AUDIT QUALITY AND EARNINGS MANAGEMENT OF LISTED DEPOSIT MONEY BANKS IN NIGERIA

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Abstract
This study examines the effect of audit quality on earnings management of the Deposit Money Banks in Nigeria. The correlation research design was employed and Ordinary Least Square (OLS) technique was used in the analysis of the secondary data collected from a sample of 14 banks for a period of seven years (2013-2019). The study found that total audit fees have a significant positive effect on earnings management l. It is also found that auditor tenure has a significant positive effect on earnings management. The study concludes that total audit fees and lengthy auditor tenure are a mechanism through which management influences auditors to compromise their independence in the deposit money banks of Nigeria, and therefore allow unethical practices such as earnings management. The study recommends that the regulatory agencies should increase surveillance on audit practices particularly statutory audit about audit fees. Also, the present audit firm tenure policy of the CBN (a bank external auditor should maintain the tenure with a given bank of the maximum period of ten years) should not be increased beyond ten years.

Keywords; Audit quality, Audit fee, Audit tenure, Earnings management

Introduction

The last decade has witnessed several accounting scandals and corporate failures that were blamed on earnings management practices of firms globally, which the audit function was not able to detect. Earnings management involves managers' manipulation of the external reporting process and structuring transactions to alter financial reports to either mislead some shareholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers (Healy &Wahlen, 1999). As a result of this practice, which went undetected or unreported by external auditors, the United States alone recorded ten largest bankruptcies in 2002, including the two largest in world history, namely WorldCom and Enron (Albrecht, Albrecht & Albrecht, 2004). In Nigeria, Cadbury Nig. Plc and African Petroleum are exemplar cases. The increasing incidence of corporate scandals or failures associated with earnings management has led to the loss of public confidence in the quality of reported accounting earnings and the audit function generally. Accordingly, earnings management has become a matter of great concern to regulators, practitioners as well as accounting researchers (Okolie, 2014) due to the perverse consequences it has on corporate survival.

The demand for auditing arises from the auditor’s monitoring role in the principal-agent relationship (Eilifsen& Messier, 2000). The performance quality of this monitoring function may vary. Audit quality describes how well an audit detects and reports material misstatements of financial statements, reduces the effect of information asymmetry between management and shareholders, and therefore helps protect the interests of stockholders. High audit quality should be associated with high information quality of financial statements because financial statements audited by high-quality auditors may be less likely to contain material misstatements. From an agency theory perspective, an audit is a monitoring mechanism that provides reasonable assurance that financial statements are free of material misstatements and therefore protects the interests of shareholders. When the interests of management conflict with the interests of shareholders, management may not act in the best interests of shareholders. A high level of audit quality is therefore expected to result in lower levels of earnings management.

The high-profile corporate scandals of 2008 through to 2009 in Nigeria have continued to raise a lot of concern about the integrity of financial and auditing reporting systems in the country. Some corporate organizations in the banking and manufacturing sub-sectors that were never suspected to have a problem were found to be living in past glory due to excessive earnings management practices. The ugly practices which were later discovered to have been on for some time went undetected or unreported by auditors. The experience has since left its perils in the mind of shareholders, prospective investors, regulators, and financial analysts.

Many studies have been conducted in the area of earnings management and audit quality most of which recognized the audit quality mechanisms as effective factors that restrain excessive opportunistic behavior amongst corporate management. Most of the studies focused on developed countries and reported mixed findings (Krishnan, 2003; Balsam, Krishnan &Yand, 2003,DeFond, Raghunandan&Subramanyam, 2002; Beasley &Petroni, 2001; Abbott & Parker, 2000; Creswell, 1999).Some of the studies documented that Big 8, Big 6,Big 5 and Big 4 audit firmsprovide higher audit quality thannon-Big 8, Big 6, Big 5 and Big 4 audit firms (Davidson &Neu, 1993; Teoh& Wong, 1993). The studies of Kim, Chung, and Firth(2003) and Lam and Chang (1994) indicate that Big 8, Big 6, Big 5, and Big 4audit firms might not always provide higher quality audit service than the others. This gave rise to the issue of inconclusiveness of findings. Given that the developed markets offer different institutional settings and litigation environments from those in the developing markets, the generalizability of their findings is limited.

Few studies have been conducted in emerging economies like Nigeria. The studies also documented mixed and inconclusiveness findings (Okolie, Izedonmi&Enofe2013; Okolie, 2014; Gabriel &Ioraver, 2015).While these studies have covered some important aspects of audit quality, none of them used auditor tenure in measuring the independence of audit firms despite the strong relationship that exists between auditor tenure and quality of audit. This study, therefore, represents a modest effort to fill the gaps identified in the literature. The study extends its analysis to cover variables that are often neglected in audit quality.

The main objective of this study is to examine the impact of audit quality on earnings management of listed deposit money banks in Nigeria. The specific objectives of the study are to:

1. Examine the impact of audit fees on earnings management of deposit money banks in Nigeria.
2. Investigate the effect of auditor tenure on earnings management of deposit money banks in Nigeria.

Based on the objectives of the study, the following hypotheses were formulated:

H_{01}: Audit fees haveno significant effect on earnings management of deposit money banks in Nigeria.

H_{02}: Auditor tenure has no significant effect on earnings management of deposit money banks in Nigeria.

Literature Review

Concept of Audit Quality

DeAngelo(1981) defined audit quality as “the market assessed joint probability that a given auditor will both (a) discover a breach in the client’s accounting system and (b) report the breach.” This definition is interpreted by the market as the ability of an auditor to detect accounting misstatements and then to express them inappropriate audit opinion. Watts and Zimmerman (1986) simplified

DeAngelo definition. They indicated that the first part refers to the auditor's competence and the number of inputs devoted to the audit, while the second part refers to the auditor's independence. In other words, according to Watts and Zimmerman, any factors that are associated with a lack of auditor competence or a lack of auditor independence can compromise the quality of audit. GivenDeAngelo‟s definition and the additional explanation offered by Watts and Zimmerman, audit quality may be described as the competence of the auditors to detect errors and the objectivity (infact and appearance) of the auditors in reporting such errors.

Palmrose (1988) described audit quality in terms of levels of assurances. Higher levels of assurances (i.e. possibility that financial statements contain fewer errors or misstatements) are associated with higher audit quality and *vice-versa*. According to Francis (2004), audit failure can be classified as extremely low audit quality (end quality) that can result in several outcomes such as regulatory sanctions, litigation rates, and business failure, and earnings restatement. From the regulator's perspective, as long as the auditors provide an independent audit opinion that is supported by adequate audit evidence, the regulator assumes that such auditors have performed equality auditing service.

Concept of Earnings Management

Earnings management is defined by Schipper (1989) as a purposeful intervention in the external financial reporting process, to obtain some private gain. While Healy and Wahlen (1999) state that "earnings management occurs when managers use judgment in financial reporting and in structuring transaction to alter financial reports to either mislead some stakeholders about the underlying economic performance of a company or to influence outcomes that depend on reported earnings". Earnings quality or accruals quality is regarded as earnings that accurately represent the economic implications of underlying transactions; the proportion of earnings relative to operating cash flows (McNichols, 2002). Thus higher the levels of cash components of earnings, the higher the quality of earnings. However, Kaplan (1985) argues that „normal‟ accruals arising in the ordinary course of business are unlikely to reflect managerial manipulations, and any manipulation of accounting numbers will most likely manifest in „abnormal or discretionary‟ accruals. Thus, the large portion of abnormal accruals is an indication of higher earnings management and poor or low quality of earnings. Discretionary accruals can be income increasing (positive) or income-decreasing (negative). Earnings management according to Bello (2010) is an attempt to cook/doctor or tailor financial accounting reports to a given desired level. He regarded earnings management as ethical misconduct of accountants and relates it to the recent time's corporate failures and loss of investors‟ confidence in both financial reports and auditors.

Prior Researches have used discretionary accruals to measure earnings management (DeAngelo, 1986; Jones, 1991 and Dechow, Sloan, & Sweeney, 1995), while auditor independence is measured in the prior researches by residual from auditor fee model (Simunic, 1980 and Ashbaug,LaFond& Mayhew, 2003). The studies establish that the primary determinants of audit fees are the size complexity and risks of the client's firm. Consequently, any portion of the total audit fee that is not explained by these three components and control variables necessary is regarded as abnormal or unexpected audit fees that are inversely related to auditor independence and which potentially affect the quality of reported earnings. Major accounting and audit scandals around the world (e.g. Enron, WorldCom, etc) involved earnings management in which the independent audit opinion indicate clean reports and out of which a widely held belief emerged that joint providing audit and non-audit services as well as excessive audit fees (abnormal audit fees) compromise auditors‟ independence and thus reduce the quality of reported earnings (Ashbaugh, Lafond&Mayhew 2003).

Audit Fee and Earnings Management

Frankel Johnson and Nelson (2002) study the association between non-audit fees, audit fees, and earnings management via discretionary accruals and the likelihood of firms meeting earnings benchmarks to draw inferences on auditor independence, in a sample of US firms and find a positive relationship between non-audit fees and small earnings surprises and the magnitude of discretionary accruals. While the result on total audit fees indicates that there is no association between total audit fees and earnings management, (and also) audit fees are significantly negatively associated with earnings management. Their results suggest that auditors" independence is compromised when clients pay high non-audit fees relative to total fees and conclude that clients are more likely to manage earnings via accruals if they also pay their auditor's high amount of non-audit fees.

Similarly, Ashbaugh*et al*., (2003) examine the relationship between discretionary accruals and audit fee ratio and total fees in a sample of US firms, after controlling for firm performance, and like Frankel, Johnson & Nelson(2002), they find that there is no statistically significant association between discretionary accruals and total audit fees. They also document a positive correlation between the absolute value of a firm's discretionary current accruals and fee ratio. In their second test, they indicate no association between fee ratio and the likelihood of firms reporting small earnings increases and a negative association between total fees and the likelihood of firms reporting small earnings increases. Contrary to Frankel *et al.* (2002), Ashbaugh*et al*., (2003) find no significant association between either the fee ratio or total fees, and firms meeting analysts' forecasts. They conclude that there is little evidence supporting the claim that auditors violate their independence as a result of clients paying high fees.

Haribar and Collins, (2002) provide evidence of a positive association between unexplained audit fees and low earnings quality from a sample of US firms. This implied higher earnings management and lack of independence. They conclude that auditors increase audit hours and audit fees in cases where they perceived client's accounting quality to be poor and this improves accounting quality.

Auditor Tenure and Earnings Management

The length of time an audit firm spends with a particular client is considered as a form of threat to the auditor's independence as a result of familiarity threats. A familiarity threat to an auditor's independence occurs when an audit firm has a particularly close or long-standing relationship with a client's directors, officers, and employees. This professional relationship causes a familiarity threat as documented by Schulte (1965). This according to Li (2007) prompted regulators and the press to allege that a long auditor-client relationship can decrease auditor monitoring strength (actual auditor competence and auditor independence).

Myers, Myers, and Omer (2003) find an inverse association between the level of discretionary accruals and auditor tenure as well as an inverse relationship between auditor tenure and the dispersion of accruals. These findings imply that auditors with longer tenure restrict management discretion in the reporting of earnings. In contrast, Davis, Soo, and Trompeter (2003) investigate the relationship between discretionary accruals and auditor tenure and report that discretionary accruals increase with auditor tenure. They also report that analyst earnings forecast errors decrease as auditor tenure increases. These findings are consistent with the possibility of auditors acquiescing more in later years of the engagement and management using this to meet earnings forecasts

Carey and Simnett (2006) find a positive relationship between auditor tenure and audit failure in Australia. This implies that there is a deterioration of audit quality as audit tenure increases. While in a sample of Belgian companies, Vanstaelen (2000) reports that for both financially distressed and non-financially distressed companies, long-term auditor-client relationships significantly increase the likelihood of an unqualified opinion or significantly reduce the auditors" willingness to qualify audit reports.

Theoretical Framework

Agency theory is a principal agent relationship, is an agreement that connects an agent to carry out services for the principal and the principal entrust policy formulation right to the agent (Jensen & Meckling,1976). The ultimate component of agency theory is the conflict of interest between the principal and the agent (Berle& Means, 1932). Xiao, Yangite and Chow (2004), this theory suggests that the auditing can help to reduce the conflict of interest between them. In Zahra and Pearce (1989), agenct theory is the most comprehensive theory that clarifies the auditor's roles and highlights the importance of their controlling role.

Principals incur monitoring coats from subjecting the financial statements to external audits. These costs are represented by audit fees payment for the efforts and time exerted for auditing (Hay, & Davis, 2004). On the other hand, agency incur bonding cost for external financial reporting and internal audits (Adams, 1994).

Methodology

The study adopted an ex-post-facto research design. The population of the study comprises of all the seventeen (17) banks listed on the Nigerian Stock Exchange Market as of 31st December 2019. This population is chosen because the banking industry is the most suitable for studying earnings management for three reasons; first, the bank loan loss provision is by far the largest and most important accrual for banks through which managers are most susceptible to earnings management; second, their large business activities as a result of large market share across the country, which could attract high audit effort and fees; and thirdly, banks are vulnerable to management manipulations due to high accruals and discretions associated with their transactions. The study arrived at fourteen (14) sample sizes based on the availability of data. The study makes use of secondary sources of data, while the method of data collection involved financial statements; income statements and the statements of financial position of the sampled banks, for the period of seven years (2013 – 2019). This is because the nature of the data warrants using quantitative data and quantitative methods of analysis.The technique for data analysis employed in this study is the Ordinary Least Squares (OLS) regression technique.

The variables of the study comprise audit quality and earnings management. As for the audit quality, the study uses audit size, audit fee, and auditor tenure basis of measurement. This is in line with DeAngelo (1981), Frankel et al (2002), Ashbaugh et al., (2003), Haribar et al (2010) and Carey and Simnett (2006). Earnings management in the context of this work is measured by discretionary accruals (discretionary loan loss provision). This is in line with the studies of Kanagaretnam, 2012).
Variables

Earnings Management	Defined as the level of discretionary accruals (discretionary loan loss provision). Measured as residuals from the Model One.
Audit Fee	Defined and measured as total audit fee as reported at the end of the accounting period.
Audit Tenure	Defined as a length of time spent by an audit with a bank. Measured by dichotomous variable, „1"for all the times spent by the same audit firm and„0" for the year of auditor change.

Model Specification

Therefore our model from which earnings management is estimated is as follows;

LLPit/BVit= β0/BVit+ β1BEGLLAit/BVit+ β2LCOit/BVit+ β3ΔNPLit/BVit+ β4LOANit/BVit+ β5ΔLOANit/BVit+ εit……………………………………………………………..…………i

Where:

LLPit/BVit= loan loss provisions of bank I in year t scaled by assets book value, as reported in the financial reports.

BEGLLAit/BVit = beginning loan loss allowances of bank I in year t scaled by book value of assets, as reported in the financial reports.

LCOit/BVit = loans charge-off/written-off of bank I in year t scaled by book value of assets, as reported in the financial reports.
ΔNPLit/BVit = changes in non-performing loans (current year NPL minus previous year NPL) of bank I in year t scaled by book value of assets, as reported in the financial reports.
LOANit/BVit = total outstanding loans and advances of bank I in year t scaled by book value of assets, as reported in the financial reports
ΔLOANit/BVit= changes in total outstanding loans and advances (current year loans minus previous year loans) of bank I in year t scaled by book value of assets as reported in the financial reports.
And β1, β2, β3, β4, β5 are the coefficients/parameters estimates; β0 intercept
εit= Residual (DLLP)
$EMGTit = \beta 0 + \beta 1AFEEit + \beta 2AUDTENit + \varepsilon it$
Where:
EMGT = discretionary loan loss provision (measure of earnings management) of bank I in year t
AFEEit = total audit fees scaled by book value of bank I in year t
AUDTENit = audit firm tenure of bank I, 1 if there is no change of auditor and 0 otherwise

β1, β2, are parameters estimates; β0 intercept
ε = Residual

Result and Discussion

Table 1: Descriptive Statistic

VARIABLES	**Mean**	**SD**	**Min**	**Max**
EMGT	0.0000	0.0219	-0.0680	0.1016
AFEE	0.0175	0.0110	0.0008	0.0586
AUDTEN	0.5918	0.4940	0	1

Source: Stata Output

Table 1 shows that our measure of earnings management (EMGT), discretionary loan loss provision (scaled by book value) has an average value of 0.0000 with a standard deviation of 0.0219, and minimum value of -0.0680 and 0.1016 as the maximum value. The standard deviation of 0.0219 signifies that the data deviate from the mean value from both sides by 0.0219, implying that there is a wide dispersion of the data from the mean because the standard deviation is higher than the mean. The table also indicates that the total auditor's fees (AFEE) has an average value of 0.0175% with a standard deviation of 0.0110%, and the minimum and maximum values of 0.008% and 0.0586% respectively.

The summary descriptive statistics in Table 1 shows that on average the auditor's tenure (AUDTEN) during the period of the study is around 59.18% with a standard deviation of 49.40%, the minimum and maximum values of tenure as measured by a dichotomous variable are 0 and 1 respectively. This implies that the data in the sample banks deviate from the mean by 49.40%.

Table 4.4: Coefficient of Correlation

Variables	**EMGT**	**AFEE**	**AUDTEN**
EMGT	1		

AFEE	0.2756 (0.0060)	1	
AUDTEN	0.2014 (0.0467)	-0.1859 (0.0668)	1

Source: Stata Output

The results in Table 2 show the Pearson correlation coefficients of the variables of audit quality (audit fees and auditor tenure) and earnings management (measured by discretionary loan loss provisions) of the listed deposit money banks in Nigeria. The table presents a significant positive association between earnings management (EMGT) and total audit fees (AFEE) from the correlation coefficient of 0.2756 which is significant at 1% level of significance (from the p-value of 0.0060). This relationship suggests that the auditor's independence is likely compromised since the association is positive.

Similarly, the results reveal that, there is a significant statistical positive association between earnings management (EMGT) and audit firm tenure (AUDTEN) from the correlation coefficient of 0.2014 which is significant at 5% level of significance (from the p-value of 0.0467). This implies that, the more audit firm stays with a client the earnings management increases, suggesting that tenure and/or familiarity between the audit firm and the client did impair auditor independence in the deposit money banks in Nigeria during the period of the study.

Presentation of Regression Results

This section analyzes and presents the regression results of the models of the study. The section begins with the analysis of model one as presented in table 3 below;

Table 4 Summary of Robust OLS Regression Results

Variables	Statistics	P-Values
R2	0.347	
F-Statistic	1124.44	0.0000
Hettest: Chi2	6.55	0.0105
Mean VIF	2.18	
Random Effect Test: Chi2	1.11	0.2929

Source: Stata Output

Panel data does not usually meet all the classical assumptions of OLS, as such this study subjected the models to other regression models (Fixed and Random Effects) in addition to OLS. The results in table 4 shows a presence of Heteroscedasticity in the panel as indicated by the Breuch Pagan/Cook-Weisberg test for heteroscedasticity Chi2 of 6.55 with p-value of 0.0105. This is corrected using robust OLS (heteroskedasticity corrected standard errors), after the results of random effect test, Breusch and Pagan Lagrangian Multiplier Test for Random Effects, which indicates that there is no statistically significant variance among the units in the panel (from the Chi2 of 1.11 with p-value of 0.2929), implying that OLS technique is appropriate concerning model one. The table on the other hand, indicates the absence of the perfect multicollinearity among the explanatory variables, as shown by the mean VIF of 2.18. The decision criterion for the Variance Inflation Factor is that a value of 10 and above implies the presence of perfect multicollinearity.

The results from Table 4. indicate that the independent variables of model one (beginning loan loss allowances, loan charge off, changes in non-performing loans, changes in loans, and total loans) explained around 0.347 % of the variations in the total loan loss provision (LLP) of listed deposit money banks in Nigeria, from the coefficient of determinations (R2 value of 0.347). The table also shows that the model is fitted as evident by the F-Statistic of 1124.44 which is significant at 1% level of significance (as indicated by the P-value of 0.0000). Therefore, the study measured the earnings management from this regression model, which is the residual of the model (Discretionary Loan Loss Provision). The study therefore assesses the audit quality (through fees, and audit tenure) in relation to earnings management. The regression results are presented in Table 5

Table 5: Regression Result

	Coefficients	**P-Values**
AFEE	60.1666	0.000
AUDTEN	0.7606	0.004

Source: Stata Output

The results from Table 4.7 show that total audit fees (AFEE) has a statistically significant positive effect on the earnings management of the deposit money banks in Nigeria, asevidenced from the coefficient of 60.1666 which is significant at 99% confidence level (p-value of 0.000). This suggests that, a N1 increase in total audit fees earnings management (discretionary loan loss provision) increases by 60.17% and, this implies poor quality of earnings, and also evidence of compromise of independence through fees. Based on this, the study rejects the null hypothesis one (H01) which states that, total audit fee has no significant effect on the earnings management of deposit money banks in Nigeria. The study, therefore, infers that total audit fees in the listed deposit money banks in Nigeria impair auditor independence, and allows for earnings management.

Table 2 also shows that audit firm tenure (AUDTEN) has a significant positive impact on the earnings management (EMGT) of deposit money banks in Nigeria, considering the coefficient of 0.7606 which is significant at 1% level of significance, (p-value of 0.0004). This implies that when an audit firm spend an additional year with a bank earnings management increases by 0.76%. It also suggests that tenure and/or familiarity between audit firm and the client bank did impair auditor independence in the deposit money banks in Nigeria during the period of the study. This result supports the view of regulators of mandatory audit rotation. Based on this, the study rejects the null hypothesis two (H02) which states that audit firm tenure has no significant impact on the earnings management of deposit money banks in Nigeria.

Summary of Findings

The studies reveals study fees has significant impact on EM. The studies show that increase in audit fees lead to increase in EM. The following findigs are in contrast with this study. Haribaret, al. (2002) and Frankel et al (2003).

Furthermore, the study also reveals that audit firm tenure has a significant positive impact on the EM. This support the reveal of the regulators of the mandatory audit rotation. This findings is in line with the following works: Schulte (1965), Davis et al (2003) and Li (2007) and in contrast with Myres et al (2003).

Conclusion and Recommendations

Emanating from the review of relevant literature on audit quality and earnings management and based on the data collected and analyzed and the hypotheses tested the study concludes that audit quality in the deposit money banks in Nigeria is compromised via total audit fees and audit firm tenure during the period covered by the study. As evidence by the significant positive effects of total audit fees and audit firm tenure on earnings management of the deposit money banks. That is, excessive total audit fees have a significant effect on the quality of earnings of deposit money banks in Nigeria. Based on the findings from this study and the conclusions reached, the study recommends that the regulatory agencies should increase surveillance on audit practices particularly statutory audit with regards to audit fees. Also,the present audit firm tenure policy of the CBN (a bank external auditor should maintain the tenure with a given bank of the maximum period of ten years) should not be increased beyond ten years.

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