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Effect of audit quality on earnings management of listed deposit money banks in Nigeria

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Abstract
This paper looks into how listed Deposit Money Banks in Nigeria manage their earnings in relation to the quality of their audits. The paper used for this publication was a panel study. The paper examines the influence of audit quality determined by the auditor's independence, audit rotation, and audit firm size on earnings management measured by discretionary loan loss provision (DLLP). The population of this article consists of the 14 listed DMBs in Nigeria, from which a sample of 12 banks was selected using the census sampling technique. Secondary data was sourced from the annual reports of the 12 sampled banks, spanning a period of ten years, from 2013 to 2023. Generalized Method of Moment (GMM) was used for the data analysis. Going by the results, audit rotation significantly and favorably affects the earnings management of listed DMBs in Nigeria. Audit independence and audit firm size have a considerable negative impact on earnings management of listed DMBs in Nigeria. The paper concludes that, audit independence and audit firm size curtail EM practices of listed DMBs in Nigeria. The paper therefore recommends among others that, the listed DMBs in Nigeria should not deviate from the statutory and professional audit independence and also listed DMBs in Nigeria should engage the service of Big4 to carry out their statutory audit as this will mitigate and curtail the chances of the listed DMBs to engage in any form of earnings management which may not be possibly seen by the other non Big4. To prevent the intimacy between the auditor and the client, the Nigerian Financial Reporting Council should make sure that long-term audit firm rotation is avoided. Since auditors tend to renew after the first five years of engagement, this lengthens the audit firm's duration and allows for greater familiarity, which raises the likelihood of earning management.

Keywords: Independence, mitigate, management

1. Introduction

According to Isa and Farouk (2018) [17], opportunistic earnings management practices are believed to be pervasive and present in a variety of industries and businesses. These practices distort the quality of earnings and their applicability to investment decisions, which reduces investor confidence in financial reports and, as a result, produces less reliable accounting earnings that do not accurately reflect the financial performance of the companies. Because it presents an overly optimistic picture of banks' financial situation, earnings management has become more prevalent in Nigeria's banking industry. This may be explained by inconsistent regulations as well as the variety of accounting policies that are accessible, many of which call for the use of discretion when creating financial statements (Ibrahim & Ali, 2018) [16].

Financial scandals are on the rise, as documented by Junaidu and Ishaku in 2020 [18]. Several institutions have failed, including Cadbury Nigeria Plc in 2006, Bank PHB, Afri Bank, African Petroleum Plc, Lever Brothers Nigeria Plc, and most recently, Stanbic IBTC Plc in 2016. Additionally, the First Bank scenario from 2021 was reported by the public and led to a false financial report. Authorities discovered over 150 billion non-performing loans and improper credit decisions, of which 75 billion belonged to the board chairman alone. As a result, there is worry regarding the quality of accounting income and how it relates to the quality of external audit, which has been shown to rise over time in the wake of regular clusters of frauds, business failures, and lawsuits.

The question of whether these company failures aren't the result of subpar audits and the external audit function's incapacity to stop Earnings Management (Yusuf, 2022) [29]. The size of an audit firm is a key factor that can either help or hinder a firm's operations, including its ability to make decisions.

However, majority of the earlier studies merely include it as a control variable (Zona *et al*., 2013) [31]. Audit rotation can impact an auditor's objectivity and independence. Junaidu & Ishaku (2022) [18] looked at Nigerian non-financial enterprises, they found a strong correlation between earnings management and audit quality. However, Livinus (2022) [20] shows a substantial negative relationship between audit quality and EM, which runs counter to Junaidu and Ishaku's (2022) [18] findings.

Audit independence is also a significant proxy of audit quality particularly in the wake of global financial crises (Dekeyser *et al*., 2023) [11]. The need for enhancement, accountability and transparency in financial reports has driven the demand for audit independence to mitigate financial misstatements and earning management practices among listed DMBs in Nigeria. It is at this junction that this paper seeks to establish the effect of audit quality on earnings management of listed DMBs in Nigeria. It is based on the above stated problems that, this paper seek to achieve its objectives by investigating the effect of audit quality on earnings management of listed Deposit Money Banks in Nigeria. The specific objectives are:

i) To determine the effect of audit independence on earnings management of listed DMBs in Nigeria.
ii) To determine the effect of audit rotation on earnings management of listed DMBs in Nigeria.
iii) To examine the effect of audit firm size on earnings management of listed DMBs in Nigeria.

2. Literature Review and Theoretical Framework

This section discussed the conceptual framework of this paper. These include audit quality and earnings management. It further reviews the empirical aspect of the paper and the theoretical framework.

2.1 Audit Quality

DeAngelo (1981) [10] defined audit quality as the joint chance that an auditor would both detect and disclose a breach in the client's accounting system. While the decision to report a misstatement is based on the auditor's motivations to do so, but the discovery of a misstatement evaluates the auditor's skill and knowledge (Ogwu *et al*., 2014) [21]. Suleiman *et al*. (2020) [25], assert that, the audit's quality may be impacted by the auditor's ability to recognize and reveal material misstatements. According to Zehri and Shabou (2011) [30], superior auditors are more likely than inferior auditors to spot major irregularities and misstatements as well as questionable accounting practices used by their customers. Habbash and Alghamdi (2017) [13] suggested that, professional public accountants must genuinely maintain quality in their work. For an auditor to preserve audit quality, independence is crucial. Similarly the objective of audit quality is to enhance the outcomes of the audit performance of financial reporting clients that can be utilized by users of audited financial statements, while maintaining the auditor's independence in carrying out their duties in searching out for material misstatements in financial statements and reporting them, along with the evidence gathered (Bedard *et al*., 2010) [5]. Hadricha (2015) [14], the results of principal component analysis approaches are used to extract information about audit quality and the findings highlight three key elements thus; education, experience, and training. The more precisely the financial report reflects the real economic situation of the company the higher the information quality, and the stronger the auditor monitoring is (Bello *et al*., 2016) [6].

2.4 Earnings Management

Earnings management is defined as management choosing accounting measurement or reporting procedures repeatedly in a specific pattern to report an income stream with a lower variance from a trend than would otherwise appear (Isa & Faruk, 2018) [17]. Furthermore, earnings management happens when managers use their discretion in transaction structuring and financial reporting to disclose financial information in a way that either misleads certain stakeholders about the real economic performance of the company or affects the outcome of contracts that rely on disclosed accounting figures (Healy & Wahlen, 1999) [15]. Thus, according to this definition, management is the group in charge of making the choices that are related to the overall management of earnings.

2.5 Review of Empirical Studies

Dorcas and Usman (2022) [12] investigate how listed deposit money banks in Nigeria manage profitability in relation to board diversity and audit quality between 2010 and 2022. The results showed that audit rotation and earnings management of Nigerian-listed DMBs were mutually exclusive.

Yasser and Soliman (2018) [28] investigate the impact of audit quality on earnings management between 2012 and 2016. The audit rotation is used as a proxy for audit quality, and the modified Jones model was utilized to estimate the discretionary accruals. Discretionary accruals and audit rotation were significantly impacted.

Ozkan (2018) [22] uses the auditor's rotation as a stand-in for audit quality to investigate the relationship between earnings management and audit quality for non-financial companies listed on the Bors between the period of 2013 to 2018. The results confirmed that one of the key elements that might significantly reduce profits management methods is a top-notch audit.

Awuye (2022) [3], in the context of French-listed companies, he examines the relationship between the nature of audits and financial reporting. Earnings management is determined by real and accruals earnings management, and audit quality is assessed by the (Big4) audit firm. According to the study, clients of Big4 audit firms indicate a statistically significant positive link with earnings management, whereas clients of non-Big4 firms report the opposite.

Aliyu (2022) [1], examines the impact of audit quality on the earnings management of Nigerian listed consumer goods companies. An ex post facto research design is used in this study. The population consisted of twenty-one consumer products companies, of which seventeen were specifically selected using a purposive selection technique to form the sample size. According to the report, the size of the audit firm significantly improves earnings management.

Singh (2021) [23] investigates the sustainability of earnings management strategies and the effect of audit quality on earnings management using a sample of all Listed Bombay Stock Exchange companies for ten fiscal years between 2010 to 2019. The results point to a strong favorable correlation between Big4 auditors and their ability to restrain all types of earnings management.

2.6 Theoretical Framework

Positive Accounting Theory

This work is based on the positive accounting theory developed by Watts and Zimmerman (1979) [27]. According to this theory, the main purpose of accounting is to value the company. This suggests that positive accounting supports an efficiency perspective, which highlights how different managers select accounting techniques that accurately depict the success of the company (Basu, 2009) [4]. An alternate explanation for the efficiency perspective of positive accounting is the opportunistic perspective of owners, or shareholders represented by the board of directors, who act in their own best interests. They believe that what is beneficial to them is also beneficial to the company, thus they only accept accounting procedures that suit their interests (Shubhankar, 2015) [24]. Watts and Zimmerman (1978) [27] outline three primary possibilities for PAT in this regard. These theories, which explain why managers select a particular accounting technique over another, are the political cost hypothesis, the bonus plans hypothesis, and the equity-debt-equity hypothesis.

3. Methodology

A Panel study was adopted for this paper. Data was analyzed from 2011-2022 from a population of 14 listed DMBs in Nigeria out of which 12 DMBs made up the sample size through a census sampling technique.. The data was obtained from the annual account and report of the sampled listed DMBs in Nigeria. Descriptive statistics, correlation analysis, and a generalized method of moment were all used in the data analysis. The study examines the effect of audit quality as determined by the auditor's independence, audit rotation, and audit firm size on earnings management which was peroxides by discretionary loan loss provision (DLLP),

This paper adopted the Chang *et al*. (2008) [8] model as used by (Isa & Farouk, 2018) [17], which is specifically built for financial sectors. It is through this model that the residual of the second model is obtained. The model is specified below:

$$DLLP/TA_{t-1} = LLP_{it}/TA_{t-1} - (\alpha_0\ 1/TA_{t-1} + \alpha_1\ LCO_i/TA_{t-1} + \alpha_2 BBAL_I/TA_{T-1}) \qquad (1)$$

Where as

DLLP = Discretionary Loan Loss Provision

LLP = Loan Loss Provision

LCO = Loan Charge-off

BBAL= Beginning Balance of Loan Loss

TA_{T-1} = Lagged Total Asset

α_0 = Constant

α 1, α 2 = firm specific parameters

The second model was adapted and re-modified as used in the study of Ahmad *et al.* (2016) to estimate the measure of the predictive ability of audit quality on earning management of listed DMBs in Nigeria. The model is presented in the following equation:

$$DLLP_{it} = \beta_O + \beta_1 AFS_{it} + \beta_2 ART_{it} + \beta_3 AI_{it} + \varepsilon_{it}$$

Where

DLLP represents Discretionary Loan Loss Provision

AFS represents Audit firm size

ART represents Audit rotation

AI represents Audit Independence

B_o =constant

$\beta_{1-}\ \beta_3$ coefficient of explanatory variables

εit = error term represents the effect of all those variables that were omitted from the regression equation.

it = companies and time

4. Results and Discussion

This section consists of the results of descriptive statistics of the variables used in the estimation, correlation and panel regression results. The results are presented in Tables:

Table 1: Descriptive Statistics

	DLLP	AFS	ART	AI
Mean	-32.50	0.89	0.69	12.08
Median	-0.22	1.00	1.00	12.27
Maximum	0.25	1.00	1.00	16.28
Minimum	-4237.00	0.00	0.00	5.73
Std. Dev.	368.75	0.31	0.46	1.82
Skewness	-11.36	-2.56	-0.85	-2.20
Kurtosis	129.99	7.55	1.73	8.41
Jarque-Bera	91544.41	257.76	24.96	267.82
Probability	0.00	0.00	0.00	0.00
Observations	132	132	132	132

Source: Authors Computation Using EViews version 12

Table 1 shows that, the mean of audit independence and audit rotation are positive. This explains that the variables recorded a positive growth rate over the study period. However, the mean of earnings management measured by discretionary loan provision (DLLP) is negative, this explains that over the period of the study, EM experienced an adverse growth rate. Furthermore, from the estimation, the result attests that, (DLLP) has the highest standard deviation which indicates that, the variable fluctuates more than any other variable in the distribution. Furthermore, the result shows that earnings management (DLLP), audit independence, audit rotation, and audit firm size are negatively skewed. The result attests that; all the variables have excess kurtosis greater than 3.00 except for the audit rotation which has a kurtosis of 1.7347.

This therefore, shows that, the distribution of the variables is leptokurtic in nature and it exhibits a fat tail (thick-tail). The Jarque-Bera coefficient of the variables indicates that the series is not normally distributed. This is reflected in the fact that the probability values of the variables in the model are less than a 5% level of significance implying that they are insignificant. The central limit hypothesis, states that as long as the number of observations in the data is greater than 100, the data variables may not necessarily be normally distributed this justifies the abnormality in the distribution of the data. Additionally, because the measurement yardsticks are flexible, normalcy in the financial data is not anticipated. In addition, one of the assumptions in a dynamic regression model like GMM does not include the data normality. The ordinary least squares regression model assumes that the data are normal.

4.2 Correlation Analysis of the Model

It is critical to understand the correlation coefficient of the variables before estimating a regression analysis. This is because selecting the variables to be included in the model will depend on an understanding of the correlation coefficient's nature. Correlation analysis may also be used to detect the presence of multicollinearity. Hence, the test results are shown in Table 2.

Table 2: Correlation Coefficients of the Model

Variables	DLLP	AI	ART	AFS
DLLP	1.0000			
AR	-0.0522	1.0000		
ART	-0.0599	-0.0826	1.0000	
AFS	-0.0326	0.1136	-0.1269	1.0000

Source: Author's computation using EViews Version 12.

Evaluating the correlation between the variables helps the researcher determine whether the variables are multicollinearity. The parameter estimations may contradict the theory due to the unexpected effect of multicollinearity among the independent variables (Carroll, 1961; Chen & Popovich, 2002) [7, 9]. The above explanation, Table 2 presents the correlation analysis of the variables. The findings show that audit independence, audit rotation, and audit firms' size have negative correlations (correlation coefficients of -0.0522, -0.0599, and -0.0326 respectively) with earnings management. This suggests that during the course of the study, an increase in these variables is linked to a decline in DMBs' earnings management. Since no variable has a correlation coefficient higher than 0.7, conclude that there is no multicollinearity among the variables and that they are appropriate to be included in the models for analysis.

4.3 Cross-Section Dependency Test

This sub-section presents the outputs of the cross-dependency test of the model measuring the effect of audit quality on earnings management of listed DMBs in Nigeria. Thus, the results are presented in Table 3.

Table 3: Result of Cross-Section Dependency Test

Test	Statistic	Prob.
Breusch-Pagan LM	82.84446	0.0787
Pesaran scaled LM	1.466122	0.1426
Pesaran CD	-1.017796	0.3088

Source: Computed by the author using EViews version 12.

From the results reported in Table .3, the test demonstrates that there is no evidence of cross- section dependency among the variables. This is due to the fact that two of the three techniques' probability values (Pesaran scaled LM & Pesaran CD) are not statistically significant at the 10% level. As a result, the null hypothesis—that the residuals have no cross-section dependence—is accepted. Therefore, this study finds that there is no cross-sectional connection among the variables based on the data.

4.4 Panel Estimation Test (GMM)

In order to determine which model between difference GMM and system GMM regression is best, this section presents the results of the panel Generalized Method of Moment (GMM) using Pool OLS, fixed effect, difference GMM, and system GMM for the estimation of the effect of audit quality on earnings management of listed DMBs in Nigeria. The results are thus displayed in Table 4.

Table 4: Results of the System GMM Regression

Dependent Variable: DLLP				
Variable	**Coefficient**	**Std. Error**	**t-Statistic**	**Prob.**
DLLP(-1)	-0.0454	0.2273	-0.1996	0.8423
AI	-0.1461	0.0321	-4.5528	0.0000
ART	0.1405	0.0341	4.1182	0.0001
AFS	-0.2111	0.0582	-3.6293	0.0005

Diagnostics: POLS = -0.0271, FE = 0.6494, DGMM = -0.1124, J. Stat. = 1.73 (0.7847), AR (1) = -1.23 (0.2162), AR (2) = 0.09 (0.9258)

Note: PLS = Panel Least Square, FE = Fixed Effect, DGMM = Difference GMM, AR = Autocorrelation and J-Sta. = Sagan Test,

Source: Author's compilation using EViews Version 12.

As indicated on Table 4, the result shows that, the system Generalized Method of Moment (GMM) is more appropriate. This is because the coefficient of lag value (-0.1124) of the difference GMM is less than the coefficient of the fixed effect regression (0.6494). Thus, the result suggests that, the difference GMM is downward biased and the system GMM should be used. According to the result, there is a negative and statistically insignificant effect between previous value lag value (-1) of earnings management and current earnings management value 0.05% of DMBs in Nigeria. It implies that, an increase in previous earnings management by 1% will leads to decrease in the current earnings management by 0.05% of the DMBs in Nigeria.

Comparably, Table 4 above shows that, at 0.0000 p-value, there is a statistically significant and negative relationship between audit independence and earnings management of listed DMBs in Nigeria. Earnings management will drop by 0.14% for every 1% rise in audit independence. The results also show that, at 0.0001 p-value, there is a positive and statistically significant relationship between audit rotation and earnings management of listed DMBs in Nigeria. It suggests that a 1% increase in audit rotation will result in a 0.15% increase in the profits management of Nigeria's listed DMBs. The outcome also shows that, for listed DMBs in Nigeria, there is a statistically significant and negative relationship between audit firm size and earnings management, with a 0.0005 p-value. A 1% increase in audit firm size will result in a 0.21% decrease in earnings management for Nigeria's listed DMBs.

4.5 Test of Hypotheses and Discussion of Findings

Hypothesis One

$H0_1$: There is no significant effect between audit independence and earnings management of listed DMBs in Nigeria:

The GMM result in table 4 above demonstrates that, with a coefficient value of -0.1461 and a 0.0000 p-value, there is a statistically significant and negative relationship between audit independence and earnings management. Since there is no discernible relationship between audit independence and earnings management of listed DMBs in Nigeria, the alternative hypothesis is supported and the null hypothesis is rejected. This result is consistent with the findings of

Dekeyser *et al*. (2023) [11] which show that audit independence significantly impairs earnings management. This runs counter to research by Qader and Cek (2023), which discovered a strong positive correlation between earnings management and audit independence.

Hypothesis Two

H0$_2$: There is no significant effect between audit rotation and earnings management of listed DMBs in Nigeria:

With a coefficient value of 0.1405 and a 0.0001 p-value, the GMM result in Table 4 above shows a positive and statistically significant relationship between audit rotation and earnings management. The null hypothesis, according to which there is no discernible relationship between audit rotation and listed DMBs' earnings management in Nigeria, is rejected. This is consistent with the findings of Aliyu (2022) [1], Kwarbi, and Osho (2021) [19], who indicate that audit rotation significantly improves earnings management. Furthermore, this runs counter to research by Livinus (2022) [20] who found no benefit from audit rotation in relation to earnings management.

Hypothesis Three

H0$_3$: There is no significant effect between audit firm size and earnings management of listed DMBs in Nigeria:

A statistically significant and negative relationship between audit company size and earnings management is revealed by the GMM result on table 4, with a value of 0.0005. The null hypothesis, according to which there is no discernible relationship between the size of the audit company and the management of listed DMBs' earnings in Nigeria, is thus rejected. Thus, the alternative theory is acknowledged. The results of the study are consistent with those of Junaidu and Ishaku (2020) [18] and Bello *et al*. (2016) [6], who found a substantial negative relationship between audit company size and earning management. However, the study contradicts Awuye (2022) [3], Aliyu (2022) [1], Kwarbi and Osho (2021) [19], and Singh (2021) [23] who find that the size of the audit firm has a major favorable impact on managing earnings.

5. Conclusions and Recommendations

5.1 Conclusion's

The finding shows that 1% increase of audit independence will lead to a decrease of EM of listed DMBs in Nigeria by 0.14%. Therefore, the paper concludes that the board of directors maintained the auditor's independence in line with the statutory and professional standard. The paper concludes that longer audit rotation increases the chances of earnings management practice in listed DMBs of Nigeria. Thus, it implies that, long-term audit and client relationship enables the management of DMBs in Nigeria to engage in manipulative accounting practice. The paper concludes that, firms audited by Big4 audit firms tend to report low earnings management. This is because larger audit firms have greater professionalism expertise to detect and then report any material misstatements which may not be disclosed in the DMBs financial statements. The Big4 have bigger reputational capital to protect and therefore have a greater professional expertise to guard against the potential risk of litigation. This means that, they may take more professional approach in dealing with financial reporting issues than the non Big4.

5.2 Recommendations

The financial reporting council of Nigeria should ensure that board of directors of DMBs in Nigeria should not deviate from the statutory and professional audit standard as this practice will not influence the auditor's independence in passing their professional judgement on the true and fair view of the financial statement. Prolonged audit rotation should be discouraged by the Nigerian Financial Reporting Council in order to prevent closeness between the auditor and the clients. The Financial Reporting Council of Nigeria ought to guarantee that DMBs in Nigeria hire Big4 to complete their required audits. This will lessen and limit the likelihood that the DMBs will manipulate their earnings in any way that the other non-Big4 companies might not be able to observe.

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