THOUGHT LEADERSHIP INSIGHTS

ATTENTIONS: AUDITOR INDEPENDENCE AND SOUND FINANCIAL REPORTING IN NIGERIA

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Auditing is a mandatory process carried out by a company on its financial statements in order to get an unbiased and independent audit opinion of the financial position of the company. It is carried out to reassure stakeholders that the financial statements present a true and fair view of the financial performance of a company; and whether the financial statements comply with relevant laws.

In Nigeria, audit practice is primarily governed by legislations such as ***Financial Reporting Council of Nigeria Act Cap. A15 Laws of the Federation (LFN), 2011 (FRCN Act), Companies and Allied Matters Act Cap. C20, LFN, 2004 (CAMA)***, etc. There are also accounting guidelines and codes of corporate governance such as: ***International Federation of Accountants Code of Ethics (IFAC), International Standards of Auditing (ISA), International Financial Reporting Standards (IFRS), FRCN Draft National Code of Corporate Governance 2018 (FRCN Code)***[1], ***Securities and Exchange Commission Code of Corporate Governance for Public Companies 2011*** (***SEC Code***), ***Central Bank of Nigeria Code of Corporate Governance for Banks and Discount Houses in Nigeria 2014 (CBN Code), National Insurance Commission Nigerian Code of Corporate Governance for the Insurance Industry 2009 (NAICOM Code)*** etc.[2] Pursuant to the foregoing, relevant and varied regulatory oversight is respectively exercised by FRCN, CBN, SEC, NSE, Corporate Affairs Commission (CAC), NAICOM, etc.

> AUDITOR INDEPENDENCE IS A VERY IMPORTANT ELEMENT IN GUARANTEEING SOUND FINANCIAL REPORTING OF CORPORATE ENTITIES.

Auditor independence is a very important element in guaranteeing sound financial reporting of corporate entities. Auditors have a duty to verify the existence of any error or fraud in the financial statements of a company that could be materially misleading.[3] Thus, their independence is essential in achieving a credible audit profile that is true and fair. This in turn helps to boost investor's confidence; supports shares value in the capital market; attracts foreign investments etc.

Preparation of financial statements is one of the many ways directors are accountable to the shareholders, because it gives a breakdown of the company's operating performance during the year. As a result, creditors, investors and other stakeholders rely on the audit opinion of the financial

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1 The draft ***FRCN Code***, though yet to be implemented, has been formulated to be consistent with best practices whilst also promoting ease of doing business. Violation of its provisions will occasion sanctions against persons, firms and companies involved in such violation - ***Article 37.2 FRCN Code***

2 Relevant legislation regulating professional bodies also include: ***Association of National Accountants of Nigeria (ANAN) Act Cap. A26, LFN, 2004; Institute of Chartered Accountants of Nigeria Act, Cap. I11, LFN, 2004(ICAN Act); Chartered Institute of Taxation of Nigeria Act, Cap. C10, LFN, 2004 (CITN Act); Institute of Chartered Secretaries and Administrators of Nigeria Act, Cap. I13 LFN, 2004 (ICSAN Act) etc.***

3 Per **Lord Oliver** in ***Caparo Industries Plc v. Dickman [1990] 1 All ER 568*** *where* he noted that "*an auditor's duty was first of all, to protect the company itself from the consequences of undetected errors or, possibly, wrongdoing.*"

statement, in making investment decisions. The sensitivity of the role requires that the independence of the auditor is non-negotiable.[4]

This article seeks to highlight threats, solutions and the impact of audit independence in ensuring sound financial reporting in Nigeria.

Auditor's independence is the cornerstone of an audit report, thus it implies that the audit opinion should not be influenced or tainted by the relationship between the auditor and the client company. By ***section 46 FRCN Act***, an auditor is mandated to carry out its audit duty independently in accordance with the *Code of Conduct and Ethics* in force and not engage in any activity which is likely to impair his independence. An auditor is also expected to carry out his duties with care, diligence and skill as is reasonably necessary in each particular circumstance. The Court of Appeal (CA) in ***G.E.B. Plc v. Odukwu***[5] held that *"The statutory report shall, so far as it relates to receipts and payments of the company on capital account, be certified as correct by auditors of the company."*

Where a company suffers loss or damage as a result of the failure of its auditor to discharge its duty the auditor shall be liable for negligence - ***section 368(1)*** and ***(2) CAMA.*** Conversely, the external auditor may be held liable to third parties who are damaged by relying on decisions based on the information in audited reports, although limited by the *doctrine of privity*. For instance, in ***Al Saudi Banque v. Clarke Pixley,***[6] the Court ruled that *"no duty of care is to exist of an auditor to the credit institution because the defendant/auditor*

had not issued his report to his client with the intention or the knowledge that the audit opinion would be communicated to the credit institution."

Threats to Auditors' Independence

Some of the significant factors threatening the external auditors' independence are: reliance on the management of the company for information and explanations needed to enable them provide an audit opinion; an audit firm being overly dependent on a single audit client for a large proportion of its income, which may impair its objectivity due to fear of losing a major source of income; the need to be re-appointed by the company after expiration of their tenure, thus auditors might be less stringent in their audit work; provision of non-audit work to a client company might make it difficult for the audit firm to criticise advice provided by its arm of non- audit services etc.

The ***IFAC*** highlights certain threats likely to influence the integrity and objectivity of the independence of the auditors. They include: [7]"(*Advocacy threats*) - a position or opinion is promoted by the auditor to the point that subsequent objectivity may be compromised; (*Intimidation threats*) - threats actual or perceived from a higher authority in an organisation; (*Familiarity threats*) - presence of a mutual business interest with company or any of its officers or personal relationship

4 Auditing is a point of great reference in verifying the due discharge of directors' obligation to keep proper books of account and to present audited financial statements to members in general meeting; and it also gives users of a company's financial statements some assurances that the information in the statements is believable: *Professor Joseph E.O Abugu,* ***'Principles of Corporate Law in Nigeria'*** *(2004), 689 - 690.*

5 ***(2016) LPELR-41489(CA)***

6 ***[1990] 1 Ch. 313***

7 ***Article 100.10 IFAC***

between a member of the audit firm and an employee of the company); (*Self-interest threats*) - as a result of the financial or other interests of a professional accountant or of an immediate or close family member; and (*Self-review threats*) - re-evaluation of the previous audit opinion by the professional accountant responsible for that judgement.

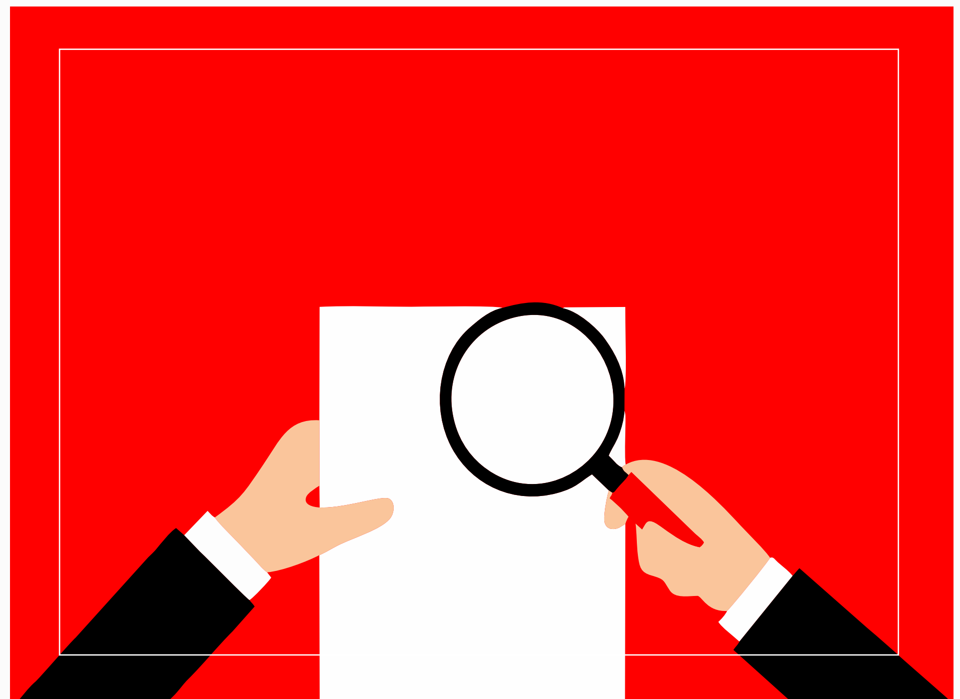
Based on the foregoing, if an organisation wants an independent auditor, they have all the powers to make it happen. It is therefore advisable that they begin by identifying these threats and putting measures in place in order to limit them to an acceptable level of risk. These measures however may include; having more than one external auditor to serve as checks on each other's audit work; ensuring the internal control system and risk management within the company is effective; and ensuring that the board operates good corporate governance.

Solutions to Achieving Auditor's Independence

Various corporate scandals and failures owing partially to poor auditing and lack of auditor independence, happening globally necessitated the need for a solution. The Enron Corporation (Enron), Worldcom Corporation (Worldcom) in the US are good examples to illustrate this epidemic, whilst in Nigeria we have scandals like Lever Brothers (now Unilever) and Cadbury Nigeria (Cadbury).

In the Cadbury scandal of 2006, the external auditors were accused of colluding with the company's executives to cover up the falsification and overstating of the company's profits by up to ₦15 billion between 2002 and 2005. In addition, the Audit Committee expected to assist in integrity oversight of the company's financial statements in accordance with ***section 359(3) & (4) CAMA*** and ***Article 30.4(a) SEC Code***[8] - failed to review the effectiveness of the internal audit and carry out investigation as necessary. Consequences followed as a result, including making adjustments to report losses for 2006 and 2007; negative reaction of the market via drop in Cadbury Nigeria Plc's share price and market capitalisation[9] and also potential cross-border impact, viz negative perception amongst foreign investors lost confidence in investing in Nigeria; the sales of Cadbury decreased nationwide etc.[10]

Also, in the Unilever case of 1997, the auditors were indicted for facilitating the falsification of



8 ***Section 357 (3)** & **(4) CAMA provides that*** *"In the case of a public company, the Audit Committee shall examine the auditors' report and make recommendations thereon to the annual general meeting as it may think fit"*; and ***Article 30.4(a) SEC Code*** provides: *"the Audit Committee should assist in ensuring the integrity and compliance with legal requirements of the company's financial statements, and to independence of external auditor; and performance of the company's internal audit function as well as that of external auditors."*

9 Auditor independence is equally relevant and important in private companies because though their share value might not be affected in the stock market, the consequence of a false financial statement can also result to loss of investor and shareholder confidence in the company, inability to monitor company's progress etc. can be affected. Also considering the cost of auditing to a small company and the benefits of having a sound financial report, cost it nothing compared to the benefits such as fraud prevention, business growth, reassuring stakeholders about the accounts, assessing tax, gathering information about profit or loss etc.

10 *Babs Ajayi, **'Cadbury: Nigeria's Enron'**, Nigeria World, Feature Article*, 14th December, 2006: https://nigeriaworld.com/feature/publication/babsajayi/121406.html (last accessed 24th July, 2018)

accounts and overstating the profits of Unilever by the then Managing Director (MD). Almost similar consequences followed as in the Cadbury scandal.[11]

The above scandals resulted in SEC sanctioning some executive and non-executive management, including prohibition from seating on boards or participating in capital market activities for stipulated periods. This in turn led to litigation, including appeals which made the disputes and enforcement actions, become drawn out.

In the wake of various corporate failures, partially due to the impairment of auditor's independence, various countries and organisations came up with various legislations to sustain the independence of auditors. The US for instance, came up with the ***Sarbanes- Oxley Act 2002 (SoX)*** seeking to register, regulate, control and monitor external auditor activity, thus creating a standard for external auditors' independence. Its establishment has helped to ensure effective corporate governance practice and protect investors, shareholders, and other stakeholders in a company.

European Union's Audit Reform Legislation came into force 2014 to impact mostly public interest entities in following ways: mandate audit firm rotation; impose additional restriction on providing non-audit services to client companies; creating new requirements for audit committee in performing their oversight audit function; and creating new reporting requirements for auditors.[12] South Africa's ***Auditing Profession Act 2005 (APA)*** seeks to regulate the conduct of registered auditors. For instance, an auditor may not conduct an audit in an entity, if the auditor has a conflict of interest.[13] Nigeria also incorporated provisions in its existing legislations to ensure the independence of external auditors.[14] For instance, in addition to earlier cited provisions, ***Article 33.1 SEC Code*** provides that "*... to guarantee the independence of the external auditors, companies should rotate both the audit firms and audit partners.*"

WHERE A COMPANY SUFFERS LOSS OR DAMAGE AS A RESULT OF THE FAILURE OF ITS AUDITOR TO DISCHARGE ITS DUTY, THE AUDITOR SHALL BE LIABLE FOR NEGLIGENCE

Audit Firm Rotation

This involves disengaging the services of the audit firms after a period of time. Here, audit firms are disengaged after ten (10) years, but may be reappointed after another seven (7) years of their disengagement - ***Article 15.2 FRCN Code & Article 33.2 SEC Code.***[15] The need for firm rotation was illustrated by the Worldcom scandal, where it was discovered that the auditors - Arthur Andersen (Andersen) - were earning three (3) times more in consultancy fees than from their audit work. As a result, Andersen overlooked Worldcom's wrongful acts of inflating its profits by falsely accounting for expenses.

It is believed that this policy is expected to enhance auditor independence because an audit firm is less likely to be involved in financial manipulation if its tenure was already certain compared to if its tenure is indefinite. Audit firm rotation also allows incoming audit firms act as watch dogs on the previous auditors minimizing the chances of audit malpractice going unnoticed.[16]

Audit Partner Rotation

Audit partner rotation on the other hand, involves rotating the audit partner's assigned to undertake external audit of the company. According to the ***FRCN Code*** this must be carried out

11 *Gregory Austin Nwakunor, **'Forgotten Brides: Companies that Colonialisation Built in Nigeria'**, The Guardian, 20th December, 2015:* <https://guardian.ng/saturday-magazine/cover/forgotten-brides-companies-that-colonialisation-built-in-nigeria> (last accessed 27th July, 2018).

12 *James Chalmers, **'EU Audit Reform Legislation – The Facts'**, PWC Global, February,2015:* https://www.pwc.com/gx/en/services/audit-assurance/publications/eu-audit-reform-legislation.html (last accessed 28th July, 2018).

13 ***Section 44(6) APA.***

14 However, where there is a difference between the provisions of this Code and any sectoral governance guidelines, the stricter provision shall apply- ***Paragraph 2, Relationship with Sectoral Guidelines, FRCN Code.***

15 However, ***Article 5.2.12 CBN Code*** provides that an audit firm should be disengaged after ten (10) years and reappointed ten (10) yeas after disengagement; on its own part, ***Article 8.0 NAICOM Code*** provides that the external auditor shall be appointed for a maximum period of five (5) years.

16 *Len Boselovic, **'Cooked Books Understanding What Worldcom Did'** Old Post-Gazette - Business News, 28th June, 2002:* http://old.post-gazette.com/businessnews/20020628account0628p4.asp (last accessed 24th July, 2018).

every five (5) years to guarantee independence and without compromising continuity of the external audit process - ***Article 15.4 FRCN Code***.[17] Supporters of this solution believe that personal relationship would have developed between the partner (not the audit firm) and the company, capable of influencing its independence.

However it is the writer's opinion that, rotating the audit firm is more viable to yield better results because partners in the same firm can still influence each other's performance since they both represent the same organisation. For instance, audit partner rotation would not have worked in the case of Andersen and Enron Corporation because Enron was a vital client for the Houston office of Andersen, thus changing the partners would have had little effect.

Restrictions on Performance of Non-Audit Work for a Client Company

Some audit firms engage in additional non-audit work such as tax advisory & consultancy, internal audit services, valuation and actuarial services, etc. However, performing both audit and non-audit functions has proven to compromise the objectivity of the auditor's opinion on financial statements. This is because the audit firm is unlikely to give an independent opinion on transactions recommended by its consultancy arm. This risk became apparent in the wake of the aforementioned Enron scandal, where Andersen earned more income in providing non-audit functions for Enron than from its audit work. It was therefore claimed that it would have been difficult for Arthur Andersen to question the wrong financial practices in the company because it would have meant losing the audit work and the substantial fee in the non-audit roles; and also it would have been difficult to challenge its non-audit consultancy opinion reflected in the financial statement.

There have been various views and approaches on how best this can be controlled, focusing on: total restriction of all non-audit work; no prohibition of non-audit work; or partial prohibition of non- audit work. However our laws do not prohibit non-audit work provided constant reviews are done on the non-audit work to ensure no conflict of interest- ***Article 6.4.7.8 & 6.4.7.9 FRCN Code*** and ***Article 30.4(k) SEC Code***. Nonetheless, it is the writer's opinion that these solutions will be better effective with a total prohibition from non-audit work, working hand in hand with rotation of the audit firm. This is because total prohibition helps the audit firm to focus better on an area which will improve efficiency, which in turn will ensure proper investor protection.

> "As Long As Investor Protection Remains A Matter Of Utmost Concern To Regulators And Other Stakeholders, Issues Of Safeguarding Auditor Independence Will Always Command Premium Attention"

Conclusion

The independence of auditors is essential to the provision of an objective opinion on the truth and fairness of the financial statements. This will help minimise corporate failures through appropriate safeguards that deter and expose improper corporate governance practice. As long as investor protection remains a matter of utmost concern to regulators and other stakeholders, issues of safeguarding auditor independence will alwa

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17 ***Article 33.2 SEC Code*** provides that an audit partner rotation should be carried out from time to time.