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IMPACT OF AUDIT QUALITY ON ANALYSTS' EARNINGS FORECAST IN NIGERIA

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ABSTRACT

Audit lends credibility to the information contained in financial statement. Consequently, higher degrees of reliability are expected on the accounting numbers and disclosures contained in the audited financial statements. This study specifically investigated the effect of audit quality on analysts' earnings forecast accuracy of non-financial listed firms on the Nigeria Stock Exchange (NSE). The sample comprised 31 firms for which data was accessible on the financial times database out of the 118 listed non-financial firms on the Nigerian Stock Exchange. The Ordinary Least Square (OLS) regression model was used in analyzing the data. It was found that higher audit quality, measured as big 4 auditor and industry specialist auditor, significantly affected analysts' earnings forecast accuracy under varying circumstances. It is recommended that analysts should factor audit quality of the financial statements in making forecasts in order to improve the accuracy of their forecasts.

Key words: Audit quality, Earnings forecast, Earnings forecast accuracy, Accounting numbers.

1. INTRODUCTION

There are numerous users of the information contained in financial statements. These users include shareholders, employees, government and regulators. However, financial analysts are a special interest group in issues relating to the quality of the information contained in the financial statements. This is because they rely heavily on the historical earnings figures in their fundamental

analysis to predict future earnings. The earnings forecasted by financial analysts form a core component of the factors considered in advising their clients in the buy, hold, or sell decision.

Empirical evidence in the literature supports improved (historical) earnings quality as a consequence of superior audit quality (Allen, Larson & Sloan, 2010; Slaheddin, 2015). However, little has been documented on how the quality of audit affects the forecast accuracy of earnings by financial analysts in developing economies. An expectation, based on the positive relationship between superior audit quality and reliable historical earnings figures (Slaheddin, 2015; Teoh and Wongs, 1993), is that financial analysts should factor the possibility of historical earnings from low quality audits not being capable of signaling the levels of future earnings in order to improve the earnings forecast accuracy. Therefore, this study examines whether there is higher level of forecast accuracy with superior audit quality. If so, this would mean that financial analysts do not consider the quality of audit in their use of historical earnings figures in forecasting future earnings.

This study is of significance to financial analysts and investors. This is because inaccuracies in analysts' earnings forecast could result in sub-optimal investment advice to clients (investors). More consequential is the magnitude of economic losses that accompany bad investment decision when actual earnings figure are lower than forecasts, causing share prices to crash. In such cases, financial analysts are also exposed to reputational risks which could significantly affect their portfolio of clientele.

This study also has theoretical implications. If earnings forecast accuracies are higher for superior audits, the tenet of the efficient market hypothesis is challenged. This is because analysts that acknowledge the relevance of audit quality in their forecasts of future earnings might be able to outperform their peers that do not factor audit quality in their forecasting model; thus, creating an opportunity for the former to render superior returns on the investments of their clients.

Therefore, this study contributes to the literature on the relevance of audit to the workings of an efficient capital market. However, this study is limited by the number of firms (thirty-one) and year (only 2016) covered. The usage of more firm-year observations might provide different results. This is because of the lack of access to

more data on the Financial Times data base that provided data on the analysts forecasts. Consequently, the findings of this study should be used in light of the small scope covered. It is aimed that this study will stimulate discussion on the relevance of audit quality in analysts earning forecast properties by providing preliminary empirical evidence on the topic. Subsequent researchers on the topic in Nigeria should extend the results of this study by collecting more firm-year observations.

The remaining part of this paper is divided into four sections. Section 2 reviews the relevant empirical evidence; Section 3 presents the methodology; Section 4 presents the findings; and Section 5 concludes and communicates the recommendation of this study.

2. LITERATURE REVIEW

There is sparse empirical evidence on the effect audit quality and properties of analysts' earnings forecasts in developing countries. The two widely used measures of audit quality used in previous literature are the Big N versus non Big N Auditor (Becker, DeFond, Jiambalvo, & Subramanyam, 1998; Datar, Feltham, & Hughes, 1991) and auditor industry specialization (Balsam, Krishnan, & Yang, 2003; Francis, Reichalt, & Wang, 2005). Behn, Choi and Kang (2008) investigated whether audit quality is associated with the predictability of accounting earnings by focusing on analyst earnings forecast properties. The study found that analysts' earnings forecast accuracy is higher and the forecast dispersion is smaller for firms audited by a Big Four auditor. It was also reported that auditor industry specialization is associated with higher forecast accuracy and less forecast dispersion in the non-Big Five auditor sample but not in the Big Five auditor sample. Choi and Kwon (2008) also provided theoretical prediction on the relationship between audit quality and analysts' accuracy and predictions that strongly agree with the findings of Behn, Choi and Kang (2008).

Givoly, Hayn and Lehavy (2008) examined the properties of analysts' cash flow forecasts on earnings forecasts, depreciation expense, working capital accruals and other accrual adjustments. It was found that the coefficients on the earnings forecasts and depreciation expense approached 1.0 while those of working capital

accruals and other accrual adjustments, although positive, are very small (0.06). The study therefore concluded that analysts' cash flow forecasts appear to be simple, mechanical adjustments to the study's earnings forecast. Also, Call, Chen and Tong (2009) examined whether analysts' earnings forecasts are more accurate when they also issue cash flow forecasts. It was found that analysts earnings forecast issued together with cash flow forecasts are more accurate than those not accompanied by cash flow forecasts. The study also asserted that analysts earnings forecast reflect a better understanding of the implications of current earnings for future earnings when they are accompanied by cash flow forecasts.

Salemo (2014) investigated the impact of the quality of reported earnings on the accuracy of financial analysts' earnings forecasts in USA. The study used two measures of forecast accuracy to assess the impact of earnings quality on the forecast accuracy of financial analysts. One measure considered the environment in which the analyst operates and compared their accuracy to that of their peers. The second compared the individual analysts forecast to the actual reported earnings. For both measures of accuracy, the results show that higher earnings quality is associated with improved forecast accuracy.

Ching, Sung, Sun and Mussetta, (2014) investigated whether the accuracy of analysts' forecasts is affected by the customer satisfaction. The results showed that properties of analysts' earnings forecast namely: consensus accuracy, forecast dispersion and forecasts range, are positively associated with customer satisfaction. The study also found that analyst's cash flow forecast properties are also affected by customer satisfaction in a similar way. Overall, the study suggested that information intermediaries, such as financial analysts, should take customer satisfaction into account in their forecasting activities. As analysts' forecast accuracy affects investment risk, the study contributed to the existing literature by providing evidence that customer satisfaction is value relevant to investors.

Hutira (2016) examined the determinants of the sell-side analysts forecast accuracy using median forecast data from 2000-2013 as provided by I/B/E/S. The study provided evidence of a steady decrease in forecast accuracy over the study period. However, the study confirmed size of the firm, the analyst coverage, the type of earnings and the change in earnings to be significant in explaining analyst

forecast accuracy.

Ahmed and Boutheina, (2017) investigated whether, following the Tunisian stock market opening, both the analyst forecast accuracy and the market's reliance on analyst forecasts, increased with time. The study was based on the hypothesis that accuracy is expected to increase over time as analysts exert more effort and gain valuable forecasting experience, and also that the reliance on analyst forecasts should increase with time as the market opens and investors become more sophisticated. The result generally confirmed that both the accuracy and the higher quality of analyst earnings forecasts are increasing with time. Also, they find out that earnings expectations are not mainly based on analyst forecast, as analyst forecast better explain returns and exhibit greater relative information content.

From the empirical literature reviewed, it can be deduced that the debate on the determinants of analysts' forecast properties (accuracy and dispersion) is not yet conclusive. Consequently, this study contributes to the discussion on the factors that affect analysts' forecast properties by examining how the quality of audit affects analysts' forecast accuracy in a developing country like Nigeria.

3. METHODOLOGY

The sample size consists of thirty-one (31) firms. This was as a result of the limited forecast data available on the Thoman Reuter's website. An ordinary least square regression model was used across the 31 firms for the period of 2016. The dataset used for this study were hand collected from the annual report of the sampled listed firms and Thomson Reuter's database (Institutional Brokers Estimate System (I/B/E/S)).

The data collected were analysed using Ordinary Least Square regression. This was achieved through the use of Eviews. The analysis seeks to explain the effect of the dependent variable (Forecasts Accuracy) on the independent variable (Audit Quality). Following prior research, audit quality was measured using firm size and firm specialization.

The following are the model specification:

In order to ascertain the audit quality and properties of analyst earnings forecasts in Nigeria. The following model was adopted with modifications from the study of Behn, Choi and Kang (2008).

$$\text{ACCY} = \beta_0 + \beta_1 \text{AUDITOR} + \beta_2 \text{ISPEC} + \beta_3 \text{SIZE} + \beta_4 \text{SURPRISE} + \beta_5 \text{LOSS} + \beta_6 \text{ZMIJ} + \beta_7 \text{HORIZON} + \beta_8 \text{STDROE} + \beta_9 \text{NANA} + \beta_{10} \text{EL} + \varepsilon$$

..... Equation (1)

In Equation (1), forecast accuracy model is measured by the negative of the absolute value of forecast error scaled by stock price at time t-1, following Behn, Choi and Kang, (2008).

$$\text{ACCY}_i = (-1) \frac{\text{FORECAT}_{i,t} - \text{AEPS}_i}{\text{PRICE}_{i,t}} \dots \dots \dots \text{Equation (2)}$$

Definition of variables:

ACCY = Accuracy in analysts' earnings forecast

AUDITOR = Dummy variable that determine the big 4 (coded as 1) and non-big 4 (coded as 0) auditors

ISPEC = Industry specialist auditor (highest audit firm in a sectors are being classify as industrial specialist coded as 1 otherwise 0)

SIZE = Firms size (logarithm of total assets of the client)

SURPRISE = Absolute value of earnings surprise (this year's earnings minus last years' earnings deflated by share price)

LOSS = Loss indicator (coded as 0 (one) for firm-year observations with positive (negative) earnings)

ZMIJ = Zmijewski's (1984) financial distress score.

Zmijewski score = $-4.336 - 4.513 * (\text{net income}/\text{total asset}) + 5.679 * (\text{total liabilities}/\text{total assets}) + 0.004 * (\text{current assets}/\text{current liabilities})$

HORIZON = Log of mean forecast horizon (log of average of the number of calendar days between mean forecast announcement date and subsequent actual earnings announcement date)

STDROE = Earnings volatility (Standard deviation of Profit After Tax over the previous five years)

NANA = Number of analysts following the client

EL = Earnings per share

ε = error term

FORECAST = Forecast EPS

AEPS = Actual earnings per share

PRICE = Share price

4. Regression Analysis and Discussion of Results

This section presents the regression analysis to achieve the objective of this study which is to examine the effect of audit quality on analysts' earnings forecast accuracy of Nigeria listed companies. The dependent variable in this objective is analysts' earnings forecast accuracy, and effects of audit quality is evaluated, controlling for AUDITOR, ISPEC, SIZE, SURPRISE, LOSS, ZMIJ, HORIZON, STDROE, NANA, and EL. The model was estimated using the Ordinary Least Squares (OLS) technique.

Table 1: Regression Results of Analysts' Earnings Forecast Accuracy for all Companies

All Companies Variables	coefficients	p-value
AUDITOR	0.532*** (0.197)	0.008
ISPEC	-0.412* (0.240)	0.090
SIZE	0.00830 (0.0160)	0.605
SURPRISE	-0.00893 (0.00627)	0.158
LOSS	-2.126*** (0.181)	0.000
ZMIJ	-0.786** (0.320)	0.014
HORIZON	0.411* (0.223)	0.065
STDROE	0.296 (0.368)	0.422
NANA	-0.094 (0.483)	0.845
EL	-1.63*** (0.584)	0.005
Constant	1.313 (1.585)	0.407
Observations	31	
R-squared	0.567	
F-statistic	3.70**	
p-value(F)	0.0263	

Standard errors in parentheses

***significant at 1%, **significant at 5%, *significant at 10%

Source: Author's Computation, 2017.

Table 1 presents the regression result for all sampled firms. The result shows that AUDITOR, SIZE, HORIZON and STDROE have positive signs while other variables have negative signs. These show each of the direction of effect on analysts' earnings forecast accuracy of sampled firms. However, the p-value shows for each of their effects is statistically significant. The decision rule is to reject null hypothesis that a variable is not statistically significant in affecting analysts' earnings forecast accuracy if p-value is less than significance level and accept null hypothesis if otherwise. The result shows that the effects of AUDITOR, ISPEC, LOSS, ZMIJ, HORIZON and EL are statistically significant. This is evident from each of their p-values being less than 0.1, signifying 10% significance level. The effects of other variables are not statistically significant since their p-values are greater than 0.1. This implies that the latter variables do not have an obvious effect on analysts' earnings forecast accuracy of firms. The statistically significant positive effect of AUDITOR and HORIZON indicates that increase in them increases analysts' earnings forecast accuracy (ACCY). Since AUDITOR is a dummy variable, its positive coefficient implies that companies with big four audit firms have higher analysts' earnings forecast accuracy than other counter parts by 0.532. This finding is consistent with those of Lang and Lundholm, (1996), Behn, Choi and Kang, (2008) and Choi and Kwon, (2008). As for HORIZON, the positive coefficient implies that a unit increase in HORIZON brings about 0.411 increase in analysts' earnings forecast accuracy. This finding also concurs with that of Ahmed and Boutheina, (2017). On the other hand, the significant negative effect of ISPEC, LOSS, ZMIJ and EL indicates that a unit increase in each of them brings about a decrease in analysts' earnings forecast accuracy by 0.412, 2.216, 0.786 and 1.63 respectively. This implies that the former variables (AUDITOR and HORIZON) influence analysts' earnings forecast accuracy positively while the latter variables influence it negatively. The inverse relationship between loss firms and analysts' forecast accuracy conform with the findings of Hwang, Jan and Basu, (1996). The reported R-squared value of 0.567 indicates that about 56.7 percent of variations in analysts' earnings forecast accuracy of all companies are explained by audit quality and other factors included in the model. The reported F-statistic value of 3.70 also

indicates that the variables are jointly significant in affecting analysts' earnings forecast accuracy of all companies at 5% significance level. This is evident from its p-value (0.0263) being less than 0.05.

SENSITIVITY ANALYSIS

Table 2: Regression Results of Analysts' Earnings Forecast Accuracy for Consumer Goods Companies

Consumer Goods Company Variables	Coefficients	p-value
AUDITOR	0.374 (0.517)	0.471
ISPEC	-1.044** (0.403)	0.011
SIZE	-1.07e-09 (2.54e-08)	0.966
SURPRISE	-0.0232 (0.0344)	0.502
LOSS	0.000209 (0.000211)	0.323
ZMIJ	-18.36 (36.99)	0.621
HORIZON	-1.438 (3.024)	0.635
STDROE	-21.28 (19.58)	0.280
NANA	-0.094 (0.483)	0.845
EL	0.378 (0.392)	0.337
Constant	251.6 (52.40)	0.407
Observations	12	
R-squared	0.130	
F-statistic	2.82**	
p-value(F)	0.0701	

Standard errors in parentheses

***significant at 1%, **significant at 5%, *significant at 10%

Source: Author's Computation, 2017.

In order to ensure that the result holds for at least an industry segment of the population, the model was analysed using data from the consumer goods companies only. Table 2 presents the regression result for consumer goods firms. The result shows that AUDITOR, LOSS and EL have positive signs while other variables have negative signs. The result shows that only the effect of ISPEC is statistically significant.

The reported R-squared value of 0.130 indicates that about 13 percent of variations in analysts' earnings forecast accuracy of consumer goods companies are explained by audit quality and other factors included in the model. The reported F-statistic value of 2.82 also indicates that the variables are jointly significant in affecting analysts' earnings forecast accuracy of consumer goods companies at 10% significance level. This is evident from its p-value (0.0701) being less than 0.1.

CONCLUSION AND RECOMMENDATION

Based on the findings of this study, it can be concluded that, except for firms in the consumer goods industry, audit quality has a positive effect relationship with analysts' earnings forecast accuracy. This finding has theoretical consequence. It provides evidence in support of the role of auditing in ensuring an efficient stock market. The study recommends that firms should employ highly competent audit firms who can provide superior audit quality. Financial analysts should also factor the type of auditor that audited the earnings figures that are used in their forecasts while forecasting future earnings.

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