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External Monitoring Mechanism and Financial Reporting Quality Tunnelling from REM Perspective in Listed non-financial Firms Nigeria

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Abstract
Fraud cases and financial anomalies are becoming order of the day in Nigerian reporting setting and these signal flaws in auditing and internal control monitoring mechanisms from various segments of the economy. To restore audit client and other stakeholder's confidence and to provide enabling environment many strategies have been deployed by authorities to checkmate the daunting practice. This study used firm financial audit as a monitoring mechanisms utilizing audit pricing, audit tenure and auditor type to deter the debacle. A data was source from Thomson Reuters DataStream and firm financial reports from 2013-2021. The 2013-2014 were used for the lagging of variable as is germane prior to the deriving earnings management model. In the first phase, cross-sectional regression analysis of Roychowdhury (2006) models was performed using the 334 firm-year observations. In the second phase, the longitudinal panel data was analyzed using the two-step system Generalized Methods of Moments (GMM). Two key findings emerged from the data analyses. Firm External monitoring mechanism has dual effect in value addition and value reduction on the effectiveness of financial reporting quality in listed non-financial firms in Nigeria.
Keywords: External Monitoring, FRQ, Tunneling

Introduction
One of the most significant current discussions in contemporary accounting studies is the management of earnings. It is becoming increasingly difficult to ignore the importance of earnings as it affects businesses from all spectra of life (Ismail et al., 2015). Various firm decisions depend on its earnings power and poor earnings is the major factor contributing to

the demise of businesses globally (Ibrahim et al., 2020). Earnings management is a business practice disorder characterized by reporting smokescreen financials which may not portray the actual firm performance and position. Among many topics in accounting none is more exciting than earnings management it erstwhile looks like potential wrong doing, or a conflict of interest among owners and agents or within the different class of shareholders which may sometime be difficult to detect (Zaharaddeen et al., 2016). The causes and consequences of earnings management entice accounting researchers from the time immemorial (Dechow et al., 1995; Vladu et al., 2010). The glut in accounting researches pertaining to management of earnings may be attributable to so many reasons which are: desire to keep momentum, save for the rainy day, meet or beat analysts' expectation, volatility of reported earnings, lower tax burden and avoidance of reporting losses depicted by the financials which if not carefully addressed may erodes the quality of their financials. (Al-rassas, 2015; Bhaumik & Gregoriuo, 2009; Dechow et al., 2010; Lemma et al., 2013). The last couple of decades, academics, regulators, investors, policymakers, and other capital market participants have been progressively focusing on the need for firms to have an active monitoring and accountability system of corporate governance in curtailing agency problems prevalent in listed firms globally (Shin et al., 2019). These firms were blamed for their dearth of business ethics, fraudulent accounting practices, and weak regulations. The downfall of these businesses was a wake-up call for many in the developed countries because, before these high-profile scandals and failures, many stakeholders had blamed only developing countries for poor corporate governance practice and lack of disclosure and transparency in the firm financials but the issue escalate to even the giant economies as witnessed by the demises of: Enron, WorldCom, Parmalat, Tans-mile, Cadbury etc. the need for good governance is germane for the survival of businesses globally (Coville & Kleinman, 2012; Shirur, 2011). This study examine the effect of external monitoring mechanisms (audit fees, audit tenure, and auditor type) on real earnings management in listed non-financial firms Nigerian firms.

Literature Review

Earnings Management

Earnings management is a multifaceted and complex phenomenon defined in a variety of forms that connote researcher's different perceptions of the term earnings management (Goel, 2016). In a study conducted by Kighir et al (2013), earnings management is seen as a prevalent and challenging agency-related debacle that required urgent attention to safeguard the interest of many stakeholders (Appelbaum et al., 2018). View earnings management as utilizing flexible accounting principles and allow managers to manipulate the outcomes of the reported earnings numbers to be larger or smaller in achieving certain financial reporting objectives (Ilyasova, 2015). Financial reporting enables the selection of best and less performing firms in the economy and facilitates efficient resource allocation and monitoring by the stakeholders. The above role of financial reporting implies that good reporting add value if it enables financial statements to effectively portray differences in firms' economic positions and performances in a timely and credible manner (Sonu et al., 2016). The relevance and reliability of accounting numbers depend on the credibility of financial reporting with little or no deviations from the actual firm operation (Rusmanto, 2014). The current earnings of the firm can be credible if they can be used to predict the future cash flows of the firm's operations (Gisbert & García, 2003; Sani et al., 2018). Prior empirical literature documented that firms managed earnings using three known methods which are accrual-based earnings management, real activity-based manipulation, and classification shifting. REM is achievable through sales manipulations such as offering more lenient and favourable terms than usual, reductions in discretionary expenditures to increase income, and overproduction of inventories to report the lower cost of goods sold. All of these manipulations are happening within the year and have cash flow consequences to the firms (Beattrice & Dacian, 2014; Chen et al., 2015; Vladu et al., 2010).

External Monitoring and Earnings Quality

External monitoring and earnings quality are perceived to be used by the hitherto empirical studies to enhance the earnings quality by listed firms (Choi et al., 2010; Leung et al., 2017). External monitoring refers to the audit fee premium, audit tenure and auditor type and are assumed to align the shareholders' interests with those of the managers and restrain opportunistic earnings management. The external auditors attest to the firm stakeholders that the financial reports prepared by the management follow the relevant standards and aid the firms' economic decisions making (Habbash, 2010; Herrmann, 1996).

Theoretical Framework

The study utilized agency and institutional theories to underpin the study. Since earnings management is an asymptomatic agency dilemma which emanate either between an agent with the principal or within the different classes of shareholders in the agency relationship. Agency theory focused on how the management of firms can be highly ethical in operation and producing what is true and fair financial reports, while institutional theory focused on how firms incorporate social culture and meet the demand of social, environmental, legal, and political environs for the long-term survival of the firm. Given these agency norms, independent variables of external monitoring mechanisms from firm's financial audits were used for the study (Darweesh, 2015; Jensen & Meckling, 1998; Watts & Zimmerman, 1983).

Methodology

Annual balance panel data source from Thomson Reuters DataStream and firm financials were employed from 2013-2021, but 2013 and 2014 were used to lag in the derivation of the dependent variable (Haga et al., 2015; Ibrahim et al., 2020). The 334 firm year observation using two-step system GMM regression (Kamat & Kamat, 2013). Financial firms, mining and regulated industries were excluded due to dissimilar accrual choices and valuation process. The composite real earnings management of abnormal cash flow from the operation, abnormal production cost, and abnormal discretionary expenses were used to proxy earnings quality (Al-shattarat, 2017; Dechow & Skinner, 2000; Haji-Abdullah & Wan-Hussin, 2015).

The explanatory variables of the study are (i) audit fees which is measure by the natural logarithm of annual transaction value usually derived under note 10 of profit before taxation in the firm's financial statements (Dechow et al., 2010; Dechow & Skinner, 2000). The study further used audit tenure, (ii) It is usually measured as the natural logarithm of audit firm tenure (iii) Also, the brand name auditors Brand name auditors measured by using dummy variable as big4 1 and non-big4 0 as reported by the preceding studies (Dechow et al., 1995; Herrmann, 1996; Ibrahim et al., 2020). The study moreover employed control variables that are documented to be effective in enhancing the earnings quality by prior empirical studies which are firm size and leverage. They are firm size measured as the natural logarithm of total assets (Andres, 2008; Cheng, 2014; Songini & Gnan, 2015). Besides, the study measured leverage as debts to total assets ratio (Dechow et al., 1995; Kim & Yoo, 2017; Wang, 2006)

Model Specification

Segment one, cross-sectional regression analysis of cash flow from operation divided by the past year total assets will be regressed against recent year sales by lagged total assets plus the change in sales divided by previous year total assets. The regression residuals are the abnormal cash flow from operation.

$$\frac{CFO_t}{Ta_{t-1}} = \alpha o + \alpha 1 \left[\frac{1}{Ta_{t-1}}\right] + H_1 \left[\frac{St}{Ta_{t-1}}\right] + H_2 \left[\frac{\Delta St}{Ta_{t-1}}\right] + \varepsilon_{it} \qquad \text{Equation 1}$$

Segment two, additional cross-sectional regression analysis of summation of discretionary expenses (advertising, research and development, selling, general and admin expenditure) divided by preceding year total assets against current year sales divided by previous year total assets. The regression residuals stand as abnormal discretionary expenses (Dechow et al., 1995; Zhang, 2015).

$$\frac{DISEXP_t}{Ta_{t-1}} = \alpha o + \alpha 1 + \left[\frac{1}{Ta_{t-1}}\right] + H_1 \left[\frac{St-1}{Ta_{t-1}}\right] + \varepsilon_{it} \qquad \text{Equation 2}$$

Segment three, similarly, cross-sectional regression analysis of production cost divided by the lagged total assets against current year sales scaled by total assets plus the change in sales by prior year total assets, plus also contemporaneous sales divided by the preceding year total assets. The residuals from the model stand as abnormal production costs (Randall Xu & Kenneth Taylor, 2007; Sani et al., 2018).

$$\frac{PROD_t}{Ta_{t-1}} = \alpha o + \alpha 1 + \left[\frac{1}{Ta_{t-1}}\right] + H_1 \left[\frac{St}{Ta_{t-1}}\right] + H_2 \left[\frac{\Delta St}{Ta_{t-1}}\right] + H_3 \left[\frac{\Delta St-1}{Ta_{t-1}}\right] + \varepsilon_{it} \qquad \text{Equation 3}$$

The three real earnings management components are computed separately, and then applied as follows: abnormal cash flow to be multiplied by (-1) as firms that are more likely to involve in real activities manipulations normally have lower cash flow from operation. Abnormal discretionary expenditures multiplied by (-1) so that higher value indicates that it is more likely that firm reduces discretionary expenditures and the abnormal production cost is multiplied by (+1). The study used the combined residuals as REM (Ghaleb et al., 2020).

Main Model of the Study

$$\mathbf{REMit = \beta 0 + \beta 1REMit(-1) + \beta 2AUFLit + \beta 3AUTit + \beta 4BRNit + \beta 5LEVit + \beta 5FSZ4it + \varepsilon it}$$

The Summary Statistics of firm External Monitoring and REM

Variables	Mean	Std. deviation	Min	Max	Skewness	Kurtosis
Rem	-0.053	2.029	-3.810	13.381	-2.526	4.323
Audit fees	6.107	0.446	5.872	9.208	-1.029	2.629
Audit Tenure	4.753	2.548	0.000	8.283	-1.029	2.629
Brand name	0.543	0.4567	0.400	0.706	-0.402	1.123
Leverage	0.592	0.362	0.000	5.375	5.925	6.558
Firm size	11.40	3.053	10.43	26.141	0.938	3.734

The table above portrayed the summary statistics of the variables under study, and the table further showed that the variables under study fall within the relevant range minimum and maximum values as depicted by their means. The table further depicts that, audit fees, audit tenure, auditor type, leverage and firm size are associated with the real earnings management. The mean value of the real earnings management of (0.053) implies that, averagely listed non-financial firms, Nigeria. The table further revealed that external monitoring from audit fees, accounted for 6.107 million Naira (equivalent to 14,203.8 USD), indicating an average amount paid as audit fee by listed non-financial firms in Nigeria with a minimum and a maximum values of (11,750 and 18,602 USD) 5.872 and 9.208. The disparity in the audit fees may be attributable to engaging the services of the Big4 versus non-big 4 audit firms in the country. Furthermore, audit firm tenor with the client is averagely accounted for almost 50% demonstrating that nearly 50% of the audit firms in Nigeria are staying from first to the second tenure with their respective client, though the remaining can stay for less or even more than ten year period with the client, despite the cost and benefits of the longer or shorter period with the client from the existing empirical literature. The table added that brand name auditors had 0.543 with a minimum and a maximum of 0.400 and 0.706 respectively. The brand name accounted for almost 55% of the audit practice in the country. This dominance of brand name auditors, is assumed to positively impact the audit quality and deter manipulation in listed non-financial firms, Nigeria. The control variables of firm size and leverages are within the relevant range as depicted by their minimum and maximum values. The standard deviation is consistently less than the mean as reported in the study. (Adamu et al., 2017; Gujarati, 2004; Ibrahim et al., 2016).

Two-Step System GMM Regressions of External Monitoring on REM

Variables	Coefficients	T-Statistics	Standard Error	P-values
REM	-0.4114	-5.4132	0.0760	0.000
Audit Fees	-0.5724	-1.84	0.3113	0.050
Audit Tenure	-0.2066	-3.99	0.0517	0.000
Auditor Type	-0.041	-2.16	0.019	0.087
Leverage	0.0008	-1.4	0.0006	0.161
Firm size	-0.3506	9.96	0.0352	0.000
No of observation	334			
F (Prob)	5840.45			0.0000
AR (1)	-2.29			0.024
AR(2)	-1.00			0.317
Sargan	247.08			0.0000
Hansen	49.05			0.391
No. of instruments	42	No. of group	49	

***, **, and * denotes significant at 1%, 5% & 10% levels respectively, and the figures in columns are coefficients, T-Statistics, Standard error of the estimates, and the last column are Coefficients from the GMM regression.

Micro-balance panel data were used in which the cross-section far exceeded the time dimension using Harris Travaliz and Fisher type for unit root test. The data were stationary at level and first difference, which means the data, has mixed stationarity and this permit the use of two-step system GMM regression (Baltagi, 2010; Saona & Muro, 2018). The study moreover revealed that the generalized methods of moment outcome reveal that the number of instruments are less than the number of groups (42 < 49), and the F-statistics are jointly significant (0.000). Further, AR2 second-order autocorrelation is not significant, as depicted in table. The table also documented that Hansen's statistics across the models are not significant. The dynamic dependent variable and the regressors are all statistically significant, as reflected in the table. The heterogeneity and endogeneity were properly taking care of by the use of system generalized method of the moment to address time and firm effect (Saona & Muro, 2018; Tian et al., 2018).

Audit Fee and Earnings quality

The study findings indicates that audit fee is negatively related with the earnings management in listed non-financial firms Nigeria. This indicates that earnings quality will be improve when the listed non-financial firms Nigeria pay appropriate audit fee. As documented in the studies of (Amran & Bala, 2018; Asthana et al., 2018; Gupta et al., 2011; Krauß et al., 2015; Sohn, 2018).

The studies were conducted in US, Nigeria, German, Spain, Italy and Malaysian study. In contrast, the findings of this study is not in congruence with the studies of (Boo & Sharma, 2008; Choi et al., 2010; Songini & Gnan, 2015; Xudong & Guo, 2007). These studies were carried out in Singapore, Italy, Hong Kong, USA, China, New Zealand and Korean firms which revealed that the fee premium compromises auditor independence and prejudice the audit quality.

Audit Tenure and Earnings Quality

The results of this study agreed with the current trend of inquiry which advocates that longer audit firm tenure does not compromise auditor independence but rather ameliorate the audit quality especially where the business has many tentacles and complex operations; in this case, ample time is required by the audit firm to understand the firm operation before given the professional opinion as to whether the firm financials buttress true and fair operation of the firm as reported in the studies of (Bratten & Causholli, 2017; Davis et al., 2009; Guindy & Basuony, 2018; Kyriakou & Dimitras, 2018; Lily & Brooks, 2015; Litt et al., 2014) in UK, USA, USA, Germany and USA. In contrast, the outcome of the study is not in line with prior studies which proclaim that the higher the tenure the more likely they will succumb to clients' demand and jeopardize their independence and the audit quality (Al-Thuneibat et al., 2012; Chi et al., 2011; Garcia-Blandon & Argiles, 2015; Ilyasova, 2015; Kamarudin et al., 2012; Krauss et al., 2011; Oscar et al., 2012; Yasser & Soliman, 2018) in listed non-financial firms in USA Malaysia, Jordan, Spain, German, Nigeria and Egypt.

Auditor Type and Earnings Quality

higher-quality auditors popularly called brand name auditors are more likely to detect questionable accounting practices and restrain manipulative attitudes and are associated with the higher earnings quality, This finding is in tandem with the notion that big4 auditors are capable of mitigating accruals-based earnings management (Alzoubi & Saleem, 2016; Becker et al., 1998; Bonacchi et al., 2016; Can, 2017; Hegazy et al., 2014; Krambia-Kapardis et al., 2010; Krishnan, 2003; Rusmin, 2005) in listed firms in Jordan, Turkey, US, Egypt, Cyprus, Singapore, US and Italy. In contrast, the findings of this study is in not in concord with the hitherto empirical studies (Baatwah et al., 2018; Dehkordi & Makarem, 2011; Piot & Janin, 2005; Taktak & Mbarki, 2014) in listed USA, Nigeria, Oman, France, Tunisia and Iran, which claimed that the Brand name auditors do not lead to quality earnings in listed non-financial firms mentioned.

Conclusion

1. The auditors' incentives to discourage prejudiced financial reporting differ systematically, conditional on whether their clients pay more or less than the normal level of audit fees. Proponent of higher fee premium are of the view that fee premium entice the auditors to engage the capable hand and ensure the audit quality. In contrast, others are of the view that, aggressive earnings management occurs mainly among firms that pay less than expected for audit services because auditors relaxed and not necessarily deployed competent staff in the discharge of the audit exercise. The audit fee paid by the client needs to be carefully studied, looking at fundamental factors into consideration, such as the audit firm, the client, and its complexity of operation and industry average of the fees paid within the threshold to avoid compromising the quality of earnings.
2. The choice of a short or longer tenure depends on the size of the audit firm, the auditee, and the density of client operation. The client with lesser operation shorter period is enough to critically examined his operations while, the clients with many branches and complexity required ample time to be able to give professional opinion as to his financial position and performance.
3. The brand name auditors can lead to production of earnings quality but depends on the prevailing factors at their disposal.

Recommendations

1. First, in order to ameliorate the monitoring capabilities of firm's board, decision control & management and to reduce any agency related debacles, appropriate audit fees should be charged and strike the balance to avoid excessive fee or lower fee which may erode the audit quality in listed non-financial firms Nigeria.
2. Secondly, to ensure the quality of earnings in listed non-financial firms Nigeria audit tenor needs to be observed with cautions looking at the audit client, simplicity or complexity of his operation and other relevant issues surrounding the activities in order to have quality financial reports.
3. Brand name auditors are also found to be ameliorating and ensure the audit quality in listed non-financials Nigeria and enhance firm's earnings, firm's value and deter opportunistic attitude in Nigeria.

Frontier for Future Research

a) The relationship between firm external monitoring mechanisms can be extended to other sector of the economy such as financial service industries, ICT, industries, services and natural resources industries sector etc.
b) Furthermore, another study can use the abnormal oil and gas production with derivatives seems to be fruitful areas of research since there is a scarcity of documented evidence from Nigeria

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