RELATIONSHIP BETWEEN AUDIT QUALITY VIA SPECIALIZED AUDITOR AND AUDITOR OPINION WITH EARNINGS MANAGEMENT IN FINANCIAL INSTITUTIONS IN NIGERIA

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ABSTRACT

The study investigated relationship between audit quality with respect to specialized auditor and auditor opinion with earnings management of quoted financial institutions in Nigeria The population of this study comprised all the banks and insurance companies that are listed on the Nigerian Stock Exchange (NSE) from 2007 to 2011. The study adopted the cross sectional research approach while stratified random sampling technique was used in selecting the respondents. Data collected were analyzed using descriptive statistics and inferential statistics was used to test the hypotheses. From the results of the data analysis, it was observed that there is remarkable relationship between quality factors as regard specialized auditor and auditor's opinion with earnings management in some financial institutions in Nigeria. In conclusion, the study provided both empirical and statistical evidence on the usefulness of audit quality factors namely: specialized auditor and audit opinion in explaining and predicting opportunistic earnings management in sampled financial institutions in Nigeria. It was therefore recommended that the regulatory agencies should create more awareness on the concept of corporate governance mechanism and its role in developing the financial sub-sector of the economy.

INTRODUCTION

Background of the Study

Earnings Management has received considerable attention in recent years from academics, market participants, and regulators. It continues to receive attention as a result of recent corporate failures linked to opportunistic earnings management that has generated doubts in the minds of shareholders and stakeholders on the credibility and reliability of financial reports. Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend largely on reported accounting numbers (Watts and Zimerman, 1986; Healy and Whalen, 1999).

In the last few decades, accounting scandals in both developed and developing countries have been widely reported and the scandals have brought about a major awareness of the need for more transparency, credibility and objectivity in financial reporting by companies in order to protect shareholders and stakeholders alike. The objective of financial reporting is to provide relevant, understandable, reliable, objective, timely, complete and comparable financial information to users. However, the validity of this objective is being challenged by many users of corporate financial reports because of the probable effects of earnings management on the information contents of such reports.

In the Nigerian context, comprehensive study of Nigerian quoted companies has been conducted by World Bank Group. It was observed that Nigerian financial reporting practices are deficient (World Bank, 2004). In addition, financial information reporting practices by Nigerian firms have been empirically investigated by Wallace, Naser and Mora (1994), Okike (2000), Adeyemi (2006), Ofoegbu and Okoye (2006), Umoren (2010) and Hasan (2012). Their findings are quite similar, portraying that the Nigerian corporate reporting practices are weak. Although all of them except Hasan adopted level of disclosure as a proxy for financial reporting quality, none of the studies used earnings management, which is central to quality of information in financial reports. A major setback in the use of this research methodology is that the disclosure index is often determined by several items that can be weighted or un-weighted. Notwithstanding the absence of one common practice, the weights are assigned judgmentally without scientific or statistical justification. Besides, the study conducted by Hasan that used earnings management as a proxy for financial reporting quality covered quoted manufacturing firms using the modified Jones model. This study also applies the Modified Jones Model to capture and detect earnings manipulations in order to determine the relationship between corporate governance and earnings management among quoted financial institutions in Nigeria.

Statement of the Problem

The doubt about the quality of financial reporting implies that financial reports of corporate entities are not reliable and useful for decision making. Accounting earnings turn out to be a less reliable measure of a firm's financial performance when managers have an incentive to manipulate reported earnings in an opportunistic manner (Dechow and Skinner, 2000; Brown, 1999; Healy, Wahlen, 1999). The less reliable earnings are, the less informative and useful they become. The surge in accounting scandals that have been witnessed within the international financial arena in recent years has raised many questions and concern about the quality of financial reporting (Agrawal and Chalda, 2005; Brown, Falaschetti and Orlando, 2010 and Shehu, 2011).

Inadequate and manipulated accounting and inaccurate reporting, on the other hand, constitute waste and inefficiency and thereby prevent our economic resources from being allocated in a rational manner. Another consequence of opportunistic earnings management practices is that the quality of financial information in Nigeria remains weak compared to many developed economies. This has hindered the growth of efficient capital markets. The frequent complaint among investors in Nigeria is that financial information on company's' performance is either unavailable or, if provided, lacks reliability (Shehu, 2011). The impaired independence results in poor audit quality and allows for greater opportunistic earnings management. This study therefore, seeks to examine the relationship between specialized auditor, auditor opinion and earnings management in financial institutions in Nigeria.

Objectives of the Study

The main objective of this study is to determine the relationship between audit quality with respect to specialized auditor and auditor opinion with earnings management of quoted financial institutions in Nigeria.

Specifically, the study seeks to achieve the following objectives;

1. To determine the relationship between specialized auditor and earnings management in financial institutions in Nigeria.
2. To ascertain the relationship between auditor opinion and earnings management in financial institutions in Nigeria.

Hypotheses

The following hypotheses are formulated for the study. All hypotheses to be tested in this study are stated in the null form.

1. There is no relationship between specialized auditor and earnings management in financial institutions in Nigeria.
2. There is no relationship between auditor opinion and earnings management in financial institutions in Nigeria.

Literature review

Role of Auditors

The attestation function of the auditor is crucial in accomplishing the goals of corporate governance and thereby mitigate opportunistic earnings management. The Companies Act provides that the auditor should exercise all such care, diligence and skill, as is reasonably necessary in each particular circumstance. In the event of any financial misrepresentation, the auditors are held liable for their actions as financial information not considered to be reliable and credible may be attributed to poor audit quality. Auditors provide financial reports that do not give a true and fair view of the financial reports of firms. The action of the auditors therefore leads to loss of shareholders funds. The weak corporate law and different accounting standards also diminish the performance of the auditors and create financial instability in the developing markets.

The Role of Audit Quality in Discouraging Opportunistic/Earnings Management

Accounting scandals that have been reported in the past few years such as Enron, Arthur Andersen, World com and some financial institutions in Nigeria have affected the regulators and investors trust of financial statements. This scandals and its subsequent results were the main reason for drawing attention towards the quality of financial statement. Moreover, the financial crisis which has affected most of the world in the recent years has pushed up the demand for high audit quality. This result may signal that auditors are being more watchful after such crisis and that they now tend to perform their work in a highly ethical missing link and ensure the high quality of their work. Thus, audit quality is one of the main factors that affect the credibility of financial information.

Thus, the various changes in accounting, financial reporting and auditing were all designed to provide protection to investors. This is being achieved by imposing a duty of accountability upon the managers of a company (Crowther and Jatana, 2005). In essence, auditing is used to provide the needed assurance for investors when relying on audited financial statements. More precisely, the role of auditing is to reduce information asymmetry on accounting numbers, and to minimize the residual loss resulting from managers' opportunism in financial reporting. Effective and perceived qualities are necessary for auditing to produce beneficial effects as a monitoring device. The perceived audit quality by financial statement users is at least as important as the effective audit quality. In this study, we will study the factors which contribute to audit quality: Auditor size, industry specialization, auditor tenure, audit delay and auditor opinion.

Agency Theory

Agency theory explains the agency problems arising from the separation of ownership and control. It provides a useful way of explaining relationships where the parties' interests are at odds and can be brought more into alignment through proper monitoring and a well-planned compensation system (Davis, Schorman and Donaldson, 1997:24). It is an acknowledged fact that the principal agent theory is generally considered the starting point for any debate on the issue of corporate governance emanating from the classical thesis on The Modern Corporation and Private Property (Berle and Means, 1932). In relation to the research objectives, this study will adopt the agency theory because of its emphasis on the board (i.e. board size, board composition, separation of Chief Executive Officer and chair position, skill levels of board and management, quality of governance and size of audit committee) of directors as a mechanism which dominates the corporate governance literature. This is in accordance with the works of Fama (1980) and Sanda, Mukaila and Garba (2003).

The agency theory asserts that the demand for audit quality has been triggered by the need to manage agency conflict. In Nigeria issues relating to auditor monitoring strength, as it affects information quality and credibility have been significantly established by the agency conflict of interest relationship between managers and stakeholders as exhibited in the case of Savanna Bank Plc and Oceanic Bank Plc among others where the auditor's internal report was hidden under the carpet at the detriment of the firms' stakeholders.

Auditor Opinion and Earnings Management

From the proceeding section of this study, it was stated that the aim of auditor's report is to express an independent opinion, whether the financial report is fairly stated in conformity with GAAP and whether the financial report also reflects the "true" and economic condition and operating results of the entity. Consequently, the auditor report represents the final stage of an audit examination that the auditor uses to communicate the information regarding a company's financial position (Porter et al., 2003). The auditor's report could be qualified or unqualified report. The auditor issues a qualified report when the financial report does not give a true and fair view of the entity's activities. However, the auditor issues an unqualified report when they consider the audited financial statements to provide a true and fair view in accordance with the financial reporting standards and the company's law.

Conversely, a number of studies have shown that there is no association between auditor opinion and level of earnings management. For example, Butler et al. (2004) concluded that discretionary accruals or earnings management is not associated with qualified audit opinion. He explained that the auditor forms his opinion using qualified report according to circumstances such as scope limitation, material uncertainty, and disagreement with managers, rather than the incidence of earnings management. In addition, he suggested that large negative accruals may arise from financial problems rather than an intention to manipulate earnings. Consequently, this study argues that companies with an unqualified auditor opinion are less likely to have high discretionary accruals.

METHOD

Research Design

This study adopted the cross sectional research approach that involved a content analysis of the annual reports of a cross sectional sample of banks and insurance companies from 2007 to 2011 listed on the Nigerian Stock Exchange.

Population of the Study

The study was carried out in the financial sector of the economy. The population of the study for the secondary data therefore is made up of all the banks and insurance companies that are listed on the Nigerian Stock Exchange (NSE) from 2007 to 2011. The total population of the study is 17 banks and 30 insurance companies.

Sampling Procedure and Sample Size

The sample of the financial institutions was selected using a combination of convenience sampling technique and stratified random sampling technique. Using the stratified random sampling technique, a total of 16 banks and 25 insurance companies was used as sample size. The convenience sampling technique ensures that only banks and insurance firms that have the accounts and annual reports from 2007 to 2011 are used for the study. These financial institutions were considered because they are listed in the Nigerian Stock Exchange market which therefore enabled us to have easy accessibility to their annual reports which is the major source of our secondary data. Moreover, the five year period which the study covers is the period during which financial institutions witnessed financial crisis at an alarming rate.

Method of Data Collection

The data for the two independent variables that reflect the characteristics of the board and other corporate governance mechanisms as well as that of the audit quality are hand collected from the financial institutions' annual reports. The financial data used to calculate earnings management was sourced from the annual reports and accounts of 16 banks and 25 insurance firms. There are a total of 205 annual reports of financial institutions listed in the Nigerian Stock Exchange market for the years 2007 to 2011. Similarly, the control variables used in this study were derived from the financial institutions' annual reports. Thus, data collection procedure was systematically done. Cross checking and verifying by research assistants during the comprehensive collection process minimizes omissions and errors.

Method of Data Analysis

The researcher used descriptive method to analyse the personal data of the respondents, while inferential statistics was used to test the hypotheses. Such statistical techniques include regression analysis and factor analysis. All the hypotheses were tested at the 0.05 level of significance. The statistical package for social science (SPSS) was used to generate the results. The test was carried out at $P>0.05$ through the following procedures:

Results and Discussions

Hypothesis One

The null hypothesis states that there is no significant relationship between specialized auditor and earnings management in financial institutions. In order to test the hypothesis, two variables were identified as follows:-

1. Specialized auditor as the dependent variable
2. Earnings management in financial institutions obtained as the dependent variable.

The two sets of variables were subjected to regression analysis in order to generate the R-value. (See table 1).

Table 1: Regression analysis of the relationship between specialized auditor and earnings management in financial institutions

Model	**R**	**R Square**	**Adjusted Square**	**Std Error of the estimate**
1	.484[a]	.234	.215	.40085

$P<0.05$; df =39; critical R-value =0.326

Table 1 above presents the result of the data analysis which showed the relationship between specialized auditor and earnings management in financial institutions. From the result of the data analysis, the calculated R-value (0.48) was greater than the critical r-value of (0.326) at 0.05 alpha level with 39 degree of freedom. The calculated R- square values (co-efficient) of (0.23) predict (23%) of the relationship between specialized auditor and earnings management in financial institutions. This rate of percentage is lowly positive and therefore implies that there is significantly low relationship between specialized auditor and earnings management in financial institutions. The significance of the result is in agreement with the findings of Balsam *et al.* (2003) who argued that an industry-specialist auditor provides a higher level of assurance than does a non-specialist because of the specialist auditors knowledge of the firm and its accounting. The result further relate with the opinion of Ashen (2011) who opined that firms audited by industry specialist auditors are associated with higher earnings quality. Similarly, Kwon *et al.* (2007) in an impact evaluation of specialist auditors on earnings quality of firms across countries, found out that audit by industry specialists is very effective in enhancing earning quality in countries with weak legal environment. Finally, the results agree with the work of DeAngelo (1981) who acknowledged that industry specialization is one of the possible reasons for the selection of Big-5 auditors by IPO Companies. Contrary to the above, Lawrence *et al.* (2011) found no association between industry specialization and absolute discretionary accruals. The result of this study is consistent with the theory that auditor industry specialization plays a role in enhancing audit quality. This portrays further that firms that engage industry specialists to audit their external financial reports may benefit from a reduced likelihood of opportunistic earnings management (Dunn and Mayhew, 2004; Rusmin, 2010; Gul *et al.* 2010). The significance of the result caused the null hypothesis to be rejected while the alternative one was accepted.

Hypothesis two

The null hypothesis states that there is no significant relationship between auditor's opinion and earnings management in financial institutions. In order to test the hypothesis, two variables were identified as follows:-

1. Auditor's opinion as the dependent variable
2. Earnings management in financial institutions obtained as the dependent variable.

The two sets of variables were subjected to regression analysis in order to generate the R-value. (See table 2).

Table 2: Regression analysis of the relationship between auditor's opinion and earnings management in financial institutions

Model	**R**	**R Square**	**Adjusted Square**	**Std Error of the estimate**
1	.519[a]	.269	.251	.39159

P<0.05; df =39; critical R-value =0.326

Table 2 above presents the result of the data analysis which showed the relationship between auditor's opinion and earnings management in financial institutions. From the result of the data analysis, the calculated R-value (0.52) was greater than the critical r-value of (0.326) at 0.05

alpha level with 39 degree of freedom. The calculated R- square values (co-efficient) of (0.27) predict (27%) of the relationship between auditor's opinion and earnings management in financial institutions. This rate of percentage is lowly positive and therefore implies that there is significantly low relationship between auditor's opinion and earnings management in financial institutions. The significance of the result is in agreement with the opinions of Bartov *et al.* (2001) who suggested that modified auditor opinion is associated with the level of absolute abnormal accruals. In the contrary, the findings disagrees with that of Butler *et al.* (2004) who concluded that discretionary accruals or earnings management is not associated with qualified audit opinion. He explained that the auditor forms his opinion using qualified report according to circumstances such as scope limitation, material uncertainty, and disagreement with managers, rather than the incidence of earnings management. In addition, he suggested that large negative accruals may arise from financial problems rather than an intention to manipulate earnings. Lastly, the result confirms the opinions of Porter *et al.* (2003), who posited that the auditor report represents the final stage of an audit examination that the auditor uses to communicate the information regarding a company's financial position. The significance of the result caused the null hypothesis to be rejected while the alternative one was accepted.

Conclusion

Based on the findings of the research work, the following conclusions are drawn:

The study has provided both empirical and statistical evidence on the usefulness of audit quality factors namely: specialized auditor and audit opinion in explaining and predicting opportunistic earnings management in sampled financial institutions in Nigeria. The study also established the existence of earnings management practices in financial institutions in Nigeria. The general conclusion of this study is that there exist earnings management practices in some financial institutions in Nigeria. And that there is remarkable relationship between quality factors as regard specialized auditor and auditor's opinion with earnings management in some financial institutions in Nigeria.

Recommendations

The following recommendations are deemed necessary:

The findings of this study led to the conclusion that earnings management exists in some financial institutions in Nigeria and is likely to be so in the foreseeable future. Consequently, the regulatory agencies such as the Central Bank of Nigeria (CBN) and Securities and Exchange Commission (SEC) among others can only endeavor to curb it by, for instance, compelling companies to activate the role of internal corporate governance and audit firms by raising the audit quality. The following recommendations may contribute to mitigating the opportunistic earnings management practices and raise the quality of corporate governance and audit quality in financial institutions in Nigeria:

i. Auditors should be aware of their legal obligation towards shareholders by increasing the skills and competence of their audit team to detect earnings management.
ii. The regulatory agencies should create more awareness on the concept of corporate governance mechanism and its role in developing the financial sub-sector of the economy.
iii. The composition of the board of directors should be done in such a manner that guarantees diversity of experience without trading-off independence and integrity.
iv. The relevant professional bodies and regulatory agencies should facilitate the application of International Financial Reporting Standards (IFRS) in financial institutions in Nigeria as this would improve the quality of financial reporting and reduce earnings management practices.

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