

## **AUDITOR INDEPENDENCE AND THE PROVISION OF NON-AUDIT SERVICES– INVESTORS’ PERSPECTIVE IN NIGERIA**

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**ABSTRACT:** *Based on the assumption that non-audit fees compromise auditor’s independence and result in lower quality services, the Sarbanes-Oxley Act of 2002 bans certain non-audit services for audit clients. The link between non-audit services and required auditor’s independence has been heavily debated by accounting scholars. The purpose of this study is to identify the threats to auditors’ independence, and to examine the relationship between auditor’s independence and non-audit services. The lack of clear definition of auditor independence contributes to the resilience of this debate. The Sarbanes-Oxley Act (2002) prescribed a list of non-audit services essentially to help restore investor confidence in the reliability of financial information. A survey design using well-structured questionnaire was used to collect data. Respondents were sampled from five sectors of the Nigerian economy: Banking, Brewery, Chemical & Paints, Conglomerates, and Health. The non-parametric statistical tests used in this study include the Kruskal-Wallis Test and the Mann-Whitney U Tests to draw inferential conclusions regarding the data collected since the data collected from the different categories of respondents. The findings indicate that the provision of non-audit services significantly affects investors’ perceptions of auditor independence, and there is high correlation between auditors’ independence and non-audit services in Nigeria. To maintain public confidence, auditors should continually assess their standing in the community. Any reduction in confidence in the auditing profession will immediately reflect a lack of confidence in audited financial statements, leading to an overall decline of trust in the country’s capital market.*

**KEYWORDS:** *Non-audit services, Auditor independence, conglomerates, Sarbanes-Oxley Act.*

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### **INTRODUCTION**

In Nigeria, auditors play an important role as ‘gatekeepers’ to public capital markets. By attesting to the accuracy of a company’s financial statements, the auditor lends his credibility to that company and its financial robustness as he expresses a professional opinion on whether the financial statements give true and fair view and are properly prepared in accordance with Companies and Allied Matters Act 1990 (as amended) and other legislations. The question of auditor independence has received increased attention from practitioners, regulators, and academics around the globe in recent years due to highly publicized audit failures (Hope and Langli, 2009). This is not surprising since the fact that auditors receive their fees from their client’s firms clearly creates a potential problem for auditor’s independence. The effect of lack of auditor’s independence can extremely have great to the audit process; this has affected audit quality (Abdullah, 2003). Several countries have moved swiftly to pass legislations to curtail/eliminate auditors-providing non-audit services and imposed compulsory auditor rotations. Gul, Basioudis and Ng (2011) argue that such legislations have, in effect, reduced the auditor-client relationship, although it may

potentially raise the cost to an auditor of expressing an independent opinion. It is a general regulatory belief that non-audit services provided by auditors to their audit clients compromise audit quality and audit independence.

On one hand, in furtherance of the requirements of Section 201 of the Sarbanes Oxley Act of 2002, the American Securities and Exchange Commission adopted final rules prohibiting accounting firms from providing non-audit services to their audit clients that are SEC reporting companies. The prohibition of specified non-audit services is predicated on three basic principles; (i) an auditor cannot function in the role of management; (ii) an auditor cannot audit its own work; and (iii) an auditor cannot serve in an advocacy role for its client. However, the validity of such position is yet to be verified in Nigeria, hence the need for this study. The current study intends to bridge the research gap on this issue by using Nigerian data.

On the other hand, auditor independence is the cornerstone of the audit function (Lowe, Geiger & Pany, 1999). As such, auditor independence gives the public assurance that the audited financial statements are reliable and trustworthy. This logic cannot exist unless rational financial statement users perceive auditors as independent and expert professionals who have no personal interests in their audit clients [Securities and Exchange Commission (USA SEC) 2000]. A great deal of research have been conducted on the topic of auditor independence and challenges of provision of non-audit services, however, the bulk of these studies have been conducted on the major economies of the Western industrialized countries such as United States of America, United Kingdom, New Zealand, and Canada. The purpose of this study is to identify the major threats to auditor independence and to examine the effects of the provision of Non-Audit Services (NAS) on auditor independence in Nigeria.

## **THEORETICAL AND EMPIRICAL REVIEW**

The demand side of audit services can be explained using different theories. Theories that are often driven by public perceptions are the Policeman Theory and Lending Credibility Theory. According to the Policeman Theory, the auditor's job is to focus on the arithmetical accuracy of financial statements and on prevention and detection of fraud. The Lending Credibility Theory states that the audited financial statements are used by management to enhance the stakeholder's faith in management's stewardship (Hayes, Knechel and Wong 2006). The theory that is most often used in research contexts and incorporates parts of the Policemen Theory and Lending Credibility Theory is the Agency Theory because the Agency Theory is the most important theory explaining the demand for audit. This research is anchored on Agency Theory. Agency Theory is built on the premises that there is an agency relationship wherein the principal delegates work to the agent. As a result, there evolves risk sharing and conflict of interest between the two parties. It is the belief that the agent will be driven by self-interest rather than the desire to maximize the profits for the principal. The theory describes the conflicts that arise as a result of the separation of ownership and control. There is considerable information asymmetry between the agent and the principal. Auditors serve to reduce agency costs by reducing this information asymmetry and consequently contractual conflict (Jensen and Meckling, 1976; Ng, 1978; Baiman, Evans and Noel, 1987).

Theoretically, the demand for audit services originates from the need to facilitate contractual relations between the audit client and stakeholders groups (Duff, 2004), the preparation of

financial statements is typically controlled by the board of directors of the company who are separate from the company's stakeholders. This separation of ownership and control creates a contractual conflict between the parties leading to the so-called agency cost. An important assumption within the Agency Theory is that the auditor is independent and he provides an independent opinion.

### **NON-AUDIT SERVICES (NAS)**

Non-audit services are defined as all services provided by an auditor that are not considered as an audit. Such services may be Management Advisory Services (MAS) and compliance related services (tax and accounting services). These services can be provided by the incumbent audit firm or another audit firm. Non-audit services constitute the source of non-audit income. It may be described as any other services rendered to an audit client different from the examination of financial statements and expression of a professional opinion thereof. Ye Carson and Simnett, (2006) opine that the economic dependence of auditors on non-audit services, lengthy audit tenure and personal relationships built through alumni employees have contributed to the erosion of auditor independence. The work of Hayes, *et al.* (2005) suggests that there exists a potential for the impairment of auditor independence in appearance when they render non-audit services.

DeAngelo (1981a) defines audit quality as the joint probability of the auditor discovering, observing and reporting financial statement errors. Auditors of high quality are less willing to accept questionable accounting methods and are more likely to report errors and irregularities uncovered during the audit. non-audit services on auditor objectivity has long been an area of concern. That concern has been compounded in recent years by significant increases in the scope and amounts of non-audit services by audit firms. The auditor is not independent, if he is auditing his own work (Okaro and Okafor, 2009). The potential impact of independence of an auditor providing non-audit services to an audit client has also been studied by a wide variety of observers. These include the U.S. Congress, various Securities and Exchange Commission (SEC), the Public Oversight Board (POB), and academics.

The research on audit or independence under these conditions identifies a number of salient issues. Providing NAS to an audit client may impair or be perceived to impair auditor independence (Shockley, 1981; Knapp, 1985); alternatively, NAS enhance auditors' knowledge of the client and thus objectivity and independence should increase (Jenkins and Krawczyk, 2002; Lennox, 1999). Lastly, NAS is not proven to have an effect on auditors' independence (Barkess and Simnett, 1994; Pringle and Bushman, 1996; Hussey, 1999). Audit quality is an important issue for an accounting profession facing criticism from regulators and stakeholders group. A highly quality audit should reduce stakeholders groups' uncertainty associated with financial statement prepared by managers (Wallace, 1985). Frankel, Johnson and Nelson, (2002) observe that auditor independence is compromised when clients pay high non-audit fees relative to total fees.

An observation of statutory pronouncements like Section 357 of the Nigerian Companies and Allied Matters Act (CAMA) 1990, as amended, requires companies to have their financial statements audited by an independent auditor for any financial year. It can be perceived that managers are responsible for the preparation of annual account, designing and implementing internal controls, and above all ensuring the smooth running of the business. CAMA (1990)

Section 358(2a) disqualifies a person or firms who or which offers to the company professional advice in a consultancy capacity in respect of secretarial, tax action or financial management from acting as auditor of that same company. This ensures that an auditor is independent (in appearance) of the organization on whose accounts he reports.

Anichebe (2010) observes that in Nigeria auditors accept all services (except those for which the auditor has no expertise) as long as there are engagement letters. He argued that the existing independence rules are clearly breached. The same auditor is allowed to prepare and audit the financial statements due to a lack of qualified accountants (Anichebe, 2010). Hay, Knechel and Li (2006) suggest that, there exists a potential for the impairment of auditor independence in appearance when they render non-audit services (Hay, *et al.* 2006) to mitigate self-interest threat which is caused by rendering non-audit services (Byrne 2001).

Concerns about impairment of auditor independence have been raised by regulators all over the world and have led to restriction on auditor's provision of Non-Audit Services (NAS) to audit clients (Auditing Practices Board 2009, 2010). Various accounting scandals that involved auditors who also provided NAS raised the level of these concerns and led to the passage of Sarbanes-Oxley Act (SOX) 2002. The purpose of SOX is to improve the accuracy and reliability of corporate financial reports. Specifically, Section 202 of SOX Act 2002 prohibits the rendering of non-audit services by statutory auditors to their clients. By implication, the American Congress is of the opinion that these restrictions strengthen auditors' independence and improve the quality of financial reporting. Abbott, Parker and Raghunanda, (2003) state that companies with independent audit committees pay lower non-audit services fees, however Reiner and Bent (2009) proposes that rendering of non-audit advisory services increases quasi-rents, thereby posing a threat to auditor independence.

## **AUDITOR INDEPENDENCE**

In performing statutory audits, auditors comply with generally accepted auditing standards. These standards require that auditors perform the engagement with due care and an objective state of mind. Independence is an abstract concept and it is difficult to define (Schuetze, 1994). Nevertheless, in defining auditor independence, the literature selects objectivity, the ability to avoid biases; and integrity, willingness to report a truthful opinion that reflects the matters discovered during the audit. (DeAngelo, 1981b). This author defines auditor independence as the conditional probability of reporting a discovered breach of contract. The author argues that auditor independence may be impaired when auditors earn client specific fees, which provide an incentive not to report the discovered breach to retain the client. The relative strength of this incentive depends on the significance of the client to the auditor's portfolio. The client-specific fee-for-services lead to the practice of setting audit fees below the market on initial audit engagements to retain the client (DeAngelo, 1981b). The Cohen Commission 1977 as reported in (DeAngelo, 1981a) adds that this practice is manifested either as a receivable account or as an unpaid audit fee and it impairs auditor independence-in-appearance.

Knechel and Sharma (2008) argue that auditor providing non-audit services have been a controversial topic in the auditing profession for many years and are one of the key issues in debates between regulators and the accounting profession regarding potential threats to auditor's independence. The lack of auditor independence is a main cause of many corporate

collapses and corporate scandals across the world including the US case of Enron (Terry, 1996). Beattie and Fearnlay (2003) argue that after the collapse of Enron, it was generally believed that rendering non-audit services compromised the independence of external auditors. According to Ojo (2009), the provision of non-audit services by audit firms does not necessarily influence the independence of auditors. However, where the fees generated from such non-audit services are considerably high, and insufficient safeguards operate to protect the interests of users, auditor's independence is likely to be compromised.

## **THREATS TO AUDITORS INDEPENDENCE**

Sharma (2006) and Sharma and Sidhu (2001) argue that for an effective list of threats to auditor independence, there is a need to study the opinion the auditor ought to have given relative to the actual opinion given. If it is determined that the auditor ought to have given a qualified audit opinion, but had given a clean opinion; the reasons for the deviation could be attributed to independence impairment after controlling for other explanations. According to ICAN (1999), a number of threats to independence were identified. These threats include: self-interest; self-review; advocacy, familiarity, and intimidation. A brief outline of the five types of threats which may occur as a result of Non-audit services are:

### *The Self-interest Threat*

An auditor's independence may be threatened if a firm or a member of the audit team benefits from a financial interest in an audit client. This could arise, for example, from a direct or indirect interest in a client; or from a fear of losing the client. In other words, all works that create a financial relationship between the auditor and the audit client may create a self-interest threat. The perceived threat to independence grows with the amount/size of the ensuing fee payable, and the self-interest caveat is thus increased further by providing Non-audit services to the audit client. But the most significant dimension of any threat, real or perceived, is likely to be the size of the total fees earned from a client in relation to the whole fees of the auditing firm.

### *The Self-Review Threat*

This relates to the difficulty of maintaining objectivity when conducting a self-review procedure. This can arise when any product or judgment from a previous audit (or non-audit) assignment needs to be challenged, or re-evaluated in reaching the current audit conclusions; or when a member of the audit team has previously been a director or officer of the audit client, or was employed in any position likely to affect the subject matter of the audit engagement. Therefore an auditor should give careful consideration to every issue bearing on the self-review threats. This includes the materiality of the amounts involved (in relation to the financial statements) and the degree of subjectivity inherent in any judgment of the elements concerned.

### *The Advocacy Threat*

This occurs when the auditor promotes, or is perceived to promote, a client's opinion to a point where people may believe that objectivity is getting compromised. For instance, advocacy in any sharpened form is likely to threaten an auditor's independence, and appears to be incompatible with the particular objectivity required by the audit-reporting role. This separation of roles is vital to auditor's credibility. Therefore, if a firm, or a member of the



audit team, becomes an advocate for (or against) the audit client's position in any adversarial proceedings (or situations) there may be serious ethical compromise. Examples of this confusion of roles may occur when acting as an advocate on behalf of the client in litigation; or when the client litigates against the auditor; when Business and dealing in or promoting shares (or securities) issued by the client. These activities are obviously considered likely to impair or compromise auditor independence.

#### *The Familiarity to Trust Threat*

By virtue of the close relationship with an audit client, its directors, officers and employees, there is a risk that the auditor may be influenced by the client's business ambience. This caution against over-familiarity must also include the influence of a client's personality and other personal qualities. There is the danger that these factors may subsequently contribute to excessive trust in that client. In this situation the auditor runs the risk of becoming too sympathetic to the client's representations and claims may be insufficient. An auditor should be extremely careful not to go beyond the advisory role and not drift into influencing the management sphere. Such a drift is potentially damaging to both parties. For example, too long and too close relationships with client personnel may result in excessive trust in the client and insufficient objective testing of his representation.

#### *Intimidation Threats*

This occurs when auditors are deterred from accounting objectively with an adequate degree of professional skepticism because of threats of replacement. According to CIMA (2002), independence may be compromised when preparing accounting records and financial statements. There is an obvious self-review threat and auditors must not make 'management decisions'. For audit clients that are not listed entities, the firm may provide an audit client with accounting and book-keeping services of a 'routine or mechanical nature'. Doing so for a listed company is not generally acceptable other than if immaterial or in emergencies with appropriate safeguards.

Sharma and Sidhu (2001) examine audit opinions of bankrupt companies and found that higher non-audit service fees influenced audit opinion regarding going concern. Proponents of the provision of audit services argue that synergies of knowledge spillover and audit efficiency arise from providing both audit and non-audit services. The opponents contend that provision of non-audit services increases the auditor's financial reliance on the client and therefore may impair auditor's independence. The impact if the provision of NAS to the audit client on perceptions of auditor independence was the subject of empirical studies in many countries over the last forty years. The results of these studies indicate three different findings: negative effects; positive effect; and no effect. Despite this strong evidence of auditor independence in academic literature, the regulatory actions towards auditors have been aimed at imposing stricter requirements on performing non-auditing services.

## **RESEARCH METHOD**

Purposive sampling survey design was adopted in this study. The sample consisted of one hundred and eighty knowledgeable investors in Lagos State. The choice of Lagos State is due to reasons such as accessibility to target respondents, concentration of audit firms in the selected area and the volume of audit activities being carried out by the audit firms. It is opined that Lagos will be a good representation of Nigeria which would no doubt furnish the

needed information. The data collection instrument consisted of a self-administered questionnaire, developed to capture individual respondent's perception of Non-audit Services and Auditor Independence. The questionnaire was constructed using a five-point linear numeric scale. The two variables in the study, Non-Audit Services and Auditor Independence were measured by adopting scales used in earlier studies and tested for reliability. These constructive scales using a five point linear numeric scales were incorporated in the relevant sections of the questionnaire.

## DATA ANALYSIS

Two main hypotheses were formulated and tested for this study. They were:

- (i) Provision of Non-Audit Services significantly has effect on Auditors independence.
- (ii) There is no significant difference in the investors' perception that the various threats identified, in totality, do not have significant effect on auditors' independence in Nigeria.

A total number of one hundred and fifty copies of the questionnaire were distributed among the five category of the professionals selected but one hundred and forty-two were returned. The responses are presented as follows:

Table1: Which of these five major threats, do you think affects auditor Independent mostly in Nigeria.

Threats	Frequency	Percentage
Self Interest	52	34.2
Self Review	17	11.2
Advocacy	28	18.4
Familiarity	33	21.7
Intimidation	22	14.5
<b>Total</b>	<b>152</b>	<b>100</b>

Source: Field Survey 2013

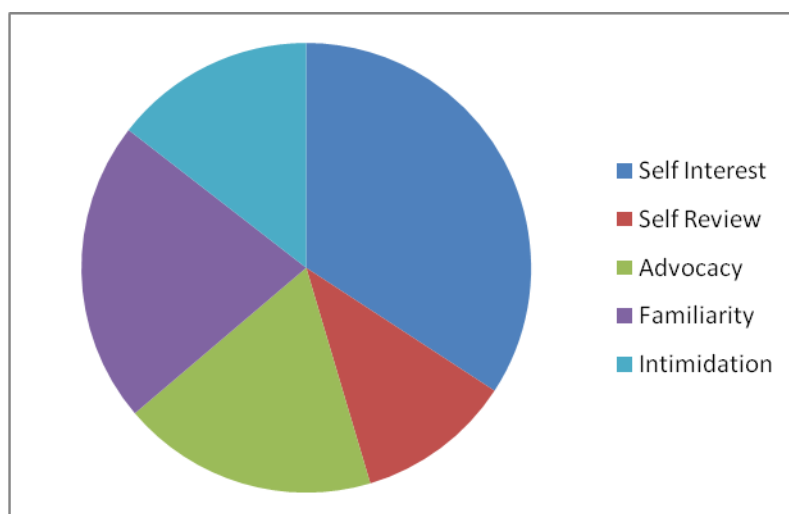
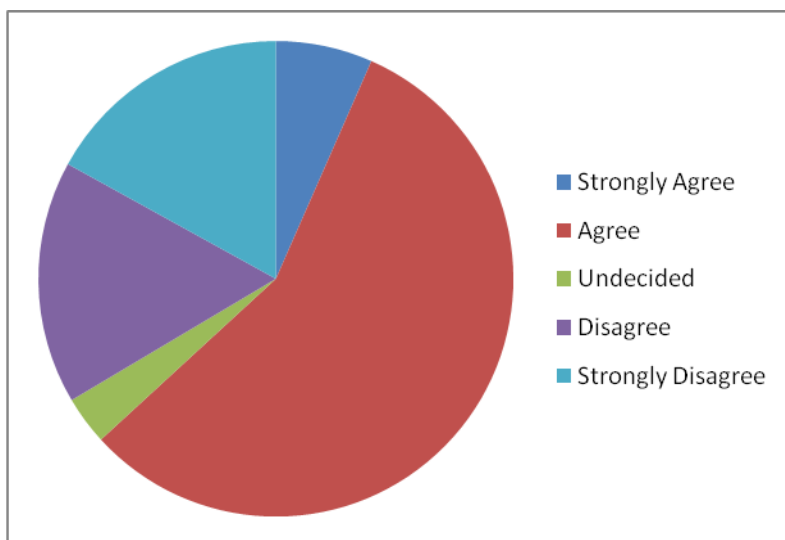


Table 2: Auditors should not legally be allowed to provide non-audit services for the clients.

Threats	Frequency	Percentage
Strongly Agree	10	6.6
Agree	86	56.6
Undecided	5	3.3
Disagree	25	16.5
Strongly Disagree	26	17
<b>Total</b>	<b>152</b>	<b>100</b>

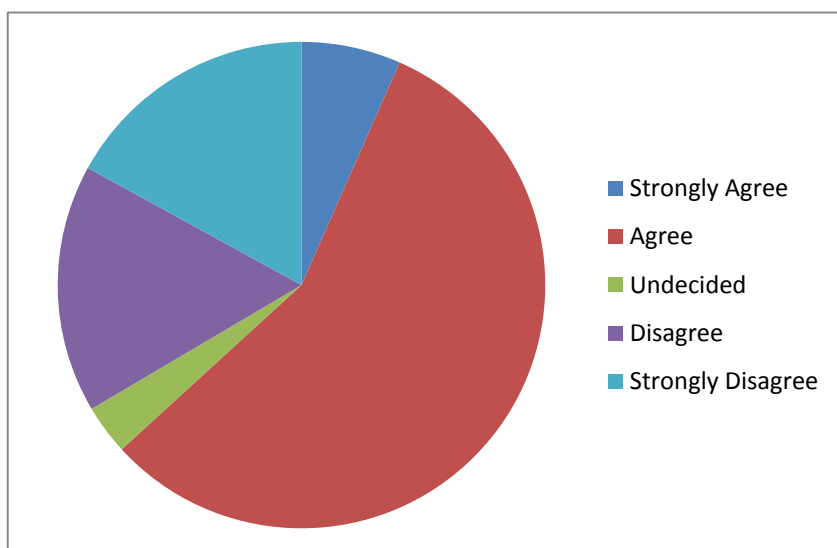
Source: Field Survey 2013

Table3: Can Auditors maintain their independence while providing non-audit services to their clients

Threats	Frequency	Percentage
Strongly Agree	10	6.6
Agree	86	56.6
Undecided	5	3.3
Disagree	25	16.5
Strongly Disagree	26	17
<b>Total</b>	<b>152</b>	<b>100</b>

Source: Field Survey 2013





### **Testing of hypothesis one**

H<sub>01</sub>: Provision of non-Audit services does not significantly affect auditors independence in Nigeria.

Kwallis Independence (by Category)

Test: Equality of population (Kruskal-Wallis test)

Category	Observation	Rank
1	30	1895.50
2	28	2389.00
3	29	2033.00
4	27	1801.50
5	28	2034.00

Source: Field survey, 2013.

$X^2 = 4.806$  with 4.d.f      Probability = 0.3077

**Decision rule:** The P-value calculated is 0.3077, which is greater than the P-value tabulated 0.05. Since P-value > P-value tabulated; we will reject H<sub>01</sub> and accept alternative hypothesis. From the decision rule, it can be deduced that provision of non-audit services significantly affects auditors' independence.

### **Testing of hypothesis two**

H<sub>02</sub>: There is no significant difference in investor's perception that the various threats identified do not totally have significant effect on auditors' independence in Nigeria.

Kruskal-Wallis independence (by Category)

Test: Equality of population (Kruskal-Wallis test)

Category	Observation	Rank
1	30	2149.00
2	28	1930.00
3	29	2146.00
4	27	1856.00
5	28	2072.00

Source: Field survey, 2013.

$X^2 = 7.244$  with 4.d.f

Probability = 0.0235

**Decision rule:** The P-value calculated is 0.0235, which is less than P-value tabulated at 0.05. Since P-value calculated < P-value tabulated, we retain  $H_0$  and reject the alternative hypothesis. From the decision rule, it can be concluded that the various threats identified in totality, do not have significant effect on auditors independence.

## CONCLUSION

This study investigates the perception of Nigerian investors on the effect of provisions of audit and non-audit services on audits independence. The major of the respondents agreed with the statement that provisions of non-audit services to audit clients by audit engagement team would threaten audits independence. These findings disagree substantially with previous studies such as: Palmrose, 1986; Hudaib, 2003; Abdulazeez, 2009; where the results were consistent with increased with the quality of provision of audit services. The authors concluded that non-audit services are useful to the clients, but were practicable; they should be performed by a firm other than the audit firm. Independent encompasses both fact and in appearance situations.

## RECOMMENDATIONS

Based on the findings and the conclusion above, we recommend that provision of non-audit services should not be allowed for audit clients. Efforts should be made to safeguard and maintain the independence of external auditors of Nigeria. In addition, non-audit services fees should not exceed 25% of total fees paid to external audit firms. Finally, in order to maintain public trust and confidence, auditors should continually assess their appearance and value in the community and then take necessary measures where there assessment falls below expectation. Any reduction in confidence in the auditing profession will immediately reflect a lack of confidence in audited financial statements, thereby leading to an overall decline of trust in the auditors and in the capital market. Thus, auditors are of value to capital market only through the maintenance of their value and integrity in clients' relationship.

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