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EXTERNAL AUDITOR ATTRIBUTE AND INCOME SMOOTHING: EVIDENCE FROM LISTED NON-FINANCE FIRMS IN NIGERIA

Augustine Obayagbona
Postgraduate student, Department of Accounting
Igbinedion University, Okada

Oseji Magath Chibuzor
Postgraduate student, Department of Accounting
Igbinedion University, Okada

Mary Josiah (PhD)
Department of Accounting
Lecturer, Igbinedion University, Okada

Gina Olufemi (PhD)
Department of Accounting
Lecturer, Wellspring University, Benin City.
Email: atugina18@gmail.com

Abstract

The broad objective of this study was to empirically investigate external auditor attribute effect on income smoothing of listed firms in Nigeria. The time frame of this study is a ten (10) year period beginning from year 2013 to year 2022. To achieve the specific objectives, slated out in this study, we employed external auditors' proxies to include external auditor firm type, external auditors' fee, external auditors' opinion, and external auditors' delay to account for the independent variables while income smoothing was employed as the dependent variable. Several related theories to include but not limited to the Economic Bonding and the Economic Consequences theories upon which this study is anchored were reviewed. Further, ex-post facto and analytical research design together with a set of panel data sourced from annual financial reports of selected listed non-finance companies in Nigeria were employed. Binary Logistics regression analysis technique was employed to test the formulated hypotheses after fulfilling the necessary conditions for obtaining non-spurious regression estimates. Specifically, the result reveals differences in the outcomes of the tested hypotheses. Particularly, the result showed that external auditor firm size has no significant effect on income smoothing while external auditors' opinion, external auditors' fee and external auditors delay proved to significantly affect income smoothing of listed non-finance firms in Nigeria during the period under consideration. Based on these empirical outcomes, and specifically on the bases that external auditors' fee has a negative statistically significant effect on income smoothing, one key recommendation offered in this study is that regulators of the audit environment in Nigeria will have to strengthen enforcement mechanisms and develop rules and regulations that constrain income smoothing behaviour of listed non-financial firms in Nigeria through incentives such higher fees for auditors to enable them deliver higher quality information. Further, policymakers in Nigeria need to strengthen regulatory oversight and enforcement mechanisms to ensure timely and efficient audits. Such measures should include reviewing and enhancing auditing standards to emphasize the importance of timely audits and the consequences of audit delays. Much more, auditors should prioritize timely reporting to reduce the risk of income smoothing.

Keywords: External Auditor Attribute, Income Smoothing, Logistics Regression Analysis, Economic Bonding Theory

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Introduction

External audit attribute and firm income smoothing is an important topic in accounting research. However, while income smoothing refers to the practice of intentionally manipulating financial results to create a more consistent pattern of earnings over time, often to portray a more stable financial performance, auditing is progressively an essential part of the financial reporting process because it helps to protect the interest of investors, creditors, government agencies, all of which represents the stakeholders who rely on auditor' s opinion to make well-informed decisions (Eng, Li Li., Fang, Tian, Yu, & Zhang, 2019; Ramalingegowda, Utke and 2021; Abernathy, Kang, Krishnan, & Wang, 2018) Specifically, external audits are conducted by independent auditing firms to examine a company's financial statements and express an opinion on their fairness and compliance with accounting standards (Han, Ding and Zhang, 2022). In this regard, high-quality audit attribute provides reasonable assurance that financial statements are free from material misstatements, enhancing the reliability and credibility of the reported financial information (Vasilakopoulos, Tzovas, & Ballas, 2018).

In the context of income smoothing Ozili (2017) note that income smoothing is a critical strategy of earnings management which can be either "artificial" or "real" where real smoothing involves decisions that affect cashflow and dissipate firm value having obvious costs. However, artificial smoothing has subtler costs, such as those related to loss of credibility or consumption of the manager's time in such activities. Boudiche, (2013), document that managers seek to change the stakeholder's perception of the financial situation of the company while Dechow & Skinner, (2000) posit that managers manipulate the figures "down" to reduce the amount of taxes or manage it "upward" or smooth income to meet the expectations of financial analysts. Similarly, Bartov, Givoly, and Hayn (2002) note that managers are forced to manage earnings to prove good performance records to shareholders and other financial statement users. Furthermore, Amat and Gowthorpe, (2004) document that managers are more likely to smooth income not by providing information but simply using it as an illusory device to manipulate accounting information to suit their interests. This clearly supports the notion of intentionally smoothed income which arises from artificial smoothing procedures (Eckel, 1981). Therefore, income smoothing is viewed as unethical under accounting principles, irrespective of whatever reasons that motivate the managers to practice it.

Statement of the problem

Adeyemi and Fagbemi, (2018) assert that the high-profile corporate scandals of 2008 through to 2009 in Nigeria have continued to raise a lot of concern about the integrity of financial and auditing reporting systems in the country. Studies in Nigeria such as those of Okoh (2015), Okolie (2014), Ndubuisi and Ezechukwu (2017), and Mohammad (2016) document varying result as regards the relationship between audit quality and earnings management. While the study of Okoh (2015) and Okolie (2014) reveal positive outcome, the study of Ndubuisi and Ezechukwu (2017), Mohammad (2016) document negative outcome. These inconsistencies in results suggest that there is need for further investigation in this area of study.

Much more, earnings management have also surfaced in certain other formats including but not limited to fraud cases, restatements, and abnormal accruals (Abbott, Park & Parker: 2000, Antle Gordon, Narayanamoorthy & Zhou; 2006). However, prior studies particularly in the context of Nigeria shows that discretionary accrual models dominate earnings management literature (Lin & Hwang, 2010) which is also consistent with the study of Dechow, Sloan and

Sweeney (1995) who mentioned that the analysis of earnings management mostly focuses on management's use of discretionary accruals. These studies tend to neglect other possible earnings management avenues, one of which is income smoothing. In the views of Assem (2011) the use of income smoothing conceals information about the current year and the future year earnings of the company noting that this action mis-informs users of the financial statements about the actual underlying economic performance of the company. Therefore, this study is conducted in a bid to evaluate weather managers of listed non-finance firms in Nigeria do practice other forms of earnings manipulations specifically income smoothing and investigate how well certain external audit characteristics tend to checkmate such activities.

According to Bartov, Givoly, and Hayn (2002) managers are forced to manage the results to prove good performance records to shareholders and other financial statement users. Hence curbing income smoothing behaviour cannot be effectively executed without putting into consideration the need for audit quality. Earnings quality, which is essentially a product of audit quality, is critical for investor's decisions making.

Research Objectives

The main objective of this study is to determine the effect of external audit attributes on income smoothing of listed manufacturing firms in Nigeria. However, the specific objectives of this study are to:

1. Investigate the effect of audit firm type on income smoothing of listed non-finance firms in Nigeria.

2. Examine the effect of auditor opinion on income smoothing of listed non-finance firms in Nigeria.

Research Questions

This study tends to find answers to the following research questions:

1. To what extent does audit firm type affect income smoothing of listed non-finance firms in Nigeria?

2. How does auditor opinion affect income smoothing of listed non-finance firms in Nigeria?

Research Hypotheses

The following formulated hypotheses will serve as tentative answers to the research questions:

H_{01}: Audit firm type has no statistically significant effect on income smoothing of listed non-finance firms in Nigeria.

H_{02}: Auditor opinion has no statistically significant effect on income smoothing of listed non-finance firms in Nigeria.

Scope of the Study

This study examines the effect of external auditor's attributes on income smoothing of listed non-finance firms in Nigeria. This study covers the period 2013 to 2022 fiscal year which is considered sufficient for a study of this nature. This period witnessed unprecedented competition for fresh capital by companies listed on the Nigerian Exchange Group which is capable of motivating public companies to engage in earnings manipulation.

Theories used for the Study

Positive Accounting Theory

The positive accounting theory was initiated by Watts and Zimmerman (1986) to explain why the agents (management or executive directors) act in a particular manner or take specific actions. The positive accounting theory's central development is based on the "rational economic person assumption", which states that managers are motivated particularly by self-interest and will behave opportunistically to maximize their self-fish interest or utility using accounting rules (Watts & Zimmerman 1986).

Gordon's Theory of Income Smoothing

Managers carry out income smoothing for increased profits in cases when profit is down, and reduce it when profit is up. Gordon who propounded this theory in 1964 suggests that management should smooth (within the accounting rules) reported income, for stockholder satisfaction and with the rate of growth and stability of its income.

Stakeholder Theory

The relationship between the stakeholder theory and the positive accounting theory has been viewed by many researchers as conflicting. Stakeholder's theory as propounded by Freeman in 1984 is viewed as "a theory of organizational management and business ethics that addresses morals and values in managing an organization" Freeman originally detailed it in his book "Strategic Management: a Stakeholder approach". He finds out and models the group that is called stakeholders of a firm. Furthermore, he describes as well as gives solution to strategies that management can give due regards to the interest of these groups. Stakeholder's theory addresses the- principle of who or what really counts (Feeman, 1984).

Empirical Review

Egbunike, Igbinovia, Okafor, and Mmadubuobi, (2023) investigated the relationship between residual audit fee and real income smoothening, proxied as real operating cash flow and production expenditure smoothing of non-financial firms in Nigeria. The study relied on secondary data from annual financial statements of 75 firms in the non-financial sector from 2010 to 2019. The study estimated the residual audit fee using a modified model from several contexts to suit the Nigerian environment. The hypotheses were tested using the dynamic panel GMM estimation procedure. The results showed a significant negative effect of residual audit fee on (real) operating cash flow smoothing and production expenditure smoothing of non-financial firms. The control variables showed mixed effects for the industry-related (firm size and profitability), auditor attribute (audit quality and audit report lag) and the board related (board size and board independence).

Warrens (2022) investigates the relationship between corporate governance and earnings management, based on evidence produced from the accounts of banks in two of Africa's largest economies, Nigeria and Ghana using the Modified Jones model to estimate the accruals in an emerging economy such as Nigeria and Ghana. The study aims at examining whether the board size, audit committee independence and board structure are able to restrain earnings management practices in the banking sector in Nigeria and Ghana. The data for the study is sourced from the annual reports and accounts of ten banks i.e., five banks from Nigeria and five from Ghana for an eight-year period, 2010-2017. Variables employed include Dependent Variable: DAC: discretionary accruals (income-increasing and income decreasing accruals) and independent variables: BRDSIZE: board size (number of directors on the board) for firm i CEO: CEO duality (equals 1 if CEO is also chairperson of the board and 0 if otherwise). AUDCOM: audit committee independence (number of Non-executive directors/size of audit committee) SIZE: firm size (log of turnover) LEV: leverage (the ratio of long term debt to total assets (%) AGE: firm age (company age since incorporation) AUDTYP: the auditor type (categorical variable where 1 is assigned to the big four audit firm and 0 otherwise) and ROA: return on assets (profit after tax/total assets) The findings revealed a positive significant relationship exist between the board size, the return on assets and earnings management.

Methodology

The methodology of a research work elucidates the methods adopted in the analysis of the data in any research undertaking. Considering the above, this chapter discusses the method that was applied to carry out the study. It included the research design, population of the study, sample technique, sample size, sources of data and model specification.

Research Design

Research design is the plan, strategy or the structure that relates to the investigation of the activities of the researcher in providing solutions or answers to the research questions. It is also a blueprint in a research work or study. The method adopted in a research is a function of the nature of the research, its design, purpose and scope as well as other variables. In this study, the ex-post facto research design was employed since the data were obtained from a secondary source of which the researcher does not intend to manipulate. Further, to answer the research questions, the ex-post facto research design allows the researcher to retrieve the needed data from the annual report of non-finance firms for the period under consideration.

Population

The population of this study consists of all non-finance firms listed on the floor of the Nigerian Exchange Group (NGX) as of December 31st, 2022. Industries recognized in the non-finance sectors includes agriculture, consumer goods, conglomerate, natural resources, construction and real estate, industrial goods, healthcare, ICT, oil and gas, and services. Specifically, as of 31st December 2022 there were one hundred and twelve (112) listed non-finance firms in Nigeria.

Sample Size

In view of the foregoing, 38 non-finance listed firms were dropped from the population and ensured that all sectors from the stock exchange are represented. Therefore, the size of the sample for this study consists of 74 listed non-finance firms

Sample Technique

The selection of firms that made up the sample size follows the non-probability sampling procedure which allows for the sample filtering technique to be employed in this study

Sources of Data

Data collection plays a very crucial role in a research work. In research, there are different methods used to gather information. However, secondary method of data collection was employed in this research work.

Model Specifications

Based on the theoretical literature and earlier empirical studies on external auditor's attributes /income smoothing nexus, this study specifies the model that captured the objective of this study which is the effect of external auditor's attributes on income smoothing of listed non-finance firms in Nigeria. In so doing, this study modifies the model specified by Doan, Ta, Pham, Nguyen, and Tran (2021) to suit the purpose of establishing the effect of the independent variables on the dependent variable captured in this study. Succinctly, the econometric form of the model is expressed as follows.

$$In\left(\frac{INSM}{1-INSM}\right)_{it} = \beta_0 + \beta_1 AUFS_{it} + \beta_2 AUDO_{it} + \beta_3 AUDL_{it} + \beta_4 AUDF_{it} + \mu_{it}$$

Where:

INSM	=	Income Smoothing
AUFS	=	Audit firm size
AUDO	=	Audit Opinion
AUDL	=	Audit Delay
AUDF	=	Audit Fees
β_0	=	Constant
β_1- β_4	=	Slope Coefficient
μ	=	Stochastic disturbance
i	=	i^{th} company
t	=	period

DATA PRESENTATION ANALYSIS AND DISCUSSION OF RESULTS

Data Presentation

In testing for the effect of external auditors' attributes on income smoothing of listed non-financial firms in Nigeria, binary logistic regression in addition to correlation analysis were conducted. However, preliminary analysis such as descriptive statistics, correlation analysis and normality test were also conducted. The results are analysed as follows.

Descriptive Statistics Analysis

Each variable is examined based on the mean, standard deviation, maximum and minimum. Table 1 displays the descriptive statistics for the study.

Table 1. Summary of Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
insm	748	.2620321	.4400342	0	1
aufs	748	.5572005	.4970519	0	1
audo	748	.0589812	.2357476	0	1
audl	748	112.7527	83.96545	-187	934
audf	748	4.09929	.584805	2.3	5.84

Source: Author (2023)

The table 1 shows the descriptive statistics of the study. The table shows that the mean value of the dependent variable of income smoothing (INSM) is 0.26 with a standard deviation of 0.44. The descriptive statistics results for income smoothing indicate that about 26% of the firms' observations under study tend to participate in smoothing their income during the period under study. For the independent variable, the study shows that audit firm size (AUFS) has a mean of 0.56 with a standard deviation of 0.50 implying that on average, 56% of the firms in the sample were audited by big4 audit firms during the period under study which also indicate that about 44% of the firms under study were audited by non-big4 audit firms.

Further, the descriptive statistics results show that audit opinion (AUDO) have a mean value of 0.06 with a standard deviation of 0.24 connoting that on average, 6% of the firms in the sample were issued qualified audit opinion during the period under study. For the variable of audit delay, the result reveals that the mean value of audit delay is 113 days indicating that on average, it takes the external auditors approximately 113 days after financial year end to complete audit the annual financial statement of the firms under study. Finally, in terms of audit fees, the result shows that on average, the mean value of audit fees is 4.10 with a standard deviation of 0.58.

Normality Test

In this study, Shapiro Wilk test for data normality is adopted and justified following the findings of Mendes and Pala (2003) and Keskin (2006) who concluded that Shapiro-Wilk test is the most powerful normality test for samples less than 2000. Particularly, when testing for normality, where the probabilities > 0.05, it indicates that the data are normally distributed. Conversely, where the probabilities < 0.05, it indicates that the data are not normally distributed.

Table 2. Test of Data Normality

Variable	Obs	W	V	z	Prob>z
insm	748	0.99509	2.379	2.120	0.01700
aufs	748	0.99986	0.068	-6.559	1.00000
audo	748	0.95807	20.256	7.360	0.00000
audl	748	0.55206	214.830	13.132	0.00000
audf	748	0.98794	5.826	4.311	0.00001

Source: Author (2023)

The table 2 shows the result obtained from the Shapiro-Wilk normality test for the data employed in this study. It is observed that the dependent variable of income smoothing (Z=2.120 Prob>Z=0.01700) is not normally distributed since the probabilities of the z-statistics is significant at 5% level. In the case of the independent variables, the table shows that audit opinion (Z=7.360 Prob>Z=0.00000), audit delay (Z=13.132 Prob>Z=0.00000), and audit fees (Z=4.311 Prob>Z=0.00001) are not normally distributed since the probabilities of their z-statistics are statistically significant at 1% and 5% level. However, the independent variable of audit firm size (Z=-6.559 Prob>Z=1.00000) is normally distributed since the probability of the z-statistics is insignificant at 1% or 5% level.

Correlation Analysis

In this study, Spearman rank correlation analysis technique is employed since the data employed does not come from a normal distribution. The result obtains from the Spearman correlation is presented in table 3.

Table 3: Correlation Analysis

	insm	aufs	audo	audl	audf
insm	1.0000				
aufs	-0.1343	1.0000			
audo	0.3488	-0.0280	1.0000		
audl	0.2218	0.0594	0.2078	1.0000	
audf	-0.2523	0.5979	-0.1932	-0.1071	1.0000

Author's (2023)

The correlation between external auditors' attributes and income smoothing proxy obtained from the Spearman rank correlation analysis shows that there exist a positive association between audit opinion (0.3488) and the dependent variable of income smoothing. This correlation outcome suggests that there is a tendency for companies receiving qualified audit opinions to engage in income smoothing practices. This outcome raises questions about the accuracy and transparency of financial reporting among nonfinance listed firms in Nigeria. The table also shows that there exist a positive association between audit delay (0.2218) and the dependent variable of income smoothing suggesting that there is a tendency for companies with longer audit delays to also engage in income smoothing practices. A longer audit delay can raise questions about the timeliness and efficiency of a company's financial reporting process. Also, it is seen that there exist a negative association between audit firm size (-0.1343) and the dependent variable of income smoothing. This outcome suggests that larger auditor firms are associated with a lower likelihood of income smoothing by the companies they audit. Larger auditor firms are often perceived as having more resources, expertise, and reputation in the auditing field. The negative association implies that companies audited by larger firms may be less inclined to engage in income smoothing practices. Finally, the result from the correlation table shows that there exist a negative association between audit firm fee (-0.2523) and the dependent variable of income smoothing. In this variable, it implies that higher auditor fees are associated with a lower likelihood of income smoothing by non-financial listed firms paying such fees. The negative association suggests that companies paying higher auditor fees may be less inclined to engage in income smoothing practices. All association is seen to be weak hence the presence of multicollinearity among the explanatory variables could be null.

Binary Logit Regression Analyses

Specifically, to examine the effect of the independent variables on the dependent variable binary logit regression analysis technique is employed since the dependent variable is dichotomous in nature. The result obtained is presented in table 4.

Table 4: Binary Logistic Regression Result

	INSM MODEL (LOGISTIC REGRESSION)	INSM MODEL (MARGINAL EFFECT)
CONS.	1.052 {0.171}	
AUFS	-0.212 {0.352}	-0.034 {0.351}
AUDO	2.764 {0.000} ***	0.448 {0.000} ***
AUDL	0.002 {0.051} **	0.000 {0.050} **
AUDF	-0.607 {0.003} **	-0.098 {0.002} **
LOG LIKELIHOOD RATIO (PROB>CHI2)	103.13 (0.0000) ***	
PSEUDO R- SQUARED	0.1228	
GOODNESS OF FIT TEST	673.44 {0.4446}	
VIF/COND. NUM	1.32/23.64(0.4962)	
SENSITIVITY	20.00%	
SPECIFICITY	98.17%	
CLASSIFICATION	77.96%	

Note: (1) bracket {} are p-values
(2) **, *, implies statistical significance at 5% and 1% levels respectively**

In the table 4 it is observed from the Logistic regression analysis of the income smoothing model that the Pseudo R-squared value of 0.1228 shows that about 12% of the systematic variations in income smoothing of non-finance firms over the period of interest is jointly explained by the independent variables in the model. The Log likelihood Ratio (LR) Statistics of the logistic regression [103.13 {0.0000}] shows that the model on the overall is statistically significant at 1% level, indicating that the Logistic regression model is valid and can be used for statistical inference. Further, the result of the LR Statistic is confirmed by the Pearson goodness of fit test [673.44 {0.4446}] indicating that the model on the overall is good fit. From the foregoing, we subject the model to further diagnostic test to validate the reliability of the estimates.

Findings of Results

However, small positive income is employed as the dependent variable which also proxy for income smoothing activities of firm managers. In the final analysis the logistic regression analysis reveals that for non-financial listed firms in Nigeria:

i. Audit firm type has no statistically significant effect on income smoothing in Nigeria during the period under investigation.
ii. Audit opinion has no statistically significant effect on income smoothing in Nigeria during the period under review.

Conclusion

The widespread failure in financial disclosure has created the need to improve financial information quality. Consequently, the factors which might influence the occurrence of earnings smoothing have been an intense and inconclusive area of research and thus have provided an interesting issue of discourse and have been observed that most such factors are exogenous to the firm. Based on the review of the literature and propelled by the gaps in the existing literature four factors have been identified and framed as hypotheses that were tested in this study. In general, it is revealed that managers of non-financial firms in Nigeria do practice earnings smoothing and seems clear that except for the variable of audit firm type, all other variables of interest do significantly impact the variable of income smoothing.

Therefore, with respect to the results obtained from the regression analysis, the following recommendations are suggested.

Recommendations

1. Policymakers in Nigeria may need to strengthen regulatory oversight and enforcement mechanisms to ensure timely and efficient audits. Review and enhance auditing standards to emphasize the importance of timely audits and the consequences of audit delays. Auditors should prioritize timely reporting to reduce the risk of income smoothing.
2. For the variable of audit firm type and noting that hiring big four audit firm for the purpose of providing specialized audit services has no statistically significant likelihood of affecting income smoothing, the study recommends that audit quality policy issues that considers the services of big four audit firm in checkmating income smoothing activities should be less prioritized.

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