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CONTENTS

AUDIT QUALITY, TENURE AND REAL EARNINGS MANAGEMENT OF LISTED NONFINANCIAL FIRMS IN NIGERIA

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Abstract

Earnings management is volatile due to its asymmetric nature by managers of non-financial firms. Yet, very few studies have examined the issues that cause this manipulation, especially in non-financial firms. This study, therefore, examines the relationship between audit big4 and audit tenure on REM of 76 listed non-financial firms in Nigeria using a 10-year data set (2010-2019). The MachammeRatios Database is used for data extraction. The results indicate that audit big4 shows significant positive effects on real earnings management. However, audit tenure shows in significant adverse effects on real earnings management. The paper, therefore, concludes that Audit Big4 is very important in mitigating real earnings management in the non-financial companies in Nigeria. The empirical findings are essential for non-financial firms' policy enhancement and further research and contributions to the body of knowledge. Managers should improve audit tenure while enhancing audit big4 independent to reduce incidence earnings management.

Keywords: Audit Big4, audit tenure, real earnings management.

1. Introduction

Earnings management is a pervasive problem, spreading across organizations and industries; it distorts earnings quality and utility for investment decisions, diminishing investor confidence in financial reporting. The level of information asymmetry between shareholders, management, and knowledgeable and uninformed investors is the cause. Therefore, the demand for external audits is fueled by agency issues related to ownership and control separation—shareholders' investments in public companies to their contracting agent and management. Stakeholders want the agent to supply relevant and trustworthy data for various corporate operations, such as investments, financing, liquidity, dividends, mergers, and acquisitions, to name a few (Adamu et al., 2017; Hassan & Ibrahim, 2014). Due to extensive accounting and financial manipulation at the hands of its contractual agent, the public faith in businesses has badly broken in recent years (Brown, 2013; Hassan & Bello, 2013). Firms must act as good stewards to their owners, displaying their actual situation and performance and demonstrating the quality of their earnings (Admati, 2017; Ibrahim et al., 2020).

Experienced accountants will be able to arrange transactions that satisfy their earnings aim where businesses diverge (REM) or manipulate their performance metrics to provide the appearance of success without actually creating value. The output may be favorable in the short term but not in the long run (Adamu et al., 2017; Ibrahim, 2020). Enron, Tyco, and other financial reporting crises have highlighted the need for audit quality and governance systems, which are critical for influential non-financial firms in Nigeria.

Furthermore, external examination, like an internal audit, is essential to improve the reliability, objectivity, and soundness of financial reporting, promote accountability, reduce any intelligent board behavior, and improve the proficiency and effectiveness of internal controls (Wolnizer, 1995). According to Anderson et al. (2001), a director with a more considerable profit incentive, the auditor perceives such a director as more aggressive, as someone who wants their financial accounts to seem reasonable and expects the auditors to agree with their reports. As a result, when auditors become aware that CEOs are manipulating earnings, they will report income smoothing. Similarly, the financial scandals have cast doubt on the audit function truthfulness, reliability, utility, or value relevance. In the last decade, Badawi (2008) compiled a list of corporations involved in accounting scandals involving poor external audit quality and earnings manipulations in the United States. Corporate scandals in Nigeria, such as those involving Cadbury Nigeria Plc and Lever Brothers Nigeria Plc, have been widely publicized and have resulted in false financial reporting (Adeyemi & Fagbemi, 2010; Yusuf, 2020).

The Nigerian context provides a rich contextual foundation for examining the impact of audit quality on earnings management. Apart from a few instances of accounting fraud, the dearth of scientific research in this sector adds to the case. Previous studies focus on financial institutions, while few in the oil and gas industry see Alao and Gbolagade (2019); Tyokoso and Tsegba (2015). The Big4 audit companies continued dominance in the Nigerian audit sector, the country's flawed corporate governance system, and little or no lawsuit risk against auditors are all considered in this study.

This study investigated the relationship between audit big4 and audit tenure on REM among Nigerian quoted non-financial firms. As a result, the findings of this study will be helpful to the appropriate authorities. Following the introduction, the work proceeds as follows: the second portion covers past related empirical investigations in addition to the theoretical review. Meanwhile, the various sections explain the methodology, practical results, conclusion, and recommendation.

2. Literature Review and Hypothesis Development

According to agency theory, monitoring systems are supposed to align the interests of managers and shareholders, removing the inherent conflict of interest in the corporate form of organization and the managers' opportunistic behavior (Alzoubi 2016). An auditing function is a monitoring tool that aligns managers' and shareholders' interests, limits managers' opportunistic behavior in earnings management, etc. It reduces the asymmetry of knowledge between management and shareholders (Alvin et al., 2012). Big 4 auditors have proxied audit quality (Ibrahim et al., 2020, Wu et al., 2016). According to research on audit quality and earnings management, firms audited by the Big 4 have lower earnings management levels than firms examined by non-Big4 auditors (Alzoubi 2016; Ibrahim et al. 2020).

Audit Big4 and Earnings Management

Studies that demonstrated Big4 auditors perform higher-quality audits than non-Big4 auditors have primarily examined in the United States and other countries where auditors face a substantial risk of shareholder litigation if they provide lower-quality auditing. Recent data reveals that client factors, particularly size, play a role in audit quality disparities between Big 4 and non-Big4 auditors (Lawrence et al. 2011). According to Ajona et al. (2008), Big 4 auditors behave differently in different nations regarding profit management, which varies systematically with differences in the economic environment and particular institutional contexts. Alzoubi (2015) discovered that the level of earnings management is significantly less among companies hiring a Big4 audit firm. The Big4 auditors will enforce higher earnings quality and greater conservatism on clients' financial statements (Eilifsen & Knivsfla, 2016; Agyei-Mensah, 2019; Ibrahim et al., 2020; Le & Moore, 2021). According to research conducted in Belgium, France, Greece, Korea, Malaysia, and Turkey, there is no substantial difference in the levels of earnings management of Big 4 and non-Big4 audited enterprises, according to research conducted in countries such as developed and emerging economies (Yasar 2013; Ching et al. 2015; Abid et al. 2018). Therefore, it is pertinent to investigate audit big4 against REM. Thus, we hypothesize that;

H1. There is a significant relationship between audit big4 and REM.

Audit Tenure and Earnings Management

The audit committee has the responsibility and role of overseeing the financial reporting process on behalf of the commissioners who represent the owner to ensure that no manager's actions affect the owner. Over a more extended period, the committee can better understand management's features when running a business (Prasetyo 2014). Audit committees who have been in office for a long time may have knowledge and expertise in financial statement auditing. The tenure has no bearing on REM. The length of service positively impacted accrual quality (Dhaliwal et al., 2010). The size of one's employment has a good impact on REM.

Meanwhile, Bedard et al. (2004) discovered a link between aggressive earnings management and audit committee terms. According to auditing literature, the shorter the tenure of an audit company, the better the firm's performance and audit quality (Guindy & Basuony, 2018). On the other hand, some believe that the longer an audit company works with a client, the greater the risk of compromising audit quality and eroding long-term firm performance (Chi et al., 2011, Sun et al., 2014; Ibrahim et al., 2020; Soyemi et al. 2020; Susanto & Pradipta, 2020). The hypothesis is:

H2: Audit committee tenure does not have significant effects on REM.

3. Methodology

This study adopted panel data from financial statements from 2010 to 2019 to analyze the nexus between the audit big4 and audit tenure on REM in listed non-financial firms of Nigeria. The data accesses from the MachameRatios DataBase and financial statement. There are 112 listed non-financial firms in Nigeria as of 31st December 2019, and this study deleted 37 firms on technical suspension by the Nigerian Stock Exchange. As a result, the study utilized the remaining 75 firms. Therefore, the study uses correlational research analysis since it addresses cause and effect linkages. Similarly, skewness and kurtosis, correlation analysis, variance inflation factor, and tolerance level for multicollinearity are carried out to make the estimation free of bias. Test for heteroskedasticity, Breusch/Pagan Lagrangian Multiplier test for panel effect/Ordinary Least Squares, and Hausman specification test for random effect model/fixed-effect model used to diagnose the data, and together with descriptive and inferential analyses, and the test results interpreted at 5 percent level of significance. The empirical models for the study are as follows:

Variable Measurement

Previous studies on earnings management used the Dechow et al. (1995) model, advanced by Roychowdhury (2006), and later studies used modified Roychowdhury (2006) models to quantify REM. On the subject of corporate finance and associated literature, authors such as Roychowdhury (2006) emphasize the idea of earnings management. This research used the Cohen et al. (2008); Kouaib and Jarboui (2017); Almashaqbeh et al. (2019) model, which includes three proxies for REM:1) unusual discretionary spending, 2) unusual manufacturing costs, and 3) unique cash flow of funds

$DISXt/TA_{t-1} = a_0+(1/TA_{t-1})+a_1(SALES_{t-1}/TA_{t-1})+e_t$ …………………………………………………… (1)

$PRODt/TA_{t-1}= a_0+(1/TA_{t-1})+ a_1(SALES_t/TA_{t-1})+a_2 (\Delta SALES_t/TA_{t-1})+a_3(\Delta SALES_{t-1}/TAt\text{-})+e_t$……… (2)

$CFO\ t/TA_{t-1} = a_0+(1/ TA_{t-1})+ a_1(SALES_t/TA_{t-1})+a_3 (\Delta SALES_t/TA_{t-1}) + e_t$…………………………..... (3)

Therefore, these equations are to calculate normal DISEXP, PROD, and CFO and derived residual.

Where;

DISEXP, and PROD: discretionary expenses. St: the sales in year t. ΔSALES t: (SALES t - SALES t-1) change in current sales from t-1 to t. SALES t-1: sales in year t-1. ΔSALES t-1: change in sales, TAt-1: is the total asset by the end of the year as expressed through t-1, and PRODt: the cost of production CFOt: current cash flow from operation. Outside the average level of expenditures in the business (REMDIXEPt) and abnormal levels of production cost (REM PRODt) as measured as the residuals of equation (2) while, operating cash flows for the business (REMCFOt) calculated under the title of equations (3) and 2 multiplied by −1. REMt is the sum of REMDIXEPt ; REMPRODt, and REM CFOt. The residual is:

REM= CFO*(-1) + DISEXP*(-1) + PROD.

The regression model used to examine the association among the independent variables (i.e., audit big4, audit tenure) and REM is as follows:

$REM_{it} = \beta_0+ \beta_1 AUDB4_{it} + \beta_2 AUDTE_{it} +\beta_3 FSIZE_{it} + \beta_4 FAGE_{it} + e_{it}$.

Whereas:

REM = Real earnings management,
AUDB4 = Audit Big4 (Non-Jordanian).
AUDTE = Audit tenure,
FSIZE = Firm size,
FAGE = Firm Age,
e = Error term

Abnormal levels of production cost (REM PRODt) as measured as the residuals of equation (2), while the outside the normal level of expenses in the business (REMDIXEPt) and operating cash flows for the business (REMCFOt) are measures under the title of equations (1) and (3) multiplied by −1. REMt is the sum of REMPRODt , REMDIXEPt and REM CFOt. REM= CFO*(-1) + DISEXP*(-1) + PROD (4). The measurement of independent and control predictors depicts in the table 1:

Table 1: Operationalization of the variables

Variables	Measurement
AUDQ	Audit quality is proxy with big4 which is equal to 1 if the company is audited by a Big 4 audit firm and 0 otherwise (Alzoubi, 2015;).
AUDTE	Audit tenure is the number of years audit big4 client relationship (Ibrahim et al., 2020; Lee & Moore, 2021)

FSIZE	Firm size is the natural logarithm of total assets (Alzoubi, 2016).
FAGE	Firm age is the natural logarithm of fit age of incorporation to date (Wu et al., 2020).

Source: Authors compilation, 2021.

4. Result and Analysis

This section is devoted to the results of the series of analyses carried out, the contrast and comparison with empirical results from previous related studies, and the results of the descriptive analysis depicted in Table 2 as follows:

Table 2: ***Results of Descriptive Analysis***

Variables	No. of Obs.	Mean	Standard Deviation	Min	Max	Skewness	Kurtosis
REM	760	.041	.028	.000	.3062	3.188	22.058
AUDQU	760	.572	.495	0.000	1	-.2923	1.086
AUDTE	760	.766	.424	0.000	1	-1.255	2.576
FSIZE	760	7.081	.816	5.093	9.241	.206	2.587
FAGE	760	26.183	13.379	1	55	-.258	1.743

Source: STATA 13 Outputs, 2022

Table 2 presents a summary of the descriptive indicators of the variables of interest in the paper. The number of observations is 760, derived from the 76 listed non-financial firms and the study's ten (10) years. In terms of the audit big4 of the firms, the average audit big4 over the ten years is 0.572. However, the minimum audb4 is 0.000, and the maximum audb4 is 1. Concerning audit tenure, the average AUDTE is .766. These results clearly show that the audit tenure is extended even as big4, which implies that the uses of audit big4 in non-financial firms in Nigeria are underutilized. In terms of control variables, the average value of FSIZE is 7.081, while the minimum is 5.093 and the maximum is 9.241. Also, the average FAGE is 26.183 with minimum and maximum values of 1 and 55, respectively.

Table 3: ***Results of Correlation Test***

Variables	REM	AUDB4	AUDTE	FSIZE	FAGE
REM	1.0000				
AUDB4	0.1501	1.0000			
AUDTE	-0.0035	0.0495	1.0000		
FSIZE	0.0497	0.3311	- 0.0079	1.0000	
FAGE	0.0076	0.0655	-0.0443	0.1533	1.0000

Source: STATA 13 Outputs, 2022

Table 3 reports a bivariate association between variables. Results indicate that AUDB4 has significant positive associations with REM. However, AUDTE failed to show any meaningful relationship with REM price. The associations among the predictors offer a maximum coefficient of 15.01 percent (between AUDB4 and REM), which falls short of the 80 percent required to prove the presence of multicollinearity among the independent variables.

Table 4: Multicollinearity Test Results

Variables	VIF	1/VIF
AUDQU	1.15	0.872670
AUDTE	1.13	0.887383
FSIZE	1.03	0.974313
FAGE	1.01	0.994914

Source: STATA 13 Outputs, 2022

Table 4 presents the results of the VIF and tolerance value of the series to consider the likelihood of multicollinearity. The variables have VIFs of less than 2 and a tolerance of higher than 0.5 across the panels. Therefore, it suggests an absence of multicollinearity because values are below the benchmark of 10 for VIF above 0.10 for tolerance (Wooldridge, 2010; Field, 2013).

Table 5: ***Results of Breusch/Pagan Lagrangian Multiplier Test***

Chibar2 (01)	11.28
Prob > Chibar2	0.001

Source: STATA 13 Outputs, 2022

Table 5 presents the outcome of the Breusch/Pagan Lagrangian Multiplier Test assists in deciding between a random-effects model and a simple Ordinary Least Square (OLS). As clearly indicated in Table 6, the Prob > Chibar2 is not significant (p-value = 0.001), which implies that there are no panel effects in the model, and therefore, OLS is the most appropriate for the study.

Table 6: ***OLS Regression Results***

REM	Coef.	Robust Std. Err.	t	P>t
AUDB4	.0085648	.002169	3.95	0.000
AUDTE	-.0007341	.0023929	-0.31	0.759
FSIZE	5.18e-06	.0013269	0.00	0.997
FAGE	-5.82e-06	.0000766	-0.08	0.939
_cons	.0367642	.0092751	3.96	0.000
Number of Obs. = 760				
F(4, 755) = 4.38				
R-squared = 0.0227				
Adj R-squared = 0.0175				
Hettest: Chi2(1) = 11.28.				
Prob>chi2= 0.0008				

Source: STATA 13 Outputs, 2022

As indicated in Table 6, for every unit of increase in audit Big4, there is a 1per cent increase in REM. Also, the t-value (3.95) and p-value (.000) indicate that the effect of audit Big4 on REM is significant. These results align with the results of Alzoubi, 2015; Ibrahim et al. 2020, who found significant effects. Thus, hypothesis one, which states that audit has no significant impact on the REM of listed non-financial firms in Nigeria, is rejected. However, Table 5 indicates that for every one-year tenure of an auditor (AUDTE), REM reduces by 0.02. The t-value (-0.31) and p-value (0.759) indicate that the effect AUDT has on REM is insignificant. These results align with Soyemi et al. (2020); Susanto & Pradipta (2020) found no significant impact. Thus, hypothesis two is accepted, that depicted AUDTE has no considerable effect on REM. Finally, from Table 5, the results of control variables also reveal a positive association between FSIZE and REM. At the same time, it is not statistically significant with FAGE and REM.

5. Conclusion and Recommendation

The paper examines the relationship between Audit Big4 and Tenure on Real Earnings Management in Nigerian Non-Financial Firms. To achieve this goal, we developed a measure of REM based on the theory of Rowchebberry, 1976, which derived from the cash flows and expenses of the firms. We analyzed if big4 auditors and audit turnover influence REM within the Nigerian economy's non-financial firms. The study used an OLS regression model similarly used by Alzoubi; (2016). We used the 76 listed non-financial firms on the Nigerian Stock Exchange over ten years (2010-2019) and found that audit big4 has significant positive effects on REM. However, we failed to find any substantial impact from audit tenure on REM. Based on the results of this study, the contributions of this paper to empirical literature are many. First, we established that engagement of audit big4 in the non-financial firm has a significant bearing on REM. We, however, also failed to establish that audit tenure mitigates REM. These results have policy and performance implications, future empirical studies, and the present body of knowledge (conceptual and theoretical). Finally, the paper offers directions for future empirical studies. The sample should cover the entire financial sector (banks, insurance, mortgage banks, possibly microfinance banks). These would have to provide an opportunity for comparison among different financial institutions. In addition, future research should examine the effect of other measures on earnings management, for example, discretionary accruals. OLS application is another cause of worry, as broader coverage could have provided a data set that indicates the presence of panel effects.

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