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EXTERNAL AUDIT CHARACTERISTICS AND EARNINGS MANAGEMENT: INCOME SMOOTHING APPROACH

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Abstract

This study seeks to evaluate the effect of external audit characteristics on earnings management of listed consumer goods firms in Nigeria. based on the principal-agent theory which assumes that the auditor may impair his ability and freedom to make a sound assessment. This study specifically, explored the subject by employing a sample of seventeen (17) listed consumer goods firms in Nigeria for the period between 2010 and 2019. External audit characteristics which were employed as independent variables include; audit tenure and joint audit together with asset tangibility which is employed as control variable. In this study, a unique measure of earnings management (small profit) is employed as the dependent variable following related extant literature. Further, the effect of external audit characteristics on earnings management is evaluated using logistic regression analyses technique which revealed that on average and all things being equal, higher auditor independence has a significant likelihood of reducing managers income smoothing activities in Nigeria. Particularly, this result is consistent with the expertise hypothesis which postulates that extended tenure improves working relationship between the auditor and the firm which makes for better understanding and learning on the job. However, based on the outcome of this study, it is recommended that serious attention should be given to policies that tend to improve audit tenure system compliance in Nigeria.

Introduction

The devastating effects of earnings management recorded among corporate entities all over the world have been a subject of attention in recent decades. Worse among these scandals is the case of Enron and WorldCom in the USA. Little wonder why Albrecht, Albrecht, and Albrecht (2004) noted that the United States alone recorded over ten largest bankruptcies in year 2002. Surprisingly, all the cases have been linked to earnings management practices carried out by managers which heightened the search for the actual relationship between accounting quality and audit process quality. However, a second critical issue lies in the question of whether these corporate collapses are not a result of

poor audit quality and the failure of the audit function to stop earnings manipulations. Okolie, Izedonmi, and Enofe (2013) document that to restrain the rise in vicious corporate collapses and to assure the integrity of auditors, audit quality codes of best practice should be developed. Hence, quality audit process tends to examine the probability of material misstatements and decreases the possibility of undetected misstatements to a manageable level.

Earnings management cannot be completely addressed without considering income smoothing, which is a special strategy in earnings management. It is an earnings management tactic that conveys the impression that managers have incentives to reduce excessively high earnings and raise excessively low earnings. Earnings smoothing, according to Ozili (2017), is a vital earnings management technique that can be either "artificial" or "absolute," with real smoothing involving decisions that affect cashflow and dissipate firm value at obvious costs. Managers are well-known for attempting to influence stakeholders' perceptions on company's financial situation (Boudiche, 2013). This have prompted scholars such as Dechow & Skinner (2000) to propose that managers manipulate the figures "down" to minimize the amount of taxes owed, or "upward" to smooth earnings in order to meet financial analyst standards.

According to Bartov, Givoly, and Hayn (2002) managers are forced to manage the results to prove good performance records to shareholders and other financial statement users. Hence curbing income smoothing behaviour cannot be effectively executed without putting into consideration the need for audit quality. Earnings quality, which is essentially a product of audit quality, is critical for investors' decisions making. According to Susanto (2013), audit quality will reduce uncertainty in financial statements, which is essential in reducing earnings management. In addition, audit efficiency refers to how well an audit identifies and records material financial statement misstatements. Little wonder why Broberg, Noland and winters (2017) noted that high audit quality should be associated with high information quality of financial statements because financial statements audited by high-quality auditors should be less likely to contain material misstatements and consequently reduce earnings management. In the opinion of Zeptian and Rohman, (2013) one way to ensure high-quality audits is to use the services of qualified and professional auditors.

Studies conducted in Nigeria such as those of Okoh (2015), Okolie (2014), documents significant positive relationship between audit firm size and earnings management while Ndubuisi and Ezechukwu (2017) documents significant negative relationship between firm size and earnings management. These inconsistencies in results show that there is a need for further investigation. More than these, earnings manipulation through discretionary accrual method dominates earnings management literature (Lin & Hwang, 2010) which is also consistent with the views of Dechow, Sloan and Sweeney (1995) who posit that the analysis of earnings management mostly focuses on management's use of discretionary accruals. These studies tend to neglect other possible earnings management avenues one of which is the income smoothing method employed to conceal information about the current year and future year earnings of the company. Therefore, in this study the researcher attempts to discover weather managers of non-financial listed companies in Nigeria do

practice other forms of earnings manipulations (specifically income smoothing method) and investigate how well specific audit characteristics (both internal and external) checkmates such activities. It is in line with this rare measure of earnings management that the researcher conducts this study thereby applying small profit model of earnings smoothing.

Literature Review

Income Smoothing

The intentional normalization of income in order to achieve the desired pattern is known as income smoothing. If the smoothing supplies more knowledge being expressed in the stock price, it is likely to increase resource allocation and can be a key factor in investment decisions. Income smoothing is described by Greenawalt and Sinkey (1988) as managers' strategic reporting behaviour to smooth out fluctuations in realized earnings. Income/earnings smoothing is a common occurrence that Graham et al. (2005)'s in their study indicated that 96 percent of managers which they surveyed showed a clear preference for smoother earnings. Income smoothing entails minimizing recorded earnings variability over time, as well as moving revenue and expenditures between reporting periods to give false impression that a company's earnings are consistent. This practice has been around for decades, and two schools of thought have emerged as to why managers engage in it. First, it provides an ostensibly effective means for managers to disclose confidential information. Second, smoothing is a type of "garbling," in which managers attempt to deceive analysts and others in order to increase managerial compensation (Li & Richie, 2009).

Audit Characteristics

The quality of accounting information has turned an important issue owing, above all, to the evolutionary modern technological changes and business practices witnessed worldwide (Afify, 2009). A major remarkable factor affecting the quality of information consist in corporate annual reporting punctuality and accuracy, which is considered a critical factor affecting information usefulness at the disposal of external users. (Owusu-Ansah & Leventis, 2006). The performance of the audit process of publicly traded corporations is particularly dependent on the views of both external and internal auditors. External auditing is an assessment of a company practices based on current documents including information verifications in order to ascertain financial statements' quality, validity, and reliability. Specifically, Johnstone, Gramling, and Rittenberg (2016) argue that the outcome of the external auditor's services is a function of many factors, including but not limited to: (a) Audit Tenure and (b) joint audit.

Audit Tenure

Adeyemi, Okpala and Dabor, (2012), suggest audit tenure is short when the same auditor has audited the financial statements for a period of three years or long when the same auditor have been engaged for up to nine years. In Pierre & Anderson (1984) audit tenure requires the same auditor to have audited the financial statements of a company for two or three years. Okoh, (2015) remarked that auditor tenure can be seen to be when the same auditor has audited the financial statement of a company for at least a period of nine or more years. But Hartadi (2009) defined "Audit tenure" as the agreed period of engagement between the client and the auditor. Adeyemi and Okpala (2011) opined

that an audit firm's tenure can result in a loss of auditor's independence which indicates that a long audit-client relationship could lead to an alignment of the auditors' interest and that of its client which makes a truly independent behaviour of the auditor a probability.

Joint Audit

Previous studies (Zerni et al., 2012; Alanezi et al., 2012; Baldauf & Steckel, 2012; Ratzinger-Sakel et al., 2013) define joint audit as an audit in which two or more independent auditors, from separate audit firms, are appointed to audit financial statements of an audit client, in such a way that involves: joint development of the audit plan; performing the audit work jointly; making periodic cross reviews and mutual quality controls; issuing and signing a single audit report; and bearing joint liability in case of audit failure. The concept of joint audit should be differentiated from the concept of dual audit, where two or more independent auditors from separate audit firms are appointed to audit financial statements of an audit client in a way that involves: developing the audit plan separately; performing the audit work separately; no periodic cross reviews and mutual quality controls; and issuing two or more audit reports, in which every auditor is not responsible for the audit opinion expressed by the others (Alanezi et al., 2012; Ratzinger-Sakel et al., 2013; Jane lin et al., 2014). Also, the concept of joint audit differs from the concept of Double Audit, where a single auditor is required to fully perform the audit work twice (Alanezi et al., 2012; Ratzinger-Sakel et al., 2013). In a joint audit, two different audit firms jointly form an opinion of a client's financial statements of which they are also jointly liable for the issued audit opinion.

Theoretical Framework

Principal-Agent Theory

The principal-agent theory refers to a relationship or an arrangement in which one entity legally appoints another to act on its behalf. In a principal-agent relationship, the agent (in this study the auditor) acts on behalf of the principal (Owners/Shareholders) and should not have a conflict of interest in carrying out the act. The relationship between the principal and the agent is called the "agency," and the law of agency establishes guidelines for such a relationship. According to the two-tier principal-agent theory, external audits are an incentive to strengthen public trust in financial accounting. The external audit is a monitoring and bonding instrument for management activities and is meant to motivate legally sound and orderly financial accounting. The principal-agent theory assumes that the auditor may impair his ability and freedom to make a sound assessment. There is the possibility of a moral hazard if the auditor and management collaborate. In such a case, the auditor might tolerate faulty financial accounting and grant an unqualified audit opinion in exchange for hidden transfer benefits. Since an auditor's compensation is not fully transparent for the capital market, incurring the risk of hidden actions, there is a danger of biased judgment by the auditor and untruthful reporting on the outcome of the audit. This study relates to this theory as it has been observed that certain auditors' attributes (which we intend to ascertain) may impair his ability and freedom to make sound assessments. Specifically, one or more of these attributes may spur income smoothing of a firm's financial information. (Watts & Zimmerman, 1983).

Auditor Tenure and Income Smoothing

Academic literature shows mixed results on the effect of auditor tenure on earnings manipulations. To this extent, Hohenfels (2016) reports a positive effect of auditor tenure on earnings management, arguing that investors perceive a potential impairment of audit quality as the tenure increases which would affect earnings quality. On the other hand, as auditor tenure increases, the auditor should become better at recognizing material misstatements by gaining experience and better insights into the clients' business strategies and internal financial reporting process (Arens et al., 2005). Several studies show that a long audit relationship improves the conditions of the audit work result. Thus, they argue that the duration of the audit-client relationship can have a positive impact on the quality of the audit performed.

Joint Audit and Earnings Smoothing

There is a strong debate raised by proponents and opponents of the joint audit. Proponents of joint audit (Baldauf & Steckel, 2012; Zerni et al., 2012; Lobo et al., 2013) argue that the practice of joint audit could increase audit quality thereby lowering income smoothing for the following reasons. First, the type of audit report issued by two auditors seems to be more precise than the type of audit report issued by a single auditor because having four eyes to obtain audit evidence could increase the precision of audit opinion that will be issued based on this evidence. Second, Joint audit could improve the auditors' ability to detect material misstatements because it allows each auditor to check the work done by the others to make sure that the other auditors have taken the appropriate audit procedures to obtain the appropriate and sufficient audit evidence. Third, joint audit could improve auditor independence by weakening the economic relationship between the auditor and the client because joint auditors share audit fees between them. In addition, it weakens the economic relationship between the auditor and the management because it might be more difficult for management to manipulate two auditors instead of one. Fourth, Joint Audit could improve auditor competence through preserving knowledge that results from auditors' meetings. Finally, joint audit could reduce audit market concentration by reducing the domination of big audit firms and allowing small audit firms to collaborate with big audit firms, resulting in the emergence of new generation of big audit firms.

On the other side of the divide, opponents of joint audit (Marmousez, 2009; Zerni et al., 2012; Alsadoun & Aljaber, 2014; Deng et al., 2014) argue that the practice of Joint Audit could reduce audit quality for the following reasons. First, it could result in Free Riding problem because small audit firm has fewer resources than the big audit firm, so it will have an incentive to withhold its limited resources and free ride the big audit firm's effort. Second, joint audit could result in Opinion Shopping problem because management may offer to purchase the audit opinion of the small audit firm, and the small audit firm may accept this offer because, in this case, the big audit firm will bear the reputation costs alone. Third, joint audit may result in insufficient information exchange, resulting in compromising audit quality because auditors from competitive audit firms may not have an incentive to cooperate while conducting the audit.

Fourthly, accounting standards contain many accounting alternatives, which may make cooperation between

auditors difficult and lead to conflict between them in the event an auditor chooses a different accounting alternative than the other auditor would prefer. This could lead to a difficulty in reaching a common opinion among the auditors. Fifth, the adoption of joint audit approach may become a ceremonial process. If the same two audit firms participate in the audit of the same clients, an informal agreement may occur between them where each reviews the financial statements of a certain number of clients on their own while the other auditor only signs the report. The audit becomes, in practice, an individual audit, which may adversely affect the accuracy and quality of the audit evidence (Piot, 2007).

Review of Empirical Literature

The study of Enegbe and Atu (2016) aimed at examining the determinants of earnings management using 30 selected quoted companies from 2007-2014 in Nigeria. The study employed corporate governance, firm size, audit firm type and financial performance and made use of ordinary least squares (OLS) regression technique for data analysis. The result revealed the existence of a negative significant relationship between board size, audit firm type and earnings management. The result also showed a non-significant relationship between firm size, return on asset and earnings management, and recommended that there is the need for companies to consider the need to increase their board independence. The authors further recommended that companies must ensure that the auditors' they engage are credible and have a track record of delivering reports that show the actual situation of a company. Furthermore, Financial Reporting Council (FRC) should have stiffer penalty for companies caught engaging in the act of earnings management.

Hamm (2017) create a measure of earnings smoothing through research and development (R&D) expense adjustment and show that firms with stronger labor unions tend to smooth earnings to a greater extent using both discretionary accruals and R&D expenditure adjustment. While there is evidence suggesting that managers use real activities earnings management (RAM) to smooth earnings in addition to accrual management, there is no prior evidence on whether smoothing using RAM improves earnings informativeness.

Mokoaleli-Mokoteli and Latridis (2017) carried out a study on Big 4 auditing companies, earnings manipulation, and earnings conservatism among South African listed companies. The independent variables include discretionary accruals, conditional and unconditional conservatism while the independent variables include Audit big4, operating cash flow, firm size, market to book value ratio, net income, annual stock price, and firm leverage. Results obtained from the regression analysis shows that companies audited by a Big 4 auditor led to a timelier recognition of large losses and to lower levels of earnings manipulation and higher conditional conservatism. The findings also show that the conditional form of conservatism is negatively related to unconditional conservatism.

Obaidat (2017) examines Income Smoothing Behaviour at the Times of Political Crises of non-financial firms listed on the Amman Stock Exchange from 2006 to 2015. The study used Chi-square, Correlation, and Ordinary Least Square Regression for its analysis. The independent variable for the study is political crises while the dependent variable income smoothing was broken down into gross profit (GP),

operating income (OI), income before tax (IT), and net income after tax (NI). The results of the study showed that there are no significant differences in net sales (NS), gross profit (GP), operating income (OI), and current liabilities (CL) before and during the crisis. For net income after tax (NI), the results show a significant difference for industrial firms before and during the crisis, as these firms realized losses during the crisis compared to profits before the crisis. On the contrary, service firms show an increase in NI during the crisis. Although NI for service firms increased during the crisis, the significant increase in total assets (TA) for these firms lead to a decrease in ROA.

The study of Donatella, Haraldsson and Tagesson (2018) tend to answer the question, do audit firm and audit costs/fees influence earnings management in Swedish municipalities? The aim of their study is to explore whether audit firms and audit costs/fees influence municipalities' probability of applying earnings management in their annual accounts. The independent variables of the study include Audit Firm Size, Audit Cost and Audit Fee while the dependent variable was proxy by earnings accruals. Both political and economic factors were employed as control variables. The result from the regression analysis reveals that the probability of earnings management increased if audit costs/fees increased. The study also indicates that different audit firms make different trade-offs between professional versus commercial logics and that this is reflected in the clients' propensity to engage in earnings management and recommended that in order to obtain de facto harmonization and implementation of common accrual-based accounting standards, it is also necessary to ensure that common rules for oversight and an independent high-quality audit are implemented.

The study of Sumiadji, Chandrarin and Subiyantoro (2019) was conducted to test the effect of audit quality on earnings quality in Indonesia. The data set consists of 116 annual data of manufacturing companies listed in the Indonesia Stock Exchange within 2011-2014. The proxies of audit quality are auditor size, audit tenure, and audit specialization while earnings quality proxies include accrual quality, persistence, predictability, and income smoothing. Two analysis techniques include confirmatory factor analysis and multiple regression analysis to test the effect of auditor size, audit tenure, and audit specialization on earnings quality. The result reveals that earnings quality is formed by the attributes of persistence and predictability. Research results showed that auditor size and audit tenure influence earning quality, but audit specialization do not.

Methodology

Ex-post facto research design and descriptive research design have been employed in this study. This study employed secondary data collection technique. In this study, the entire population includes nineteen (19) listed consumer goods firms in Nigeria for the period between 2010 and 2019. To obtain the sample size and based on the nature of this study where we need to employ cross-section (consumer goods firms) that poses similar characteristics and attributes, we draw the sample size through the procedure of sampling filtering where a sample size of 17 consumer goods was obtained. We delete two consumer goods firms which the researcher deems unfit as all relevant information required for this study were not available. Logistic regression analyses is employed in this study to

determine the effect of audit characteristics on income smoothing of listed consumer goods companies in Nigeria. Specifically, the researcher modified the model of Francis & Yu (2009) which has been specified as;

Model Specification

SMLPROFIT = π_0 + π_3AUDTEN + π_4JOINTAUD+ π_6ASSETTAN + μt

Where:

smlprofit = Small Profit
audten = Audit Tenue
jointaud = Joint Audit
assetan = Asset Tangibility

Results and Discussion

In identifying the possible auditor's characteristics that determines income smoothing, first, the researcher conducted descriptive statistics. The descriptive statistics provided in the table below provides some insight into the nature of the selected Nigerian listed consumer goods firms that have been employed in this study.

Table 1: Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
smlprofit	170	.1588235	.3665912	0	1
jointaud	169	.0473373	.2129904	0	1
audten	170	.7941176	.4055394	0	1
assettan	170	48.00341	19.19671	2.81	95.46

Authors Computation (2021)

From the table shown above, we observed that on average income smoothing as measured by small profit (a proxy that takes a value of "1" if the firm's return on asset is greater 3% and "0" for otherwise) is 16%. This implies that 16% of the firms in our sample had return on asset above 3% indicating income smoothing. More than this, we observed that 5% of the sampled firms had their accounts jointly audited as revealed by the mean value of joint auditor (0.047). On average, the table shows that auditor's tenure is 0.79 indicating that 79% of the firms in our sample met the tenure requirement for an auditor which in Nigeria is statutory at 3years. For the control variable, asset tangibility averaged at 48.00 during the period under consideration.

Logistic Regression

Logistic regression is a specialized form of regression that is formulated to predict and explain a binary categorical variable rather than a metric dependent measure. Therefore, in line with existing literature on dichotomous measurement of small profit as a proxy for income smoothing, logistic regression is used in this study and the results is shown below;

Table 4.2: Logistic Regression Estimates

Variables	**Joint Auditor**	**Auditor Tenure**	**Asset Tangibility**
Income Smoothing Model			
Coefficient	2.164	-1.151	0.027
z_ Statistics	(2.40)	(-2.30)	(2.01)
Probability_z	{0.016} **	{0.022} **	{0.044} **

No. of Obs. = 169 **Prob. > chi2 = 0.0154** **Pseudo R-Square = 0.0717**

Note: t-statistics and respective probabilities are represented in () and {}
Where: ** represents 5% represent level of significance
Source: Authors' Computations (2021)

The table above show a summarized result obtained from the small profit logistic model where the coefficient, Z_statistics as well as the corresponding probability of the Z_statistics for the model are shown. The logistic regression result above reveals a Pseudo R^2 value of 0.0717 which indicates that about 7% of the variation in the dependent variable has been explained by all the independent variables in the model. This also suggest that 93% of the variation in the dependent variable is left unexplained but have been captured in the error term. Furthermore, the model goodness of fit as captured by the Likelihood ratio statistics and the corresponding probability value (0.0154) shows a 5% statistically significant level suggesting that the entire model is fit. Particularly, the classification table shown in the appendix section reveals that out of 1 case that fell into the group of positive small profit likelihood, 1 case was predicted correctly (100%) with 3.85% sensitivity accuracy while 143 out of 168 cases that fell into the group of negative small profit likelihood were predicted correctly (85.63%) with 100% specificity accuracy. However, it is observed that the overall accuracy rate is seen to be roughly 85.21% which suggest that the model is free from any significant bias hence can be employed for interpretation and policy recommendation.

In view of the result obtained from the logistic regression model, it is observed that joint auditor has a significant likelihood of increasing income smoothing. This is evident from the variable of joint auditor with coefficient = 2.164, z-statistics = 2.40 and Probability z = 0.016. Clearly, this result indicates that on average and all things being equal, there is a significant chance that adopting the services of joint auditor will increase income smoothing. Our result tally with the result of Geirger and Raghunandan, (2002) who stressed that joint audit is important because long-running intimacy with the client by two auditors can erode independence hence income smoothing becomes inevitable but disagrees with those of Cahan and Zhang, (2006); Krishnan, (2007); Nagy, (2005); Barbadillo et al. (2009); Kim and Yi (2009); Cahan and Zhang, (2006); Krishnan, (2007); Nagy, (2005); and Chung (2004). We find that auditor's tenure has a significant negative likelihood on income smoothing during the period under consideration. This is evident from the variable of auditor's tenure with coefficient = -1.151, z-statistics = -2.30 and Probability z = 0.022. Clearly, this result indicates that on average and all things being equal, higher auditor independence has a significant chance of reducing managers income smoothing activities in Nigeria. Particularly, our finding is consistent with the expertise hypothesis which postulates that extended tenure improves working relationship between the auditor and the firm which makes for better understanding and learning on the job. However, the result disagrees with the hypotheses that longer audit tenure could be a threat to independence which is hinged on the fact that longer union between the client and the auditor may raise

too much familiarity which could threaten "honest neutrality" as opined by Vanstraelen, (2000); Carey and Simnett, (2006).

Conclusion and Recommendation

The widespread failure in financial disclosure has created the need to improve financial information quality. Consequently, the factors which might influence the occurrence of income smoothing have been an intense and inconclusive area of research thus has provided an interesting issue of discourse. Based on reviewed literature and also propelled by the gaps in the literature two factors both exogenous and endogenous have been identified and framed for analytical purpose in this study. It seems clear that both variables of joint auditor and auditor's tenure have significant likelihood on income smoothing of listed consumer goods firms under study. Hence, in this study, we recommend a policy shift. This requires that serious attention should be given to issues that tend to improve compliance to audit tenure system in Nigeria. Furthermore, we believe that less effort should be geared towards engaging policies that will discourage joint audit practices since joint auditing will likely lead to increase income smoothing behavior of firm managers as evidenced from the study.

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