Unethical Practices of External Auditors and Corporate Governance Failure

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Abstract

Corporate failures have been associated with various issues, the role of external auditors has been pin pointed as a contributory factor resulting in a critique of the audit profession. Engaging in unethical practices by external auditors has undermined the audit function leading to corporate failure. This necessitated a critical examination of these unethical practices of external auditors and how they can result in corporate failure. This study adopted doctrinal analysis. The primary sources include the Companies and Allied Matter Act 2020, Financial Reporting Council of Nigeria Act, 2011, Banks and Other Financial Institutions Act, 2020 and Nigerian Corporate Governance Code 2018. The secondary sources comprised books, journal articles and online articles. The study found that external auditors engagement in unethical practices, impacts on their independence negatively. The study also found that their involvement in unethical practices affects audit quality, is a bane of good corporate governance and the audit profession. The study concluded that the outcome of audit processes depends on the quality of external auditors and the activities they engage in. Unprofessional activities of external auditors affect their independence and the performance of their audit function. The study recommended that regulatory and professional bodies should be part of engagement of external auditors to raise the standard for the engagement process. Also, there should be a review of ethical codes of companies and regulatory. Professional bodies should include stiff punishments for auditors who engage in unethical practices.

Keywords: Corporate Governance, Unethical Practices, Corporate Failure, Audit Process, External Auditors.

1.1 Introduction

Corporate governance became a topical issue owing to the collapse of high profile companies like WorldCom, Enron, Lehman Brothers and Parmalat due to their poor corporate governance practices. In many of these corporate failures, the complicit role of external auditors were prominent. Engaging in unethical practices by external auditors is a factor that affects the survival of corporations. The issue of breach of duties by Arthur Anderson (the external auditors of Enron) and its involvement in consultancy services rather than focus on its auditing role was one of the poor corporate governance practices in Enron, a US based

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Energy Company.[1] Investigation into the Enron's failure revealed wrong accounting practices that led to the bankruptcy of the firm.[2] These practices also led to the conviction of Arthur Andersen in the United States of America Federal Court and its eventual dissolution.[3] Investigation into the Enron's failure revealed wrong accounting practices that led to the bankruptcy of the firm.[4] These practices also led to the conviction of Arthur Andersen in the United States of America Federal Court and its eventual dissolution.[5]
Poor financial reporting was the bane of WorldCom and Lehman Brothers. WorldCom, a telecommunication company based in the United States of America was involved in manipulating their accounts to inflate the figures on their assets and to reduce their debts. Lehman Brothers failed to use the appropriate accounting system in their accounting process and also had poor financial disclosure. The issue of breach of duties by external auditors was also the case in Enron as the external auditor of Enron became involved with consultancy rather than focus on auditing role.[6]

External auditor's practice of engaging in certain practices regarded as unethical hampers the effective performance of their jobs. Furthermore, it is a potential threat to the continuous existence of a corporation which becomes their audit client. It is a distraction for external auditors from their core audit function, a threat to their required independence to perform their audit roles effectively and portends danger for the audit profession. The problem of engaging in unethical practices by external auditors is the central focus for this paper.

1.2 Objective of the Study
One of the objectives of this paper is to identify and examine unethical practices which external auditors get involved in during the course of performing their audit role. Another objective to be considered is to examine the impact of engaging in unethical practices by external auditors and how they can result in the failure of corporations.

1.3 Research Questions
In line with the objectives of this work, the research questions are firstly, what are the unethical practices which external auditors engage in alongside performing their audit function? The second research objective is what is the relationship between the unethical practices which external auditors engage in and the failure of organization?

2.1 Review of Literature
The review of literature will begin with the explanation of related concepts and furthermore, this aspect of the paper will review works of authors on corporate governance theories relevant to the subject matter of this work.

2.1.1 Corporate Failure
Corporate failure is a terminology of corporate governance which occurs as a result of a continuum of activities. This means that there are several issues that come together to result

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[1] AI L. Hartgraves 'Andersen's Role in Enron's Failure' (2004). <https://www.researchgate.net/publication/313607848_Andersen's_Role_in_Enron's_Failure> accessed 3 March 2023.
[2] Syed Abdul Rehman Bukhari, 'The Enron Case Study: History, Ethics and Governance Failures' < <https://www.researchgate.net/publication/332247240_The_Enron_Case_Study_History_Ethics_and_Governance_Failures> accessed 5 February 2023.
[3] Hartgraves (n 1) 758.
[4] Syed Abdul Rehman Bukhari, 'The Enron Case Study: History, Ethics and Governance Failures' < <https://www.researchgate.net/publication/332247240_The_Enron_Case_Study_History_Ethics_and_Governance_Failures> accessed 5 February 2023.
[5] Hartgraves (n 3) 758
[6] ibid. 760.

in the failure of a corporation and corporate failure can be presented in a range of things from a corporation losing power to the firm actually stopping operations. A firm can stop existing due to a voluntary action such as bankruptcy or as a result of the company getting involved in court actions. Corporate failure resulting in corporate governance issues can be caused by certain factors and these drivers of corporate failure include: non-independent board of directors, lack of independence of external auditors, lack of independence of audit committee members, lack of board committees, poor risk management systems, fraud, corruption, unethical conducts, low attention to risk management, poor/wrong choice of board members, unproductive distribution of roles and responsibilities, ineptitude of management and board members, poorly decided or ill-timed mergers, acquisitions and business expansions, ineffective mechanisms of governance, unethical practices of external auditors, internal auditors, board members, management and other staff members, ineffective internal auditor, among other factors. Several factors have been put forward as the reasons for corporate failure in organizations. Corporations may experience failure in business, however, only some of these failures in business result in actual collapse of a corporation. Sometimes it may lead to a scandal for the firm, reputational loss and at other times, it may result in the collapse of the business. There is no economic theory that gives an explanation on why corporations fail. However, some factors can be connected with the failure of corporations and some of them are agency conflict, ineffective corporate governance, technological innovations, and misplaced incentives.[7]

Sheth and Sisodia are of the view that the corporate life expectancy of firms is on the decrease and to a large extent is as a result of mergers and acquisitions which corporations erroneously get involved in.[8] They are of the opinion that firms who went into mergers and acquisitions mostly do so based on wrong moves and the wrong decision taken often results in failure in and of the business.

2.1.2 Auditing

Auditing can be described as an objective examination and also evaluation of the financial statements of a company, which act is usually performed by an external third party.[9] Also, it is the independent review or examination of the financial statements of a corporation to enable an opinion to be expressed, give a true and fair view and also complying with the relevant laws and standards of reporting.[10] It is the role of an auditor to carry out the audit function in a company. An auditor can perform audit as a financial activity both internally and outside a corporation. An external auditor carries out an independent and objective examination and review of the accounts of a company for the purpose of financial reporting. An audit of this kind can be referred to as the audit of the financial statement of a corporation by an external third party who can be an external auditor which is the focus of this research.

An organization can ensure the accuracy of its financial accounts with the help of audit. The goal of the audit is to make sure that all departments adhere to the defined system of documenting transactions. Evaluation of an organization's internal controls is a part of the auditing process. An organization is expected to set up sufficient internal control measures so they can keep an eye on the business's financial activities.

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[7] 'Corporate Failures: Declines, Collapses and Scandals', <https://www.sciencedirect.com/science/article/abs/pii/S0929119920303163#:~:text=Corporate%20failure%20has%20generally%20been,et%20al.%2C%202017).>accessed 15 January 2022.

[8] J. Sheth and R. Sisodia, 'Why Good Companies Fail' [2005] European Business Forum, 22, pp. 25-30.

[9] 'Auditing', <https://corporatefinanceinstitute.com/resources/accounting/what-is-an-audit/> accessed 5 January 2023.

[10] John Ugoani and Grace Iyi Ibeenwo, 'External Audit Process Failures: Unethical Practices and Business Demise'[2022] 8(1) *Business, Management and Economics Research* 1.

The law requires public companies to provide their audited financial statements on the website of the corporation.[11] The Companies and Allied Matters Act (CAMA) provides that every company shall appoint an auditor or auditors at the annual general meeting of the company who will have the responsibility to audit the financial statements of the company and the auditor (s) so appointed at the annual general meeting of a company will hold office from the conclusion of the annual general meeting to the conclusion of the next annual general meeting.[12] The board of directors of a corporation have a duty to prepare a financial statement for the company each year.[13] The financial statements of a company prepared by the directors which include statement of the accounting policies, balance sheet as at the last day of the year, a profit and loss account or income and expenditure account for the year, notes on the accounts, the auditors' report, the directors' report, statement of cash flow, changes in equity, a value-added statement for the year, a five year financial summary, the group financial statements (in the case of a holding company, and such other matters as are required in accordance with the applicable accounting standards.[14] The directors have a duty to lay the financial statements of a company before the company in general meeting and it must be not later than eighteen months from the incorporation of a company and subsequently, same should be done at least once each year.[15]

An external Auditor is required to provide an independent opinion on the true and fair view of the financial statements of the corporation.[16] It is the duty of an external auditor to carry out his audit function with skill, care and caution and this will boost the confidence of stakeholders in the financial statements of a corporation[17] Incorrect assessment of the financial statements of a company and opinion of external auditor as a result of negligence may result in litigation against an external auditor. The report of the auditor of a corporation is to be read before the company in general meeting.[18] An external auditor is appointed by shareholders in general meeting. The board audit committee of a corporation is responsible for making recommendations to the board of directors on the appointment, removal and remuneration of external auditors.[19] The outcome or result from an external audit, is an audit opinion and it is a statement made by an external auditor regarding the financial statements of an audit client.[20] An audit opinion is contained in an audit report which is contained in the financial reporting[21] presented during the annual general meeting of a corporation and the financial report submitted to the relevant government authorities.

2.1.3 Financial Reporting

Good financial reporting has a positive correlation with corporate governance. When there is an effective financial reporting, it has a positive bearing on good corporate governance. On the other hand, when a company operates effectively based on good corporate governance, such a company will provide an environment that will encourage proper financial reporting. This is made possible by a company that upholds ethical practices and professionalism.

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[11] Companies and Allied Matters Act (CAMA) 2020, s 374(6).
[12] ibid, s 401(1).
[13] ibid, s 377(1).
[14] ibid, s 377(2).
[15] CAMA 2020, s 388(1).
[16] Nigerian Code of Corporate Governance (NCCG) 2018, principle 20.
[17] *Re: London & General Bank* [1895] Ch.D 673-683.
[18] CAMA, s 388(2).
[19] NCCG 2018, principle 11.4.6.5.
[20] 'Auditor's Opinion Definition' (2022) <https://www.accountingtools.com/articles/auditors-opinion> accessed 13 March 2023.
[21] 'Auditor's Opinion' https://www.wallstreetmojo.com/auditors-opinion/ accessed 13 March 2023.

By providing information to shareholders and various stakeholders, financial reporting aids the smooth running of an organization and a well-run corporation is a pointer to good corporate governance. When relevant stakeholders are kept in the loop regarding the finances of the organization, it will facilitate good corporate governance. Essentially, good financial reporting aids the efficient management of a company.

Financial reporting will increase transparency in financial reporting. This will ensure that users of the finances of a company as well as auditors (internal and external) to be open about all their dealings with the financials of the company. Closely related to transparency is that financial reporting will foster accountability because the financial statement of a company can be laid bare for public view, management, board and employees will prefer to work carefully knowing that their deeds or misdeeds in this regard can be exposed.

A credible financial reporting is also relevant to corporate governance because it will increase the value of a company. Shareholders, investors and the public at large will be more confident and willing to deal with the company when they know that the company upholds the ethical principles of corporate governance such as transparency of financial reporting, accountability, fairness, honesty and impartiality. When financial reporting is properly done, it will help to reduce the financial risk of a corporation. This is because it will place the financials of a company in better perspective to enable the board, management and employees avoid transactions that will be detrimental to the company. Good financial reporting is also relevant because it enhances the capital market by reducing the risk of information. This is because accessibility to accurate financial information is beneficial to all stakeholders in the capital market.[22]

2.2 Theoretical Framework

The two theories that will be examined in this work for understanding of the study are the Shareholder and Agency theories.

2.2.1 Shareholder Theory

A shareholder has been described in general terms as an entity which owns shares in a company and the entity can be an individual, firm or institution.[23] The proponent of the shareholder theory, Milton Friedman in his article, 'The Social Responsibility of Business to Increase Profit,' opined that a business has the major and sole object to maximize the profit of the shareholders because they are the owners of the business[24]. According to this theory, management are employed by shareholders as their agents and therefore, they have a sole object of maximizing shareholders value.[25] According to this theory, the interest of shareholders which forms the primary objective of management is prioritized more than the interests of other corporate stakeholders which include customers, employees, suppliers and the public[26].

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[22] Miljan Lekovic and Slavica Arsenovic, 'The Role and Importance of Quality Financial Reporting' (2013) < <https://www.researchgate.net/publication/283637993_The_role_and_importance_of_quality_financial_reporting> accessed 13 March 2023.
[23] Christina A. Mallin, *Corporate Governance* (6th edn, Oxford University Press, 2019).
[24] ibid.
[25] ibid.
[26] ibid.

Rakan Alhumaymidi is of the view that a company is first formed by some individuals who come together as contributors to establish the company and they are called, shareholders.[27] The company becomes entitled to sue and be sued, can enter into contracts, raise funds, make investments, own property amongst other things.[28]
The involvement of the shareholders in the creation of the company becomes their motivation in the activities of the company and the decisions made in the company.[29] And also that shareholder plays a dominant role in decision making in a company because of their ownership of the company.[30] The amount of shares owned by shareholders in a company is indicative of the extent of power a shareholding can exercise in the company and it is also a representation of the risk to be borne by the shareholder.[31] Impliedly, shareholders are the owners and also the risk bearers of companies.[32] Against the backdrop of the ownership of companies by shareholders and their risk bearing capacity, the shareholder theory seeks to focus on the interests of shareholders.

The shareholder theory has been criticized on some grounds, one of which is that it focuses only on the interests of shareholders and not on the interests of other stakeholders of the corporation. This has led to vices such as manipulation of company's accounts and corporate scandals because the managers are under pressure to maximize shareholder value. The shareholder theory is relevant to this research because it provides insight on who the owners of a company are and the relevance of representing their interests by maximizing their investments. Moreso, this theory provides understanding on the need for external auditors to audit financial statements of companies because the records of a company is one of the avenues by which shareholders know the financial status of the company.

2.2.2 Agency Theory

An agency relationship is created when a person who is regarded as a principal hires and authorizes another person, referred to as the agent to act on his or her behalf and giving the agent some of his powers to make decisions[33]. Agency theory has to do with agency relationship whereby a party called the principal delegates work to another party called the agent who carries out the work.[34] In relation to companies, the agency theory is about the separation of ownership of a company from the control of the company such that the owners of a company delegate the duty of running the company to the management. This theory is utilized in the resolution of conflicts in the relationship between owners of business, otherwise called shareholders and the executives of the corporation. Agency problem arises

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[27] Rakan Alhumaymidi, 'Shareholder Theory vs. Stakeholder Theory' (2021) <https://www.researchgate.net/publication/351491876_Shareholder_Theory_vs_Stakeholder_Theory> accessed 25 March 2023.
[28] *Farrar v Farrars Ltd*. [1888] 40 ChD 395, See also, John Lowry & Arad Reisberg, *Pettet's Company Law: Company Law and Corporate Finance* (4th edn, Pearson 2012).
[29] Xavier Hollandts, 'Who are The Owners of The Firm: Shareholders, Employees or No One' (2014) 10\1 Journal of IE<http://journals.cambridge.org/abstract_S1744137413000301> accessed 25 March 2023.
[30]Rakan Alhumaymidi, 'Shareholder Theory vs. Stakeholder Theory' (2021). <https://www.researchgate.net/publication/351491876_Shareholder_Theory_vs_Stakeholder_Theory> accessed 25 March 2023.
[31] ibid.
[32] Hollandts (n 29).
[33] Felix Zogning, 'Agency Theory: A Critical Review' [2017] 9(2) *European Journal of Business and Management* 2.
[34] Kathleen M. Eisenhardt, 'Agency Theory: An Assessment and Review' [1989] 12 (1) *The Academy of Management Review* 57-74.

from agency relationship and it is an offshoot of the separation of ownership from control and this led to the concept of corporate governance.[35]

Jensen and Meckling observed that agency problem arises when cooperating parties have different goals and division of labour.[36] In a corporation, the cooperating parties are the shareholders and management, where the shareholders own the company while the management are in control of the company on behalf of the owners of the firm. Therefore, in line with the proposition of Jensen and Meckling, shareholders and management have different roles and goals and these lead to issues referred to as agency problem which the agency theory focuses on to resolve. This implies that the theory recognizes that in a firm, ownership exists as different from control. Shareholders are the owners of a business and they are separate from the directors and other business executives who are in charge of controlling and managing the business in order to maximize the wealth of shareholders.

Yong Tan describes the agency theory as a concept used to describe how a firm behaves in view of the different contracts which exist between parties in a corporation.[37] The view of Yong Tan aligns with that of Jensen and Meckling in acknowledging that different parties exist in a company. Jensen and Meckling make an attempt to portray the relationship between a principal and agent as in shareholders and management as a contract.[38] The goals, roles and activities of these contracting parties result in conflicts as in the case of shareholders and management of a company. For Kathleen Eisenhardt, there are two problems associated with agency relationships which the agency theory seeks to resolve; one of the problems stems from the conflicting goals of principal and agent and the difficulty which a principal experiences in trying to ascertain the activities of the agent.[39] The second problem associated with agency relationship is that when the principal and agent have different attitudes towards risks, then an issue of risk sharing will arise. The difference in their preference to risk will cause them to act in different ways.[40]

The owners (as principals) of a company are not involved in its day-to-day running of the corporation. They delegate the duty of running the company to the management. This results in conflicts between the principals and the agents which may cause the principals to lack trust and confidence in the agents on the management of their wealth. This is a source of agency conflict which the agency theory seeks to resolve. The divergent interests of agents and principal can result in agency conflict which may lead to corporate failure.

The principal will want to ensure that the agent makes the best decisions for him and acts in his best interest but this will be at a cost to both the principal and agent and the costs are the monitoring cost, obligation cost and opportunity costs.[41] Monitoring cost is borne by a principal in order to limit the opportunistic behaviour of an agent and the incentive cost the

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[35] AY Abdullahi, 'The Practical Utility of Corporate Theories And Governance Under The Nigerian Corporate Environment: An Overview' in O.V.C Okene, G.O Akolokwu and G.G Otuturu (eds), *Legal Essays in Honour of Mary Odili* (Princeton & Associates Publishing Co. Ltd. 2022).

[36] M. Jensen and W. Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305-360.

[37] 'Agency Theory'<https://www.sciencedirect.com/topics/social-sciences/agency-theory#:~:text=Agency%20theory%20is%20an%20economic,on%20his%20or%20her%20behalf.> accessed 23 January 2023.

[38] Jensen and Meckling (n 36).

[39] Eisenhardt (n. 34) 57-74.

[40] ibid.

[41] Felix Zogning, 'Agency theory: A critical review' *European Journal of Business and Management* (2017)9 (2) 2

principal incurred when he manages the behaviour of the agent to align with the intention of the principal.[42] It can be deduced that a principal will incur monitoring cost when it utilizes the services of an external auditor in reviewing the financial statements of the company.

Therefore, an external auditor is appointed based on the recommendation of the audit committee of the board[43] and has a role to provide an independent opinion on the true and fair view of the financial statements of a company. This role of an external auditor serves as a type of check on the financial activities in a company for the benefit of shareholders. It will also aid the elimination of agency conflict between shareholders and management. The purpose of this is because of the role of external auditors in reviewing the financial statements of a company and giving an audit opinion thereafter.

The Agency theory is relevant to this research because it establishes that in a company, owners exist as different from the agents of a company. This agency relationship attracts conflict between the owners of a company as the shareholders and the management as the agents of the shareholders. Further to the need to resolve the agency theory, the shareholders will incur monitoring cost by engaging an external auditor to review the financial statements of the firm as a form of check on the agents. The role of external auditors in achieving control cannot be undermined because it is useful in curbing agency conflict and also portrays the practice of good corporate governance practice in general.

3.1 Unethical Practices of External Auditors

Ethics which is also referred to as moral philosophy is applied to any system or theory of moral values or principles.[44] Ethics is fundamental to the operations of organizations and therefore, they must operate within ethical guidelines.[45] It is the study of moral principles and values that govern the way people act and make decisions.[46]. Actions or decisions that are not morally compliant are considered to be unethical. A situation of ethical problem arises when the alternative options a person adopts affect the well-being of another person.[47]

Ethics is relevant to societies, corporations, professional bodies and various groups because members ought to function based on ethical guidelines in order to achieve set objectives and goals of their organization. Additionally, by aligning with ethical standards, a company will practice good corporate governance and avoid issues. Ethical practice is produced when ethical values are imbibed and expressed.[48] Ethical values are moral guides for how to live and make decisions. It is important for corporations to establish and maintain a reputation for upholding ethical values.[49]

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[42] ibid.
[43] NCCG 2018, principle 11.4.6.5.
[44] 'Ethics', <https://www.britannica.com/topic/ethics-philosophy>accessed 22 April 2023.
[45] Roman O. Omorokpe and Jude O.Nomuoja, 'Unethical Practices by Accountants, Auditors, Company Secretaries and Directors: Types, Causes and Remedies' (2010) 21(1) *Knowledge Review* <https://www.globalacademicgroup.com/journals/knowledge%20review/UNETHICAL%20PRACTICES%20BY%20ACCOUNTANTS,%20AUDITORS,%20COMPANY%20SECRETARIES.pdf> accessed 22 April 2023.
[46] ibid.
[47] JC Robertson and JJ Louwers, *Auditing and Assurance Services* (10th ed., McGraw-Hill/Irwin Companies Inc. 2002).
[48] Ethical Practice, <https://peopleprofession.cipd.org/profession-map/core-behaviours/ethical-practice#gref> .accessed 15 April 2023.
[49] Omorokpe and Nomuoja (n 46)88.

Professional bodies provide ethical guidelines for members of their profession to guide their practice of the profession on various areas which include the basic areas of their accounting work, relationship with their clients, how to deal with conflict of interest, how to safeguard independence of auditors among other things.[50] External auditors or accountants in Nigeria operate based on the ethical guidelines provided by some professional bodies like the Institute of Chartered Accountants of Nigeria (ICAN) and the Association of Chartered Certified Accountants (ACCA). Apart from professional bodies, corporations also provide code of ethics as a document to serve as a guide for ethical behaviours and practices of members of the corporations. A document on code of ethics is an internal document of a corporation which is binding on its staff members. Also, the Financial Reporting Council of Nigeria Act (FRCNA) provides that an external auditor in the exercise of his professional function, shall do so in compliance with the Code of Conduct and Ethics that may be made by the Council or under any other enactment in force[51].

Incidents of professional misconducts by corporate executives and professionals are unethical practices and have led to the passing of some legislations as a form of regulations and check. Some of those laws are the Sarbanes Oxley Act, 2002 in the USA, the CAMA, 2020, BOFIA, 2020, Economic and Financial Crimes Commission (EFCC) Act, 2004, Investment and Securities Act (ISA), 2007 and the Independent Corrupt Practices (ICPC) and Other Related Offences Act, 2003. The External audit is regarded as a watch dog mechanism of an organization.[52] This is because an external auditor checks financial statements and records of a corporation to ensure that in all material aspects they conform to ethical and relevant accounting and financial reporting standards.[53] They ensure that they perform their audit function based on standard and also that they are consistent. Auditors are by reason of the nature of their profession required to conform to ethical practices in order to effectively perform their audit roles. But their resort to unethical practices is inimical to the effective performance of their audit roles and lead to poor corporate governance and demise of an enterprise.[54]

Unethical practice can be seen as a professional misconduct done by a professional in a field. As regards, external auditors, an unethical practice are professional practices which they carry out that are not in tandem with the rules, policies, codes or ethics of the accounting profession or the organization of the audit client. A corporation with a reputation for ethical behaviours is an important component of the business community which makes up the general society. Therefore, it is expected that the business community of a society makes positive contributions to the society. Such positive contributions can be achieved by a corporation operating on the basis of ethical principles and values.

Unethical practices result in ethical issues which revolve around competency, integrity, competency, objectivity, impartiality and confidentiality.[55] External auditors are required to make their audit report based on their findings in the financial statements irrespective of its effect on their audit client. This will be for the avoidance of integrity issue. Also, they are expected to make their audit report devoid of bias and partiality. Conflict of interest can result

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[50] ibid.
[51] Financial Reporting Council Act 2011, s 46(a)
[52] John Ugoani and Grace Iyi Ibeenwo, 'External Audit Process Failures: Unethical Practices and Business Demise' *Business, [*2022] 8(1) *Management and Economics Research* 1.
[53] ibid.
[54] ibid.
[55] 'Ethical Issues for External Auditors', <https://brainmass.com/business/ethical-issues-for-external-auditors> accessed 1 May 2023

in biased audit report; therefore, an external auditor must not engage in activities that would amount to conflict of interest. If a situation of conflict of interest arises, an external auditor should withdraw from taking up the audit role for the organisation to avoid giving an opinion that would be biased. An external auditor ought to have ample knowledge of the data provided by the audit client to give his audit opinion on the financial status of the company. If otherwise, he is required to give his audit opinion.

Some unethical practices which external auditors engage in include performance of non-audit services, failure to comply with relevant accounting and audit standards or best practices in audit process, corporate accounting fraud such as misrepresenting assets and liabilities (by making or allowing audit clients or other persons to make misleading and false entries in accounts and financial statements), disclosure of audit client confidential information (such as trade secret) without their consent, manipulating payroll, requesting for loans or other types of financial inducements from audit clients, requesting for directorship and or equity holdings in audit client company, non-filing of tax returns, non-remittance of income tax, imposing unreasonable fees on audit clients and giving incorrect audit opinion on audit client financial statements (like giving unqualified audit opinion where audit financial statements have material misstatements).[56]

3.2 Consequences of Unethical Practices of External Auditors

Corporate governance provides a structure for the running of a corporation and good corporate governance implies that a company is operating effectively. Since unethical practices by external auditors is indicative of poor corporate governance, it is not without consequences in order to ensure efficiency in companies and enable companies remain a going concern.

The NCCG clearly prohibits the engagement of external auditors in unethical practices.[57] If an external auditor engaged in unethical practice, abused its office, acted in a fraudulent manner or colluded in any fraud and the board of the company is satisfied that these occurred, the board may recommend that the external auditor is removed in accordance with provisions of extant laws.[58]

3.3 Types of Unethical Practices

Some of these unethical practices which external auditors engaged in are providing non-audit services, conflict of interest, receipt of financial inducement from audit client, engaging in corporate accounting fraud, and giving of dishonest opinion.

(a) Providing Non-audit Services

Non-audit services refer to services other than audit services which an incumbent external auditor provides to an audit client[59]. They can also be referred to as practices which external auditors sometimes get involved in which are not related to their core audit roles. The need for specialized or expert services in the corporate business sector has led to the expansion of the scope of the services they provide by public accounting firms. This expansion of business

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[56] Omorokpe and Nomuoja (n 50) 92.
[57] NCCG 2018, principle 20.7.
[58] NCCG 2018, principle 20.7.
[59] Mahdi Salehi, 'In the Name of Independence: with Regard to Practicing Non-Audit Service by External Auditors' [2009] 2(2) *International Business Research* 137,139

relates to services which are non-audit in nature and include outsourcing of internal audit, human resources services, individual and corporate tax planning (tax compliance and tax planning advice), training, risk management advice, information systems, portfolio monitoring, corporate recovery and insolvency and mergers and acquisitions consultancy.[60] Consequently, a company could suffer loss of profits, scandal, reputational loss or a worst case scenario, which is corporate failure.

Engagement of external auditors in non-audit practices is an unethical practice which can mar the process of auditing because it affects both the independence and objectivity of an external auditor.[61] When this is the situation, it can undermine audit process and audit quality. Non-audit services imply that the services are not audit services which are the core concern of auditors. On one hand, an audit client may be seen to be saving cost by engaging the services of an external auditor for multiple tasks which are audit and non-audit in nature. And on the other hand, an external auditor may be seen to be making money revenue from increased tasks of different nature. These services can enhance the relationship which an external auditor has with an audit client by strengthening their economic bond.[62] However, it can also create a professionally compromising relationship resulting in the auditor potentially or actually losing professional independence in providing audit service to the audit client.[63]

The expansion of scope of services to include non-audit services implies more revenue stream and invariably, more revenue can be derived by public accounting firms. However, this can be detrimental to the independence of auditors. The issue that can arise is whether an external auditor can actually be impartial in performing his audit function in this context and not be afraid of losing the patronage of the audit client or not getting additional services from the audit client. The absence of independence of an external auditor as a result will result in a compromised audit process. Independence of an external auditor will allow him room enough to function maximally in his capacity as an auditor for an audit client and yield better audit outcome. When an external auditor enjoys independence in performing his audit role, he will be more objective, his audit opinion more reliable and the financial statements credible and reliable and financial reporting system is enhanced.[64]

(b) Conflict of Interest

According to the Companies and Allied Matters Act, directors owe fiduciary duties to the company, shareholders and any person dealing with the company's securities.[65] Directors are required by law to observe utmost good faith in any transaction with a company or on its behalf.[66] However, directors and top management connivance with external auditors for unethical practices like fraud-sheltering and accounts manipulation exemplifies a situation of conflict of interest which can undermine auditor's independence and can be fatal to the

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[60] ibid.
[61] Salehi (n 59).
[62] ibid.
[63] ibid.
[64] P Sucher and K Maclullich, 'A Construction of Auditor Independence in the Czech Republic: Local Insight Accounting' [2004] 17(2) *Auditing and Accountability Journal*, 276-305. see also; S Swanger and E Chewning (2001) 'The Effect of Internal Audit Outsourcing of Financial Analysts'
(PDF) In the Name of Independence: with Regard to Practicing Non-Audit Service by External Auditors. Available from: <https://www.researchgate.net/publication/42385900_In_the_Name_of_Independence_with_Regard_to_Practicing_Non-Audit_Service_by_External_Auditors> accessed 12 May 2023.
[65] CAMA 2020, s 279 (1) and (2).
[66] *Okeowo v Miglore* [1979] SC 133.

existence of a company.[67] The Financial Reporting Council Act makes it a requirement for an external auditor who has a conflict of interest with an audit client to disclose to the client and Council the nature of the conflict of interest.[68] This will enable the audit client determine the extent of the conflict of interest and to decide whether or not to continue with the audit engagement with the external auditor.[69]

Conflict of interest can also arise when an external auditor provides both audit and non-audit services for a particular audit client. The implication of this type of situation is that the external auditor is serving two different sets of clients who are firstly, the management and audit committee and secondly, and the shareholders, creditors and investors. The resultant effect of conflict of interest involving external auditors can be their lack of independence. This means that external auditors can be influenced to act based on the whims and caprices of executives of their audit client company and not necessarily as best as their professional code of ethics requires. The credibility of the auditors will be affected as well as their audit opinion and report.

In the case of Enron, it was established that the external audit firm, Arthur Anderson provided both audit and non-audit services for their audit client, Enron and received $25m as audit fees and $27m for providing non- audit services.[70] Where an external auditor receives huge consultancy fees from an audit client can expose the auditor to influence from the audit client and also cause the auditor to be unduly biased in favour of an audit client.

(c) Receipt of Financial Inducement from Audit Client

Another form of unethical practice which external auditors can be engaged in is receiving financial inducements from their audit clients. When an external auditor request for loan from his audit client, this can serve a negative influence on the auditor and consequently obstruct his objectivity in the review of the financial of the audit client.

(d) Engaging in Corporate Accounting Fraud

It is possible for external auditors to engage in corporate accounting fraud which is against the ethics of their profession. When an auditor in reviewing the financial statements of a company misrepresents its assets and liabilities, it would have committed fraud and this opens such an auditor up to litigation. It would also amount to corporate accounting fraud if an external auditor allows an audit client to make entries in accounts and financial statements that are misleading or outrightly false. Fraudulent financial reporting (otherwise referred to as financial statement fraud) affects a company, its shareholders and stakeholders negatively.[71] It impinges on the decisions of users of financial statements. The board may recommend the removal of an external auditor who engages in fraud in accordance with the provisions of extant laws.[72]

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[67] John Ugoani and Grace Iyi Ibeenwo, 'External Audit Process Failures: Unethical Practices and Business Demise' [2022] 8(1) *Business, Management and Economics Research* 1.
[68] Financial Reporting Council of Nigeria (FRCN) Act 2011, s 47.
[69] FRCN Act 2011, s 47
[70] Salehi (n 61).
[71] Augustine Ehijeagbon Akhidime, 'Drivers of Audit Failure and Fraudulent Financial Reporting: Evidence from Nigerian Distressed Banks', [2019] 18(1) *Management and Accounting Review*, 7.
[72] NCCG 2018, principle 20.7

(e) Giving of Dishonest Opinion

An external auditor gives an audit opinion after doing a review of the financial statements of a corporation. He is expected to give honest opinion on the true state of the financial statements of the company and not otherwise. A misrepresentation of things by an external auditor would amount to giving a dishonest opinion. For instance, if an external auditor detects material misstatements caused by corrupt practices of a company and that can have a material effect on its financial statements, he ought to flag it off and not conceal. It is important to note that this does not imply that an external auditor has a role of fraud detection. If an external auditor ought to give a qualified or adverse opinion in his audit report but instead gives an unqualified opinion, is implies that his opinion is dishonest, not credible and therefore, unreliable. An unqualified audit opinion means that in the course of performing his audit role, an external auditor did not find any material irregularities or misstatements that are serious enough to warrant a qualified opinion, adverse opinion or a disclaimer.

4.1 Summary

External auditors are utilized in managing the agency conflict that exist in a corporation due to the existence of shareholders as owners of a company and management as agent of shareholders. Therefore, they are appointment by shareholders to act as a check on the excesses of management of companies in which the shareholders are owners.
This paper found that independence of external auditors is one of the factors that positively impact on the performance of their audit role. Another finding of this work is that the involvement of external auditors in unethical practices is a source of their lack of independence which they require to perform effectively. This is because it causes them to not be objective in their auditing role, brings about audit opinions that lack credibility and result in poor corporate governance.

4. 2 Conclusion

In conclusion, it is trite to note that the outcome of an audit activity is a function of the quality of the external auditor who performed the exercise. When an audit process is efficiently managed, it has the ability of enhancing good corporate governance. It will also help with the management of potential corporate risks. Engaging in unethical practices by external auditors is an unprofessional act which will mar the existence of a company.

4.3 Recommendations

The recommendation of this study is geared towards strengthening the framework of the independence of external auditors in order to forestall misconducts which can possibly result in losses, corporate scandals, litigation and collapse of companies. It is recommended that government should increase its regulation of companies to forestall misconducts by external auditors. Since the outcome of an audit process is heavily relied upon by many stakeholders, one of which is the public, the government should step up with more regulations for external auditors through the Corporate Affairs Commission (CAC).
Also, companies should be made to strengthen their internal control mechanism to ensure that external auditors are allowed to function independently as they ought to and not have their independence compromised due to the internal policies of the company.

Furthermore, auditing and accounting bodies like the Institute of Chartered Accountants of Nigeria (ICAN) and Association of Chartered Certified Accounts (ACCA) should ensure to carry out proper investigation of conducts of erring members and if they are found guilty, stiffer measures of punishment should be meted out on them to deter defaulters.