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Effect of Audit Committee Expertise on the Relationship between Audit Quality and Earnings Management of Consumer Goods Firms in Nigeria

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Abstract
The collapse of high profiled companies was mainly due to the manipulation of accounting figures reported in their published financial statements and considering the danger associated with this problem, this study examines the moderating effect of audit committee financial expertise on the relationship between audit quality and real earnings management of quoted consumer goods companies in Nigeria. Real earnings management as dependent variable was proxied by discretionary accruals while audit quality as independent variable is explained using audit fees and auditor industry specialization. The study used secondary data were used by extracting from the annual reports of the consumer goods of 21 companies quoted on the Nigerian stock exchange out of which 17 were sampled through filtering process for the purpose of data collection from 2010 to 2019. The study employs Pooled OLS regression techniques to analyze the data. The result of the study shows that both audit fees and auditor industry specialization have positive and significant relationship with real earnings management when moderated by audit committee financial expertise. The study concludes that both variables can be used as determinants of real earnings management when there is a finance expert in the audit committee. The study recommends that efforts should be made with respect to legislations mandating audit committees to have more financial accounting experts among its members since it is viable corporate governance tool towards enhancing quality and reliable financial reporting.

Keywords: Moderating Effect, Audit Quality, Audit Fees, Real Earnings, Consumer Goods

1. Introduction

There have been concerns globally, about audit quality in the present environment where severe failures have come to light, such as Enron scandal of 2001; Parmalat in 2003; Cadbury Nigeria Plc in 2006; Afribank Nigeria Plc in 2009 and most recent collapse of giant companies like carillion in Italy, Patisserie Valerie and London Capital and Finance in the UK, failings in South Africa's state owned entities Transnet, Eskom, and South African Airways and the 1MDB

scandal in Malaysia. High-quality external auditing is considered a vital element of a well-functioning capital markets. Firms with a reputation for reliable financial reporting are likely to change auditors when their audit quality is questioned to avoid capital market consequences of unreliable financial reporting (Hennes, Leone & Miller, 2012). The performance of independent auditors is deemed fundamental to the functioning of the financial and capital markets based on the assumption that, by issuing an opinion on the reliability of accounting information, it contributes to a business environment characterized by trust and credibility (Ojo, 2008; Zagonov, 2011). Therefore, the collapse of these high profiled companies due to frivolous manipulation of accounting figures triggered global concern on the integrity of financial reporting, competence matrix of audit committees and reliability of external auditors' reports.

However, there are existing studies on the effect of audit quality and real earnings management around the world, few studies examined this phenomenon in Nigeria. Other studies in this area include (Alzoubi, 2017, Ghosh & Moon, 2005; Krishnan, 2003; Rusmin, 2010). However, most of these studies are foreign-based and given the disparities in the nature of economies, the level of sophistication in the monitoring mechanisms and litigation risks faced by external auditors, studies from Nigeria may produce different results. This approach limits the generalizability of findings concerning the indirect effect of audit committee financial expertise on the relationship between audit quality and real earnings management of quoted consumer goods companies in Nigeria which have been ignored by prior studies. This constitutes one of the gaps in the literature that this study attends to fill.

Furthermore, most of the studies which were conducted in developing countries including Nigeria did not make use of industry specialist auditors as an audit quality attributes. Hoang Khanh & Khuong, 2018; Gul, Fung & Jaggi, 2009; Emeka-Nwokeji & Ojinta,2016). However, industry specialist auditors could be familiar with the business operations of the industry of their specialization and also possess industry relevant experience and knowledge that enable them to audit companies in the industry more effectively than their counterparts (Minutti- Meza, 2013; Sarwoko & Agoes, 2014).

Given these puzzles and the gap existing in literature, this study empirically examined the indirect effect of audit committee financial expertise on the combined relationship between audit fees and auditor industry specialization on real earnings management of quoted consumer goods companies in Nigeria.

2. Literature Review

2.1 Conceptual Review

2.1.1 Real Earnings Management

Earnings management has been considered as one of the most crucial

ethical financial reporting issues which accountants confront in everyday practices around the world. Basically, earnings management has numerous classifications. One of the earnings management activities is called real activities manipulation or real earnings management. Xuerong and Li (2017) defined real earnings management (REM) as management operational activities to alter reported earnings in a particular direction, which is achieved by overproducing inventory to lower the cost of goods sold (COGS) or cutting discretionary expenses (i.e., advertising expenditures, research and development, deferred taxes) to achieve a specified earnings level.

2.1.2 Audit Fees

International Standards on Auditing defines Audit fees as "the amount that remunerates the financial auditor's activity, the certification of financial statements. The code of Ethics for professional accountants also states that audit fees should be calculated in an objective way and the auditor's independence should not be influenced by them. Audit fee can be explained to be the amount charged by the auditor for an audit assignment carried out.

2.1.3 Auditor Industry Specialization

Industry specialist auditors are auditors who have gained great training and experience concentrated in a specific industry. Solomon et al. (1999) averred that industry specialist auditors have more accurate non-error frequency knowledge than non-industry specialists. Owhoso, Messier and Lynch (2002) suggested that industry specialists can more effectively detect seeded errors in staff work papers during the audit review process. Low (2004) finds that auditors' industry specialization improves their audit risk assessments. Therefore, the use of an auditor with industry specialization will help to curb earnings management. These behavioral auditing studies suggest that auditor industry specialization can enhance the effectiveness of auditors' work as a result of their greater industry-specific knowledge.

2.1.4 Audit Committee Financial Expertise

Audit committee financial expertise is the ability of a member or members of the audit committee to analyze and interpret a full set of financial statement. Audit committee financial expertise is the most prominent feature of audit committee effectiveness that has caught the attention of regulators in recent years (Griffin, 2016). Carcello et al (2013) noted that audit committee with members having both accounting and non-accounting expertise can be beneficial in terms of earnings quality.

2.2 Empirical Review

Emeka-Nwokeji and Ojinta (2016) examined the relationship between audit fee and earnings management of pharmaceutical firms in Nigeria using total accrual management. Archival data were extracted from annual reports of selected quoted pharmaceutical firms in Nigerian Stock Exchange which was based on panel data ranging from 2006 – 2015. Ex post facto research design was used. Descriptive statistics correlation and panel multiple regression were used to analyze the data. The result of the regression showed that all the independent variables (firm size, firm complexity, and type of audit firms were generally and positively significant to the level of total accruals since the p-value is 0.4 (4%). The study although, done in Nigeria did not capture so many variables in the audit quality literature as variables such industry specialization and tenure are good determinants of audit quality.

Okolie, Izedonm and Enofe (2013) examined the impact/ relationship between audit quality and earnings management represented by companies' discretionary accruals manipulations in Nigeria. Archival data were extracted from annual reports of 57 quoted companies in Nigeria between 2006 and 2011. Audit Firm Size, Audit Fees, Auditor Tenure and Audit Client Importance served as audit quality proxies. The number of Discretionary Accruals (DAC) was used to measure earnings Management. The results showed that audit quality was significant and negatively related to the amount of DAC of quoted companies in Nigeria. The study population was not specifically stated before the 57 samples were drawn. Also, the result of findings of the various variables was not defined for understanding.

Yasser and Soliman (2018) examined the effect of Audit quality on Earnings Management in the listed firms in Egypt. In this research, OLS regression analysis is used to explore the relationship between Audit quality proxies which are Audit firm size, auditor industry specialization and auditor tenure and Earnings management in listed companies during the period 2012-2016. The results revealed that; auditor tenure has a significant positive relationship with earnings management, while the rest of the hypotheses indicate that the other variables remain to have an insignificant relationship with earnings management.

Hegazy (2017) investigated the effect of industry specialization on the audit quality and earnings quality. It examines the relation between industry specialization and earnings quality, financial reporting quality, and audit quality. The research posits that industry specialization constrains earnings management. In addition, it hypothesized a positive relationship between industry specialization and financial reporting quality. An experiment was conducted in an audit firm with international affiliation in Egypt to test the research hypotheses. The results indicate that there is no significant difference between industry specialist auditors and non-specialists in constraining earnings management. In addition, findings

support that financial reporting quality was significantly higher when specialists conducted the audit. The results provide empirical evidence consistent with the hypothesis that auditor industry specialization improves audit quality.

Karimi and Gerayli (2014) studied the relationship between audit quality (represented by auditor industry specialization and auditor tenure) and earnings management estimated through modified Jones1991model of 91 companies listed on Tehran Stock Exchange (TSE) for the period 2008-2012. Evidence from the study indicated that auditor industry specialization is associated with less earnings management of firms listed on TSE.

In consent with such studies, a firm with financial expert on its audit committee enjoys a higher level of earnings quality. The general expectation is that financial experts have more advanced accounting and financial knowledge than an ordinary audit committee member because they are more effective in monitoring and constraining management activities to manipulate earnings.

2.3 Theoretical Framework

Essentially, agency theory, signaling theory, and auditors' theory of inspired confidence justify the key function of auditing as a mechanism for mitigating information asymmetries among related parties. This study is anchored on signaling theory. The theory is propounded by Spence (1973). Signaling theory suggests that companies with good performance use financial information disclosure to send signals to the market.

Craven and Marston (1999) showed that firms will attempt to accept the same level of disclosure as similar firms operating in the same industry since if a firm does not keep up with the same level of disclosure as others, it may be perceived by stakeholders that it is hiding bad news or negative information. A high-quality audit sends a signal to the market that the financial statements are more credible than those audited by lower quality auditors. The market perceives audit firm size and specialist auditors to be of a higher quality than others and rewards (punishes) companies with larger improvements (or falls) in share prices accordingly (Teoh & Wong, 1993; Krishnan & Yang, 1999; Menon & Williams, 1994).

Therefore, signaling should, theoretically, affect the demand for audit quality over and beyond the monitoring function alone. The positive Signal of transparency and credibility it sends to the market and the assurance it provides to stakeholders about the quality of earnings performance disclosures suggests a positive and significant association between audit quality and REM.

3. Methodology

This study adopts ex-post facto research design using Pooled OLS Regression. The population of the study comprised of all the twenty-one (21)

consumer goods companies quoted on the floor of Nigerian Stock Exchange (NSE) as at the end of 2019 accounting period, and are operating throughout the period of the study (2010-2019). However, through filtering, 17 companies were considered for the purpose of data collection because they were consistent in the publication of their annual financial statements within the period under study and the data were collected from secondary sources through the company's annual reports.

Consistent with prior studies such as Roychowdhury (2006), Cohen and Zarowin (2010), Zang (2012), Ge and Kim (2013), this study employs three metrics to examine real earnings management (these are the abnormal cash flow from operations, abnormal production costs, and abnormal discretionary expenses). In line prior studies, this study estimates the abnormal cash flow from operations, abnormal production costs, and abnormal discretionary expenses as the standardized differences between the actual and calculated estimates from the following models;

$$CFOit\ /Ait-1 = \gamma 0(1/Ait-1) + \gamma 1Salesit/Ait-1 + \gamma 2\Delta Salesit/Ait-1 + \mu it \quad \text{.....1}$$

Where;

CFOit = Cash flow from operation of firm i in year t

Ait-1 = Total assets of firm i in year t-1;

Salesit = Sales of firm i in year t

ΔSalesit = Sales of firm i in year t less sales of firm i in year t-1;

μit = A residual term that captures the level of abnormal cash flow of firm i in year t.

γ0 is the intercept and γ1 and γ2 are the coefficients.

$$PRODit/Ait-1 = \gamma 0(1/Ait-1) + \gamma 1Salesit/Ait-1 + \gamma 2\Delta Salesit/Ait-1 + \gamma 1Salesit-1/Ait-1 + \mu it \quad \text{.....2}$$

Where;

PRODit = the sum of cost of goods sold and change in inventory of firm i in year t;

ΔSalesit-1 = Sales of firm i in year t-1 less sales of firm i in year t-2;

μit = A residual term that captures the level of abnormal production costs of firm i in year t.

$$DISEXPit\ /Ait-1 = \gamma 0(1/Ait-1) + \gamma 1Salesit-1/Ait + \mu \quad \text{.....3}$$

Where;

DISEXPit = The discretionary expenses, sum of Selling, General & Administrative expenses of firm i in year t;

μit = error term of firm i in year t.

Therefore, the overall real earnings management is the sum of the standardized differences between the actual and calculated abnormal cash flow from operations, abnormal production costs and the abnormal discretionary expenses.

This study estimates the following models; this model derives their impetus from the work of Abbott, Parker, Peters and Raghunandan (2003).

$REMit = \beta 0 + \beta 1AFit + \beta 2AISit + \beta 3AISit * ACFEit + \beta 4AFit * ACFEit + e_{it}$.....4

Where:

REM= Real Earnings Management

ACFE= Audit Committee Financial Expertise

AF= Audit Fees

AIS= Auditor Industry Specialization

$\beta 0$= is The intercept

$\beta 1$-$\beta 2$= Parameters estimate or coefficients in equation

μ= error

Table 1: Measurement of Variables/ Validity

S/N	Variables	Definitions	Type	Measurement	Construct validity source
1	REM	Real Earnings Management	Dependent	Measured by summing up the standardized differences between actual and computed abnormal cash flow from operations, abnormal production cost and abnormal discretionary expenses.	Cohen and Zarowin (2010); Kim and Ge (2013); Roychowdhury (2006); Zang (2012).
2	ACFE	Audit Committee Financial Expertise	Moderator Variable	Proportion of audit committee members with financial literacy to the total audit committee size	Abbott, Parker, Peters and Raghunandan (2003); Kent (2002); Salawu, Okpanachi Dikki (2017)
3	AF	Audit Fees	Independent	Natural Log of Audit Fees Paid by the company	DeAngelo, 1981; Deis and Giroux, 1992;

					Yunairti (2017)
4	AIS	Auditor industry Specializatio n	,,	Dichotomous variable 1 for the companies audited by industry specialist auditors and 0 for non-specialist auditors.	Heninger (2001); Ebrahim (2001)

Source: Researcher's Compilation, 2021.

The study is based on two hypotheses stated as follows:
HO_1: Audit committee financial expertise as a moderator has no significant effect on the relationship between audit fees and real earnings management of quoted consumer goods companies in Nigeria.
HO_2: Audit committee financial expertise as a moderator has no significant effect on the relationship between auditor industry specialization and real earnings management of quoted consumer goods companies in Nigeria.

4. Results and Discussions

Table 2: Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
REM	170	.5222685	.1591353	.1098	.799997
AF	170	4.304034	1.317712	1.812913	6.623249
AIS	170	.5823529	.4946283	0	1
ACFE*AF	170	3.430462	1.580854	1.578223	5.53257
ACFE*AIS	170	.342287	.416456	0	1

Source: Stata Output, 2021.

A total number of seventeen (17) listed consumer goods companies were sampled over a period of seven (10) years yielding a total of 170 financial firm-year observations. In respect to real earnings management, table 2 shows a mean of 52%. This showed the real earnings management for the companies stood at an average 52% and standard deviation of 15% and hence, it can be said that the data had little variations. The study showed that the lowest REM was 10% and the highest within the period was approximately 80%. The table also, showed that Audit fees has an average of 4.304034 and an SD of 1.317712 signifying that within the period of the logged total fees collected stood at approximately 4.3 million with the value of SD which is 1.3 million showing that data is not scattered

around the mean. The figure of the standard deviation showed that there are no much variations in the data.

The study showed that auditors' industry specialization has a mean of.5823529 indicating that 58% of the companies used industry specialist auditors within the period of the study. The result also, indicated that at least one company used industry specialist auditors every year within the period of the study. The standard deviation of 49% shows the levels of difference in compliance level from the mean. The study observed that the average amount of fees paid when moderated with audit committee financial expertise stood at 3.430462with a corresponding SD of 1.580854. This shows a decline in fees paid as moderated by the presence of financial expertise on the audit committee. Finally, the study showed that average value of AIS with audit committee financial expertise as a moderator stood at .342287with a corresponding SD of .416456 which show that the data is clustered around the mean. There is also, an indication of drop in use of industry specialist auditors when financial experts are on the audit committees.

Table 3: Correlation Matrix

	REM	AF	AIS	ACFE*AF	ACFE*AIS
REM	1.0000				
AF	-0.0247	1.0000			
AIS	-0.2009	0.2747	1.0000		
ACFE*AF	0.0909	0.4403	0.1130	1.0000	
ACFE*AIS	-0.2762	0.173	0.0015	0.3735	1.0000

Source: Stata Output, 2021.

The correlation matrix in table 3 reveals that the correlation coefficient between real earnings management and audit fees stood at -0.0247. The result implied that audit fees have a negative relationship with REM of consumer goods companies in Nigeria. The result also, showed that auditor industry specialization has a negative value of -0.2009. This means that auditor industry specialization relates with REM to the level of -20%. The coefficient between REM and audit fees as moderated by audit committee financial expertise stood at 0.090. This means that audit committee financial expertise positively moderates the relationship between audit fees and real earnings management. The study result, finally, shows that audit committee financial expertise as a moderator has a negative association between AIS and REM to the tune -27%. This means audit committee financial expertise negatively moderates the relationship between AIS and REM in the area covered by the study.

Table 4: Tolerance and Variance Inflation Factors

Variable	VIF	1/VIF
AF	1.37	0.727993
AIS	1.09	0.917540
ACFE*AF	1.43	0.698017
ACFE*AIS	1.17	0.858327
Mean VIF	1.26	

Source: STATA Output, 2021.

Table 5: Heteroskedasticity Test

F-statistic	0.236784	Prob. F(4,165)	0.1220
Obs*R-squared	8.484123	Prob. Chi-Square(4)	0.1223
Scaled explained SS	15.02818	Prob. Chi-Square(4)	0.0046

Source: STATA Output, 2021

From Table 4 VIF values for all the independent variables were consistently below the benchmark of 10 which is considered harmful for regression analysis. This is supported by a mean VIF value of 1.22 which is above the benchmark of 1 considered suitable for regression analysis. Also, the TV for all the variables was above 0 and close to 1 which is recommended for regression analysis. The table shows good indicators that multicollinearity is not a problem among independent variables. Meanwhile, table 5 the Breusch-Pagan/Cook-Weisberg test for heteroscedasticity shows a chi2(1) of 0.23 and a Prob > chi2 of 0.122 which means there is no problem of heteroscedasticity among the data inferring that the data is homogeneous in nature.

Table 6: Hauseman Specification Test

Correlated Random Effects - Hausman Test
Equation: Untitled
Test period random effects

Test Summary		Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Period random		1.20417	4	0.9440
Period random effects test comparisons:				
Variable	Fixed	Random	Var(Diff.)	Prob.
AF	-0.039986	-0.037266	0.000005	0.2107
AIS	-0.012789	-0.009929	0.000006	0.2275
ACFE_AF	-0.005797	-0.005773	0.000001	0.9820
ACFE_AF	0.075000	0.075043	0.000003	0.9795

Source: STATA output, 2021

Table 7: Breusch and Pagan Lagrangian Multiplier Test for Random Effects

Estimated results:

```
         |       Var     sd = sqrt(Var)
---------+-----------------------------
     rem |  .003586       .0598832
       e |   .0033622      .0579841
       u |   .0003235       .017987
Test:   Var(u) = 0
                chibar2(01) =     0.10
              Prob > chibar2 =   0.0720
```

Source: STATA Output, 2021.

The Hausman Specification test was conducted to ascertain between the fixed and random effect models which was more appropriate for interpretation. The result of the Hausman Test revealed that the value of chi2 is 1.20 and a corresponding prob>chi 0.944. The significant value as reported by the probability of chi2 that the Hausman test favours the random effect model. However, since the hypotheses for study are stated in null form, the study went further to conduct the lagrangian multiplier test to ascertain whether is appropriate to interpret the pooled OLS or random effect model. The Breusch and Pagan Lagrangian multiplier test for random effects shows a chi2 of 0.10 and a corresponding probability of 0.0720 which indicates that the pooled OLS is appropriate for the study.

Table 8: Summary of Pooled OLS Result Regression Result

	Coef.	t	P>|t|
AF	-.0537889	-2.51	0.013
AIS	-.076079	-2.25	0.027
ACFE*AF	.0248769	2.11	0.038
ACFE*AIS	.3993318	3.50	0.001
R-squared	0.1762		
Adj R-squared	0.1277		
Prob > F	0.0050		

Source: STATA Output, 2021.

A close look at the result presented in table 8 reveal that the R2 value is 0.1762 which indicates that the audit quality attributes as moderated by audit committee financial expertise can explain only about 17% of the total systematic variation of real earnings management among quoted consumer goods firms in Nigeria. This implies that, about 83% of the total systematic variation in the

dependent variable has been left unaccounted for by the model hence captured by the stochastic error term. This implies that other factors not included in the model mostly accounts for real earnings management in the area covered by the study. On the basis of the overall statistical significance of the model, it was observed that the probability of F-statistics is 0.0050 which is significant at 5% level of significance.

Table 8 described the result of the pooled OLS regression conducted for the study. The analysis shows a negative but significant relationship between audit fees and real earnings management with a coefficient value of -0537889 and probability of F-statistics of 0.013 which is considered significant at 5% level of confidence. This implies that audit fees have a negative influence on real earnings management of listed consumer goods companies in Nigeria.

However, the result of the intervening role of audit committee effectiveness on the relationship between audit fees and real earnings management show a positive and significant effect as evidenced by the result in Coefficient=.0248769 and P-Value= 0.0038). This result implies that the relationship between audit fees and real earnings management is positively and significantly moderated by audit committee financial expertise in the area covered by the study. Based on this result the study rejects the null hypothesis one which states that audit committee financial expertise as a moderator has no significant effect on the relationship between audit fees and real earnings management of quoted consumer goods companies in Nigeria.

Auditors' industry specialization has a negative but significant effect on real earnings management among listed consumer goods companies in Nigeria. This is evidenced by a coefficient of -076079 and p-value of 0.027 which is significant at 5% level of confidence. This implies that irrespective of the fact that auditors' industry specialization has a negative effect on real earnings management, it is significant in influencing real earnings management. This finding collaborates with that of Bhattachaeya (2011).

Conversely, the relationship between AIS and real earnings management as moderated by audit committee financial expertise indicates a positive and significant effect as evidenced by the coefficient of 0.3993318 and a p-value of 0.001 which is considered significant at 50% level of confidence. The import of this result is that a unit increase in the number of audit committee members with financial expertise would lead to an improvement in the strength of the relationship between AIS and real earnings management of quoted consumer goods companies. Based on this result, the study rejects the null hypothesis which state that audit committee financial expertise as a moderator has no significant effect on the relationship between AIS and real earnings management of quoted consumer goods companies in Nigeria.

5. Conclusion and Recommendations

This study examined the moderating effect of audit committee effectiveness on the connection between audit quality as an important aspect of corporate governance and real earnings management among listed consumer goods companies in Nigeria. Real earnings management as dependent variable was proxied by discretionary accruals. The study concluded that both audit fees and auditors' industry specialization have significant influence on real earnings management among consumer goods companies in Nigeria. It therefore, means that these variables are determinants of real earnings management in the area covered by the study. Audit fee is considered a predictor of real earnings management. This is in line with the school of thought which posit that a higher level of audit fees is the major driver of enhanced audit quality, in turn reducing managers' flexibility to use real earnings management and to manipulate reported earnings. The conclusion drawn from industry specialization also, holds true because it is assumed that industry specialist auditors have gained great training and experience concentrated in a specific industry and are considered to have more accurate non-error frequency knowledge than non-industry specialists.

Based on the findings and conclusion, it was recommended that consumer goods companies should encourage having more members in the audit committee with financial accounting expertise while charging audit fees commensurate with the task expected by the incumbent auditor and in comparison, with similar organizations within the same industry. Also, consumer goods companies should hire auditors with industry specialization since they have a better understanding of the specific industry peculiarities and operations distinct from other sectors. This can be complemented by the presence of financial expertise on the audit committee.

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