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Political Connections of Boards and the Selection of Auditors in Nigeria

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ABSTRACT

The aim of this study is to examine the relationship between the political connections of board members and the selection of auditors by non-financial listed firms in Nigeria. The financial and non-financial information of 94 non-financial companies listed on the Nigerian stock exchange from 2008 to 2013 were analysed using a logistic regression model. The results of the logistic regression revealed that listed companies with politically connected board members were unlikely to appoint a Big 4 audit firm to audit their companies. This was likely because of difficulties in influencing such firms to issue an audit report in their favour. Regulatory bodies can use the outcome of this study to make necessary adjustments in codes directed at reducing the influence of political cronyism on the choice of auditor.

Keywords: Political Connections, Auditor Selection, Nigeria
JEL Classifications: M41, M42

1. INTRODUCTION

The market for audit service has been a focus of many policy debates mainly owing to the high degree of concentration in the market and its resulting consequences[1]. Globally, the top-tier audit firms, namely, Deloitte, PricewaterhouseCoopers, Ernest and Young and KPMG dominate the market for audit services across the world[2], and they accounted for more than 50% of the Nigerian audit market in 2014[3]. Given the increasing unhealthy dominance of these audit firms, the Institute of Chartered Accountants of Nigeria has embarked on an active discussion on mandating joint audits. Mandating joint audits would lead to increased competitiveness for small- and medium-sized practitioners through capacity building, would improve the quality of financial reports and ultimately would increase stakeholder confidence (Ajaegbu, 2014). With the recent concerns about audit market concentration, determining how client attributes affect the choice of audit firms among public listed companies in Nigeria would provide useful insights on the process. This is because a company's choice of auditor could signal its commitment to transparent financial reporting and because a client will possibly consider an audit firm whose product offerings aligns with its reporting incentives[4] (Gerakos and Syverson, 2015).

Like other markets, product differentiation exists in the market for audit services (DeAngelo, 1981). Big 4 audit firms have incentives to provide a higher quality of services compared to their counterparts in the market (Choi and Wang, 2007). Big 4 audit firms are exposed to higher litigation costs and are susceptible to reputational loss due in the event of an audit failure. Hence, the decent reputation of a Big 4 audit firm could motivate companies that are committed to high-quality financial reporting to hire

1 Audit market concentration often leads to increase in audit fees, low audit quality and auditor independent impairment due market monopoly.

2 http://www.big4.com/wp-content/uploads/2015/01/The-2014-Big-Four-Firms-Performance-Analysis-Big4.com-Jan-2015.pdf.

3 Presently, more than 50% of audit engagement in public listed companies in Nigeria is handled by the Big 4 firms.

4 Reporting incentive refers to the willingness of clients to disclose adequate and sufficient information in their annual reports.

them. Prior studies have used different regulatory settings and company attributes as metrics to test the choice of auditor. For instance, Ho and Kang (2013) studied the selection of audit in family-owned companies, Ahmad et al. (2006) examined the role of ethnic networking in the choice of auditors in Malaysia while Guedhami et al. (2014) investigated the selection of auditors in privatized firms.

To the best of our knowledge, except Guedhami et al., (2014), a client attribute that has not received much attention in choosing an auditor is how the political connection of board members affects the choice of auditor. The role of the political economy is very well established in the accounting literature. In 1978, Wattz and Zimmerman established in their work that a firm's incentives to reduce political costs arising from the threat of government intervention could drive a firm to reduce accounting transparency. Consistent with Wattz and Zimmerman's (1978) assertion, Bushman et al. (2004) and Bushman and Piotroski (2006) found that financial statements of non-state owned firms operating in countries with high government intervention were not transparent, and the general earnings quality of firms in such countries were poor. Further, Gul (2006); Abdul Wahab et al. (2011); Yatim et al. (2006) studied auditor's risk response (audit fees) in politically connected firms, and all these studies established a relationship between the two variables. More recently, Guedhami et al. (2009); Wang et al. (2008) studied the choice of the auditor in privatized firms and Chinese state-owned firms. Guedhami et al. (2014) investigated the importance of the political connections of corporate insiders on the choice of an auditor across different regulatory setting. The authors posited that politically linked companies have distinctive financial reporting incentives that shape their choice of an auditor. Using a cross-country analysis, they reported that politically connected firms are likely to appoint a Big 4 audit firm to convince investors about their commitment to financial reporting transparency.

However, Miller (2004) pointed out several limitations of cross-sectional studies[5]. Our study is founded on Miller (2004) suggestions that future research could benefit from cross-sectional studies by focusing on regions or countries that demonstrate a more general issue in international studies. Following previous studies (Faccio, 2006; Guedhami et al., 2014), this current research defines politically connected firms as those whose board members or substantial shareowners are a close associate of a current or former political office holder, a past military head of state or retired serving officers in the Nigeria Army[6]. Additionally, board members themselves may belong to one of the categories.

Nigeria was used as a research setting for some reasons. First, according to Ujunwa et al. (2013), quite a number of Nigerian listed companies are politically connected by the presence of former military officers or their relations serving on the board of directors. Second, the presence of Nigeria National Award winners on some Nigerian boards might also indicate patronage for such a firm. Public analysts have questioned the integrity of the awards system, claiming the Nigeria National Award is used to reward political cronies, and those that deserve the award are often dropped for political reasons (Vanguard Newspaper[7] 2012 & 2014). Third, Nigeria presents unique cases, allegedly being one of the most corrupt countries in the world[8] in which political cronyism thrives (Faccio, 2006). According to the 2014 Report of Transparency International, Nigeria ranked as the 136th most corrupt in the world and third most corrupt in West Africa. Fourth, the country has a high concentration of minority shareholders with little or no protection that further exacerbates the role of political cronyism in this emerging market. In such an environment, embezzlement of public funds through cronyism activities is worse (Faccio, 2010).

The study used financial data of 94 non-financial publicly listed companies on the Nigerian stock exchange (NSE) from 2008 to 2013 leading to 429 observations. Consistent with the collusion incentive theory, our results indicated that politically connected firms were less likely to appoint a Big 4 audit firm. This is in conformity with the theoretical view that politically connected firms have poor earnings quality resulting from the need to hide the activities of cronyism. Such obfuscation is necessary to reap benefits far exceeding the costs of their political patronage and comes at the expense of minority investors. Therefore, politically connected firms are less likely to hire big audit firm because this class of audit firm will not tolerate any transactional or accounting choices that might expose them to litigation and reputation risks. Although this finding contrasts with those of Guedhami et al. (2014), the difference in results might be attributable to the nature and different characteristics of the country involved in the analysis.

The remaining part of this study is structured as follows: Section two presents a review of how the hypothesis concerning political connections and auditor choice was developed. The third section discusses the research design, sample selection, and estimated model. The fourth part presents the main result, and the fifth part presents the conclusions of the study.

2. THEORETICAL FRAMEWORK AND HYPOTHESIS DEVELOPMENT

2.1. Political Connection and Auditor Choice

A major concern for modern corporations as highlighted in agency theory is the issue of financial reporting bias caused by information asymmetry between the agent and the principal. An extensive literature has acknowledged the essence of reducing financial reporting biases and suggested ways to reduce financial reporting biases. Auditing is regarded as an important

5 Miller (2004) identifies limitations in the number of observations, endogeneity issues on data availability, noisy variables and correlated omitted variables as likely problems in cross-sectional studies.

6 Nigeria experienced a period of military dictatorship lasting for close to 30 years. Anecdotal evidence reveals that the military personnel enriched themselves by siphoning public fund through close allies.

7 http://www.vanguardngr.com/2012/09/criticisms-trail-national-awards-david-west-utomi-adebanjo-others-slam-fg/ and http://www.vanguardngr.com/2014/04/national-honours-national-horrors/.

8 According to the 2014 report of Transparency Internationa,l Nigeria ranked 136th most corrupt in the world and the 3rd most corrupt in West African. https://www.transparency.org/cpi2014/results.

monitoring mechanism to reduce agency costs, as it enhances the value of financial reports through the reduction of financial reporting misreporting. According to DeAngelo (1981); Francis (2004) an audit is a differentiated produce defined by the identity of the supplier. The brand name and reputation of an auditor are defining attributes that differentiate the quality of service rendered by audit firms (Simunic and Stein, 1987). Large audit firms with a global presence have the reputation for providing high-quality audits resulting from economies of scale and their investments in human and technological resources. Hence, the choice of a firm's auditor signals to the investing public the quality of its financial statements (Bewley et al., 2008). However, the factors that drive the choice of a firm's auditor are complex and vary among firms based on a firm's reporting incentives. Recently, many researchers have begun to link the information content of accounting numbers with political economy. Some of the literature in this regard has noted that political connections worsen the agency problem between inside and outside investors. Because controlling insiders in politically, connected firms want to conceal their expropriation activities arising from political cronyism and corruption from minority shareholders (Piotroski et al., 2015). Chaney et al. (2011) stressed that the benefits reaped from political connections exceed the costs incurred in establishing the connection.

Therefore, controlling insiders will purposely conceal or delay reporting such benefits with the intent to reap private benefits. In Stulz's (2005) research, politicians were found to collude with controlling insiders to extract undue advantages from minority outsiders. Corroborating this view, Faccio (2006), in his cross-country regression results of stock price reactions to the membership of politicians on company boards, reported that outside shareholders were concerned that politicians conniving with controlling shareholders would expropriate their interests. Therefore, owing to the expropriation of the benefit of minority shareholders, politically connected firms tend to reduce accounting transparency and resist any reform geared towards improving corporate transparency (Guedhami et al., 2014). In fact, Leuz and Oberholzer-Gee (2006) observed that connected firms in Indonesia avoid foreign financing that insists on more transparency and makes it difficult to extract private benefits from political connections. Bushman and Piotroski (2006) reported that firms in state-dominated economies were less conservative in their financial reporting. Such firms tend to recognise good news early and delay reporting bad news. Similarly, Piotroski et al. (2008) found that connected firms falsified in China their financial information to conceal their diversionary activities. While other studies that examine the extent of state involvement in the financial economy have established that, to minimize their political costs, companies reduced their financial transparency (Dyck and Zingales, 2004; Goncharov and Zimmerman, 2006).

Thus, the expropriation activities of connected firms thrive in a low corporate disclosure environment and restrict strict outside monitoring (Guedhami et al., 2014). Because higher transparency exposes questionable political favours and reputable audit firms tend to be stricter in their external monitoring, connected firms are less likely to appoint reputable audit firms. This is because a reputable audit firm would constrain their discretionary incentives to distort financial information. In other words, the choice of auditors in a connected firm that wishes to extract private benefits would be a low-quality (less reputable) audit firm. Bushman and Piotroski (2006) obtained empirical support from twenty-five countries that politically linked companies have lower levels of financial reporting transparency because politically linked companies are incentivised to suppress actual financial performance to hide their ill-gotten political wealth. Accordingly, audit firms that will further their "diversionary acts" might be engaged as the external auditor. Otherwise, politically connected firms that choose to eschew "self-dealing" could engage the service of top-tier auditors to signal their commitment to financial transparency.

In a countervailing argument, managers with incentives to reduce information asymmetry in politically connected firms might signal this to minority outsiders through the appointment of reputable audit firms. Overall, the available empirical evidence on the effects of political connection on a firm's financial reporting incentives are inconsistent, hence, the choice of an external auditor. Guedhami et al. (2014) found in their cross-country regression that public firms with political connections are more likely to appoint a Big 4 audit firm, which signals their commitment to accounting transparency to outside investors. The authors found the relationship was stronger in corruption-ridden countries. Guedhami et al. (2009) found that privatised firms conditioned on the extent of state ownership are less likely to appoint Big 4 auditors. Similarly, Wang et al. (2008) revealed that state-owned enterprises in the People's Republic of China preferred to engage the services of local auditors. The findings of Guedhami et al. (2009); Wong et al. (2008) are partly consistent with the collusion incentive theory whereby insiders in politically connected firms distorted financial statements to conceal their value-destroying activities from outside investors thus leading to severe information asymmetry. Accordingly, politically connected firms will avoid Big 4 audit firms that are less likely to act consistently with their actions due to reputational risks. Therefore, following this line of argument, we hypothesise that:

H_1: Compared to non-connected firms, politically connected firms are less likely to hire a Big 4 audit firm.

3. MODEL SPECIFICATION AND RESULTS

Following prior research (Ahmad et al., 2006; Guedhami et al., 2014), the hypothesis on political connectedness was tested using the following logits regression model to investigate the choice of the auditor in Nigeria is demonstrated in Table 1 of this study.

PROB(AUDITOR CHOICE) = α_{it}+α_{it} POLITICAL+α_{it} LOGTA+α_{it} ASSTOVER+α_{it} CA+α_{it} BUSISEG+α_{it} DEBTRATIO+α_{it} ROA+α_{it} CASHFLOW+α_{it} LOSS+α_{it} ACDILIG+α_{it} INSTITSHR+α_{it} BINDP+α_{it} MGROWN+α_{it} LOGAF+α_{it} BUSY+α_{it} DELAY+α_{it} INDUSTRY EFFECT+α_{it} YEAR EFF

Table 1: Variable description of independent variables in log it model

Variable	Description
PROB (Auditor choice)	The probability of a company using differentiated quality auditor
POLITICAL	A dummy variable equal 1 if at least one of the board members is politically connected
Control variables	
LOGTA	Log_{10} of total asset
ASSTOVER	Measured as sales divided by total asset
CA	Log of the current asset divided by the total asset
BUSISEG	Number of business segment
DEBTRATIO	Long-term debt divided by total asset
LOSS	Set to 1 if net income before extraordinary items is less than zero and o otherwise
QUICKRATIO	Current asset less inventory divided by current liabilities
ROA	Earnings before interest and tax divided by total asset
CASH FLOW	Cash flow from operations scaled by total sales
ACDILIG	The number of audit committee meetings
INSTITSHR	The percentage of shares held by institutional investors
BINDP	Percentage of independent directors on the board
MGROWN	Percentage of shares held by directors
LOGAF	Log_{10} of audit fees
BUSY	Busy season
DELAY	Log of number of days between accounting year end and auditor's report
INDUSTRY EFFECT	Industry specific fixed effect
YEAR EFFECT	Year specific fixed effect
μ_{AF}	Error term

3.1. Test Variables

As a metric for the political connections of board members, this study defines a politically connected board member as a member of parliament, a minister, a top ex-military officer or someone who has a close connection with top politicians[9]. Consistent with the definition of Guedhami et al. (2014); Faccio (2006), a firm that is politically connected if at least one of the top officers sits in the national parliament or is an ex-parliament member, is related to a minister or ex-head of state or is related to a senior government official. In our case, Ujunwa et al. (2013) found that a former military officer or those connected with the government chaired 75% of the board of directors, suggesting that crony capitalism exists in the Nigerian corporate environment. Based on Ujunwa et al. (2013) this study identifies companies with ex-military chiefs and those companies with top officials that are close to those in the government by being a national award recipient. The names of board members and top officers of the company were hand collected from annual reports and in instances in which such information was unavailable in the annual reports from company websites were used. To test our hypothesis, the dummy dichotomous variable political was utilized in the regression with 1 used for firms classified as politically connected firms and 0 for those that were not. The use of a dummy variable is similar to Faccio (2006); Faccio (2010).

3.2. Control Variables

The control variables used were based on prior studies (Ahmad et al., 2006; Gul, 2006; Guedhami et al., 2014). As widely documented in the previous literature, firm-level characteristics such as client size, client riskiness, and client complexity were controlled for, and the expectation is that these variables will affect the choice of auditor. Client size was proxied by the natural logarithms of total assets, as noted by Palmrose (1984), for the severity of conflict agency increases as client size increases. In addition, proxy client complexity was controlled for by asset turnover, current assets, and the number of business segments. The complexity measure takes into consideration client scope of operations and balance sheet composition as explained in Chan et al. (1993). On client risk, the long-term debt ratio, quick ratio, return on assets and losses were included in the regression model. CASHFLOW, which is cash flow from operating activities scaled by total assets, is another measure of risk is included in the model to control for the possible association between the financial performance of a firm and the choice of auditor. The effect of corporate governance characteristics and ownership structure were also captured. These variables included audit committee diligence (ACDILIG), institution share (INSTITSHR), board independence (BINP) and managerial ownership (MGROWN). Lastly, those factors that might affect auditor-client relationship were considered. These included the natural log of audit fees (LOGAF), busy season (BUSY) and some days taken between financial year-end and auditor's report (DELAY). Variations across the industry (INDUSTRY EFFECT) and over time (YEAR EFFECT) were also controlled for.

3.3. The Sample

To analyse the impact of political connections on the selection of an auditor, data was gathered by hand from the annual reports of companies listed on the NSE from 2008 through 2013. During this period, the government conducted on-going efforts to improve the quality of financial reporting in Nigeria. Financial institutions were excluded due to the distinctness in their regulatory environment. The final number of observations was 429 for the 6-year period for 94 firms. Table 2 presents the descriptive statistics for the variables for the sample audited

9 Other studies as well used the percentage of share ownership by connected individuals to identify the extent of political connections. We as well used this to the extent to which the available information permitted. In Nigeria, due to the high level of corruption, firm ownership in firms by top government officials is often held in proxy through associates and friends.

by Big 4 audit firms and those audited by non-Big 4 audit firms. As shown in the table, 45% of the politically connected (POLITICAL) firm chose a Big 4 audit firm with an average fee of 23,274 Naira, while 28% of politically connected firms chose non-Big 4 audit firms with an average audit fee of 9,631.8 Naira. The difference in the politically connected firms board in their choice of Big 4 and non-Big 4 firms was not statistically significant.

Compared to firms audited by Big 4 auditors, firms audited by non-Big 4 auditors tended to be smaller regarding total assets (TA) and lower assets turnover (ASSTOVER), and higher current ratios (CA). Conversely, firms audited by Big 4 firms had a higher number of business segments (BUSISEG), a lower debt ratio (DEBTRATIO), incurred fewer losses (LOSS) and had a higher cash flow (CASH FLOW). Likewise, compared to non-Big 4 firms, Big 4 audit firms were busier (BUSY) than non-Big 4 firms and had a longer audit lag (DELAY) between the accounting year-end and the signing of annual reports. Firms audited by Big 4 audit firms tended to have diligent audit committees (ACDILIG), an independent board (BINP), a higher concentration of institutional shareholders and less managerial ownership. The descriptive statistics provide directional support for the regression analysis.

3.4. Regression Result for Auditor's Choice

Table 3 present this study's regression results. Reported t-values are on an adjusted basis, using robust standard errors corrected for heteroscedasticity (Petersen, 2009). The χ^2 statistics show that the model was statistically significant at the 1% level ($P < 0.000$). The pseudo-R^2 was 37% indicating a moderately good fit. A diagnostic test for multicollinearity was performed and found that the variance inflation factor on all variables was far below the threshold of 10 that Kennedy (1998) suggested. Hence multicollinearity was not an issue. The result of our logit regression showed that the coefficient for politically connected firms was negative and significant, suggesting that politically connected firms were less likely to hire Big 4 auditors. The results support the theoretical intuition that, due to the strictness of Big 4 auditors, politically connected firms would be less willing to hire a Big 4 firm so that they could conceal their distortionary acts stemming from political cronyism.

Concerning the control variables, the results were consistent with the findings of prior studies (Ahmad et al., 2006). Table 3 shows that the firm size variable (LOGTA) was negative and significant, indicating that large-size company was not statistically associated with Big 4 audit firms, which is contrary to theoretical postulation (agency theory). These was true for the variables that proxied client complexity (DEBTRATIO) as well. DEBTRATIO had a significant negative association with Big 4 audit firms. The explanation for this finding is that the majority of large-size companies in the sample were politically connected, as the finding revealed that politically connected firms were less likely to appoint a Big 4 audit firm. Thus, this might be a plausible reason for the deviation in the results. Meanwhile, highly geared companies fell into the category of connected companies (DEBTRATIO). Palmrose (1984) found that highly geared companies might portend high risk for auditors; hence, Big 4 auditors might not consider them to be cost-effective clients.

Table 2: Descriptive statistic

Variable	BIG 4 (275)	NON-BIG 4 (154)	MEAN
	Mean±SD	Mean±SD	DIFF
POLITICAL	0.4509±1.4500	0.2828±0.9861	1.154
AF	23,273.7±32505.6	6702.1±9631.8	−0.6.154***
TA (000)	363,000±7.3	930.815±1.33	−4.520***
ASSTOVER	1.2298±1.3175	1.0427±0.96	−1.459
CA	1.7841±1.3191	2.2052±6.1673	1.699***
BUSISEG	2.9197±1.5433	2.7987±1.6857	−0.753
DEBTRATIO	0.1474±0.1575	1.2331±12.9933	1.384
LOSS	0.1355±0.3429	0.2078±0.4071	1.952**
ROA	0.0644±0.2491	0.3881±0.3246	−0.913
CASH FLOW	0.1379±0.2064	4.4201±37.3116	1.904**
BUSY	0.7172±0.4533	0.6753±0.4698	−0.809***
DELAY	122.4721±57.4930	119.8514±66.8463	−0.420
ACDILIG	3.0959±1.2700	2.9864±1.0979	−0.882
BINDP	0.4509±1.4500	0.2829±0.9861	1.275
INSTITSHR	47.8982±26.5991	42.0323±31.1713	−2.505***
MGROWN	1.0300±1.5500	1.7500±3.3800	2.307***

SD: Standard deviation, ***Significant at 1% level, **Significant at 5%, (one-tailed for hypothesis variable for all variables).

Table 3: Regression result for auditor's choice

Variable	Coefficient	P	VIF
CONS	−17.456	0.000***	1.23
POLI	−0.897	0.000***	2.65
LOGAF	2.172	0.000***	2.99
LOGTA	−0.387	0.067**	1.13
ASSETTOVER	0.029	0.408	1.1
CRATIO	0.393	0.050**	1.09
CASHFLOW	−0.012	0.063**	1.11
BUSISEG	−0.098	0.142	1.02
LTD2TA	−17.604	0.000***	1.35
LOSS	−0.309	0.047***	1.22
ROA	−0.719	0.047***	1.17
ACDIILIG	−0.079	0.294	1.44
INSTITSHR	−0.010	0.056**	1.13
INDP	0.015	0.434	1.33
DIRSHR	−0.003	0.494	1.18
BUSY	0.605	0.039***	1.18
LOGDELAY	0.979	0.010*	
YEAR EFFECT	Yes	Yes	
INDUSTRY EFFECT	Yes	Yes	1.39
MEAN VIF			
OBS	429		
PROB	0.000		
PSEUDO R2	0.36		

***Significant at 1% level, **Significant at 5%, *Significant at 10% (one-tailed for hypothesis variable for all variables). The dependent variable was auditor choice (CHOICE). A dummy variable coded 1 if the auditor is Big 4 and 0 otherwise

LOGAF (audit fees) was significant at $P < 0.01$ and positive in the regression model. The result indicates a strong association between increased audit fees and the possibility of hiring a Big 4 audit firm. The result is consistent with the view that Big 4 audit firms charge premiums for delivering a product-differentiated service. The result for the variable BUSY was significant and positive at $P < 0.05$ while DELAY was also significant and positive at $P < 0.01$. As expected, Big 4 audit firms are busy during December financial year-end because the majority of the firms have December as their financial year-end, and Big 4 firms serve as auditors for more than 60% of listed companies. This as well explains the longer number of days taken to audit the accounts of listed companies.

4. CONCLUSION AND IMPLICATIONS

Motivated by the ongoing efforts by Institute of chartered Accountants of Nigeria to encourage joint audits, this paper investigated the extent to which political connections influence the choice of auditors in Nigerian listed firms. Although the literature on auditor choice and audit fees has grown, the impact of the political connectedness of firms has not received much attention. This research covers the period between 2008 through 2013. The result shows that politically connected firms are less likely to hire Big 4 audit firms. The results are consistent with the proposition that politically connected firms have poor financial reporting quality and that, to remain less transparent, they purchase the audit services of non-Big 4 audit firms that are more likely to tolerate their earnings manipulation practises.

The findings of this study have important implications for regulatory authorities in Nigeria as they further enhance the understanding of the likely effects of a firm's political connections on financial reporting and the audit process in Nigeria. As Guedhami et al. (2014) pointed out, political connections exacerbate the agency problem, most especially in a regulatory setting in which the control of a firm is concentrated in the hands of a few individuals. This study recommends that regulators should consider political cronyism in future regulatory initiatives. Like any other study, the interpretations of this study's findings should be considered within the scope of the definition of political connection it uses. The present study has only considered firm political connection based on the political connectedness of board members. Future studies could as well consider a firm's connections through controlling shareholding of political appointees who either served in a past political regime or are serving in the current government regime. Meanwhile, the ethnic and gender diversity of boards should be studied because they could as well predict the choice of auditors in Nigeria.

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