Effect of Audit Firm Tenure on Audit Quality of Listed Deposit Money Banks in Nigeria

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Abstract
The purpose of this study was to examine the effect of audit firm tenure on audit quality of listed deposit money banks in Nigeria. Binary logistic regression estimation technique was used to analyze the effect of audit firm tenure on audit quality of listed deposit money banks in Nigeria. The finding of the study reveals that the tenure of audit firms does not affect the audit quality of listed deposit money banks in Nigeria. The study recommends that there is need for the Central Bank of Nigeria and other regulatory bodies to look into the issue of audit firm tenure and its effect on audit quality in Nigeria, and review the policies on audit firm tenure. Further researches should also consider other variables that affect audit quality such as auditors’ independence.

Keywords
Audit firm tenure, Audit quality, Audit firm rotation, Auditors independence and Financial Reporting

1.0 Introduction
Audit involves performing procedures to obtain evidence about amounts and disclosures in financial statements so as to evaluate the appropriateness of accounting estimates made by management (KPMG, 2016). Audit quality is a basic requirement to enhance the credibility of financial statements among stakeholders, because it is what will show the evidence of management’s activities. Audit quality therefore, is a basic ingredient in enhancing the credibility of financial statements to users of accounting information. Consequently, Coate, Florence and Kral, 2002 noted that audits add credibility to financial information by providing an independent verification of management-provided financial reports, thus reducing investor’s risk. Financial reporting credibility is reflected in the confidence of users in audited financial reports. As opined by Levitt (2000), the perception of audit quality plays a critical role in maintaining systematic confidence in the integrity of financial reporting.

Concerns about audit quality have gained increased ascendancy especially as a result of the financial reporting scandals experienced in major organizations in Nigeria and across the world, such as the defunct Oceanic bank Plc now part of ECO Bank, the defunct Intercontinental bank Plc which was purchased by Access Bank, Cadbury (Nig) Plc, and Parmalat in Italy. The aftermath of these scandals have led to the identification of a perceived “expectation gap” in the audit function, as many users of audited financial statements have different expectations of the audit function from what it actually delivers. Therefore, there has been a call for sweeping changes in the auditing profession to ensure improved audit quality.

This is evident in the various codes of corporate governance in Nigeria addressing the issue of audit services and audit tenure for external auditors. The Central Bank of Nigeria in 2006 after the consolidation of Banks published a code of corporate governance for Banks and Discount Houses in Nigeria mandating them to rotate their statutory auditors after ten (10) years of service. A new unified code of corporate governance (NCCG) has also been published by the Financial Reporting Council of Nigeria (FRC) mandating all private companies to rotate their external auditors after 10 years of service. In addition, they are also required to request that the audit partners be rotated after every five (5) years. All these regulations are being put in place to ensure that audit quality is enhanced and maintained among public and private businesses.
Some studies (Healey and Kim, 2003; Dopuch, King, and Schwartz, 2001; Myers, Omer, and Myers, 2003; and Mgbame, Eragbhe, and Osazuwa, 2012) have attempted to analyze some explanatory variables for the state of audit quality. In view of these studies, audit firm tenure has become the focus of much debate. Should a company replace its auditors on a regular basis, or should the auditor be allowed to build a long-term relationship with the client? Previous studies results on the effect of audit firm tenure on audit quality are at divergent. The bane of the problem has been linked to long audit firm tenure which has also been linked with audit failure. Thus, this study will examine the effect of audit firm tenure on audit quality of listed deposit money banks in Nigeria. In doing this, the study will attempt to answer this question: Does the length of audit firm tenure affect audit quality of Nigerian listed deposit money banks? The objective of the study is to determine whether the length of audit firm tenure affects audit quality of listed deposit money banks in Nigeria. With this objective, the hypothesis below is formulated for testing in this study: 

**Ho:** Audit firm tenure does not have a significant effect on audit quality of listed deposit money banks in Nigeria.

The results from this study could be useful to regulators of accounting practice as a feedback to enhance audit quality in Nigeria. It will also broaden existent literature on audit quality in Nigeria and assist policy makers in formulating and administering pragmatic policies to address the issue of audit firm tenure for listed entities in Nigeria.

Section 2 of this study reviews previous empirical literatures on the effect of audit firm tenure on audit quality, section 3 deals with the methodology that was adopted for the study. Section 4 presents the data collected and analysis of results, and finally, section 5 carries the conclusion drawn and recommendations made by the researcher.

### 2.0 Review of Related Literature

De Angelo (1981) defined audit quality as the probability that an auditor will both discover and truthfully report material errors, misrepresentation and omissions detected in a client’s accounting system. This probability depends upon the broad concept of an auditor’s professional conduct, which includes factors such as objectivity, due professionalism and conflict of interest. Some studies (Francis 2004, and Geiger & Raghunandan, 2002) measure audit quality in terms of audit or reporting failure, based on the idea that audit quality is inversely related to audit or reporting failures. However, the non-quantitative nature of “audit quality” as a variable has necessitated the existence of a plethora of proxies and indicators for its measurement by researchers. Other studies (Nagy, 2005; Myers, Omer & Myers, 2003) used earnings quality as a surrogate for audit quality. The implicit assumption is that high audit quality implies high earnings quality (Johnson, Khurana & Reynolds, 2002). Researchers have also used estimated discretionary accruals as a proxy for audit quality. Dechow and Dichev 2002 assumed that higher estimated discretionary accruals reflect lower earnings quality and thus lower audit quality. Modrich, Jackson, and Roebuck (2008) note that true audit quality is when the audit does not result in a type 1 error: a failing company being given an unqualified report or a type 2 error: a non-failing company being given a qualified report. Mgbame, Eragbhe, and Osazuwa (2012) opines that all the divergences with regards to the appropriate measure of audit quality may be seen to reflect the need by researchers to monitor and provide indices amenable to control, so as to make inferences on audit quality. Healey and Kim (2003) attempted to identify possible control variables for the state of audit quality. In the light of these studies, audit firm tenure has become the focus of much debate.

There are two opposing views on the effects of audit firm tenure on audit quality. One states that as the auditor–client relationship lengthens, the auditor may develop a close relationship with the client and become more likely to act in favor of management, thus reducing audit quality. This view supports mandatory audit firm rotation. The other view is that as audit firm tenure lengthens, auditors increase their understanding of their clients’ business and develop their expertise during the audit, resulting in higher audit quality. The resulting dilemma is that a company is faced with the decision of whether to
replace its auditors after a period of time or to build and maintain a long-term relationship with the audit firm. The outcome is at polarity with conflicting findings. While some researchers have identified the need and have provided justification for auditor rotation (Healy and Kim, 2003; Ebimobowei and Oyadonghan 2011; Geiger and Raghunandan 2002) others have argued on the positive effects of longer tenure on audit quality (Ghosh and Moon, 2005; Defond and Francis, 2005). For example, in the United States, the Metcalf Committee report argued that long association between a corporation and an accounting firm may lead to such close identification of the accounting firm with the interests of its client’s management that truly independent action by the accounting firm becomes difficult. Therefore, the report suggested a mandatory auditor rotation as a way for the accounting profession to bolster their independence from clients.

**Empirical Review**

Vanstraelen (2000) examined the effect of long-term audit client relationship on audit quality. The external user’s perception of the audit report was used as the indicator for audit quality. Using the logistic regression model, the study findings show that long term auditor client relationships is positively related with the increased likelihood of the auditor issuing an unqualified opinion. The policy implications of Vanstraelen’s findings support mandatory auditor rotation to maintain the value of an audit for external users. Walker, Lewis, and Casterella, (2001) provide empirical evidence relating to the link between the length of the audit engagement and audit failures. A logit model was used to predict failures. The results suggest that risk increases early on in audit client relationship and then declines over long term periods. As the failure rate in long term engagements is low, the authors conclude that auditor rotation may not necessarily improve audit quality. Dopuch, King, and Schwartz (2001) also examined the impact of auditor tenure on audit quality. The result is consistent with the hypothesis that the auditor compromises his independence most often in a long term auditor contract and suggests that after all auditor tenure may have significant effect on the audit quality. Geiger and Raghunandan (2002) investigated the relationship between the length of the auditor-client relationship and audit reporting failures. The result indicates the existence of a positive and significant relationship between tenure variable and audit reporting failures. Hence, they agreed that auditor tenure affects audit quality. Johnson, Khurana, and Reynolds, (2002) opined that as the auditor-client relationship lengthens, there is the tendency that the auditor may develop a “learned confidence” in the client which may result in the auditor not performing rigorously, the required testing of financial reports. This learned confidence results in the auditor making assumptions about outcomes and using less rigorous audit procedures or static audit programs. Potentially, a loop hole for a decline in audit quality has been created. Myers, Myers and Omer, (2003) using proxy variables such as discretionary accruals and current accruals, investigated the relationship between audit tenure and audit quality. The univariate results show that when auditor tenure is longer, the negative value of accrual measures was observed to be minimal. Furthermore, the study also employed multivariate analysis in order to examine if the discovered relationship between tenure and accrual is also influenced by other factors. The relationship between auditor tenure and accrual measures was also observed to be consistent in multivariate analysis as in the univariate analysis. These results suggest that audit quality does not appear to deteriorate with tenure. Carcello and Nagy, (2004) also considered the relationship between audit quality and mandatory rotation of auditor’s tenure which is investigated from the point of view of fraudulent financial reporting. A logistic regression model was used and the results reveal a significant positive relationship between short auditor tenure and audit quality. Nashwa (2004) using a sample of U.S companies, carried out a study to examine the relationship between long term auditor-client relationship and the probability of audit failure. A logit regression model was used to predict failure using tenure as the independent variable. The results indicate that audit risk increases early in the auditor-client relationship and then declines over time suggesting that longer audit tenure overtime will smoothen out any initial challenges that may impair the quality of the
auditor’s performance. The results of the study do not support the hypothesis that short auditor tenure improves audit quality.

Knechel and Vanstraelen (2007) using a sample of stressed bankrupt companies, and stressed non-bankrupt companies in Belgium, provides evidence on the effect of auditor tenure on audit quality. The study measured audit quality as the likelihood of an auditor issuing a going concern opinion. The study findings reveal that auditors do not necessarily become less independent as the audit duration increases neither is their ability to predict bankruptcy is improved with longer duration. The study concludes that the evidence for tenure either in signaling increasing or decreasing effect on audit quality is unsubstantiated.

Barbadillo and Aguilar (2008), in a study of the relationship between the duration of audit engagement and audit quality, reveals an inverse relationship between audit firm tenure and audit quality and suggested that auditors tend to be more dependent in the first years of the audit engagement. They used a sample of non-financial Spanish companies quoted on the Madrid Stock Exchange. The study concludes that the shorter the auditor’s tenure, the more they behave in a dependent fashion. Ebimobowei and Oyadonghan, (2011) examined the role of mandatory auditor rotation on quality, costs and independence of an audit in South-South, Nigeria. The data for the study were collected through primary and secondary sources. The findings of the study show that there is statistical significant relationship between mandatory rotation of auditors and the quality of audit reports, independence of auditors and the cost of audit. The study concludes that a policy favoring mandatory rotation of auditors could have positive effects on the quality of audit reports as it would allow for a fresh approach and restore public confidence in the audit function. Though they also said that, the rotation may result to increase in the cost of audit services.

Mgbame, Eragbhe and Osazuwa (2012), examined the relationship between audit partner tenure and audit quality. They used Binary Logit Model estimation technique in analyzing the relationship between the tenure of an auditor and audit quality. Their findings reveal that there is a negative relationship between auditor tenure and audit quality, though the variable they used was not significant.

Adeniyi and Mieseigha (2013) studied the effect of audit tenure on audit quality of all listed companies in Nigeria. They used the binary logit estimation model to analyze the relationship between the dependent and independent variable. Their findings revealed that there is a negative relationship between auditor tenure and audit quality.

Johnson and Waidi (2013) investigated how mandatory audit firm rotation rule could affect audit quality in Nigerian Deposit Money Banks (DMBs). The data for this study were collected through primary and secondary sources. The Binary Logit Model estimation technique was used to analyze the relationship between the mandatory audit firm rotation and audit quality. The study’s results show that mandatory audit firm rotation rule does not affect the audit quality. They therefore recommended that rotation of external auditors should be made voluntary.

Finally, Ilaboya, and Ohiohka (2014) empirically examined the impact of audit firms’ characteristics on audit quality. They proxy the dependent variable (audit quality) using the usual dichotomous variable of 1 if big 4 audit firm and 0 if otherwise. Data for the study were sourced from the financial statements of 18 food and beverage companies listed on the Nigerian Stock Exchange market within the period studied (2007-2012). They adopted multivariate regression technique with emphasis on Logit and Probit method in analyzing their data for the study. Their study revealed that there is a positive relationship between firm size, board independence and audit quality whereas there is a negative relationship between auditor’s independence, audit firm size, audit tenure and audit quality. In light of the positions of the various studies reviewed, one can argue that the effect of audit firm tenure on audit quality is controversial, previous literatures have divergent conclusions on the matter. Also, this study to the best of the researcher’s knowledge could not access any documentary evidence from Nigeria in this subject area focusing on the listed deposit money banks which are the first listed entities that were imposed with a mandatory rotation of their auditors in Nigeria by the CBN code of corporate governance for Banks in 2006. Therefore, this study which was motivated by a lack of consensus in the literatures on the effect of audit firm tenure on audit quality will contribute to the
debate by examining the effect of audit firm tenure on audit quality of listed deposit money banks in Nigeria.

Theoretical Review

Lending Credibility Theory

The lending credibility theory states that audited financial statements are used by management to enhance the stakeholders’ faith in management’s stewardship so as to increase investment (Hayes, Dassen, Schilder & Wallage, 2005). This theory regards the primary function of auditing to be the addition of credibility to the financial statements. Audited financial statements are produced by management in order to increase shareholders faith in the functioning of the management and also to reduce the information asymmetry between them. Audited financial statements are seen to have elements that increase the financial statement user’s confidence in the figures presented by the management. The users are perceived to gain benefits from the increased credibility, these benefits are typically considered to be that the quality of investment decisions improve when they are based on reliable information.

The theory upon which this study rests is the Lending Credibility theory. The theory is suitable for the study given that it can explain a manager’s incentive to change to a higher quality audit firm. The company’s owners are always seeking the services of “better quality” auditors, so that the monitoring of management’s stewardship will be more effective. This theory influenced the formulation of the study hypothesis, informs the research methodology and statistical technique used in the study.

3.0 Methodology

This study adopts the descriptive research design method. Cross-sectional data from audited annual reports of listed deposit money banks for the year 2015 was used for this study. The population of the study consists of the fifteen (15) listed deposit money banks on the Nigeria Stock Exchange as at 31st December, 2015. Thirteen out of the fifteen listed deposit money banks in Nigeria as at 31st December, 2015 were studied. The other two (Skye Bank and Stanbic IBTC) which were not included in the sample is due to the unavailability of their audited financial statements for the year 2015. The effect of audit firm tenure on audit quality was analyzed using the binary logit model estimation technique. The choice of Maximum Likelihood (ML) binary logit regression model is based on the inability of the OLS multiple regression model to yield reliable coefficients and inference statistics in situations where the dependent variable is binary (0 and 1). Thus the binary logit regression model unlike others is based on the use of a dichotomous dependent variable.

The model adopted basically relates audit firm tenure with audit quality measured by the likelihood that a sampled bank employs the services of one of the big four audit firms in Nigeria, namely; Ernst & Young, Price Waterhouse Coopers, Akintola Williams Deloitte and KPMG. Krishnamurthy, Zhon and Zhon (2002) provided both empirical and theoretical justification for the use of the big audit firms as a proxy for audit quality. Consequently, a dummy value of 1 is used if a firm uses any of the big 4 audit firms, and 0 if otherwise.

In line with the empirical study by Many, Mock and Turner (2005), a number of control variables were included to boost the results of the study; Return on Assets, Board independence, Director Ownership and Board size.

The model that will be used in the analysis of the data is adopted from Adeniyi and Mieseigha, 2013. The following variables are considered relevant in the specification of the model examining the effect of audit firm tenure on audit quality.

AUDQUA = measured by the likelihood that a sampled Bank employs the services one of the big 4 audit firms. A dummy value of 1 is used if a firm uses any of the big 4 auditors and 0 if otherwise.

TENURE = Measured in terms of number of years spent as auditor for a sampled Bank. If greater than 5, we assign 1, if equal to or less than 5 we assign 0.

ROA = Return on Assets, calculated by dividing a bank's profit before income tax by its total assets.

BOARDI = Board Independence, measured as the proportion of independent
non-executive directors on the board to the total number of directors on the board.

\[
\text{BOS} = \text{Board Size, measured as the natural logarithm of the number of directors on the Board of a sampled Bank.}
\]

\[
\text{DOWN} = \text{Directors’ ownership, measured as the percentage of ownership by Directors in equity shares.}
\]

Consequently, the econometric model is specified below;

\[
\text{AUDQUA} = \beta_0 + \beta_1 \text{BOARDI} + \beta_2 \text{BOS} + \beta_3 \text{TENURE} + \beta_4 \text{DOWN} + \beta_5 \text{ROA} + \varepsilon
\]

\[
\beta_0 = \text{Constant}
\]

\[
\varepsilon = \text{Error term}
\]

4.0 Results and Discussion

Table 1

<table>
<thead>
<tr>
<th>Variables in the Equation</th>
<th>B</th>
<th>S.E.</th>
<th>Wald</th>
<th>df</th>
<th>Sig.</th>
<th>Exp(B)</th>
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<td></td>
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<td></td>
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<td>TENURE(1)</td>
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<td>35335.258</td>
<td>.000</td>
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<td>.999</td>
<td>.000</td>
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<td>ROA</td>
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<td>11312.353</td>
<td>.000</td>
<td>1</td>
<td>.007</td>
<td>641.000</td>
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<td>BOS</td>
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<td>.086</td>
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<td>BOARDI</td>
<td>-6.881</td>
<td>3123.249</td>
<td>.000</td>
<td>1</td>
<td>.998</td>
<td>.001</td>
</tr>
<tr>
<td>DOWN</td>
<td>11.389</td>
<td>226.710</td>
<td>.000</td>
<td>1</td>
<td>.039</td>
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<td>Constant</td>
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<td>1</td>
<td>.999</td>
<td>2091</td>
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</table>

\(^a\) Variable(s) entered on step 1: TENURE, ROA, BOS, BOARDI, DOWN.

Source: SPSS 23 Output, 2017

Analysis of Results

The result above shows no significant effect between the main explanatory variable in the model (Audit firm tenure) and the dependent variable Audit quality. The overall fitness of the model is tested using the Hosmer and Lemeshow test for model goodness-of-fit. The non-significant value of 0.940 which is 94% (Appendix) for Hosmer and Lemeshow test implies that the estimated model is fit for the data. The overall explanatory power of the model is revealed in the Nagelkerke R\(^2\) square which shows a value of 0.890 (Appendix), this means that the model fits the data. Furthermore, the \(\beta\) coefficient of -27.897 and the significant value of 0.999 which is far above the p-value threshold of 0.05 for significance, shows that an inverse relationship exists between Audit firm tenure and Audit quality but the relationship is not significant. This result means that Audit firm tenure whether long or short does not affect the Audit quality of listed deposit money banks in Nigeria. This result is consistent with the findings of Johnson and Waidi, 2013; Mgbame, Eragbe, and Osazuwa, 2012; and Knechel and Vanstraelen, (2007). These studies also found that auditor tenure does not affect audit quality. Other variables examined alongside audit firm tenure in the model such as board independence was found to be negatively related with audit quality. Board size was seen to have a non-significant positive effect as can be seen in the significant value of 0.586.

Directors’ ownership and Return on assets were the only variables observed to have an effect on audit quality. This is seen from their significance values of 0.007 and 0.039 which are below 0.05. P-value of \(\leq 0.05\) means that the both variables have significant effects on audit quality, and these effects are positive as can be seen from their \(\beta\) coefficients of 41.027 and 11.389.

Based on the above result, we accept the null hypothesis (Ho) formulated for the study, which states that Audit firm tenure does not have a significant effect on Audit quality of listed deposit money banks in Nigeria. This implies that longer or shorter audit firm tenure may not signal an increase or decrease in audit quality. The Sarbanes-Oxley Act of 2002 consolidates this view as it requires rotation of the lead audit partners every five years, rather than the audit firm. The result of this study is in line with the lending credibility theory which states that a manager would want to improve the audit quality of
the firm by maintaining a particular audit firm over a long period so as to gain the confidence of the investors. Moreover, for familiarity threat which is always an issue in longer audit tenure, it is the individuals that get familiar with themselves, not the firm and the client company. This is why in most developed countries like the US, UK, Canada, and Australia it is mandatory audit partner rotation that is imposed on listed public companies rather than mandatory rotation of audit firms.

**Discussion of Findings**

The Sarbanes-Oxley Act of 2002 prescribes a change of audit partners every five years. The Central Bank of Nigeria mandated Deposit Money Banks to rotate their statutory auditors after ten (10) years of service. The argument basically is that longer auditor-tenure tends to result in an opportunity cost of auditor independence.

Walker, Lewis and Casterella, (2001), and Knechel and Vanstraelen (2007) have argued that auditor rotation may not necessarily improve audit quality and the effect of tenure does not have either an increasing or decreasing effect on audit quality and at best the effect is weak. The finding of this study is at variance with the conclusions made by Geiger and Raghunandan (2002); Johnson, Khurana and Reynolds (2002) and Myers, Myers and Omer (2003) that auditor tenure is associated with lower quality audits. For the other variables examined alongside audit firm tenure such as board size, board independence and directors’ ownership which are all mechanisms of corporate governance were found to be inversely related with audit quality, except for directors’ ownership which showed a positive significant relationship.

**5.0 Conclusion and Recommendations**

The objective of this work was to examine the effect of audit firm tenure on the audit quality of listed deposit money banks in Nigeria, measured by the likelihood that a sampled Bank employs the services of one of the big four audit firms. The study attempts to provide empirical evidence in the Nigerian context. The findings from the study reveal that audit firm tenure does not affect audit quality of listed deposit money banks in Nigeria. The other explanatory variables in the model; Board independence and Board size were also found not to have any significant effect on audit quality of listed deposit money banks, but Return on assets and directors ownership showed a positive significant effect on the dependent variable which is Audit quality.

Thus the debate about audit firm tenure may be seen as still ongoing as reflected in the plethora of divergent research findings in this regard. A limitation of the result of this study may stem from the possible detection of an appropriate time period to indicate long or short tenure. Thus, studies like (Adeniyi & Mieseigha, 2013; Ilaboya & Ohiokha, 2014) have utilized different time frames ranging from 3 years, 4 years, or like the Sarbanes Oxley Act in the United States which stipulates five years as an average long tenure period. This study used 5 years as the maximum short tenure period, and these may have effects on empirical findings. However, the desire for quality audits that minimizes the expectation gap between suppliers of audit and users of audit services is globally recognized, and as such x-raying the effect of audit firm tenure on audit quality will require more ex-post evidence across different contexts and sectors.

The recommendations of this study are that there is the need for the Central Bank of Nigeria and other regulatory bodies in line with best practices to look into the issue of audit firm tenure in Nigeria and review the policies on audit firm tenure. Also the names of the senior audit partners of an audit engagement should be disclosed by companies in their financial statements so as to enable future researchers to be able to control for audit partner rotation when assessing whether mandatory audit firm rotation has an incremental effect on audit quality. This would be useful from the perspective of policy making.
References


APPENDIX A

<table>
<thead>
<tr>
<th>S/N</th>
<th>Banks</th>
<th>Their Auditors</th>
<th>Audit Quality</th>
<th>Firm Tenure</th>
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<tr>
<td>1</td>
<td>ACCESS BANK</td>
<td>Price Waterhouse Coopers</td>
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<tr>
<td>2</td>
<td>DIAMOND BANK</td>
<td>KPMG Professional Services</td>
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<td>FIRST BANK</td>
<td>Price Waterhouse Coopers</td>
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<td>5</td>
<td>FCMB</td>
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<td>1</td>
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<td>FIDELITY BANK</td>
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- Stanbic IBTC and Skye Bank were not included in the study sample.

**Binary Logistic Regression Results:**

**Model Summary**

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**Hosmer and Lemeshow Test**

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