
AUDIT QUALITY AND THE RELEVANCE OF ACCOUNTING NUMBERS: EVIDENCE FROM NIGERIA

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ABSTRACT

The present study examined the relationship between audit quality and the relevance of financial reporting in Nigerian consumer goods manufacturing companies that are publicly listed. The investigation focused on analyzing data collected before the onset of Covid-19 pandemic. The research adopted a correlation research approach, assessing a sample of thirteen publicly listed manufacturing companies operating in the consumer goods sector over a span of seven years (2012-2018). Ordinary Least Square regression technique was used to analyze a pool of panel data extracted from the published annual reports of the sampled organizations. The findings showed a weak association between audit quality measured by audit fee and value relevance of the sampled organizations' financial reports. The implication is that audit fee does not necessarily guarantee the relevance of financial statements numbers. Based on the results obtained, the study recommends that audit fee should be adequate enough to guarantee the auditor's independence and objectivity which are integral quality of external auditor.

Keywords: Audit fee, audit quality, auditor's independence, auditor's objectivity, value relevance

INTRODUCTION

Accounting is an information system that measures, processes, and communicates financial information about an identifiable economic entity (Kenter & Pressley, 2008). For accounting information to be useful, it has to be communicated to users of such information. This is what is termed financial reporting. The communication is accomplished through the preparation of financial statements.

IFRS conceptual framework gave no definition of financial reporting, but provides that the general purpose of financial statements is to provide information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity (Agwor & Zukbee, 2020). When defining financial report and reporting, the IFRS conceptual framework currently equates these terms with general purpose financial reports (GPFRs) and the act of presenting those reports.

Within the standards, GPFRs and general purpose financial statements (GPFS) are treated as synonyms. Broadly, financial reporting is the process of providing periodic information in financial statements (including the notes thereto) about the financial position and performance of a reporting entity to parties (users) external to that entity to assist them in making informed decisions about allocating scarce resources. The goal of financial reporting is to provide useful information for decision making (Agwor & Zukbee, 2020).

In general, quality financial reporting improves the investment climate and fosters competitive business development. Moreover, it is a key device in protecting the interest of the public. A necessary requirement for financial reporting quality is to adhere to the objective and the qualitative attributes of financial information (International Accounting Standard Board [IASB], 2008). Qualitative attributes are those that make financial information useful to users and comprise relevance and faithful representation. (BPP Media, 2012).

Value relevance measures the quality of financial reporting information by focusing on the associations between accounting figures and stock-market reactions (Barth et al., 2001; Choi et al., 1997; Nichols & Wahlen, 2004). The stock price is assumed to represent the market value of the firm, while accounting figures represent firm value based on accounting procedures. When changes in accounting information correspond to changes in market value of the firm; it is assumed that earnings information provides relevant and reliable information for market participants (Nichols & Wahlen, 2004). This method is also used to examine earnings persistence, predictive ability and variability as elements of earnings quality (Schipper & Vincent, 2003; Francis et al., 2004). Generally, value relevance literature focus on information disclosed in financial statements to assess financial reporting quality (Healy & Wahlen, 1999; Barth et al., 2001; Leuz, 2003).

DeAngelo (1981) defines audit quality as the market-assessed joint probability that a given auditor will both discover a breach in an accounting system and report the breach; thus, audit quality is determined by the auditor's ability to detect material misstatements (auditor competence) and the auditor's willingness to report discovered material misstatements (auditor independence). Audit quality is therefore linked to auditor's independence and competence. Direct empirical proxies for effort and effectiveness include hours spent auditing (Caramanis & Lennox, 2008) and auditor industry expertise (Krishnan, 2003). There is a general opinion expressed in audit literature that audit quality cannot be directly observed by outside parties. However, audit quality is measured by auditor independence, audit compensation (Fee), auditor type, Size, industry specialization, and joint audit (DeAngelo, 1981; Palmrose, 1986; Krishnan, 2003; Dechow, et al., 2010).

Audit services have been critical to financial reporting quality since the industrial revolution (that is, separation of ownership from management). Research has shown that audit quality should be associated with financial reporting quality (Jeff et al., 2014), which in turn should affect both the firm and the economy positively. However, audit failure has often led to the eventual collapse of firms of various sizes and even called to questions the integrity of auditors. In view of the foregoing, this study focuses on examining the correlation between audit quality and the relevance of financial reporting in Nigerian consumer goods manufacturing companies that are publicly listed.

LITERATURE REVIEW

Audit Quality

According to IASB, the objective of financial statements is to provide information about financial position, performance and changes in financial position of an entity that is useful to users in making economic decisions. A good accounting information system will result in accounting information that is useful for users to make sound decision. Investors are the most important group of decision makers who use accounting information. Therefore, the relevance of accounting information is essential to value companies (Peters & Zukbee, 2023).

Drawing from extant literature, relevance is operationalized using items which have predictive and confirmatory value. Researchers tend to focus on earnings quality instead of financial reporting quality. Many researchers have defined predictive value as the ability of past earnings to predict future earnings (Francis et al., 2004; Schipper & Vincent, 2003). Predictive value explicitly refers to information on the firm's ability to generate future cash flows: "information about an economic phenomenon has predictive value if it has value as an input to predictive processes used by capital providers to form their own expectations about the future" (IASB, 2008).

In addition to predictive value, confirmatory value contributes to the relevance of financial reporting information. Information has confirmatory value "if it confirms or changes past (or present) expectations based on previous evaluations" (IASB, 2008). Jonas and Blanchet (2000) argue that if the information in

the annual report provides feedback to the users of the annual report about previous transactions or events, this will help them to confirm or change their expectations.

Financial Reporting Quality

Mainstream accounting research and standard setters agree that the investors are the primary reason for preparation of financial statements. Accounting reports are presented to enable investors make equity valuation for investment purposes (Akintoye, 2008). Value relevance research empirically investigates the usefulness of accounting information to stock investors (Agwor & Zukbee, 2020). Accounting information is denoted as value relevant if there is a statistical association between the accounting numbers and market values of equity (Peters & Zukbee, 2023).

For financial information to be value relevant, accounting numbers must be related to current company value. If there is no association between accounting numbers and company value, accounting information cannot be termed value relevant, and hence, financial reports are unable to fulfil one of their primary objectives (Peters & Zukbee, 2023; Zukbee & Ogaluzor, 2023). Research in value relevance examine if accounting variables are useful in valuing a company by comparing the variable to market value. Barth, Beaver & Landsman (2001) argue that studies in value relevance analyzes if an accounting variable reflects information used by investors when valuing the equity of a company.

There are four perspectives to value relevance: (1) fundamental analysis perspective, (2) prediction perspective, (3) information perspective and (4) measurement perspective (Peters & Zukbee, 2023). The fundamental analysis describe value relevance as the ability of financial statement information to capture intrinsic share value; the prediction perspective captures value relevance as the ability of financial information to predict future dividends, future cash flows, and future earnings of future book values. The information perspective describe value relevance as the statistical association between financial information and prices or returns; while the measurement perspective describe value relevance as the ability of financial statement information to capture information that affects share values (Nilsson, 2003; Adzor & Abanyam, 2014).

Audit quality and Financial Reporting Quality

Extant literature on audit quality and financial reporting quality from different part of the world provide mixed results. Although the studies used different methodologies in different environment, this study is designed to provide evidence from Nigeria. The extent of audit fee is basically elucidated by client attributes related to audit effort and audit risk (Turpen, 1995). Previous studies document that higher audit fees are related to lesser earnings management and higher financial reporting quality. Franke et al. (2002) studied effect of audit fees and earnings management in the US, and reveal that audit fees have negative significant relationship with earnings management. This reports is affirmed by Hoitash et al. (2007) who apply 13,860 firm-year observations to determine the influence of audit fees and audit quality in the US. Their finding show significant negative correlation between audit fees and discretionary accruals.

Mitra et al. (2009) examine the relationship between audit fees and financial reporting quality of the Big 5 client firms in US. They employ a sample of 6,852 firm-year observations for the period of 2000 to 2005. Their finding reveals that audit fees reduce the likelihood of abnormal accruals and thus increase earnings quality. More so, Carmona et al. (2015) explore the relationship between audit fees and audit quality of listed firms in Spain. They show that audit fee is negatively and significantly related to discretionary accruals. This indicates that higher audit price is related to lower discretionary accruals and higher financial reporting quality.

In Nigeria, Semiu and Kehinde (2011) studied the perception of auditor independence in Nigeria during the period of 2000 to 2008; their results showed that size of audit fee is the most influencing factor capable of deterring auditor independence in Nigeria. In a similar study, Felix (2015) confirmed that audit and/or non-audit fees threaten auditors' independence in Nigeria. In contrast, Umar (2012) investigated

the stakeholders' perception of non-audit services provision via auditor independence in Nigeria during the period 2005 to 2010, his findings reveal that non-audit services do not impair auditor's independence. However, the findings reveal that there are a number of threats to auditor independence and one of which is familiarity, which comes as a results of long-term audit firm-client relationship.

Researchers have argued that the quality of an external auditor is an important factor affecting financial reporting quality, whereby a high quality external auditor is expected to have an influence on the quality of financial reporting (Zukbee & Ogaluzor, 2023). Given the existence of information asymmetries and the potential conflicts of interest between company management and outside users of financial information, an audit of financial reports by third party can enhance the quality of the financial information reported by management because a high quality auditor is more likely to detect questionable accounting practices and to a certain extent may compel management to follow accounting practices as prescribed by the accounting standards (Rahman & Ali, 2006). However, some prior studies have failed to prove this contention.

METHODOLOGY

The present study utilizes a correlational and ex-post facto research design. The analysis utilized panel data sourced from the public financial reports of the selected manufacturing organizations. The study's population comprises 21 manufacturing enterprises (specifically in the consumer products industry) that were listed on the Nigerian Exchange Group (NGX) from 2012 to 2018. The selection of 13 consumer products manufacturing companies included in the sample was based on the following criteria:

- a) The first criteria is to use post IFRS adoption and pre-Covid 19 data so as to eliminate the influence created by Covid 19.
- b) The company is required to be actively engaged in business operations and listed on the Nigerian Exchange Group (NGX) within the time frame spanning from 2002 to 2018. The study period encompasses the years 2012 to 2018; however, in order to accurately estimate discretionary accrual using the modified Jones model, it is necessary to have data spanning from 2002 to 2018.
- c) The organisation is required to operate as a producer of consumer goods, as per the classification provided by the NGX.
- d) The company's delisting status must have remained unchanged for the whole duration of the research. The purpose of this measure is to guarantee the uninterrupted flow and accessibility of data.
- e) Finally, it is imperative that data pertaining to the sampled organisations is both obtainable and readily accessible, ensuring its completeness, throughout the time frame spanning from 2002 to 2018.

For the purpose of this study, cross sectional time series (Panel) data was used. Panel data combines the property of cross sectional and time series data. The sources of the data include the financial reports and statements of the sampled manufacturing firms for the period under study. The research utilized the Ordinary Least Square (OLS) regression method for data analysis. The parameters for our study model were computed using the Econometric View (E-View version 10.0).

Measurement of Variables

Value relevance was measured using the following price level and returns as demonstrated in Ohlson's model:

$$P_{i(t+1)} = \beta_0 + \beta_1 BEQ_{it} + \beta_2 EPS_{it} + \mu \quad \dots \dots \dots (2)$$

Where,

$P_{i(t+1)}$ = Share Price of firm i at time (t)

$\beta_0 - \beta_2$ = Intercept/ coefficients of the model

BEQ_{it} = Book value of equity per share of firm i at time t.

EPS_{it} = Earnings per share of firm i at time t .

μ = Error term.

The explanatory power of the EPS was measured by the coefficient of determination (R^2) of the equation. In regression analysis, the explanatory power or simply R^2 measures the proportion of variance in the dependent variable explained by the independent variable(s). If stock prices or returns are regressed on accounting variables, R^2 is a measure of how much variation in stock prices or returns is explained by the accounting variables analyzed. Hence, explanatory power is a measure of value relevance (Lang et al., 2003; Sami & Zhou, 2004; Francis & Schipper, 1999; Ohlson, 1995).

Audit Quality was measured using its attribute of audit fee. In order to bring all firms in the panel of sampled firms on the same level, audit fee was scaled by total assets. In specific terms,

$$AQ_{it} = (\text{Audit Fee} / \text{Total Assets})$$

The division by total assets is necessitated by the need to take cognizance of the cross-sectional difference in the paneled sample of firms.

DATA PRESENTATION AND ANALYSIS

Univariate Analysis fig. 1 and fig. 2 below present the univariate analysis of the variables under consideration.

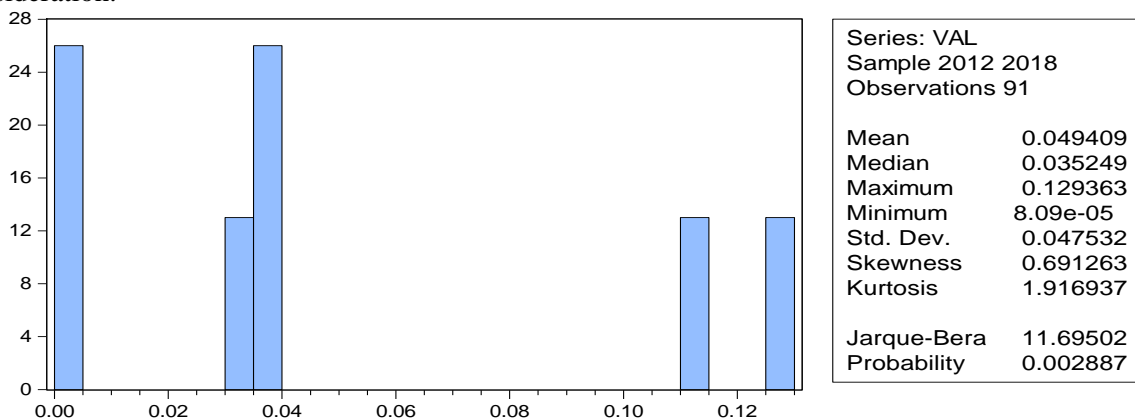


Fig. 1: Value relevance of reported earnings (Univariate)

Value relevance is positively skewed with over 60 observations (out of 91) less than the mean. The mean and median are 0.049409 and 0.035249 respectively. The distribution is not normal as indicated by the Jarque Bera probability ($P < 0.05$). The standard deviation is 0.047532.

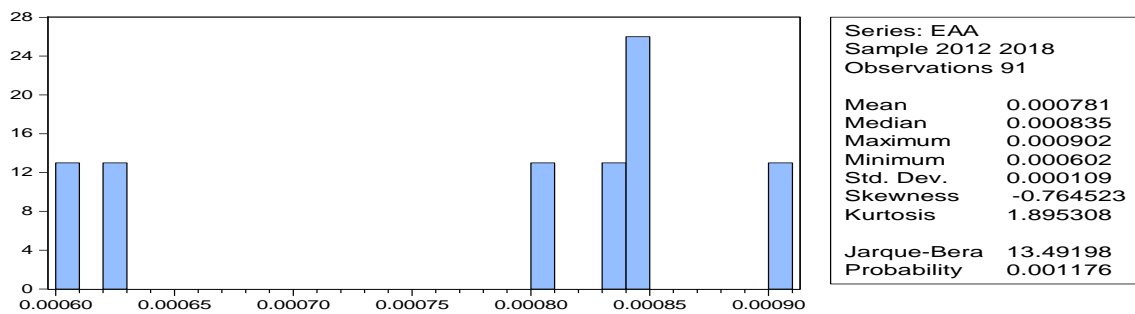


Figure 2: External Audit Attribute (Univariate)

The distribution of audit fee is negatively skewed. The implication is that most firms in the sample pay audit fee above the average value. The data is not normally distributed as indicated by the Jarque Bara probability ($P < 0.05$).

Table 1: Correlation Matrix of Audit Quality and Value Relevance

Covariance Analysis: Ordinary	
Correlation Probability	
Observations	
	EMGT
AQ	0.175539
	0.0960
	91

Audit fee is also positively correlated with value relevance at a coefficient of 0.175539, however the strength of the relationship is insignificant as indicated by the probability value of 0.0960, which is greater than the threshold of 5%. The implication is that as audit fee increases, the relevance of financial reporting also slowly increases. The computed P-value (0.000) is greater than the established significance level ($\alpha = 0.05$), therefore, we accept the null hypothesis and conclude that there is no significant relationship between external audit attribute (audit fee) and value relevance of quoted manufacturing companies in Nigeria.

DISCUSSION OF FINDINGS

It is generally accepted that audit effort or effectiveness should be associated with improved financial reporting quality (Jeff et al., 2014), which in turn should affect both the firm and the economy positively. Audit quality should be associated with high information quality of financial statements because it has been suggested that the contents of annual reports are not only audited but also influenced by the audit functions (Wallace et al., 1994).

An increment in audit fee will increase stakeholders' expectation of quality financial statements. This goes to confirm the important role external auditors have in producing quality financial reports when audit fee is increased. The findings from this study show that external audit fee is positively and insignificantly associated with relevance of accounting information. This means that audit quality, measured by higher audit fee will insignificantly result into relevant accounting numbers. In other words and specifically too, the predictive power of accounting numbers cannot be seriously influenced by increasing audit fee. This is contrary to the views expressed by Francis and Ke (2003); Reynolds and Francis (2000); Umaru (2014), Bala et al. (2018) who found that increased audit fee will improve the quality of financial reporting.

CONCLUSION AND RECOMMENDATIONS

This work has provided additional evidence from Nigeria on the relationship between audit quality and financial reporting quality. Specifically, it established a positive but insignificant relationship between audit fee and value relevance of accounting numbers using post IFRS adoption data from consumer goods manufacturing companies in Nigeria. Although audit fee has little positive influence on the relevance of financial reports, it is worth recommending that external auditors should be adequately compensated. Adequate compensation may be relative but should include the provision of necessary resources both financial and otherwise necessary for quality audit. However, the increment in fee should not be expected to result into relevant accounting numbers, following the findings of this research. Furthermore, in negotiating fees, auditors should adopt the institute's recommended rate or accept only fees that can guarantee their independence and objectivity.

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