

## AUDIT FIRM CHARACTERISTICS AND LITIGATION RISK IN NIGERIA

**Onatuyeh Aruobogha Edwin**

*Department of Accountancy, School of Business Studies, Delta State Polytechnic, Ozoro,  
Delta State*

*Email: [edwin.onatuyeh@yahoo.com](mailto:edwin.onatuyeh@yahoo.com), Tel No: 08032466517*

**Nwabuko Oluchi Bavy**

*Department of Accounting, Faculty of Management Sciences, University of Benin,  
Benin City, Edo State*

*Email: [olubev@yahoo.com](mailto:olubev@yahoo.com), Tel No: 08029570462*

### Abstract

*The study investigates the relationship between audit firm characteristics and litigation risk in Nigeria. The population of the study comprises all the audit firms in audit practice in Nigeria that are registered with the Institute of Chartered Accountants of Nigeria (ICAN) as at 31<sup>st</sup> December, 2014. Using the judgmental sampling technique, 20 Nigerian audit firms were chosen. From the 20 selected audit firms, a final sample of 156 respondents (representing 78% response rate) who have been in audit practice for over 3 quinquennia was drawn. Data was estimated using ordinary least squares regression method. Audit fee and litigation were positive and statistically significant. Whereas audit tenure and audit firm size, introduced into the model as control variables, were statistically insignificant, non-audit fee was negatively related to litigation risk. Against the background of the findings, it was recommended that partners in audit firms should always endeavor to evaluate the attributes of their firms, or possibly link those attributes to the risk of being sued for a deficient work, as understanding the link between audit-firm characteristics and litigation risk would allow firms to further reduce litigation risk through practice management. The study noted that the demise of Arthur Andersen (one of the big 5 audit firms) can be largely attributed to the partners' inability to identify changes within their firm that increased the risk of audit failure and litigation to an unreasonable level.*

**Keywords:** Litigation risk, audit firm, audit independence, audit fees, audit quality

### 1. Introduction

Users of financial statements such as the banks, shareholders, prospective shareholders and financial analysts frequently base their loan and investment decisions on information in financial statements. In order for them to take the right decisions, these financial statements must provide reliable and objective information concerning the company's financial situation. However, since information presented in financial statements has huge impact on managers' compensation and

the way they are evaluated, users are not sure if these financial statements have been properly prepared, and therefore demand that the financial statements be audited by an independent external auditor (Gul, Jaggi and Krishnan, 2007). Naturally, it is essential that these auditors are actually independent and that they perform the audit in such a way that all (material) errors in the financial statements are discovered.

In recent years however, problem of lack of independence in auditors due to over dependence on fees from providing other services to clients has been expressed by the government, regulatory authorities, academic researchers and the accounting profession itself (Gul, Jaggi and Krishnan, 2007). They emphasize the fact that clients' directors/managers control the current and future audit (and non-audit) fees that the audit firm hopes to get from the relationship with the auditee, and therefore are in a influential position in audit conflict situations. Empirical studies indicate that directors and managers often apply pressure on auditors in audit conflict situations by (subtle or overt) threatening to break off the relationship with the audit firm, and that auditors are perceived as submitting more easily to this pressure if they profit more from the audit (Knapp, 1985; Farmer, 1987; Gul, 1991 and Bartlett, 1993).

Several studies have shown that increasing competition in the audit market has resulted to increasing pressure on audit time budgets, often making these budgets to become very tight (Marxen, 1990 and Otley and Pierce, 1996). Research has also shown that these tight budgets often make to auditors omit parts of the audit program, and thus lower audit quality (Margheim and Pany, 1986; McDaniel, 1990; Kelley and Margheim, 1990 and Otley and Pierce, 1996). If auditors drop the quality of the audit by submitting to management pressure or by omitting parts of the audit program, the risk of financial statements containing material errors will increase of course. However, not all errors in financial statements will harm the audit firm or the auditor who audited the statements.

Problems only occur when users of financial statements discover these errors and these errors have led to financial losses. In that case, injured users will endeavor to recover their losses by filing lawsuits and claims against the auditor who wrongly approved the statements or had performed a deficient audit work. Research by Palmrose (1988) has demonstrated that such lawsuits and claims can lead to high costs and can greatly damaged reputation and as a result, are very harmful to the auditor and the audit firm. Therefore, it may be expected that auditors' willingness to submit to management pressure and to omit parts of the audit program will decrease if there is a high possibility that poor audit work will increase litigation risk.

Although, numerous researches have been extensively done as regards audit litigation, most empirical assessments in this area have not only been predicated on data from developed countries, especially Anglo-American and Europe, but the focus has been on the relationship between audit-client characteristics and audit litigation. Studies on relationship between audit-firm characteristics and audit litigation have been quite limited with the exception of few notably studies (e.g. Stice, 1991 and Casterella, Jensen and Knechel, 2007 and few others). Our study, therefore, extends and contributes to extant literature by offering empirical evidence on the relationship between audit-firm characteristics and litigation risk using, as a reference point, audit firms that have been in audit practice in Nigeria for over three quinquennia.

The remaining part of this paper is organized as follows: The next section focuses on the review of related literature and hypotheses development. The ensuing section highlights the theory on which the study is anchored. Section four discusses the research methodology and presents the specific measure used to test the hypotheses developed in the study. A section on data analysis,

discussion and synthesis precedes the final sections, which lay out some concluding remarks and recommendations.

## **Literature Review**

### **2.1 Concept of Audit Litigation Risk**

Litigation risk can be regarded as any breakdown in audit quality that leads to a claim alleging professional negligence against an auditor and/or its insurer (Hwang and Chang, 2010). Depending on the circumstances, this may result in a formal lawsuit or simply as a claim against the insurance company of the audit firm which may be settled without any formal litigation. The features of an audit engagement can determine audit litigation risk. This includes characteristics of the audit firm and the audit client, together with their interactions. Previous research has shown that certain audit-client characteristics are related to audit failure and litigation risk (Latham and Linville 1998). Some audit firms often extract from their portfolios clients with such attributes. However, insurers of audit firms usually cannot observe the attributes of individual audit clients. Rather, they tend to make risk related decisions based on the available information about the audit firms themselves. Understanding the link between audit-firm characteristics and litigation risk is of significant importance to those stakeholders interested in finding out the difference in quality among audit firms (Hwang and Chang, 2010). This includes organizations seeking high-quality audits, but is of particular importance to both the audit firms and companies who insure the audit firms against audit failure.

An audit failure is said to have occurred when an observed event (such as bankruptcy, subsequent discovery of material error or fraud, restatement) is linked to the auditor's inability to perform an effective audit work. Auditors can manage or reduce litigation risk by screening potential clients (Johnstone 2000; Asare et al. 1994), and by removing risky clients from their overall clients' portfolios (Johnstone and Bedard 2004). However, partners in audit firms are not always in better positions to either evaluate the attributes of their own firms, or link such attributes to the risk of being sued for a deficient work. At the same time, they are not free from potential bias and self-deception in making such assessments (Bazerman et al. 2002). Indeed, the demise of Andersen can be deemed to have arisen from the audit partners' inability to identify changes within their firm that increased the risk of audit failure to unreasonable levels (Toffler 2003). Hence, understanding the relationship between audit-firm behavior and litigation risk should enable firms to further reduce litigation risk through practice management.

Litigation risk can be viewed in terms of the likelihood of a claim being filed against an audit firm for an alleged audit failure (Lys and Watts 1994; Stice 1991), but also in terms of the magnitude (or naira amount) of such claims. Although existing research has used the likelihood measure alone, it is apparent that audit failures resulting in small naira losses are more tolerable than audit failures resulting in catastrophic losses. Insurance models outside of accounting frequently make use of the severity of the litigation loss (Cummins and Derrig 1993). Hence in this study, litigation risk is defined by both its likelihood and magnitude.

### **2.2 Audit - Firm Characteristics**

Previous accounting research has addressed the issue of audit litigation by identifying problem areas that should be considered while performing audit (St. Pierre and Anderson, 1984; Kellogg, 1984). Stice (1991) extended this research by developing and testing a model to predict litigation against auditors which includes both client and auditors' characteristics. According to the researcher, while audit-client characteristics include financial conditions, level of accounts receivable and inventory, sales growth, market value of equity, and variability in the client's stock returns, audit-firm characteristics include audit quality, audit independence, and audit

tenure. The audit-firm characteristics used in this study were adapted from the ones developed by Stice in 1991, and these characteristics are discussed as follows:

### **2.2.1 Audit Fees and Litigation Risk**

The work of Beatty (1993) was one of the first studies to focus on the relationship between litigation risk and audit fees - a relation he characterized as the legal liability hypothesis. According to him, as the expected losses from imposition of legal liability increase, the audit fee will increase, *ceteris paribus*. For Francis and Krishnan (1999), one way in which auditors can respond to a litigation risk and an audit engagement risk is to adjust their audit fees accordingly. While frictions may not allow auditors to fully adjusting audit fees upwards to reflect higher perceived level of litigation risk, it is expected that auditors, on average, will charge higher fees for two reasons. First, audit fees will increase the extent auditors would expand audit scope and assign more experienced professional staff to help reduce these risks (Simunic and Stein, 1996). Second, auditors may charge a risk premium to make up for the additional audit risk the audit engagement entails (Abbott et al., 2006; Chen et al., 2012; Krishnan et al., 2012). On the other hand, audit clients expect the auditor to carry out quality audit after being charged so much for the audit. In the event of any financial loss from negligently performed audit, the injured party may file lawsuit against the auditor.

It is therefore important for auditors to understand how client characteristics are related to audit and litigation risk so as to be able to assess risk levels and institute appropriate audit procedures (Stice, 1991). Extant literature on audit pricing provides evidence that auditors respond to higher perceived audit and litigation risks by demanding higher audit fees (Hwang and Chang, 2010). For example, Simunic (1980) found that proxies for auditors' expected litigation costs are positively associated with current period audit fees. In the light of the above, it is therefore hypothesized that:

***H<sub>1</sub>: There is positive relationship between audit fees charged to auditor's clients and perceived litigation risk***

### **2.2.2 Audit Independence and Litigation Risk**

There is a common view that auditor independence is threatened by the economic dependence of an auditor on fees from audit clients. The additional fees obtained through the provision of non-audit services increase an auditor's economic dependence on a client, and this has been perceived by regulators and concerned stakeholders to threaten auditor independence. Prior research has provided some evidence to suggest that the volume of non-audit services provided by auditors impairs perceived auditor independence, threaten audit quality and increases audit litigation risk (Khurana and Raman 2006; Francis and Ke 2006; Krishnan et al. 2005; Brandon et al. 2004; Frankel et al. 2002).

In an experimental study, Dopuch et al. (2003) also established that the provision of non-audit service does affect perceived auditor independence and as a result, increases the chances of lawsuit and claims by injured parties. Francis (2006) argued that fees from the provision of all services (audit and non-audit services) create economic dependence and could be perceived to threaten audit independence. Gul (2011, 1991) noted that the amount of audit fees rather than NAS fees affects perceived auditor independence. On the other hand, Ghosh et al. (2009) found that client importance, in the shape of contributing a large proportion of revenues to an auditor's total revenue stream, rather than fees from non-audit service actually impairs perceived auditor independence. It is, therefore, hypothesized that:

***H<sub>2</sub>: There is positive relationship between highly impaired audit independence and litigation***

*risk*

### **2.2.3 Non-audit Service Fee and Litigation Risk**

Prior research has demonstrated that the provision of non-audit services creates economic bonds with a client and this bond can weaken an auditor's independence and audit quality (DeAngelo 1981; Simunic 1984; Beck et al. 1988) and therefore increases litigation risk. Conversely, DeFond et al. (2002) empirically demonstrated that firms that pay high non-audit fees are not related with going concern issues, suggesting that auditor independence, as well as audit quality, is not compromised with high payment of non-audit fees, thereby reducing auditors' liability exposure.

More evidence in extant literature suggests that a high degree of fee dependence may impair auditor independence and affect the objectivity of an audit (Becker et al. 1999). For example, using client-specific ex-ante cost of equity as a proxy for investor opinions about financial reporting reliability, Khurana and Raman (2006) discovered that high non-audit and total fees are connected with lower financial reporting credibility. However, concerns about auditor's reputation and litigation exposure are likely to motivate auditors to be more independent while carrying out their audit and non-audit works (Shu, 2000; Palmrose, 1988; Watts and Zimmerman, 1983). We posit that:

***H<sub>3</sub>: There is positive relationship between increased non-audit fees, impaired audit independence and litigation risk***

### **2.2.4 Audit Quality and Audit Litigation Risk**

Research has demonstrated that if audit firms lower the quality of their audit work by yielding to management pressure or by omitting parts of the audit program, the chance of financial statements containing material errors and misstatement would be high. However, not all errors found in financial statements will be detrimental to the audit firm or the auditor who have audited the statements. Problems arise only if users of financial statements discover these errors and if these errors have caused financial losses. Thus, injured parties would try to recover their losses by filing lawsuits and claims against the erring audit firm. Research by Palmrose (1988) has shown that such lawsuits and claims increase costs massively and greatly damaged reputation, and therefore are very detrimental to the auditor and the audit firm. For this reason, auditors would provide higher quality audit in order to reduce exposure to audit litigation (Palmrose, 1988).

Dye (1993) predicted audit quality as having a negative relationship with lawsuit and claims by injured parties. In his analytical model, he linked perceived quality of an audit to the auditor's wealth. Based on this "deep pocket" theory, it could be argued that auditors would provide higher quality audit if they have more wealth at risk in case of litigation. It follows that the higher the quality of audit auditors would perform, the lower the perceived litigation risk. It is hypothesized as follows:

***H<sub>4</sub>: There is negative relationship between audit quality and litigation risk***

## **2. Theoretical Framework**

A framework for the analysis of the relationship between audit firm characteristics and audit quality is the stakeholder theory. The stakeholder theory, originally defined by Freeman (1984) 'is a theory of organizational management and business ethics that addresses morals and values in managing an organization'. In this theory, the concept "stakeholders" refers to managers, shareholders or other users of financial reports which are influenced, either directly or indirectly by the actions of the auditor. A fundamental characteristic of stakeholder theory is therefore to

attempt to identify individuals and groups that organizations and companies are accountable to. This has also been part of the theory's challenge (Anheier, 2005).

Variations in stakeholders' perception about lawsuits and claims for poorly executed audit work that causes financial losses suggest that no single element should be adjudged as having the dominant influence on audit litigation explained in this study as "audit fees", "audit independence", "audit quality", and "non-audit service fee". This means that a broader and deeper understanding of the complexities of the issue needs to be addressed more holistically in line with the response divergent stakeholder's theory (Freeman, 1984) through investigating the impact of these variables. Consequently, different stakeholders should carefully analyzed their actions so as to establish the effects of their actions on the perspectives of audit litigation because audits provide assurance to shareholders, managers, investors, payables and other stakeholders for the purpose of instilling confidence on financial reporting.

### **3. Methodology**

#### **3.1 Model Specification**

Following the above framework, and existing extant literature on the audit-firm attributes that impacts on audit related-litigation, we therefore assume that audit litigation risk is a function of audit fees, audit independence, non-audit services and audit quality:

$$AUDLITRISK = f(AUDFE, AUDIND, NAS, AUDQUAL)$$

In order to measure the effect of other external factors that can be responsible for any disparity in the relationship between audit-firm characteristics and audit litigation risk, there was the need for the introduction of control variables. The control variables selected in this study are audit tenure and audit-firm size. Thus, incorporating these control variables into the above linear function will produce the following new function:

$$AUDLITRISK = f(AUDFE, AUDIND, NAS, AUDQUAL, AUDTEN, AUDFSIZ)$$

Expressing the above function in econometric form will produce the following equation:

$$AUDLITRISK = \alpha_0 + \alpha_1 AUDFE + \alpha_2 AUDIND + \alpha_3 NAS + \alpha_4 AUDQUAL + \alpha_5 AUDTEN + \alpha_6 AUDFSIZ + \mu_t$$

Where AUDLITRISK = Audit litigation risk

- AUDFE = Audit fees
- AUDIND = Audit independence
- NAS = Non-audit service fees
- AUDQUAL = Audit quality
- AUDTEN = Audit tenure
- AUDFSIZ = Audit firm size
- $\mu_t$  = error term

$\alpha_0, \alpha_1, \alpha_2, \alpha_3, \alpha_4, \alpha_5, \alpha_6$  = unknown coefficients of the variable. Presumptively, it is expected that  $\alpha_0, \alpha_1, \alpha_2, \alpha_3, \alpha_4, \alpha_5, \alpha_6 > 0$ .

#### **3.2 Population and Sample Size**

The population of the study comprises all the audit firms in audit practice in Nigeria that are registered with the Institute of Chartered Accountants of Nigeria (ICAN) as at 31<sup>st</sup> December, 2014. Using the judgmental sampling technique, 20 Nigerian audit firms were chosen. The study was restricted to Lagos State as it harbours 60% of the Federation's total industrial investments and foreign trade and attracts 65% of Nigeria's commercial activities (The Academy of Business

Strategy 2011). From the 20 selected audit firms, a sample of 200 chartered accountants who have been in audit practice for over 3 quinquennia was drawn, and they are between the ages of 40 and 60 years.

### **3.3 Research Instrument**

Content validity was achieved through a pilot scheme in which copies of the questionnaire were administered on some few selected respondents. Their responses were used to adjust the questions. Three research assistants were commissioned to administer the questionnaire. There was a response rate of 78% having received and analyzed 156 copies of the questionnaire. The questionnaire included items adopted from previous researches as well as some self developed ones. The questionnaire consisted of two sections: Section A was in the format of a five-point Likert type scale. This section investigated the seven variables of interest used in the study (see table 1). Section B gathered demographic information from the respondents.

**Table 1: Measurement of Variables**

<b>Variables</b>	<b>Questions</b>	<b>sign</b>
Audit litigation risk (AUDLITRISK)	1 – 4	
Audit fees (AUDFE)	5 – 8	+ ve
Audit independence (AUDIND)	9 – 12	+ ve
Non-audit service fees (NAS)	13 – 16	+ ve
Audit quality (AUDQUAL)	17 – 20	- ve
Audit tenure (AUDTEN)	21 – 24	+ ve
Audit firm size (AUDFSIZ)	25 – 30	- ve

### **3.4 Data Analysis, Discussion and Synthesis**

The correlation result below (table 2) revealed that the coefficient of the variable with respect to itself is (1.00) signaling perfect correlation. The values of the mixed coefficients are not indicative of any problem of multicollinearity. The highest correlation coefficient of (0.443) between audit tenure and audit firm size is a strong indication of absence of multicollinearity.

**Table 2: Spearman Correlation Analysis**

		<b>AUDLITRI SK</b>	<b>AUDF E</b>	<b>AUDIN D</b>	<b>NAS</b>	<b>AUDQU AL</b>	<b>AUDTE N</b>	<b>AUDFSI Z</b>
<b>AUDLITRI SK</b>	<b>Corr. Coeff. Sig. (2 tailed) N</b>	1.000 - 156						
<b>AUDFE</b>	<b>Corr. Coeff. Sig. (2 tailed) N</b>	0.242 0.109 156	1.000 - 156					
<b>AUDIND</b>	<b>Corr. Coeff. Sig. (2 tailed) N</b>	0.127 0.160 156	0.323 0.005 156	1.000 - 156				
<b>NAS</b>	<b>Corr. Coeff. Sig. (2 tailed) N</b>	0.078 0.332 156	0.163 0.061 156	-0.506 0.016 156	1.000 - 156			
<b>AUDQUAL</b>	<b>Corr. Coeff. Sig. (2 tailed) N</b>	0.380 0.078 156	0.021 -0.071 156	0.320 0.130 156	0.331 0.000 156	1.000 - 156		
<b>AUDTEN</b>	<b>Corr. Coeff. Sig. (2 tailed) N</b>	0.045 0.517 156	-0.068 0.912 156	-0.075 0.341 156	0.369 0.530 156	0.223 0.130 156	1.000 0.223 156	
<b>AUDFSIZ</b>	<b>Corr. Coeff. Sig. (2 tailed) N</b>	0.164 0.618 156	0.091 0.477 156	0.090 0.982 156	0.321 0.630 156	0.092 0.543 156	0.443* 0.530 156	1.000 0.733 156

*Source: Researcher’s Compilation, 2016. \*Correlation is significant at the 0.01 level (2-tailed)*

The result of the correlation coefficient was strengthened by the Variance Inflation Factor (VIF) test. From the results as presented in table 3, it was observed that none of the variables tested indicates the presence of multicollinearity as the centered VIF of the variables are all less than 10.

**Table 3: Variance Inflation Factor**

Variables	Coefficient Variance	Uncentered VIF	Centered VIF
C	0.161181	79.01258	NA
AUDFE	0.005245	15.52182	1.067593
AUDIND	0.004708	11.34624	1.171325
NAS	2.46E-05	14.69785	1.121076
AUDQUAL	1.87E-07	13.04229	1.075219
AUDTEN	0.003788	46.38717	1.060444
AUDFSIZ	0.006750	68.51713	1.057788

*Source: Researcher's Compilation, 2016*

The result of the Breusch-Pagan-Godfrey (table 4) test shows the absence of heteroskedasticity with a probability value of (0.1204) which is greater than the 5% critical value.

**Table 4: Heteroskedasticity Test: Breusch-Pagan-Godfrey**

F-statistic	1.738452 Prob. F(6,146)	0.1204
Obs* R-squared	9.649687 Prob. Chi-Square (6)	0.1204
Scaled explained SS	12.83464 Prob. Chi-Square (6)	0.0466

*Source: Researcher's Compilation, 2016*

The result of the Breusch-Godfrey serial correlation test (table 5) shows f-statistic and obs\* R-squared values of (0.67) and (1.69) with probability values of (0.58) and (0.56) which indicates the absence of serial correlation. The Durbin-Watson statistic of (1.998687) is substantially close to (2.00) and indicates the absence of serial correlation.

**Table 5: Breusch-Godfrey Serial Correlation LM Test**

F-statistic	0.674190 Prob. F(2,146)	0.5806
Obs*R-Squared	1.693843 Prob. Chi-Squared (2)	0.5642

*Source: Researcher's Compilation, 2016*

As reported in table 6, the OLS result revealed that 62% of the variation in audit quality is explained by the explanatory variables while the balance of 38% variation is attributable to the error term. On the basis of the overall model significance, the f-statistic of (56.4) exceeds the f-critical value at 5% level which explains the fitness of the specified model.

**Table 6: Ordinary Least Square (OLS) Regression Analysis**

Variables	Coefficient	Std. Error	t-statistic	Prob.
<b>AUDFE</b>	1.178158	1.108865	10.04627	0.0002
<b>AUDIND</b>	0.181347	0.426362	0.375204	0.6641
<b>NAS</b>	-0.192073	0.473426	-0.343753	0.7337
<b>AUDQUAL</b>	-0.466802	0.182631	-2.063806	0.0465
<b>AUDTEN</b>	0.006581	0.075363	0.334868	0.8385
<b>AUDFSIZ</b>	-0.021074	0.385314	-0.239874	0.5887
R-squared 0.623501		Mean dependent var		6.091444
Adjusted 0.568720	R-squared	S. D. dependent var		6.877629
S. E. of 2.575253	regression	Akaike info criterion		6.390939
Sum squared resid 1859.149		Schwarz criterion		6.702374
Log likelihood 307.0827		Hannan-Quinn Criter		6.639875
F-statistic 56.42274		Durbin-Watson stat.		1.998687
Prob 0.000000	(f-statistic)			

*Source: Researcher’s Compilation, 2016*

Also, as shown on table 6, audit fee (AUDFEE) was found to be positive and significant with a robust t-value of (10.04627) and the coefficient of (1.178158). This means that auditors would respond to an engagement’s perceived audit and litigation risk by adjusting their audit fees accordingly. On the other hand, after paying so much fees and the audit is carried out negligently to the extent that the client suffers some financial loss, the client will go to court to recover such loss, indicating that high audit fees could increase litigation risk if there is an audit failure. The hypothesis 1 which proposes a positive relationship between litigation risk (AUDLITRISK) and the audit fees (AUDFEE) charged to that auditor’s clients is therefore upheld. This finding is supported by studies of Simunic, (1980), Simunic and Stein (1996), and Hwang and Chang (2010) who provided evidence that auditors respond to higher perceived audit and litigation risks by demanding higher audit fees. The audit fees will increase the extent auditors expand audit scope and assign more (and more experienced) professional staff to help mitigate these risks

The relationship between highly impaired audit independence (AUDIND)and litigation risk (AUDLITRISK)was found to be positive and significant with a t-value of (0.375204) and the coefficient of (0.181347), thus supporting hypothesis 2 which proposes a positive relationship between highly impaired audit independence and litigation risk. The result corroborates the work of Frankel et al. (2002); Brandon et al. (2004); Krishnan et al. (2005); Francis and Ke (2006); Khurana and Raman (2006) who all stated that impaired auditor independence threatens audit quality and consequently increases litigation risk.

Again, the relationship between audit quality (AUDQUAL)and audit litigation risk (AUDLITRISK)was found to be negative and significant with a t-value of (-2.063806) and the coefficient of (-0.466802). Thus, hypothesis 4 which proposes a negative relationship between

audit quality and litigation risk is supported. This result corroborates findings of Dye (1993) and Palmrose (1988) who established a negative relationship between audit quality and lawsuit and claims by injured parties. The fact is that auditors would be more motivated to provide higher quality audit when they have more wealth at risk in case of litigation than when they do not.

Furthermore, non-audit fee (AUDFEE) was found to have a negative impact on litigation risk (AUDLITRISK). The relationship between both variables was found to be negative and significant with a t-value of (-0.343753) and the coefficient of (-0.192073). The implication of this finding is that hypothesis 3 which postulates a positive relationship between increased non-audit fees, impaired audit independence and increased litigation risk is not upheld. This means that non-audit fee (AUDFEE) may not necessarily influence the audit litigation (AUDLITRISK) via impaired audit independence. This finding deviates from those of Krishnan et al. (2005); Francis and Ke (2006); Khurana and Raman (2006) who argued that the amount of NAS fees paid to auditors impairs perceived auditor independence, threaten audit quality and increases audit litigation risk and lawsuits, but corroborates those of Ghosh et al. (2009) and DeFond et al. (2002). Audit tenure (AUDTEN) was found to have positive and insignificant relationship with audit litigation risk (AUDLITRISK) with a t-value of (0.334868) and coefficient of (0.006581). This shows that higher audit-client relationship increases the chances of litigation risk due to threat of over familiarity with the audit client arising from many years of audit engagement even though the impact is statistically insignificant in this study.

Finally, the relationship between audit firm size (AUDFSIZ) and audit litigation (AUDLITRISK) was negative but insignificant, meaning that the larger the size of the audit firm, the less likelihood of the audit firm being exposed to audit litigation due to the availability of the required capacity to carry out quality audit. Given the result of this study, the audit firm size did not exert significant impact on audit litigation. That is, with a negative coefficient of (-0.021074) and a t-value of (-0.239874), results show that audit firm size does not significantly influence audit litigation in Nigeria.

#### **4. Conclusion**

The study investigated the relationship between audit firm characteristics and litigation risk in Nigeria against the backdrop of the vulnerability of the auditing profession to reputation-damaging lawsuits by injured parties arising from negligence and poorly executed audit work which has been described as a crisis. Given the peculiarities of this study, it was hypothesized that audit fees is positively related to litigation risk. The reason being that an injured audit client can easily file lawsuits and claims to recover the financial losses suffered from negligently carried out audit work which has cost the client so much. The study hypothesized an inverse (negative) relationship between audit quality and litigation risk. This means that to reduce any legal related liability, auditors are motivated to provide higher quality audit especially if huge amount of their wealth is at risk.

Against expectation, the result of the present study showed a negative relationship between non-audit fee and litigation risk. The fact that extant literature has demonstrated that the provision of non-audit services creates economic bonds with a client, which weakens auditor's independence as well as audit quality and increases litigation risk, one expects that the results would have produced a positive relationship between non-audit fees and litigation risk. Rather both variables were found to be negatively related and statistically significant, showing that non-audit fee has no influence on audit litigation. The study also revealed a positive and statistically significant relationship between highly impaired audit independence and litigation risk. An auditor who is not independent would hardly carry out quality audit that would reduce litigation risk. Although,

the study found a positive but insignificant relationship between audit tenure and litigation risk, the same cannot be said of the relationship between the other control variable (audit-firm size) and litigation risk, as a negative relationship was rather found between both variables, indicating that the availability of the required capacity in large audit firms would enable the firms perform quality audit and thus reduce their exposure to litigation risk. However, as the result of this study is insignificant, one would hardly conclude that audit-firm size reduces litigation risk in Nigeria.

## **5. Recommendations**

Based on the findings of the present study, the following recommendations are therefore suggested:

Firstly, audit firms should only accept engagements that require them to provide audit and non-audit services if they have the capacity to manage both types of engagement. To avoid familiarity threats which could subsequently impair independence, audit firms should ensure that certain members of staff are not allowed to remain on an assignment for too long. Over familiarity with clients can affect audit independence, lower audit quality which exposes the audit firm to litigation risk.

Secondly, since the result of this study has shown that audit firm size does not significantly influence audit litigation in Nigeria, smaller audit firms should be encouraged as they are more likely to perform more thorough audit assignment. Irrespective of the audit firm size, all potential audit clients should be properly screened so as to identify any risk of litigation before an engagement is accepted by the audit firm.

Thirdly, partners in audit firms should always endeavor to evaluate the attributes of their firms, or to link them to the risk of being sued for deficient work. This is very important because understanding the link between audit-firm behavior and litigation risk should allow firms to further reduce litigation risk through practice management. The demise of Andersen (one of the big 5) can be attributed largely to partners' inability to identify changes within their firm that increased the risk of audit failure to unreasonable level.

Finally, the Institute of Chartered Accountants of Nigeria (ICAN) provides opportunities for members in audit practice to consult the institute where they run into any difficulty in private practice. Unfortunately, most members have not been taking advantage this option. Seeking guidance from ICAN can help audit firms develop strategies for reducing their exposure to litigation risks.

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