

RESEARCH ARTICLE

Audit Fees, Corporate Governance Mechanisms, and Financial Reporting Quality in Nigeria

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Abstract: This study examines whether audit fees impair the independence of auditors in Nigeria and also examines the effects of independent non-executive foreign directors, foreign institutional ownership, and local institutional ownership on the quality of financial reporting. This study employs the Generalized Methods of Moment (GMM) estimation to control the presence of unobserved heterogeneity effects and endogeneity issues in our auditors' independent model. The data was obtained from the annual reports of 89 listed companies in the Nigerian Stock Exchange (NSE) for the years 2008 to 2013. Our findings revealed that abnormal audit fees charged by Nigerian auditors do not impair their independence, but rather they might reflect additional efforts undertaken during the course of the audit. Likewise, the study found that the presence of independent non-executive foreign directors on a board improved the quality of financial reporting and an increased in the percentage of share ownership of foreign institutional shareholders also improved the quality of financial reports. However, percentage of local institutional ownership is not significant. The first limitation of this study is that audit fees and non-audit fees were lumped together as auditor remuneration in the annual reports. Thus, this summation did not permit the testing of individual components of auditor remuneration, as had been done in several previous studies. The second limitation is that accrual earnings management was used as the metric for financial reporting quality. Due to data limitations, real earning management, which is another proxy of earning management, was not tested. The study's findings provide significant implications for auditors, regulators, and preparers. First, any attempt to reduce the remuneration of auditors in Nigeria might also result in the reduction of the quality of financial reporting; however, regulators must redouble their efforts to regulate audit fees. Second, evidence of weak monitoring by local institutional investors suggests a possible weakness in shareholder activism. This paper provides additional insights into the quality of financial reporting, the impairment of auditor's independence, and the expropriation of minority shareholders' interests from a less-studied environment characterized by a weak institutional framework. Our findings are robust with respect to the issues of unobserved heterogeneity and endogeneity, which previous studies had failed to consider.

Keywords: abnormal audit fees, financial reporting quality, Nigeria, Generalized Methods of Moment

JEL Classifications- M41, M42

Issues affecting financial reporting quality remain of great interest to regulators, practitioners, and scholars alike. Liberally applied accounting rules give managers the ability to use their discretion on what to report. In view of this, managers sometimes apply accounting standards in an opportunistic manner for private gain. The primary role of auditing is to enhance the value of financial reporting through the reduction of information asymmetry. Auditors are supposed to thwart management efforts to manage earnings creatively by enforcing the use of proper accounting policies (Gibbins, 2002; Francis & Wang, 2008). However, the impairment of an auditor's independence can stifle his or her ability to enforce appropriate accounting policies. One major factor causing the impairment of an auditor's independence is the extent of that auditor's economic bond with the client (DeFond et al., 1999; Chung & Kallapur, 2003). When an auditor-client bond occurs, auditors become subservient to the client and have no other choice but to agree with the clients' choice of reporting, even when such reporting does not represent reality (Francis & Wang, 2008). However, as argued in some research, high audit fees also could be a reflection of auditors' efforts, and hence, related to the quality of financial reporting.

This study seeks to answer the question of whether audit fees paid to Nigerian auditors are reflective of their efforts or whether auditors are bonded economically to their clients, thus, losing their independence. In recent times, regulators and academic reports from Nigeria have expressed concern over the high level of Big4 audit firm concentration and excessive audit fees in the Nigerian audit market (Okike, 2004). The effect of these concerns has caused dissatisfaction with the quality of accounting information. In the eye of the storm are the Big 4 audit firms that have been widely acclaimed as delivering quality audit services (DeAngelo, 1981; Francis & Wang, 2008). Reports of major accounting scandals in Nigeria have alleged that audit firms operating within this market segment, specifically Akintola Williams Deloitte, have not delivered the expected high quality.

Interestingly, regulatory authorities have responded to the quality issue with new initiatives. An example of such an initiative was the long overdue revision of the 2003 Code of Corporate Governance in 2011 and the Financial Reporting Council of Nigeria Act, No. 6, 2011 that established the Financial Reporting

Council of Nigeria (FRCN). This government agency has the mandate to monitor the activities of auditors of a public reporting entity. A provision of this act is the mandatory registration with the council and financial statements for those in audit practice. In addition, starting from 2013, audited annual reports must bear the personal signature of a named auditor/audit partner. This process differed from the previous practice, which required that only the seal of the auditing firms be used (Egene, 2014). The expectation was that all the regulatory initiatives would improve auditor's independence, which in turn, would improve financial reporting quality.

This study contributes to the extant literature in several ways. First the study investigates auditor independence issues of Nigerian-listed companies during the pre- and post-regulatory change periods. Although several studies have investigated the effects of post-regulatory changes on the quality of financial information, according to Broye and Weil (2008), differences in legal environments for an auditor affect the quality of service rendered. Such differences, in turn, impose restriction on the ability to generalize the results of previous studies. For instance, Adelopo (2011) and Ujunwa (2012) reported that the ownership structure of large corporations is characterized by concentrated controlling shareholders. Adelopo (2011) and Ujunwa (2012) findings painted a different picture of agency conflict compared to the agency conflict arising from diverse ownership structure in the United Kingdom and the United States. This situation also differs from the institutional concentration of banks in Germany, Japan, and family-concentrated ownership in both Asia and Europe (Shleifer & Vishny, 1997).

Moreover in Nigeria, factors such as corruption, bribery, a weak market, and inadequate infrastructure further exacerbate the agency problem, as exemplified in the case of Lever Brothers Nigeria where senior management unduly increased their perquisite and engaged in other abuse of office while the majority shareholders could not resist such act. These factors help facilitate the exploitation of minority shareholders by controlling stockholders (Ahunwan, 2002). Interestingly, our findings show that the presence of local institutional shareholders are not efficient monitoring mechanisms. Their presence, according to the study's finding, increases the magnitude of discretionary accruals, thereby reducing earnings quality. This finding is novel, as it contradicts the

findings of most previous studies that have examined the link between the effects of local institutional investors and earnings management. In addition, it gives empirical backing to Ahunwan's (2002) assertion of the inability of majority shareholders to act as an effective monitor due to corruption, ethnic loyalty, and infrastructure.

To the best of our knowledge, no previous study has examined the presence of foreign directors and ownership structure on reporting quality. The potential advantage of foreign directors and foreign institutional ownership aligns with Performance Theory and has been debated in corporate governance studies. First, Masulis, Wang, and Xie (2012) claimed that, when a foreign director is present on a board, monitoring could get better. The reason for this improvement is that foreign directors can bring their diverse orientations and expertise to local board processes. Consistent with the Reputation Capital Theory, foreign directors could invoke stringent procedures to ensure that companies are managed professionally. Therefore, foreign directors and institutional shareholders can lower information asymmetry (i.e., reduce earnings management) through close monitoring of a company's activities.

Second, the findings of previous studies remain inconclusive (Eshleman & Guo, 2014). Two factors that might be partly responsible for this situation are issues of unobserved heterogeneity and the presence of endogeneity among explanatory variables. Endogeneity is a problem that results in biased and inconsistent parameter estimates. However, despite its presence, accounting and finance researchers have often failed to address the issue (Gippel, Smith, & Zhu, 2015). For instance, financial reporting quality and audit fees are two variables that can be jointly determined (Antle, Gordon, Narayanamoorthy, & Zhou 2006). Ignoring the issue of endogeneity as done in most previous studies limits the validity of empirical tests of the model used (Gippel et al., 2015; Wintoki, Linck, & Netter 2012).

This current study uses a dynamic panel, including the Generalized Method of Moments (GMM) to alleviate concerns about endogeneity in the auditors' independence model utilized. When the traditional fixed effect was applied to the static model, an approach past studies adopted, we find a positive, but weak, significant relationship between our proxy for financial reporting quality and abnormal total audit fees. Also,

we find a negative relationship between abnormal audit fees and discretionary accruals, while accrual earnings quality decreased after regulatory changes. Again, when the dynamic GMM was used, the estimated coefficients of abnormal audit fees had a negative and significant relationship with financial reporting quality. Finally, GMM methodology was applied to examine how financial reporting quality and audit fees affected each other. After correcting for heterogeneity and simultaneity issues present in the regression model, the proxy for financial reporting quality in this current study is negatively and significantly related to abnormal audit fees. This result is similar to that of Eshleman and Guo (2014) and Mitra, Deis, and Hossain (2009). The association remained the same in the post-regulatory periods as well. Similarly, consistent with previous studies (Hadani, Goranova, & Khan, 2011; Edmans, 2009; Dechow, Sloan, & Sweeney 1996) we find that an increase in the percentage of foreign institutional investors improved the quality of financial statements. Overall, an improvement in the signs and the significance levels of other explanatory variables was present when the GMM method was adopted.

The remainder of the paper is organised as follows: Section 2 presents a review of the relevant literature and hypothesis development; Section 3 lays out the research design, describes the sample selection approach, and describes the dynamic panel GMM estimators; Section 4 provides an empirical analysis of our investigation; and Section 5 provides the conclusions and suggestions for future research.

Literature Review and Hypotheses of the Study

Financial Reporting Quality and Abnormal Audit Fees

Conflicting evidence exists on how the amount of fees received by auditors affects financial reporting quality. The conflicting findings of prior studies are partly attributable to the differing proxies used to characterize reporting quality, sample selection procedures, or various approaches taken to measure abnormal audit fees (Eshleman & Guo, 2014). The majority of the arguments of these studies have adopted the auditor-economic bond viewpoint. Recently, however, several studies have also argued

that excessive audit fees might not necessarily bond auditors, but rather, these fees could be a signal of high-quality audits instead of a sign of abnormal audit fees. The literature in this area is divided into those supporting the economic bonding view and those supporting the auditors' effort view.

Several studies have examined the economic bonding view. Frankel, Johnson, and Nelson (2002) presented evidence which suggested that the magnitude of absolute discretionary accruals was negatively associated with the percentile rank of audit fees, suggesting that auditors were less likely to allow biased financial reporting. However, Ashbaugh, LaFond, and Mayhew (2003) found an insignificant relationship between the two. More recent literature has tended to consider the signs of abnormal audit fees, noting that the signs have implications for auditors' reporting incentives. Choi, Kim, and Zang (2010) documented an insignificant relationship between abnormal audit fees and audit quality. However, their findings were sensitive to the sign of abnormal audit fees. When positive (audit fees were higher than expectations), the auditor was likely to lose independence. Conversely, when negative (fees lower than expectations), the relationship was not significant. They concluded that audit fees and audit quality were asymmetrical and non-linear. In other words, the association between abnormal audit fees and audit quality depends on what is determined by the sign of abnormal audit fees. Asthana and Boone (2012) examined client bargaining power with respect to economic bonding. They found that absolute discretionary accrual and meeting or beating analysts' earnings forecasts declines as negative audit fees increase this effect, and this decline increases as clients gain more bargaining power. However, after Sarbanes-Oxley the effect declined, implying that the new regulation improves auditor's independence.

Several studies have examined the "auditor's effort" viewpoint. According to the proponents of this view, audit fees reflect the level of effort, which translates into the quality of service provided (Hoitash, Markelevich, & Barragato, 2007). Abnormal audit fees might indicate an increase in audit quality and not necessarily reflect economic bonding of auditors. Conversely, audit fees below the normally accepted level could reduce the quality of audit services. Eshleman and Guo (2014) used a sample of firms having incentives and the ability to beat or meet consensus earnings

forecasts using discretionary accruals. They found a negative relationship between the level of abnormal audit fees and the probability of using discretionary accrual to meet or beat consensus earnings forecast. Their findings demonstrated that excessive audit fees are a reflection of additional effort exerted by the external auditor, which translates to an improvement in audit quality. Blankley, Hurtt, and MacGregor (2012) examined the relationship between abnormal audit fees and client restatements controlling for internal control quality. They revealed that abnormal audit fees were negatively associated with restatement. Although available practical issues in Nigeria suggest that auditor independence is compromised through excessive audit fees; empirical findings about the effect of audit fees on auditors' independence are mixed. Consistent with theoretical arguments, the first hypothesis postulates that:

H1: Abnormal audit fees will affect financial reporting quality.

The first hypothesis naturally leads to the second hypothesis. Although anecdotal evidence suggests that high audit fees impair auditor's independence, the issue of auditor objectivity and fairness is more compelling with the recent regulatory initiatives in the Nigerian market for audit services, because auditors are held accountable in the current regime. That is because the FRCN concerns itself more with financial report quality. All stakeholders involved in the production of financial reports are to register with the council. More so, subsequent to rulings of the Court of Appeals, both the audit firm and the audit partners are responsible for all documents submitted at the SEC. Subsequent to the various initiatives, this study postulates that:

H2: Regulatory changes will improve financial reporting quality.

Financial Reporting Quality and Foreign Independent Directors

Subsequent to the separation of ownership from management in modern corporations, the fundamental responsibility of a board of directors is to protect the best interests of the shareholders who they represent from the unscrupulous desires

of management. The board of directors achieves this through monitoring and sanctioning of management when necessary. The central role played by independent directors in this regard is without doubt. Currently, a clamor has developed for including at least one independent foreign director on the boards of companies seeking an international listing. According to Oxelheim and Randoy (2005), the presence of independent foreign directors signals a company's willingness and commitment to corporate monitoring and transparency. Fich and Shivdasani (2007) and Fama (1980) have argued that director reputational incentives enhance board control incentives, primarily because the directors involved are disciplined in the directors' labour market. For instance, an external director might find it difficult to obtain an appointment on the board of other companies if he/she is implicated in reported cases of financial irregularity (Fich & Shivdasani, 2007).

Despite the aforementioned benefits of the presence of a foreign director on a board, their presence could also weaken the effectiveness of board monitoring (Masulis et al., 2012). For instance, local accounting principles, governance, and laws and regulations could be alien to a foreign director. Similarly, a lack of access to "valuable soft information" due to reduced geographical proximity is a factor. Masulis et al. (2012) found that foreign independent directors had poor board meeting attendance records, and firms with foreign independent directors (FID) were more prone to commit intentional financial misreporting and overpay their CEOs and had lower CEO turnover related to performance. Finally, firms with FIDs were associated with significantly poorer performance, especially as their business presence in the FID's home region became less important.

In Nigeria, a substantial number of companies have at least one foreign director on their board, although the mandate for foreign directors varies. Some foreign directors represent either the interests of their parent companies or the interests of foreign owners with a large equity stake. The presence of foreign directors on a board often signals a firm's commitment to sound corporate governance.

The empirical association of independent foreign board of directors and financial reporting quality to the best of our knowledge remains lacking. Thus, we hypothesize that:

H3: The higher the proportion of foreign independent directors on board, the higher the financial reporting quality will be.

Financial Reporting Quality and Institutional Ownership

Empirical evidence exists that institutional shareholders are actively involved in their firm's corporate governance (Gillan & Stark, 2002; Shleifer & Vishny, 1986). In fact, their participation improves the quality of financial information in the capital market (Parrino, Sias, & Starks, 2003; Koh, 2003; Yeo, Tan, Ho, & Chen 2002). Several studies on the role of institutional shareholders have asserted that shareholders with large equity positions are more efficient in monitoring roles compared to shareholders with equity positions that are not substantial (Johnson & Greening, 1999; Ciccotello & Grant, 1999; Maug, 1998). The reason for this is that, by virtue of their equity holdings, institutional shareholders stand a better chance of challenging and influencing corporate decisions because monitoring costs are minimal compared to expected benefits. Koh (2003), among other studies, has investigated the effects of ownership structure on the earnings management behavior of management, providing evidence that institutional investors complement the role of other corporate governance mechanisms. Dechow et al. (1996) emphasized that firms dominated by large institutional shareholders are less likely to engage in fraudulent financial reporting. This is because, as Edmans (2009) explained, institutional shareholders "see through" financial situations and prevent problematic financial reporting. For example, Hadani et al. (2011) found a negative relationship between the shares held by institutional investors and earnings management. In line with previous findings, this current study argues that the higher the stake of institutional shareholders in a firm's equity capital, the better the financial reporting quality. That is, an institutional shareholder will most likely constrain the manipulation of accounting numbers by managers. Accordingly, the following hypotheses are posited:

H4: The higher the percentage of ownership by local institutional investors, the better the financial reporting quality will be.

H5: The higher the percentage of foreign institutional investors, the better the financial reporting quality will be.

Research Design

Estimation of Expected and Unexpected Audit Fees

Past studies have consistently argued that auditee client size, client complexity, risk, profitability, and liquidity all affect audit fees (Simunic, 1980; Abbott, Parker, Peters, & Raghunandan 2003). Previous studies have provided evidence suggesting that these variables have good explanatory power and robustness across various countries of study at different points in time. In this current study, the following audit fees expectation model, consistent with Francis and Wang (2005), is used to measure the presence of abnormal audit fees. Consistent with Eshleman and Guo (2014) and Mitra et al. (2009), the error term from the audit fees model was employed as a proxy for abnormal audit fees, as follows:

$$\begin{aligned} LOGFEES_{it} = & \alpha_1 + \beta_1 LOGTA_{it} + \beta_2 ROA_{it} + \beta_3 LOGRITA_{it} + \beta_4 QUICK_{it} + \\ & \beta_5 INVT_{it} + \beta_6 REC_{it} + \beta_7 LEV_{it} + \beta_8 NOSUB_{it} + \beta_9 BIG4_{it} + \\ & \beta_{10} YREND_{it} + \beta_{11} LAG_{it} + \varepsilon_{it} \end{aligned} \quad (1)$$

where LOGFEES = log of actual audit fees;
 LOGTOVER = log of turnover;
 LOGRITA = log of inventory to total assets;
 Quick = ratio of current assets less inventory;
 REC = receivable;
 LEV = total debt divided by total assets;
 NOSUB = number of subsidiaries;
 BIG4 = dummy variable (1 for Big4 audit and 0 if otherwise);
 YREND = account year end; and
 LAG = number of days taken to issue an auditor's report.

Discretionary Accruals Estimation

Discretionary accrual earnings management was estimated using Kothari, Leone, and Wasley's (2005) performance matched cross-sectional model. Performance matched accrual is necessary in order

to control for a firm's extreme performance. Thus, consistent with Kothari et al. (2005), Return on Assets (ROA) was included as an explanatory variable in our accrual model. In addition, in line with Warfield, Wild, and Wild (1995) and Frankel et al. (2002), the absolute value of discretionary accruals was utilized, as this value captures the effects of both income increasing and income decreasing accrual earnings management. Total accrual is therefore estimated using the following cross-sectional regression for each industry and year for the sampled companies:

$$\begin{aligned} \frac{TA}{Asset_{t-1}} = & \partial_1 \frac{1}{Asset_{t-1}} + \partial_2 \frac{\Delta REV - \Delta REC}{Asset_{t-1}} + \\ & \partial_3 \frac{PPE}{Assets_{t-1}} + \partial ROA_{t-1} + \varepsilon_{it} \dots \end{aligned} \quad (2)$$

where TA = total accruals computed as the difference between earnings before extraordinary items, discontinued operations and operating cash flows
 Asset_{t-1} = lagged of total assets
 ΔREV = change in revenues
 ΔREC = change in receivables
 PPE = property, plant and equipment
 ROA_{t-1} = lagged return assets calculated as net income before extraordinary items of prior period divided by lagged total assets
 ε_{it} = residuals

Discretionary accruals (DA) are residuals obtained from equation (1). The cross-sectional regression was run for each industry and year.

Estimation Method

The following panel regression model was used to test the relationship between the variables. The panel approach controls for the unobserved individual heterogeneity effect, which is otherwise not controlled for in ordinary least squares (OLS), and if neglected, leads to biased estimates. The problem of unobserved heterogeneity arises because of audit fees; hence, several factors are likely to affect the quality of financial information. Some factors affecting audit quality that are often not included are audit team composition, allocation of work between the year-

end and influence of internal audit assistance, and the quality of client financial reporting reputation (Asthana & Boone, 2012). Similarly, the presence of endogeneity among explanatory variables also makes estimates of parameters using OLS and a static panel inconsistent. That is, the dependent variable can also behave like an independent variable. Therefore, because of the endogeneity issues identified, this study uses the dynamic panel method to estimate the regression model (GMM). The coefficient estimate the GMM produced is consistent even in the presence of unobserved heterogeneity and likely endogeneity among explanatory variables. The dynamic panel method is of two types: 1) the Difference Generalized Method of Moments of Arellano and Bond (1991), and 2) the system Generalized Method of Moments (system GMM) of Blundell and Bond (1998).

It should be noted that the observed outliers in the data set were not deleted since they are legitimate observation arising from inherent variability of the data. However, in line with many studies in audit pricing literature, we specify the relationship between auditee characteristics and audit fees in natural logarithms form. This specification reduces the influence of outliers and improve regression model properties (Clatworthy & Peel, 2007) while at the same time accounting for the economies of scale in the audit (Palmrose, 1986).

Ordinarily, it is a common knowledge, most especially in audit fees literature, to take log value of variables with extreme observations. Log transformation is the inverse operation to exponentiation which reduces the variation caused by extreme values. However, variables with negative and zero values, observations cannot be logged. Those variables with zero values were actually scaled. For instance, INDP, NONEXC, and FDIR were divided by board size while INTS and FSHR are in percentage and the value ranges from zero to 100 as not all the companies have the presence of institutional investors.

To assess the effect of regulatory changes and the presence of foreign directors and foreign institutional ownership on reporting quality, the following model is estimated:

$$\begin{aligned}
 ABDAC = & \alpha_{it} + \alpha_{1it}ABNRAF + \alpha_{2it}POSTREG + \alpha_{3it}FDIR + \alpha_{4it}FSH + \\
 & \alpha_{5it}INTS + \alpha_{6it}INDP + \alpha_{7it}NONEXC + \alpha_{8it}LOGTA + \\
 & \alpha_{9it}TEMP + \alpha_{10it}BIG4 + \alpha_{11it}BUSISEG + \alpha_{12it}DR + \\
 & \alpha_{13it}GROWTH + \alpha_{14it}ROA + \alpha_{15it}ACCR + \alpha_{16it}CF + \\
 & \alpha_{17it}RLAG + \alpha_{18it}INDDUM + \alpha_{19it}YRDUM + \\
 & \mu_{RQ}
 \end{aligned} \tag{3}$$

where Sub-index *i* denotes the firm; sub-index *t* denotes the period

ABDAC = absolute discretionary accrual computed from cross sectional performance adjusted model (Kothari, Leone, & Wasley, 2005)

ABNRAF = abnormal audit fees based on the residuals from the regression in equation (1)

POSTREG = a dummy variable of 1 for post regulatory period, or 0 if otherwise

FDIR = number of foreign directors on board scaled by board size

FSH = percentage of institutional foreign shareholders

INTS = percentage of local institutional shareholders

INDP = number of independent directors on board scaled by board size

NONEXC = number of non-executive directors on board scaled by board size

LOGTA = natural log of total assets

TEMP = natural log of total number of employees

BIG4 = a dummy variable of 1 for Big 4 audit firm, or 0 if otherwise

BUSISEG = number of business segment operated by the firm

DR = total debts divided by total assets

GROWTH = sales growth

ROA = return on assets

ACCR = ACCRUAL is calculated as net income less operating cash flow scaled by total assets.

CF = cash flow from operation divide by total assets.

RLAG = is the log of length of time between company's financial year-end and the date of auditor's report.

YRDUM = industry dummy

INDDUM = year dummy

Table 1. *Sample Selection Process*

Panel A: Sample selection	Number	%
Initial sample of firms with sectors reported in (NSE) for the year 2013	181	
Less: firms operating in the financial sector	56	
Less: firms in the agriculture sector	5	
Less: firms with missing annual reports	31	
Final sample	89	
Panel B: Distribution of sample firms by industry		
Natural Resources	10	11.2
Conglomerate	15	16.9
Industrial goods	15	16.9
Service	22	25.0
Consumer	27	30.0
<i>Total</i>	89	100.0

Sample Selection

The data used for this study were obtained from the annual reports of companies listed on the Nigerian Stock Exchange (NSE). Non-financial companies with available data to compute all the variables between 2008 and 2013 were selected for this study. For the purpose of estimating the earning management proxy, industries with less than 10 observations were eliminated. The final sample comprised 409 observations, grouped into five industries. Table 1, Panel A contains the sample selection process, while the distribution of the sample firms across the sectors is shown in Table 1, Panel B.

Results

Univariate Tests

Table 2 reports the univariate tests. To assess the effects of regulatory changes on financial reporting quality and audit fees, the total sample was divided into two subsamples: 1) the pre-regulatory period, and 2) the post-regulatory period. The mean and median of the financial reporting quality and audit fees measures were compared in the two subsamples. As displayed in Table 3, the mean and median values of ABDAC were high in the post-regulatory period, with a significant change between the pre- and post-regulatory period

Table 2. *Univariate Measures of Regulatory Changes on Financial Quality and Audit Fees*

	Pre-regulatory	Post-regulatory	Full Sample	<i>t</i> -statistic
ABDAC				
Mean	2.91	16.82	10.26	-2.45
Standard deviation	19.09	76.95	57.79	
ABNRAF				
Mean	-0.05	0.04	3.63	-3.35
Standard deviation	0.30	0.27	0.29	

(t-statistic = -2.45). Similarly, a significant difference (-3.35) existed between the pre- and post-regulatory periods for abnormal audit fees (ABNRAF). Overall, the results in Table 2 indicate that financial reporting quality increased in the post-regulatory period and was accompanied by a significant increase in audit fees. This suggests that auditor's independence was not impaired.

Descriptive Statistics

Table 3 reports the descriptive statistics for variables employed in the analyses. In the sample in this study, the maximum number of foreign directors on board was eight, the minimum was zero, and the mean was 1.71. The average number of companies

with foreign institutional ownership was 24%, and local institutional ownership was 46%. With respect to board composition, the ratio of independent directors (INDP) to total directors in boardroom was 0.35 and the ratio of non-executive directors (NONEXC) inside the boardroom was 5.74 to total directors in the boardroom. The average size of firms measured by the total assets (TA) in the sample was 27,400,000 Naira and the average number of employees was 53.7. Big 4 audit firms had audited 67% of the firms in the sample.

Empirical Regression Results

The explanatory variables and financial reporting quality relationship was tested using FE and dynamic GMM specifications, and the results are presented in

Table 3. *Descriptive Statistics*

Continuous variables	Mean	Standard Deviation	Min	Max	%
FDIR	1.71	1.89	0	8	
FDIR (scaled by board size)	0.20	0.21	0	1.14	
FSHR	23.86	29.65	0	91	
INTS	46.43	27.92	0	98	
INDP	0.35	1.23	0	10	
INDP (scaled by board size)	0.36	0.13	0	1.29	
NONEXC	5.74	2.13	0	13	
NONEXC (scaled by board size)	0.69	0.18	0	1	
TA	27,400,000	61,900,000	68,953	843,000,000	
LOGTA	6.87	0.76	4.83	8.93	
TEMP	53.70	157	3	1454	
BUSSEG	2.87	1.65	1	7	
DR	1.12	1.39	-0.36	15.95	
GROWTH	0.00	0.12	-1.21	0.75	
ROA	0.05	0.28	-1.72	3.41	
ACCR	-1066844	11,900,000	-105,000,000	22,400,000	
CF	-0.96	0.487	-2.21	2.54	
RLAG	4.71	0.44	3.58	5.91	
Dichotomous					
BIG4					66.99
POST					52.81

Table 4. The fixed effect panel model assumptions assume strict exogeneity in the abnormal audit fees, corporate governance and firm control characteristics. Therefore, the fixed effect model account for the issue of unobservable heterogeneity that exists between the dependent variable and the explanatory variables. However, the GMM specification corrects for all sources of endogeneity, namely, dynamic endogeneity, unobservable heterogeneity, and simultaneity problem. For the FE model, the R^2 reported was 0.51 with 0.000 $\text{prob} > F$ statistic, which indicates the fitness of the model. With respect to the GMM specification test, the Sargan-Hansen test was correctly specified. Similarly, the Arellano-Bond test estimation indicated that no second order autocorrelation existed in the GMM techniques.

The results of fixed effect estimates show that the coefficient of abnormal audit fees (ABNRAF) is negative but not significant. However, after correcting for the potential bias introduced by dynamic endogeneity, unobservable heterogeneity and simultaneity, the coefficient (-6.362) of ABNRAF became significant at one percent under the GMM step 2 model. This suggests that, as the magnitude of abnormal audit fees increased, the magnitude of accrual earnings management decreased. Because of this decrease, an improvement in the quality of financial reporting existed for clients who paid abnormally high audit fees. In line with the finding, there is no evidence that indicate that abnormal audit fees led to financial reporting bias. Hence, the issue of auditor independence impairment did not arise. This finding is consistent to those of previous studies (Eshleman & Guo, 2014; Mitra et al., 2009).

Next, the coefficient of the post-regulatory (POSTREG) variable is negatively significant at one percent in both the FE model and the GMM model, which is consistent with the findings of Mitra et al. (2009). This result indicates an improvement in financial reporting quality after the regulatory changes. In addition, the coefficient of the percentage of foreign directors (FDIR) is negative and insignificant in the FE model. However, after controlling for all possible sources of endogeneity using the GMM techniques, the coefficient is still negative but now significant, suggesting that a one percent increase in the percentage of foreign directors led to a -3.885 decrease in the magnitude of accrual earnings management.

The coefficient of foreign share ownership (FSHR) in the FE model indicates a negative but insignificant relationship. However, FSHR turns significantly negative after accounting for dynamic endogeneity. With respect to local institutional ownership (INTS), the coefficient is negative and significant under the FE model; meanwhile the coefficient is insignificant in the GMM model. The findings of this current study with respect to the effects of concentrated ownership were consistent with those of previous studies including, Edmans (2009), and Dechow et al. (1996). They had documented that institutional shareholders improved the quality of financial information.

Like other studies, firm size was controlled for using the log of total assets (LOGTA) and the total number of employee (TEMP). Under the FE model, the coefficient of LOGTA is negative and insignificant while the coefficient using the GMM model is significant and negative, which is consistent with the findings of Choi et al. (2010). For TEMP, the coefficient is negative and not significant in the FE model; however, the coefficient is negative and significant in the GMM model. This finding is consistent with the view that big firms are less likely to engage in accrual earnings management. The coefficient for BIG4, which was a proxy for audit quality, had a negative and significant sign in both the FE model and the GMM model in line with the audit production differentiation theory. The coefficient of the number of client business segments (BUSISEG) is insignificant in both of the two models, and, thus, did not have any effect on financial reporting quality, which is consistent with the findings of Asthana and Boone (2012). The coefficient of DR (client total debt to equity) is insignificant in the FE model, but the coefficient is positive and significant in the GMM model consistent with the findings of Choi et al. (2010). GROWTH is negatively significant in the FE model; however, when the endogeneity issue was controlled for, GROWTH is positive and significant.

Profitability measures ROA, ACCR, and CF were controlled for as well. ROA is insignificant in the FE model, but in the GMM model the coefficient of ROA turned positive and significant. ACCR is positive and significant in both the FE model and the GMM model. CF is negative but not significant in the FE model; however, it is negative and significant in the GMM model that controlled for all sources of endogeneity problems. RLAG, which controlled for the duration in the total number of days taken to audit a client's

Table 4. *Regression Table*

	FE	GMM STEP 1	GMM STEP 2	VIF
ABDAC L1.		0.161 (1.800**)	0.161 (6.46***)	
ABNRAF	1.102 (-0.460)	-6.590 (-1.290)	-6.362 (-1.63*)	1.13
POSTREG	-1.659 (-4.250***)	-0.678 (-0.760)	-1.029 (-2.42***)	1.28
FDIR	0.525 (-1.050)	-1.563 (-0.800)	-3.885 (-6.48***)	2.19
FSHR	-0.003 (-0.640)	-0.012 (-0.570)	-2.040 (-0.041***)	2.02
INTS	-0.008 (-1.930**)	-0.005 (-0.440)	0.000 (-0.01)	1.56
INDP	-1.419 (-1.820**)	1.024 -0.740	2.510 (3.26***)	1.74
NONEXC	-0.556 (-0.940)	1.106 -0.640	3.337 (4.36***)	1.77
LOGTA	0.050 (-0.350)	1.314 (2.720***)	1.025 (-5.51***)	1.57
TEMP	-0.001 (-1.520)	-0.003 (-0.780)	-0.005 (-2.03***)	1.05
BIG4	-0.686 (-3.280***)	-1.994 (-3.530***)	-2.129 (-7.30***)	1.29
BUSISEG	0.041 (-0.740)	-0.083 (-0.620)	-0.064 (-0.74)	1.12
DR	-0.078 (-0.970)	0.174 -1.390	0.145 (2.18***)	1.11
GROWTH	-1.273 (-2.110***)	13.025 (2.130***)	6.363 (2.71***)	1.05
ROA	0.196 (-1.280)	0.676 (1.640*)	0.620 (4.69***)	1.21
ACCR	0.004 (4.140***)	0.011 (2.710***)	0.012 (8.00***)	1.12
CF	0.006 (-0.860)	-0.002 (-0.320)	-0.009 (-2.67***)	1.07
RLAG	-0.002 (-1.040)	-0.002 (-0.410)	-0.003 (-1.02)	1.27
_cons	0.459 (-0.390)	-9.523 (-2.350***)	-7.712 (-4.82***)	
YRDUM INDDUM	and YES	YES	YES	

No of Observations		217
AR 1	0.001	0.013
AR 2	0.949	0.669
Sargan	0.117	0.993
Hansen J	0.445	0.997
Prob > F =	0.000	
R-square	0.51	
Mean VIF		1.39

Note: * $p < .05$, ** $p < .01$, and *** $p < .001$.

financial statement, is negative but insignificant in the FE and GMM model (See Table 4.)

Conclusion

This study examined the relationship between abnormal audit fees and earnings management (a proxy for financial reporting quality). The study makes several contributions. First, the study examined the relationship between earnings management and corporate governance characteristics, specifically foreign directors, local institutional share ownership, and foreign institutional share ownership. A clear understanding of the factors that impair the quality of financial reports remains a topical issue for researchers, investors, and regulators of financial reporting. However, findings of prior studies have remained inconsistent. This current study extended research by adopting the GMM estimation technique that alleviates the problem of unobserved individual heterogeneity and endogeneity, which have characterized previous studies of this nature, but which researchers have mostly overlooked.

Second, by using a sample of listed companies drawn from an unexplored, non-Western and developing environment from 2008 to 2013, this current study found that abnormal audit fees are negatively and significantly related to earning management in our proxy for financial reporting. This indicates that the excessive fees charged by auditors improve financial reporting quality. This finding contradicts the study's hypothesis, which predicted a negative relationship between abnormal audit fees and financial reporting quality. By implication, the current study suggests that the excessive fees received by Nigerian auditors do not impair their independence. One explanation is that the excessive fees charged by Nigerian auditors

reflect additional efforts expended during the audit process. The finding is consistent with that of other studies (Eshleman & Guo, 2014; Mitra et al., 2009) who argued from the auditor effort perspective that abnormal audit fees reflect additional effort by the external auditor. Interestingly, this relationship holds true after the various regulatory changes as the quality of reports improved after regulatory changes.

Third, the relationship between earnings management and corporate governance mechanisms, specifically foreign directors, foreign institutional share ownership, and local institutional share ownership was investigated. The hypothesis predicted that this mechanism would improve financial reporting quality. Consistent with this prediction, the current study found that the percentage of foreign directors in the boardroom reduced the magnitude of accrual earnings management practices by management, thus, improving the quality of financial statements as hypothesized. As also expected, a higher percentage of foreign institutional ownership reduced earnings management practices. However, in the GMM model, the percentage of local institutional investors did not have any significant effect on earnings management. This finding contrasts with most prior studies that noted the complementary role played by institutional shareholders in improving the quality of financial reporting. The insignificant relationship suggests a weakness in the monitoring ability of local institutional investors.

This finding is novel, revealing that weak institutional frameworks, as well as corruption-ridden environments, dampen efficient monitoring of corporate governance mechanisms in the Nigerian context. As evident in some of the financial accounting scandals in Nigeria, the majority of shareholders have used their positions to exploit minority shareholders by

colluding with management to falsify financial figures.

The findings in this study have important implications for auditors, preparers, and regulators. Given the crisis faced by auditors regarding their quality of work, auditors and regulatory authorities must understand the additional risk this portends. First, the findings in this study revealed that abnormal audit fees received by auditors did not impair their independence, thus, any attempt to reduce the fees might have deleterious consequences on the quality of reported figures. Nevertheless, regulators should pay attention to audit fees structures to prevent likely future impairment of auditors' independence. Second, additional regulations are necessary to protect the best interests of minority shareholders. The minority shareholder group should have a voice on the board, and an independent non-executive director should ultimately represent and protect their interests on the board of directors.

Future studies could employ more contextual variables that reflect listed companies reporting characteristics to moderate the effect of regulatory changes on financial reporting quality. Likewise, such studies could consider the costs associated with regulatory change in Nigeria to determine whether those costs do or do not exceed the desired benefits. Finally, although our findings suggest an improvement in reporting quality, the finding is limited to our proxy of financial reporting quality. Future studies could consider whether managers shifted between accrual earning management and real earning management as suggested in prior literature.

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