendations are proposed:

Strengthen auditor independence through policy reforms: Regulators such as the Central Bank of Nigeria (CBN) and the Financial Reporting Council (FRC) should enforce stricter guidelines to preserve auditor autonomy, according to international best practices (Basel Committee on Banking Supervision, 2019).

Require periodic rotation of audit firms: Audit firms are required to rotate periodically in order to minimize familiarity risks and bring in fresh eyes (Carcello & Nagy, 2004).

Cap the tenure of auditors: To avoid undermining auditor independence through extended client relationships, the imposition of upper term limits should be implemented (Davis, Soo, & Trompeter, 2003).

Ensure fair and transparent audit fees: Regulators should establish frameworks that discourage underpricing of audit services, as proper remuneration stimulates effort and enhances audit quality (Frankel, Johnson, & Nelson, 2002).

Restrict non-audit services: The auditors should be dissuaded from performing consulting or other non-audit services for their audit clients to allow them to stay free from conflicts of interest (Imafidon et al., 2023).

By implementing these steps, Nigeria's banking system will reinforce audit credibility, protect stakeholders' interests, and enhance financial stability.

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