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Effect Of Audit Client Importance On Earnings Management Of Nigerian Listed Consumer Goods Firms

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Abstract

The primary focus of this study was to examine the influence of audit client importance on earnings management of Nigerian listed consumer goods firms. The study adopted a descriptive research design. From 2012 to 2019, data were collected from 13 consumer goods firms listed on the Nigerian Exchange Group. Discretionary accrual was used to estimate earnings management. Descriptive statistics and random effects regression were used to analyse the data. The findings indicated that audit client importance (β=-0.1872) has a significant effect on the earnings management of Nigerian listed consumer goods firms. The study concluded that earnings management practices of Nigerian listed consumer goods firms are curtailed when the firms are of important clients to their auditors. The recommendation was that management of firms should enhance approaches that will improve their performance in terms of sales to remain important clients to their auditors.

Keywords: : Audit, audit client importance, earnings management.

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1.Introduction

Earnings management has been commonly linked to the deliberate activities of managers and those charged with firm management to manipulate the earnings they report, to mislead the owners about the true state of the firm. The goal of this action is primarily to obtain the contractual advantages, incentives, and bonuses that are typically ascribed to managers based on the profits they report. Although it is usually done within the bounds of accounting regulations, the practice of earnings management has resulted in the failure of many firms all over the world. Parmalat, Enron, Lehman Brothers, Parmalat, Tyco, HealthSouth, WorldCom, American Insurance, Xerox, Transmile, and Toshiba were among the corporations that failed in the United States, Europe, and other parts of the world. These corporate scandals affected Nigerian banks such as Afribank Plc (now Polaris Bank Plc), Wema Bank Plc, Oceanic Bank Plc (now EcoBank Plc), and Bank PHB Plc (now Keystone Bank Plc). Similarly, consumer goods firms such as Cadbury Nigeria Plc and Unilever Nigeria Plc have been documented to have experienced such corporate failures. There was also the instance of African Petroleum (now Forte Oil), a Nigerian oil and gas firm.[1,2,3]

Consequently, auditors are statutorily saddled with the responsibility of guaranteeing the confidence of a firm's investor. It is expected that the auditor demonstrates competence and independence in assessing the financial reports of a firm and reporting any form of material misstatements discovered. In Nigeria, the Financial Reporting Council of Nigeria Act, Firms and Allied Matters Act, and Corporate Governance Codes exist to regulate the financial reporting, auditing, and corporate governance practices of firms. However, the corporate failures of firms linked to earnings management under the watch of auditors have questioned the effectiveness of auditors in detecting and divulging financial malpractices. For instance, one of the Big 4 audit firms Akintola Williams and Deloitte was indicted for facilitating the management of earnings in Afribank Plc and Cadbury Nigeria Plc respectively.[4]

Audit client importance is one of the crucial attributes of audit quality capable of affecting the management of earnings of firms. Audit Client importance may be attributed to the economic status of an auditor's client usually tied to performance. Existing literature defines client importance as a ratio of a client's sales to the sum of all clients' sales audited by an auditor.[5,6,7] There is however a debate as to whether client importance increases or decreases audit quality in mitigating financial malpractices. It is argued that the fear of losing a client with a good market share (important client) may cause the auditors to compromise in the discharge of their duties. Contrary to this assertion, it is also likely that auditors may demonstrate competence while discharging their duties to maintain important clients. There is however a paucity of literature that has examined the effect of audit client importance on earnings management of firms in Nigeria, especially among listed consumer goods firms. Susanto and Herusetya[8], Al-Mousawi and Al-Thuneibat[9], and Sharma, Sharma and Ananthanarayan [10] all examined this relationship in Indonesia, Jordan, and the United States of America (USA) respectively. A study that will account for emerging economies like Nigeria is therefore desirable.

The consumer goods sector is one of the most important sub-sectors contributing to Nigeria's economic development. As of 2019, they accounted for around 60.96

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% of the manufacturing sector's GDP (CBN 2020). The fact that two firms have previously experienced corporate failures implies that the sector is likewise susceptible to earnings management. Against this backdrop, this study investigates the effect of audit client importance on earnings management of Nigerian listed consumer goods firms.

1.1 Objective of the Study

i.To determine the effect of audit client importance on earnings management of Nigerian listed consumer goods firms.

1.2 Research Question

i.To what extent does audit client importance affect earnings management of Nigerian listed consumer goods firms?

1.3 Hypothesis

The formulated hypothesis is presented in its null form as follows:

H01: Audit client importance does not significantly affect earnings management of Nigerian listed consumer goods firms.

2.0 Review of Related Literature

This section is structured into conceptual framework, theoretical framework and empirical works.

2.1 Conceptual Framework

A client's importance is exactly proportionate to the client's performance. Client importance is defined in existing literature as a ratio of a client's sales to the sum of all clients' audited sales, as well as a ratio of the individual client's audit fees, non-audit fees, and total fees to the client's total sales.[5,6] In general, a client is regarded as substantial if it contributes considerably to the firm's overall fees in terms of income. However, in this study, client importance is defined as the proportion of a client's sales to the overall client sales audited by an auditor in a given time.

Many scholars have defined the term called earnings management. Earnings management, according to Bergstresser and Philippon[11], is a management activity geared at generating profits and reflecting the management's objectives rather than offering an accurate picture of business performance. Earnings management is described by Akers, Giacomino and Bellovary [12] as attempts by management to manipulate or influence reported earnings by employing accounting procedures, recognising one-time non-recurring items, postponing or accelerating cost, or revenue transactions, or using other strategies aimed to impact short-term earnings. According to Cheng and Warfield (2010), it is an opportunistic behaviour utilized by managers to maximize earnings while coping with compensation contracts, debt commitments, and political expenses. This research however describes earnings management as a deliberate action by those in control of a firm's management to fabricate fraudulent earnings reports to acquire incentives related to the firm's reported earnings.

Existing research, however, is divided on whether client significance affects audit function in moderating earnings management. According to Tyokoso [7], an auditor is more likely to ignore a client's accounting problems when the client is important. Nevertheless, Al-Mousawi and Al-Thuneibat (2011) and Susanto and Herusetya [8] still believe that an auditor may still maintain objectivity and impartiality in carrying out audit functions for their important clients.

2.2 Theoretical Framework

This study is anchored on the agency theory of Jensen and Meckling.[13] The agency theory describes the owners' delegation of authority to the managers to operate the firm on their behalf, with the owners' welfare reliant on the managers.[13]Because managers' incentives may motivate them to opportunistically use business resources to suit their interests, the agency theory aims to resolve possible conflict of interests between owners and managers.[14] Essentially, corporations seek to maximize shareholder wealth, which may differ from managers' interests. When the agent (managers) has more relevant knowledge than the shareholders, information asymmetry emerges, and the possibility of the agent acting in ways to further their own interests increases. According to agency theory, managers are driven by personal gains and endeavour to exploit their interests rather than the interests of the shareholders. Managers, for example, may be interested in purchasing expensive offices, business vehicles, and other opulent objects because the expense of these assets is paid not by them (managers), but by the owners (shareholders). The primary issue in agency theory is how to reconcile managers' competing objectives with the interests of shareholders.

A typical issue in the application of agency theory is information asymmetry. In an agency relationship, information asymmetry arises when the quantity or load of information obtained and received by the agent differs from that of the shareholder, resulting in an uneven amount of corporate knowledge or information between the two, which may disadvantage either party. The issue of information asymmetry may lead to confusion or misunderstanding between agents and principals. As a result, disputes emerge between managers and stockholders, preventing each from carrying out their respective roles in a firm.[15]

As a result, when managers are incentivized to control earnings, such as meeting or exceeding earnings targets and receiving performance-based remuneration, they manipulate the firm's reported results. This manipulation diminishes the relevance and dependability of reported accounting results and financial statements in general. However, agency theory supports monitoring techniques such as high-quality auditing to decrease these conflicts and align managers' goals with the interests of shareholders. This study, on the other hand, is based on the agency theory because it discusses the motive for earnings management by firm managers, as well as the relationship between audit client importance (a strategy for improving audit quality) and earnings management.

2.3 Empirical Works

Susanto and Herusetya [8] examined the effect of client importance on auditor independence as evaluated by accrual earnings management and going-concern opinion. The researchers used a descriptive research approach, and data for the study were acquired from 135 listed corporations on the Indonesian Stock Exchange during eight years (2004-2011). Earnings management was measured using discretionary accruals. Pooled Ordinary Least Squares (OLS) regression was used to analyse the data. The study discovered that client importance has a negative relationship with earnings management as

well as a positive relationship with going-concern opinion. According to the study, client importance as a measure of auditor independence has a negative relationship with earnings management and a good relationship with a going-concern opinion. The researchers used client importance as a measure of audit independence, but the findings may solely represent the Indonesian experience, making generalisation of the study conclusions challenging.

Al-Mousawi and Al-Thuneibat [9] investigated the impact of audit quality on earnings management activities. The researchers used a descriptive study approach. From 2002 to 2006, data were collected from 100 Jordanian businesses. In the research, discretionary accruals were employed to examine earnings management while audit quality was evaluated by client importance. Multiple regression analysis was employed, while ANOVA was used to compare the impacts of client importance on earnings management. According to the findings, audit quality has a relatively weak negative effect on discretionary accruals, which in turn has a relatively weak negative influence on managerial manipulations. The study concluded that audit quality has an impact on business earnings management. From 2002 to 2006, the researchers used a large sample size of 100 Jordanian enterprises. However, the study's data analysis methodologies, multiple regression analysis, and ANOVA could not account for the cross-sectional nature of the data used. Furthermore, the study was based on the Jordanian economy, therefore the conclusions may not be completely applicable in other regions of the world.

Sharma, Sharma and Ananthanarayanan [10] examined link between client importance and earnings management as mediated by the audit committee. Earnings management was measured using adjusted total discretionary accruals and current accruals. The findings demonstrated a link between client importance and earnings management. The study also discovered that when the audit committee does not follow best practices, the relationship between client importance and earnings management becomes more significant. The findings solely depict the experience of the United States. As a result, the investigations must be replicated in various parts of the world.

The empirical studies reviewed focused on Indonesia, Jordan, and the United States. As a result, studying in other nations such as Nigeria is appealing desirable. Furthermore, the majority of the data in the studies were panel in nature, yet the researchers usually employed pooled OLS without applying the Lagrange Multiplier (LM) test as a decider. As a result, a recent study that uses recent data with a more robust methodology to account for the influence of audit client importance on earnings management in Nigeria is essential.

3.0 Methodology

3.1 Design

A descriptive research design is adopted for this study as it allows for investigating the relationships between audit client importance and earnings management through the prediction of the behaviour of the variables.

3.2 Population and Sample

The population for this study consists of all the twenty (20) consumer goods firms listed on the Nigerian Exchange (NGX) Group as of December 2019. The sample size of the study is 13 firms out of the 20 listed consumer goods firms and they were selected as a result of employing the following criteria:

i.The firms must be consumer goods firms in Nigeria: 20 firms made it through this criterion.

ii.The firms must be listed on the NGX Group during the study period (2012-2019): 20 firms made it through this criterion.

iii.The firms must make their annual reports publicly available and accessible via reliable sources such as websites among others: 13 firms made it through this criteria.

iv.Financial statements of the firms must be prepared in absolute compliance with the International Financial Reporting Standards (IFRS). 13 firms made it through this criterion.

3.3 Sources of Data

Secondary data stood as the main source of data employed by this study. Data were obtained from the published annual reports of the sampled listed consumer goods firms in Nigeria, from 2012 to 2019. These data were both quantitative and qualitative in nature. The data were panel in nature as they had both time series (8 years) and cross-sectional (13 firms) attributes.

3.4 Data Analysis Technique

Descriptive statistics were used to compute summary statistics for the study variables. Pooled OLS regression was conducted to carry out a model robustness test. These tests (normality, heteroscedasticity, and VIF) also enhance the reliability of the study’s findings. The normality test checks whether the residual of the model contains outliers that produce spurious regression results and was performed using the Shapiro Wilk test for Normality. Similarly, the Heteroscedasticity test which checks if the error terms in the models have a constant variance or not was conducted using Breusch-Pagan/Cook-Weisberg statistics. The Multi-collinearity test was conducted using the Variance Inflation Factor (VIF) statistics. Panel multiple regression analysis stood as the major technique of data analysis to examine the effect of audit client importance on earnings management of Nigerian listed consumer goods firms. Hausman specification test was conducted to ascertain whether the fixed or random effect model is most appropriate for the data while Lagrange Multiplier Test was further employed to determine whether to continue with random effects or to revert to the pooled OLS. The study’s hypothesis is tested using the p-values from the regression results. The decision rule is to accept the null hypothesis if the p-value is greater than 5% (0.05) level of significance, otherwise reject the null hypothesis, and accept the alternative hypothesis.

3.5 Model Specification

$$EMGT_{it}=\beta_0+\beta_1 ACI_{it}+\beta_2 Age_{it}+\beta_3 Profit_{it}+\beta_4 Size_{it}+e_{it} \quad \ldots\ldots\ldots\ldots\ldots\ldots (2)$$

Where;
EMGT = Earnings Management
ACI = Audit Client Importance
Age = Firm age
Profit = Firm profit
Size = Firm size
β_0 =Model constant
β_1, β_2, β_3 and β_4 = Model coefficients
it = industry i at time t
e = error term

Table 1: Definition of Variables

Name	Type	Measurement
Earnings Management (EMGT)	Dependent	Modified Jones Model (Dechow, Sloan & Sweeney, 1995) $\frac{TAC_{it}}{A_{it-1}} = \beta_0\left(\frac{1}{A_{it-1}}\right) + \beta_1\left(\frac{\Delta REV_{it}-\Delta REC_{it}}{A_{it-1}}\right) + \beta_2\left(\frac{PPE_{it}}{A_{it-1}}\right) + \varepsilon_{it}$..............(1) Where: TAC= total accruals A_{-1} = lagged total assets ΔREV= change in sales revenues ΔREC = change in accounts receivables PPE = gross property, plant and equipment ε= residual term (discretionary accruals) it= firm I at time t β_0,β_1,β_2 = estimated parameters
Audit Client Importance (ACI)	Independent	Ratio of client's sales to the sum of all clients' sales audited by an auditor within the sample.
Age	Control	Current age of the firm from the date of incorporation at any given period.
Profit	Control	Ratio of profit after tax to total assets of the firm at any given period.
Size	Control	Total assets of the firm at any given period

Source: Authors' Compilation (2021)

4.0 Results

Table 2: Descriptive Statistics

Variable	n	Mean	SD	Minimum	Maximum
EMGT	104	0.0028	0.2183	-0.8	1.2
ACI	104	0.3656	0.3418	0.001	1
Age	104	3.8259	0.5212	1.9459	4.5648
Profit	104	0.0776	0.1419	-0.1967	1.2402
Size	104	17.723	1.4212	13.7542	19.7801

Source: Output from STATA version 16.0

Table 2 presents the summary statistics of all the variables in the study. The number of observations (n) reflects a value of 104, indicating that data collected were from 13 firms for a period of 8 years. EMGT shows a mean and standard deviation (SD) value of 0.0028 and 0.2183. This means that an average discretionary accrual of about 0.28% exists among the firms with fluctuations amounting to about 21.83%. The minimum value of EMGT stood at -80% while the maximum stood at about 120%. ACI revealed a mean and standard deviation of 0.3656 and 0.3418. This suggests that on average, 36.56% of the firms were important clients of the auditors within the industry with fluctuations amounting to 34.18%. The minimum proportion of client importance stood at 0.1% while the maximum stood at 100%.

Table 3: Robustness Tests

Variable	VIF	Shapiro Wilk	Heteroscedasticity	Hausman	LM
p-value		0.0006	0.4084	0.3800	0.0000
Size	1.17				
ACI	1.11				
Profit	1.09				
Age	1.05				
Mean VIF	1.11				

Source: Output from STATA version 16.0

From Table 3, all the VIF values are less than 10, suggesting that multi-collinearity is absent in the study model. This is confirmed with the mean VIF of 1.11. Results from the Shapiro Wilk test showed a p-value of 0.0006, implying that the residuals of the study model are not normally distributed ($p<0.05$). However, this may not negatively affect the study since the number of observations is more than 30 (Singh, Lucas, Dalpatadu & Murphy, 2013). The Heteroscedasticity test showed a p-value of 0.4084, suggesting the absence of heteroscedasticity in the study model ($p>0.05$). The p-value for the Hausman Specification test stood at 0.3800, indicating that the random effect model is most suitable for the study ($p>0.05$). The result from the Lagrange Multiplier test revealed a p-value of 0.0000. This affirms that the random effect model is most appropriate for the study ($p<0.05$).

Table 4: Random Effects Regression Results

EMGT	β	z	P>z
ACI	-0.1872	-2.28	0.023
Age	0.0225	0.29	0.769
Profit	0.7827	6.33	0.000
Size	0.0225	0.98	0.327
β_0	-0.4734	-1.03	0.305
R_2=21.44			
Wald Statistics=44.43			
p-value=0.0000			

Source: Output from STATA version 16.0

Table 4 presents the random effect regression results for the study model. The Wald Statistics which represents the joint significance of all estimated parameters in predicting the dependent variable showed a value of 44.43, with a p-value of 0.0000, suggesting that the model is fit for analysis. R2 which is the coefficient of determination revealed a value of 21.44. This indicates that 21.44% of the total changes in EMGT are jointly explained by the predictors while the remaining 78.56% are explained by other variables not included in this model.

Table 4 also presents a statistical measure of the average functional relationship between the dependent and independent variables in terms of regression coefficients and p-values. ACI shows a coefficient of -0.1872 with a p-value of 0.023, suggesting a negative and significant relationship existing between ACI and EMGT. This implies that earnings management of the firms significantly reduces by 18.72% when audit client importance increases.

4.1 Test of Hypothesis

Given that the p-value of ACI in Table 4 is 0.023 and less than 0.05, the null hypothesis that audit client importance does not significantly affect earnings management of listed consumer goods firms in Nigeria is rejected. The study, therefore, assumes that audit client importance significantly affects earnings management of Nigerian listed consumer goods firms.

4.2 Discussion

Results from the test of hypothesis reveal that audit client importance has a significant effect on earnings management of Nigerian listed consumer goods firms. The results also reveal a negative relationship between client importance and earnings management. This implies that client importance improves the competence of auditors to mitigate earnings management of Nigerian listed consumer goods firms. Although scholars like Sharma, Sharma and Ananthanarayanan [10] and Tyokoso [17], believe that an auditor's objectivity may be compromised when faced with the risk of losing an important client and not reporting irregularities, findings from the study suggest client importance as a motivating source for auditors to maximize audit quality for their clients. When the auditors identify an important client, they tend to improve their quality of service delivery to the owners of the firms so that they are reappointed for subsequent periods. Auditors are keener to enhance the quality of services provided to firms with high sales income than to firms with low sales revenue. This is consistent with the findings of Al-Mousawi and Al-Thuneibat [8] and Susanto and Herusetya [9], who discovered a negative association between client importance and firm earnings management.[16,17,18]

5.0 Conclusion and Recommendation

This study examined the effect of audit client importance on earnings management of Nigerian listed consumer goods firms. The study was motivated by the extent to which audit client importance increases or decreases earnings management of firms in Nigeria. The findings of the study however suggest that audit client importance significantly decreases earnings management of Nigerian listed consumer goods firms by 18.72%. In line with the findings, it is concluded that the earnings management practices of Nigerian listed consumer goods firms are curtailed when the firms are of important clients to their auditors. It is therefore recommended that managers should improve approaches of increasing their performance most especially with regards to sales volume to remain important clients to their auditors.

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