# Auditors' Liability and Creative Accounting in Nigeria

**[1]ADEOSUN O. A. (PhD) & [2]OLAYEMI A . E.**
[1,2]Department of Management Science, Bamidele Olumilua University of Education, Science and Technology, Ikere Ekiti. [2]Olayemiadebayo1234@gmail.com

***Abstract***
*The study examined auditors' liability and creative accounting in Nigeria. It specifically sought to ascertain relationship between auditor ethical judgments and liability to users of financial statement in Nigeria; determine the relationship between auditor's opinion on creative accounting and liability to uses of financial statements. The study adopted both primary and secondary sources of data. Purposive sampling technique was used to select five biggest audit firms and four medium sized audit firms in Nigeria. The results showed that there is no significant relationship between auditors' ethical judgments and their liability to users of financial statements among other findings and that these may pose liability to both the auditors and users of financial statements. Furthermore, results of the relationship between auditors' opinion on creative accounting and their liability to users of financial statements in Nigeria showed that there is statistical significant relationship between auditor opinion on creative accounting and their liability to users of financial statements.*
***Keyword: Auditors' liability, Creative accounting, Financial Statements***

## Introduction

Polly Peck, a UK textile company on 3rd September, 1990 announced record interim results for the six months to June, 1990 and made enthusiastic comments on prospects for the year and beyond. Poly Peck was placed in administration on 25 October, 1990 (Smith, 1992:221). In Nigeria, the equivalents of what happened at Polly Peck were recorded in Cadbury Nigeria Plc and African Petroleum Plc. Though these companies were not taken over, but they were reported to have suffered colossal financial losses due to the incidence of creative accounting. How can a company that reports substantial profit during a particular period collapse shortly afterward? Part of the possible answer can be found in creative accounting. The next question that may task ones imagination is, were the accounts of these companies not audited? For avoidance of doubts, both Cadbury Nigeria Plc and Africa Petroleum Plc are public quoted companies whose financial statements were audited before being presented at the company's Annual General Meeting (AGM).

Dillip & Inanga (2004) defines creative accounting as accounting techniques in which financial information is distorted by window dressing and various manipulations in order to present, theoretically, a better financial picture by either increasing or reducing profit as the case may be, by giving misleading appearance of capital size or structure and by concealing relevant information from existing or potential investors.

Published financial statements are usually relied upon by shareholders (as primary users) and other stakeholders, for major decisions. This they can do because the statements are audited (a form of assurance by experts) and if they prove to contain error (whether deliberate or inadvertent) parties adversely affected by such error can take the auditor up in law court for breach of trust. This is why relevant laws in Nigeria, the Company and Allied Matters Act (CAMA) 1990, regulatory bodies such as Nigeria Accounting Standards Board (NASB) and professional accounting bodies recognise the risk associated with published financial statements and consequently require accountants and auditors to follow provisions of the law and extant rules in order to avoid liability.

In most of the corporations where creative accounting has been carried out successfully in Nigeria - Cadbury Nigeria Plc and Africa Petroleum as examples, it is on record that auditors failed to report to shareholders through qualified reports until these companies had suffered huge losses. Thus in the event of creative accounting leading to business collapse the fortune and image of audit firms are always adversely affected.

**Statement of the problem**

The Companies and Allied Matters Act (CAMA) 1990, specifically gives responsibility for the preparation of financial statement to the company management (Sec. 334). However, management combines facts and judgments while preparing financial statements. Such statements require management to make significant accounting estimates and judgments, as well as determine the appropriate accounting principles and methods used in the preparation of the financial statements. Management, seen in law as agents or (trustees) of company properties, are often distinct from the shareholders (equity holders) who are the owners. Furthermore, management holds so much information on day to day operations of companies, when compared with shareholders a situation characterized as “information asymmetry”.

Most financial statements are laden with misleading and often out rightly deceptive figures meant to conceal liabilities or 'manage' assets to give an impression of rosy performance on the part of the company and its management. This practice has been described variously as creative, deceptive or inventive accounting or simply 'earnings management" and/or disclosure management etc.

If management engages in creative accounting, the law provides a way out for shareholders who appear to be at the mercy of the managers. This legal lee-way is that financial statement to be presented to shareholders at AGM must be audited. It is mandatory for quoted companies in Nigeria to comply with the legal requirements by auditing their financial statements. But can shareholders take financial statements issued by companies and duly audited as giving security on the truth and fairness of figures contained in such document?

The truth is that in Nigeria today and the world over, the corporate arena stinks with dubiously packaged financial statements, meant to deceive users of such statements. Nwagbose (2008) observes that "events in the Nigerian and other economies the world over in the recent past have made the general public to wonder whether accountants do at all have ethics,, i.e, “rules of conduct - that guide their exercise of judgment and whether accountants both in private and public do abide by such ethics, if any’. According to Nwagbose (2008) the

public seem to be asking whither accountants? Similarly, Horam (1993) submits that "public esteem for accountancy profession has declined, not only in Nigeria, but also in other countries like Britain, following the collapse of many seemingly strong companies with clean audit report and the highlight of various creative accounting techniques used". Examples are Enron, WorldCom in the USA, Cadbury Nigeria Plc and Africa Petroleum Plc in Nigeria. While some companies suffered huge losses as a result of unreported creative accounting, some just collapsed.

*The law gives a broad list of responsibility to the auditors in connection with reporting on financial statements. For example section 359 of CAMA 1990 requires the auditors to state explicitly whether in their opinion the annual accounts have been properly prepared in accordance with the Act and in particular whether a true and fair view is given. As expected, any breach of the above section of the law should attract qualified audit report if management refuses to make necessary adjustments. In spite of this onerous responsibility and powers, it appears that financial statements with questionable (and sometimes) out-rightly misleading contents are issued by companies and they are not qualified by auditors.*

The scenario painted so far points to the fact that auditors are liable wherever, and whenever financial statements with misleading or dubious figures are presented to the shareholders unqualified and even other third parties.

**Research Questions**

This study was guided by the following questions:

(a) What is the relationship between auditors' ethical judgment and liability to users of financial statements?

(b) What is the relationship between auditors' opinion on creative accounting and liability to users of financial statements?

**Objectives of the study**

The objective of this study is to investigate the link between auditors" liability and creative accounting in Nigeria. The specific objectives are:

(a) To ascertain the relationship between auditors' ethical judgments and liability to users of financial statements in Nigeria.

(b) To determine the relationship between auditors’ opinion on creative accounting and liability to users of financial statements.

**Significance of the Study**

The phenomenon of creative accounting is no longer new in literature. However, a study that establishes a nexus between creative accounting and auditors" liability in Nigeria is fairly novel. This study would shed light on the liability that could accrue to audit firms when litigation on creative accounting practice is successfully proved; highlight the fact that creative accounting is a global phenomenon hence investing public should be wary of taking information in financial statements hook, line and sinker among others.

## Scope of the Study

The study was carried out in the big five audit firms and other four medium and small size audit firms all having their operational headquarters in Lagos though their clientele spread all over the whole country. The purposively sampled audit firms all carried out audit of both public quoted companies and private companies.

## Review of Related Literature

### Creative Accounting

Barnea et al (1976) in Okoye & Alao (2008) defines creative accounting as euphemisms for accounting practices that tend to circumvent, albeit cleverly, or manipulate the rules of standard accounting practices or the spirit of those values. They are characterized by dubious complication and use of novel, ways of presenting income, assets or liabilities. It involves the deliberate dampening of fluctuations about "some levels of earning considered normal for the firm". Schipper (1989) argues that 'creative accounting can be equated with 'disclosure management", in the sense of a purposeful intervention in the financial reporting processes. Okoye & Alao (2008) contends that the information perspective is a key element underpinning the creative accounting phenomenon. This is because a conflict is created by the information asymmetry that exists in complex corporate structures between a privileged management and a more remote body of stakeholder. Furthermore, managers may choose to exploit their privileged position for private gain, by managing financial reporting disclosures in their own favour. Naser (1993) views creative accounting as the transformation of financial accounting figures from what they actually are to what prepares' desire, by taking advantage of the existing rules and/or ignoring some or all of them.

Healy & Wahlem (1999*)* observes that "earning management" (a form of creative accounting) occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of a company or to influence contractual outcomes that depend on reported accounting numbers.

### The Ethical Perspective of Creative Accounting

What should be the attitude of auditors to a situation where Management has indulged in creative accounting? Vasuderan (2008) observed that "the judgmental freedom, to record a transaction in any manner without breaking the basic rule, but against the spirit of it is the tool for inventive accounting". Drever et al (2007) suggest that the main reason for creative accounting relates to the desire to influence wealth transfers the various stakeholders, including management, controlling shareholders, other shareholders and potential shareholders. This happens because managers and controlling shareholders take advantage of the information asymmetry between themselves and existing and potential shareholders Breton (2004). The use of accounting as a tool for manipulation raises ethical questions. Drever et al (2007) try to differentiate between manipulation that is within the law (earnings management) and manipulation that is outside the law (fraud), it is instructive that they concluded that "often the difference between the two is narrow".

**Auditors Liability**

Auditors liability arises from the obligations they have in particular to their principal (the company shareholders) and by extension other shareholders who are the third party. Section 368 of the CAMA 1990 specifically states the obligations (liabilities) of the auditors to include:

1. a company's auditor shall in the performance of his duties, exercise all such care, diligence and skill as is reasonably necessary in each particular circumstance.
2. where a company suffers loss or damages as a result of the failure of its auditor to discharge his fiduciary duty he shall be liable for negligence and the directors may institute an action for negligence against him in the court.
3. if the directors fail to institute an action against the auditor any member may do so after the expiration of thirty days notice to the company of his intention to institute such action.

Furthermore, Oladipupo (2005) asserts that auditor's liabilities can arise if the auditor can be shown to be professionally negligent; loss has been suffered; that negligence is the direct cause of the loss and that the auditor has legal liability in the circumstances.

**Methodology**

The study focuses on auditors' liability and creative accounting in Nigeria. However, the study will concentrate on audit firms in Lagos. The choice of Lagos for the study is informed by the fact that no less than 80% of practicing audit firms in Nigeria have their headquarters in Lagos and the remaining 20% though operate in other locations outside Lagos also have branches in Lagos where substantial audit take place. This ***choice*** will make it feasible for the researcher to administer the instrument to prospective respondents.

The population of this study will comprise all audit firms in practice in Nigeria. The sample of this study was being made up of the audit partners, managers audit senior and other professionally qualified staff in the "big five" audit firms and other four medium and small size firms. The choice of these firms is hinged on the fact that quoted companies prefer to give their external audit service to reputable and well established firms. This is in line with global practice. The sampled firms fall under the three categories indicated above. Approximately one hundred and fifty (150) questionnaires were distributed to the different categories of staff.

**Results and Discussion**

Table 1 shows analysis of the questionnaires administered in this study. One hundred and fifty questionnaires were administered as shown in the Table while only 77 were retrieved. A similar study on auditors' attitude towards creative accounting by Rabin (2005) showed that 600 questionnaires were distributed and 40 received which is a response rate of 6.3%. This rate of return was attributed to the fact that auditors are sensitive about earnings management and that partners may not have distributed surveys to managers or did not encourage managers to respond. Gibson and Fakes (1977:170) warn that self reported

unethical behaviour may be understated due to the social desirability bias against reporting unethical behaviour. So, a study on auditors' liability and creative accounting might have generated partially low response due to some of the factor identified above.

**Table 1 Analysis of the Questionnaires Administered**

| Name of the Firm | No of questionnaire administered | No of questionnaire retrieved |
|---|---|---|
| Akintola Williams Deloitte Touche | 20 | 13 |
| KPMG Audit | 20 | 11 |
| Ernest and Young Osindero | 20 | 10 |
| Z.O. Ososanya & CO | 20 | 8 |
| Ijewere & CO | 20 | 11 |
| Dafinone & CO | 13 | 6 |
| Giwa Osagie & CO | 13 | 6 |
| Balogun Badejo & CO | 12 | 7 |
| Babington Ashaye & CO | 12 | 5 |
| Total | 150 | 77 |

**Auditors Ethical Judgment and Liability to Users of Financial Statements**

In this study, a number factors that tested auditors ethical judgment and liability to users of financial statements were presented to the respondents in Section A of the questionnaires and were requested to state their agreement or otherwise on a 5-point Likert scale of strongly agree (5), agree(4) undecided (3), disagree (2) and strongly disagree (1). The descriptive analyses of their responses are presented in Table 2 below.

Table 2 presents the descriptive analysis of the auditors ethical judgment and liability to users of financial statements in Nigeria. Result showed that 23.4% of the respondents strongly agree that failure to fully examine underlying records is a source of liabilities for auditors while 11.6% strongly disagree with the statement. However, larger percentages of the respondents agree that failure to fully examine underlying records is a source of liabilities for auditors with a weighted mean of approximately four (3.55). This result implies that auditors could be liable for failure to fully examine all underlying records when preparing financial statement and this may pose a risk to the users of such financial statements. The Table further showed that larger percentage of the respondents (40.8) disagree that client proposal for tax evasion could be permitted with convincing explanation from management, as this might make auditors' liable and pose a risk to user of such statements.

Furthermore, it was revealed from the Table that majority of the respondents disagree to item 2,3,4,5.6,7,8 and 9 with a weighted mean of approximately two (2). Hence, it was discovered from this result that: auditors could tolerate failure by management to disclose debt that are long overdue; auditors could disagree with the management on the way certain items are treated in the accounts; sharing of information in respect of accounts of a client with a professional colleague without client consent is ethically wrong; auditors could not accept the practice whereby management delays timing of recognition of liabilities to influence profitability; that auditor could not allow recognition of revenue when important uncertainties

exist or services are still to be rendered; tax consulting and revenue collection for the same client was ethically wrong and might expose auditors to risk. And that management might not use depreciation to either increase or decrease profits as this may pose risk to the auditor.

It was also discovered from the result of the analysis that the auditors were not certain (weighted mean of 3.05) whether it *was* ethically right to decrease fees to attract new clients or warn a client of a debtor's bankruptcy, where the debtors were also clients. However, the results showed that respondents agree (weighted mean of 3.36 > 4) that capitalising revenue expenditure such as R&D could be done by management in agreement with the auditors.

**Auditor Opinion and Liability to Users of Financial Statements**

Auditors' opinion on the financial statements audited should be clear. An unqualified opinion on financial statements is expressed when in the auditors' judgment they give a true and fair view (where relevant) and have been prepared in accordance with relevant accounting or other requirements. In view of this, a number of opinions were examined whether they would give a true and fair view of financial statement where relevant. These opinions were presented to the respondents in part B of the questionnaires and were requested to state their agreement or otherwise on a 5-point Likert scale of strongly agree (5), agree (4), undecided (3), disagree (2) and strongly disagree (1). The descriptive analyses of their responses are presented in table 4.5

It was shown in Table 3 that majority (73.7%) of the respondents strongly agree to the opinion that an auditor might issue a qualified report if management was unwilling to accept his/her advice and opinion on treatment of transaction in a financial report while very small (1.3%) number of respondents disagree to the opinion. The weighted mean (4.09) across all the respondents implied that majority of the respondents agree to issue this opinion so far as it posed liability and risk to the auditors and users of financial statement respectively. The result of opinion of auditor accepting a strong argument by management where there was a change in accounting policy that caused significant changes to the financial statement showed that generality of the respondents were undecided (weighted mean of 2.93 -3) whether they should issue such opinion or not. Result further showed that larger percentage of the respondents (66.7%) disagrees on the point that auditor could permit a situation whereby financial statement had been prepared not fully in accordance with relevant legislation or application accounting standards with explanation from management. This result implied that the issue might be a source of liability to the auditors as well as pose a risk to the user of such financial statement, hence, strong rejection of the point.

Furthermore, it was revealed from the result that auditor refusing to accept situation where there was inadequate disclosure of information relevant to proper understanding of the financial statement with weighted mean of 2.22 while it was generally accepted by the respondents to issue an adverse opinion no matter the pressure from management if the accounts do not give a true and fair view. It was deduced from the result that the auditor would only issue an opinion such as a qualified report if management was unwilling to accept his/her advice and opinion on treatment of transactions in a financial report as well as issue of an adverse opinion no matter the pressure from management if the accounts did not give a true and fair view as this posed liability to the auditor and users of such financial statements.

The study showed that auditors' could be liable for failure to fully examine all underlying records when preparing financial statements and this might pose a risk to the users of such financial statements. The study also showed that if auditor permitted client proposal for tax evasion with convincing explanation from management, it might make him liable and pose a risk to user of such statements. Further results on ethical issues revealed that: auditors' could not tolerate failure by management to disclose debts that are long overdue; auditor could also disagree with the management on the way certain items are treated in the accounts; sharing of information in respect of accounts of a client with a professional colleague without client consent was ethically wrong; auditor could not accept the practice whereby management delays timing of recognition of liabilities of influence profitability; auditor could not allow recognition of revenue when important uncertainties exist or services are still to be rendered; tax consulting and revenue collection for the same client is ethically wrong and may expose auditors to risk and that management may not use depreciation to either increase or decrease profits as this may pose risk to the auditor.

Result on auditors' opinion and liabilities to users of financial statement showed that if auditor permits a situation whereby financial statement have been prepared not fully in accordance with relevant legislation or applicable accounting standards with explanation from management, such opinion will be a source of liability to the auditor and as well pose risk to the users of such financial statement. It was further discovered that auditor can issue an opinion such as a qualified report if management is unwilling to accept his/her advice and opinion on treatment of transaction in a financial report as well as issue of an adverse opinion no matter the pressure from management if the account does not give a true and fair view as this poses no liability to the auditor or pose no risk to the users.

**Conclusions**

This study examined auditors' liability and creative accounting in Nigeria. It sought to ascertain the relationship between auditors' ethical judgments and liability to users of financial statements and determined the relationship between auditors' opinion and their liability to users of financial statements; the following conclusions were drawn:

Auditors' from the point of view of ethical judgments cannot tolerate failure by management to disclose debts that are long overdue as this may pose liability to both auditor and users of financial statements. It was also concluded that auditors can disagree with the management on the wav attain items are treated in the accounts, sharing of information in respect of accounts of a client with a professional colleague without client consent is ethically wrong, auditor cannot accept the practice whereby management ill-lay timing of recognition of liabilities to influence profitability, auditor cannot allow recognition of revenue when important uncertainties exist or services are still to be rendered management may not use depreciation to either increase or decrease profits as this may pose risk to the auditor. Also, it was concluded that if auditor issues an opinion whereby financial statement was been prepared not fully in accordance with relevant legislation or applicable accounting standards with explanation from management, such opinion will be a source of liability to the auditor and as well pose risk to the users of such financial statement. Furthermore, it was discovered that auditor can issue an opinion on treatment of transaction in a financial report as well as

issue of an adverse opinion no matter the pressure from management if the accounts do not give a true and fair view as this pose no liability to the auditor or pose risk lo the users.

**Recommendations**

Based on the findings of the study, the following recommendations emerged:

i. Since there appeared to be almost consensus of opinion among the respondents (most of whom are professionally qualified accountants) that right ethical judgments' have implications on auditors liability and users of financial statements, it will be important for professional accounting bodies such as ICAN, which issues practice license to auditors to continue emphasizing professional ethical practice and behaviour for accountants in training and members already in practice through continuous professional education in form of seminars/conferences on accounting and auditing ethics.

ii. In view of prevalence of creative accounting scheme by management of companies globally, auditors have to take a stand on correct audit practice of reporting on financial statements as they are, if the public is to continue to trust the quality assurance role that auditors are expected to give to stakeholders in public quoted companies.

iii. In view of global dimension of creative accounting and its menace to corporate practice, Nigeria legislature should come up with a law to curb creative accounting just the way we have the Sarbanes-Oxley Act 2000 in the USA,

iv. Users of financial statements, in particular investors are advised to be wary of taking the content of published financial reports as sufficient they should employ the services of professionals for correct interpretation of the contents of financial statements.

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## APPENDICES

**Table 2 Description Statistics of Auditors' Ethical Judgment and liability to Users of Financial Statements**

| S/N | Variable | SA F(%) | A F(%) | U F(%) | D F(%) | SD F(%) | Weighted means |
|---|---|---|---|---|---|---|---|
| 1 | Failure to fully examine underlying records is a source of Liability tor Auditors. | 18 (23.4) | 37 (48.1) | - | 13 (16.9) | 9 (11.6) | 3.55 |
| 2 | Client proposal for tax evasion can be permitted with Convincing explanation from management | 4(5.3) | 9(11.8) | 3(3.9) | 31(40.8) | 29 (38.2) | 2.05 |
| 3 | Tax consulting and revenue collection for the same Client does not expose auditor to risk | 9(11.7) | 21 (27.3) | 4(5.2) | 21(37.7) | 14(18.2) | 2.77 |
| 4 | You can tolerate failure by management to disclose Debts that are long overdue | 1(1.3) | 6(7.8) | 8(10.4) | 43(55,8) | 19(24.7) | 2.05 |
| 5 | You should avoid disagreement with management on the way certain items are treated in the accounts | 1(1.3) | 3(3,1) | 2(2.6) | 52(68.4) | 18(23.7) | 1.91 |
| 6 | Sharing of information in respect of accounts of a client with a professional colleague without client Consent is ethically right | - | 10(13.3) | 4(5.3) | 47(62.7) | 14(18.7) | 4.36 |
| 7 | Auditor may accept the practical whereby management Delay liming of recognition of liability to influence profitability | - | 3(3.9) | 2(2.6) | 47(61.8) | 24(31.6) | 3.94 |
| 8 | Auditor can allow recognition of revenue when important Uncertainties exist or services are still to be rendered. | 1(1.3) | 5(6.7) | 7(9.3) | 47(62.7) | 15(20.0) | 4.27 |
| 9 | Management may use depreciation to their increase or decrease Profits, this does not pose any risk to the auditor | 6(8.1) | 14(8.9) | 3(4.1) | 34(45.9) | 17(23.0) | 4.10 |
| 10 | You can sometimes decrease tees m attract new client | 3(4.0) | 32942.7) | 11(4.7) | 24(32.0) | 5(6.7) | 3.05 |
| 11 | You could warn a client of a debtor's bankruptcy, where | 7(9.5) | 28(37.8) | 9(12.2) | 22(29.7) | 3(4.1) | 3.36 |
| 12 | Capitalising revenue expenditure such as R&D can | 12(16.2) | 31(41.9) | 6(8.1) | 22(29.7) | 3(4.1) | 3.36 |

| | be done B\ management in agreement with me auditors | | | | | | |
|---|---|---|---|---|---|---|---|

Source: Author's field survey, 2018

**Table 3 Description Statistics of Auditor opinion and liability to Users of Financial Statements**

| S/N | Variable | SA F(%) | A F(%) | U F(%) | D F(%) | SD F(%) | Weighted means |
|---|---|---|---|---|---|---|---|
| 1 | You may issue a qualified report if management is unwilling to accept your advice and opinion on treatment of transaction in a financial report. | 16(21.1) | 56(73.7) | 1(1.3) | 1(1.3) | 5(1.6) | 4.09 |
| 2 | As an Auditor, you could accept a strong argument by management where there is a change in accounting policy that causes significant changes to the financial statement | 11(17.1) | 16(21.1) | 6(7.9) | 35(46.1) | 6(7.9) | 2.93 |
| 3 | Auditor can permit a situation whereby financial statement have Been prepared not fully in accordance with relevant legislation or applicable accounting standards, with explanation from management | - | 1(1.3) | 2(2.7) | 50(66.7) | 22(29.9) | 1.76 |
| 4 | You can accept a situation where there is inadequate disclosure of information relevant to proper understanding of the Financial statement, it' at least such information is disclosed to you | 3(3.9) | 12(15.8) | 30-9) | 39(51.3) | 19(25) | 2.22 |
| 5 | You should issue an adverse opinion no matter the pressure from management if the accounts do not give a true and fair view | 9(25) | 26(34.2) | 2(2.6) | 25(32.9) | 4(5.3) | 3.41 |