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AUDIT QUALITY AND ITS EFFECT ON EARNINGS MANAGEMENT OF LISTED CONSUMER GOODS FIRMS IN NIGERIA

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Abstract

The main objective of this study is to examine how audit quality is related to the earnings management of listed consumer goods firms in Nigeria. Expo facto research design was used and a sample of nine (9) consumer goods firms from a population of twenty-one (21). OLS regression was employed for data analysis. The result reveals that there is a significant negative relationship between audit firm size and earnings management suggesting that big 4 auditors do constrain earnings management of the sampled firms, while a significant positive relationship was observed between audit fees and earnings management implying that audit fees do not constrain earnings management. However, the study therefore recommends that regulators and policy makers should encourage the deployment of Big Four audit companies in auditing annual reports and accounts of listed firms to constrain earnings management.

Keywords: Audit Quality, Audit Fee, Audit Firm Size, Earnings Management and Discretionary Accruals

Introduction

To enable interested parties, including creditors, analysts, the government, and the general public, to evaluate the performance and financial situation of the reporting entity, a company's management is tasked with stewardship and is expected to prepare and present annual financial reports to their principals and shareholders, who are the firm's owners (Nyikyaa, et al 2019; Orbunde, et al, 2022). In the meantime, it is debatable whether managers must disclose information about the company's operations sufficiently. Agency theory contends that managers, being fallible human beings, frequently act in ways that gratify their desires, which influences the kind and extent of information they choose to reveal to their principals and other stakeholders to enhance their pay (Nyikyaa et al, 2019).

By focusing on their pay, managers take an opportunistic approach to managing earnings, leading to erroneous accounting profits that do not accurately reflect or portray the actual and fair picture of the reporting entity's financial performance. Investor confidence in financial reporting is diminished by this frequent occurrence, which impacts companies and other industries (Alu et al., 2022; Utami 2017). Over the decades, there have been numerous accounting scandals, primarily as a result of managers' handling of annual financial reports. These managers could deceive stakeholders by using a range of accounting alternatives in financial statement planning (Kurawa & Ahmed 2020). Concerns have been raised regarding the effectiveness of auditors' oversight and management of managerial opportunistic behaviour due to the auditing mechanism's duty to guarantee that reported profits are consistent (Alu et al., 2022).

It's interesting to note that, despite the effectiveness of audits in guaranteeing a reliable financial report, corporate fraud continues to be a major source of controversy, lowering profits control by businesses globally, particularly in Nigeria (Enofe 2010). As a result of recent corporate fraud, investors have doubts regarding the audit feature's dependability, value, integrity, utility, and authenticity (Rusmin 2017). To maintain the trust of investors, the calibre of audits and audit opinions published on financial reports are essential (Alu et al, 2022). Improved quality of recorded revenues may result from or be a contributing factor to increased audit efficiency (Clement & Adzor 2017). When it comes to audit quality, high-quality auditors seem to be able to spot questionable accounting practices and either refuse to submit them or make changes to the audit report after they are discovered (Umar et al., 2019). As a result, companies with lower-quality auditors engage in earnings management to a greater extent than companies with higher-quality auditors (Oladejo 2020).

Nonetheless, research suggests that one of the most successful defences against managerial opportunism is audit quality. The capacity to identify a designated auditor and document a GAAP violation in the company's accounting framework is directly related to the accuracy of the audit (Hassan, et al, 2020). Furthermore, inconsistent and occasionally contradictory empirical evidence has been provided by earlier studies in this field from both developed and developing economies. While some of the studies documented a significant negative relationship, others suggested a significant positive relationship or no relationship between audit quality indicators, such as the size of the audit firm and the companies' earnings management (Hassan et al, 2020; Alu et al, 2020; Egwu, 2020; Nyikyaa, 2019; Inua & Okoh, 2018; Nwoye, 2021; Isaac, 2022; Thomas, 2022). Because audit quality is crucial as a technique for monitoring managers' opportunism, it is therefore the subject of this research. Thus, the current study sheds light on audit quality and its impact on earnings management.

Literature Review

This section centres on related literature on Earnings Management, Audit Quality and its measures (Audit firm size and Audit fees). The section also provided an underpinning theory.

Concept of Earnings Management

According to Healy and Wahlen (1999), earnings management is the process by which managers manipulate financial reports by using their judgement in transaction structuring and financial reporting to either mislead certain shareholders about the company's underlying economic performance or to influence contractual outcomes that depend on reported accounting numbers. Aziatul et al. (2015) defined earnings management as the use of discretion by managers in the preparation and reporting of accounting information to external users. Roychowdhury (2006) defined it as a departure from normal operational practices, motivated by managers' desire to mislead some stakeholders into believing that, certain financial reporting goals, have been met in the normal course of operations.

Concept of Audit Quality

Investor protection was the main goal of the numerous modifications made to accounting, financial reporting, and auditing (Ogbodo & Akabuogu, 2018). This is accomplished by putting an accountability requirement on a company's managers. More specifically, auditing's function is to lessen the information asymmetry around accounting figures and to lessen the residual loss brought on by managers' financial reporting opportunism (Ogbodo & Akabuogu, 2018). According to DeAngelo (1981), audit quality is the jointly estimated market chance that a particular auditor will find and disclose a breach in the client's accounting system. Furthermore, audit quality is extracted from the principal component analysis techniques and outcomes indicate three major factors such as education, experience and training (Setyaningrum, et al 2013). The greater the auditor monitoring strength, the more closely the financial report will reflect the true economic circumstances of the client and the higher the information quality

Audit Fees

Audit fees are all the costs that businesses pay to external auditors for audit services as well as non-audit services like management advisory and consulting (Al-Khaddash, et al 2013). The expenses paid for yearly audits and reviews of financial statements for the most recent fiscal year are known as audit fees (Securities and Exchange Commission). Oladejo (2020) reports that scholars have postulated that large auditors command a higher fee because their larger resources lessen their clients' vulnerability to lawsuits (profound pocket theory); on the other hand, some have contended that there isn't a difference in audit performance, but rather that large corporations have gained a reputation and appreciation for their quality. In Nigerian corporate organisations, the payment of auditors is a significant issue (Paradisa & Yustrida 2020).

Audit Firm Size

Small businesses and regulators argued that audit standards should not be set solely based on the size of major public accounting firms (Abu, et al 2020). DeAngelo (1981) disputed this accusation against small organisations, asserting that the work of major audit firms was more adaptable and productive. Furthermore, Francis and Yu (2009) discovered that major irregularities in financial accounts are more likely to be uncovered by large accounting firms. When large audit companies are well-known, have inadequate audit standards, and their decision-making is not independent, they run the danger of losing clients. These problems provide a compelling reason to enhance audit performance. Researchers found that an auditor's performance is correlated with the size of the organisation (Thomas 2022). Oladejo (2020) asserts that audit partners need to be aware of the reputation of audit firms. In the international context, researchers compared auditors' judgments of CPA international firms as big firms versus auditors' judgments of local and regional firms as small and medium firms (Utami 2017).

Empirical Review

Isaac (2022) looks into the connection between French-listed businesses' financial reporting quality and audit quality. Real and accruals earnings management estimation is utilised to determine earnings management, and the auditor brand name (Big4) is employed as a stand-in for audit quality. Real earnings management is estimated using methods put out by Roychowdhury (2006), whereas discretionary accruals are estimated using the Jones Model and the Modified Jones Model. The results indicate that clients of Big4 audit firms record higher levels of accruals and real earnings management.

In their 2022 study, Alu et al. investigated the impact of audit quality on earnings management in Nigerian listed companies. Specifically, they looked at the effects of audit quality on discretionary accruals, earnings smoothing, and earnings per share. An ex-post facto research design is used in this study. It takes information from ten companies' annual reports. These comprised ten years (2010-2019) of purposeful selection of five financial and five non-financial companies. Descriptive and inferential analyses were employed in data analyses. The findings indicate that audit quality significantly affected earnings smoothing. Moreover, audit quality did not significantly affect discretionary accruals and earnings per share.

In his study, Thomas (2022) looked at the relationship between audit quality; one of the key components of sound corporate governance and earnings management in Nigerian listed consumer goods companies. The study specifically examined audit firm size, audit fees, auditor tenure, industry specialisation of the auditors, and gender diversity of the audit engagement partners as independent factors, and earnings management as the dependent variable, represented by discretionary accruals. It uses a descriptive correlational research design. All 21 consumer goods companies were included in the population; 17 of them were purposefully selected to facilitate data gathering. The research employed secondary data that was taken from the companies' annual reports for the study period, which was 2011–2020. With the assistance of STATA version 16, the study used the multiple regression analysis technique to analyse the data. From the regression results, it was revealed that audit fees, audit firm size and auditor industry specialization have a statistically positive significant effect on earnings management while auditor tenure and audit engagement partner gender diversity were found to have no significant influence on earnings management of listed consumer goods companies in Nigeria.

Nwoye (2021) examined the effect of audit quality on earnings management in insurance companies in Nigeria with special consideration on accruals and performance measures of earning manipulations using insurance companies in Nigeria. Preliminary analyses were conducted, such as descriptive statistics and correlation matrix. In analyzing the data, the study adopted panel multiple regression to identify the possible effects of audit quality on earnings management of financial institutions in Nigeria We interpreted fixed effect analysis after using the Hausman test. The result shows that audit quality had a significant effect on earnings management

Mehdi, et al (2021) investigate whether unethical earnings management behaviour is restrained in a French-mandated joint audit context by gender-diverse engagement partners. The research employed the multiple regression analysis technique to evaluate the data, and the empirical findings indicate a negative correlation between gender-diverse audit partners and client organisations' discretionary accruals. It has also been discovered that gender-diverse audit partners limit earnings management, regardless of whether clients use one or two reputable audit companies. Lastly, the study discovers that when client firms move from having all-male audit partners to having audit partners of varying genders, the prevalence of earnings management decreases.

Table 1: Summary of Empirical Review

Author	Country-Scope	Dependent	Independent	Result
Orbunde et al, (2022)	Nigeria (2011-2020)	Discretionary accruals	-Audit firm size -Auditor Industry Specialisation -Auditor Tenure -Audit Committee Expertise	-Positive Significant -Positive Significant -Negative Significant -Positive Significant
Nyikyaa, et al (2019)	Nigeria (2005-2016)	Discretionary accruals	Audit size	Positive insignificant
Alu et al(2022)	Nigeria (2010-2019)	Discretionary accruals -Earnings Smoothing -Earnings per share	-Audit Tenure -Audit Size -Audit Fee	Positive insignificant Negative insignificant Positive significant
Thomas (2022)	Nigeria (2011-2020)	Discretionary accruals	-Audit Size -Audit Fee -Auditor Tenure - Auditor Industry Specialization - Audit engagement Partner Gender Diversity	Positive-significant Positive significant Negative insignificant Positive significant Negative insignificant
Hassan et al (2020)	Nigeria (2012-2019)	Discretionary accruals	-Audit firm size - Auditor industry specialization - Auditor tenure	Positive insignificant Positive significant Negative significant
Nwoye (2021)	Nigeria (2012-2017)	Discretionary accruals	-Audit Tenure -Audit firm size -Audit committee independence -Audit committee fin. Expertise -Audit fees	Negative significant Negative significant Positive significant Positive significant Positive significant
Isaac (2022)	France (2009-2016)	Discretionary accruals	-Big 4 audit firm	Positive Significant
Livinus (2022)	Nigeria (2012-2018)	Discretionary accruals	-Audit Tenure -Joint Audit	Positive Insignificant Positive Significant
Mehdi, Fahim and Haithem (2021)	France	Discretionary accruals	- gender-diverse engagement RM size	Negative Significant

Theoretical Framework

Agency Theory

Jensen and Meckling established the theory of agency (1976). The relationship between the principal, or owners, and the agent, or managers, is the foundation of the agency theory. The stakeholder theory is highly criticised due to its difficulty in treating all stakeholders equally and meeting their conflicting demands, even though it has greater theoretical and practical appeal than agency theory and stewardship theory. Therefore, the relationship between audit quality and earnings management strategies cannot be sufficiently explained by the hypothesis. The link between the principal, or shareholder, and the agent, or management, is the foundation of the agency theory. The premise for the operation of agency theory is the division of ownership from management and control in contemporary corporate enterprises. This division offers the chance to designate an agent (manager) to oversee day-to-day business operations. However, this relationship raises the possibility of conflicts of interest between the principal and the agent, necessitating monitoring the expenses related to resolving these conflicts (Jensen & Meckling, 1976).

According to agency theory, managers operate to further their interests rather than the interests of the shareholders since they are driven by personal gain. Since the owners (shareholders) bear the expense of these items rather than the managers, they may be inclined to purchase opulent offices, company automobiles, and other ostentatious items. How to reconcile the managers' competing interests with the interests of shareholders is the fundamental challenge facing agency theory. Managers therefore alter the company's reported results when they have incentives to control earnings, such as to reach or exceed earnings targets and performance-based compensation. The relevance and dependability of reported accounting earnings and financial statements, in general, are diminished by this manipulation. To lessen these conflicts and match managers' interests with those of shareholders, agency theory recommends monitoring tools like high-quality audits (Orbunde, et al 2022). Based on the aforementioned, agency theory provides a clearer and more effective explanation for unethical accounting methods and financial concerns like earnings management (EM). Thus, to examine the connection between audit quality and the prevalence of earnings management in Nigeria, this study makes use of agency theory. The reason agency theory was selected above other theories is that it provides a clearer explanation of the reasons for earnings management as well as the connection between audit quality as a monitoring tool and earnings management

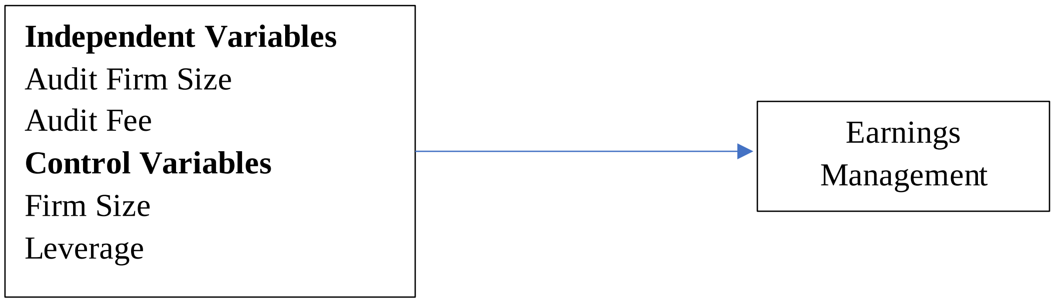

Figure 1: Research Framework

Ho1: Audit firm size has a significant negative relationship with earnings management of listed consumer goods firms in Nigeria

Ho2: Audit fees have a significant negative relationship with earnings management of listed consumer goods firms in Nigeria

Methodology

The expo facto research design was adopted for this study based on a positivist approach. The population of the study is all twenty-one (21) consumer goods firms listed on the Nigerian Exchange Group as of December 2022. The period covered by the study is ten (10) years from 2012-2021. The sample size of the study comprises nine (9) quoted consumer goods firms in Nigeria. The data for this study were obtained from secondary sources. Secondary data were extracted from the published annual reports and accounts of the companies for the relevant years. Descriptive statistics was used to compute summary statistics for both the dependent and independent variables of the study. The study also used panel OLS regression analysis to show the nature, direction and extent of the relationship between and among the dependent and independent variables. The model in this study was adopted and modified from the studies of Orbunde et al (2022) and Alu et el (2022). The model is expressed as follows:

$DAC_{it} = \beta_0 + \beta_1 Afs_{it} + \beta_2 Auf_{it} + \beta_3 Fiz_{it} + \beta_4 Lev_{it} + \varepsilon it$ - - - - (i)

Where: DAC = Discretionary accruals (modified Jones Model)

Afs = Audit firm size

Auf = Audit Fee

Fiz = Firm size

Lev = Leverage

β_0 = constant of the model

$\beta_1 - \beta_4$ = coefficients of the study model

ε = error term

Result and Discussion

Descriptive Statistics

The descriptive statistics of the dependent, independent and control variables from the sampled consumer goods firms are presented in Table 1 where the mean, standard deviation, minimum and maximum values of the data for the variables used in the study are described.

Table 2: Descriptive Statistics

Variable	Obs	Mean	Std. Dev	Min	Max
Dac	90	0.1099	0.0119	0.0899	0.1344
Afs	90	0.8888	0.3160	0	1
Auf	90	5.5921	0.4791	4.4963	6.5549
Fiz	90	8.0073	0.3938	7.03	8.68
Lev	90	57.752	12.3692	4.28	88.1

Source: STATA, 2024

Table 1 above shows the summary statistics of the dependent, independent and control variables to effectively appreciate the nature of the results. It provides a basic intuition into the nature of the data upon which analysis is done. The summary statistics include the mean, standard deviation, minimum and maximum of both the dependent variable and explanatory and control variables. From Table 1, discretionary accruals show a mean of 0.1099, and a standard deviation of 0.0899 which is an indication that the firms may not differ on the extent of their earnings management. The mean of audit firm size proxy by Big 4 is 0.8888 signifying about 88.8% of the sampled firms are audited by Big 4 (KPMG, PWC, Ernst and Young, Akintola Williams Deloitte). Audit fees have a mean value of 5.5921 and a standard deviation of 0.4791 with a minimum and maximum of 7.03 and 8.68.

Summary of Regression

Table 3: Regression Result

Variables	Coeff	T	Sig	VIF
Constant	0.0043	0.15	0.881	
Afs	-0.0089	-2.66	0.009	1.06
Auf	0.0107	4.70	0.000	1.14
Fiz	0.0092	3.27	0.002	1.18

Lev	-0.0003	-4.20	0.000	1.10
R^2	0.3632			
Adj. R^2	0.3332			
F-statistics	12.12			
Prob	0.0000			

Source: STATA output, 2024

Table 2 above revealed that the pooled- OLS regression has an R^2 of 0.3632 which implies that 36.32% of variation in discretionary accruals of the firms is jointly explained by the independent variables. Under the OLS regression result, audit firm size had a significant negative relationship with discretionary accruals of sampled companies at 1%. Audit fees had a significant positive relationship with discretionary accruals of the sampled firms at 1%. More so, the control variables reveal a significant positive relationship between firm size and discretionary accruals while a significant negative relationship can be seen between leverage and discretionary accruals. The F-statistics of the OLS regression model were significant at 1%.

Test of Hypothesis and Discussion

Based on the empirical evidence, audit firm size has a significant negative effect on the earnings management of listed consumer goods firms in Nigeria. This finding is consistent with those of Tyokoso and Tsegba (2015), Aliyu, et al (2015) and Ching, et al (2015) documented a negative relationship between audit firm size and earnings management of firms but contradict the findings of Thomas (2022) and Isaac (2022) who documented a positive relationship between audit firm size and earnings management. This finding supported the hypothesis which state that audit firm size has a significant negative relationship with earnings management. This result equally supported the findings of Inua and Okoh (2019), Nam (2014) and Nwoye (2021) who found a positive relationship between audit fees and earnings management of firms. This result does not conform to expectation and thus, the hypothesis is rejected which states that audit fees have a significant negative relationship with earnings management.

Conclusion and Recommendation

Based on the findings from the data analysis and discussion, the study concludes that there is a significant negative relationship between audit firm size and earnings management suggesting that big 4 auditors do constrain earnings management of the sampled firms, while a significant positive relationship was observed between audit fees and earnings management implying that audit fees does not constrain earnings management but rather increases it. In line with the findings of this study, we therefore recommend that regulators and policy makers should encourage the deployment of Big Four auditing firms in auditing annual reports and accounts of listed firms and also audit firms should charge fees that would cover all expenses and ensure that it is incurred in conducting the audit exercise.

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