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The Effect of Audit Tenure and Financial Reporting Quality in Nigeria Listed Companies

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ABSTRACT

This paper conceptualizes the effect of audit firm tenure and financial reporting quality. There has been conflicting results from prior studies. One school of thought is of the view that the longer the audit tenure it may cause intimacy between the auditor and the client that will reduces the readiness of auditor to qualify audit report. On the other hand, the contrary view is that the longer the audit firm tenures it will bring familiarity with the operations and accounting system thereby enhancing the audit quality. This paper suggested that the audit firm tenure should be moderate between the range of one and three years.

Keywords: Audit tenure, Financial reporting quality and Audit quality.

1. Introduction

In the past few years auditors had been blamed due to their role in the mega corporate scandals such as Enron, World Com, Global crossing, Imclone system an Tyco international and in Nigeria such as Cadbury (Nig)Plc, African Petroleum (Nig) Plc Lever Brother Nigeria plc, Intercontinental bank, Oceanic bank, Stanbic IBTC bank (Ogbonna & Ebimobowei, 2011).. The criticism had raised a lot of question regarding auditors independence such criticism leveled against auditor because they have been auditing their clients for a long time and subsequently concentrated more on non- audit services rather than audit.

The familiarity that exists between the auditors and their clients as a result of long audit tenure encourages failure in auditor independence. Though, there has been a call for sweeping changes in the auditing profession to ensure independence and therefore improved their audit quality (Palmrose, 2006).

There have been a lot of corporate scandals in the academic literature and across accounting profession on audit tenure, independence and financial reporting quality. The debate center whether the auditor's independence in the auditor client relationship should be allowed to build a short or long term relationship with the client. The corporate scandals in many countries have raised question about the effectiveness and efficiency of auditor independence in financial reporting but the regulatory and professional bodies tried in enforcement and compliance to enhance the audit quality and restoring the investor's confidence (Holma & Zamanb, 2011) Lennox(2014) opined that the main objective of audit have been shifted from presenting the financial statement in true and fair view and emphasis was not on the arithmetical accuracy but on a fair presentation of financial reporting. Accounting and auditing play a significant role in principal – agent relationship (i.e. agency relationship). The agency relationship between owners and managers in a firm creates a natural conflict of interest because of the information asymmetry that exists between manager and shareholders. This information asymmetry means that manager generally has more information about "true" financial position (shown by statement of financial position), and result of operations (in a statement of comprehensive income) of the company than the absentee owners does. Thus, contact relationship between the shareholders and managers in a firm lead to the demand for firm auditing.

The quality of an audit depends concurrently on several audit firm characteristics such as independence of auditor, tenure of auditor, specialty of auditor and auditor enterprise. (Abedalgader Ibrahim & Baker, 2010). Levitt (2000), posit that the understanding of audit quality plays an important role in maintaining efficient confidence in the integrity of financial reporting. The higher the perceived audit quality, the more reliable the financial reports. Also, the findings will enhance user's confidence in those financial reporting quality. De Angelo (1991) defined audit quality as the view that an auditor will both determine and truly report material misstatements, errors, omission and falsification detected in clients' financial reports.

This possibility depends upon the broad opinion of an auditor's professional conduct, which includes factors as objectivity, conflict of interest, independence and professionalism. Wallace (1980) opined that a substitute of audit quality is the audit's ability to reduce noise bias and improves the financial reporting quality. Knechel and Vanstraelen (2007) suggested that audit quality is an alternative by the tendency of the auditor to state a going concern opinion. Audit quality is a fundamental ingredient in enhancing the credibility of financial statements to users of accounting information. Coate, Florence and Kral, (2002) and Fairchild(2008) portrays that audits add reliability to the financial information by providing an independent certification of management-provided financial statements, thus decreasing investor's risk. Watkins, Hillison, and Morecroft, (2004) posits that financial reporting credibility is reflected in the confidence of users in audited financial reports. Financial Accounting Standard Board (FASB, 2011) defines financial reporting as activities which are intended to communicate the informational needs of externals users who lack the authority to demand the financial information they want from an organization and therefore must use the information the management serve them. Lewis and Pendrill (1996) asserted that financial information that is given to users rather than information which is required by an individual or group of individual who are in a position to enforce their request.

Previous researchers have examined the relationship of audit tenure audit quality with financial reporting quality and their findings remain inconclusive. In the Nigeria context, the issue of audit tenure with weak corporate governance practice is still lingering with the problem of fraud thereby making the investors' confidence on financial reporting quality to be biased. The certaininty of the duration of the tenureship whether to long or short is posing problem to the independence of the auditor clients' relationship (Ilaboya & Ohokha, 2014) and this paper have adequately made suggestion on how this issue can be resolved by adopting the moderate audit tenure rotation that could assist to improve the independence of the auditor and thereby enhanced the investors confidence.

From previous researches the relationship between weakness of corporate governance and poor financial reporting quality, audit tenure, financial manipulation and misappropriation, and weak internal control. Other researchers asserted the necessities for enhancement of corporate governance and financial reporting quality process (Klein (2002); Beasley et al 2000; Sloan 2002; Cohen et al 2004). This paper will extend the literature by examining the weak compliance and enforcement of corporate governance practice that affect the tenureship structure in Nigeria and propagate adequate corporate governance models that will ensure the effectiveness of audit tenure and decrease fraudulent activities in Nigeria social economic environment (ROSC,2011).

1.2 Statement of the research problem

Dopuch, King and Schwartz (2001) and Myers, Myers and Omer (2003) ascertained the possible descriptive variables in relation to audit quality, considering the association amongst audit tenure and financial reporting factors that could enhance audit quality. In this study auditor tenure becomes the core of discussion whether firm should change their auditor on regular basis or auditor be allowed to retained a long clients relationship? The important factor is how auditor lengthens tenure affect audit quality. Other school of thought suggests that independence will improve auditor lengthen tenure because of enhanced expertise of auditor from knowledge of superior client-specific. Dopuch et al. (2003) noted that independence is not observable, academics, practitioners and regulators rely on the appearance for the definition of auditor independence.

The issue of lack of independence of auditors in clients' relationship that has curb fraud activities into the financial statements of an organization .Long auditor rotation has also caused the auditor to give a qualified opinions in financial reporting matters The loophole has brought adverse effect on financial reporting statement and lack of confidence from the shareholders perspective and have resulted to agency problem between the managers and the owners in the company (Jensen & Meckling, 1983). Also the lack of the independence of the auditor has led to compromise of transparency and reliability of the financial statement (ROSC, 2011).

Similarly, the Nigerian audit setting, the challenge of auditor independence on audit tenure and client association with financial reporting though still growing has not concerned much investigative attention and empirical studies beyond mere subjective opinions. Also, there has been a shortage of research in this area and insufficient empirical evidence from Nigeria. It is against background the study attempts to examine audit tenure rotation and the effects of the independence of the auditor on financial reporting is still exist, the recent cases of financial irregularities between Stanbic IBTC Plc and the KMPG in the financial year of 2014 accounting year and using study from Nigeria and from previous studies the results are inconsistence this study attempts to fill this gap.

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

1.3 Research question

1. What is the relationship between duration of auditor and financial reporting?
2. Does audit tenure improve the quality of financial reporting in achieving organizational goals?
3. Does audit objectives help in maintaining accountability?

1.4 Objectives of the study

This study's main objective is to examine if audit tenure has influence on financial reporting.

The specific objectives are to:

1. To examine the relationship between the duration of auditor and the quality of financial reporting
2. To examine it audit tenure help to improve the quality of financial reporting
3. To determine whether audit tenure help in maintaining accountability of financial reporting in an organization.

1.5 Statement of hypotheses

1. There is no significant relationship between the duration of auditor and the quality of financial reporting
2. There is no significant difference between auditor objective and ability to maintain accountability by firm.
3. There is no significant relationship between audit rotation and fraud detection.

2.0 LITERATURE REVIEW

A lot of recent debate on mandatory audit tenure, financial reporting quality, auditor independence and financial statement fraud (Lyer & Rama, 2004; Mantz & Sharaf, 1998; Blandon & Bosch, 2015; Jenkins & Vermeer, 2013; Petty & James, 1987); GAO, (2003) asserted that the recently released study of mandatory audit tenure may not be the most effective and efficient and effective way to improve auditor independence. Financial Reporting Council (2006) considers five features that control audit quality to include: personal qualities of audit partners and staff, effectiveness of the audit process, audit firm culture, skills and, and the dependability and effectiveness of audit reporting, amongst issue that are exogenous to the auditors. Previous studies adopted obvious results as proxies for audit quality this includes; decision and analyst forecast, financial statements outcomes, auditors select and change and audit opinions. In Nigeria, this statutory duty is provided for in Section 359(1) of the Companies and Allied Matters Act (CAMA), 2004. The auditor has a statutory responsibility by virtue of Section 359(3) of the Company and Allied Matter Act (CAMA), 2004, to issue a report to the members of the audit committee which must be statutorily set up by such a client.

Moizer (1997) and Francis (2004) posited that the evaluation of the indices of proxy the quality of the audit service is not without its challenges since audit quality is typically unobservable. Similarly, Hay and Knechel (2010) suggested that auditing could be subdivided as a type of credence good and hence auditors add reliability to financial reporting quality 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 important.

Previous studies have suggested some viewpoints of the consequences of audit tenure on the credibility of financial reporting; professional view, shareholder view, regulators view and economic view (Geiger & Raghunandan, 2002). In the point of regulatory view, long relationship between a client and an audit firm may lead to impair their independence (Geiger & Raghunandan, 2002). In the United States, the Metcalf Committee report argued that long relationship between a business and an accounting firm may lead to such close recognition of the accounting firm with the interests of its client's organization that truly independent action by the accounting firm becomes difficult. Thus, the report recommended a mandatory auditor rotation as a way for the accounting profession to strengthen their independence from clients (Geiger & Raghunandan, 2002). Simunic and Stein (1994); Geiger& Raghunandan, (2002), Lewis and Evans (1994), Deis and Giroux (1992) found that the long auditor tenure would decrease financial reporting. However, Vanstraelen (2000) found negatively association between auditor tenure and opinion and then again provide to maintain mandatory audit firm rotation.

Barbadillo and Aguilar (2008), examine an inverse association among auditor tenure and financial reporting quality and imply that auditors tend to be more dependent in the first years of the auditing appointment. The study concludes that the shorter the auditor's tenure, the more they act in a dependent fashion.

Johnson et al (2002), examined auditor longer tenure may develop a "learned confidence" which may impair the independence of the auditor and resulted to qualified reports from the auditor that could also affect the quality of the financial reporting. Arrunada and Paz-Ares (1998) suggested that a long auditor–client relationship could result to the growth of personal rapport that may lead to the bonds of trust, emotional, and loyalty relationship been developed among the client and the auditor.

There are mixed and conflicting results in audit tenure and financial reporting quality. Previous studies found that audit tenure is a double- edge sword that has proof from past literatures that longer tenure of audit firm tenure has a positive impact on the competence of the auditor while other school of thought opines a negative perception on the auditor independence (Barbadillo et al, 2008). Audit tenure and financial reporting quality have mixed and conflicting results some of the studies opines a decrease in the financial reporting quality when there is an increase in the audit firm tenure (Gunny et al, 2007; Myers et al , 2003; Johnson et al, 2002; Casterella et al 2002; Davies et al 2002) while other studies reported positive relationship with audit firm tenure (Gul et al 2006 & 2007; Raghanathan et al 1994; Stice,1991; AICPA,1992, Wakel et al 2001; St Pierre & Anderson 1984). In Green Paper the US Public Company Accounting Oversight Board (PCAOB) reported that mandatory audit tenure in mid-2011. Chason (2014) asserted that effort by PCAOB to impose mandatory audit tenure in public companies failed 2 years when US House of prohibits audit tenure by amending Section 103 of the Sarbanes- Oxley Act 2002 in 2013. Fairchild (2008) reported by using a game theory asserted that the auditor ability to detect fraud increase with the audit tenure and the opinion that as auditor increases managerial incentive to fraud decrease and giving rise to reduction in qualified audit reports.

2.1 Audit Tenure and Audit Quality

Earlier studies have revealed that audit tenure has an important role on audit quality. This result was either negative or positive. Watts and Zimmerman (1983) opined that the longer the length of auditor tenure, the more dependence on customers. The objectivity and independence of auditors will be dented and hence, audit quality reduces. Copley and Doucet (1993) suggested that the longer the period of appointment, the higher the risk of lower audit quality. Arrunada and Paz-Ares (1998), Dopuch, King and Schwarts (2001); Ebrahim, (2001) also trail the same line with previous studies. Walker, Lewis and Casterella (2001) posits that the length of audit appointment and audit failure found no relationship with audit tenure therefore, do not improved audit quality. Carcello and Nagy (2004) investigated the relationship of audit quality and auditors long tenure from the of view of fraudulent practices and their result indicated that no significant relationship and concluded that mandatory changes of auditor could have negative effect on audit quality. Abedalgader, Ibrahim and Baker (2010)examined the association among the length of audit tenure in relation with audit quality for firms listed on the Ammon Stock Exchange (ASE) the result shows that there was no significant effect on audit quality. Ilaboya Ofuan James and Ohiokha Friday Izien investigated the relationship between audit firm characteristics and audit quality in Nigeria auditor's rotation is negatively associated to audit quality. Similarly, Adeniyi and Mieseigha (2013) examined the association between audit rotation and audit quality the findings shows that there is a negative relationship between auditor rotation and audit quality. Summer (1998) investigated that audit tenure will enhance audit quality for firms reporting in short term than long term appointment might have an adverse effect as the incentives for building character of transparency and honesty. Johnson, Khurama and Reynolds(2002) suggested that longer auditors tenure could enhance the auditor relationship with the clients by improving the accounting and internal control system and regulate the irregularities in the management financial reporting process. Ghosh and Moon (2003) and Myers, Myers and Omar (2003) opined that information from investors and higher earnings quality will enhance audit quality. Nashwa (2004) and Barbadillo and Aguilar (2000) posits that auditor engagement in the first years are more dependent than in the longer period of engagements.

2.2 Audit tenure and financial reporting quality

In relation of audit tenure and financial reporting quality from previous empirical studies the effect of audit tenure has mixed and conflicting findings (Carey & Simnett, 2006; Chen et al, 2004; Chi & Hang 2005). Some of these studies reported a positive relationship between audit tenure and financial reporting quality measured by discretionary accruals (Chen et al, 2010; Manry et al., 2008; Chi et al., 2009) while others recorded a negative relationship (Fargher et al ., 2008; Carey &Simnett 2006;; Hamilton et al 2006).

The argument of mandatory audit firm tenure is that financial reporting quality is lower and poorer in the early years of audit tenure relationship (Seidman, 2003; AICPA, 1993; O'Malley, 2002; St Pierre & Anderson 1994). The financial reporting quality is judged to be poorer and lower in the early years relationship because the auditor is unfamiliar with the ethical norms of client companies operations, accounting policies, internal control system (Seidman, 2003). Prior studies reported that auditor will engaged in fraudulent financial reporting thereby financial reporting quality may more likely poorer (Beasley et al 1999, 2000; Maletta & Wright, 1996).

Firth et al (2012) opines a positive significant relationship of mandatory of audit firm tenure with short tenure relationship and Daniels and Booker (2011) asserted that audit tenure with a short period enhances the independence of auditor having a significant positive association with financial reporting quality. Isenmila and Elijah (2012) asserted how Nigerian corporate companies engaged in earnings management (fraudulent financial reporting) through the negligence of audit tenure that is posing threats and adverse effect on investors' confidence and credibility of public financials to the society at large.

2.3 Audit tenure and fraud

According to AICPA (2005) reported the standard known as Achilles heel of fraud prevention that if the internal control system of an enterprise may be well designed and effective the management team can still override the firm in perpetrating fraud. Fraud is a deliberate misrepresentation of financial books and records of an entity. Gupta (2005) defines fraud as the intentional manipulation, misrepresentation, falsifying of financial information by one or groups of individual. Oxford Advanced Learners dictionary 6th edition defines fraud as the crime of deceiving somebody in order to get money or goods illegally. Examples of fraudulent financial statements are falsifying profit figure, manipulation of entity accounts, understating of expenses, overstating of turnover of company. The effect of fraud committed can lead to liquidation of business operations, loss of confidence of potential investors', corporate failures that have an adverse effect on company such as Enron, Cadbury Nigeria plc, Lever Brothers plc in Nigeria. Adeyemi & Fagbemi, 2011). Ogbonna (2016) explored that any society that involved in fraud practices may not survive for a long time to achieve its desired goals and objectives and that of its stakeholders.

Mantz and Sharaf (1981), Lyer and Rama (2004) posited in their findings that there is an issue in long duration of auditor tenure to the detriment of the clients and financial reporting quality.. Geiger and Raghumandan (2002) revealed a negative association between financial reporting failures and audit tenure by using a US sample companies to test the relationship between financial reporting failures and audit tenure.. On the other hand, Carey and Sumnett (2006) posited that long auditor tenure enhances the ability of the auditor to detect fraud and improve financial reporting quality in Australia. Marnet (2004) examines the state of independence of the auditor accompanied with psychological pressure to change the unqualified report to qualified report due to self justification of earlier opinion. Fairchild (2008) suggested that the longer the auditor tenure the more the auditor detect fraud in the clients' financial statement and also improve the financial reporting quality.

Salaauden, Ibikunle and Chima (2015) reported how Akintola Williams Deleotte (AWD) the external auditor of Afribank (Nig) plc was accused of falsification of the financial statement with the Manager Director of the organization. Similarly, Securities and Exchange Commission (2011) found Cadbury (Nig) plc falsifying and overstating their financial statement. Financial Reporting Council of Nigeria (2015) FRCN found the auditors of Stanbic IBTC (Nig) plc involved in fraudulent activities in their financial statement. These fraudulent activities from the auditor opinions would reduce the integrity, objectivity, professional competence, confidentiality that the stakeholders have on the auditor and the financial reports.

2.4 Audit tenure and independence

Independence is the ability of an auditor to be free from psychological pressure and self biased state of mind in perform audit responsibilities in accordance to standards. (Izedonni, 2000). The independence is characterized by integrity and objectivity of auditor and standpoint of opinions in judgment. The academician and accounting professional have argue and asserted that audit firm tenure could help to maintain auditor independent (PACOB, 2011; ICAEW, 2002; Dopuch et al., 2001; Mantz & Sharaf 1961; Gutzman & Sen 2002).

The auditor can only maintain truly independent in the auditor client relationship by complying with the stream of income in mandatory audit firm tenure (Bazerman et al.,2002).Also, the auditor will be in a stronger position to resist management pressure and be independent with integrity and objectivity professional judgment when there is a mandatory audit firm tenure (Chung, 2004; Wolf et al., 1999; Brody & Moscove 1998). For auditor to maintain auditors' independence and objectivity audit firm should periodically relinquish their client. Examples of countries that have oversight boards and have implemented mandatory audit tenure are United Kingdom 2003,Austria and Canada 2005, Spain 1989, South Korea 2006, Brazil 1999, Italy 1974, France 1998-2004, Singa pore 2002 (Cameran et al., 2005). Jeong and Rho (2004) opined that auditor abstaining from non- services audit relation makes an auditor to be more independent. The size of the audit firm also determine the level of independence provides big auditors with stronger negotiation stance with their chart compared with smaller audit firms (Nelson, Elliott & Tarpley, 2002).Also, previous studies that have shown that auditor independence affects audit tenure positively include (Uwhejevwe-Togbolo, 2016 and Alim, Trisni, & Lilik, 2007). It therefore follows that auditor independence is directly proportional to audit tenure.

3.0 THE THEORETICAL FRAMEWORK

The model of the paper is premised on the agency theory where an agency relationship occurs when one or more principals engage another person as their agent to do a service at their behest. Notably, such an arrangement may result in the delegation of accountability by the principal which necessitates the placement of trust in an agent to act in the principal's best interest Jensen and Meckling (1993).This lead to conflict of interest between the managers and the shareholders that the need for an auditor. It is supported by the stakeholder theory. Freeman (1984) noted that stakeholder theory is to address norm and values of the business ethics and managing the organization. The concept of this theory "stakeholders" refers to managers, shareholders, financial analyst and other users of financial report either indirectly or directly. The basic ingredients of stakeholder theory is to identify all groups of individuals state, organization and companies in which the firm operates and how beneficial the firm to the corporate society (Anhier, 2005).

The agency and stakeholder theory viewpoint of financial reporting quality reveals that there are various element should be assured as having the prevailing influence on financial reporting quality as portrayed in the study as audit tenure. This requires that different stakeholder should critically examined their actions so as to determine the influence of their action and their effect on the perception of financial reporting quality reason be that audit provide assurance to stakeholders, shareholders, managers, creditors and other investors enhancing confidence on financial reporting quality.

4.0 CURRENT REGULATORY ISSUES ON AUDIT TENURE

In the US AICPA (1998) specifies the practices of mandatory audit firm tenure requirement to be every seven years. In case of public companies the Sarbanes Oxley (SOX) Act 2002 mandated that audit tenure should be every five years. The US House of Representation canvassed integrity or job protection bill I the 113 US congresses 2013 as amended the SOX Act of 2002 which require the PACOB from requiring the use of different auditor in an audit firm tenure basis. The UK listed companies uses seven years and Australian uses five years for their audit firm tenure. The European Parliament introduced in favor of new standards (proposal 2011) to enforce and comply European companies to hire new auditor at 10-24 years intervals. This new standard extend the six years period of mandatory audit firm tenure proposed in 2011 with cooling period of four years (Chasan 2014).

4.1 The regulatory framework in Nigeria

The regulatory bodies in Nigeria comprises of (SEC) Securities and Exchange Commission which is responsible for regulating the listing requirements and the capital market. The (CAC) Corporate Affairs Commission which regulates companies' registration, supervision, incorporation and winding up and formation, the (NSE) Nigerian Stock Exchange is the trading floor for companies' equity and debt and ensuring companies comply with the listing requirements (CBN) Central Bank of Nigeria which is the apex bank and in charge of currency. (CAMA) Companies and Allied Matters Act 1990 is responsible for the preparation for financial statements by listed companies. (FRCN) Financial Reporting Council of Nigerian which is responsible for review and removal of local accounting standards and is also in charge of accounting information is prepared in accordance to standards. SECN proposed a significant to its code of corporate governance to secure better alignment FRCN (2015) code for a new 10-year mandatory audit firm rotation requirements with a 7-year ''cooling off" period.

5.0 CONCLUSION

There is conflicting evidences on the relationship between audit firm tenure and financial reporting quality. Short audit tenure provides high financial reporting quality while longer audit tenure produces a low financial reporting quality. Audit tenure has a direct impact on fraud commission and financial reporting quality. From the papers it is observed that the longer the tenure the association with management and client the auditor gets more intimate and this situation can impair the independence of auditor and would affect the objectivity and integrity that would enhance fraud.

If the auditor tenure becomes longer the tendency of knowing more about the operations and more detail about the accounting system this will help the auditor to detect fraud and irregularities of the client thereby the quality of audit report is enhanced. To strike a balance in the range of the audit firm tenure there is need for moderate length of audit tenure. The length audit tenure should be between one and three years so that the auditor can combat and prevent fraud and improved the financial reporting quality. The law and enforcement agency should back the three years professional requirement for an auditor in Nigeria. Since there is a negative relationship between audit tenure and financial reporting quality. The recommendation is that there is the need for the Nigerian financial reporting council and other regulatory bodies in line with best practices to look critically into in Nigeria.

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