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The Effect of Audit Quality on Accruals Earnings Management in Nigerian Listed Firms

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Abstract*: *Earnings manipulation studies are of utmost importance to both the shareholders and stakeholders because of its effect in investment and management decisions. The practices are directly affecting the quality of financial reporting and increase information asymmetry between the management and shareholders. Thus, Audit Quality is one of the tool academicians use in measuring the level of earning practices in the organizations. However, this study investigated the possible effect of audit quality towards the change of earnings management level among the Nigerian listed firms. The study used all the public listed firms in the main flow of the Nigerian Stock Exchange (NSE) as a population from the year 2012 until 2017. Sixty-three selected companies were selected as a sample based on the filtration criteria of the study. The financial data was obtained from the Thompson Reuters DataStream, and the corporate governance data was from the annual reports and accounts of the companies. Audit quality and accrual model was used to test the relationship between the study variable. The study applied multiple regression to test the model. It was revealed from the regression that audit quality is negatively significant with accrual earnings management. This finding is indicating that any increases in the unit of audit fees will decrease the earnings management of the selected firms. Thus, the finding is supporting agency theory and is contrary to the assumption of creative accounting theory. The result of this study will assist the relevant authorities in decision making and policy setting towards the best practices of the Nigerian listed firms.

Keywords: Audit Quality; Accruals Earnings Management; Nigerian Listed Firms.

I. INTRODUCTION

There are numerous ways and wherefores that lead to the preparation of misleading financial statements which include the need for higher returns by shareholders on their investments. Seeking to have or maintain corporate goodwill in the eye of the business community or to win the power of competitiveness, the craze to satisfy the greed of company's insiders (1) The Nigerian corporations are extremely engaged in this menace which led to the collapse of many institutions in Nigeria. They include Savannah Bank Plc., Society General Bank Ltd, Alpha Merchant Bank Ltd Afri Bank, Oceanic Bank, Bank PHB, and Intercontinental Bank (2). A case in point includes the poor appointment of the board members which caused some auditors engagement in unethical governance and professional malpractices (3,4).

Sound as well as effective corporate governance can fortify strong audit quality to control the activities of the managers in Nigerian corporations, and also will minimise the level of earning management activities (5). Audit quality and earning management in emerging economies has presently received much attention from many scholars. See for example, (6-11).

This study is aimed at investigating the effect of audit quality on earning management in the Nigerian listed companies. Audit fees have motivated the study as a proxy of the audit quality due to the number of increased in the price of audit in Nigerian particularly by the top audit firms now a day.

The paper is organised as follows. The first section started with an introduction. The second section reviewed the literature on the relationships between the study variables. The third section explained the methodology of the study and the process of sampling and data collection. Section four is the result discussion and section five end up with conclusion of the study.

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II. LITERATURE REVIEW

Earnings management involves management use of accounting discretion in reporting of accounting numbers that undermine the reliability and integrity of the company (12,13). It involves the selection of accounting choice and real action that sooth likely objective managers are aiming at in the course of reporting financial information. (14) defined audit quality as the “market-assessed joint probability that a given auditor will both detect a breach in the client’s accounting system, and report the breach”. Thus, better auditing is recognized for its independent assurance of the trustworthiness of the financial statements, which enhances investors’ protection and improves their confidence. Audit quality reduces the earnings manipulations process and improving the credibility of the financial reports (9,11). (9) argued that audit quality is a continuous construct of earnings quality.

They also contended that earnings quality is a function of adequate audit quality. It implies that audit quality and earnings quality are jointly determinable outcomes.

Therefore, several proxies have been employed by various researchers as measures of audit quality, though this current study has used audit fees as proxies for audit quality because it is the only construct that appears in all of the classifications. It has a relatively higher construct validity (9). This act has considerably received regulatory and academic attention in recent years.

See the following studies for instance, from the emerging markets, (6) conducted a study on audit quality and earnings management in Indonesia. The study established that audit quality is inversely related to earnings management. The result from the random model reveals that the audit fee has a significant negative influence on earnings management. Similarly, (15) examined non-audit services, audit firm tenure, and earnings management by utilizing a sample of 525 public firms in Malaysia in 2009. The study shows that the audit fee has an insignificant negative association between the total and current discretionary accruals. Similarly, a study done by (16,17) was also indicate the significant influence of the audit quality to the corporate tax planning level which might reflect to the positive earnings management activities in the business organization.

In Nigeria, (18) studied the impact of audit quality and earnings management. They employed a sample of ten banks from 2006 to 2013. The result from the OLS reveals a significant positive impact between audit fees and abnormal loan loss provisions. That indicates that auditors' financial dependence increases the rate of earnings management in Nigerian banks. It was also observed by (19) who examined the effect of audit quality and earnings management in Nigeria. They utilized a sample of 18 banks from 2005 to 2010. The study showed that audit quality is negatively associated with earnings management. That has been affirmed by (20) who examined the determinants of audit quality amongst the listed banks in Nigeria. They took a sample of 11 banks from 2010 to 2015. The findings reveal that audit fees and audit firm size have a significant positive influence over audit quality. (21) adopted 57 and 89 listed non-financial companies in Nigeria, and the study found a significant positive relationship between the independent and dependent variables respectively. It can be observed that the inconsistency of the findings between the above studies may be due to the different sample sizes used by the authors or differences in the unit of analysis. That is because (22) used only 11 banks, which may be considered too small for the generalization of the findings. While, (21) adopted 57 and 89 listed non-financial companies, respectively. However, it can be argued that banks are offshoots of the financial sector which have characteristics and regulations different from other sectors of the economy. Therefore, from the studies and theories above the following hypothesis is proposed:

H: There is a significant positive relationship between audit quality and earnings management for the listed firms in Nigeria.

III. METHODOLOGY

This study has been designing based on explanatory research to test the relationship between the study variables. The audit quality data was collected using published annual reports and accounts of the companies, while the financial data was collected from the Thompson Reuters DataStream. However, the population of the study is all the Nigerian public listed companies on the main flow for the Nigerian Stock Exchange (NSE) from the year 2012 to 2017 respectively. As at 31 Dumber 2017 there 169 listed companies on the flow. Thus, the study excluded 56 companies from the financial sector among the selected sample. That is as a result of the nature of their regulations and laws governing the sector. The remaining 113 companies were also reduced to 92 as NSE delisted 21 companies in the year. However, 29 firms have not been able to provide adequate data requested as per the period of this study. Lastly, a total of 63 companies was used as the final sample which make 378 firm-year observations in the study.

A. Model Specification and Variable Measurement

The independent variable of audit quality was measured by the Audit fees using the Natural logarithm of audit fees for the year as measured by (23,24). However, the performance matched model proposed by (25) was used as a proxy for accrual earnings management which is the defendant variable following the studies of (26). From the model, the absolute discretionary accruals were being represented by the error terms. The estimated residual values found from the regression analyses for the model was used as the substitute for the accrual earnings management amongst the sampled firms. The model is given as follows.

AEM= [(TACCit = a0 + a1(1/TAit-1) + a2(ΔSales/TAit-1) + a3(PPEit/TAit-1) + a4ROAit (or it-1) + εit)]….Equation (1)

Whereby: AEM = Accrual earnings management, TACC = Total accruals measured as Net Income-Cash flow from the operation, TAi, t-1 = Lag of total assets of a firm, ΔSALES = Changes in sales from current year to last year, PPE = Gross property plant and equipment at the end of the year, and ROA = Return on asset. Using the estimated residuals from the above model, the discretionary accruals were used to test the main regression analysis of the study as highlighted in the following model. It explained the relationship between the dependant and the independent variables employed by the study.

AEMit = β0 + β1AUQit + β2LEVit + β5FGROWit + β6ROAit +εi……………………...……………..Equation (2)

Whereby: AEM = accruals earnings management, AUQ = audit quality measured as natural logarithm of audit fees, LEV = leverage, FGROW = firm's growth, ROA = return on assets.

IV. RESULT AND DISCUSSION

A. Descriptive Statistics

Form Table 1, the study provides descriptive statistics of the related variables. However, the Table discloses an average mean value of accruals earnings management at a tendency of 0.823 with the minimum value of (0.000) and maximum of (10.646) respectively. Also, it revealed that AFEE has an average value of 16.503million Naira (equivalent to 47,229 USD).

Therefore, from this arithmetic table, it stipulated that the minimum amount of the audit fee is 13.710 million Naira as (equivalent to 39,171 USD) and maximum of 19.536 million Naira (equivalent to 55,817 USD) as audit services for the listed firms in Nigeria. The average value of LEV is 37%, and it has marks a minimum and highest ratio of 7% and 45% respectively. FGROW disclose a mean value of 0.711 and a minimum and maximum of -1.000 and 35.211 respectively. Thus, finally, the table discloses that average of the listed firms in Nigeria has ROA return on asset 0.018 and a minimum and maximum of -1.196 and 0.641 respectively.

Table 1: Descriptive Statistics

Variable	Median	Mean	Min	Max	Sd
AEM	0.397	0.823	0.000	10.646	1.354
AFEE	16.598	16.503	13.710	19.536	1.013
LEV	0.343	0.373	0.007	0.450	0.226
FGROW	0.057	0.711	-1.000	35.211	3.751
ROA	0.041	0.018	-1.196	0.641	0.183

Note: AEM= accruals earnings management, AFEE = audit fees, LEV = leverage, FGROW = firm's growth, ROA = return on assets.

B. Correlation Matrix

Correlation analysis is suitable in labelling the strength and direction of the linear relationship between two variables. In this study, the Pearson Correlation analysis was used to assess and clarify the strengths of the relationship among the study variables as provided in Table 2. From the table, it shows that AFEE has a significant negative correlation with the accruals earnings management at 10% significant level. Therefore, this indicates the primary evidence about the direction of their relationship in the model. It also revealed that FGROW and ROA has a significant negative correlation with accrual earnings management also at 10% level of significance each. Nevertheless, LEV is also positively and significantly correlated with accrual earnings management at 5% level of significance.

Table.2 Correlation Matrix

Variabl e	AEM	AFE E	LEV	FGROW	ROA
AEM	1.000				
AFEE	-0.159 ***	1.000			
LEV	0.136**	-0.026	1.000		
FGROW	0.453***	0.090	0.088	1.000	
ROA	-0.298***	-0.077	-0.115* *	-0.036	1.00 0

Note: AEM= accruals earnings management, AFEE = audit fees, LEV = leverage, FGROW = firm's growth, ROA = return on assets, * p<0.01, ** p<0.05, *** p<0.010.

C. Regression Result

This research employed the use of R^2 (R Square) coefficient as an indicator for providing the hypothesis model using linear regression analysis. The R^2 also highlighted how the DV is different; the DV describes it as accrual earnings management which has been measured by the discretionary accruals. That shows the level of IV influence over the DV as 31% approximately from table 3. However, the table presented the regression result of the relationship between the IV audit quality proxies by audit fees and DV accruals earnings management. The beta coefficient of -0.188 and P value of 0.019 was recorded. It highlighted a significant negative relationship between audit quality and earnings management. Nevertheless, the negative significance value is indicating the effect of a unit increase in audit fees will reduce the level of earnings manipulations in the Nigerian listed firms.

Table 3: Relationship between Audit Quality and Accruals Earnings Management

AEM	Coef.	Robust Std. Err.	t-val	p-val
AFEE	-0.188	0.078	-2.410**	0.019
LEV	0.369	0.461	0.800	0.427
FGROW	0.153	0.028	5.530***	0.000
ROA	-2.122	0.678	-3.130***	0.003
Cons	3.719	1.296	2.870***	0.006
R2		0.309		
F-Stat		20.130		
P.Value		0.000		
Link Test(Hatsq)		0.752		
Hettest (Chi2)		46.970		
P.value		0.000		
HM Test (Chi2)		2.100		
P.value		0.734		

Note: AEM= accruals earnings management, AFEE = audit fees, LEV = leverage, FGROW = firm's growth, ROA = return on assets, * p<0.01, ** p<0.05, *** p<0.001. = significant at 1%, 5% and 10% respectively.

V. CONCLUSION

Accruals admit firms to account for the expected revenues and expenses when they are earned, or they are incurred, respectively. Hence, financial statements are mostly prepared under accrual bases. Accruals reflect expected future cash flows and outflows. It is the reason behind the use of accrual model as a yardstick for earnings manipulation in this study to prove whether the use of accrual items help corporate managers in manipulating the financial information of the firms in Nigeria for their best interest. However, the audit fee is also one of the prominent measures of the audit quality of the firms. Hence, using the highlighted variables above, this study tested the relationship between audit quality and earnings management in Nigerian listed firms. The result from the selected sample of 36 companies documented a significant negative relationship which indicated that the more audit fees increase, the lower the earnings manipulation activities in the companies. Thus, the finding is in line with agency and against the creative accounting theories. The finding will alert the relevant authorities such as policymakers, regulators and potential investors on the current situation of the audit fees effect on the earnings manipulations in Nigerian listed companies. Therefore, this study is recommending for further research on this area to employ more measures of audit quality and also to apply the use of other earnings management indicators in order to have the robustness of the study.

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