PDF - EFFECTS OF AUDIT QUALITY ON EARNINGS MANAGEMENT OF LISTED OIL MARKETING COMPANIES IN NIGERIA - researchcub.info**CHAPTER ONE**

## INTRODUCTION

### 1.1Background to the Study

Financial reporting is one of the primary responsibilities of management which enables them give account of their stewardship. Managers of public companies are expected to prepare and present annual financial reports to shareholders, who are owners of the firm and other interested users such as creditors, analysts, government, and the general public to enable them assess the performance and financial position of the reporting entity. The main objective of financial reporting therefore is the provision of information on the financial performance and position of the reporting entity that is useful to different users, to enable them assess the stewardship of management and make informed economic decisions (International Accounting Standards Board (IASB), 2008; Glautier, Underdown, & Morris, 2011). This means that published financial reports that fail to meet the information needs of its users do not achieve their intended purpose.

In order to achieve this objective, information contained in financial statements has to meet basic qualitative attributes of relevance and faithful representation in addition to quantitative attributes. Relevance of financial statements information is associated with the extent to which published financial information is able to influence the decision of the users. Faithful representation on the other hand entails that published financial statements information should be verifiable, neutral and complete (IASB, 2008).

The need for financial reporting arises originally because of the separation of ownership from management and control in modern day business organizations. This relationship creates conflict of interests and information asymmetry between the shareholders (principal) and managers (agent), who are involved in the day to day running of the firm. The conflict sometimes reflects in the preparation of financial statements as managers use their discretion over accounting choices to manipulate financial information contained in published financial reports for their personal benefit

at the expense of other stakeholders. Reported accounting information is, therefore, often not free from complete bias as expected by different users of the financial reports.

The manipulative behaviour of managers, called earnings management is associated with the deliberate altering of financial statements through the use of judgment in structuring transactions to either mislead the firms stakeholders about the true economic picture of the firm or to achieve some contractual benefit that is based on reported accounting numbers (Healy & Wahlen, 1999). Extant accounting literature suggests that managers engage in earnings management for different reasons such as, to earn compensation bonus (Healy, 1985), to beat analyst forecast (Comprix, Mills & Schimidt, 2007), to attract favorable subscription during Initial Public Offerings (IPO) (Teoh, Wong & Rao, 1998), and so on. The practice of earnings management however, is not without consequences for the reporting entity. Examples of these consequences include but not limited to reduction in the relevance of reported accounting information and corporate failure in worst scenarios. Earnings management is, therefore, of great concern to regulators, practitioners and accounting researchers since it obscures facts that different stakeholders need to know about the reporting firm (Okolie, 2014).

In view of the consequences of earnings management for the reporting firm, regulatory authorities need to put in place constant monitoring mechanisms to ensure that managers run the firm in the best interest of the shareholders. Literature suggests that audit quality is one of the mechanisms that are effective in monitoring managerial opportunism. Audit quality is associated with the joint probability that a given auditor both detects and reports a violation of generally accepted accounting principles (GAAP) in the clients accounting system. Consequently, company laws from different countries of the world make the external audit of financial reports of public companies by high quality auditors a statutory requirement. Examples include the company laws in United States (US), United Kingdom (UK), France, Japan and Malaysia. Similarly,

section 357 of the Companies and Allied Matters Act (CAMA) Cap 20 LFN 2004 makes the annual audit of all companies listed on the Nigerian Stock Exchange (NSE) by competent external auditors a statutory requirement for public companies.
Though several countries from both developed and developing economies have made external audit of the financial reports of public companies by high quality auditors a statutory requirement, accounting scandals and corporate failures linked to earnings management still continue to occur globally. Notable accounting scandals and corporate failures in the last decade include: Enron and Worldcom in US, Parmalat in Italy, Cadbury PLC, African Petroleum (now Forte Oil) PLC, and Unilever PLC in Nigeria among others (see Ghosh, Marra & Moon, 2010; Fodio, Ibikunle & Oba, 2013; Chandrasegaram, Rahimansa, Rahman, Abdullah & Mat, 2013; Miko & Kamardin, 2015; Mishra & Malhotra, 2016). These scandals led to loss of public confidence in the quality of published financial reports and the audit function globally. In response to the aforementioned corporate scandals, regulators from many nations of the world have embarked on new reforms to strengthen the independence of the external auditor and also restore the lost public confidence in the quality of published financial reports. In the US for instance, the Sarbanes-Oxly act was passed in 2002, which established the Public Company Accounting Oversight Board (PCAOB) to oversee the financial reporting process of public companies. Similar regulatory reforms aimed at enhancing audit quality and the quality of annual financial statements produced by public firms were also carried out in UK, Canada, Malaysia, South Africa and Nigeria. However, despite these regulatory reforms to mitigate earnings management, enhance audit quality and by extension the quality of published accounting reports, accounting scandals and corporate failures involving highly reputable external auditors are still prevalent globally. This has attracted the attention of accounting researchers who sought to establish the empirical link between audit quality and earnings management of firms.

Literature on audit quality has documented a number of audit quality attributes that

affect earnings management of firms. Popular among these attributes are audit firm size, auditor industry specialization, auditor tenure, client importance, and audit committee financial expertise. The size of audit firm is thought to affect the earnings management of companies because big audit firms have more resources to acquire latest auditing technology than small audit firms (Sawan & Alsaqqa, 2013; Hosseinniakani, Inacio & Mota, 2014). In addition, big audit firms have more clients and their total fees are allocated among the many clients, thereby making them less dependent on any one client. Big audit firms perform more effective audit than small audit firms because they have greater wealth that is exposed to litigation risk in case of audit failure (Dye, 1993). The association between audit firm size and earnings management issupported by much empirical evidence such as Jordan, Clark and Hames (2010), Kamolsakulchai (2015), Gumanti, Nastiti, Utami and Manik (2015), and Khalil and Ozkan (2016).

Auditor industry specialization is another attribute of audit quality which extant literature suggests could affect earnings management practices of firms. This is because industry specialist auditors are familiar with the business operations of the industry of their specialization and also possess industry relevant experience and knowledge that enables them to audit companies in the industry more effectively than their counterparts (Minutti- Meza, 2013; Sarwoko & Agoes, 2014). The empirical link between auditor industry specialization and earnings management is documented by several studies such as Jaggi, Gul and Lau (2012). Auditor tenure is another attribute of audit quality which extant literature suggests can affect earnings management of firms. This is because as the length of auditor- client relationship increases, the auditor becomes more effective in detecting unethical accounting practices than he was at the beginning of the audit engagement in view of his familiarity with the operations and financial reporting environment of the client (Lim & Tan, 2010; Siregar, Amarullah, Wibowo & Anggraita, 2012). The empirical relationship between auditor tenure and earnings is documented by many studies such as Moeinadin, Heirany and Moazen

(2013), Bamahros and Wan – Hussin (2015), Brooks and Guo (2015), and Nawaiseh (2016).

Extant literature has also associated client importance with earnings management practices of firms. It is argued that relative to other clients, auditors allow their big clients more discretion in financial reporting. Auditors facing the risk of losing a big client and reporting unethical accounting practices of the client are more likely to compromise the quality of the audit exercise
(Chen, Sun & Wu, 2010; Sharma, Sharma & Ananthanarayanan, 2011). The relationship between client importance and earnings management of firms is supported by empirical evidence such as Okolie (2014a) and Park (2015). Also, audit committee financial expertise is another proxy of audit quality which extant literature associates with earnings management of firms. This is because audit committees whose members have accounting and financial expertise are already familiar with financial reporting environment and therefore more effective in their monitoring role over the external auditor and financial reporting process of the company. The association between audit committee financial expertise and earnings management is documented by several empirical studies such as Badolato, Donelson and Ege (2013), Salleh and Haat (2014), Ayemere and Elijah (2015), and Mishra and Malhotra (2016).

In light of the aforementioned, empirical evidence has suggested that audit quality could constrain the opportunistic earnings management behavior of managers, and ensure the credibility and transparency of financial reports produced by firms. Consequently, users of audited financial reports believe that such audited reports are completely free from bias and material misstatements, and so reliable. However, the accounting scandals and corporate failures witnessed globally, including the two largest in the world history – Worldcom and Enron (Albrecht, Albrecht & Albrecht, 2004) have cast doubts on the ability of audit quality to constrain earnings management practices of firms across sectors.

In Nigeria, the oil sector contributes significantly to the economic growth of the

country. According to the Central Bank of Nigeria (CBN, 2010), the industry contributes about 90% of Nigerias foreign exchange earnings. Despite its strategic importance, the operations of the oil
industry have been associated with allegations of scandalous financial practices recently. For example, the Punch (February, 2015) reported the case of non-remittance of funds to the federation account and excessive expenditure of oil proceeds by the Nigerian National Petroleum Corporation (NNPC). Similar allegations are associated with listed oil marketing companies in Nigeria as exemplified by the case of African Petroleum (now Forte Oil) Plc, where a credit facility of 24 billion naira was not disclosed in the financial statements of the company (Samaila, 2014). Interestingly, this material omission occurred under the watch of a big 4 audit firm that is expected to constrain such unscrupulous practice.
Owing to the importance of the oil sector to the economy of Nigeria and the allegations of manipulative tendencies labelled against the oil industry, it is imperative to examine the earnings management behaviour of oil marketing companies and the extent to which audit quality affects such behaviour. This study is therefore motivated by the fact that researches in this area which are mostly foreign based documented inconsistent and mixed findings due largely to jurisdictional and sectoral differences. The inconclusiveness of findings has provided incentive for further research effort. In addition, the fact that the oil sector in Nigeria has undergone a number of reforms particularly from 2009, coupled with dearth of local empirical studies on the association between audit quality and earnings management practices of the sector, make a study that will enable better understanding of the nature and extent of the association more desirable.

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