THE NEXUS BETWEEN AUDIT FIRM CHARACTERISTICS AND EARNINGS MANAGEMENT AMONG QUOTED INSURANCE COMPANIES IN NIGERIA

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ABSTRACT

The study investigated the nexus between audit firm characteristics and earnings management among quoted insurance companies in Nigeria. Audit firm characteristics is examined in terms of audit fees, auditor experience, audit quality, and auditor switching. The population of the study consists of quoted insurance firms in the Nigerian Stock Group for the period of 2016 to 2022, and data were analyze using descriptive statistics, correlation matrix and Generalized Linear Regression technique. The results show that audit fees have a negative and insignificant relationship with earnings management. Auditor experience has a negative and significant with earnings management at 5% level of significance. Audit quality has a positive and insignificant relationship with earnings management. Auditor switching has a negative and insignificant effect on earnings management. The study recommends that shareholders of insurance companies in Nigeria should engage the services of audit firms that with reasonable sound knowledge and experience about the industry for reducing earnings manipulations.

Keywords: Auditor experience, audit fees, audit quality, auditor switching and earnings management

INTRODUCTION

Earnings management (EM) is primarily achieved by management actions that make it easier to achieve desired earnings levels through accounting choices from among Generally Accepted Accounting Principles (GAAP) and operating decisions. Meanwhile, standard setters and the accounting profession are critically concerned about the practice of EM and the unfavorable consequence it has on financial reporting. Umobong and Ironkwe (2017) posited that EM is also known as creative accounting, income smoothing, window dressing accounting, cosmetic accounting, innovative accounting, and financial engineering, and it has been in existence since the origin of accounting. Mamo and Aliaj (2014) affirmed that manipulation of financial reports has a large asymmetry of information for readers of financial statements and affect their decision making. However, in recent years, many corporations are found in the practice of EM, and this has been a global concern due to the havoc it has caused to the global economy, that is, it attracts more and more attention in the whole financial market and its presence distorts the true and fair view of the financial position of companies, and may cause serious corporate failure (Mahmia, 2017).

Monametsi and Agasha (2020) opined that audit firm characteristics help to ensure that financial statements of quoted companies are reliable, faithfully represented, comparable, understandable, and credible to enhance market confidence and sustainable performance. The essence of audit firm characteristics is to promote sound audit practice for strong corporate governance principles and effective internal control mechanisms that result in prudent financial management for enhancing sustainable performance.

The Nigeria insurance service sector has been faced with turbulent operating business environment resulting from intense competition, strict regulatory requirements, dynamic customer preference, fraudulent financial reporting, investor expectations, among other stakeholders' interests (Syder & Miebaka, 2022). In spite of this, the high-profile corporate scandals that resulted in the collapse of highly rated companies both at home and abroad have decreased the extent to which stakeholders placed their trust on the quality of reported earnings by corporate managers (Awuye & Aubert, 2022). This study extends debates by investigating the nexus between audit firm characteristics and earnings management among quoted insurance companies in Nigeria. Therefore, this study contributed to the body of knowledge in the application of Generalized Linear Model regression approach in investigating the nexus between audit firm characteristics and earnings management among quoted insurance companies in Nigeria.

LITERATURE REVIEW

Earnings Management

Earnings management (EM) is a strategy used by the management of a company to deliberately manipulate the company's earnings so that the figures match a pre-determined target. According to Rahman and Akande (2022), corporate managers carried out earnings management by abusing the accrual component in the financial statements. This practice is carried out for the purpose of income smoothing. Thus, rather than having years of exceptionally good or bad earnings, companies will try to keep the figures relatively stable by adding and removing cash from reserve accounts. Akenbor and Ibanichuka (2012) viewed EM as an accepted accounting approaches or methods which allow business organization to report financial results that may not accurately portray the substance of their business operation. For instance, an accountant can create accounting figures using his or her professional judgment to estimate the useful life of an asset. The accountant may err on the side of caution or optimism in the estimation. Lestari (2017) defined EM as a situation whereby the preparers of the financial statement deviate from the application of accounting standards and as a result, lead to low quality of the financial reporting. However, creative accounting in some cases is not illegal, but due to the financial pressure managers found themselves, they manipulate the financial reporting without considering the ethical issues. Emudainohwo (2021) described EM as a kind of corporate disclosure planned by corporate managers, presented to corporate stakeholders as well as financial statement users for the achievement of private benefits. It is a way of misleading corporate stakeholders and potential investors by reporting dishonest financial information as regards corporate performance as if it were true.

Audit Firm Characteristics

Audit firm characteristic reflects the professionalism of auditors in an audit engagement. Audit fees, auditor experience, audit quality and auditor’s switching were considered in this study.

Audit Fees and Earnings Management

Audit fee (AUDF) is one the paramount variables of interest that might influence earnings management. AUDF are payments made to the auditor for carrying out the audit function and non-audit fee is the payments for other non-audit services carried out by the auditor which may not be part of the audit engagement negotiation. Audit is playing an important role in developing and enhancing the global economy and business firms (Husam, et al., 2013). Auditors base their opinion on the true and fair view of the financial statements. Therefore, auditors must improve on their skills to increase the probability to rely more on the auditor's report and audited financial statements which are more relevant, unbiased, and accurate for the decision makers. Akrawah and Akhor (2016) defined AUDF as the process of determining the fees payable to the auditor, for carrying out audit services offered to the auditing company. Ohidoa and Okun (2018) added that AUDF fee is the money received by an auditor for carrying out an audit assignment for clients. Gandía and Huguet (2021) examined the effect of AUDF on AUDQ proxied by the level of EM in Spain. Spanish SMEs composed of both voluntarily and mandatorily audited companies were sample for the collection of data and analyzed using descriptive statistics and regression technique. Mat et al. (2021) studied the effect of auditor’s reputation, auditor’s fee and auditor’s skepticism audit quality in EM in Nigeria and documented that auditor’s fee has no significant effect on EM. The results showed that AUDF has a significant negative relationship with EM.

This study hypothesis proposed that audit fees have a significant relationship with earnings management among quoted insurance companies in Nigeria.

Audit Experience and Earnings Management

Auditor’s experience (AUDE) is a good will or professional judgment which is the ability to separate vital information and make decisions regarding the accounting information (Agevall et al., 2018). AUDE is an ability based on sound knowledge, experience gained through regular training, adaptability, technical ability and technological ability and assisting the auditor in discharging his/her professional ethics behaviour in the audit assignment (Nurhadi et al., 2022). Tumundo, et al. (2019) stated that AUDE is the number of tasks carried out within the length of time spent as based on the examination of the financial reports and accounts. Salma and Maha (2022) studied the effect of audit quality (AQ) on timeliness of financial reporting quality (FRQ) proxied by accounting conservatism in Egypt and established that audit experience exerts a significant negative effect on EM and audit firm size and audit firm fees exert a significant positive on EM. Mat et al. (2021) studied the effect of auditor’s reputation, auditor’s fee and auditor’s scepticism audit quality in EM in Nigeria and found out that auditor’s experience has a significant positive effect on EM while auditor’s fee has no significant effect on EM.

The study hypothesis proposed that audit experience has a significant relationship with earnings management among quoted insurance companies in Nigeria.

Audit Quality and Earnings Management

Quality audit (AUDQ) is the process of auditing financial statements by qualified auditors to find and report material errors resulting in quality information (Rahmawati et al., 2017). The credibility of the financial report is a pivotal of AUDQ. AUDQ can reduce EM practices because audited financial statements especially with public accounting firms like the big four (Deloitte Touche Thomatsu, Klynveld Peat Marwick Goerdeler, Price Waterhouse Coopers, and Earnest & Young) are able to provide better AUDQ assurance to prevent the company from carrying out EM (Rinta, 2021). Prior study conducted by Alawadi and Rashid (2023) on the mediating effect of AUDQ on the relationship between financial indicators EM in Jordan for the period of 2009 to 2018 revealed that audit quality had a mediating effect on the relationship between financial structure ability and EM. Awuye (2022) studied the impact of AUDQ on earnings management (EM) in France. AUDQ was proxied by Big 4 and non-Big 4 while was EM proxied by real and accruals EM estimation and data was analyzed using multivariate regression techniques. The empirical evidence revealed that AUDQ has a significant positive impact on EM. Nwoye et al. (2020) used a sample of selected insurance companies in Nigeria to examine the effect of AUDQ on EM and establish from the fixed effect panel regression that AUDQ had a significant effect on EM.

The study hypothesis proposed that audit quality has a significant relationship with earnings management among quoted insurance companies in Nigeria.

Audit Switching and Earnings Management

Auditor switching has been a major issue in research to be addressed in order to improve audit quality for decades (Choi et al., 2017). Qawqzeh et al. (2018) argued that mandatory audit firm rotation reduces audit quality and will lead to additional costs for switching audit firms. Onwuchekwa et al. (2012) added that firms are mandated to switch after a number of years irrespective of the objectivity, independence, efficiency and quality of the auditor, the willingness of the shareholders and the management to keep the auditor. Salehi et al. (2022) investigated the effects of mandatory requirements of audit firm rotation (auditor switching) on EM among companies listed in Iran for the period of 2003 to 2012. The results showed that auditor switching has a significant positive effect on accruals-based EM while insignificant effect on real EM. The study of Can (2019) in Turkey on the impact of auditor qualifications on EM established that auditor switching has an insignificant impact on EM.

The study hypothesis proposed that audit experience has a significant relationship with earnings management among quoted insurance companies in Nigeria.

Review of Related Theory

Agency theory was introduced by Alchian and Demsetz in 1972 and further developed by Jensen and Meckling in 1976. The theory is based on the relationship between the principal (owners) and agents (managers). The separation of ownership from management in the modern organization provides the context for the function of the agency theory. Jensen and Meckling (1976) suggested that the distinction between ownership and control creates the potential for conflict of interest between shareholders and managers, which results in costs associated with resolving the conflict. Evidence from literature considered this conflict to be the foundation of EM. Meanwhile, managers cannot be fully trusted, and there must be strict monitoring of managers (agent) by the owners (principal) through their representatives such as firm's board which serves as fundamental mechanism to protecting shareholder's interest from being compromised when managers maximize their self-interest at the expense of the organization's profitability. Generally, EM and creative accounting activities that reduce transfers from stockholders to the government should enhance shareholders' wealth. Therefore, agency theory assumes a model of a manager that is individualistic, self-serving, and opportunistic in nature. Managers prefer to maximize their own interests by creating accounting to improve their bonus package at the expense of the owners. When there are conflicts between the interests of the principal and the agent, the agent may not act in the best of interests of the principal. To avoid or minimize such divergences from their interests, the principal can establish monitoring systems.

METHODOLOGY

Research Design

The study research design is quantitative nature implies the use of numerical data to examine the nexus between earnings management and audit firm characteristics. The population of the study would consist of quoted insurance firms in the Nigerian Stock Group (NGX, 2022). The simple random sampling technique was used to sample twenty (20) insurance firms that consistently published audited financial reports and accounts for the period of 2016 to 2022.

Model Specification and Measurement of Variables

Generalized Linear Regression analysis was used to estimate the nexus between earnings management and audit firm characteristics. The regression model is to explain change or variation in the value of the dependent variable (earnings management) on the basis of changes in the independent or explanatory variables. The regression model with an error term is specified in econometric form as follows

$EMGT_i = \beta_0 + \beta_1 AUDF_{i1} + \beta_2 AUDE_{i2} + \beta_3 AUDQ_{i3} + \beta_4 AUDS_{i4} + e_i$ ………………………… (1)

EMGT = Earnings management. EM was measured by discretionary accruals. The discretionary accruals measurement for EM is consistent with the existing EM literature (Bala, et al., 2018).

AUDF = Audit fees. It was measured by the sum of money paid to the audit firm for the audit assignment (Akrawah & Akhor, 2016).

AUDE = Auditor experience. It was measured as the length of work experience in the client relationship. 1 for 1-5 years audit experience, 2 for 6-10 years audit experience, 3 for 11-15 years audit experience, and 4 for more than 15 years audit experience (Suryandari & Yuesti, 2017).

AUDQ = Audit quality. It was measured by a dummy variable: “1” if big-4 audited the firm “1” or OTHERWISE “0” (Hung, et al., 2018)

AUDS = Auditor switching. It was measured by a dummy variable: “1” if audit firm has been switched “1” or OTHERWISE “0”, (Akrawah, et al., 2020).

β_1- β_4= Coefficients to be estimated.

e_t = Error term

RESULTS

The presentation of result begins with the summary statistics which was presented in Table 1 below:

Table 1: Descriptive Statistics

	EMGT	AUDF	AUDE	AUDQ	AUDS
Mean	0.371809	24923.72	1.198529	0.573529	0.161765
Median	0.165000	16739.00	1.000000	1.000000	0.000000
Maximum	8.122000	134344.0	2.000000	1.000000	1.000000
Minimum	0.001000	2580.000	1.000000	0.000000	0.000000
Std. Dev.	1.069807	21234.93	0.400367	0.496392	0.369596
Skewness	6.090083	2.076390	1.511537	-0.297351	1.837063
Kurtosis	41.06202	8.653103	3.284743	1.088417	4.374801
Jarque-Bera	9050.085	278.8179	52.24697	22.71097	87.20592
Probability	0.000000	0.000000	0.000000	0.000012	0.000000
Sum	50.56600	3389626.	163.0000	78.00000	22.00000
Sum Sq. Dev.	154.5058	6.09E+10	21.63971	33.26471	18.44118
Observations	136	136	136	136	136

Source: EViews 9.0 Output (2023)

It was observed from Table 1 above that earnings management (EMGT) has a mean value of 0.37 with a corresponding standard deviation value of 1.07. It was observed that on the average audit fee (AUDF) was N24,923.72 million with a standard deviation value of N21,234.93. Auditor’s experience (AUDE) has a mean of 1.19 with a corresponding standard deviation of 0.40. Audit quality (AUDQ) had a mean of 57% with a corresponding standard deviation of 0.50 while Auditor switching (AUDS) has a mean of 16% with a corresponding standard deviation of 0.37. The skewness statistics showed that EMGT, AUDF, AUDE and AUDS were positively skewed while AUDQ was negatively skewed. Therefore, the Jarque-Bera (JB) statistics showed that none of the variables is normally distributed. The correlation analysis was presented in Table 2 below.

Table 2: Correlation Matrix Result

	EMGT	AUDF	AUDE	AUDQ	AUDS
EMGT	1.000000	-0.028630	-0.096395	0.047215	-0.079841
AUDF	-0.028630	1.000000	-0.158041	0.520624	-0.040236
AUDE	-0.096395	-0.158041	1.000000	-0.353536	-0.118521
AUDQ	0.047215	0.520624	-0.353536	1.000000	0.096188
AUDS	-0.079841	-0.040236	-0.118521	0.096188	1.000000

Source: EViews 9.0 Output (2023)

The result in Table 2 above showed that audit fee (AUDF) has a negative and weak correlation with earnings management (EMGT =-0.0286). Audit experience (AUDE) has a negative but weak correlation with earnings management (EMGT=-0.0963). Audit quality (AUDQ) has a positive and weak correlated with earnings management (EMGT=0.0472). It was also revealed that auditor switching (AUDS) has a negative but weak correlation with earnings management (EMGT=-0.0798). Based on the correlation coefficient, none of the independent variables were perfectly correlated which implies there is absence of multicollinearity among the variables. This was represented in Figure 1 below.

Table 3: Variance Inflation Factors

Variable	Coefficient Variance	Uncentered VIF	Centered VIF
C	0.139826	16.50222	NA
AUDF	2.63E-11	3.314873	1.388250
AUDE	0.061397	11.56166	1.152954
AUDQ	0.053577	3.626532	1.546609
AUDS	0.064288	1.227351	1.028809

Source**:** EViews 9.0 Output (2023)

5.1. Regression Results

The regression result was presented using Generalized Linear Estimation Models. The regression result was presented in Table 3 below.

Table 4: Regression Result

Variable	Coefficient	Std. Error	z-Statistic	Prob.
C	0.258660	0.952429	0.271580	0.7859
AUDF	-1.11E-05	6.30E-06	-1.756120	0.0791
AUDE	-0.941476	0.426395	-2.207989	0.0272
AUDQ	0.334179	0.532171	0.627955	0.5300
AUDS	-0.977028	0.386003	-2.531140	0.0114

Mean dependent var	0.371809	S.D. dependent var	1.069807
Sum squared resid	150.7543	Quasi-log likelihood	-95.27392
Deviance	116.1623	Deviance statistic	0.886735
Restr. deviance	126.8040	Quasi-LR statistic	10.64167
Prob(Quasi-LR stat)	0.030900	Pearson SSR	310.8033
Pearson statistic	2.372544	Dispersion	1.000000

Source**:** EViews 9.0 Output (2023)

Table 3 above revealed that Quasi-LR statistic value of 10.64 with p-value of 0.03 indicating that the model has high predictive power. It was found out that audit fee (AUDF) has a negative and insignificant coefficient of −1.11 with a p-value > 0.05. This implies that the audit fees had a negative and insignificant relationship with earnings management among quoted insurance companies in Nigeria. The result was consistent with prior research that audit fees had an insignificant relationship with earnings management (Mat et al., 2021) while contrary with prior research that audit fees had a significant relationship with earnings management (Gandía & Huguet, 2021; Salma & Maha, 2022). Auditor experience (AUDE) has a negative and significant coefficient of −0.94 with a p-value < 0.05. This implies that the auditor experience had a negative and significant relationship with earnings management at 5% level of significance among quoted insurance companies in Nigeria.

The result was consistent with prior research that auditor experience had a significant relationship with earnings management (Salma & Maha, 2022; Mat et al., 2021). Audit quality (AUDQ) has a positive and insignificant coefficient of 0.33 with a p-value > 0.05. This implies that the audit quality had a negative and insignificant relationship with earnings management among quoted insurance companies in Nigeria. The result was contrary with prior research that AUDQ had a significant relationship with EM (Alawadi & Rashid, 2023; Awuye, 2022). Auditor switching (AUDS) has a negative and significant coefficient of -0.97 with a p-value < 0.05. This implies that the auditor switching had a negative and a significant relationship with earnings management at 1% level of significance among quoted insurance companies in Nigeria. The result was consistent with prior research that auditor switching had a significant relationship with earnings management (Salehi, et al., 2022) while contrary to prior research that auditor switching had insignificant relationship with earnings management (Can,2019)

CONCLUSION AND RECOMMENDATIONS

The study investigated the nexus between audit firm characteristics and earnings management among quoted insurance companies in Nigeria. The essence of audit firm characteristics is to promote sound audit practice for strong corporate governance principles and effective internal control mechanisms that result in prudent financial management for enhancing sustainable performance. Earnings management is primarily achieved by management actions that make it easier to achieve desired earnings levels through accounting choices from among Generally Accepted Accounting Principles (GAAP) and operating decisions. The agency theory is the basic theory to buttress the study. Therefore, agency theory assumes a model of a manager that is individualistic, self-serving, and opportunistic in nature. The regression results show that audit fee has a negative and insignificant relationship with earnings management among quoted insurance companies in Nigeria; auditor experience has a negative and significant with earnings management at 5% level of significance among quoted insurance companies in Nigeria; audit quality has a positive and insignificant relationship with earnings management among quoted insurance companies in Nigeria; and auditor switching has a negative and insignificant coefficient with earnings management at 1% level of significance among quoted insurance companies in Nigeria. Based on these findings, the study recommends as follows:

i. The shareholders of insurance companies in Nigeria should engage the services of audit firms with reasonable sound knowledge and experience about the industry for reducing earnings manipulations.
ii. The shareholders of insurance companies in Nigeria should ensure that auditor switching would be carried out on a mandatory basis to the presence of earnings management.

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