Effect of Audit Quality on Earnings Management in Nigeria Manufacturing Sector

BY

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A PROJECT SUBMITTED TO THE DEPARTMENT OF ACCOUNTING AND FINANCE, MOUNTAIN TOP UNIVERSITY, IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR THE DEGREE OF BACHELOR OF SCIENCE IN ACCOUNTING AT THE COLLEGE OF HUMANITIES, MANAGEMENT AND SOCIAL SCIENCES, MOUNTAIN TOP UNIVERSITY, PRAYER CITY, OGUN STATE, NIGERIA.

(B.Sc. Hons in ACCOUNTING)

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DECLARATION

I hereby declare that this project report written under the supervision of Dr. O. J. Akinyomi, is a product of my own research work. Information derived from various sources have been duly acknowledged in the text and a list of references provided. This research project has not been previously presented anywhere for the award of any degree or certificate.

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AKPABIO, Favour. **Date**

CERTIFICATION

This is to certify that this research project work titled **"EFFECT OF AUDIT QUALITY ON EARNINGS MANAGEMENT IN NIGERIA MANUFACTURING SECTOR"** was carried out by AKPABIO, IDONGESIT FAVOUR, with the matriculation number **16020101017**. This project report meets the requirements concerning the award of Bachelor of Science (B.Sc.) Degree in Accounting, Department of Accounting and Finance of the Mountain Top University, Ogun State, Nigeria and is approved for its contribution to knowledge and literary presentation.

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Dr. O. J. Akinyomi **Date**

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(Head of Department)

DEDICATION

This project is dedicated to the almighty God for His faithfulness to me throughout the process of writing this project.

ACKNOWLEDGMENTS

I give all glory to God for His faithfulness and I magnify Him for sustaining me throughout the process of writing this project. Without Him I am nothing. By His grace, he has made my ending in Mountain Top University better than my beginning. All glory, honor, and praise be ascribed to you, Lord.

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Abstract

This study focused on the effects of audit quality on earnings management in the Nigeria manufacturing sector. Specifically, a number of audit quality variables that affect earnings management of firms such as audit firm size, auditors' tenure, and auditors' industry specialization, were examined in relation to earnings management in food manufacturing sub-sector. The research design adopted for this study is the time series Ex-post Facto design and analytical research design. The method through which data were gathered and sampled to facilitate this research was the secondary method of data collection in which information were sourced from the financial statement of the companies used. In analyzing the data, the researcher made use of descriptive statistics and the pooled OLS regression method was used to test the relationship between audit quality and earnings management. The results of the study showed that among other variables of audit quality capable of enhancing the earnings management of food manufacturing companies in Nigeria, auditors' industry specialization is the most significant. It was also observed that audit tenure have a positive and significant effects on earnings management of food manufacturing companies in Nigeria. The researcher concluded that financial reports provide a basis in which investors and owners of firms usually appraise the performance of their companies and so can be greatly influenced by the audit quality of audit reports. The study recommends a reasonable period of auditor tenure.

CHAPTER ONE

INTRODUCTION

1.1 Background to the Study

In recent times, the call for reliable financial reporting has gained prominence in Nigeria and global economy at large. In order to improve transparency and accountability through fraud identification, auditors are instructed to report financial misdemeanors in company accounts. Gallegos (2004), was of the opinion that the external auditors' report is used in corporate financial statements as offering key guarantees of shareholder interest.

Financial reports contain accounting information which different users use to appraise firm’s performance. Investors use the cash flow statement to make financial decisions, thereby making space for highly oriented and knowledgeable management teams to distort actual economic processes to impact the true image of the cash flow from operations of a business.. Managers of manufacturing firms are expected to prepare and present annual financial reports to shareholders, who are owners of the firm and other interested users such as creditors, analysts, government, and the general public In order to allow them evaluate the performance and the reporting entity's financial status.

Accordingly, the main purpose of financial reporting is to provide information on the financial results and status of the reporting agency that is useful to multiple consumers, to enable them determine management stewardship and to make informed economic decisions. (International Accounting Standards Board (IASB), 2008; Glautier, Underdown, and Morris, 2011). This means that published financial reports that fail to meet the information needs of its users do not achieve their intended purpose. The need for audit accuracy in the financial statements of these businesses needs this.

In order to achieve this objective, information contained in financial statements has to meet basic qualities of relevance and faithful representation, among others. Relevance of financial statements information is correlated with the degree to which published financial information is able to influence the decision of the users. Faithful representation on the other hand entails that published financial statements information should be verifiable, neutral and complete (IASB, 2008).

The need for financial reporting arises originally because of ownership independence from administration and control in modern day business organizations. This relationship creates conflict of interests and information asymmetry between the shareholders (principal) and managers (agent), who are involved in the day to day running of the firm. In the preparing of financial statements, the controversy often illustrates how executives use their discretion over accounting decisions to distort financial details found in published financial reports for their own benefit at the detriment of other stakeholders.

Reported accounting information is, therefore, often not free from complete bias as expected by multiple users of the financial reports. Many users of financial reports are challenging the accuracy and credibility of these reports because of the possible impact of earnings management on the information value of those reports. Hence Earnings management is now a rising topic of concern, jeopardizing both the accounting and auditing roles' reputation. This issue is not new, it was one of the key themes in finance and corporate governance in the 1980s (Merchant and Rocknes 1994). In the early 1990s, earnings management was well and truly accepted as one of the main problems in financial reporting by national and international regulators and has grown internationally, both in the scope of its operations and in its nomenclature. Thus, the term preferred in the USA and the most frequent one is that of “earnings

management” In Europe the phrase “creative accounting” is often used. In the study, creative accounting can still be found under the name of income smoothing, earnings smoothing, cosmetic accounting or accounting cosmetics, financial crafts or accounting crafts.

According to Lin (2006), earnings management involves those strategies which are openly demonstrated (window dressing) as well as those which are sophisticated ones (off-balance sheet financing). Merchant and Rockness (1994) defines earnings management as any action from management which can distort profits and which is not a consequence of the economic reality, it actually represents the privilege of the financial engineering. Thus, the economic entity displays to the investors or to the prospective investors financial statement that have passed through the filter of some techniques capable of generating a more favorable image on the market but also the illusion of certain more appealing outcomes. A firm can intentionally alter reported financial results, i.e., income statement and statement of cash flows, or reported financial position, i.e., the balance sheet, in some desired amount and/or some desired direction.

Earnings management is primarily accomplished through accounting transactions that are designed to achieve desired earnings level. Previous literature shows that administrators have both personal and company reasons to reliably show excellent or at least adequate outcomes in their reports on a consistent basis (DeFond and Park, 1997; Greenfield, Carolyn, Norman, and Wier 2008). However, due to a variety of reason, the sustainability of such a performance is sometimes impossible. In these cases, managers may seek to take advantage of their discretion in implementing accounting rules and procedures that may lead to a more desirable outcome by modifying company operations. For example, the existence and negative influence of earnings management on the integrity of financial reports and business loss has also been encountered in the Nigerian corporate environment, a study of creative accounting scandal in African Petroleum

Plc revealed that the company's financial statements did not adequately reflect the financial condition of the company (Oyejide and Soyibo, 2001). In November 2006, Cadbury Nigeria Plc's accounting fiasco has posed more questions than responses about creative accounting. (Itsueli, 2006).

Thus these problems have formed the motivation for the research, as the tendency for earnings management has been witnessed amongst companies in Nigeria and this suggests that earnings management is fast becoming a key challenge to stakeholders in the Nigerian business environment. The implication is that there will be gradual emergence of skepticisms in the mind of investors, shareholders and other stakeholders on the credibility and quality of financial reports of businesses, manufacturing firms especially, in Nigeria.

However, Literatures suggests that one of the tools effective in monitoring management opportunism is the consistency of audit. Audit quality is linked with the joint probability that a given auditor both detects and disclose a violation of generally accepted accounting principles (GAAP) in the client's accounting system. Consequently, company laws from different countries of the world make the external audit of financial reports of public companies by high quality auditors a statutory requirement. Examples include the company laws in United States (US), United Kingdom (UK), France, Japan and Malaysia. Similarly, section 357 of the Companies and Allied Matters Act (CAMA) Cap 20 LFN 2004 conducts an annual audit of all the companies listed on the Nigerian Stock Exchange (NSE) by competent external auditors a statutory requirement for public companies.

Though several countries from both developed and developing economies have made external audit of the financial reports of public companies by high quality auditors a statutory

requirement, accounting scandals and corporate failures linked to earnings management still continue to occur globally. Over the past decade, major accounting controversies and corporate failures have included: Enron and Worldcom in the United States, Parmalat in Italy, Cadbury Plc, African Petroleum (now Forte Oil) Plc, and Unilever Plc in Nigeria, among others. (Ghosh, Marra and Moon, 2010; Fodio, Ibikunle and Oba, 2013; Chandrasegaram, Rahimansa, Rahman, Abdullah and Mat, 2013; Miko and Kamardin, 2015; Mishra and Malhotra, 2016). These scandals led to loss of public confidence in the quality of published financial reports and the audit function globally. Regulators from many countries across the world have insisted on new legislation in reaction to the aforementioned corporate controversies to improve the integrity of the external auditor and also to regain eroded public trust in the consistency of reported financial results.

Hence the study, using a number of audit quality variables that affect earnings management of firms such as audit firm size, auditors' tenure, and auditors' industry specialization, will bring the issues of audit quality and earnings management to the fore with a view to providing research based recommendations.

1.2 Statement of the Problem

Recently, there have been growing criticisms against accountants both in the public and business world on questionable acts. According to Bakare (2007), through the collusion of accountants and auditors with company managers and executives to falsify and knowingly overstate the accounts of firms, investors in Nigeria have lost several billion dollars. As a profession which people reposed much trust in, it is required of professional accountants to pay

proper attention to the concept of audit quality which have serious implications on the earnings of every business firm, the manufacturing firms inclusive.

Historically, but the accounting scandals that occurred in major U.S. companies such as Enron, WorldCom, have damaged the public trust and credibility, and have resulted in substantial criticism of the profession (Frohnen and Clarke, 2002). The case of Enron failure is one evidence that accounting ethics is required (Elias, 2006).

In Nigeria, there are cases of inappropriate accounting disclosures and financial recklessness, such that led to the collapse of the five biggest Nigerian banks in 2009. The manufacturing sector has also experienced such financial recklessness, notably, the Cadbury Nigeria PLC scandal of 2006. Investigations into the Cadbury Nigeria Plc's case uncovered an undisclosed offshore remuneration package paid to the executives by the company's board (This Day Live, 2012). For instance, Adewale (2013) reports that early in 2006, Cadbury Schweppes Plc, the UK parent company of Cadbury Nigeria Plc, made considerable effort to increase its shareholdings from 46 to 50 percent in Cadbury Nigeria Plc. In the course of carrying out its due diligence of Nigerian corporation, content overstatements were contained in the accounts. In addition, in October 2006, the Board of Directors of Cadbury Nigeria Plc reported to its shareholders and regulatory bodies that it had found excess claims in the accounts for the period 2002-2005. Price Water House Coopers (PWC), an independent audit firm, reported an overstatement of earnings in between N13billion and N15billion to the board of Cadbury Nigeria Plc. Further investigations revealed that such overstatement was initiated by the executives to fulfil their personal gains.

To this end, aggressive earnings management has been of greater concern to regulatory authorities around the globe, and in particular Nigerian business environment. Such cases of

improper accounting disclosures and financial recklessness in the Nigerian manufacturing sector have therefore exacerbated the concern. The need for seven regulatory authorities to tighten the financial reporting practices of publicly traded firms in Nigeria is further proven by these incidences.

Importantly, financial reports provide a framework for investors and company owners to typically determine the success of their corporations. Earnings (net profits) are referred to as the main determinant of firm's economic performance and they also provide important information for potential decision about investment. In order to either meet the expectations of shareholders or the desire for personal gains, executive managers render misleading financial results, thereby impairing the quality of audit reports.

Solving the above problems will make Nigerian economy a more realistic target for cross border investments that will further increase the fortune of the Nigerian manufacturing sector and economic buoyancy of the nation. It is therefore critical to know the magnitude of earnings management in the food manufacturing sub-sector, and understand the effect of audit quality on same, and that is the motivation for this study.

1.3 Objectives of the Study

The main objective of this study is to examine the effect of audit quality on earnings management in the Nigeria manufacturing sector. The specific objectives however include:

i. To ascertain the effect of audit firm size on earnings management in the Nigeria consumer goods manufacturing companies.

ii. To determine the effect of audit tenure on earnings management in the Nigeria consumer goods manufacturing companies.

iii. To assess the effect of auditors' industry specialization on earnings management in the Nigeria consumer goods manufacturing companies.

1.4 Research Questions

i. What is the relationship between audit firm size and earnings management in the Nigeria consumer goods manufacturing companies?

ii. How does audit tenure significantly affect earnings management in the Nigeria consumer goods manufacturing companies?

iii. What is the link between auditors' industry specialization and earnings management in the Nigeria consumer goods manufacturing companies?

1.5 Research Hypotheses

In line with the research questions and objectives, the following null hypotheses are formulated:

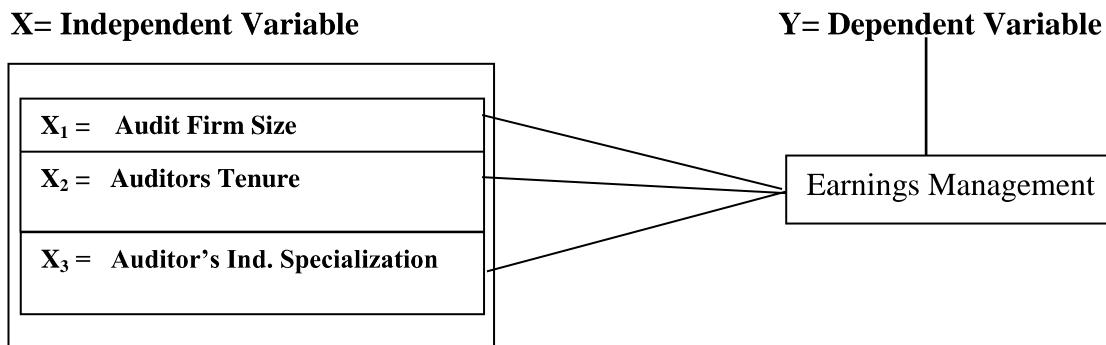
Ho_1: There is no significant relationship between audit firm size and earnings management in the Nigeria consumer goods manufacturing companies.

Ho_2: There is no significant relationship between audit tenure and earnings management in the Nigeria consumer goods manufacturing companies.

Ho_3: There is no significant relationship between auditors' industry specialization and earnings management in the Nigeria consumer goods manufacturing companies.

1.6 Operationalization of Variables

For the purpose of this study audit quality, proxy by audit firm size, audit tenure, and auditors' industry specialization, represent the independent variable while earnings management proxy by discretionary accruals represents the dependent variable. Their relationship is depicted below semantically:



Source: Researcher's Conceptual Model (2020).

1.7 Significance of the Study

The auditing profession plays a significant role in making information available for decision making in the capital market. Therefore, this research is expected to be of benefit to financial reporting and auditing stakeholders in the Nigerian economy because accounting and indeed auditing plays a fundamental role in the activities of a national economy. The study will be of immense benefits to other stakeholders such as the regulatory bodies, the investors, managers of manufacturing companies, and researchers. For instance, the empirical evidence provided in this study could be used by regulatory authorities such as the Securities and

Exchange Commission (SEC) and Central Bank of Nigeria (CBN) among others, to strengthen existing regulatory policies that would enhance audit quality and the integrity of financial reports of manufacturing companies quoted on the NSE. Also, the Financial Reporting Council of Nigeria (FRCN) would also benefit immensely from the findings and recommendations of this study.

In addition, the study could also benefit both current and potential investors in Nigeria, who may want to invest in the shares of the quoted manufacturing company. This is because the empirical evidence on the effect of audit quality on earnings management would guide current investors to either divest or maintain their investments in the manufacturing companies listed on the Nigerian Stock Exchange (NSE). Potential investors could use the outcome of the study to understand the earnings management behaviour of these companies and consequently decide on whether or not to invest in the companies.

The study also contributed to the existing literature on audit quality and earnings management in Nigeria, especially because the study covered variables not covered by most previous studies on the same subject. The study could also serve as a good library material for students and researchers who intend to carry out similar studies in this area. In addition, studies on audit quality and earnings management of manufacturing companies in Nigeria are relatively scanty compared to foreign literature. This study is, therefore, a modest contribution to the existing local literature.

1.8 Scope and Limitations of the Study

This study examines the effect of audit quality on earnings management of consumer goods companies under the manufacturing companies in Nigeria. Specifically, the researcher

focused on the consumer goods sector under the manufacturing companies listed on the Nigerian Stock Exchange which are required by law to publish their annual financial reports.

The study focuses on three proxies of audit quality: audit firm size (AFS), auditor tenure (AT), and auditor's Industrial Specialization (AIS), Earnings management, the dependent variable is represented by discretionary accruals (DAC). Discretionary accruals are the difference between total accruals and non – discretionary accruals of a firm.

However, in the course of carrying out this research, the researcher encountered some constraints which limits the scope of this study. These include the limited time frame given for the completion of the study, difficulty in gathering data due to limited access to most manufacturing companies, among others. Despite these challenges, the research came out with valid and reliable result.

1.9 Organization of the Study

This study is organised into five chapters. Chapter one is the introductory part, and it covers the background to the study, statement of the research problem, research objectives, research questions, hypotheses of the study, significance of the study, scope of the study, limitations of the study, organisation of the study, and definition of key terms. In chapter two, the researcher presents the review of related literature, consisting subheads which are treated in sections; as the conceptual framework, theoretical framework, and empirical framework. The research methodology is presented in in chapter three, and it comprises of the research design, the research area, population of the study, sample and sampling techniques, source and method of data collection, method of data analysis, and model specification, and decision rule among others. Chapter four is devoted to data presentation, analysis, and interpretation of findings,

while chapter five provides the summary of work done, conclusion, and made recommendations based on the findings of the study.

1.10 Definition of Terms

Audit: It is a methodical and self-governing review of books, accounts, statutory records, documents and vouchers of an organization to establish a true and fair view of an organization or company's financial statements.

Auditor: An auditor is a self-governing person appointed to examine the organization's records and financial statement prepared by them, thus form an opinion on the accuracy and correctness of the financial statements.

Audit Quality: This occurs when financial accounts are prepared in accordance to the generally accepted accounting principles (GAAP).

Auditor Independence: This means that auditor's should be free to reveal any fact discovered in the examination of the financial statement, he should be free in the expression of his opinion as guided by the ethics of the profession.

Earnings Management: earnings management is witnessed when directors exercise their discretion over accounting numbers, with or without restrictions. Such preference can be either firm value maximizing or opportunistic (Filed, Sullivan and Lin, 2001).

Independence: This is the independence of an auditor's proficiency in order to form an objective opinion of the financial statement examined by him without any direct or indirect interference.

Financial Reporting: This is the disclosure of financial statements and related facts about the organization's financial performance over a precise period of time to management and other stakeholders.

CHAPTER TWO

LITERATURE REVIEW

2.0 Introduction

This chapter reviews relevant studies on audit quality and earnings management of manufacturing firms. This review is done under three broad headings- conceptual review, theoretical review and empirical review. Specifically, the chapter covers the concept of audit quality, attributes of audit quality, concept of earnings management, motives of earnings management and measurement of earnings management. It further provides both theoretical framework for the study, and review of empirical studies on audit quality and earnings management.

2.1 Conceptual Review

2.1.1 Concept and Attributes of Audit Quality

Though audit quality in accounting literature is not a new term, it still doesn't have a single widely agreed definition. The most generally used definition of audit quality is the one by DeAngelo (1981) which states that "the quality of audit services is the market-assessed joint chance that a given auditor will both (a) determine a breach in the client's accounting system, and (b) report the breach." This definition is anchored on the competence and independence of the external auditor. Competence is allied with the auditor's ability to identify violations of accounting principles in the accounting system of a client. Independence on the other hand entails the ability of the auditor to report observed breaches in the accounting system of a client.

Other definitions equate audit quality to the steadfastness of financial statements" information. Heralding this argument is Titman and Trueman (1986) who asserted that audit quality improves the reliability of financial statements information and enables investors to make more precise estimates of the firm's value. This definition suggests that audit quality enhances the accuracy of reported accounting information. Thus, financial statements audited by high quality external auditors are expected to rarely contain material misstatements. In another definition, Bedard, Johnstone and Smith (2010) associated audit quality with the auditor's compliance with generally accepted auditing standards (GAAS). They asserted that high quality audit is conducted in accordance with GAAS in order to deliver sensible assurance that the audited financial statements, and related disclosures are fairly presented in accordance with generally accepted accounting principles (GAAP). This definition suggests that high quality audit is more likely to comply with GAAS than low quality audit in the conduct of audit assignments. Similarly, Francis, Michas and Seavey (2011) associated audit quality with the issuance of appropriate audit report on the compliance of the client with GAAP. They argued that nonetheless audit quality is a complex concept that is difficult to reduce to a simple

definition, it basically entails that the auditor issues an appropriate audit report concerning the level of compliance of the client with GAAP. They also contended that high quality audit complies with appropriate auditing standards and issues an accurate view on the client's financial statements at an appropriate level of risk. The definitions of Bedard, Johnstone and Smith (2010) and Francis, Michas and Seavey (2011) suggested two major characteristics of high-quality audit. Firstly, the auditor must issue an appropriate audit judgment on the financial statements of the client concerning its compliance with GAAP. Secondly, the audit must reasonably comply with GAAS in carrying out the independent examination of the client's financial statements.

The aforementioned definitions clearly suggest that accountants are yet to agree on a single definition for audit quality that suits all purposes. Consequently, and following DeAngelo‟s initial definition, this study views audit quality as the joint chance that a given auditor both identifies and reports a defilement of GAAP in the accounting system of the client. This study adopts DeAngelo's definition of audit quality in view of the fact that it captures the fundamental elements of quality audit which are competence and independence of the auditor. Competence is linked with the ability of the auditor to detect violation of GAAP in the accounting system of a client while independence is what makes the auditor to report the said violation of GAAP.

Similarly, the difficulty encountered in defining audit quality also extends to its measurement. Different proxies have been used in extant literature to represent high quality audit. For example, audit firm size (DeAngelo, 1981; Becker *et al.*, 1998), auditor industry specialization (Balsam, Krishnan & Yang, 2003; Krishnan, 2003; Tyokoso & Tsegba, 2015), audit fees, audit tenure, and auditor client importance (Okolie, Izedonmi & Enofe, 2013), audit committee financial expertise, audit committee independence and audit committee meeting

(Molik *et al.,* 2013) have been documented in the literature to explain audit quality and its connection with earnings management. Extant literature suggests a positive correlation between audit quality and audit firm size (DeAngelo, 1981). Empirical studies on audit quality and earnings management have found a connection between the size of an audit firm and earnings management of firms. This is confirmed by (Becker *et al*. 1998; Tyokoso and Tsegba, 2015) who documented adverse connotation between audit firm size and earnings management of public companies. Big audit firms are better able to constrain earnings management because they invest more in reputation capital and expertise than small audit firms (DeAngelo, 1981; Piot & Janin, 2005). Providing quality-differentiated audit services is, therefore, necessary for big audit firms to protect and maintain their investment in reputation capital.

Accounting literature also suggests a positive relationship between auditor industry specialists and audit quality. Specialist auditors possess industry specific knowledge and experience which make them more effective in identifying accounting irregularities than non-specialist auditors. Industry specialist auditors also invest more in relevant audit technology than their counterparts. This gives them an advantage over other auditors in detecting unethical accounting practices such as earnings management. Empirical studies on audit quality and earnings management also associate auditor industry specialization (proxy for audit quality) and earnings management in firms. This is confirmed by Balsam, Krishnan and Yang (2003) and Tyokoso and Tsegba (2015) who documented an adverse relationship between earnings management of firms and auditor industry specialization.

Another proxy of audit quality often associated with earnings management in accounting literature is auditor tenure. There are two contending arguments concerning the connotation between auditor tenure and earnings management. The first argument suggests that an overly

long auditor- client relationship threatens the auditor's independence due to personal ties and familiarity with the client. Long auditor tenure is, therefore, likely to make the auditor lose his objectivity and make the audit engagement become a routine exercise (Piot and Janin, 2005).

Consequently, long auditor tenure is not likely to mitigate earnings management (Knapp, 1991). In contrast, proponents of long auditor tenure contend that it leads to more audit efficiency and experience as the length of auditor-client relationship increases. This makes auditors more effective in detecting questionable accounting practices of the client than they were at the premature years of the audit engagement. The second argument suggests that long auditor tenure is likely to be related with less earnings management of firms. Empirical evidence supports the connotation between auditor tenure and earnings management (see Okolie, 2014; Tyokoso and Tsegba, 2015).

2.1.2 Concept of Earnings Management

The accounting literature is yet to provide a universally accepted definition of the term "earnings management". Earnings management is called by several names such as accounting numbers game (Mulford & Comiskey, 2002), creative accounting (Balaciu, Bogdan & Vladu, 2009), income smoothing (Tucker & Zarowin, 2006), and so on. The concept of earnings management is defined differently by different researchers, depending on how they perceive it. Healy and Wahlen (1999) associated earnings management with the modification of financial statements over the use of decision in financial reporting and in organising transactions to modify financial reports to either deceive some stakeholders about the fundamental economic routine of the company or to manipulate predetermined outcomes that depend on reported

accounting numbers. According to Schipper (1989), earnings management comprises "disclosure management" in the sense of a focussed interference in the external financial reporting procedure, with an interpretation to obtain private improvement for shareholders or managers. To Fields, Lys and Vincent (2001), earnings management rises when managers workout discretion over accounting numbers, with or without limitations. The discretion is drilled to either maximize firm value (shareholders wealth) or to maximize the self-centred interest of managers (opportunistic earnings management). The definition of Fields, Lys and Vincent (2001) unlike the first two definitions proposes that earnings management could either be within or outside GAAP.

The definitions above suggest that accounting research is yet to agree on a lone definition of earnings management. This is because the concept is quite broad, and so not easily reducible to a single definition that is generally accepted by all accounting scholars. The definitions presented two opposing views concerning earnings management. The first argument sees earnings management as legitimate and beneficial to shareholders, especially when it is within the framework of GAAP. In contrast, the second argument views earnings management as unethical and not beneficial to the shareholders, particularly when it violates accounting principles (GAAP). Consequently, this study aligns itself with the second argument which views earnings management as unethical and not beneficial to shareholders of the firm. In the background of this study, earnings management is seen as the manipulation of financial statements by managers using accounting choices, estimates and methods that violate GAAP to achieve specific objectives that do not reflect the underlying economic realities of the reporting firm.

Generally, earnings management involves different activities ranging from legitimate to outright fraudulent financial reporting. These activities can be generally classified into four major types (Bauwhede & Willekens, 2003; Zhao, 2012). The first sort of earnings management arises from the exploitation of flexibilities in accounting principles (GAAP), commonly called "within GAAP earnings management". GAAP allows flexibilities to enable firms prepare financial statements that reflect underlying economic reality. However, some managers abuse these accounting flexibilities through earnings manipulation. Examples of flexibilities in GAAP include choosing between various inventory valuation techniques and depreciation methods. This sort of earnings management is alleged by some scholars as legitimate and beneficial to shareholders particularly, when it is well disclosed in the financial statements.

The second group of earnings management activities involves violation of accounting principles (GAAP). It is called "with-out GAAP" earnings management. Earnings management of this nature involves outright management fraud and is mostly associated with firms that have exhausted flexibilities in accounting principles to manage earnings. Dechow and Skinner (2000), call this form of earnings management fraudulent financial reporting. Fraud is described as "the intentional, deliberate misrepresentation or exclusion of physical facts or accounting data that is deceptive and will persuade the reader to alter or change his or her belief or decision if viewed with all other evidence made accessible". (The National Association of Certified Fraud Examiners, 1993: 12). Unlike "within GAAP" earnings management, this type of earnings management lacks legitimacy and is not disclosed in the financial statements. This is the kind of earnings management activities that normally attract auditors and regulatory sanctions.

The third classification of earnings management activities is called real activities manipulation. This is also a "within-GAAP" earnings manipulation but is different from earnings

management through accounting choices and is hardly subjected to auditor scrutiny. Earnings management through real activities manipulation involves “management activities that swerve from normal business practices, undertaken with the primary impartial of meeting certain earnings thresholds” (Roychowdhury, 2006). Examples of physical activities manipulation contain but not limited to earlier spending on maintenance or research and development (R & D) when reported earnings are higher than expected to reduce earnings number to desired level. The fourth group of earnings management activities is called classification shifting. Classification shifting is another form of “within-GAAP” earnings manipulation which entails “misclassifying line matters within the income statement to inflate core earnings” (Zhao, 2012: 2). An example of classification shifting is the shift of core expenses such as selling, administrative and general expenditures to special items such as restructuring charges.

2.1.3 Rationale for Earnings Management

There are different reasons that motivate managers to manage reported earnings. According to extant literature, some of the reasons for earnings manipulation include: increasing share prices (Schipper, 1989), meeting performance-based compensation target (Bergstresser & Philippon, 2006), avoiding debt covenant violations (DeFond & Jiambalvo, 1994), and manipulating earnings around equity offerings such as IPO and seasoned equity offerings (SEO) (Rangan, 1998; Teoh, Wong & Rao, 1998). Though several reasons can be given for earnings management, Healy and Wahlen (1999) categorized these motives into four main groups. These are capital market incentive, management compensation contracts incentive, debt contract incentive, and political and regulatory requirements incentive.

2.1.3.1 Capital Market Incentives

The interaction between reported accounting earnings and stock prices in the capital market has a potential influence on managers‟ ability to participate in earnings management. For instance, Kim and Yi (2006) provided evidence which shows that discretionary accruals for companies, whose stocks are traded publicly, are greater than private firms by a magnitude of at least 1.2 percent of lagged total assets. This result implies that stock markets are likely to provide incentives for public organisations to partake in earnings management.

In more advanced economies such as UK and US where the capital market is efficient, investors depend on analysts‟ forecasts in selecting portfolio of their investments from potentially successful firms. Meeting analysts‟ expectations in such capital markets is very important. Firms that meet or beat analysts‟ expectations attract higher returns on their stocks, even when it is likely that the expectations are achieved through earnings manipulations (Bartov & Mohanram, 2004). Missing analysts‟ forecasts for instance, in efficient capital markets have severe negative consequences for stock returns of publicly traded firms (Matsunaga & Park, 2001). This is because investors consider firms which miss analyst forecasts as being riskier than those that meet forecasts expectations. Consequently, when pre-managed earnings are less than forecasted earnings, managers are likely to manage earnings upwards to boost reported earnings. On the other hand, when pre-managed earnings are above analysts‟ forecasts, managers manipulate earnings downwards to defer some returns to future reporting periods (Habbash, 2010).

Other capital market situations such as equity offerings (e.g. IPO) also serve as incentives for earnings management in firms. For example, Companies which are going public for the first

time do not have previous stock prices, and so their initial stock prices are determined mainly by their financial performance before going public. This situation influences managers of IPO firms to manage earnings prior to IPO in order to attract favorable stock prices for their shares (Teoh, Wong & Rao, 1998).

2.1.3.2 Management Compensation Contract Incentives

Management compensation contracts also provide incentives for earnings manipulation of firms. Agency theory suggests that management compensation contracts could align the interests of shareholders with managers and minimize agency costs such as earnings manipulation. This is because management compensation contracts serve as monitoring and bonding contracts between managers, and shareholders of the firm (Habbash, 2010).

Management compensation contracts are often tied to accounting numbers to monitor whether or not the contract conditions are breached. However, when managers‟ compensation is tied to financial performance, managers are likely to make income-increasing accounting choices in order to maximize the value of their bonus rewards (Watts & Zimmerman, 1986). This implies that performance-based compensation plans have an unintended consequence over managers, as it motivates them to engage in earnings management to boost their rewards. Prior research confirms the positive association between earnings-based compensation plans and managers opportunistic behaviour. For example, Healy (1985) found evidence that managers manage earnings in order to increase cash compensation, when bonus rewards are tied to financial performance of the firm. Healy concluded that there is a strong association between accruals (proxy for earnings management) and managers‟ income-reporting incentives under a

management bonus plan. Also, Leuz, Nanda and Wysocki (2003) provided similar evidence in support of the association between performance-related reward and mangers‟ opportunistic behaviour. Therefore, management compensation plans tied to firm performance, provide incentives for managers to manipulate reported accounting earnings upwards in order to maximize their rewards at the expense of other stakeholders.

2.1.3.3 Debt Contract Incentives

There may be a conflict of interests between shareholders and bondholders, in addition to the conflict of interests between shareholders and managers predicted by the theory of the agency. (Jensen & Meckling, 1976). For instance, decisions such as excessive dividend payments made to favour shareholders' interests may be injurious to the interests of debt holders. The conflict of interests between shareholders and bondholders result in agency costs of debt to the firm. Jensen and Meckling (1976) suggested that these costs may be borne by shareholders and managers if no action is taken to reduce them by monitoring and bonding contracts. Consequently, managers have incentives to enter into monitoring and bonding contracts such as writing restrictive covenants in debt agreements. The debt covenants restrict for instance, the ability of management to pay dividends, issue new debt and also give debt holders the right to demand early repayment of their debt if minimum accounting numbers are not achieved (Habbash, 2010). Though debt is a cheap source of financing compared to equity, according to the debt covenant hypothesis (Watts & Zimmerman, 1978), more debts impose more restrictive conditions on the borrowing firm. The firm is therefore, under constant pressure to avoid violation of restrictive debts covenants associated with borrowing. But when highly indebted firms are close to violating these debt covenants, they resort to make income-increasing accounting choices to boost reported earnings (Bello & Yero, 2011) in a bid to avoid costs

associated with debt violation. Managers of firms close to violating debt conditions are therefore, more likely to manipulate accruals in order to avoid costs associated with debt covenant violation.

Abundant research also confirms the positive association between debt covenant violation and earnings management practices of firms. For instance, DeFond and Jiambalvo (1994) investigated the relationship between accrual manipulation and debt covenant violation for a sample of US firms. The study reported a positive association between debt covenant violation and abnormal accruals (proxy for earnings management) of US firms. Similarly, Sweeney

(1994), Bello and Yero (2011), Kim, Lisic and Pevzner (2011), Sincerre, Sampaio, Fama and Santos (2015) and Sepasi (2016) provided evidence of a positive correlation between debt and earnings management practices of firms.

2.1.3.4 Regulatory Requirements and Political Cost Incentives

Managers sometimes manage earnings because they are influenced by regulatory and political cost requirements. Regulatory requirements related to accounting numbers could provide the incentive for earnings management in public firms. Tight regulatory conditions in some countries put reporting firms under constant pressure and often influence them to manage reported earnings upwards. For instance, stringent listing requirements of some stock exchange provide incentives for earnings manipulation. Managers of firms listed on such exchanges often resort to manipulate earnings when they are close to violating listing regulations in order to remain listed on the stock exchange. Empirical evidence such as Haw, Qi, Wu and Wu (2005) and Johnson and Rock (2005) supported the positive association between regulatory requirements and earnings management of public firms.

Managers are sometimes motivated to manage earnings in order to avoid political costs (Watts & Zimmerman, 1986). The relationship between political costs and managerial opportunism is confirmed by many empirical studies such as Guay (2010), Kurdi (2010), Chen, Li, Liang and Wang (2011) and Braam, Nandy, Weitzel and Lodh (2015). For instance, Han and Wang (1998) provided evidence which shows that oil companies used income-decreasing accounting policies during the Gulf War to avoid political costs of showing higher profits from increased retail prices. In summary, regulatory requirements and political costs are more likely to motivate managers of public firms to manage accounting earnings. Managers utilize the deficiencies in regulatory requirements to manage reported earnings.

2.2 Theoretical framework for the study

The theories relating to audit quality are reviewed under this section. Most researches on audit quality and earnings management practices have often used the stewardship theory, the stakeholder theory and the agency theory to explain the relationship.

2.2.1 Stewardship Theory

The stewardship theory maintains that the benefits of managers (stewards) are aligned with those of the organization and the owners (Albrecht, Albrecht & Albrecht, 2004). The theory focuses on mechanisms that empower and facilitate the functioning of stewards rather than structures that monitor and control agents. Stewardship theory rejects the “policeman” attitude of the agency theory which assumes that the interests of principal and the agent are different, and sees agents as self-serving and self-centered (Habbash, 2010).

The stewardship theory proposes that managers as representatives of shareholders are dependable and good stewards of properties assigned to them and therefore need no monitoring (Donaldson, 1990; Donaldson & Davis, 1994). The theory posits that since managers are not unscrupulous and act in the best interest of the owners, they should be given self-sufficiency based on trust as this will reduce the cost of checking and regulating their behavior. Stewardship theory views monitoring of agents by the owners, and their representative as unnecessary, since managers are not opportunistic and will always act in the best interest of shareholders. Stewardship theory further argues that corporate executives are not only concerned with financial gains but by nonfinancial motives such as recognition from peers and bosses, and satisfaction from performing challenging tasks (Donaldson & Davis, 1994).

Consequently, the stewardship theory attracted several criticisms by those who believe that the interests of managers cannot be aligned with the interest of shareholders. Critics argue that monitoring mechanisms such as high-quality external auditors are necessary in cutting information asymmetry between shareholders and managers, in order to reduce agency costs such as earnings management. Heralding this argument is Albrecht *et al*. (2004) who contend that relying on the relationship between owners and stewards based on stewardship theory could rather provide opportunities for management to commit fraud. This theory therefore fails to sufficiently explain and analyze the relationship between audit quality and earnings management of firms.

2.2.2 The Stakeholder Theory

The stakeholder theory on the other hand views the firm as a nexus of relationships. Freeman (1984: 52), cited in Schilling (2000: 225) defines a stakeholder as "any group or person

who may or is impacted by the accomplishment of the goals of the organization". In the words of Clarke (2004), stakeholder theory defines the firm as multilateral agreements between the enterprise and its multiple stakeholders. Unlike the agency theory which reduces the stakeholders in a firm to only shareholders and managers, stakeholder theory views the firm as comprising more than two stakeholders (e.g. employees).

The company's relationship with its internal partners (such as workers, administrators and owners) is framed by structured and informal rules established over the relationship's history. While management receives finance from shareholders, they depend upon employees to accomplish the productive purpose of the company. External stakeholders (such as customers, suppliers and the community) are equally important, and also constrained by formal and informal rules that business must respect. The stakeholder theory recognizes that the firm and the society are interdependent. The firm therefore serves a broader social purpose than its responsibilities to only shareholders and managers as proposed by the agency theory (Kiel & Nicholson, 2003).

Though the stakeholder theory has more theoretical and practical appeal than agency theory, and stewardship theory, it is also heavily criticized because of the difficulty to treat equally and satisfy the competing demands of the multiple stakeholders in the firm as proposed by the stakeholder theory. The theory therefore, fails to adequately explain the connotation between audit quality and earnings management practices.

2.2.3 The Agency Theory

The agency theory is based on the association between the principal (shareholder) and the agent (managers). The separation of ownership from management and control in modern day

business corporations provides the basis for the function of agency theory. This separation provides the opportunity for an agent (manager) to be appointed to manage the daily operations of the company. This relationship however, creates the potentials for conflicts of interests between the agent and principal, and requires monitoring costs associated with resolving these conflicts (Jensen & Meckling, 1976).

Agency theory accepts that managers are motivated by their personal gains and work to exploit their personal interest and not the interest of the shareholders. Managers for instance may be interested in buying lavish offices, company cars and other extravagant items, since the cost of these items is not borne by them (managers) but the owners (shareholders). The main delinquent of agency theory is how to align the conflicting interests of the managers with the interests of shareholders. Consequently, when managers have incentives to manage earnings such as to come across or beat earnings target and performance-based compensation, they manipulate the company's reported earnings. This manipulation reduces the significance and dependability of reported accounting earnings and financial statements generally. Agency theory therefore suggests checking mechanisms such as high-quality audit to minimize these conflicts and bring into line the benefits of managers with the shareholders' interests.

The self-seeking interest of managers therefore, increases costs to the firm such as costs of contract formation, loss due to decisions taken by the agents and the costs of observing and controlling the actions of the agents. In light of the above, managers cannot be fully trusted by shareholders. Consequently, strict monitoring of managers by the shareholders or their representatives such as external auditors is suggested by agency theory to protect the benefits of shareholders from being compromised by the self-interest of managers. Agency theory adopts

that earnings management could be indicative of agency problem and may be constrained by observing mechanisms such as high-quality audit.

From the foregoing, agency theory explains better and clearer unethical practices in accounting and financial issues such as earnings management (EM). This study therefore draws on agency theory to ascertain the connection between audit quality and the incidence of earnings management in quoted oil marketing companies in Nigeria. Agency theory is chosen because it better explains the motivation for earnings management and the connotation between audit quality as a monitoring mechanism, and earnings management than the other theories.

2.4 Empirical Review of Literature

Literatures abound generally on the association between audit quality and earnings management both in the developed and developing economies. This is evident in the quantity of empirical studies conducted from both economies over the years. In developed economies for instance, the study of Becker, DeFond, Jiambalvo and Subramanyam (1998) investigated the connotation between audit quality- in terms of audit firm size and earnings management of a sample of United States (US) companies. The study estimated discretionary accruals (proxy for earnings management) using the cross-sectional Jones (1991) model. The result suggested that revenue increasing discretionary accruals for clients audited by big 6 auditors are lower than those of clients audited by the non- big 6 auditors. They observed further that variation in discretionary accruals for firms audited by Big 6 is lower than that of firms audited by non-big 6. The finding of the research is however limited because given the distinct nature of the US and Nigerian economies, findings of the research are not likely to apply to Nigerian companies in

general. Also, the study estimated discretionary accruals using the Jones 1991 model which erroneously assumes that all changes in revenue are non-discretionary accruals. Supposing the modified Jones (Dechow, Sloan, & Sweeney, 1995) model was used to estimate discretionary accruals, the findings might not have been the same. In addition, the study was conducted over a decade ago. With several developments that took place in the world's accounting system (US inclusive) since then, a new study might produce different results.

Ebrahim (2001) investigated the effect of audit quality on earnings management the research used a sample of 1,938 companies listed on NYSE, AMEX and NASDAQ for the period 1988- 1999. Earnings management- represented by discretionary accruals (DA) was estimated using the modified Jones model while audit quality was proxy by audit firm size, audit tenure and client importance. Results of the study indicated a significant negative association between audit firm size and DA in US firms. Audit tenure and client importance had insignificant negative relationship with DA in US firms. The negative association between client importance and DA implies that auditors are not more likely to allow their big clients more discretion in financial reporting than small clients. However, this study is also limited because given the distinct nature of the US and Nigerian economies coupled with the sampled companies, findings from the study are not likely to apply to listed manufacturing companies in Nigeria owing to the peculiarity of the sector.

Krishnan (2003) studied the association between audit quality measured by auditor industry expertise and earnings management for the period 1989-1998 for US firms. Using a sample of 4,422 firms audited by Big 6 auditors, the study documented evidence that firms audited by non-specialist auditors, report complete discretionary accruals that are higher than the discretionary accruals described by firms audited by specialist auditors. Similarly, Balsam,

Krishnan and Yang (2003) studied the connotation between audit quality measured by auditor industry specialization and earnings management. Using a sample of over 50,000 firm year observations for the period 1991-1999, they documented evidence that clients of specialist auditors have lower incidence of earnings management than clients of non-specialist auditors.

Piot and Janin (2005) examined the effect of audit quality on earnings management of a sample of 102 non-financial companies in France from 1999-2001. Earnings management represented by abnormal accruals was estimated using Jones 1991 model while audit quality was represented by big 5 audit firms and audit committee. The result of data analysis showed that big 5 audit firms have no effect on earnings management of the sampled companies in France. In contrast, apart from audit committee independence, audit committee is associated with less abnormal accruals of the sampled companies in France. Though this study is different from some prior studies as it included audit committee attributes in addition to external auditor attributes in measuring audit quality, the study is limited because it estimated abnormal accruals using Jones 1991 model which erroneously assumes that all changes in revenue are non-discretionary accruals.

Habbash (2010) examined the effect of external auditor quality and corporate governance attributes on earnings management in UK. Using a sample of 350 non-financial companies quoted on the London Stock Exchange to examine the connection between external audit attributes and earnings management, the study documented evidence that independent and specialized external auditors are negatively associated with earnings management of the sampled firms at significant levels. The result suggested that both auditor independence and auditor industry specialists impact negatively on earnings management of UK firms.

Gul, Fung and Bikki (2009) investigated the association between audit quality and earnings management for a sample of 32,777 firm year observations in US for the period 19932004. Using performance matched model (Kothari, Lcone, & Wasley, 2005) to estimate discretionary accruals (DA) and regression analysis to analyze the data collected, they documented evidence that the correlation between shorter auditor tenure and lower earnings quality is fainter for firms audited by industry specialists compared to those audited by nonspecialist auditors. This finding supported previous studies that documented an adverse connotation between auditor industry specialists and earnings management of firms. However, the study is limited because it estimated DA using Kothari, Lcone and Wasley (2005) model which is relatively more prone to type II error (accepting the null hypothesis when it should be rejected). Also, the model is relatively not widely tested in accounting research for estimating DA, like the Jones model. Consequently, its accrual estimation power is doubtful.

Rohaida (2011) studied the connotation between audit quality (represented by audit fees, industry specialist auditor, audit committee size, audit committee independence, audit committee financial expertise and audit committee meeting) and earnings management of companies in UK. Earnings management, represented by discretionary accruals, was estimated using Jones and modified Jones 1991 model, and Kothari, Lcone and Wasley (2005) model. Findings of the research showed that both audit fees and industry specialist auditors are associated with less earnings management of the sampled firms for all the measures of earnings management. Similarly, audit committee size and audit committee independence had insignificant negative relationship with the different measures of earnings management. Audit committee financial expertise and audit committee meeting had mixed results with the different measures of earnings management.

Molik, Mir, Mclver and Bepari (2013) examined the effect of audit quality on earnings management of Australian firms during the global financial crisis of 2006 to 2009. Earnings management represented by discretionary accruals were estimated using Jones (1991) model, modified Jones model (Dechow, Sloan & Sweeney, 1995) and the modified Jones model adjusted for firm performance (Kothari, Leone & Wasley, 2005) to enhance robustness. Panel regression analysis was used as the tool of data analysis for a sample of 149 firms. Findings of the study indicated a significant adverse connotation between audit committee independence and earnings management of firms. An insignificant positive relationship was however, found amid audit firm size (represented by Big 4), audit committee size, audit committee meeting, audit committee financial expertise and earnings management of the firms. Though the study is relatively better than some of the previous studies as it included audit committee attributes to capture the internal control aspects of audit quality, it is limited because it focused on only audit firm size and ignored other attributes of external audit quality such as auditor industry specialization, audit fees and auditor tenure.

Zhou and Guan (2014) examined the correlation between audit quality and earnings management of companies in China for the period 2008-2011. Discretionary accruals were estimated using the modified Jones model for a sample of 4,640 firm year observations. The study revealed that audit firm size has significant negative effect on earnings management in China, especially for firms with income increasing abnormal accruals. A positive connection was found between auditor industry specialization and earnings management of the companies. The relationship however, turns negative in firms with income decreasing earnings management in China. Though the findings of the research is in line with some prior studies, it focused on only

the external aspect of audit quality and excluded audit committee which indirectly improves the quality of audit services offered by external auditors.

There are also many studies from developing economies that examined the connection between audit quality and earnings management practices of firms. Gerayli, Yanesari and Ma'atoofi (2011) studied the association between audit quality and earnings management in Iran using 540 firm-year observations for the period 2004-2009. The dependent variable, discretionary accruals was estimated using the modified-Jones model (Dechow, Sloan & Sweeney, 1995) while multiple regression analysis was used to review the data collected. The findings indicated that discretionary accruals are negatively related to auditor size, auditor industry specialization and auditor independence measured by audit fees. The result implies that firms audited by high quality auditors are more likely to have less discretionary accruals than firms audited by lower quality auditors.

Also, Karimi and Gerayli (2014) studied the affiliation between audit quality (represented by auditor industry specialization and auditor tenure) and earnings management estimated through modified Jones 1991 model of 91 companies quoted on Tehran Stock Exchange (TSE) for the period 2008-2012. Evidence from the study indicated that auditor industry specialization is associated with less earnings management of firms listed on TSE. Auditor tenure had a negative but insignificant correlation with earnings management of the sampled companies. The study focused on just auditor industry specialization and auditor tenure, thus, giving a partial picture of the association between audit quality and earnings management of firms.

Hegazy (2015) investigates the effect of audit firm specialization on earnings management in Egyptian firms. A sample of seventy (70) auditors, comprising both specialist

auditors and nonspecialist auditors were given a common task with the same time to perform under the supervision of a professor of auditing and three (3) senior practicing auditors. Findings at the end of the experiment indicated that industry specialist auditors do not constrain earnings management better than non-specialist auditors.

Memis (2012) examined the association between audit quality and earnings management in 8 emerging countries using a sample of 1507 firm-year observations for 2008-2009. Discretionary accruals- a proxy for earnings management was measured using the modified Jones model. The discoveries of the study indicated that except for Brazilian and Mexican companies, there is significant relationship between discretionary accruals and audit quality measured by big 4 auditors. The result implies that audit quality does not constrain earnings management in all the sampled emerging countries (Brazil, Greece, Israel, South Korea, Mexico, Poland, Russia, and Turkey).

Inaam, Khmoussi and Fatma (2012) investigated the relationship between audit quality and earnings management of Tunisian firms using 319 firm year observations for the period 2000-2010. Using the modified Jones model (Dechow, Sloan & Sweeney 1995) to measure discretionary accruals, the study showed that auditor industry specialization and auditor size-measured by Big 4 auditors are negatively associated with earnings management of their clients. Auditor tenure had a negative but insignificant association with discretionary accruals. The study is limited because even though Tunisia and Nigeria are developing nations with several similarities, in view of the fact that the study was not directly in relation to manufacturing firms makes the findings unlikely to apply to oil manufacturing companies in Nigeria.

Ahmadzade, Hassanzadeh, Pooryegane and Ebrahimi (2012) examined the relationship between audit quality and earnings management of a sample of 73 companies listed on the Tehran Stock Exchange for the period 2008-2011. The result of the regression analysis indicated that audit firm tenure and audit firm industry specialization are negatively associated with earnings management of Iranian firms during the study period. The result implies that both auditor tenure and auditor industry specialization are associated with less earnings management in Iran. However, the fact that the study focused on listed companies in Iran generally and not specifically in relation to manufacturing companies may likely affect the application of the findings to listed oil marketing companies in Nigeria due to sectoral differences.

Yasar (2013) investigates the effect of audit quality on earnings management of companies quoted on Turkish Stock Exchange for the period 2003-2007. Empirical evidence from the regression analysis indicated a positive association between audit firm size and discretionary accruals of manufacturing firms in Turkey. The result implies that audit quality does not constrain earnings management in Turkey. The result of the study is however, limited because given the economic differences between Turkey and Nigeria findings from the study are not likely to apply to oil companies in Nigeria. Also, the study focused on only audit firm size and excluded many important attributes of audit quality such as auditor industry specialization which extant literature suggests could mitigate earnings management. The focus on only one attribute of audit quality therefore limits the generalisability of findings on the impact of audit quality on earnings management of firms. Pouraghajan, Tabari, Emamgholipour and Mansourinia (2013) investigated the association between audit quality and earnings management of a sample of 140 firms listed on Tehran Stock Exchange for the period 2006-2011. The modified Jones model was used to estimate discretionary accruals, a proxy for earnings

management. The result of data analysis showed an insignificant positive relationship between audit firm size and discretionary accruals. The result supported the findings of Yasar (2013) and suggested that audit firm size does not constrain earnings management of the sampled firms in Iran during the study period.

Chen, Wu, and Zhou (2006) also examined the association between audit quality and earnings management of the Taiwanian companies for the period 1998-2002. The study estimated discretionary accruals using the modified Jones model. Result of the regression analysis revealed that both Big 5 auditors (proxy for audit firm size) and industry specialist auditors are associated with less earnings management in Taiwan. The study is limited in view of the fact that its findings are not likely to apply to listed manufacturing firms in Nigeria due to economic and jurisdictional differences between Nigeria and Taiwan. Though Nigeria and Taiwan may all be developing nations, a few differences still exist between the two countries such as the level of capital market development and governance mechanisms in the stock market.

Bamahros and Wan-Hussin (2015) investigated the effect of audit quality on earnings management for a sample of 525 companies listed on Malaysian Stock Exchange (MSE) in 2009. Earnings management was represented by discretionary current accruals (DCA) estimated by the performance- adjusted model of Ashbaugh, Lafond and Mayhew (2003) and discretionary total accruals (DTA) estimated by the modified Jones model. Results of the study revealed a significant negative association between audit firm tenure and both measures of earnings management. Using audit firm size (big 4), audit fees, audit committee independence, audit committee financial expertise and audit committee meeting to control for other audit quality proxies that affect earnings management, the study found significant negative association between audit committee financial expertise and both measures of earnings management. Audit

committee independence had a significant positive association with DCA but became insignificant with DTA. The results also revealed an insignificant negative relationship between audit firm size and audit committee meeting, and earnings management.

Also, Ching, Teh and San (2015) investigated the relationship between audit quality and earnings management for a sample of one hundred (100) industrial products and consumer products companies listed on the main board of Bursa Malaysia during the period of 2008-2013. Audit quality was proxy by audit firm size, audit fees, and audit partner tenure. Earnings management, represented by absolute discretionary accruals was estimated by the modified Jones (1991) model. The result of data analysis using regression technique indicated that both audit firm size and audit fees have insignificant negative relationship with earnings management of listed industrial products and consumer products companies in Malaysia. Audit partner tenure had an insignificant positive relationship with the sampled companies in Malaysia during the study period.

There are also relatively few studies in Nigeria that examined the association between audit quality and earnings management of firms. Okolie, Izedonmi, and Enofe (2013) examined the effect of audit quality on earnings management of companies listed on the NSE for the period 2006-2011. Using a sample of 57 manufacturing firms and regression analysis to analyze the data, the study documented a significant negative association between audit quality (proxy by audit firm size, audit tenure, audit fees, audit client importance) and discretionary accruals of the sampled companies. Similarly, Okolie (2014) investigated the relationship between audit quality and accrual-based earnings management of Nigerian firms. Using a sample of 57 non-financial firms listed on the NSE and the modified Jones model to measure discretionary accruals, the study documented a significant positive association between audit fees and discretionary

accruals, and a negative association between audit tenure and discretionary accruals of Nigerian companies. Though the two Nigerian studies produced consistent results, there are also limited because all of them ignore the internal control aspect of audit quality (audit committee).

Also, Aliyu, Musa and Zachariah (2015) examined the effect of audit quality (represented by audit firm size, joint audit and auditor financial dependence- a measure of client importance) on earnings management of listed deposit money banks in Nigeria. Earnings management proxy by discretionary loan loss provision was estimated using Beaver and Engel (1996) model, tested by researchers such as Fiechter and Meyer (2011). The study used a sample of seven (7) deposit money banks listed on the NSE for the period of 2006 – 2013 while data analysis was done using ordinary least square (OLS) regression technique. Findings from data analysis indicated that both audit firm size and joint audit have significant negative effect on earnings management of listed deposit money banks in Nigeria. Auditor financial dependence had a significant positive effect on earnings management of listed deposit money banks in Nigeria during the study period. Though this study is from Nigeria, it is limited because given the peculiar nature of the banking sector; it is likely that its earnings management will be different from other sectors such as the manufacturing companies.

Tyokoso and Tsegba (2015) investigated the effect of audit quality on earnings management of listed oil marketing companies in Nigeria for the period 2004-2013. The dependent variable earnings management represented by discretionary accruals (DA) was estimated using the modified Jones model while the independent variable audit quality was represented by audit firm size, auditor industry specialization and auditor tenure. The findings of the study indicated that both audit firm size and auditor industry specialization have insignificant

negative effect on DA of the sampled listed oil marketing companies in Nigeria during the period of study. In contrast, auditor tenure had a significant negative effect on DA of the companies.

The review of the empirical literature above revealed that most of the empirical evidences are foreign literatures. Thus, empirical studies from Nigeria are relatively scanty and have just started gathering momentum. Besides, empirical evidence on the relationship between audit quality and earnings management from both developed and developing economies are mixed and inconclusive, thereby providing a basis for further research.

CHAPTER THREE

METHODOLOGY

3.0 Introduction

Methodology describes the procedures to be followed in realizing the goals and objectives of the research (Ogolo, 2012). This chapter therefore presents in details the instrument and procedure that is employed for this research. It discusses the research design, study area, population of the study, sample of size and sampling technique, source of data collection, instrument of data collection, method of data analysis, and model specification.

3.1 Research Design

The research design adopted for this study is the time series Ex-post Facto design and analytical research design. Ex post facto was adopted in the study because it allowed data with qualities that already exist to be compared on some dependent variable. In doing this, the required information is obtained from the annual financial reports of the selected companies and classification of data were also done in line with certain models where appropriate.

3.2 Study Area

The research was conducted in Lagos State where many of the manufacturing companies operating in Nigeria are located or have the operation offices.

3.3 Population of the Study

The population of the study comprises of all the listed consumer goods companies under manufacturing sector listed on the floor of the Nigerian Stock Exchange, which are 20 in number as at 31st December 2018.

3.4 Sample Size

The sample size is usually a compromise between what is desirable and what is feasible. For the purpose of this study, five (5) consumer goods manufacturing companies are selected.

3.5 Sampling Technique

The sample size of 5 consumer goods manufacturing companies was selected using the purposive sampling technique for the period (2014-2018).

3.6 Sources and Method of data collection

The method through which data were gathered and sampled to facilitate this research is secondary methods. The secondary data used for literatures were sourced from the company's financial reports, journal articles, published and unpublished papers, online resource, text books, and library search. Data used for the purposes of analysis span a period of 2014 to 2018 period. This information is retrieved from the websites of the Nigeria stock exchange and those of the selected companies.

3.7 Instrument of Data Collection

For the purpose of this research, annual reports of the companies were used as the instrument for collection of secondary data. The annual report was collected from the stock exchange website. This information collected was used in providing answers to the questions raised in the study.

3.8 Data Analysis Technique

In analyzing the data, the researcher made use of Statistical Package for Social Sciences (SPSS) to generate the analysis. The pooled ordinary least square (OLS) regression technique was used to test the relationship between the dependent variable and the independent variables.

3.9 Model Specification

The pooled ordinary least square (OLS) regression technique model is used to test the research hypotheses. The regression model is stated thus:

$$Y = \beta_0 + \beta\chi_1 + \beta\chi_2 + \beta\chi_3 + u_t$$

Where:

Y = Earnings Management (proxy by discretionary accruals)

X_1 = Auditor Firm Size (AFZ)

X_2 = Auditor's Tenure (AT)

X_3 = Auditors' Industry Specialization (AIS)

u_t = Error term

3.10 Identification and Measurement of Variables

In this study, audit quality (proxy by audit firm size, audit tenure, and auditors' industry specialization) represents the independent variable while earnings management (proxy by discretionary accruals) represents the dependent variable. The measurement yardstick of each of these variables are discussed as follows:

Audit Firm Size (AFZ): The size of the audit firm takes the value 1 if the firm is audited by the "Big 4" and 0 otherwise (DeAngelo,1981; Chalmers & Godfrey, 2004).

Audit Tenure (AT): This is measured as number of consecutive years the client has retained a particular audit firm (Zgarni, Hlioui & Zehri,2012; Chinga, Tehb, Sanc &Hoed, 2015).

Auditors' Industry Specialization (AIS): A dummy variable 1 if market size (MS) of the auditor ≥ 20 percent and 0 otherwise.

CHAPTER FOUR

DATA PRESENTATION, ANALYSIS AND INTERPRETATION

4.1 Introduction

In this chapter the researcher focused on the presentation and analysis of the data obtained from the financial statements of the sampled food manufacturing companies. The researcher used descriptive statistics to analyze the data and observed statistical measures such as the mean, standard deviation, minimum, and maximum. Thereafter, the pooled ordinary least square (OLS) regression technique was used to test the research hypotheses.

4.2 Descriptive Analysis of Data

In this section, preliminary analysis was done on the data collected. This involve the use of descriptive statistics such as mean, standard deviation, maximum, and minimum. The mean describes the average value in the series and the standard deviation measures the volatility of the data or the amount of deviation of the data from the average. This is presented in Table 4.1 below:

Table 4.2: Descriptive Statistics

Variables	DAC	AFS	AT	AIS
Mean	5.06	0.57	5.80	4.32
Maximum	0.74	1	1	1
Minimum	0.01	0	0	0
Std. Dev.	0.13	0.41	4.06	2.08

Source: Researcher’s Computation, 2020.

The descriptive analysis from Table 4.1 above revealed that the mean value of discretionary accruals is 5.06, while the standard deviation is 0.13 which implies a high deviation of the values from the mean. The maximum and the minimum values are 0.74 and 0.01 respectively.

The next variable is the Audit Firm Size (AFZ), this has a mean value of 0.57 and a standard deviation of 0.41 which portrays a moderate deviation from the mean. The maximum value for AFS is 1 while the minimum value is 0.

The descriptive analysis further revealed that Auditors' Tenure (AT) has a mean value of 5.80, with a standard deviation of 4.06. This shows a reasonable deviation from the mean. The maximum value for AT is 1 while the minimum value is 0.

Lastly, Auditors industry specialization (AIS) has a mean value of 4.32, a standard deviation of 2.08, which indicate a slightly moderate deviation from the mean. The maximum and the minimum values here are 1 and 0 respectively

4.3 Regression Analysis

Table 4.2: Pooled OLS Regression Results

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Constant	-0.006	85.836	0.007	0.897
AFS	0.059	58.798	0.633	0.426
AT	0.003	152.519	1.601	0.008
AIS	0.086	580.581	2.069	0.000
R-squared	0.844			
Adj. R-squared	0.778			
F-statistic	12.703			
Prob(F-statistic)	0.003			
Durbin-Watson	1.828			

Source: Regression Result extracted from Appendix II (SPSS Regression Output, 2020)

Interpretation of Results

Table 4.2 above shows that the coefficient of determination (R-squared) is 0.844, implying that over 84.4% of the systematic variations in the dependent variable (discretionary accruals) is due to the influences of the independent variables (AFS, AT, and AIS) used in the model. The remaining 15.6% variation were caused by other random variables not included in the model but captured by the error term (u_t). The implication of this is that the independent variables are good predictors of earnings management, and therefore the model is a good fit.

The regression constant value of -0.006 is slightly negative, which implies that earnings management as proxy by discretionary accruals would be insignificantly negative if the independent variables are held constant. The implication is that without the influence of the independent variables (AFS, AT, AIS), the dependent variable (DAC) will remain negative.

Considering the positive coefficient values of the independent variables, these show that positive relationship exists between auditors' firm size (AFS), auditors' tenure (AT), auditors' industry specialization (AIS), and discretionary accruals (DAC). However, the coefficient of auditors' tenure (AT) and auditors' industry specialization (AIS) having a p-value < 0.05 are statically significant. This implies that increase in AT and AIS will result to a significant increase in the discretionary accruals.

The F-statistics measures the overall significance of the regression model. Here, F-statistics = 12.71, with p-value 0.003, $p < .005$. The implication is that in the overall, the independent variables are jointly significant.

4.4 Test of Research Hypotheses

The decision rule for test of the hypotheses in this study will be based on the p-value. This will be considered at 5% level of significance. Thus, the null hypothesis is rejected if p-value < 0.05, otherwise it is retained. The decision to reject or fail to reject the null hypotheses (H_0) is shown in Table 4.3.

Table 4.3: Statistical Significance of Independent Variables

Variable	t-stat	p-value	Remark	Decision
Audit Firm Size	0.633	0.426	Not Significant	Retain H_0
Audit Tenure	1.601	0.008	Significant	Reject H_0
Auditor Ind. Specialization	2.069	0.000	Significant	Reject H_0

Source: Researcher's Computation, 2020.

4.4.1 Test of Hypotheses I

Ho_1: There is no significant relationship between audit firm size and earnings management in the Nigeria consumer goods manufacturing companies.

In the first case, the null hypothesis which states that there is no significant relationship between audit firm size and earnings management in the Nigeria consumer goods manufacturing companies is retained. From the results, Audit Firm Size = (t = 0.633; and p= 0.426). Therefore, since the p-value is > 0.05 at 5% level of significance, shows a weak evidence against the null hypothesis, the null hypothesis is retained; and we can conclude that there is no significant

relationship between audit firm size and earnings management in the Nigeria consumer goods manufacturing companies.

4.4.2 Test of Hypotheses II

Ho_2: There is no significant relationship between audit tenure and earnings management in the Nigeria consumer goods manufacturing companies.

In the second case, we reject the null hypothesis which states that there is no significant relationship between audit tenure and earnings management in the Nigeria consumer goods manufacturing companies. Results from the regression analysis revealed that Auditor Tenure = (t = 1.601; and p= 0.008). Since p-value of 0.008 > 0.05, at 5% significance level, there is a strong evidence against the null hypothesis, hence the null hypothesis is therefore rejected. The implication of this is that a significant relationship exists between audit tenure and earnings management in the Nigeria consumer goods manufacturing companies.

4.4.3 Test of Hypothesis III

Ho_3: There is no significant relationship between auditors' industry specialization and earnings management in the Nigeria consumer goods manufacturing companies.

Also in the third case, the null hypothesis which states that there is no significant relationship between auditors' industry specialization and earnings management in the Nigeria consumer goods manufacturing companies is rejected. From the results, Audit industry specialisation = (t = 2.069; and p= 0.00). Therefore, since the p-value 0.000 is < 0.05 at 5% level of significance, it presents a strong evidence against the null hypothesis, hence the null hypothesis is rejected. The

implication is that there is a significant relationship between auditors' industry specialization and earnings management in the Nigeria consumer goods manufacturing companies.

4.5 Summary of Findings

From the test of research hypotheses, there was a mix empirical result. The following findings can be summarized as follows:

i. Audit firm size, though has a positive effect on earnings management of the Nigeria consumer goods manufacturing companies, it is not significantly so. This means that there is no significant relationship between audit firm size and earnings management
ii. On the other hand, a significant positive relationship exists between audit tenure and earnings management in the Nigeria consumer goods manufacturing companies.
iii. However, the results revealed that the relationship between auditors' industry specialization and earnings management is the most significant in the model.

CHAPTER FIVE

SUMMARY CONCLUSION AND RECOMMENDATIONS

5.0 Introduction

In this chapter, the researcher provides the summary of the study, the conclusion, and recommendations made based on the findings.

5.1 Summary

This study focused on the effects of audit quality on earnings management in the Nigeria manufacturing sector. Specifically, a number of audit quality variables that affect earnings management of firms such as audit firm size, auditors' tenure, and auditors' industry specialization, were examined in relation to earnings management in food manufacturing sub-sector. The research design adopted for this study was the survey research design. The method through which data were gathered and sampled to facilitate this research was the secondary method of data collection in which information were sourced from the financial statement of the companies used. In analysing the data, the researcher made use of descriptive statistics and the pooled OLS regression method was used to test the relationship between audit quality and earnings management. The results of the study showed that among other variables of audit quality capable of enhancing the earnings management of food manufacturing companies in Nigeria, auditors' industry specialization is the most significant. It was also observed that audit tenure has a positive and significant effects on earnings management of food manufacturing companies in Nigeria.

5.2 Conclusion

Financial reports provide a basis in which investors and owners of firms usually appraise the performance of their companies. Earnings (net profits) are referred to as the main determinant of firm's economic performance and they also provide important information for potential decision about investment, and so can be greatly influenced by the audit quality of audit reports. The results of the study showed that, to checkmate decisions taken and ensure correct reporting of state of affairs of a business the audit quality became a paramount. It has been expressed that credible financial information is vital to the growth of any economy, in the same vein that auditors are expected to be objective in the discharge of their responsibilities.

As discussed earlier, the outcome of the tests revealed that among other components of audit quality capable of enhancing the earnings management of a business firm, auditors' industry specialization is the most significant, followed by audit tenure. Therefore, management, directors and owners of business ought to pay keen attention to auditors' industry specialization, and audit tenure as these have positive and significant effects on earnings management of food manufacturing companies in Nigeria.

5.3 Recommendations

The increasing concern intensified in earning management is due to cases of inappropriate accounting disclosures and financial recklessness in the Nigerian food manufacturing sub-sector. These incidences further prove the need for regulatory authorities to tighten the financial reporting activities of listed companies in Nigeria to ensure quality financial

reporting. However, the following recommendations are made based on the findings of this study:

i. In Nigeria, regulatory authorities such as the SEC should come up with a policy that allows audit firms in Nigeria to create divisions within their companies that specialize in companies listed on the Nigerian Stock Exchange (NSE) along industry lines. This is necessary despite the fact that there are relatively few companies listed on the NSE and irrespective of the significant positive relationship between auditor industry specialization and earnings management of sampled firms. Auditor industry specialization should be encouraged because of its significant in financial report quality

ii. The study recommends a reasonable period of auditor tenure. Auditor tenure of at least three years would enable the auditor acquire client specific experience that could make him detect questionable financial reporting practices of the firm more easily than he was at the beginning of his audit engagement while an auditor tenure of less than three years could deny the auditor firm specific experience, thus resulting to increase in earnings management of firms.

iii. Companies who hire the services of audit firms should judge audit firms on the basis of performance in prior assignments and not just the size of the audit firm. Those who hire audit services in Nigeria should consider competence and experience of the audit firms rather than size. Also, users of audited financial statements should subject all audited financial statements to the same scrutiny regardless of whether the audit report is from a big or small audit firm. This is to avoid making wrong investment decisions.

iv. Attention should also be focused through periodic checks and proper audit actions on attempts by companies to smooth or increase earnings to beautify its attractions in the

financial reports through unnecessary manipulation of real economic operations and cash flows.

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