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An Assessment of the Quality of Auditors' Reports in the Nigerian Banking Industry

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Abstract

The preparation, presentation, analysis, and interpretation of financial statements of an organization are major functions of the accounting system. This paper therefore, assesses the quality of auditor's reports in the Nigerian Banking Industry, with a view to ascertaining the level of reliance such reports should enjoy from users. The study X-rayed management letter and the role of the audit committee on financial reporting performance of the Nigerian Banking sector. Primary and secondary data were employed. The respondents were selected randomly from a stratified sample. Ten (10) Banks and their auditors were sampled out for the study, covering a period of five (5) years (2004-2008). The Pearson product moment correction coefficient was used to test the two hypotheses. The paper discovers that the quality of auditor's report is very significant to the assessment of a bank's performance, and that auditors' management letters contain useful comments on the internal control weaknesses observed during an audit. The paper recommends that implementation of auditors' recommendations contained in management letters should be timely in order to close gaps and rectify weaknesses likely to cause fraud, thereby adding more reliability to the final report of the auditor.

JEL classification numbers: M41
Keywords: Quality, Auditors report, Industry, Bank.

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1 Introduction

The monetized economy is an economy that has come to replace the trade by barter economy where goods were exchanged for goods, goods for services or services for service**.** Entities, profit-oriented or not, engage in financial transactions in the course of their operations, and maintaining records of these transactions is a vital function of the accounting system. Section 331 Subsection 1 of CAMA 1990 affirms this by stating that every company must cause accounting records to be kept. There is, therefore, the need for the preparation, analysis and interpretation of financial statements by all reporting entities for meaningful and useful judgments and decisions about their performances (Millichamp, 1996).

Before the presentation of the financial statements, sections 359-360 of CAMA 1990 mandate the auditors to carry out such examinations and investigations as may enable them to form an opinion. The owners who appoint the auditors as independent examiners are concerned with what happens to their investments. The directors of reporting entities are expected to render stewardship accounts to the shareholders and all parties needs to believe and rely on the account. Auditing is an independent examination of the financial statements of an entity with a view of the financial position of a reporting entity, to expressing an opinion as to whether these statements give true and fair view and comply with the relevant statutes (Aguolv, 2002).

The desirability of auditing in Nigeria stems from the ambit of the laws. CAMA 1990 requires companies in Nigeria to have their accounts audited to attest to the truth and fairness of the view shown by the financial statements. Auditing has played and have been playing vital role in the banking industry. Auditors' reports are relied upon for investment decisions in Nigeria, especially in the banking industry (Kamar, 1996).

Most audit reports issued on financial statements by auditors in Nigeria are not qualified (Asein, 2002). This does not imply that there were no weaknesses noted during the examination of documents and accounts, but that such weaknesses may not have been very material to warrant qualification of the financial statements. Failure to report certain weaknesses because of the auditors' negligence in his reports to management often affect the performance of banking industry negatively. Also the cost and weight of litigation which sometimes emanate from negligence in reporting weaknesses noted in the system to management is bound to have negative performance on the banking industry (Ojukwu, 1995). Investors and other users of financial statements often cast doubts over an organization's downturn especially if its certified financial statements had earlier created the impression of an impressive performance. Such doubts culminate in hypotheses that point to the likelihood of negligence on the part of the auditor. According to such hypotheses, if the auditor had not failed to report on certain weaknesses, the management would have taken steps to averts any misfortune that occurred. Frequent Changes in Policy formulation and implementation affect the performance of the banking industry negatively. Financial reports certified by auditors cannot be relied upon in isolation of matters disclosed in a management letter. This is because the management letter amplifies deficiencies embedded in internal control systems, the rectification of which improves financial reports and enhances its reliability.

The main objective of this study is assessing the quality of Auditors' report in the Nigerian Banking industry, with a view to ascertaining the level of reliance such report should enjoy from users. Other specific objectives are : to determine the relationship between auditors reports and bank performance; to ascertain the impact of management

letter on performance of the banking industry in Nigeria. The study gauges the performance of ten quoted banks vis-à-vis auditors' reports for five years (2004-2008).
Two null hypotheses were formulated in line with the objectives of the paper: **t**here is no significant relationship between auditors' report and bank performance and that **t**here is no significant impact of management letter on the performance of banks in Nigeria.
This research centers on an assessment of the quality of auditors reports in the Nigerian Banking Industry for a period of five years (2004-2008). Accounting profession insists that every organizations be it profit-oriented or not that would want to keep proper records of its transactions both for internal and external purposes requires the services and expertise of accountants. Now, with the current spate in the quality of auditors' reports, things have changed considerably and as such accountants have had to imbibe changed in their profession. They, therefore, need to appreciate the challenge of continuous relevance which they face with the advent of the quality of auditors reports. This study will serve as a big guide to them.
Government and its various agencies, shareholders, prospective ones, creditors, debtors, suppliers, customers, financial press and the general public, etc. will also benefit from this research work. Similarly, this study will add to the existing literature on the quality of auditors' reports and aid any researcher on this field for further research. Our identification of quality assurance strategies in the auditors' reports will surely enrich existing literature on the subject.

2 Theoretical Framework and Literature Review

2.1 Theoretical Underpinnings

Auditing is generally a practical discipline dealing with control mechanisms and instruments within organizations of different types. The audit profession, its associated bodies and public firms, have played an important role in developing the various standards roles and practice in this field (Belkaou, 1981). To discuss the usefulness of audit practices, it may be interesting to look at auditing issues from a different angle because most of the techniques and instruments have evolved with the behaviour of the various parties involved in making economic. Failure to devote sufficient attention to the theoretical foundations of auditing can not only limit its perspectives, but may also prevent appropriate development of the field in relation to its changing environment.
Theory provides a cornerstone for explaining auditing practices. The following auditing theories are, therefore, diagnosed.

2.1.1 Theory of inspired confidence

According to Limperg (1985), auditing theory of inspired confidence is viewed as a dynamic theory. This is because the theory connects the society's needs for reliable financial information to the technical possibilities of auditing to meet these needs.

2.1.2 Theory of rational expectations

This auditing theory takes into account the evolution of the need of the business community and of auditing techniques in dealing with changes in the auditor's function. Changes in the needs of the business community result in changes in auditor's view

(Blokdijk, 1995). The theory of rational expectations states that the auditor's report derives its added valve from expert work on which the audit opinion is to be founded. The auditor' in performing his task, should be governed by the rational expectations of those who may use his report. The auditor should act in such a way that he does not disappoint these expectations (general auditing norm).

2.1.3 Agency theory

This theory talks about the separation of ownership from administration or management. The shareholders are owners while the directors run the business on a day-to-day basis. Agency theory views the role of the auditor in an economically reductive way, as a monitoring cost between two parties (Watts and Zimmerman, 1983).

2.1.4 The probability theory

Auditing is like other applications of scientific thinking in its reliance on this theory. The traditional influence of this theory on auditing is best exemplified by the use of the term "opinion" in describing the auditor's final overall judgment with respect to the financial statements examined. According to Mautz and Sharaf (1961), it appears also in the auditor's employment of tests and samples a necessary and accepted practice.

2.1.5 Fund theory

The focus of this theory is on the management of the assets of the organizations. An effective asset management of a group of assets and related obligations and restrictions governing the assets is the focus of this theory. This is so because auditors place high premium on the assets and liabilities. Auditors must satisfy themselves on the fact that all assets have been safeguarded, all liabilities have been authenticated, all expenses have been authorized and all income well captured (Teoh, 1993).

From the above theories underpinnings, the theories that will guide this study are Agency theory and theory of inspired confidence, because, in Agency theory, the audit committee plays the intermediary role between the auditor and the shareholders. The audit committee reviews the auditor's report for onward submission to the shareholders and therefore the level of inspired confidence on the audit committee is established by the shareholders.

2.2 Conceptual Issues

The terms audit report, management letter and audit committee report have to be thoroughly understood for a better appreciation of the subject matter. Different authors and authorities have offered various definitions to these terms. According to Aguolv (2002), an audit report is a short statement expressing the auditor's opinion on the financial statements of a reporting entity. Ejembi (1999) sees audit report as a statement that summarizes the results of audit examination or special investigation. The statement describes the scope or purpose of the examination, followed by the auditor's findings which may be a statement of his opinion and recommendations.

Management letter, according to Ejembi (1999) is an internal control letter prepared for submission to the client pointing out the deficiencies in the internal control systems and requesting the client to amend them, highlighting the possible consequences if not amended. It is a letter of the weaknesses identified from the internal control questionnaire evaluation, showing major departures and break downs ascertained from the compliance tests (Aguolv, 2002). Ejembi (1999) views audit committee report as a report by the audit committee confirming the audit plan and scope, the drafts, account and balance sheet and the management letter on the audit of the accounts of the company. The audit committee ensures that the accounting and reporting polices of the company are in accordance with legal requirements and ethical practices.

2.3 Auditor's Management Letter

Auditor's management letter contains comments on weaknesses observed during an audit and recommendations for improvement. Thus, the management letter is a vital medium for communicating to an organization's management, problems which may lead to a loss if not averted. In this way, auditors strengthen an organization's accounting system, and enhance reliability and acceptance of the financial statements by users.

According to Pany and Whittington (1997), "Auditors often communicate operational suggestions and less significant weaknesses in greater detail to management in a report called management letter. This report serves as a valuable reference document for management and may also serve to minimize the auditor's legal liability in the event of a defalcation or other loss resulting from a weakness in internal control".

It is often viewed by (Adeleke, 1996) that it is not the responsibility of the auditor to discover and prevent fraud. However, auditors may unwittingly aid fraudulent practices where loopholes in an organization's internal control system identified during examinations of accounting records are not reported to management. The use of management letter as a vehicle for notifying the management of bottlenecks and dangers inherent in the control system exonerates the auditor from any liabilities resulting there from. Considering the cost and weight of litigation which sometimes emanates from negligence in reporting weaknesses noted in the system to management, the adoption of management letter should be regarded as an essential component of any audit assignment.

To affirm the indispensability of management letter in financial reporting, Asein (2002), in relation to the Enron matter, said: "However, given the public's perception of Andersen in the waste management saga, it would be fair to advice that Andersen has to give serious consideration to the publication of its management letter… as a way of redeeming its credibility and that of the global accounting profession."

De Paula and Attwood (1977), while writing on management letter observed that an important secondary audit objective to bear in mind throughout is the provision of constructive assistance to management, in the form of systems recommendations and advice on matters of financial management. It is now generally accepted practice for auditors to report to management on matters coming to their attention during the course of the audit.

Obtaining advice on weaknesses in the internal controls has become a key objective of retaining auditors by companies. Considering the magnitude of global litigation on auditor's professional negligence, it has become paramount to sound to an organization's management the least observed deficiencies in operating systems especially since losses can result there from (Dandago, 2002).

Millichamp (1984), writing on management letter, identifies two factors combined in considering such letter namely, internal control evaluation and assistance to client. According to him "internal control evaluation is a fundamental part of an audit. The auditor becomes aware, indeed, must become aware of weaknesses in the internal control system and also of the quality of records in areas where internal control system is weak. He must make such extensive tests in areas of weak internal control so that he knows whether or not the records are reliable and errors or fraud have been committed. Assistance to client is a by-product of an audit which leads to good relations with a client and makes good economic sense."

According to Millichamp (1984), the purposes of management letter (letter of weakness) include: to draw directors' attention to weaknesses in internal control system which the auditor uncovered in his examination so that the directors can put the matters right-this is advice to management and is not an official part of the auditors functions; to draw directors' attention to weaknesses which if not rectified may lead the auditor to conclude that he has not sufficient assurance on the reliability of the records and consequently must qualify his report; and to draw directors attention to weaknesses which may lead to losses by the company through the courts and the auditor may wish to demonstrate to the court that the directors were aware of the weakness and consequently, in large part, responsible for the losses which flowed from them.

Deficiencies, which may lead to errors or fraud, may be human or mechanical in nature. However, weaknesses inherent in systems of internal control may be a contributory factor (Howard, 1984).

2.4 Audit Committee

The Audit Committee is considered to be a key self-regulatory governance mechanism with significant oversight responsibilities over financial reporting, internal control and Audit activities (Blue Ribbon Committee 1999). The controversy over financial reporting problems and inadequate audit committee oversight, resulting in grater demand for understanding the impact that audit committees have on the financial reporting process (Abbot etal, 2004). Recommendations by authoritative bodies such as the SEC (1991), the BRC (1999), have stressed the importance of having independent, knowledgeable and active audit committees to enhance their financial reporting monitoring role.

The existence of an effective audit committee is seen to be beneficial to both the internal and the external auditors (McMullen, 1996) as audit committee aim to facilitate the communication between management, the internal auditors and the external auditors of an organization. Furthermore, audit committees also assume important responsibilities such as reviewing the internal audit program and ensuring the adequacy of the scope of internal audit activities.

2.5 Independence of Audit Committees

Independence has been defined as having "no relationship to the corporation that may interfere with the exercise of their independence from management and the corporation" (BRC, 1999).

Independent audit committee members are more likely to demand higher audit quality in order to protect their reputation (Abbot & Parker, 2000). According to reputational capital enhancement theory, independent directors generally hold a high reputation in the business community and they view the directorship as a means of further developing their reputation as experts in decision making (Fama & Jensen, 1983). It is thus argued that independent directors are more likely to fear damage to their reputation as a result of financial misstatements, and the resulting reputational damage.

Independent directors are not economically dependent on the company, and thus are arguably less biased over an entity's financial outcomes (Carcello & Neal, 2000). Several empirical studies that have explored the association between audit committees independence and financial reporting outcomes indicate that firms with more independent members display better financial reporting quality.

2.6 Audit Committee and the External Auditor

It is important to recognize that the external auditor can contribute greatly to an audit committee's success. The auditor and the committee have common objectives and the committee is entitled to significant support from an auditor in its search for ways to strengthen the company's accountability and transparency.

Auditor is expected to provide a substantive letter of recommendations commenting on control weaknesses he observes as a result of the audit (Schneider, 1985). Also, the committee may ask the auditor to adjust the scope of his examination so as to cover a specific activity and bring his comments to the committee.

3 Methodology

Having spell out the statement of problem and the objectives of this study, it is imperative to elucidate on the methodology used to gather the data necessary for the study. This study employs a survey research design. Both secondary and primary were employed. On secondary data, relevant information from the annual reports of reporting entity as well as from the Nigerian Stock Exchange (NSE) Fact Book 2009 were examined for the accomplishment of the set objectives. Questionnaire and interview were drawn for the accounting firm and their responses are noted for the discussion of results. The respondents were selected randomly from a stratified sample. Ten Banks and their auditors were sampled out for the study, covering a period of five years (2004-2008) from the Nigerian Stock Exchange Fact Book 2009 in order to identify the number of documentary evidence by each accounting firms and the level of banks performances. The Pearson product movement correlation was used to test the two hypotheses.

4 Results And Discussions

This sub-heading deals with presentation and analysis of data. The hypotheses were also tested for discussion of results. The results form the basis for recommendations necessary for banking performances.

4.1 Respondents and Their Clients

Table 1: List Of Accounting Firms And Their Clients (2004-2008)

	Accounting Firms	**Banks Audited**
1	KPMG	Access Bank Plc
2	Akintola Williams Delaitte	Afri Bank Nigeria Plc
3	Price water house coopers	Bank PHB Plc
4	Price water house coopers	Diamond Bank Plc
5	Price water house coopers	Eco Bank Nigeria Plc
6	Akintola Williams Deloitte	Fidelity Bank Plc
7	Akintola Williams Deloitte	First Bank Plc
8	Price water house coopers	First City Monument Bank Plc
9	Akintola Williams Deloitte	First Inland Bank Plc
10	KPMG	Guaranty trust Bank Plc

Source: Nigerian Stock Exchange Fact Book 2009.

Table one shows list of Accounting firms and their client (2004-2008). These three accounting firms listed here are among the first four big accounting firms in Nigeria**.** KPMG is an accounting firm to Access Bank Plc, and Guaranty Trust Bank Plc. Akintola Williams Delaitte is an accounting firm to Afri bank Nigeria Plc, Fidelity Bank Plc, First Bank Plc and First Inland Bank Plc. Price Water House Coppers is an accounting firm to Bank PHB Plc, Diamond Bank Plc, Eco Bank Plc and First City Monument Bank Plc.

4.2 Testing the First Hypothesis

H_0: There is no significance relationship between auditors report and bank performance in Nigeria.

Table 2: Auditors' Report and Bank Performance.

Number of Documentary Evidence		**Level of Performance**
Firm 1	29	4
Firm 2	7	1
Firm 3	2	2
Firm 4	3	2
Firm 5	2	1
Firm 6	3	2
Firm 7	2	2
Firm 8	24	19
Firm 9	2	1
Firm 10	2	1

Source: Field work 2011

Table two shows the analysis of the test of the first hypothesis. The table outlined the list of each accounting firms' numbers of documentary evidence and their level of bank performance.

Table 3: Correlation of Documentary Evidences and Level of Performances

S/N	**X**	**Y**	**X^2**	**Y^2**	**XY**
1	29	4	841	16	116
2	7	1	49	1	7
3	2	2	4	4	4
4	3	2	9	1	6
5	2	1	4	2	2
6	3	2	9	2	6
7	2	2	4	1	2
8	24	19	576	361	456
9	2	1	4	1	2
10	2	1	4	1	2
Total	**76**	**34**	**1504**	**374**	**603**

Source: Field work 2011

Table three shows the correlation of documentary evidence and their level of performance. The analysis is shown below:
Applying the formula, one will have:

$$R = \frac{n\sum xy - \sum x \sum y}{\sqrt{n\sum^2 \quad -(\sum x)(\sum y^2 - \sum y)}}$$ (Abdul-Maliq, 2006)

Where:

R = The correlation of auditors' reports and the level of performance of the Banks, **n** = Number of audit firms, **x** =Evidence from Banks, **y** = Level of Performance, **Rc** = Re-calculated, **Rt** = Re-calculated Table, **Df** = Degree of Freedom

$$R = \frac{10 * 603 - 76 * 34}{\sqrt{10 * 1504 - (76^2)(10 * 394 - (34)^2)}} = 0.679$$

R-Calculated = 0.679
Rc = 0.679 > Rt = 0.632 at 5% level of significance and a df of 8. The null hypothesis is therefore rejected.

During the findings, it was discovered that auditors' report is very significant to bank performance. Thus, auditors report is a vital medium for communicating to an organization's management, problems, which if corrected, leads to good performance. The empirical evidence agrees with the position of Pany (1997), Kurt and Whittington and Millichamp (1996). They post that good auditors' report and auditors' management letter is necessary for bank performance.

4.3 Testing the Second Hypothesis

H_0: There is no significant impact of management letter on the performance of banks in Nigeria.

Table 4: Management Letter and the Performance of Banks

No. Of Items In The Letter Of Weakness	Level Of Compliance By The Management Of The Banks
(X)	(Y)
5	4
2	2
6	5
8	6
3	3
4	3
4	4
5	3
6	4
3	2

Source: Field work 2011

Table 5: Correlation of Items of Letter of Weakness and Level of Compliance.

S/N	**X**	**Y**	**X^2**	**Y^2**	**XY**
1	5	4	25	16	20
2	2	2	4	4	4
3	6	5	36	25	30
4	8	6	64	36	48
5	3	3	9	9	9
6	4	3	16	9	12
7	4	4	16	16	16
8	5	3	25	9	15
9	6	4	36	16	24
10	3	2	9	4	6
TOTAL	**46**	**36**	**240**	**144**	**184**

Source: Field work 2011

Table five shows the correlation of items of letter of weakness and level of compliances by the management of banks. The analysis is shown below:
Applying the formula:

$$R = \frac{n\sum xy - \sum x \sum y}{\sqrt{n\sum x^2 - (\sum x)^2\ (n\sum y^2 - (\sum y)^2}}$$

Where:
R = The correlation of items of the letter of weakness and the level of compliance of the Banks. **N =** Number of Banks, **X** = Items of management letter, **Y** = Level of compliance, **RC** = R-Calculated, **R**t = R-Calculated table, **Df** = degree of freedom.

$$R = \frac{10 * 184 - 46 * 36}{\sqrt{10 * 240 - (46)^2 (10 * 144 - (36)^2}} = 0.911$$

R = 0.911
RC = 0.911, Rt = 0.632, Ls = 5%, df = 8
Since Rc = 0.911 > Rt = 0.632 at 5% level of significance and df of 8, the null hypothesis is rejected.
The finding also shows that management letter is necessary for bank performance. Consequently, there is significant impact of management letter on the performance of banks in Nigeria.

5 Conclusion

5.1 Conclusion/Findings

On the basis of review of related literature, analysis and interpretation of data and general observations, the following are the major findings/conclusions of the paper:

(i) Information Technology and other environmental factors brought dramatic changes to business processes, business organization and to auditing in the Nigerian banking industry. These changes demand reconsideration of the auditor's role in the capital market of Nigerian economy, especially in the banking sector.
(ii) Auditing practice has evolved over the decades from a relatively straight forward historical verification of books of accounts; to it dynamic economic agent in owner-auditor-manager relationships. Auditors' should be conversant with the cardinal activities of banks and necessary advice should be made available to the banks.
(iii) Auditor's report has impact on bank performance in Nigeria. This agrees with the position of Millichamp (1996) that, to a very large extent, banking performance is being influenced by auditors' report. Consequently, good auditors' report should be encouraged.
(iv) Also, the empirical evidence does not agree with literature on the impact of management letter on the performance of banks in Nigerian. The finding shows that there is significant impact of management letter on the performance of banks in Nigeria.

5.2 Recommendations

1. The audit committee must walk a fine line between inquiry and interference. It should be free to study any aspect of the company's activities and ask any questions it deems appropriate under no circumstance should management restate the scope of the audit committee's inquiry.
2. The committee must not encroach on management's within the guidelines established by the full board, to allocate resources and take risks. Management is responsible for operations, and the audit committees must not interfere with management's discharge of that responsibility. Management must, however, extend all necessary cooperation to the audit committee.
3. The auditor of a reporting entity should not out of his negligence fail to report certain weakness to management. Therefore, the adoption of management letter should be regarded and recognized as an essential component of any audit assignment.
4. The professional bodies, such as ICAN, ANAN who gave license to their members to

practice as an accounting firm based an the professional body in the membership ethical code of conduct should be a watch dog on their members activities so that any member who fail to follow the due process in carrying out the audit assignment should be brought to book and withdraw their license from practice.

5. The auditors while carrying the audit assignment, should not be seen as a beggars for auditing jobs and as they enter into auditing agreement with client, they should approach the whole process of job acceptance and the performance of the job itself with high degree of professionalism.

6. Accounting firms should initiate intensive and extensive research programmes into the theories, practices of auditing and investigation so that the impact of internal audit contribution to external audit on both audit fees and audit quality is an area that needs further examination.

7. Implementation of auditors; recommendations contained in management letters should be timely in order to close gaps and rectify weaknesses likely to cause fraud, thereby adding more reliability to the final report of the auditors.

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