AUDIT QUALITY AND DIRECTORS TUNNELING OF CONSUMER GOODS FIRMS IN NIGERIA

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ABSTRACT

This study investigates the effect of audit quality on directors tunnelling in Nigeria drawing samples from listed consumer goods firms on the floor of the Nigerian Exchange Group market. While directors tunnelling proxied by directors' remuneration is the dependent variable, the independent variables adopted for this study includes audit firm size, audit independence, and audit tenure. Furthermore, in line with related extant literature, the researchers employed the variable of firm age to control our model. Data set employed in this study spans through the periods between 2011 and 2020.In the light of this, the empirical result of this study leads to the conclusion that out of the three independent variables adopted in this study, only big4 auditors and auditors' independence significantly affect directors tunnelling. Specifically, the researchers conclude that when a big4 firm audit the accounts of the firms in our sample, directors tunnelling declines. Similarly, the researchers conclude that the independence of the auditor decreases directors tunnelling. Succinctly, the researchers recommend that firms should strive towards promoting audit independence to reduced directors tunnelling from the firms. Furthermore, the researchers recommend that indigenous audit firms should be patronized to cushion the increase in directors tunnelling when a firm chooses a big4 auditors.

KEYWORDS: *Cushion, Tunneling, Remuneration*

1.0 INTRODUCTION

Tunneling is a strategy used by controlling owners to get a competitive advantage through legal or unlawful means (Faccio, Lang, and Young, 2001) **[1].** When the controlling shareholders' benefit flow is clearly visible, it can be identified as moving in one of two directions: from the subsidiary to the parent company or from the parent company to its subsidiary. Tunnelling, according to Johnson, La Porta, Lopez-de-Silanes, and Shleifer (2000) **[2],** refers to the expropriation activity carried out by the controlling shareholders of a corporation at a lower level (e.g., subsidiary) to the higher level (parent company). Controlling owners' exploitation of minority shareholders has piqued the interest of academics. When the majority shareholders control the corporation, for example, Shleifer and Vishny (1986) **[3]** find that the agency problem is no longer about the conflict of interest between management and shareholders, but about how to prevent dominant shareholders from abusing minority shareholders. Johnson, La Porta, Lopez-de-Silanes, and Shleifer (2000) **[2]** coined the word "tunnelling" to characterize asset appropriation by large owners who move assets and profits for themselves, either legitimately or criminally. Tunneling is not only harmful to minority shareholders' interests, but it also hinders the development of the capital market (Wurgler, 2000; Bertrand, Mehta, & Mullainathan, 2002) **[4,5].**

Tunneling is especially dangerous in emerging nations because of weak corporate governance frameworks that fail to protect minority shareholders and corporate ownership arrangements that encourage expropriation (Aharony, Wang, & Yuan, 2010; Claessens, Djankov, & Lang 2000) **[6,7].** Despite the fact that numerous tunneling strategies have been proposed, much empirical study has focused on Related Party Transactions (RPT). RPTs have a lot of potential to be a convenient vehicle for expropriating firm value from minority shareholders due to weak corporate governance systems and existing corporate structures in many countries throughout the world (Gao & Kling 2008) **[8].** RPTs are thought to be a high-risk factor for investors (Kohlbeck & Mayhew 2010) **[9].** Abusive RPTs are rapidly posing a threat to the Asian capital market's credibility.

Despite a lot of anecdotal evidence, there isn't much direct systematic information on the exact transactions that tunneling happens through. The majority of academic studies (La Porta, Lopez-de-Silanes, Shleifer, and Vishny, (LLSV), 2000) **[10]** has sought to assess tunneling indirectly. Furthermore, there is conflicting evidence in the literature suggesting minority shareholders lose money as a result of specific tunneling operations. Despite the fact that most academic work on directors' tunneling has been concentrated on a few developed countries such as the United States, United Kingdom, and China in the last two decades, due to data availability, most academic work on directors' tunneling has been concentrated on a few developed countries such as the United States, United Kingdom, and China. Based on the aforesaid, we investigate audit quality and director tunneling among Nigerian publicly traded consumer products companies.

2.0 Conceptual Literature

Directors Tunneling

The term of tunnelling refers to the expropriation activity conducted by the controlling shareholders of a company in the lower level (e.g., subsidiary) to the higher level (parent company). According to them the term "tunnelling" describe the asset appropriation conducted

by large shareholders who legally or illegally transfer assets and profits for themselves. Johnson et al. (2000) list several methods by which tunnelling is achieved: transferring growth opportunities belonging to listed company to themselves or their subsidiaries; transferring profits via intra-group transactions from listed companies to other subsidiaries they own or control; using assets or capital belonging to the listed company or using them as collateral or guarantees for their financing activities; and capital operations aimed at diluting the interests of other shareholders. According to Henemana & Schwab (1972), tunnelling was first used in this way in the Czech Republic during the first half of the 1990s, when several large, previously privatized banks and factories unexpectedly went bankrupt. It was discovered later that the managements of these companies were deliberately transferring company property and real estate into their own private businesses, sometimes in offshore locations. The term later became a common label for this kind of criminal activity among Czechs and Slovaks. The transfers of firm resources were accomplished through huge loans that were issued without any expectation of repayment, massive overpayment for outsourced services, or simply by selling corporations real estate for a fraction of its market price. The main conditions enabling such a fraud are weak law against conflict of interest, non-existent legal liability of managers for leading their employer towards bankruptcy, and incompetence of financial authorities.

Audit Quality

There is no universally accepted definition of audit quality since different authors define it differently. However, audit quality definition as put forward by DeAngelo (1981) **[11]** is the most widely used definition which state that the quality of audit services is defined to be the market assessed joint probability that a given auditor will both (a) discover a breach in the client's accounting system, and (b) report the breach. Many researchers then used this double approach to further define audit quality with details in competence and independence, while others adopt it as a foundation to identify other audit quality attributes. For instance, Seyyed (2012) provides further explanation that audit quality could be a function of the auditor's ability to detect material misstatements and reporting the errors. Together with other similar definitions, they all emphasize on two of the most important aspects of audit quality, namely auditor ability or auditor effort, and auditor independence. Therefore, this stream of definitions is mainly about the auditors' quality. Another stream of defining audit quality focuses on the accuracy of the information reported by the auditors. Choi and Yang (2008) **[12]** suggest that high audit quality would improve the reliability of financial statement information and allows investors to make more precise estimate of the firm's value. Schauer (2002) also proposed that "higher quality audit increases the probability that the financial statements more accurately reflect the financial position and results of operations of the entity been audited". In other words, audit quality is part of the quality of accounting information disclosed (Clinch, 2010).

Audit Firm Size

Auditor firm size is defined as the category of independent audit firm(s) engaged by an entity to perform its audit in accordance with statutory regulation and professional requirements. The audit firm in accounting literature is broadly categorized according to variations in firm size, mostly in line with big 4/non-big 4 firm. As such, the studies further categorizes auditor type into three classes; Single Big4, Single Non-big4 and joint audit team of Big4/Non-big4 audit firms looking at the audit firm structure in Nigeria. The single audit firm category refers to the

engagement of one distinct audit firm either a Big4 or a Non-big 4 firm. Wibowo and Rosienta (2009) state that audit quality is often tied to an audit firm scale. DeAngelo (1981) maintains that big audit firms have a superior audit quality, since they already have invested in large audit technology and staff training, and thus they are more competent and more accurate in detecting the problems related to misstatement and going concern assumptions than small audit firms

Audit Independence

The value of an audit lies on the perception coming from users of audited statements on the auditor's ability to detect errors or breaches in the accounting system and to resist client pressures to disclose such discoveries (DeAngelo, 1981). The calculation of fees is a sensitive issue, where professional ethics and the interest of auditing did not allow that the prices budgeted are too high or too low. Marra and Franco (2001) suggest that the best way for clients to charge fees might be using a fixed and invariable value. Nevertheless, this procedure might lead to very high fees, damaging the client, or very low, damaging the auditor, having in mind that prices are budgeted by taking into account the number of hours or days required to conduct the audit. Audit fee may have influence on audit quality and Concept of Going concern. One of the major threats to auditor independence is the fees perceived by the auditor for audit. Auditors have economic incentives that threaten their independence as well as market-based institutional incentives to act independently.

Audit Tenure

Audit tenure is defined as the number of years that an auditor is retained by a firm. Tenure within three years is considered to be short tenure, and more than nine years is considered long tenure. Academicians and accounting professional have argued and asserted that audit firm tenure could help to maintain auditor independence. Also, the auditor will be in a stronger position to resist management pressure and be independent with integrity and will provide objective professional judgment when there is a mandatory audit firm tenure. For auditor to maintain auditors' independence and objectivity, audit firm should periodically relinquish their client. Examples of countries that have oversight boards and have implemented mandatory audit tenure are United Kingdom 2003, Austria and Canada 2005, Spain 1989, South Korea 2006, Brazil 1999, Italy 1974, France 1998-2004, Singapore 2002.

Theoretical Review

Agency Theory

Agency theory (Fama and Jensen, 1983) **[13],** the dominant theory in accounting and audit (Kevin & Leigh, 2003) **[14]** suggests contractual mechanisms such as corporate governance are put in place to monitor management to address the separation in ownership and control. Under the agency view, management are viewed as self-interested actors who behave opportunistically, favouring their own interests over those they represent even if these actions are detrimental to owners (Jensen and Meckling, 1976) **[15].** Thus, two mechanisms are identified to curb this behaviour: contractual mechanisms to align management goals with the principal; and information systems introduced to reduce information asymmetry between owners and management which can also restrict opportunistic behaviour through the realization by management that they cannot deceive the monitors (Kevin & Leigh, 2003) **[14].** The agency

perspective considers independence from management and expertise as the primary and central attributes of a monitor.

Empirical Literature and Hypotheses Development

Audit firm Size and Directors Tunneling

The size of audit firm has been used as a surrogate for audit quality, that is, large audit firms have a reputation to safeguard and therefore will ensure an independent quality audit service. Larger audit firms have better financial resources and research facilities, superior technology, and more talented employees to undertake large company audits than do smaller audit firms. Their larger client portfolios enable them to resist management pressure, whereas smaller firms provide more personalized services due to limited client portfolios and are expected to succumb to management requirements. Therefore, the size of audit firm is an important characteristic that reflects auditor independence. Thus, the issue of maintaining auditor independence is more crucial for smaller firms than larger firms. A large body of research examines the relationship between audit firm size and audit quality. Large audit firms are motivated to perform better audits because they have a high reputation and do not want to risk losing their reputation. They also have substantial material and human resources to attract more specialized and skilled personnel. Large audit firms earn more revenue because they reduce their clients' exposure to prosecution because of having more experience. **[16]** Hence, the researchers hypothesized that

$H0_1$: Audit firm size has no significant effect on directors tunneling of listed consumer goods firms in Nigeria

Audit Independence and Directors Tunneling

In modern corporations characterized by the separation of ownership and control, auditors play an important monitoring role Stakeholders rely on financial information provided by management for investment, financing and other decisions. To assure users of the reliability of the financial statements, the board hires independent auditors to attest to the reliability of the statements. However, management (subject to ratification of the shareholders) controls the process of hiring and firing independent auditors and also pay quasi-rents associated with the audit contracts. In this situation, auditors may be incentivized to yield to management pressure which implies that the reliability of the information contained in audited financial statements depends upon the level of independence of the auditor. **[17]** Hence, the researchers hypothesized that

$H0_3$: Audit independence has no significant effect on directors tunneling of listed consumer goods firms in Nigeria

Audit firm Tenure and Directors Tunneling

Academic literature shows mixed results on the effect of auditor tenure on directors tunneling. To this extent, Hohenfels and Quick (2018) reports a positive effect of auditor tenure on earnings management which may lead to distress, arguing that investors perceive a potential impairment of audit quality as the tenure increases which would affect earnings quality. On the other hand, as auditor tenure increases, the auditor should become better at recognizing material misstatements by gaining experience and better insights into the clients' business strategies and internal financial reporting process. Several studies show that a long audit relationship improves the

conditions of the outcome of the audit process. Thus, they argue that the duration of the audit-client relationship can have a positive impact on the quality of the audit performed hence the possibility of detecting any material mis-statement thereby lowering directors tunneling. **[18]** Hence, the researchers hypothesized that

$H0_2$: Audit independence has no significant effect on directors tunneling of listed consumer goods firms in Nigeria

3.0 Methodology

In relation with extant literature, the researchers employed a firm-level approach based on an expo-facto and non-experimental research design. The study is longitudinal covering a period of ten (10) years. That is, from 2011 to 2020 employing listed consumer goods firms on the floor of the Nigerian Exchange Group (NGX). The sampling technique employed is purposive since firms were included in the sample on certain selection criteria. These criteria were based on the view that the firms are listed on the Nigerian Exchange Group (NGX) market from 2011-2020; there were access to their annual financial reports within the period and they were not firms operating subsidiaries in Nigeria that are not listed in the Nigerian Exchange Group (NGX). Newly listed firms and delisted firms were excluded from the study. Thus, only consumer goods firms that had all relevant data due to continuous existence were included in the sample. The final sample size consists of 16consumer goods firms that was arrived at based on the availability of data for ten years for all the research variables. **[19]** The researchers express our econometric model as

$$\boldsymbol{DRSA_{it} = \beta_0 + \beta_1 AUFZ_{it} + \beta_2 AUDI_{it} + \beta_3 AUDT_{it} + \beta_4 FAGE_{it} + \mu_{it}}$$

Where:

DRSA	=	Director's Remuneration (Measure for directors tunneling)
AUFS	=	Audit firm size
AUDI	=	Audit independence
AUDT	=	Audit Tenure
FAGE	=	Firm Age (control variable)
β_0	=	Constant
β_1- β_4	=	Slope Coefficient
μ	=	Stochastic disturbance
i	=	i^{th} firm
t	=	time-period

Variable Measurement/Operationalization

In this study, the dependent variable is directors tunneling. The researchers measure directors tunneling by the ratio of directors' remuneration to total revenue. The independent variable of audit quality is measured in terms of audit firm size, audit independence and audit tenure. The

researchers measure audit firm size as a dichotomousvariable of "1" for big4 auditors and "0" for non-big4 auditors. Audit tenure is measure as a dichotomous variable of "1" where the audit-client relationship is more than 3years and "0" when it is less than 3 years. Finally, the researchers measure audit independence by the natural logarithm of audit fees. The control variable of firm age is measured by the difference between current year and year of listing on the stock exchange. **[20]**

4.0 Empirical Results and Discussion

The study investigates the effect of audit quality on directors tunnelling in Nigeria drawing samples from listed consumer goods firms on the floor of the Nigerian Exchange Group market. While directors tunnelling proxied by directors' remuneration is the dependent variable, the independent variables adopted for this study includes audit firm size, audit independence, and audit tenure. Furthermore, in line with related extant literature, the researchers employed the variable of firm age to control our model. Data set employed in this study spans through the periods between 2011 and 2020. Table 4.1 below describes the data in terms of the companies which they belong. Overall, the descriptive statistics provides some insight into the nature of the selected Nigerian listed consumer goods companies that were employed in this study. **[21]**

Descriptive Analysis

In this section, the researchers examine the descriptive statistics for both the explanatory and dependent variables of interest. Each variable is examined based on the mean, standard deviation, maximum and minimum. Table 1 below displays the descriptive statistics for the study.

TABLE 1: DESCRIPTIVE STATISTICS

VARIABLES	MEAN	SD	MIN	MAX	NO OBS
DRSA	0.46	0.60	0.01	4.13	159
AUFZ	0.79	0.41	0	1	160
AUDI	4.32	0.54	2.6	5.8	159
AUDT	0.79	0.41	0	1	160
FAGE	32.19	13.76	3	56	160

Source: Author (2022)

The table above shows the summary of the descriptive statistics of the study. From the table it is observed that directors' remuneration (DRSA) on the average is 0.46 with a standard deviation of 0.60. Audit firm size (AUFZ) has a mean of 0.79 with a standard deviation of 0.41. This implies that about 79% of the firms in the sample engage the services of one of the big4 auditors. The researchers also find that audit independence has a mean of 4.32 with a standard deviation of .54. Audit tenure had a mean of 0.79 with a standard deviation of 0.41. In the case of the control variable, the table shows that firm age has a mean of 32years with a standard deviation of 13.76.

Correlation Analysis

In examining the association among the variables, Theresearchersemployed the Pearson correlation coefficient (correlation matrix) and the results are presented in the table below.

TABLE 2: CORRELATION ANALYSIS

	DRSA	AUFZ	AUDI	AUDT	FAGE
DRSA	1.00				
AUFZ	0.11	1.00			
AUDI	-0.14	**0.07**	1.00		
AUDT	-0.10	0.18	0.14	1.00	
FAGE	0.13	0.35	0.17	-0.24	0.18

Author's computation (2022)

In the case of the correlation between the variables of interest, the above results show that there exists a positive and weak association between directors' remuneration and audit firm size (0.11). There exist a negative and weak association between directors' remuneration and audit independence (-0.14). There exist a negative and weak association between directors' remuneration and audit tenure (-0.10). In the case of the control variable, the researchers find that firm age (0.13) has a positive and weak association with directors' remuneration. To test the hypotheses a regression results will be needed since correlation test does not capture cause-effect relationship.

Regression Results

Specifically, to examine the cause-effect relationships between the dependent variables and independent variables as well as to test the formulated hypotheses, the researchers present a robust regression and an OLS pooled results in the table below.

TABLE 3: REGRESSION RESULT

	DRSA Model (Pooled OLS)	DRSA Model (Robust Regression)
C	**1.80 {0.000} *****	**1.80 {0.000} *****
AUFZ	**0.35 {0.032} ****	**0.35 {0.017} ****
AUDI	**-0.40 {0.000} *****	**-0.40 {0.000} *****
AUDT	**-0.13 {0.257}**	**-0.13 {0.361}**
FAGE	**0.01 {0.130}**	**0.01 {0.035}**
F-statistics/Wald Statistics	**4.53 (0.01) ****	**8.28 (0.00) *****
R- Squared	**0.11**	**0.11**
VIF Test	**1.56**	
Heteroscedasticity Test	**19.73 (0.000)**	

Note: (1) bracket {} are p-values

(2) **, *, implies statistical significance at 5% and 1% levels respectively**

In the table above, the researchers observed from the OLS and Robust pooled regression that the R-squared value of 0.11 for both the OLS and the Robust regression shows that about 11% of the

systematic variations in directors tunneling proxied by directors' remuneration in the pooled consumer goods firms over the period of interest was jointly explained by the independent and control variables in the model. The unexplained part of directors tunneling can be attributed to exclusion of other independent variables that can impact on directors tunneling but were captured in the error term. The F-statistic value of 4.53 and its associated P-value of 0.01 shows that the OLS regression model on the overall is statistically significant at 1% level, this means that the regression model is valid and can be used for statistical inference. The table above also shows a mean VIF value of 1.56 which is within the benchmark value of 10, this indicates the absence of multicollinearity, and this means no independent variable should be dropped from the model. Also, from the table above, it can be observed that the OLS results had heteroscedasticity problems since its probability value was significant at 1% [19.73 (0.00)]. The presence of heteroscedasticity clearly shows that our sampled firms are not homogeneous. This therefore means that a robust or panel regression approach will be needed to capture the impact of each firm heteroscedasticity on the results. In this study the researchers adopted the robust regression method. **[22]**

Discussion of Findings

Since, the study is an extension of existing studies, only few findings in literature are not in agreement with the current positions of this study.Our results reveal that audit firm size(Robust regression =0.34 (0.032))as an independent variable to directors tunnelling appears to have a positive and significant influence on directors tunnelling at 5% significant level. This therefore means the researchers should reject the null hypothesis ($H0_1$: Audit firm size has a significant effect on directors tunneling of listed consumer goods firms in Nigeria). **[23]** This suggests that big4 audit firms significantly reduces directors tunnelling in Nigeria. Larger audit firms have better financial resources and research facilities, superior technology, and more talented employees to undertake large company audits than do smaller audit firms. Their larger client portfolios enable them to resist management pressure, whereas smaller firms provide more personalized services due to limited client portfolios and are expected to succumb to management requirements (Mahdi & Ali, 2009).Specifically, the researchers find that when a big4 firm audit the accounts of the firms in our sample, directors tunnelling tends to increase. This result disagrees with prior empirical results which show that big4 auditors significantly decrease directors tunneling (Mahdi & Ali, 2009). However, the researchers agree with the studies of Khanna and Palepu, 2000 who concluded that big auditors significantly increases directors tunneling. The researchers also provide evidence that audit independence (Robust regression = -0.40 (0.000)) as an independent variable to directors tunnelling appears to have a negative and significant influence on directors tunnelling at 1% significant level. This therefore means the researchers should reject the null hypothesis ($H0_3$: Auditor independence has a significant effect on directors tunneling of listed consumer goods firms in Nigeria). **[24]** This suggests that increase in auditors' independence significantly decreases directors tunnelling. This result agrees with prior empirical results which show that audit independence significantly decrease directors tunneling (Megginson & Smart, 2005). However, the researchers fail to agree with the studies of Khanna and Palepu, 2000 **[19]** who concluded that audit independence significantly increases directors tunneling. As for the variable of auditor's tenure, our results shows that auditor's tenure (Robust regression = -0.13 (0.257)) as an independent variable to directors tunnelling appears to have a negative and insignificant influence on directors

tunnelling. This therefore means the researchers should reject the null hypothesis ($H0_3$: Auditor's tenure has no significant effect on directors tunneling of listed consumer goods firms in Nigeria). Hohenfels and Quick (2018) reports a positive effect of auditor tenure on earnings management which may lead to distress, arguing that investors perceive a potential impairment of audit quality as the tenure increases which would affect earnings quality. On the other hand, as auditor tenure increases, the auditor should become better at recognizing material misstatements by gaining experience and better insights into the clients' business strategies and internal financial reporting process. **[25]**

5.0 CONCLUSION AND RECOMMENDATION

The exploitation of minority shareholders by controlling shareholders has attracted the attention of researchers. When the majority shareholders control the company, the agency problem is no longer about the conflict of interest between management and shareholders but about how to prevent controlling shareholders from exploiting minority shareholders. Tunnelling is not only detrimental to the interests of minority shareholders but also seriously precludes the development of the capital market. In the light of this, the empirical result of this study leads to the conclusion that out of the three independent variables adopted in this study, only big4 auditors and auditors' independence significantly affect directors tunnelling. Specifically, the researchers conclude that when a big4 firm audit the accounts of the firms in our sample, directors tunnelling declines. Similarly, the researchers conclude that the independence of the auditor decreases directors tunnelling. Succinctly, the researchers recommend that firms should strive towards promoting audit independence by considering a benchmark of audit fees to reduced directors tunnelling from the firms. Furthermore, the researchers recommend that indigenous audit firms should be patronized to cushion the increase in directors tunnelling when a firm chooses a big4 auditors.

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