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Audit Firm Reputation and Audit Quality

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Abstract

The objective of this study was to evaluate the relationship between audit firm reputation and audit quality using a sample of listed companies trading on the floor of the Nigerian Stock Exchange. The Ordinary Least Square Model estimation technique was used to analyze the relationship between the audit firm reputation and audit quality. Our findings showed that there is a positive significant relationship between audit firm reputation and audit quality. The control variables examined alongside audit firm reputation revealed that aside audit committee size; all other variables so examined have a positive relationship with audit quality. We therefore recommend that companies should employ the services of audit firms with proven track record of audit quality and reputation.

Keywords: Audit quality, Audit firm reputation

1 Introduction

The principal-audit relationship between shareholders and management is one of the many adduced reasons for engaging the services of external auditors. According to the agency theory as expounded in literature, an agency relationship will normally exist where there is a contract in which one party called the agent acts and perform delegated duties on behalf of another party called the principal. Whenever conflict of interest arises between the principal and the agent, the agent may not act in the best interest of the principal therefore, in order to avoid such, a third party is usually called upon to mediate. This third party is the external auditor (Barzegar and Salehi, 2008). In order to properly serve as a watchdog, the auditor is expected to possess and show requisite skill, diligence, and care in executing his duties, which amongst many things is to express an opinion on the state of affairs of their clients as claimed by management. The opinion as expressed in his report affects the decisions of users of the financial statement. The way and manner the auditor employs in gathering evidence for his opinion may also go a long way in affecting the quality of his report popularly referred to as audit quality.

Audit quality according to Fairchild (2008) is an essential ingredient in enriching the credibility of financial statements to users of accounting information as it helps in verifying management claims about the company activities and affairs thereby reducing the information risk exposure of users. Woodland and Reynolds (2003) claim that no two audits may be equal in terms of quality because the technical expertise and independence levels of the engaged auditors are likely to differ. That is, the ability of the auditor is brought to bear in determining audit quality. Furthermore, he asserts that the auditor's manner of approach and strategy is fundamental to the nature of the audit. DeAngelo (1981) offers a definition of audit quality regularly used in literatures as primarily a combination of two characteristics associated with the auditor viz the technical ability to identify misstatements, and independence required for the correction of misstatements. That is, the auditor based on his qualification and displayed acumen shoulders the responsibility of audit quality. He further argues that the reputation of the engaged audit firm is germane to its producing quality report

According to Generally Accepted Auditing Standards, the standards any auditor would be required to adhere while performing his work are divided into three sections viz general standards addressing the characteristics and nature of auditors, standards on fieldwork addressing the conduct of the audit, and standard of reporting addressing the manner of communicating audit findings and opinion (AICPA 1996). According to Woodland and Reynolds (2003), these three combined describe the minimum necessary requirements for audit quality. Therefore, it follows that the ability of the auditor to bring to bear these standards in the course of performing his duties will affect the quality of the audit opinion he puts forward. Hence, a "good" audit firm should produce quality reports. Furthermore, Salehi and Abedini (2008) asserts that audit quality is associated with the quality of information contained in the financial

statements and because these financial statements are audited by high quality auditors (reputable audit firms), they should be less likely to contain material misstatements. However, over the years, there have been debates on the decline in audit quality beginning from the Andersen/Enron saga (Oliverio and Newman, 2008). Mgbame, Eragbhe and Osazuwa (2012) opines that fears about audit quality have increased tremendously because of the financial reporting scandals that have rocked major known corporations such as Enron, WorldCom and others. Many have adduced these happenings to auditors. Petroni and Beasley (1996) argue that there are no systematic differences in the loss of reserve estimation accuracy between auditors with high reputation (Big Eight) and other audit firms (Non-Big Eight). Gul and Krishnan (2002) also claim that audit quality for audit firm with high reputation (Big Five) has declined after 1995 basing their assertion on increases in the percentage of unqualified audit reports and declines in the pricing of discretionary accruals to measure audit quality. Weiner (2012) asserts that most companies in the face of scandals switch to high reputation firms (Big Four) because of their perceptions that high reputation firms produce quality reports since they face more loss of public image when compared with firms having little reputation status.

From the foregoing, it seems the perception that audit firms with reputation status producing quality audit is gradually wavering as a result of more corporate scandals surfacing in the business environment. While some still opine that firms with reputation status known as Big Eight/Six/Four will always produce quality report, others view it contrary. Furthermore, many studies like Becker, DeFond, Jiambalvo, and Subramanyam (1998); Jin, Kanagaretnam and Lobo (2011) have proxy audit quality using audit firm reputation or size based on the understanding that such firms should produce quality report either because of the reputation rationale (reputable firms have greater motivation to perform a high-quality audit) or because of the insurance rationale (stronger firms in terms of resources have a stronger incentive to ensure a high-quality audit. This act signals that there may be a significant relationship between audit quality and the reputation of audit service providers and if not, there may be a problem with researches that have proxy audit quality using audit firm reputation.

2 Statement of the Research Problem and Objective

Several researchers have proxy audit quality using reputation of auditors on the premises that the loss of reputation, economic rent and increase in litigation cost amongst other things will make auditors ensure that the report they produce is of quality however, the experienced scandals across the globe points otherwise as even some companies audited by the reputable firms have been involved (Weber, Willenborg and Zhang, 2008). Furthermore, Simunic (2003) asserts the notion that audit quality varies across different classes of audit firms has been a heated debate over centuries with divergent opinions surfacing as time elapse. Prior to 2000, the argument was in favor of reputable firms providing quality audit because the audit fees of reputable firms (former) were higher than that of non-reputable firms (latter), litigation rates are lower for the former, the stock market reacts mildly to positive unexpected company earnings that are audited by the latter, companies making IPOs and POs experience less underpricing if audited by a reputable firm... just to mention a few, however, the direction of the argument is changing because of the series of corporate scandals, the mergers of reputable firms from Big Eight to Big Four, rejection of the audit quality ranking of reputable firms versus non-reputable by practitioners and a host of other revelations (Simunic, 2003). It is therefore against the foregoing discussion that we seek to examine the relationship between audit quality and audit firm reputation, we also want to evaluate the impact which audit firm reputation might have on audit quality especially in Nigeria. This study is indeed relevant as it seeks to help diffuse the tension as to whether or not the reputation of audit firms is important in determining which auditor to employ and also whether the bid to reduce auditors' liability because of the reputation issue is valid.

3 Literature Review

3.1 Concept of Audit Quality

Auditing adds to the informational value of financial statements and this makes it extremely important that the opinion of auditors reflect as much information as possible and this is why the auditor must exercise due professional skills, diligence and care in the course of his work (Arrunada, 2000). According to him, this exercised professional judgment by the auditor is a vital feature of audit quality. However, Riyatno (2007) in his work, opines audit quality

as an abstract term, which is difficult to evaluate, and may only be perceived by those who receive audit services and according to him, the definition of audit quality is not uniform.However, few of those that have defined audit quality include:

DeAngelo (1981:186) who defines audit quality as "the market-assessed joint probability that a given auditor will both (a) discover a breach in the client's accounting system, and (b) report the breach." While she describes the latter as auditors' independence, the former is referred to as technical expertise of the auditor. In other words, deducing audit quality from her definition, one will assert that audit quality is dependent on the expertise of the auditor as well as the actual level of independence exercised. According to Palmrose (1988) audit quality is the probability that financial statements as prepared by management contain no material misstatements that can render it qualified. From this definition given, it is adduced that audit quality is tied to the level of reasonable assurance that any auditor can give about the financial report.

Davidson and Neu (1993) regard audit quality as the ability of auditors to identify and bring to light material misstatements and manipulations in reported net income. This is similar to the definition put forward by Salehi and Azary (2008). They see audit quality as how well an audit is able to protect the interest of users by detecting and reporting material misstatements in financial statements and reducing information asymmetry between management and users of financial statements. In their opinion, financial statements devoid of information asymmetry and misstatements prove the existence of audit quality.

Salehi and Kangarlouei (2010) argue that audit quality can be viewed from two angles viz-financial statements users' perception and auditors' ability and expertise. The financial statements users' perception describes the manner in which users see the audit report. That is, does it reflect reliability? While the auditors' ability and expertise addresses the ability of the auditor to detect and report material misstatements. They assert that since users do not have access to know the evidence gathered during the audit process, they cannot really assess actual audit quality directly except they rely on the reputation and ability of the auditor giving the opinion.

Yuniarti (2011) claims that when talking about audit quality, some fundamental characteristics to watch out for include Significance (what importance is attached to the audit), Reliability (is the findings by the auditor a true representation of the affairs of the audited entity or is management claims about the company accurate), Objectivity (what level of independence was displayed during the course of the audit), Scope (was the entire length and breadth of the audit duly covered), Timeliness (minimal audit delay in presenting report), Clarity (was the audit work done well communicated in terms of findings and recommendations), Efficiency (was the cost incurred in tangent with the benefits accrued), and Effectiveness (was the objectives of the audit achieved). According to him, these characteristics combined confer quality to the audit. That is, where these features can be identified, audit quality is eminent.

So many studies have been conducted on audit quality and according to Salehi and Kangarlouei (2010:943), since real "audit quality is unobservable before and when an audit is performed, a valid proxy is needed when investigating the relationships between actual audit quality and other factors". Amongst all the proxies often used in literatures, one that comes to mind amidst this era of reported financial scandals is audit firm reputation.

3.2 Audit Quality and Audit Firm Reputation

Audit firm reputation refers to the corporate image built over time by auditing firms. It may be as a result of the array of auditors the firm possesses, the brand name, the perceived audit quality resulting from little or no litigations, the fees charged etcetera. Sucher, Moizer and Zarova (1999) have argued that reputation is founded upon the technical and functional quality of audit firms and this reputation will only come over time. According to Gregory and Jeanes (2007), for one to measure reputation itself, it has to be based on an assumption of quality, which is difficult to evaluate however, researchers can deduce it from the audit methods used by audit firms. From the foregoing, it follows that audit quality may be inferred from the type of audit firm.

Audit firms may be broadly grouped into two (reputable and non-reputable) however, according to Fuerman and Kraten (2008) some researches on audit firm reputation have succeeded in grouping audit firms into four distinct size levels viz- Big Eight/Six/Four, Medium 2, Small CPA firms, and Single CPA firms. The first grouping is the largest of all as Compustat Research Insight indices indicates that 496 of the fortune 500 companies are audited by this

group. The second group consists of BDOSeidman and Grant Thornton (Cheng and Reichelt 2007). The third group is composed of audit firms (excluding the prior groups) with two or more partners, and the least group is made up of sole practitioners or single partner firms (Fuerman and Kraten, 2008).

DeAngelo (1981) propounded the reputation rationale theory for audit quality. In her work, she proxy audit quality using audit firm size and strongly asserted that the big audit firms have more to lose if they go ahead to supply audits of low quality. In Klein and Leffler (1981), a model for endogenous quality was formulated and was used to investigate firm reputation and audit quality. They assert in their findings that reputable firms provide high quality because of quasi-rents that they want to sustain and fear of losing should they fall into the temptation to cheat and thereby provide audit report of low quality. In other words, audit firms with reputation have affiliation with high quality because of the stream of income connected with the audit and would do all within their power to maintain it.

Shapiro (1983) built on the model of Klein and Leffler (1981) to include a multi-period setting where there is free entry and in which reputation is an entry cost. In his summation, either firms would receive a price premium because of the motivation to produce quality audit or because of cost they incur to maintain their reputation.

Beatty (1989) investigated the relationship between auditors' reputation and IPOs. Using a two-way classification to proxy reputation made up of either Big Eight or Non-Big Eight and the compensation received on the marginal cost of performing the audit, it was discovered that there is an inverse relation between auditor reputation and initial public offering initial returns. Specifically, the low initial returns are a resultant effect of the perceived audit quality associated with the reputation of the audit firm. Furthermore, he argues that auditing firms that have spent more on reputation capital have a higher motivation to reduce errors and mistakes thus; any information disclosed in the financial statement as audited by these firms is expected to have a higher audit quality.

Moizer (1997) in his work claims that the evidence of audit firm reputation can be seen in the financial environment stating that considerable evidence exist that shows Big Six firms are different from other firms. He argues that although audit quality is unobservable, it can be inferred from the market reaction to auditor change, the degree of IPO underpricing, and the Big Six audit premium. However, Mohamad and Nassir (1997) in their study of auditing firm reputation, ex ante uncertainty and the underpricing of Initial Public Offerings on the Second Board of the Kuala Lumpur Stock Exchange discovered that although reputable auditing firms have an incentive to investigate and report irregularities because of the fear of losing reputation hence ensuring audit quality, the perception of the users of the financial statement matters. Their findings specifically showed that Malaysian investors perceive no reputation effects on audit firms and that they (Big Eight/Six/Four and Non Big Eight/Six/Four) all provide homogeneous services.

Lennox (1999) agrees with the reputation and deep pockets theories. According to him, large auditors (reputable auditors) have a greater stake to avoid issuing inaccurate reports. Furthermore, it was argued that the litigation penalty suffered for inaccurate reports is also a determining factor to make auditors have to give quality reports (Dye, 1993).

McLennan and Pack (2004) developed a model where financial auditors with identical technology were divided into two: one with a known reputation and the others lacked this feature. They discovered amongst other things that reputable audit firms charge higher fees and have economic rents as a result of their perceived reputation.

Weber et al (2008) examined the reputation effect of audit firms using one of the Big Four (KPMG) as case study. They relied on the event of a financial scandal involving the audit firm and one of their clients in Germany and discovered that there was a fall in the number of KPMG clients as a result of the scandal and that other clients of KPMG sustained declining returns as a result of the negative publicity associated with financial scandals. In summation, their result agrees with theory that asserts support for the reputation rationale for audit quality.

3.3 Control variables

Extant literatures in the area of audit quality have suggested some other factors aside our main variable as determinants of audit quality therefore, to control for these other factors, we have included the most widely suggested factors. According to the Securities and Exchange Commission Final Rule, audit fee is the amount paid for annual audits and reviews of financial statements. It differs from the fees paid for the provision of non-audit services. It is the fee a company pays its external auditor as consideration for performing an audit. Yuniarti (2011) asserts that

audit fee is a significant factor that affects the quality of audits. According to him, higher fees connote audit quality and improvement in audit quality may be attributed to audit fees earned in one year and the estimated operational costs incurred in implementing the audit process. Literature has also linked audit quality with the boards of directors, the board of audit committees. Researches have shown that companies where these committees boards are independent, the quality of audit is expected to be high (Carcello and Neal, 2000; Manry, Mock and Turner, 2005; Mgbame et al, 2012). Furthermore, according to Cadbury (1992), it is generally agreed that the effectiveness of audit committees is dependent on its level of independence. That is, a majority of its members if not all, should be independent.

3.4 Theoretical Framework

When it comes to the issue of audit firm reputation and audit quality, there is one major theory that leads the pack. That is, the theory by DeAngelo (1981). While some refer to this theory as Product Differentiation Hypothesis (Simunic, 2003), others call it Reputation Rationale. According to DeAngelo (1981:183) "audit quality is not independent of audit firm size, even when auditors initially possess identical technological capabilities". She claims that bigger audit firms have greater reputation capital compared with smaller firms because of the aggregate audit income accrued to them from other audit clients. This accrued income then acts as effective collateral making them provide higher quality audit. From the theory, it is can be deduced that audit quality is a function of audit firm size proxy by the number of clients, which over time develops in a reputation effect. The adduced reason for this as put forward by her is that quasi rent based on client-specifics results in an advantage to large audit firms because of their collateral properties and because these firms have more to lose, they will continue to provide quality audit.

Other variants of this theory include Dopuch and Simunic (1980): they proposed that audit quality is linked with audit firm reputation and brand names. In their arguments, they emphasized that audit services are required by management to influence the decisions to be made by financial statement users and since an audit firm has a single brand name per time, the type of auditor who audits the financial statement will affect the perceived reliability by users. Furthermore empirical evidence at the time, substantiated their claim that audit quality was differentiated across firms.

Watts and Zimmerman (1981) also developed an alternative theory that predicts that auditor size is a surrogate for audit quality. In their argument, large audit firms (reputable firms) supply higher quality audits because they possess a comparative advantage in monitoring individual auditor behavior. From their argument, the reputation firms seek to protect is not from the quasi rent they earn but from their comparative advantage in providing quality audit.

From the above, reputation arguments suggest that audit quality is linked with audit size and audit firm size over time have been proxy using reputation which according to Fuerman and Kraten (2008); Gregory and Jeanes (2007); Krishnan and Schauer (2000); Sucher, Moizer and Zarova (1999); Yuniarti (2011) have been grouped broadly into Big Eight/Six/Four and Non Big Eight/Six/Four or Big Eight/Six/Four, Medium 2, Small CPA firms and Single CPA firms. However, irrespective of the grouping used, the arguments that audit reputation was significant in determining audit quality were more or less settled prior to year 2000 when there was no increased corporate scandals. Now, the reverse is the case as seen in Simunic (2003) who wrote a critique of Reputation Theory by D&S. Questions are now been asked if the reputation theory still holds since it was propounded in the era of the Big Eight/Six and not the Big Four. Furthermore, the recent scandals have also caused users to doubt reliability on financial statements just because they were audited by reputable firms. It is therefore against these that we raise the following hypothesis

H1 There is no significant relationship between audit quality and audit firm reputation

4 Methodology

Data has been gathered from annual reports of selected companies quoted on the floor of the Nigerian Stock Exchange. The cross sectional data comprise audited financial statements as at 2010. A sample size of thirty-five (35) companies was selected from the list of quoted companies. The Ordinary Least Square technique (OLS) is used to analyze the relationship between our dependent variable and independent variables. Our choice of this technique is informed from the Gauss-Markov theorem which states that if the underlying system we are modeling is linear with additive noise, and the random variables representing the errors made by our ordinary least squares model are uncorrelated from each other, and if the distributions of these random variables all have the same variance and a

mean of zero, then the least squares method is the best unbiased linear estimator of the model coefficients. We used the computer software Eviews 7 in estimating our model specification.

5 Measurement of Variables and Model Specification

For the purpose of this work, the following variables are considered relevant in the specification of our model in examining the relationship between audit quality and audit firm reputation.

Audit Quality (AUDQUA) = proxy using the amount paid for audit services as present in the audited financial statements. This is in line with prior researches such as chadegani (2011); Myers, Myers and Omer (2003);Yuniarti (2011).

Audit Firm Reputation (AUDREP) = proxy using the Big Four (1)/ Non Big Four (0) dichotomy

Audit Committee Independence (ACIND) = proxy using the proportion of non-directors on the board

Audit Committee Size (ACSIZ) = proxy using the number of members in the audit committee

Audit Committee Expertise (ACFEXP) = proxy using the financial qualification of audit committee members.

Company Size (COMSIZE) = proxy using log of total assets.

Leverage (LEV) = proxy using leverage

Consequently, the econometric model is specified below;

$AUDQUA = \beta o + \beta 1AUDREP + \beta 2ACIND + \beta 3ACSIZ + \beta 4ACFEXP + \beta 5LOGTA + \beta 6LEV + Ut$

6 Analysis of Result

(Insert table 1)

The descriptive statistics as provided in our table show that about 67% of how sample employ the services of reputable audit firms. Other aspect of our descriptive statistics such as the median, minimum, maximum and standard deviation of the variables can be seen in the appendix.

(Insert table 2)

From the table, our OLS result shows that the overall fitness of the model as shown in the F statistics of 4.5144 with a probability of 0.002729 is statistically significant as it is less than the standard critical p-value of 0.05 thus the linearized functional specification of the model is appropriate. The R-square, which shows the overall explanatory power of the model, reveals that our independent variables explain about 50% of the systematic variation of the dependent variable. Furthermore, the t-ratio and equivalent p-value of our main variable indicate that there is a positive relationship between audit quality and audit firm reputation. This is in line with aprior expectation sign as seen in extant literatures. The control variables examined alongside audit firm reputation reveal that aside audit committee size; all other variables so examined have a positive relationship with audit quality. Furthermore, our result show that company size, audit committee size and audit firm reputation are statistically significant at 5% significance level as their p-values (0.0011, 0.0249 and 0.0341) respective were less than 0.05 while audit committee financial expertise, audit committee independence and leverage are not statistically significant. From the result presented and foregoing analysis, we therefore reject our null hypothesis that there is no significant relationship between audit quality and audit firm reputation.

7 Discussion of Findings

The relationship between audit quality and audit firm reputation was observed to be positive and significant. This reasons for this might not be far-fetched considering that reputation once destroyed as a result of poor audit quality or litigations cannot be easily redeemed. The implication of this finding is that firms that have accrued reputation to themselves over time understand the weight placed on them in terms of expectation to deliver and economic rent receivable from been able to attract and retain existing clients. This understanding may be one of the factors that motivate them to ensure audit quality. Our finding is consistent with theories that propose a reputation rationale as

the reason why most reputable firms maintain audit quality. Furthermore, our findings is in line with the findings of researchers such as DeAngelo (1981); Gao, Jamal, Liu and Luo (2011); and Weiner (2012) however, researchers like Lam and Chang (1994); and Mohammed and Nassir (1997) are in disagreement as they assert that there is no significant relationship between audit quality and audit firm reputation claiming that audit quality can be achieved irrespective of the reputation of audit firms. With respect to our control variables, we discovered that company size, audit committee size are significantly related to audit quality. This is in line with the findings of Adeyemi and Fagbemi (2010) who claims that the size of the company is an important factor in determining audit quality. However, our findings negate the findings of Zhang, Zhou and Zhuo (2006) who claims that audit committee financial expertise has a significant relationship with audit quality.

8 Summary and Conclusion

Our objective was to evaluate the relationship between audit quality and audit firm reputation using a sample of listed companies trading on the floor of the Nigerian Stock Exchange. The study attempted to provide empirical evidence of this relationship (if any) within the Nigerian context. Findings from the study reveal that there is a significant positive relationship between audit quality and audit firm reputation. All of the control variables (audit committee financial expertise, audit committee independence, company size, Board size, and leverage) were found to be positively related to audit quality while audit committee size had a negative relationship. Thus, we propose that companies should employ the services of audit firms with proven track record of audit quality and reputation. However, the debate on audit quality is not a settled matter. Further researchers can improve on the methodology adopted here as reputation captured was based on the popular Big X/Non Big X dichotomy as against the four-class classification by Fuerman and Kraten (2008).

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Appendix 1

Table one: Descriptive Statistics

	AUDQUA	AUDREP	ACFEXP	ACIND	ACSIZE	COMSIZE	LEV
Mean	15442.68	0.67647	0.17994	0.89838	5.44117	9.832319	0.56750
Median	8000.000	1.000000	0.16700	1.00000	6.00000	9.809795	0.55804
Max	85200.00	1.000000	0.75000	1.00000	7.00000	11.15691	1.75081
Min	750.0000	0.000000	0.00000	0.16700	4.00000	8.225263	0.00656
Std. Dev	20678.93	0.474858	0.21036	0.16563	0.89412	0.715460	0.38616
Jarque-Bera	53.34040	6.125602	6.80040	159.206	4.16917	0.582981	13.5182
Prob.	0.000000	0.046757	0.03336	0.00000	0.12435	0.747149	0.00116

Appendix 2

Table Two: OLS Regression Result

Dependent Variable: AUDQUA

Variable	Coeff.	Std. Error	t-Statistic	Prob.
C	-121884.9	46606.45	-2.615193	0.0144
AUDREP	15192.91	6806.143	2.232235	0.0341
ACFEXP	3678.665	14385.90	0.255713	0.8001
ACIND	4642.253	18014.78	0.257691	0.7986
ACSIZE	-8285.700	3487.954	-2.375518	0.0249
COMSIZE	16428.92	4501.155	3.649935	0.0011
LEV	10162.20	7593.274	1.338317	0.1920
R-squared	0.500799	Mean dependent var		15442.68
Adjusted R-squared	0.389866	S.D. dependent var		20678.93
S.E. of regression	16152.54	Akaike info criterion		22.39878
Sum squared resid	7.04E+09	Schwarz criterion		22.71303
Log likelihood	-373.7793	Hannan-Quinn criter.		22.50595
F-statistic	4.514409	Durbin-Watson stat		1.624578
Prob(F-statistic)	0.002729			