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Audit Tenure: An Assessment of its Effects on Audit Quality in Nigeria

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Abstract *The purpose of this study is to examine the relationship between the tenure of auditor and audit quality in Nigeria. The Binary Logit Model estimation technique was use to analyze the relationship between the tenure of an auditor and audit quality. Further research should consider other vital variables that affect audit quality such as non-audit services. Findings reveal that there is a negative relationship between auditor tenure and audit quality though the variable was not significant.. The recommendation is that there is the need for the financial reporting council and other regulatory bodies in line with best practices to look critically into the issue of auditor tenure and its impact on audit quality in Nigeria.*

Key words Audit quality, Audit tenure, Auditing and Financial Reporting

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1. Introduction

1.1. Background to the study

Audit involves performing procedures to obtain evidence about amounts and disclosures in the financial statements so as to evaluate the appropriateness of accounting estimates made by management (KPMG, 2008). Audit report quality is a basic requirement to enhance the credibility of financial statements within the stakeholders. The Audit quality therefore, is a basic ingredient in enhancing the credibility of financial statements to users of accounting information. Consequently, studies (Fairchild, 2008; Coate, Florence and Kral, 2002) note that audits add credibility to the financial information by providing an independent verification of management-provided financial reports, thus reducing investor's risk. Financial reporting credibility is reflected in the confidence of users in audited financial reports (Watkins, Hillison, and Morecroft, 2004). As opined by Levitt (2000), the perception of audit quality plays a critical role in maintaining systematic confidence in the integrity of financial reporting. The higher the perceived audit quality, the more credible the financial statements. This will consequently improve user's confidence in those financial statements.

Concerns about audit quality have gained increased ascendancy especially as a result of the spectacular financial reporting scandals in major corporations, such as Enron, WorldCom and other companies. The aftermath of these scandals has led to the identification of a perceived "expectation gap" in the audit quality as many users of audited financial statements have different expectations of the audit function from what it actually delivers (Beattie, Brandt and Fearnley, 1999).Therefore, there has been a call for sweeping changes in the auditing profession to ensure improved audit quality (Auditing Profession 2002).

However, the non quantitative nature of "audit quality" as a variable has necessitated the existence of a plethora of proxies and indicators for its measurement (Cameran, Prencipe and Trombette, 2007). De Angelo (1991) defined audit quality as the probability that an auditor will both discover and truthfully report material errors, misrepresentation and omissions detected in a clients accounting system. This probability depends upon the broad concept of an auditor's professional conduct, which includes factors as objectivity,

due professionalism and conflict of interest. Some studies (Francis 2004, and Geiger & Raghunandan, 2002) measure audit quality in terms of audit or reporting failure, based on the idea that audit quality is inversely related to audit or reporting failures. Other studies (Nagy, 2005; Myers, Omer & Myers, 2003) use earnings as a surrogate for audit quality. The implicit assumption is that high audit quality implies high earnings quality (Johnson, Khurana and Reynolds, 2002). Wallace (1980) notes that a measure of audit quality is the audit's ability to reduce noise bias and improve the fineness in accounting information. Researchers have also used estimated discretionary accruals as a surrogate for audit quality (Dechow & Dicheve, 2002; and Krushman, 2003) assuming that higher estimated discretionary accruals reflect lower earnings quality and thus lower audit quality. Knechel and Vanstraelen (2007) note that audit quality is measured by the propensity of the auditor to issue a going concern opinion. Finally, Modrich, Jackson and Roebuck (2007) note that true audit quality is when the audit does not result in a type 1 error: a failing company being given an unqualified report or a type 11 error: a non-failing company being given a qualified report.

Chijoke, Emmanuel and Nosakhare,(2012) opines that all the divergences with regards to the appropriate measure of audit quality may be seen to reflect the need by researchers to monitor and provide indices amenable to control so as to make inferences on the audit quality. Consequently, studies (Arrunada and Paz-Ares, 1997; Healey and Kim, 2003; Brody and Moscove, 1998) have attempted to identify possible control variables for the state of audit quality. In the light of these studies, auditor tenure has become the focus of much debate. The resulting dilemma is that the firm is faced with the decision of whether to replace its auditors after a period of time or to build and maintain a long-term relationship with the audit firm. The outcome is at polarity with conflicting findings. While some researchers have identified the need and have provided justification for auditor rotation (Healy and Kim, 2003; Ebimobowei and Oyadonghan 2011; Geiger and Raghunandan 2002) others argue on positive effects of tenure on audit quality (Ghosh and Moon, 2005; Adeyemi and Okpala 2011; Defond and Francis, 2005). In recent years, auditors had been blamed for their role in notable corporate scandals in Nigeria such as Cadbury Nigeria Plc (2006), Intercontinental Bank Plc (2009), African Petroleum Plc (2009), Afribank Plc (2009) etc. The criticism had raised lots of questions regarding audit quality and audit tenure. The question of whether audit quality is affected by the length of time that an auditor serves a client has received extensive attention from researchers. Therefore, ongoing interest in the issue suggests that this question has not been completely answered by extant research. This study is to assess the effect of audit firm tenure on auditor reporting quality in Nigeria audit setting.

1.2. Statement of the Problem

Several studies (Arrunada and Paz-Ares, 1997; Healey and Kim, 2003; Brody and Moscove, 1998; Dopuch, King and Schwartiz, 2001; Myers et al 2003; Mgbame, Eragbha and Osazuwa, 2012) have attempted to analyze some explanatory variables for the state of audit quality. In view of these studies, auditor tenure has become the focus of much debate. Should a firm replace its auditors on a regular basis, or should the auditor be allowed to build a long-term relationship with the client? Studies on the effect of auditor tenure on audit quality are at divergent. The spate of audit failure in the world, especially in Nigeria, has brought great disappointment to the users of financial reports. The bane of the problem has been linked to long term of audit firm tenure which has also been linked with creative accounting. In Nigeria audit setting, the challenge of audit tenure and audit quality reporting has not attracted much empirical studies beyond mere anecdotal opinions (Mgbame, Ezagbhe and Osazuwa, 2012). Thus, this study will examine the effect of audit tenure on audit quality report in Nigeria.

1.3. Objective of the Study

The objectives of the study are specified thus;

i. To determine whether the length of auditor tenure enhance audit quality.

ii. To examine whether audit tenure impairs auditor independence for compromising audit quality.

1.4. Research Questions

i. Does the length of auditors' tenure enhance audit quality in Nigeria?

ii. To what extent does audit tenure impairs auditor independence for compromising audit quality?

1.5. Hypotheses

H01: There is no significant relationship between the length of audit tenure and audit quality in Nigeria.
H02: Audit tenure does not impairs auditor independence for compromising audit quality in Nigeria.

1.6. Justification for the study

The results from this study are useful for the users of audited financial statement and regulators as a feedback to enhance audit quality in Nigeria. It will broaden extant literature on audit quality in Nigeria and assist policy maker in formulating and administering pragmatic policy to improve audit quality in Nigeria audit setting.

2. Literature review

The International Audit and Assurance Standard Board (IAASB), a sub-committee of the International Federation of Accountants (IFAC) defined an audit as an independent examination of, and expression of opinion on the financial statements of a business enterprise by an appointed auditor in accordance with his terms of appointment and in compliance with the relevant statutory and performance requirements. The audit report is the end product of every audit assignment that the auditor issues to the members of a client company expressing his opinion on the truth and fairness view regarding an enterprise's financial statements. In Nigeria, this statutory duty is provided for in Section 359(1) of the *Companies and Allied Matters Act (CAMA), 1990*. The auditor has a statutory responsibility by virtue of Section 359(3) of the *Company and Allied Matter Act (CAMA), 1990*, to issue a report to the members of the audit committee which must be statutorily set up by such a client.

Auditor reporting quality is a basic ingredient to enhance the credibility of financial statements to those interested parties. However, this could not been seen if the auditor is not independence. Without independence, the process of auditing can be argued to the extend that the auditor would give bias opinion to their clients. One of the factors that would adversely influence auditor independence in giving their opinion is a close relationship between auditor and clients, namely long audit tenure. For example, Deis and Giroux (1992) found that the longer the auditors audit their clients, it leads to closer relationship between the audit firms and clients and consequently decrease audit quality. Prior studies have documented two viewpoints of the effect of audit tenure on the credibility of financial statements; regulators view and economic view (Geiger & Raghunandan, 2002). In the point of regulatory view, long association between a client and an audit firm may lead to impair their independence (Geiger & Raghunandan, 2002). For example, in the United States, the Metcalf Committee report argued that long association between a corporation and an accounting firm may lead to such close identification of the accounting firm with the interests of its client's management that truly independent action by the accounting firm becomes difficult. Therefore, the report suggested a mandatory auditor rotation as a way for the accounting profession to bolster their independence from clients (Geiger & Raghunandan, 2002). Geiger & Raghunandan, (2002) Deis and Giroux (1992); O'Keefe, Simunic and Stein (1994); and Raghunandan, Lewis and Evans (1994) found that the long auditor tenure would decrease audit quality. Similarly, Vanstraelen (2000) found negatively relationship between auditor tenure and opinion and then again provide support for a mandatory audit firm rotation.

Barbadillo and Aguilar (2008), reveals an inverse relationship between auditor tenure and audit quality and suggest that auditors tend to be more dependent in the first years of the auditing engagement. The study concludes that the shorter the auditor's tenure, the more they behave in a dependent fashion.

According to Ebimobowei and Oyadonghan, (2011) concludes that a policy favoring mandatory rotation of auditors could have positive effects on the quality of audit reports as it would allow for fresh approach and restore public confidence in the audit function. Adeyemi and Okpala (2011) notes that an audit firm's tenure can result in a loss of auditor's independence. A long audit-client relationship could lead to an alignment of the auditors' interest and that of its client which makes truly independent behaviour of the auditor a probability.

According to Johnson et al (2002), as the auditor-client relationship lengthens, there is the tendency that auditor may develop a "learned confidence" in the client which may result in the auditor not performing religiously, the required testing of financial reports. This learned confidence results in the auditor making

assumptions about outcomes and using less rigorous audit procedures or static audit programmes. Potentially, a loop hole for a decline in audit quality has been created. Arrunada and Paz-Ares (1998) argue that a long auditor–client relationship may result to the development of personal relationship that may lead to the bonds of loyalty, trust or emotive relationships been developed between the client and the auditor. The implication is that truly independent auditor opinion becomes difficult and there is the increased likelihood of the auditor acceding to client's pressure in relation to their choice and application of accounting policies. This adversely affects the auditor's ability to offer a true and fair audit report. Summer (1998) analyses the hypothesis that audit tenure can enhance audit quality. This test was carried out within the framework of a stylized game model between borrowers, auditors and capital. When audit engagement lasts for two periods, the equilibrium entails that auditors report risky projects as risky, with a positive probability, in the first period. On the other hand, when the auditor engagement lasts only for one period, the equilibrium shows that auditors will report risky projects as safe in the first period. The study concludes that auditors are more unlikely to produce reporting quality in short term than in long term engagements and tenure rotation might have adverse effects on audit quality because it undermines the incentives for building up a reputation for honesty.

Dopuch, King and Schwartz (2001) also examine the impact of auditor tenure on audit quality. The result is consistent with the hypothesis that the auditor compromises his independence most often in a long term auditor contract and suggests that afterall auditor tenure may have significant effect on the audit quality. Copley and Doucet, (1993) opined that the longer the period of engagement, the higher the risk of lower audit quality. Geiger and Raghunandan (2002) investigate the relationship between the length of the auditor-client relationship and audit reporting failures .The result indicates the existence of a positive and significant relationship between tenure variable and audit reporting failures. Vanstraelen (2000) examines the effect of long-term audit client relationship on audit quality. The external user's perception of the audit report was used as the indicator for quality. Utilizing the logistic regression model, the study findings shows that long-term auditor client relationships is positively related with the increased likelihood of the auditor issuing an unqualified opinion.. Walker, Lewis and Casterella, (2001) provide empirical evidence relating to the link between the length of the audit engagement and audit failures. A logit model was used to predict failures. The results suggest that risk increases early on in audit client relationship and then declines over long term periods. As the failure rate in long term engagements is low, the authors conclude that auditor rotation may not necessarily improve audit quality. Nashwa (2004) using a sample of U.S companies, carried out a study to examine the relationship between long term auditor-client relationship and the probability of audit failure. A logit regression model was used to predict failure using tenure as the independent variable. The results indicate that risk increases early in the auditor client relation and then declines over time suggesting that longer audit tenure overtime will smoothen out any initial challenges that may impair the quality of the auditor's performance. The results of the study do not support the hypothesis that short auditor tenure improves audit quality. In the light of the positions of various studies as reviewed above, we can argue that the effects of auditor tenure on audit quality are controversial. Moreover, few empirical studies use publicly available secondary data in order to determine whether perceived threats to auditor independence actually compromise auditor independence. Again, we could not access any documentary evidence from Nigeria in this subject area. Therefore, this study which was motivated by the lack of consensus in the literature on the impact of audit tenure on audit quality will contribute to the debate by examining the relationship between auditor tenure and audit quality in Nigeria.

3. Methodology of research

Cross sectional data gathered from annual reports of selected quoted companies in Nigeria was used for this study. The data were from audits completed in 2010. A sample size of fifty (50) companies of the 199 listed equities was selected using the simple random sampling technique. Krejcie & Morgan (1970) in Amadi (2005) agrees with the sample as they proposed the population proportion of 0.05 as adequate to provide the maximum sample size required for generalization. The relationship between auditor tenure and audit quality was analyzed utilizing the binary logit model estimation technique. The choice of Maximum Likelihood (ML) binary logit regression model is based on the inability of the OLS multiple regression model to yield reliable coefficients and inference statistics in situation where the dependent variable is binary (0 and 1). Thus the

binary logit regression model unlike others is based on the use of dichotonomous dependent variable. The model developed basically relates auditor tenure with audit quality measured by the likelihood that a sampled company employs the services of the big audit firms in Nigeria. Namely;

Ernst & Young, Price Water House Coopers, Akintola Williams Delliote and KPMG. Several Studies (Skinner and Srinivasan, 2010; Krishnamurthy, Zhon and Zhon 2002; De Angelo, 1981 and Davidson, 1993) have provided both empirical and theoretical justification for use of big audit firms as a proxy for audit quality. Consequently, a dummy value of 1 is used if a firm uses any of the big 5 auditors (Ernst & Young, Price Water House Coopers, Akintola Williams Delliote and KPMG) and 0 if otherwise. In line with the empirical studies by Manry, Mock and Turner (2005), a number of control variables was included; Size, Roa, Board independence, Director Ownership and Board size. The econometric procedure was conducted using Eviews 5.0 software.

4. Measurement of Variables and Model Specification

The following variables are considered relevant in the specification of the model examining the relationship between auditor tenure and audit quality.

AUDIT QUALITY = measured by the likelihood that a sampled company employs the services one of the big audit firms. A dummy value of 1 is used if a firm uses any of the big 5 auditors and 0 if otherwise.

TENURE = Measured in terms of number of years spent as auditor for Sample company. If greater than 3, we assign 1, else 0.

SIZE = Natural logarithm of total assets.

ROA = Return on Assets Calculated by dividing a company's annual earnings by its total assets.

BOARDI =Board Independence measured as the proportion of external directors on the board.

BOS=Board Size measured as the number of directors on the board.

DOWN= Directors' ownership measured as the percentage of ownership by directors.

Consequently, the econometric model is specified below;

$AQ = \beta o + \beta 1BOARDI + \beta 2\ BOS + \beta 3TENURE + \beta 4DIROWN + \beta 5ROA + \beta 6SIZE + Ut$

The Maximum Likelihood (ML) binary logistic regression Technique will be used in the estimation of the various parameters selected in the model.

Table 1. Presentation of Results

Dependent Variable: AUDQUA				
Method: ML - Binary Logit (Quadratic hill climbing)				
sample: 1 50				
Included observations: 50				
Covariance matrix computed using second derivatives				
Variable	Coefficient	Std. Error	z-Statistic	Prob.
C	2.430303	1.607174	1.512159	0.1305
BOARDI	-3.1748	1.729074	-1.836127	0.0563
BOS	-0.00567	0.088358	-0.064157	0.9488
DOWN	-0.40793	1.533745	-0.265972	0.7903
ROA	1.448458	1.515006	0.956074	0.339
SIZE	-1.07E	-10 9.91E	-11 -1.081061	0.2797
TENURE	-0.17657	0.534356	-0.330435	0.7411
McFadden R-squared	0.175053	Mean dependent var		0.64
S.D. dependent var	0.484873	S.E. of regression		0.467789
Akaike info criterion	1.358071	Sum squared resid		9.409543
Schwarz criterion	1.625754	Log likelihood		-26.95176
Hannan-Quinn criter.	1.460006	Deviance		53.90353
Restr. Deviance	65.34182	Restr. log likelihood		-32.67091
LR statistic	11.4382	Avg. log likelihood		-0.539035
Prob (LR statistic)	0.057739			

5. Analysis of results

The Result shows a multivariate binary logit regression convergence achieved after three iterations. The overall fitness of the model as revealed in the LR statistic of 11.43829 with Probability (LR STAT) of 0.057791 which is less than the standard critical p-value of 0.05. This implies that the estimated model is statistically significant at 5% level and thus the linearized functional specification of the model is not inappropriate. The overall explanatory power of the model is revealed in McFadden R- squared, shows that about 18% of the systematic variations of the dependent variable is explained by the independent variables which is quite low. Furthermore, the z-ratio and respective p-value analysis indicative of the individual statistical significance of the explanatory variables shows that an inverse relationship exists between Auditor tenure and Audit quality. The result could stimulate discourse on the sensibleness of changing auditors after a period of time as longer tenure periods may signal increasing threats and declining possibility for quality audits. Thus, as Barbadillo and Aguilar (2000) have also observed, the shorter the auditor's tenure, the more they behave in a dependent fashion. Other variables examined alongside auditor tenure such as board independence was found to be negatively related with the likelihood of quality audits. A Similar finding was also observed for board size which is seen to be inversely related with the probability of having quality audits as shown in its slope coefficient. Director ownership and firm size were also observed to relate inversely with the likelihood of having quality audits. Return on assets was observed to exhibit a positive relationship with audit quality. However, except for board independence, all other variables were found to be statistically insignificant at the 5% level suggesting practically, the need for considerable caution in implying strict causality. Based on the result, we fail to accept the hypothesis (H0) that there is a positive relationship between auditor tenure and audit quality. This implies that longer audit tenure may not signal audit quality. The Sarbanes-Oxley Act of 2002 consolidates this view as it requires rotation of the lead audit partner every five years. However, the non-statistical significance of the variable suggests caution in implying strict causality.

6. Discussion of findings

The relationship between tenure and audit quality was observed to be inverse and as noted earlier, this could stimulate the discourse on the sensibleness of changing auditors after a period of time as it may be effective at increasing the level of audit quality. The study finding is in line with Barbadillo and Aguilar (2000) which found the relationship between the auditor tenure and audit quality to be negative and concluded that the shorter the auditor's tenure, the more they behave in a dependent fashion. Findings by Mautz and Sharaf (2002) Healy and Kim, (2003) AICPA, (1992) Carcello and Nagy (2004) have also argued that rotation of audit firms is a way of improving audit quality. This is because familiarity with the client has the effect of reducing the fresh point of view auditors have in the early years of engagement. The Sarbanes-Oxley Act of 2002 prescribes a change of auditors every five years. The argument basically is that longer auditor- tenure tends to result in an opportunity cost of auditor independence. However in the Nigerian audit setting, the challenge of auditor tenure though still budding has not attracted significant regulatory pronouncements. Consequently, the length of auditor and client relationship is still at a much more discretionary level. Though other findings such as Walker, Lewis and Casterella, (2001), Knechel and Vanstraelen (2007) have also argued that auditor rotation may not necessarily improve audit quality and the effect of tenure does not have either an increasing or decreasing effect on audit quality and at best the effect is weak. The study finding is nevertheless at variance with conclusions made by Geiger and Raghunandan (2002); Johnson, Khurana and Reynolds (2002) and Myers, Myers and Omer (2003) that short auditor tenure is associated with lower quality audits. For the other variables examined alongside tenure such as board size, board independence and director ownership which are all indicative of the corporate governance were found to be inversely related with audit quality.

The finding is at variance with those of Klein (2002) Beasley (1996) Chen and Jaggi (2000) which argues that the presence of corporate governance enhances the tendency for better audits. However, Larcker, Richardson and Tuna, (2005) provides mixed evidence with regards to the effects of corporate governance on audit quality. The findings for return on assets have also be observed to be in tandem with Jaggi and Freedman (1992) while that of company size is in contrast with O'Donovan, (1997).

7. Conclusion and Recommendation

The objective of this work was to examine the relationship between audit partner tenure on the audit quality, measured by the likelihood that a sampled company employs the services of one of the big audit firms. The study attempts to provide empirical evidence in the Nigerian context. Findings from the study reveal that there is a negative relationship between auditor tenure and audit quality though the variable was not significant. The other explanatory variables (Returns on Assets, Board independence, and Director Ownership and Board size) were found to be inversely related to audit quality aside from Returns on Assets which exhibited a positive effect. Thus the debate about auditor tenure may be seen as still ongoing as reflected in the plethora of divergent research findings in this regards. A limitation of the findings may stem from the possible detection of an appropriate time period to indicate long or short tenure. Thus studies have utilized different time frames ranging from 3 years, 4 years or like the Sarbanes Oxley act which stipulates five years as an average long tenure period and these may have effects on empirical findings. However, the desire for quality audits that minimizes the expectation gap between suppliers of audit and users of audit services is globally recognized and as such x-raying the impact of auditor tenure on audit quality will require more ex-post evidence across different contexts. The recommendation is that there is the need for the Nigerian financial reporting council and other regulatory bodies in line with best practices to look critically into in Nigeria.

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