Audit Firm Size and Earnings Restatement of Quoted Consumer–Goods Manufacturing Firms in Nigeria

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Abstract

The notion that high audit quality might increase financial reporting credibility is motivating investors and other concerned users of accounting information in looking for audit quality indicators, with which audit performance can be evaluated. Consequently, this study tested audit firm size as a potential indicator of audit quality by examining its explanatory capacity of earnings restatement using listed consumer-goods manufacturing firms as the study population. Secondary data were extracted from the annual reports of 13 quoted consumer-goods manufacturing companies covering the study period from 2012 to 2018. A Logit regression equation was utilized to specify a stochastic model of earnings restatement in terms of audit firm size. On the final analysis, it is the finding of this study that, there is significant negative relationship between auditor firm size and earnings restatement of quoted consumer-goods manufacturing companies in Nigeria, thus confirming the experience and reputation hypotheses of audit theory. In the light of the findings, it is the recommendations of this study that, Financial Reporting Council of Nigeria should mandatory auditor rotation on big-4-to-non-big-4 pairing basis in order to sustain the positive impacts of the big-4 audit firms in the Nigerian audit market.

Key words: Audit Firm Size, Earnings Restatement, Nigeria

Introduction

The presumed failure of audit process to arrest financial misstatements in its acclaimed traditional domain of attestation has prompted an ostensible upsurge of interest and attention in general financial reporting. Indeed, audit failures manifest in diverse ways, including acknowledgement of material financial misrepresentation in the form of financial statement restatement. In fact, from the policeman theory perspective, audit is effective when it can alert equity and other stakeholders about misrepresentations in financial position. Therefore, reasoning from the perspective of the policeman theory, it is logically correct to assert that financial statement restatement is an indirect confirmation of audit failure. It is also true that high frequency of such audit failures if not checked, can hurt any economy. This is because when investors lose faith in the effectiveness of audit programmes in compelling firm managers to sufficiently report accurate operational earnings, the result is often affecting investments negatively. This is especially so in Nigeria where the economy is just coming out of recession, and therefore the need for more private investments to sustain the current growth rate is imperative.

The consumer goods manufacturing sector which ought to serve as the engine of growth for the Nigerian economy, especially given the resolve of the economy managers to diversify the economy away from oil base, is not living up to its expectation. This might not be unconnected with concerns about the quality of reported earnings and the inability of audit quality to effectively constrain financial misrepresentations of companies, exemplified by recent corporate accounting scandals (Badawi, 2008; Enofe, 2010). Differences in audit quality result in uncertainty in the credibility of auditors and the reliability of the earnings reports of companies. The recent corporate financial scandals pose a great challenge to the veracity, credibility, utility or value relevance of the audit function. In the opinion of Alles et al. (2004), the degree to which assurance adds value to communication between an auditee and its audience is directly related to the credibility of the auditor. Whatever may be their real cause, the effect of corporate scandals in the last two decades, especially Enron and the subsequent collapse of Arthur Anderson, has been to undermine public confidence in the audit programme. Badawi (2008) reports a list of companies involved in cases of accounting scandals related to poor audit quality and earnings manipulations in the past decade. In Nigeria, corporate scandals include the cases of Cadbury Nigeria Plc and African Petroleum Plc (Okolie & Agboma 2008); Savannah Bank and African International Bank (Odia, 2007); Wema Bank, Nampak, Finbank and Spring Bank (Adeyemi & Fagbemi, 2010); and more recently Oandoplc, and African Petroleum plc. These are known publicly reported cases that resulted in misleading financial reports. There is therefore a concern about the quality of accounting income and its relationship with the quality of the auditing process which has been observed to increase over time following the periodical clusters of business failures, frauds, and litigations. The issue is whether these corporate collapses are not the outcome of poor audit quality and the inability of the audit function to curtail the practice of financial misrepresentation. The focus of external users on reported earnings as a central variable for making decisions and recent corporate scandals means that earnings management has become a matter of great concern. Using numbers, management may abuse "big bath" restructuring charges, premature revenue recognition, reserves and write-offs of purchased in-process research and development (Healy &Wahlen, 1999). These practices can threaten the credibility of financial reporting. There are concerns regarding earnings management which require factual and not fictional accounting to accentuate the importance of company accounts that are true and fair. The essence of this requirement is that companies must not distort, hide, fabricate, and present, in whole or in part, deceitful financial reports. Therefore, in the face of growing literature and public anxiety about the concern that audit opinion is fast losing credibility and relevance, the necessity to search for indicator of audit quality cannot be overemphasized. For instance, because the quality of auditing function may vary along individual audit firms' capabilities, there is need to look out for those factors that drive audit quality when engaging an audit firm. Efforts in measuring audit quality can be classified to direct measures and indirect measures. Direct measures include financial reporting compliance with GAAP, quality control review, bankruptcy desk review and SEC performance. Examples of outcome measures of audit quality include litigation or regulatory enforcement actions against auditors, correct issuance of a going-concern opinion and under certain circumstances; auditor switches (Francis, 2011). These proxies are limited in the sense that besides merely exemplifying poor audit quality, they only possess *ex post facto* value. On the other hand, audit firm size, auditor tenure, industry expertise, audit fees, economic dependence, reputation, and cost of capital are indirect measures of audit quality, (Chadegani, 2011). This present study prefers the indirect proxies as they can reveal high and low levels of audit quality in *a priori*. Accordingly, in this study an assessment of the impact of audit quality on earning management practices of quoted consumer-goods manufacturing firms in Nigeria is made, using audit firm size, as yardstick of audit quality.

Audit size as proxy of audit quality is anchored on the works of DeAngelo (1981). DeAngelo (1981) theoretically analyzed the relation between the quality of audit and auditor's size and argued that large audit firms have more clients, and their total fees are allocated among those clients. Defining the auditor's independence by the conditional probability that the auditor will disclose any misstatement in financial statements given that this misstatement was already discovered, DeAngelo (1981) assert that large audit firms are more independent and therefore, provide higher quality of audit. In considering auditor size and earnings management, DeAngelo (1981) argues that Big-4 auditors provide better quality audits than non-Big4 auditors. This position has gained extensive support of subsequent empirical studies including Palmrose (1988); Deis and Giroux (1992); Becker, et al (1998); Francis and Krishnan (1999); Krishnan and Schauer (2000); Kim, Chung and Firth (2003); Krishnan (2003), and Teoh and Wong (1993). Likewise, Davidson and Neu (1993) provide additional support for the use of auditor size as proxy for audit quality by using an indirect method to support the argument that size is a good proxy for audit quality. They argued that managers have incentives to manipulate the reported earnings to meet the analysts' forecasts. Using data for Canadian firms, their results support the expectation indicating that the auditor size is a good proxy for auditing quality. Lennox (1999) looked at the two explanations of the hypothesized positive relation between audit quality and auditor size. Firstly, the reputation hypothesis suggested by DeAngelo (1981) who argues that large auditors have more incentives to be accurate because they have more client-specific rents to lose if their reports are not accurate, and secondly, the deep pockets hypothesis used by Dye (1988) who argued that larger audit firms tend to be more accurate because they have greater wealth that is exposed to risk in case of any litigation. Given the above scenario, the major problem of this study is to determine whether earnings manipulation can be significantly constrained along with its negative consequences, using audit firm size as indicator of audit quality.

The rest of this paper is organized as follows: section two takes a literature review on audit firm size and earnings restatement. The third section presents the study's methodology. Section four presents the study's results and discussion on findings while the fifth and lastly section presents recommendations and limitations of the study.

Theoretical Framework

There are several theories which may explain demand for, and performance of audit services in modern societies. These includes but not limited to policeman theory, the credibility theory, and the inspired confidence theory. No single one of these theories can satisfactorily explain audit quality in relation to the demand for and supply of audit services. But collectively, these theories provide a framework for evaluating an audit programme and providing insights into the circumstances governing the audit process, thereby forming the basis of appraising the audit performance. Audit, in itself, caters to the relationship of accountability; independent from other stakeholders of the firm to provide opinion about true and fair view of the financial reports of an organization. Thus the relevance of audit is dependent on the perceived quality of this opinion (i.e. the extent of the auditors' ability and responsibility to provide reasonable assurance that financial statements are free of material misstatement, either due to fraud or error; or both) from the perspective of those who demand for the audit. Thus, the thrust of these theories is to provide us with possible explanations of the underlying incentives in meeting this expectation, and how we can reconcile such incentives with the audit performance. Quality perception of audit is often underpinned by certain theoretical logics based on which audit quality are measured in ordinal scales. Such logical abstractions include reputation loss avoidance (the '*reputation*' hypothesis) independence (the 'independence' hypothesis), and experience (the 'experience' hypothesis), Reputation hypothesis is the incentive for an auditor to be accurate because an inaccurate report may lead to a loss of client-specific rents (DeAngelo, 1981). The audit market, like any other markets, rewards consistency of maintaining excellence in product or service delivery. Consumers' repeat purchase behaviour is often elicited when a product or service meets their expectation. Business firms as consumers of audit services are therefore likely to patronize audit firms which have reputation of audit performance excellence, a situation which often result in audit market concentration. There are empirical evidence (Eguasa & Urhoghide, 2017) supporting the notion that the Nigerian audit market is concentrated in the hands of the big-four audit firms. Thus, an auditor with higher reputation incentive is likely to give more reliable assurance than an auditor with less reputation incentive, especially when the audit market is competitive. Therefore, the greater the tendency for firms to be audited by reputable auditors is, the less will be the tendency of earnings restatement. The independence hypothesis has its root on the premise that a more independent auditor is likely to give a more reliable assurance than a less independent auditor. Independence here means both in fact and appearance. Independence in fact indicates the extent to which the auditor possesses an independent mindset when planning and executing an audit, and that the resulting audit report is unbiased. Independence in appearance indicates whether the auditor appears to be independent. On the other hand, the experience hypothesis is rooted on the premise that a more experienced auditor is likely to give a more reliable assurance than a less experienced auditor.Big audit firms do not only have the financial resources to attract the best skills and most experienced hands, but they can equally be insulated against financial inducement to muffle their whistle in blowing foul. Meanwhile, auditor's independence decreases over time, while his client-specific experience increases over time. Apart from financial inducement, there are other threats to independence, such as familiarity threat. Therefore, depending on which of the two opposing forces is prevalent, bigger audit firms can associate positively or negatively with audit quality. If audit firm size relates positively with restatement, it means bigger firms, perhaps having concentrated share of the audit market for far too long, are losing their independence. But if the relationship is negative, it would be interpreted to mean that, due to their financial capacity to acquire the best skills and most experienced hands in the profession's labour market, and because they have their reputation to protect, big audit firms are able to bring their wealth of experience to bear in mitigating firms' tendencies to restate earnings.

Empirical Review

Audit Firm Sizeand EarningsRestatement

Following the theoretical analysis of DeAngelo (1981) on the link between audit firm size and audit quality, the use of firm size as proxy of audit quality have gained wide acceptance in audit quality research. Several studies (e.g. DeAngelo, 1981; Lawrence et al., 2011; Ilaboya & Ohiokha, 2014) have supported that larger audit firms provide higher quality-audit services than smaller ones. This is because larger auditors are less likely to depend on their clients' economic (Ilaboya & Ohiokha, 2014). Thus, they are less likely to agree with their client pressure for reporting misstatements than small audit firms (Choi et al., 2010). Further, they have higher motivation to deliver high-quality services in order to protect their brand name reputation (Ilaboya&Ohiokha, 2014) as larger audit firms may have greater reputation losses in case of audit failures than small firms (DeAngelo, 1981). Further, big audit firms have higher technical competence and greater resources (Lawrence et al., 2010). They also have more experienced and competent auditors and greater expertise than small audit firms (Francis & Yu, 2009). Francis, Maydew & Sparks (1999), however, argued that high audit quality in larger audit firms may be not because of their excellent auditor's performance but mainly because of the large client effect (Francis et al., 1999). Given different perspectives on explaining the effect of the audit firm size on audit quality, several empirical studies have provided evidence supporting that the bigger audit firm size is positively associated with higher audit quality. A restatement is the revision and publication of one or more of a company's previous financial statements; usually necessitated by the discovery that a previous statement contains a material inaccuracy. The need to restate financial figures can result from accounting errors, noncompliance with generally accepted accounting principles (GAAP), fraud, misrepresentation, or a simple clerical error. The choice of earnings restatements to identify financial reporting failure can be justified with the following reasons: restatements are an acknowledgement that prior financial statements were not in accordance with generally accepted accounting principles (GAAP) (Palmrose&Scholz, 2004). They indicate a breakdown in a firm's internal control system (Kinney & McDaniel, 1989). According to Ettredge, M. et al. (2010), restatements are due to intentional earnings management in as much as most financial statement restatement are blamed on the misuse of the generally accepted accounting principles (GAAP) or on error. He insisted that restatements are fraudulent and calls for more scrutiny. Pamrose et al. (2004) in their work found out that financial reporting by US companies that announced restatement with more core restatement showed a higher tendency of intentional misstatements.

In the Nigerian context, our *a priori* expectation is that audit firm size is likely to associate negatively with earnings restatement; hence this study hypothesizes as follows:

H_{01}: *Audit firm size does not significantly influence earnings restatement practices of quoted consumer-goods manufacturing companies in Nigeria.*

Methodology

A balanced panel data methodology covering the period from 2013 to 2018 was employed. Accordingly, pooled historical data were collected and analyzed, using quantitative approach. The pool data methodology provides a general framework for studying dynamic relationships across individual consumer goods manufacturing companies. Furthermore, using firm-level panel data allows us not only to econometrically control for individual firm heterogeneity but also to give more data that are informative, more degrees of freedom, and more efficiency. Thus, in the overall, our methodology enhanced the leverage to enjoy more degree of freedom and therefore increased the precision of estimates. The choice of limiting the study's period scope to 2018 is predicated on the need to avoid data availability limitation. This consideration is coming on the heels of the long reporting lag culture in Nigeria. Consumer-goods manufacturing firms whose stocks are quoted on the floor of the Nigerian Stock Exchange (NSE) as at 3rd of October2019 constitute the population of this study.As at 3rd of October, 2019, NSE had 26 listed consumer-goods manufacturing firms according to the facts as obtained at https://www.african-markets.com/en/stock-markets/ngse/listed-companies.Consumer-goods manufacturing firms in Nigeria are diverse in nature because of the range of products they produce. Some of them are engaged in the food stuff processing activities while some are in the production of household consumables and appliances. For the purpose of this study, this distinction in diversity is not taken into account. A judgmental sampling technique was used instead of random sampling because of the need to overcome data accessibility constraint. Firms with no sufficient data history falling within the study period were not included. Since the population is finite and relatively small, a census approach is adopted instead of taking a sample.

Measurement of Variables

The two main variables used in this study are audit firm size and earnings restatement measured as follows:

Table 1: Measurement of Variables

Variables	Operationalization
Audit Firm Size (ASIZE)	Dummy variable: 1 if the sampled firm was audited by any one of the big-4 audit firms (Price Waterhouse Coopers, Deloitte & Akintola Williams, KPMG and Ernst & Young) and 0 otherwise, (Habbash & Alghamd, 2017)
Earnings Restatement (REST)	Dummy variable: 1 if in any reporting year, the sampled firm made any prior year adjustment in its book, and 0 otherwise, (Palmrose, Richardson & Scholz, 2004)

Our model for testing the hypothesis is as follows:

$$REST = \beta_0 + \beta_1 ASIZE + \mu \quad . \qquad \text{Eqn. (3.1)}$$

Where *REST* is an odd-log ratio:

$$REST = \log_{10}\left[\frac{p(REST)}{1 - p(REST)}\right]$$

p is the probability of earnings restatement in the industry which is the subject of estimation.

Results

Descriptive Statistics Results

Table 2: Descriptive Statistics

	ASIZE	REST
Mean	0.670330	0.461538
Median	1.000000	0.000000
Maximum	1.000000	1.000000
Minimum	0.000000	0.000000
Std. Dev.	0.472698	0.501280
Skewness	-0.724663	0.154303
Kurtosis	1.525137	1.023810
Jarque-Bera	16.21229	15.16882
Probability	0.000302	0.000508
Sum	61.00000	42.00000
Sum Sq. Dev.	20.10989	22.61538
Observations	91	91

Audit Firm Size

A total of 91 observations from 13 quoted consumer-goods manufacturing firms were evaluated. With regards to central tendency of the observations, a mean score of 0.6703 was recorded over the range of 0 and 1. This can be interpreted to mean that out of every statutory audit in consumer-goods manufacturing subsector, approximately 67of the audits is done by a member of the big-four auditors in Nigeria(KPMG, PWC,Akintola Williams Delloitte and Ernst and Young). The frequency of big-four audits in the sector is characterized by low variability, hence the low standard deviation (0.4727) relative to the average. In addition, the frequency of big-four audit is skewed (-0.7247) to the right, away from zero. Therefore, the foregoing statistics appears to confirm the general notion of concentrated audit market in the hand of the big-four audit companies in Nigeria.

Earnings Restatement

Out of the observed 91 data points that were observed, there were 46 (or 46.15 per cent) confirmed restatement of earnings thus giving rise to 0.4615 approximate mean score. These observations were gathered from a wide range of firms; hence the standard deviation is greater than the observed means score. However, the incidences of earnings restatements and non-restatements are not only almost evenly matched as indicated by the slightly positive skewness (0.154303), but they are also not normally distributed as well. The implication of its asymmetric distribution is that, as a dependent variable, its estimation procedure may not be compatible with Ordinary Least Squares technique, thus requiring special technique that is not founded on normality assumption as a precondition. Therefore, in conclusion, with a manifestation degree as measured by the mean score, it can be concluded here that there is significant prevalence rate of earnings restatement in the quoted consumer-goods manufacturing firms subsector in Nigeria.

Inferential Statistics Results

The logit regression result is presented as follows:

Table 3: Dependent Variable: Earnings Restatement

Variable	Coefficient	Std. Error	z-Statistic	Prob.
ASIZE	-1.491655	0.480988	-3.101233	0.0019
C	0.847298	0.398410	2.126701	0.0334

According to table 3(*see appendix for full Eviews report*), the intercept of the logit regression model is 0.847. It measures the log-odds of the event that earnings restatement will occur if non-big-4 audit firm where to be the auditors in the industry. This comes down to an extremely high probability (approximately 0.8756). Meanwhile, audit firm size is significantly related with earnings restatement at 1% level. The coefficient obtained is -1.492 approximately. This means that a unit increase in the frequency of audits by "big-4" will decrease the log-odds by 1.492. In other words, for every instance where big-4 audit firms are engaged for external audit in the consumer-goods manufacturing industry, the odds that earnings restatement will occur increases by a factor of $10^{1.492}$. Hence suppose any of the listed consumer-goods manufacturing firm in any financial year-end were to be audited by one of the big-4 firms, the probability of there being earnings restatement the following year is:

$$p(REST) = 1/\left[1 + 10^{-(0.8473-1.492)}\right]$$

$$p(REST) = 1/\left[1 + 10^{-(-0.6499)}\right]$$

$$p(REST) = 1/[1 + 4.4658] = 0.182956$$

The significance of the explanatory variable is confirmed by the LR-statistic (10.416) and associated probability value (0.00125). The McFadden R^2 of 0.0829 implies that the variability of the explanatory variables can account for about 8.3% of the earnings restatement prediction.

In view of the foregoing therefore, with respect to the hypothesis (**H_{01}**), since: $\beta_1 = -1.492$ (p-value = 0.0019< 0.05), we reject **H_{01}**.

Results on audit firm size nexus with earnings restatement indicate that audit firm size hassignificantly negative relationship with earnings restatement. The result implies that continued audit by a Big-4 audit firm decreases earnings restatement tendency. The results of this research support the results of previous research (Ilaboya & Ohiokha, 2014) that concludes that auditor size has a negative influence on audit quality. The results of this research support the explanation that Big-4 auditors possess better audit resources than non-Big-4 auditors. Large audit firms possess resource capacities, including staff number and quality, application of methodology and technology in carrying out audits, internal control of the audit firms, and audit procedures that are better compared to small auditor firms. Thus,the knowledge that such vast amount of resources at the disposal of big-4 audit firms can be deployed, client firms' management are kept on their toes and under pressure to avoid cooking the books (deterrence hypothesis). Therefore, it is expected that audit firm size should be negatively related to earnings management.

Conclusion and Recommendation

In accordance with the purpose of the study, which is to identify audit quality indicators with a view to designing a framework for evaluation of external audit performance, in terms of earnings restatement constraining capacity in Nigerian quoted consumer-goods manufacturing companies, this study has produced conclusive evidence that audit firm size is a significant indicator of audit quality in terms of earnings restatement constraining capacity. The practical implication of this study is that individuals and corporate investor can use this study to develop a framework for evaluating audit performance by way of using audit firm size. Thus, this study serves to inspire hope for financial statement users and the investing public by providing them the platform to take investment decisions matters into their hand by identifying which audit deserves how much. The theoretical implication of this work on the other hand is the confirmation of some hypotheses in the Nigerian context, which before now only exists on the pages of textbooks, but which have been confirmed by this study. This study, like every other study, has limitations. The sample for this research was determined based on specific criteria purposive sampling for listed consumer-goods manufacturing companies in Nigeria. Consequently, the results cannot be generalized for companies other than members of the study population. The sample size and resulting degree of freedom in the current study is seriously limited by the consideration for IFRS compliant data. Therefore, the study period has to be from 2012 to 2018. However, it would be interesting to go beyond 2012-year data and introduce IFRS adoption as a moderator variable. With enhanced degree of freedom, may be the study's outcome might be somewhat different. In the light of the findings, it is the recommendations of this study that, Financial Reporting Council of Nigeria should mandatory auditor rotation on big-4-to-non-big-4 pairing basis in order to sustain the positive impacts of the big-4 audit firms in the Nigerian audit market.

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