CRAWFORD JOURNAL OF BUSINESS & SOCIAL SCIENCES (CJBASS)
SPECIAL EDITION, SEPTEMBER 2019: 1-9
ISSN 2141-9094; website:cjbasscru.org

# AUDIT QUALITY AND EARNINGS MANAGEMENT IN SELECTED QUOTED COMMERCIAL BANKS IN NIGERIA.

[1] **OLORUNDARE** Oluwatimileyi, [2]**OMOROGBE**, Comfort .E. & [3]**UCHEHARA**, Chris-Chigo
[1,2&3] Department of Accounting &Finance, Crawford University, Igbesa, Ogun- State
Corresponding email: omorogbece@yahoo.com

**Abstract**

*Earnings management has become a great concern to all users of financial statements especially accountants as it robs off the integrity deserved of the profession. This study examined the effect of audit quality on earnings management of quoted commercial banks in Nigeria. To achieve this objective, four quoted commercial banks that had consistently published their audited annual financial reports between the years 2011-2018 were accessed. The data gathered was analyzed using multiple regressions. The result of the multiple regression analysis revealed* $R^2 = 0.46$, $(P \leq 0.01)$ *which implied that audit quality (proxy by audit firm size, auditor industry specialization, audit committee financial expertise and audit tenure) explained 46% variation in earnings management (proxy by discretionary accruals) of selected quoted commercial banks in Nigeria. The* $\beta$ *coefficient for the variants in the regression line revealed that Audit firm size effect is not significant in the earnings management model. The conclusion of the findings of this study is that, audit firm size does not actually matter in earnings management but instead the experience and expertise of the auditors. Hence, there might be no need paying undue attention on that factor during auditor selection exercise. The study thus recommended that Auditor tenure of at least three years would enable the auditor acquire accurate experience about the goings-on in a firm to enable possibly more accurate detection of controversial financial reporting practices in the firm.*

**KEYWORDS:** Earnings-Management, Discretionary-Accruals, Size, Tenure, Expertise.

## 1. INTRODUCTION

Financial statements information have to meet basic qualitative attributes of relevance and faithful representation in addition to quantitative attributes in order to achieve the objective of Auditing. Relevance of financial statements information are associated with the extent to which published financial information could influence the decision of users. Faithful representation on the other hand entails that published financial statements information should be verifiable, neutral and complete (IASB, 2008).

Auditing is a mechanism which has been adopted to ensure equality, fairness, accountability and also protect the interest of the users of financial information by providing reasonable assurance that the financial statements are free from manipulations and misstatements; as lower risks of misstatements increase confidence in capital markets, which in turn lowers the cost of capital for firms (Heil, 2012; Watts & Zimmerman, 1986). The major responsibility of the auditor therefore is to reduce the extent of fraudulent activities and significant misstatements by ensuring that the financial statements thoroughly complied with relevant standards.

The quality of an audit can be improved by the independence of the auditors. The ability of an auditor to carry out his or her work in an objective manner will be advantageous because there will be no compromise in the audit process thereby the result of the audit will be fair and justifiable. Auditor independence is important because it has an impact on the audit quality. If the auditor refuse to uncover a breach and report the breach, the audit quality will be impaired (DeAngelo, 1981b). Audit quality has being of greater concern due to severe failures that have come to the fore. For example, Enron's scandal of 2001, robbing-off on Arthur Andersen auditing firm; and Cecilia Ibru's involvement with the Oceanic bank Plc. case. These failures are sometimes caused by auditor threats such as: self-review threat, self-interest threat, advocacy threat, and familiarity threat.

There have been increased concerns over corporate accountability as a result of these threats; hence, the need for appropriate audit which involves risk management and internal control systems (Beekes & Brown, 2006). It is against this background that this study examined audit quality and earnings management in the Banking sector with a view to identifying the extent to which audit quality can impact on earnings management practice. The

objective of this study therefore, is to determine the impact of audit quality on the earnings management in quoted banks in Nigeria. The audit quality was measured by audit firms' size; auditor's tenure auditor industry specialization, and audit committee financial expertise. The Hypothesis formulated around this core objective is $H_{0:}$ Audit quality has no significant effect on earnings management.

The paper presents literature review after this introductory section. Section three addresses research methods followed by results and discussion in section four; while section five has conclusion and implication of study to practice.

## 2. LITERATURE REVIEW

### The Concept of Audit quality

Audit quality denotes audit excellence derived from the auditor's independence, integrity and exhibition of justice. Yu (2011) indicates that audit quality occurs when an auditor issues a report, which is appropriate for the current circumstances under review. DeAngelo (1981) referred to audit quality as a service that achieves discovery of a breach in the client's accounting system, and the reporting of such breach. Similarly, Gul (2009) defined audit quality as the auditor's ability to detect and correct misstatements.

These definitions are centred on the bedrock of professionalism and independence. Professionalism deals with the experience and ability of the auditor to discover accounting manipulations on the path of the client. That is, the ability of the auditor to discover violations of accounting principles in the accounting system of a client.

There are basic procedures by which the auditor determines the reliability or the falsity of the financial statement. Association of Certified Chartered Accountants (ACCA 2015) highlighted three aspects that each procedure should include first, the assertion tested: such assertions are embodied in the financial statements, and are used by the auditor to consider the different types of potential misstatements that may occur. It may take any of the following forms: (a) According to transaction and events occurrence, completeness, accuracy, cut-off, and classification; (b) account balances at the period-end in terms of existence, rights and obligations, completeness, valuation and allocation; (c) presentation and disclosure in the areas of occurrence and rights and obligations, completeness, classification and ability to understand, accuracy and valuation.

Second, the audit procedure: audit procedures are performed in order to test financial statement assertions. Audit quality can be achieved through the following procedures; analytical procedures; enquiry and confirmation directly from a third party through inquiry, inspection of records and assets; observation; and recalculation.

Third, the reason for the procedure: the auditor must be able to state the reason(s) why the procedure is being used for the audit; the foreseen advantage it has to the audit; and how it can reduce manipulations and improve reliability. It should also state the relevant regulatory and statutory frameworks backing and supporting the use of the procedures which have been selected.

The International Auditing and Assurance Standards Board (IFAC 2011) identified threats which could affect the quality of the audit. They include: *Self-interest***-** This means that the auditor has financial and other interest in the firm in which he is auditing. This can make the auditor alter this decision to suit his interests; *Advocacy***-** This is a situation whereby the auditor is involved in promoting the client; *Familiarity-* This is a situation whereby the auditor is too familiar with the client or has a long relationship with the employees, officers or directors. This is a major threat to audit quality; *Intimidation-* This is a situation whereby the auditors are intimidated by the management or directors. This is when the auditor maybe warned or threatened from acting objectively and exercising professionalism; *Self-review***-** This is where an auditor reviews his own work. This happens when the auditor reviews a work which he has previously performed. For example, where an external auditor both prepares and audits the financial statements.

**Audit quality in this research was examined by reference to the following concepts:**

Audit firm size (AFS) – This means that the size of the audit firm will likely affect the audit. It means that an audit undertaken by any of the Big four accounting firms could be said to be more reliable than an audit undertaken by a smaller audit firm in terms of technological advancement, experience and availability of quality workforce.

Auditor Tenure (ADT) – This means that the length of time given to an auditor will determine the quality of the audit. If the auditor is given a short time to undergo an audit on a firm, there is a high probability the audit will not be performed will due care and prudence.

Auditors Industry Specialization (AIS) - This refers to the aspect of the sector or industry in which the audit firm concentrates on. This means the audit firm is an expert when it comes to auditing the industry.

Auditors Committee Financial Expertise (ACFE) – This is the proportion of committee members that are financial experts.

**The Concept of Earnings Management**

The concept of earnings management generally refers to situations where accounting techniques are used to produce financial reports that present an overly positive view of a company's business activities and financial position**.** Schipper (1989) defined earnings management as a purposeful intervention in the external financial reporting process with the intent to obtaining one private gain. To Wu (2014), earnings management, occurs through manipulations in accounting tools such as balance sheet (*statement of financial position*) and income statements, yet, these changes, though comply with the law, may mislead some stakeholders.

There are two major ways in which earnings can be managed: Accrual-based earnings management; and Real earnings management. Accruals based earnings management occurs to demonstrate the true performance of the firm by recording revenues and expenses to the period in which they are incurred, rather than presenting the cash-inflows and outflows. This means that income is recorded when earned, not when received, and expenses are recorded when incurred, not when it is paid out (Rowchowdhury 2006). On the other hand, Real earnings management is a management activity which is implemented to alter reported earnings of a firm and this can be achieved by changing some operational decision so the managers will delay discretionary expenses (Advertising expenditure, Research and Development cost) to make their earnings higher or the managers will overstate inventory, which will reduce the cost per unit, which makes cost of goods sold go down and earnings go up. (University of Pennsylvania 2017).

According to Merritt (2018), There are four (4) ways to which earnings management can be managed. They include; Revenue and Expense Recognition; Cookie Jars Reserves; The Big Bath; and Company Size

**Motives of Earnings Management**

The motives of earnings management focuses on the reasons upon which earnings management by firms is predicated. The motives of firms can either be to the benefit of the investors or to their detriment. These motives are stated below as stated by (University of Pennsylvania 2017);

- Capital markets (stock prices and valuation) such as Investors, analysts - Earnings affect stock prices directly through Price-Earnings-multiple valuations and indirectly through the use of earnings to forecast future cash flows.
- Product and labour markets such as Customers, Competitors, Suppliers, and Employees. Stakeholders use earnings as key measure of firm performance and financial health. If their earnings is low, they will manage their earnings and this can be done by increasing the net worth of the company which makes it convenient for firm to compete with other companies, buy goods on credit, and so on.
- Contracts or agreement such as Lenders, Board of Directors (Executive Compensation). Contracts often explicitly use earnings to determine rewards (bonuses) or penalties (covenant violations). When the earnings are not favourable, the managers manage the company's earnings by making the financial statement to look liquid so as to be eligible to receive bonuses, collect loans, pay debt.
- According to Kighir (2013), the problem of earnings management actually hinge on four broad areas: corporate governance issues; flexibility of generally accepted accounting principles; economic/ business fluctuations; and agency problem.

Earnings management in this research focused on the negative motive of management which might be detrimental to the company. It was examined by reference to the concept of Discretionary accruals (DAC)

Discretionary accruals (DAC) is a situation where the company uses its own discretion in deciding whether to show the accruals or not; If not, that means, they will not show the liability on their financial statements.

**Theoretical Consideration**

**The Signal Theory**

The signal theory states that managers are the most informed party of the company because they are at the executive head and they have certain important information which produces signal to different investors and market participants (Myers& Majluf, 1984). This means that they have first-hand information concerning the organization, its performance and going concern in future years and they can manipulate it before it gets to other parts of the economy.

**The Agency Theory**

The agency theory treats the relationship between an agent and a principal. The agency theory occurs when another party is appointed by the principal to take decisions on behalf of the principals with the knowledge that whatsoever decisions taken by the agents will be effected and acted upon (Jensen & Meckling, 1976). The agency theory is used to explain and resolve issues in the relationship between business principals and their agents. In a business organization, the shareholders are the principal and the agent is the manager. Disagreement occurs in a situation where by the objectives of the principal and the agents are in contrast.

**The Threshold Management Theory**

This theory states that the company's managers use earnings management to reach a level of expected result called "threshold". This means that they manage their earnings to achieve a target set by them. This theory is relevant because it also maintains or increase the good image of the company before the shareholders of the company and this encourages them to manage earnings in order to realize or exceed objectives (thresholds) and thus maintain their good reputation and increase their demand on the job market.

## 3. RESEARCH METHODS

**Research Design**

The Archival research setting was adopted for this study. The annual reports of the selected commercial banks for an eight-year period 2011-2018 retrieved from their corporate websites were used for the analysis. Four (4) out of all 22 commercial banks listed in the CBN bulletin 2018 were conveniently selected. This sample size was selected based on accessibility and proximity. A correlation research design was used to describe the statistical relationship between two or more variables. It is most appropriate for this study because it allowed testing of expected relationships between audit quality proxies and earnings management practices of some quoted commercial banks in Nigeria

The commercial banks selected were Access Bank Plc.; First City Monument Bank; Fidelity Bank and Guarantee Trust Bank Plc.

**Measurement of Variables**

This study is constructed on two constructs: Audit Quality and Earnings Management. Earnings Management is measured through Discretionary Accrual (DAC); while Audit Quality was measured through Audit Firm Size (AFS), Audit Committee Financial Expertise (AFE).

**Table 3: Summary of Measurement of Variables**

| Acronym | Variable Name | Measurement |
|---|---|---|
| DAC | Discretionary accruals | Total accruals minus non-discretionary accruals |
| AFS | Audit firm size | A dummy variable 1, if the firm is audited by a Big 4 auditor, 0 otherwise (adapted from Becker, DeFond, Jiambalvo, & Subramanyam 1998). |
| ADT | Audit firm tenure | Number of consecutive years the client has retained a particular audit firm. Dummy variable 1 for 3 years+, 0 otherwise (adapted from Inaam 2012). |
| AIS | Auditor industry specialization | A dummy variable 1 if audited by an industry specialist and 0 otherwise (adapted from Inaam 2012). . |

CRAWFORD JOURNAL OF BUSINESS & SOCIAL SCIENCES (CJBASS)
SPECIAL EDITION, SEPTEMBER 2019: 1-9
ISSN 2141-9094; website:cjbasscru.org

| ACFE | Audit Committee Financial Expertise | Proportion of audit committee members with accounting and financial expertise (adapted from Becker, DeFond, Jiambalvo, & Subramanyam 1998) |
|---|---|---|

Panel data analysis was employed, utilising multiple regression analysis. This statistical tool was

applied in this study because of its ability to predict and explain expected variation in earnings management as a result of audit quality; and also because the data set has both time series and cross-sectional attributes.

**Model Specification**

The model for this study is a multiple regression model with the independent variable (earnings management) represented by discretionary accruals (DAC) and the independent variable, audit quality represented by audit firm size (AFS), auditor industry specialization (AIS), audit committee financial expertise (AFE), audit tenure (ADT).

The model is expressed as follows:

$DAC = \beta_0 + \beta_1 AFS + \beta_2 AIS + \beta_3 ADT + \beta_4 AFE + \varepsilon$

Where: DAC = discretionary accruals

AFS = audit firm size

AIS = auditor industry specialization

ADT = auditor tenure

AFE = audit committee financial expertise

$\beta_0$ = beta constant of the model

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

$\varepsilon$ = error term

## 4. Results and Discussion

The main hypothesis of the study exemplified in the model is: $H_{0:}$ Audit quality has no significant effect on management earnings.

**Table 1a: Model Summary of Audit quality on management earnings**

| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate |
|---|---|---|---|---|
| 1 | .675[a] | .455 | .375 | .03770 |

a. Predictors: (Constant), AIS, ACFE, AFS, ADT

**Table 1b: ANOVA on Audit quality on management earnings**

| Model | | Sum of Squares | df | Mean Square | F | Sig. |
|---|---|---|---|---|---|---|
| 1 | Regression | .032 | 4 | .008 | 5.647 | .002[b] |
| | Residual | .038 | 27 | .001 | | |
| | Total | .070 | 31 | | | |

a. Dependent Variable: DAC
b. Predictors: (Constant), AIS, ACFE, AFS, ADT

**Table 1c: Coefficients on Audit quality on management earnings**

| Model | Unstandardized Coefficients | | Standardized Coefficients | t | Sig. |
|---|---|---|---|---|---|
| | B | Std. Error | Beta | | |
| (Constant) | 1.115 | .023 | | 48.039 | .000 |
| AFS | .008 | .013 | .082 | .574 | .571 |
| ADT | -.055 | .017 | -.569 | -3.197 | .004 |
| ACFE | .035 | .014 | .364 | 2.558 | .016 |
| AIS | -.062 | .017 | -.643 | -3.610 | .001 |

**Source:** Research's computations from organization records

In the regression in Table 4a, $R^2 = 0.455$, ($p \leq 0.05$) implies that about 46% of the total variation on earnings management (discretionary accruals) is jointly explained by the explanatory variables (audit firm size, auditor industry specialization, audit committee financial expertise and audit tenure). The F- statistics value of 5.647 (Prob.>F = 0.00) in Table 4b shows a significant low fitness of the model explaining the relationship expressed in the study model; and further suggests that 54% of the variation in the dependent variable is explained by other factors not captured in this study model. This suggests that apart from audit quality, there are other factors that mitigate earnings management of the selected quoted commercial banks. The nature and extent of relationship between the dependent variable and each of the independent variables of the study in terms of coefficients, t-values and p- values, it was only the beta coefficient for audit firm size (AFS) that was not significant ($p \leq 0.05$). Other factors were shown to be significant. That is, for example, auditor industry specialization could be a constraint for earnings management. The null hypothesis was rejected. This means that the more specialized an audit firm in auditing quoted commercials banks, the greater the effectiveness in the mitigation of earnings management in quoted commercial banks in Nigeria.

## 5. Conclusions and Implication of the Study for Practice

Based on these findings, the study concluded that there is a significant relationship between auditor industry specialization, auditor tenure, audit committee financial and discretionary accruals in the selected quoted commercial banks in Nigeria; this implies that audit quality mitigates earnings management of sampled firms.
Audit firm size has a positive but a not-significant effect on discretionary accruals, indicating that audit firm size is not a determinant of audit quality; thus there might be no need paying undue attention on that factor during auditor selection exercise. Instead, an audit committee comprising of accounting and financial experts should encourage companies where they operate to hire auditors that are specialized in auditing commercial banks, as has been evidenced from this study that a good knowledge and understanding of the business environment by the auditor coupled with the accounting and financial experience of the audit committee members is likely to make more effective mitigation against earnings management of firms especially commercial banks

The study recommends auditor tenure of three years and above for external auditors of quoted firms, because as shown from this study, auditor tenure of at least three years would enable the auditor acquire more precise experience that would facilitate the detection of controversial financial reporting practices of the firm more accurately than initial entrants into the audit engagement.
Lastly, public commercial banks can appoint either a big accounting firm or a small accounting firm as the study shows that it does not have significant effect on the effectiveness of audit quality in mitigating earnings management.

## REFERENCES

ACCA (2015). *Audit procedures*. Retrieved on the 6th of March 2019 from http://www.accaglobal.com
DeAngelo, L.E., (1986) Accounting numbers as market valuation substitutes: a study of management buyouts of public stockholders, *The Accounting Review*, 61: 400–420.
DeAngelo, L.E., (1988) 'Managerial competition, information costs, and corporate governance: the use of accounting performance measures in proxy contests', *Journal of Accounting and Economics*. 10: 3–36.

Gul, F.A., Fung, Y. K. S., & Bikki, J. (2009). Earnings quality: some evidence on the role of auditor tenure and auditors industry expertise. *Journal of Accounting and Economics*, 47: 265-287.

Heil, D. (2012). The influence of the auditor on the earnings quality of their clients. *(Unpublished Master's thesis*). Department of Accounting, Auditng and Control, Erasmus University, Rotterdam.

IASB (2008). *Exposure draft* on an improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting information London.

IFAC (2011). Threats and safeguards, *IFAC code of ethic*: 1106-1107

Kighir, A.(2013) Mandatory audit firm rotation and auditor independence: empirical evidence from Nigerian listed banks, *International Journal Auditing Technology*, 1,(1): 5-17.

Merritt, C. (2018). *Techniques in earnings management*. Retrieved on the 13 of February, 2019 from https://yourbusiness.azcentral.com/ techniques-earnings-management

Myers, S.C., Majluf, N.S., (1984). Corporate financing and investment decisions when firms have information that investors do not have. *Journal of Financial Economic* 13, 187-221

Schipper, K., (1989). Commentary on earnings management. *Accounting Horizons*, 3, 91-102.

University of Pennsylvania 2017, How Can Managers Manipulate Earnings? *An overview of earning management*. Philadelphia USA.

Watts, R. L., & Zimmerman, J. L., (1978). Towards a positive theory of the determination of accounting standards. *The Accounting Review,* 52(1): 112 - 134.

Watts, R. L., & Zimmerman, J. L., (1986). *Positive accounting theory*. Englewood Cliffs: Prentice-Hall.

Wu, R.S., (2014). Predicting earnings management*:* A nonlinear approach.International *Review of Economics and Finance*: 30, 1-25.

Yu, H.C., (2011). Legal systems and auditor independence. *Review of Accounting Studies,* 16(2):377.

## APPENDIX

DISCRETIONARY ACCRUALS - CASHFLOW METHOD

| Year | Access | FCMB | Stanbic | GTB |
|---|---|---|---|---|
| 2011 | 122,550,520,000.00 | 202,474,958,000.00 | -49,395,000,000.00 | -568,497,415,000.00 |
| 2012 | 315,359,929,000.00 | -421,522,875,000.00 | -2,536,000,000.00 | -395,043,496,000.00 |
| 2013 | -457,391,008,000.00 | -16,102,985,000.00 | -8,332,000,000.00 | -97,514,508,000.00 |
| 2014 | -569,366,991,000.00 | 77,968,838,000.00 | -807,000,000.00 | -521,137,652,000.00 |
| 2015 | -1,075,481,881,000.00 | -11,394,914,000.00 | -822,000,000.00 | -617,315,932,000.00 |
| 2016 | -1,601,871,262,000.00 | -17,676,662,000.00 | -1,569,000,000.00 | -772,631,343,000.00 |
| 2017 | -2,047,932,709,000.00 | -12,681,062,000.00 | 8,364,000,000.00 | -935,914,479,000.00 |
| 2018 | -1,097,653,554,000.00 | -9,059,908,000.00 | -20,651,000,000.00 | 270,552,977,000.00 |
| | | | | |

A dummy variable 1 if the firm is audited by a big 4 and 0 if otherwise

| Year | Access | FCMB | Stanbic | GTB |
|---|---|---|---|---|
| 2011 | big 4 | big 4 | Non big 4 | Non big 4 |
| 2012 | big 4 | big 4 | Non big 4 | Non big 4 |
| 2013 | big 4 | big 4 | Non big 4 | Non big 4 |
| 2014 | big 4 | big 4 | big 4 | Non big 4 |
| 2015 | Non big 4 | big 4 | Big 4 | Non big 4 |

| | | | | |
|---|---|---|---|---|
| 2016 | Non big 4 | big 4 | Big 4 | Non big 4 |
| 2017 | Non big 4 | big 4 | Big 4 | Non big 4 |
| 2018 | Non big 4 | big 4 | Non big 4 | Big 4 |

**Audit committee financial expertise (AFE)**

| Year | Access | FCMB | STANBIC | GTB |
|---|---|---|---|---|
| 2011 | Industry | Industry | Non industry | Non Industry |
| 2012 | Industry | Industry | Non industry | Non Industry |
| 2013 | Industry | Industry | Non industry | Non industry |
| 2014 | Industry | Industry | Non industry | Non industry |
| 2015 | Non industry | Industry | Non industry | Industry |
| 2016 | Non industry | Industry | Non industry | Industry |
| 2017 | Non industry | Industry | industry | Industry |
| 2018 | Non industry | industry | Industry | Industry |

**Auditor's industry specialization (AIS)**

| Year | Access | FCMB | STANBIC | GTB |
|---|---|---|---|---|
| 2011 | Industry | Non industry | Industry | Industry |
| 2012 | industry | Non industry | Industry | Industry |
| 2013 | Industry | Non industry | Industry | Industry |
| 2014 | industry | Non industry | Industry | Industry |
| 2015 | Industry | Non industry | Industry | Industry |
| 2016 | Non industry | Non industry | Non industry | Industry |
| 2017 | Non industry | Non industry | Non industry | Industry |
| 2018 | Non industry | Non industry | Non industry | Industry |