

## **Audit Quality and its Impact on Earnings Management of Quoted Conglomerates in Nigeria**

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**Abstract:** Recent events and corporate scandals resulting in corporate failures in the Nigerian financial and Non-financial sector brought auditors into sharp focus and caused the public to question the role of accountants and auditors. This study aimed at examining the impact of audit quality on earnings management of listed conglomerates in Nigeria using secondary data collected from the annual report of sampled banks covering a period of 10 years from 2005-2016. The study analyzed the panel data using both OLS and random effect regression. The findings from the study indicate that audit quality have positive and significant impact on earnings management which is an indication of audit failure in delivering their assurance service, the study therefore recommends that regulation of professional accounting firms should be enhanced so as to ensure their assurance service effectively so as to restore investors' confidence.

**Keywords:** Discretionary accruals, Audit firm size, Audit quality, Earnings management

### **Introduction**

Managers are saddled with the responsibility of stewardship in coordinating the activities of an organization through ensuring that their principals are served with adequate information on the position of their investments in the organization. While it is agreed that managers are responsible for adequate disclosure of information pertaining the activities of an organization, agency theory argues that managers are rational human beings and tend to exploit any opportunity at their disposal to satisfy their selfish interest thereby influencing the nature and type of information to disclose to their principal so as to maximize their compensation.

Financial reporting serves as a mechanism by which managers communicate to their principal on the affair of the organization. The efficacy of this communication relies heavily on the quality of information being disclosed in the financial reports. Financial reporting as a communication mechanism between managers and shareholders are being regulated by reporting standards such as the international financial reporting standard (IFRS).

Financial reporting standards allows for the use of management discretion and judgement in preparing financial reports. Earnings management involves the use of this management judgement and discretions so as to mislead users of financial reports or to influence contractual agreement. Similar to this view of earnings management is that it is primarily achieved by managed actions that make it easier to achieve desired earnings levels through accounting choices inherent in Generally Accepted Accounting Principles (GAAP). This is commonly occasioned by discretionary accruals manipulations that are likely to present some problems for a true and qualitative earnings report in an emerging market such as the Nigerian Stock Exchange (NSE). (Okolie, Izedonmi, & Enofe, 2013).

Financial reporting is said to be reliable and free of material misstatement only when an independent auditor assent to the financial report. Auditing involves the independent examination of financial report so as to ensure that the information disclose therein are free of material misstatement, in other words, the information are true and fair.

Audit quality is the ability of an auditor to examine financial reports prepared by managers effectively and efficiently thereby ensuring the financial reports being devoid of material misstatement. DeAngelo (1981)

defines audit quality as the market assessed joint probability that a given auditor will both discover a breach in the clients accounting system and report the breach.

From the definition of audit quality above, it can be said that when the audit of a financial statement is of high quality, the tendency of managers to mislead the users of financial statement through the use of judgement in the preparation of financial reports will be greatly minimized. In support to this statement (Okolie et al., 2013) posited that the audit of a company's accounts is a monitoring and control mechanism that diminishes information asymmetry and protects the interests of the principal. Thus, the audit process assesses the probability of material misstatements and reduces the possibility of undetected misstatement to an appropriate assurance level.

### **Statement of the Problem**

Recent events and corporate scandals resulting in corporate failures in the Nigerian financial and Non-financial sector brought auditors into sharp focus and caused the public to question the role of accountants and auditors. The quality of audits and audit opinions expressed on financial reports are crucial to achieving a sustained investor's confidence. However, a number of accounting and reporting irregularities and frauds in the last one decade have led to intense scrutiny of corporate governance frameworks and drove intense debate about issues such as financial statement audit, audit approach, audit quality and earnings management.

### **Objective of the Study**

This study therefore aims to examine the impact of audit quality on earnings management. That is, to determine whether audit quality can significantly constrain or minimize the negative consequences of earnings management of quoted conglomerates in Nigeria.

## **Literature Review**

### **Conceptual Framework**

#### **Concept of Audit Quality**

DeAngelo (1981) defines audit quality as the market assessed joint probability that a given auditor will both discover a breach in the clients accounting system and report the breach. The discovery of a misstatement measures quality in terms of auditor's knowledge and ability, while reporting the misstatement depends on the auditor's incentives to disclose.

Titman and Trueman (1985) earlier observed that a high-quality audit is an audit that improves the reliability of financial statement information and allows investors to make more precise estimate of the firm's value.

According to Palmrose (1988) audit quality is the probability that financial statements as prepared by management contain no material misstatements that can render it qualified. From this definition given, it is adduced that audit quality is tied to the level of reasonable assurance that any auditor can give about the financial report. Audit quality is also viewed as a component of the quality of accounting information disclosed and higher disclosure quality leads to lower information asymmetry between traders (Clinch, Stokes & Zhu, 2010).

Base on the aforementioned therefore, this study conceptualize audit quality as the ability of an auditor to examine financial reports prepared by managers effectively and efficiently thereby ensuring the financial reports being devoid of material misstatement.

### **Determinants of Audit Quality**

The following factors had been considered by scholars among the determinants of audit quality; Auditor independence; Audit firm size; Audit tenure; Earnings quality; Audit timeliness; Audit reputation; Audit fees; Audit qualification and proficiency among others. While extant literature had adopt one or more of these factors as measure for audit quality, this study adopts audit firm size measures for audit quality and audit fee as control variable.

The adoption of audit firm size as a measure of audit quality is based on the fact that auditor size is a useful surrogate for audit quality because it serves as a readily observable quality indicator. This can be quite helpful given that the underlying quality of audits and other accounting services are difficult to determine, even after they have been performed. DeAngelo (1981) once states earlier that "larger auditors, as captured by

membership among the Big N, tend to provide higher quality audits. In later theoretical and empirical researches, it is confirmed that firm size is closely associated with audit quality.

### **Concept of Earnings Management**

Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some shareholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers (Healy & Wahlen, 1999).

According to Fields, Lys and Vincent (2001) and Watt and Zimmerman (1990), earnings management may be derived from the flexibility of accounting choices that are given by Accounting Principles. The Accounting Principles allow managers to choose the appropriate reporting procedures and to make estimations, guess estimations and assumptions according to their business environment. Thus, with an alternative on offer, the manager may choose the reporting procedure that best suits him in order to maximize their wealth by exhibiting opportunistic behavior.

Managers therefore engage in opportunistic manipulation of earnings for several reasons such as bonus compensation, avoidance of debt covenant violations and prevention of earnings decreases and losses (Okoh, 2015).

Earnings Management through is motivated by the need for accounting adjustments and allocations made at the end of a given year for a number of reasons. Usually, accounting for routine exchange transactions does not result in accounting records being properly stated on the accrual basis to make adjusting and allocation entries at the end of the accounting period. The required adjustments are necessitated by the need to ensure that the financial accounts disclose a true picture of the transactions and operations of the organization, as well as comply with GAAP. While the key concept is that GAAP based accounting is supposed to reflect, and not obscure true economic performance, GAAP may also be violated by actions that result or do not result in fraud (Okolie et al., 2013).

In another view, the motivations for earnings management are narrowed down to three perspectives, that is; regulatory motivation, contractual motivation and market motivation.

### **Determinants of Earnings Management**

Researchers usually use accruals as measures of earnings management, measured by the absolute value of discretionary accruals. In accordance with Becker et al. (1998), the absolute value of discretionary accruals measures the level of opportunistic earnings management activities and extreme reporting decision exercises by managers. The total accruals are identified in order to estimate the discretionary accruals.

The discretionary accruals are estimated using a cross-sectional variation of the Jones (1991). The modified Jones (1991) and Dechow et al. (1995) and the performance adjusted model by Kothari et al (2005). Two steps are involved in the estimation of discretionary accruals. First is the estimation of non-discretionary accruals by estimating on the coefficients of each industry in each year by using OLS regression. The second step is to estimate the error term in the model, which represents the discretionary component of accrual. The error term is the difference between the total accruals and the non-discretionary accruals.

The estimation of discretionary accruals under the modified Jones (1991) model is relatively similar to the original Jones model, except that it takes into account the changes in accounts receivables. Kothari et al. (2005) suggest that there are two ways to control the firms' performance in the estimated accruals. The first is by matching each firm-year observation with another from a similar industry and year with the closest ROA in the current. Alternatively, firm performance, including ROA, can be included in the discretionary accruals regression as an additional variable.

### **Empirical Studies**

Several studies had been conducted in Nigeria on audit quality and earnings management in Nigeria such as the studies of (Okolie et al., 2013); (Jajeola, Taofiq, & Toluwalase, 2017); (Okoh, 2015); (Tyokoso & Tsegba, 2015); (Eriabie, & Dabor, 2017) and (Effiok, & Eton, 2016).

The conflicting results of these prior studies require that further studies be done to confirm or refute aspects of extant literature relating to audit quality and earnings management especially in developing economies like Nigeria. While the study of (Eriabie, & Dabor, 2017); (Jajeola, et al 2017) used abnormal loan loss provision as a measure for earnings management, this study differ on this measurement by applying

absolute discretionary accruals using the modified Jones's model as a measure of earnings management which is considered more reliable and have gain wider acceptance. This study also make an extension to the studies of (Okolie et al., 2013); (Tyokoso & Tsegba, 2015); and (Okoh, 2015) by studying the conglomerate sector of the Nigerian economy which has not been examined based on the knowledge of the researcher.

Several studies conducted in Nigeria had attempted to examine how audit quality significantly impact earnings management. These studies are therefore reviewed in this section so as to guide this study to a logical conclusion.

Okolie et al (2013) examine audit quality and accrual based earnings management of quoted companies in Nigeria using archival data which 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 amount 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.

Jayeola et al (2017) examined the relationship between audit quality and earnings management of deposit money banks in Nigeria using longitudinal research design. The study uses secondary data covering the period from 2005-2015 and panel data technique. The study revealed that there is a significant positive relationship between joint audit and earnings management which implies that a change to joint audit from single audit increases earnings management, so also there exist a positive relationship between audit independence and earnings management while negative but insignificant relationship between audit tenure and earnings management.

Okoh (2015) examined the relationship between audit quality and earnings management in the Nigerian chemical and paints sector over a period of seven years (2006-2012). The management of earnings was measured using Discretionary Accruals (a modified Jones model). Generalized Least squares technique was used to estimate the regression coefficients of the data obtained from the eight (8) listed chemical and paints firms using STATA 10. The results show that, audit firm size has a significant negative impact on the earnings management of the firms. The study also found that chemical and paints firms that engage the services of big-4 auditors engage less in earnings management, which implies that the bigger the audit firms, the lower these chemical and paints firms engage in earnings management.

Tyokoso and Tsegba (2015) investigated the impact of audit quality on earnings management of 8 oil marketing companies listed on the Nigerian Stock Exchange (NSE) from 2004 to 2013. Earnings management is represented by discretionary accruals estimated by the modified Jones Model while audit firm size, auditor industry specialization and auditor tenure as proxies for audit quality. The study reveal that both audit firm size and auditor industry specialization have negative but insignificant impact on earnings management of the sampled companies and evidence of a significant negative impact of auditor tenure on earnings management.

Eriabie and Dabor (2017) studied audit quality and earnings management of quoted banks in Nigeria. Data was gathered for the period 2005 to 2010. Cross-sectional year by year regression analysis was performed. Audit quality was measured by using audit fees and auditor change, and abnormal loan loss provision is used to measure earnings management. The result revealed that both audit fee and auditor change were positively related to abnormal loan loss provision.

It could be observed from the review of these literatures that the studies are having conflicting results. The study of Okolie et al (2013) seems to be comprehensive as it covers wide number of companies. The study's investigation and findings is generalized to all quoted companies, the study could not explain the resulting effect on individual sector of the economy and as such the need for examining the effect of individual sectors of the economy. The study of Jayeola et al (2017) and Eriabie and Dabor (2017) also attempt to measure earnings management by using abnormal loan loss provision. This proxy is considered weak and inappropriate as the modified jone's model discretionary accrual is more superior, comprehensive, appropriate and more reliable for measuring earnings management.

### **Theoretical Framework**

The theoretical framework for this study is anchored on the agency theory. The agency theory articulates principal –agent relationship between the shareholders and the managers with managers acting as agents whose personal interest does not always cohere with the company and the shareholder interest (Jensen & Meckling, 1976). The separation of ownership from management and control in modern business corporations provides the basis for the function of agency theory; it creates the potential for conflicts of interests between the

agents and principals and requires monitoring of the activities of the managers (the agents). One of the monitoring mechanisms advocated in corporate governance literature is the setting up of a monitoring board, but the collapse of Enron and WorldCom demonstrates the limits of a monitoring board (Deakin & Konzelmann, 2004). The major predicament of agency theory, therefore, is how to align the conflicting interests of the managers with the interests of shareholders but when managers have incentives to manage earnings such as to meet or beat earnings target, performance-based compensation, etc. they are likely to manipulate the company's reported earnings. This reduces the relevance and reliability of reported accounting earnings and financial statements generally. Agency theory, therefore, suggests monitoring mechanisms such as high quality external auditors to reduce these conflicts and align the interests of managers with the shareholders' interests.

### Methodology

This study examined the impact audit quality on earnings management of listed conglomerate companies in Nigeria for a period of 12 years (2005-2016). There are 6 listed conglomerate companies on the Nigerian Stock Exchange as obtained from the Nigerian Stock Exchange (NSE) as at 31<sup>st</sup> December, 2016 (Appendix B). Out of the 6 companies, four companies are studied. The selected companies are those that their annual reports and accounts were obtained for complete 12 years period. The companies include; AG Leventis PLC, Chellarams PLC, John Holt PLC and UAC of Nigeria PLC (Appendix C). This study utilized documentary firm – level data collected from the annual reports and accounts of the sampled firms. Panel data methodology using Pooled OLS, and random effect regression methods were used in analyzing the data using STATA 14.0. This is because the panel data methodology helps in exploring both time series data and cross-sectional data simultaneously (Muhammad, 2011).

### Model Specification

In this study audit quality is measured by audit firm size. DeAngelo (1981) once states earlier that larger auditors, as captured by membership among the Big N, tend to provide higher quality audits. A common proxy for earnings management is the absolute value of discretionary accruals. To estimate to what extent a company was able to manage its earnings, the modified Jones-model can be used. Dechow, Sloan and Sweeney (1995) compared several models to detect earnings management and found that this modified Jones-model has the most power to do so. This study therefore, used modified Jones-Model as proposed by Dechow et al. (1995) and Karsemeijer (2012) to estimate the discretionary accruals. With this method total accruals are calculated from the cash flow statement using the income before extraordinary items and cash flows from operations:

$$TA_{it} = EXBI - CFO \dots\dots\dots (1)$$

Where:

- TA<sub>it</sub> = total accruals in year t
- EXBI = income before extraordinary items (in year t)
- CFO = cash flows from operations (in year t)

Discretionary accruals are then estimated using the total accruals that are obtained from equation 1 in the following model:

$$TA_{it} = \beta_1(1/A_{it-1}) + \beta_2(\Delta REV_{it} - \Delta REC_{it}) + \beta_3(PPE_{it}) + \epsilon_{it} \dots\dots\dots(2)$$

Where:

- TA<sub>it</sub> = calculated total accruals (in year t)
- A<sub>it-1</sub> = Assets (in year t-1)
- ΔREV<sub>it</sub> = change in revenue from year t-1 to year t
- ΔREC<sub>it</sub> = change in receivables from year t-1 to year t
- PPE<sub>it</sub> = property, plant and equipment (in year t)

The variables ΔREV<sub>it</sub>, ΔREC<sub>it</sub> and PPE<sub>it</sub> are scaled by total assets in year t-1. After estimating β<sub>1</sub>, β<sub>2</sub> and β<sub>3</sub> with the model, the discretionary accruals were estimated using the residual value or error term (ε<sub>t</sub>). Therefore, the discretionary accruals as used in this study is the difference between total accruals and the fitted normal accruals, defined as  $DA_{it} = (TA_{it} / Asset_{it-1}) - NA_{it}$ .

Therefore;

$$DAC_{it} = \beta_0 + \beta_1 ASIZE_{it} + \beta_2 LAFEE_{it} + \epsilon_{it} \quad (3)$$

Where:

1. DAC = estimated discretionary accruals from the modified Jones model.
2.  $\beta$  = is the individual effect taken to be constant over time and specific to the individual cross-sectional unit  $i$ .
3.  $ASIZE_{it}$  = Audit firm size in firm  $i$  at a time  $t$ , measured by Dummy variable, if Auditor is big 4 (Deloitte, PWC, Ernst & Young and KPMG) = 1, else 0 (Asthana & Boone, 2012 and Kimeli, 2016).
4.  $LAFEE_{it}$  = Control variable, Audit fees in firm  $i$  at a time  $t$ , measured as the natural logarithm of audit fees paid for auditing annual accounts of parent companies and consolidated accounts. Audit fees do not include fees for auditing annual reports of branches and subsidiaries (Kimeli, 2016).

### Result and Discussion

#### Descriptive Statistics

Table 1

Variable	Obs	Mean	Std. Dev.	Min	Max
da	48	.6287985	.036685	.545522	.733483
asize	48	.6875	.4684174	0	1
lafees	48	7.170454	.5324803	6.25527	8.43618

**Source:** researcher's computation using STATA v 14.0

Table 1 provides the summary statistics of the dependent and independent variables in order to effectively appreciate the nature of the results. It provides a basic insight into the nature of the data upon which analysis is done. The summary statistics include measures of central tendency, such as mean, measures of dispersion (the spread of the distribution) such as the standard deviation, minimum and maximum of both the dependent variable and explanatory variables. From Table 1, discretionary accruals show a mean of 0.6287985, a standard deviation of .036685 which is an indication that the firms may not differ on the extent of their earnings management. The mean of audit firm size is .6875 and a standard deviation of .4684174.

#### Correlation Analysis

Table 2

	da	asize	lafees
da	1.0000		
asize	0.5975	1.0000	
lafees	0.2567	0.3413	1.0000

**Source:** researcher's computation using STATA v 14.0

The correlation result indicates that there is a positive association between discretionary accruals and audit firm size. It is also found that, Audit fee is positively related to discretionary accruals.. The respective cases indicate the significance of the relationship given by 1.0000. It is also indicated in the results that the explanatory variables are not highly correlated.

**Regression**

Table 3

da	OLS				Random Effect			
Ind var.	Coefficient	Std error	T	p>/t/	Coefficient	Std error	Z	p>/z/
Constant	.5682086	.060833	9.34	0.000	.5682086	.060833	9.34	0.000
asize	.0451973	.0099354	4.55	0.000	.0451973	.0099354	4.55	0.000
lafees	.0041164	.00874	0.47	0.640	.0041164	.00874	0.47	0.638
F	12.67				25.33			
P- Value	0.000				0.0000			
R <sup>2</sup>	0.3602				0.3602			
Wald Chi <sup>2</sup>					25.33			
P- Value					0.0000			
R Squared:								
Within					0.1088			
Between					0.09609			
Overall					0.3602			

Source: researcher's computation using STATA v 14.0

Table 3 shows the results of both the OLS and Random Effect regression. The OLS shows the F-Value of 12.67 and its P-Value is 0.000 which means that the overall model is fit. Further, both the OLS and the Random Effect showed the value of R<sup>2</sup> as 0.3602 which is the multiple coefficient of determination that gives the proportion or percentage of the total variation in the dependent variable explained by the explanatory variables jointly. Hence, it signifies that approximately 36% of total variation in earnings management of listed conglomerates in Nigerian is caused by audit quality.

The regression results as shown in table 3 indicate that audit quality (audit firm size) in both the OLS and Random Effect regressions has positive and significant impact on earning management because the level of significance is 0.000 which is below 5%. This implies that as audit quality improves, earnings management also improves. This indicates that audit firm size does not hinder management distortion and manipulation of earnings. This result is not as expected, since audit quality is expected to have a negative impact on earnings management.

The findings from this study could be explained by the recent corporate scandals in Nigeria that tend to question the role of auditors and their assurance services. This is an indication of the inability of auditors to effectively examine the financial reports prepared by managers thereby reducing the possibility of undetected misstatement to an appropriate assurance level.

The finding from this study is an indication of audit failure in delivering their assurance services. The finding from this study is consistent with the findings of jayeola et al (2017) and Eriabor and Dabor (2017) while it contradict the findings of okolie et al (2013) and Okoh (2015).

**Post Residual Diagnostic Test  
Multicollinearity Test**

Table 4: Variance Inflation Factor

Variable	VIF	1/VIF
asize	1.13	0.883484
lafees	1.13	0.883484
Mean VIF	1.13	

**Source: researcher’s computation using STATA v 14.0**

The VIF for asize and lafees are 1.13 & 1.13 respectively. This indicates that, the VIFs are less than 10 respectively. Thus, the study concludes that there is no problem of multicollinearity. That multicollinearity exists only when the VIF is greater than 10.

**Heteroscedasticity Test**

Table 5: Heteroscedasticity

Breusch-Pagan / Cook-Weisberg test for heteroskedasticity
Ho: Constant variance
Variables: fitted values of da
chi2(1) = 1.53
Prob > chi2 = 0.2162

**Source: researcher’s computation using STATA v 14.0**

The Breusch Pagan/ Cook-Weisberg Test of Heteroskedasticity on da and afsize given the Chi2 Prob. of 0.2162, indicates that the data are homokedasticity. Thus, the p-value of 0.2162 is greater than 0.05 makes the study to accept the hypotheses that the residuals are not heteroskedasticity but homokedasticity and are desirable.

**Conclusion and Recommendation**

The study examined the impact of audit quality on earnings management of conglomerates in Nigeria. The finding from the study indicates that audit quality have a positive and significant impact on earnings management. This is not as expected as it is assume that effective audit will reduce the ability of management to manipulate earnings. While the outcome of this study cannot be distorted it can however be interpreted as an indication of audit failure with regard to the recent corporate scandals witnessed in the country and also the poor performance of conglomerates in Nigeria.

Therefore, this study indicates that audit quality measured by audit firm size does not reduce the possibility of undetected misstatement to an appropriate assurance level. The finding from this study confirms the findings of jayeola et al (2017) and Eriabor and Dabor (2017) while it refutes the findings of okolie et al (2013) and Okoh (2015).

The study recommends that regulations on professional accounting bodies should be enhanced so as to ensure they deliver an effective assurance services.



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