Effect of Auditor Attributes on Real Earnings Management of Quoted Food and Beverages Companies in Nigeria

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Abstract

Over the past years, the markets have witnessed several accounting scandals mainly because of the manipulation of the accounting figures reported in the financial statements. This has led to questioning the ability of auditors to effectively constrain such practices, especially in developing countries. Given the prominence of this problem and the expected role of the auditor this study examined the combined effect of auditor tenure and auditor industry specialization on real earnings management among quoted food and beverages companies in Nigeria. Real earnings management as dependent variable was proxied by discretionary accruals. Ex post facto research design was adopted; population included all the 13 companies in the food and beverages sub-sector. The entire 13 companies were used for the purpose of data collection. The study covered the period 2012 to 2018. Secondary data was extracted from the annual accounts of the companies for the period of the study. The study employed the use of multiple regression technique to analyse the data. The result of the study showed that both auditor tenure and auditor industry specialization have negative but significant effect on real earnings management. The study concluded that both variables can be used as determinants of real earnings management. The study recommended that efforts should be made with respect to legislations to strengthen auditors' quality in Nigeria since it is viable corporate governance tool towards enhancing reported earnings quality.

Keywords: Real Earnings Management, Auditor Tenure, Auditor Industry Specialization, food and beverages companies, Nigeria.

Introduction

High-quality external auditing is a vital element of a well-functioning capital markets. firms with a reputation for reliable financial reporting are likely to change auditors when their audit quality is questioned to avoid capital market consequences of unreliable financial reporting. The performance of independent auditors is deemed fundamental to the functioning of the financial and capital markets based on the assumption that, by issuing an opinion on the reliability of accounting information, it contributes to a business environment characterized by trust and credibility (Newman, Patterson & Smith, 2005; Ojo, 2008; Zagonov, 2011). However, with the corporate scandals at the start of the 21st century, characterized by fraud and accounting manipulations, much has been discussed about the scope of responsibilities of auditors, given that the opinion on financial statements has not changed.

The statutory audit can reinforce confidence because auditors are expected to provide an external, objective opinion on the preparation and presentation of financial statements. Auditors need to be independent in the opinions they express, while the work they have to do to form their opinions is highly dependent on and rooted in the real world and may become challenging in some business environments such as the consumer goods sector. It is against this background that this research work is carried out. The purpose of this study therefore is to determine the effect of audit quality on the real earnings management of quoted food and beverages companies in Nigeria. There have been concerns about audit quality in the present environment, where severe failures have come to light, for example; Enron scandal of 2001; Parmalat in 2003; Cadbury Nigeria Plc in 2006 and Afribank Nigeria Plc in 2009 (Ajani, 2012; Miettinen, 2011).

Though there are existing studies on the effect of audit quality and real earnings management around the world, few studies examined this phenomenon in Nigeria. Other studies in this area include (Hoang Khanh & Khuong, 2018, Alzoubi, 2017, Ghosh & Moon, 2005; Gul, Fung & Jaggi, 2009; Krishnan, 2003; Rusmin, 2010). However, most of these studies are foreign-based. Given the disparities in the nature of economies, the level of sophistication in the monitoring mechanisms and litigation risks faced by external auditors, studies from Nigeria may produce different results.

However, most of the studies which were conducted in developing countries including Nigeria did not make use of industry specialist auditors as an audit quality attributes. It is still important to study auditor industry specialization (one of the proxies for audit quality) to decide empirically the extent which it is associated with real earnings management of quoted food and beverages companies in Nigeria. This because Auditor industry specialization is another attribute of audit quality which extant literature suggests could affect earnings management practices of firms. This is because industry specialist auditors are familiar with the business operations of the industry of their specialization and also possess industry relevant experience and knowledge that enables them to audit companies in the industry more effectively than their counterparts (Minutti- Meza, 2013; Sarwoko & Agoes, 2014).

These variables are very important because given the complex nature of the food and beverages companies, business operations, industry specialist auditors are expected to play a prominent role in mitigating real earnings management of companies operating in the sector due to their specific knowledge of the industry. Quoted food and beverages companies in Nigeria are considered in this study due to the little or absence based on the researchers' knowledge of empirical studies on audit quality and real earnings management in this sector. Given the puzzles and the gap existing in literature, this study empirically, examined the combined effects of audit firm size, audit fees and auditor industry specialization on real earnings management of quoted food and beverages companies in Nigeria.

The study is based on two hypotheses;

HO_1 Auditor Tenure has no significant effect on real earnings management of quoted food and beverages companies in Nigeria.

HO_2 Auditor industry specialization have no significant effect on real earnings management of quoted food and beverages companies in Nigeria.

Literature Review

Xuerong and Li (2017) defined Real earnings management (REM) as management operational activities to alter reported earnings in a particular direction, which is achieved by overproducing inventory to lower the cost of goods sold (COGS) or cutting discretionary expenses (i.e., advertising expenditures, research and development, deferred taxes) to achieve a specified earnings level. Examples of real activities manipulation include 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. Merchant and Rockness (1994) described Earnings Management as any action on the part of management which affects reported income and provides no true economic advantage to the organization and may in fact, in the long-term be detrimental.
Audit tenure is the agreed period of engagement between the auditor and client (Hartadi, 2009). The issue of audit tenure is usually linked to auditor independence. Research conducted by Ghosh and Moon (2003), shows that audit quality increases as audit tenure increases. This result is however contrary to the results of a research conducted by Indah (2010), which reveals that as the length of auditor-client relationship increases; there could be decrease in the level of audit quality, because too long auditor-client relationship impairs auditor's independence. Furthermore, the audit quality decreases as the auditor-client relationship lengthen (Deis & Giroux, 1992). However, the study involving going-concern report in the US suggest that audit reporting failures are significantly higher in the first few years of auditor-client relationship (Geiger & Raghunandan, 2002). According to Chen (2008), audit firm tenure as well as audit partner tenure, affects quality of reported earnings.

Empirical Review

Yasser and Soliman (2018) examined the effect of Audit quality on Earnings Management in the listed firms in Egypt. In this research, OLS regression analysis is used to explore the relationship between Audit quality proxies which are Audit firm size, auditor industry specialization and auditor tenure and Earnings management in listed companies during the period 2012-2016. The results revealed that; auditor tenure has a significant positive relationship with earnings management, while the rest of the hypotheses indicate that the other variables remain to have an insignificant relationship with earnings management.

Karimi and Gerayli (2014) studied the relationship between audit quality (represented by auditor industry specialization and auditor tenure) and earnings management estimated through modified Jones 1991 model of 91 companies listed 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.

Bhattachaeya (2011) examined the effect of auditor industry specialization (as a proxy for audit quality) and Earnings Response Coefficient (ERC) in New Zealand. This study is carried out with a sample of NZX listed companies for the time period 2000 to 2009. Using an established model (Balsam, Krishnan and Yang, 2003), the study found that industry specialization of auditors is not a significant factor which influences ERC in New Zealand. This study was carried out in New Zealand while the current study is conducted in Nigeria which brings about the problem of external validity. Because, given the differences in economic and social cultural attributes of these countries the findings of New Zealand cannot be applied here for policy and economic decision purposes.

Essentially, agency theory, signaling theory, and auditors' theory of inspired confidence justify the key function of auditing as a mechanism for mitigating information asymmetries among related parties. For the purpose of this study only signaling theory is discussed. The study is anchored on signaling theory.

Signaling through auditor choice stands on the agency theory, and is a manner by which managers and/or directors may impart to the market additional information about their company and their own behaviour. Signaling theory suggests that companies with good performance use financial information disclosure to send signals to the market. Craven and Marston (1999), showed that firms will attempt to accept the same level of disclosure as similar firms operating in the same industry since if a firm does not keep up with the same level of disclosure as others, it may be perceived by stakeholders that it is hiding bad news or negative information. As the types of financial statements produced have become standardized, potential information differentiation that a company can use to send a signal to the market through its financial statements is reduced. Companies are thus, provided an incentive to signal, other than through transparency in their notes to the accounts and other voluntary disclosures, through their choice of auditor. Moreover, even voluntary disclosures that may be used as signals achieve enhanced credibility in the presence of a quality auditor. A high-quality audit sends a signal to the market that the financial statements are more credible than those audited by lower quality auditors. The market perceives audit firm size and specialist auditors to be of a higher quality than others and rewards (punishes) companies with larger improvements (or falls) in share prices accordingly (Teoh & Wong, 1993; Krishnan & Yang, 1999; Menon & Williams, 1994).

Methodology

This study adopts correlational research design using panel data of a multiple number of firms, over a period of time. The population of the study comprised of all the twenty-one (21) consumer goods companies quoted on the floor of Nigerian Stock Exchange (NSE) as at the end of 2019 accounting period, and are operating throughout the period of the study (2010-2019). However, through filtering 17 companies were considered for the purpose of data collection. The data were collected from the company's annual reports.

In view of the panel nature of the data for the study, the study employs different regression models, which include Ordinary Least Squares (OLS) Model, Fixed Effect (FE) Model and Random Effect (RE) Model. The Hausman Specification test was used to select the most suitable model for the study. The study on the other hand conducts regression diagnostics to ensure the validity and fitness of the results. This includes test for Heteroskedasticity and Multicollinearity. This is an effort to comply with the classical assumption of OLS and the model of the study in general. The analysis was conducted using STATA 16.0 version.

Consistent with prior studies such as Roychowdhury (2006), Cohen and Zarowin (2010), Zang (2012) and Ge and Kim (2013), this study employs three metrics to examine real earnings management (these are the abnormal cash flow from operations, abnormal production costs, and abnormal discretionary expenses). In line with these studies, this study estimates the abnormal cash flow from operations, abnormal production costs, and abnormal discretionary expenses as the standardized differences between the actual and calculated estimates from the following models;

$CFOit /Ait\text{-}1 = \gamma0(1/Ait\text{-}1) + \gamma1Salesit/Ait\text{-}1 + \gamma2\Delta Salesit/Ait\text{-}1 + \mu it$. ………………………i

Where;

CFOit = Cash flow from operation of firm i in year t

Ait-1 = Total assets of firm i in year t-1;

Salesit = Sales of firm i in year t

ΔSalesit = Sales of firm i in year t less sales of firm i in year t-1;

μit = A residual term that captures the level of abnormal cash flow of firm i in year t.

γ0 is the intercept and γ1 and γ2 are the coefficients.

$PRODit/Ait\text{-}1 = \gamma0(1/Ait\text{-}1) + \gamma1Salesit/Ait\text{-}1 + \gamma2\Delta Salesit/Ait\text{-}1 + \gamma1Salesit\text{-}1/Ait\text{-}1 + \mu it$…. ii

Where;

PRODit = the sum of cost of goods sold and change in inventory of firm i in year t;

ΔSalesit-1 = Sales of firm i in year t-1 less sales of firm i in year t-2;

μit = A residual term that captures the level of abnormal production costs of firm i in year t.

DISEXPit /Ait-1 = γ0(1/Ait-1) + γ1Salesit-1/Ait + μit…………………………………...........iii

Where;

DISEXPit = The discretionary expenses, sum of Selling, General & Administrative expenses of firm i in year t;

μit = error term of firm i in year t.

Therefore, the overall real earnings management is the sum of the standardized differences between the actual and calculated abnormal cash flow from operations, abnormal production costs and the abnormal discretionary expenses.

However, to examine the moderating effect of audit committee effectiveness on the relationship between audit quality on real earnings management of listed consumer goods firms in Nigeria, this study estimates the following models; This model derives their impetus from the work of Abbott, Parker, Peters and Raghunandan (2003).

$REM_{it} = \beta_0 + \beta_1 AFS_{it} + \beta_2 AT_{it} + \beta_3 AFS_{it} * ACE_{it} + \beta_4 AT_{it} * ACE_{it} + e_{it}$

Where:

REM= Real Earnings Management

ACE= Audit Committee Effectiveness

AFS= Audit Firm Size

AT= Auditor Tenure

β0 = is the intercept

β1-β2 = are the parameters estimate or coefficients in equation

μ = error

Result of the Findings

This section deals with analysis and interpretation of data extracted from the annual reports and accounts of the sampled food and beverages companies for the purpose of testing the hypotheses formulated earlier in the introductory chapter and as captured in the model. The section analysed the descriptive statistics from the sample and data collected. Discussion of findings and the various robustness tests were also, captured in this section.

Table 1. Descriptive Statistics

VARIABLE	Obs	Mean	Std. Dev.	Min	Max
REM	91	.5222685	.1591353	.1098	.799997
AT	91	.5494	.5003	0	1
AIS	91	.6373626	.4834249	0	1
FS	91	7.619637	1.591327	4.5782	11.6274
LEV	91	.4196141	1480042	.123889	.723746

Source: Stata Output, 2019.

A total number of thirteen (13) listed food and beverages companies were sampled over a period of seven (7) years yielding a total of 91 financial firm-year observations. In respect to real earnings management, table 1 shows a mean of 52%. This showed the real earnings management for the companies stood at an average 55% and standard deviation of 15% and hence, it can be said that the data had little variations. The study showed that the lowest REM was 10% and the highest within the period was approximately 80%. The table also, showed that Audit tenure has an average of 55% and an SD of 50% signifying that within the period of the study about 55% of the companies were retained auditors for a tenure of more three and half years. The percentage of the standard deviation showed that there are no much variations in the data. The study showed that auditors industry specialization has a mean of 63% indicating that 63% of the companies used industry specialist auditors within the period of the study. The result also, indicated that at least one company used industry specialist auditors every year within the period of the study. The standard deviation of 48% shows the levels of difference in compliance level from the mean. The study observed that average firm size stood at 7.6196 and a standard deviation of 1.5913. The study shows that the lowest assets value within the period was 4.578 billion and the highest was 11.627 billion. Finally, the study showed that average total debt equity was 41% which shows that 41% of capital for the companies within period of the study was debt equity. The lowest was 12% while the maximum debt equity capital was 72%.

Table 2: Correlation Matrix

	REM	AT	AIS	FS	LEV
REM	1.0000				
AT	-0.0247	1.0000			
AIS	-0.2009	0.2747	1.0000		
FS	0.0909	0.4403	0.1130	1.0000	
LEV	-0.2762	0.173	0.0015	0.3735	1.0000

Source: Stata Output, 2019.

The correlation matrix Table 2 revealed that the correlation coefficient between real earnings management and audit tenure stood at -0.0247. The result implied that auditor tenure has a negative relationship with REM of food and beverages companies in Nigeria. The result also, showed that auditor industry specialization has a negative value of -0.2009. This means that auditor industry specialization relates with REM to the level of -20%. The coefficient between REM and firm size stood at 0.090. This means that 9% of REM can be guaranteed by firm size. The study result, finally, shows that leverage has a negative relationship with REM to the tune -27%. That there is no positive relationship between real earnings management and leverage.

Table 3: Tolerance and Variance Inflation Factors

Variable	VIF	1/VIF
AT	1.37	0.727993
AUS	1.09	0.917540
FS	1.43	0.698017
LEV	1.17	0.858327
Mean VIF	1.26	

Source: STATA Output, 2019.

From Table 3, VIF values for all the independent variables were consistently below the benchmark of 10 which is considered harmful for regression analysis. This is supported by a mean VIF value of 1.22 which is above the benchmark of 1 considered suitable for regression analysis. Also, the TV for all the variables was above 0 and close to 1 which is recommended for regression analysis. The table shows good indicators that multicollinearity is not a problem among independent variables. Meanwhile, the Breusch-Pagan / Cook-Weisberg test for heteroscedasticity shows a chi2(1) of 0.23 and a Prob > chi2 of 0.122 which means there is no problem of heteroscedasticity among the data inferring that the data is homogeneous in nature.

Hauseman Specification Test

The Hausman Specification test was conducted to ascertain between the fixed and random effect models which was more appropriate for interpretation. The result of the Hausman Test revealed that the value of chi2 is 1.20 and a corresponding prob>chi 0.944. The significant value as reported by the probability of chi2 that the Hausman test favours the random effect model. However, since the hypotheses for study are stated in null form, the study went further to conduct the lagrange multiplier test to ascertain whether is appropriate to interpret the pool OLS or random effect model. The Breusch and Pagan Lagrangian multiplier test for random effects shows a chi2 of 0.10 and a corresponding probability of 0.0720 which indicates that the pooled OLS is appropriate for the study.

Table 4: Summary of pooled OLS Result Regression Result

	Coef.	t	P>|t|
AT	-.0537889	-2.51	0.013
AIS	-.076079	-2.25	0.027
FMZ	.0248769	2.11	0.038
LEV	-.3993318	-3.50	0.001
R-squared	0.1762		
Adj R-squared	0.1277		
Prob > F	0.0050		

Source: STATA Output, 2019.

A close look at the result presented in table 4 review that the R2 value is 0.1762 which indicates that the audit quality attributes along with the control variables (firm size and leverage) can explain only about 17% of the total systematic variation of earnings management among quoted food and beverages firms in Nigeria. This implies that, about 83% of the total systematic variation in the dependent variable has been left unaccounted for by the model hence captured by the stochastic error term. This implies that other factors not included in the model mostly accounts for earnings management in the area covered by the study. On the basis of the overall statistical significance of the model, it was observed that the probability of F-statistics is 0.0050 which is significant at 5% level of significance.

Table 4 described the result of the pooled OLS regression conducted for the study. The analysis in table 4 shows a negative but significant relationship between auditor tenure and real earnings management with a coefficient value of -.0537889 and probability of F-statistics of 0.013 which is considered significant at 5% level of confidence. This implies that auditor tenure has a negative influence on real earnings management of listed food and beverages companies in Nigeria. Although still significant according to the result of the study in affecting earnings management. Based on the result of the pooled OLS regression, the study rejected the first null hypothesis, implying that auditor tenure is a good indicator of real earnings management. This result confirms the findings of Okoli (2014).

Table 4 indicates that auditors' industry specialization has a negative but significant effect on real earnings management among listed food and beverages in Nigeria. This is evidenced by a coefficient of -.076079 and p-value of 0.027 which is significant at 5% level of confidence. This implies that irrespective of the fact that auditors' industry specialization has a negative effect on earnings management, it is significant in influencing real earnings management. Given this particular circumstance, the study rejects that null hypothesis which states that auditors' industry specialization has no significant effect on earnings management of quoted food and beverages companies in Nigeria. This finding collaborates with that of Bhattachaeya (2011).

The control variable- firm size (FS) has a significant positive effect on real earnings management of listed food and beverages companies in Nigeria with the probability value of 0.038. While leverage has negative significant (0.001) effect on real earnings management of listed food and beverages in Nigeria.

Conclusion

This study examined the connection between auditor tenure and auditor industry specialization, as important features of audit quality, and real earnings management among listed food and beverages companies in Nigeria. Real earnings management as dependent variable was proxied by discretionary accruals. Based on the findings, the study concluded that both auditor tenure and auditors' industry specialization have significant influence on real earnings management among quoted food and beverages in Nigeria. It therefore, means that these variables are determinants of real earnings management in the area covered by the study. Auditor tenure is considered a predictor of real earnings management because as the length of auditor- client relationship increases, the auditor becomes more effective in detecting unethical accounting practices than he was at the beginning of the audit engagement in view of his familiarity with the operations and financial reporting environment of the client. The conclusion drawn from industry specialization also, hold true because it is assumed that industry specialist auditors have gained great training and experience concentrated in a specific industry and are considered to have more accurate non-error frequency knowledge than non-industry specialists.

Recommendation

Based on the findings and conclusion, it was recommended that;

i. The study recommends that food and beverages companies should encourage longer auditor tenure given the complicated nature of their operations. This is because elongated tenure gives the auditor a better understanding of the company and works towards improving the quality of reported earnings.
ii. Consumer goods companies should hire auditors with industry specialization since they have a better understanding of the specific industry peculiarities and operations distinct from other sectors.

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