Examination of the relationship between audit committee characteristics and financial reporting quality of Nigerian deposit banks

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Abstract. This study investigates the effects of audit committee characteristics on the quality of financial reporting by deposit banks in Nigeria. The study employs a multivariate regression analysis to assess the aggregate and individual effect of certain audit committee characteristics on financial reporting of sample banks. The study documents a positive relationship between audit committee independence and quality of financial reporting. Findings also revealed that audit committee expertise has positive effect on the quality of financial reporting. Results demonstrate that audit committee size has an insignificant effect on quality of financial reporting; however, an aggregate significant effect of audit committee characteristics on financial reporting quality was established. The recommendations from this study highlight the need for financial expertise as a means of strengthening the monitoring and oversight role that the audit committee plays in financial reporting. Also, emphatic considerations should be given to audit committee independence as a key factor for ensuring the credibility of financial reports.

Keywords: financial credibility, audit independence, accruals, audit committee size.

1 Introduction

As Nigeria marches forward in her desire to become one of the top 20 economies in the world by the year 2020, one dominant issue that remains on the front burner is how to build investors' confidence in the domestic economy through sound financial reporting (Fodio et al, 2013). Financial reporting is one major way of demonstrating the accountability and transparency of a company. It is the communication of the company's activities to various stakeholders who rely on information therein for economic decision making. Recently, well publicized cases of accounting scandals in Nigeria and beyond have greatly shaken investors' confidence in the integrity of corporate financial reporting. Several efforts have been put in place in the western world to address the malaise. Such includes the Sarbanes Oxley act alternatively known as the corporate oversight bill in July 2002 and the new corporate Governance of the New York Stock Exchange and NASDAQ. In Nigeria, the code of Good Corporate Governance 2003 and the Central bank of Nigeria code of Corporate Governance 2006 have been strategized to reduce the adverse effects of creative financial reporting.

According to Madawaki (2012), the search for mechanism to ensure reliable high quality financial reporting has largely focused on the structure of audit committee whose function is to oversee the financial reporting process as well as the audit of financial statement. The audit committee represents a standing committee of the board of directors which is charged with dealing with audit-related concerns. It actually acts as liaison between the auditor and the board of directors and its activities include the review of nomination of the auditors, overall scope of the audit, results of the audit, internal financial controls, financial information for publication and corporate gate keeping. Certainly, the existence of an effective audit committee is seen to be beneficial to both internal and external auditors since they enhance the quality of the internal audit function and external auditors' reliance on the internal audit work (McMullen, 1996). The role of audit committees in the oversight of financial reporting continues to be of importance to regulators, academics, the accounting profession and investors alike as the credibility of financial reporting in a company depends upon the monitoring mechanism of the company itself.

The need for an audit committee in a transparent company cannot be overemphasized. However, despise the presence of audit committees in various firms, spectacular corporate scandals have continued to shock the business community and have led to serious concerns over the effectiveness of audit committees. The primary question of this study is whether certain characteristics which are associated with audit committee effectiveness lead to the quality of financial reporting in Nigerian banks. Sequel to the New York Stock Exchange (NYSE) crash in 1929 and the economic depression in the 1930s which had a negative depreciation of shares, the evolution and integration of audit committees into corporate finance became deeply rooted in corporate America. As a result, many public companies decided to tighten their audit and financial reporting standards which brought about the creation of audit committee is incorporated in the Companies and Allied Matters Act (CAMA) 1990. Section 359(3) of the Act provides for the establishment of audit committees. Section 359(4) of the CAMA states that audit committees shall be made up of directors and shareholders of the same public company subject to a maximum of 6 members and that the committee shall examine auditors' reports and make recommendations to the annual general meeting (AGM). Section 359 (6) of the same act lists out the functions of audit committees which includes to oversee all accounting policies and principles of the company and to ensure regulatory compliance to financial reporting standards and ethics. The 2008 financial crisis in corporate Nigeria is an issue to consider in this direction. Several inspectors from the Central Bank Nigeria (CBN) had criticized audit committees over their inability to identify and report incongruities in the financial results of disturbed banks whose executives were sacked by the CBN for mismanagement of shareholders and depositors funds. These banks include Afribank Nigeria Plc, Intercontinental bank Plc, Finbank Plc, Oceanic bank International Plc, Spring Bank Plc, Wema bank Plc and Unity bank plc amongst others . Most of these banks are presently defunct. The problems in the banking sector under the weight of accounting improprieties generated an avalanche of corporate investigation in recent time and hence elevated the discourse of audit committees as a key pillar of sound corporate governance and reliability of current corporate practices, structure and financial reporting. Section 30 (1) of the SEC's code of corporate governance provides for the establishment of audit committees as stated by section 359(3 and 4) of the CAMA 1990.

In 1999, the Nigerian banking sector witnessed developments characterized by increased complexity, competitiveness and reforms, and the impact of a globalised environment. The banking sector has witnessed drastic challenges and changes over the years and more so in recent times. These challenges have been and are still being tackled in consideration with audit issues.

2 Review of Related Literature and Hypotheses Development

Audit committees are an essential element of corporate governance. According to Marriam (1998) an audit committee is a 'committee of the board normally comprising three to five directors with no operating responsibility in financial management. Its primary tasks are to review the financial statements, the effectiveness of the company's accounting and internal control systems and the findings of the auditors, and to make recommendations on the appointment and remuneration of the internal auditors'. Audit committees provide a focus and means for a fuller view and analysis of the matters relating to auditing, internal controls and financial reporting.

The quality of financial reporting has always been an issue of interest among regulatory bodies, shareholders, researchers and the accounting profession itself. This is due to the fact that financial reporting has always been a principal means of communicating financial information to provide users (Johnson, Khurana and Reynolds, 2002) and the use of financial reporting itself in assessing the economic performance and condition of a business in the past to monitor management's actions and assists in making economic decisions (Warrren, Fess and Reeve, 2004). Several variables have been used by previous researchers for quality financial reporting in their studies. Among the proxies that have been used are the compliance with accounting or auditing standards (Song and Windram, 2004); accuracy of accounts (Abbott, Parker and Peters, 2004); manipulation of accounting treatments (Davidson, Stewart and Kent, 2005) and disclosure (Alsaeed, 2006; Haniffa and Cooke, 2002). Rahman and Ali (2006) employed the level of accruals as a proxy for financial reporting quality, whereby companies with higher level of accruals are identified as having low quality financial reports and vice versa. Abbott, Parker and Peters (2004) had used restatement of financial reporting quality. This study will use accrual quality as a proxy for financial reporting credibility because it reflects the level of earnings management of the bank based on the idea that accruals improve the informativeness of earnings by smoothing out transitory fluctuations in cash flow.

Existing research have linked changes in audit committee composition to changes in financial reporting quality. Klein (2002) documents that firms transitioning from an independent audit committee to a non independent audit committee have significantly higher levels of abnormal accruals following the switch. Felo (2003) provides evidence that an increase in the fraction of audit committee members with general financial expertise is associated with improvements in analyst perceptions of disclosure quality, while Carcello et al. (2008) find evidence of a decline in abnormal accruals in the year after an accounting expert joins the audit committee. According to Menon and Williams (2004), discretionary accruals are larger following the appointment of an audit committee member that was formerly employed by the firm's external auditor. This suggests that engaging an accounting expert that is a former audit partner impairs the audit function's independence. Empirical evidence between audit committee size and quality of financial reporting is mixed. While McMullen (1996) found a significant positive association between these variables, Mengana and Pike (2005) did not find any association. The 2006 Central Bank of Nigeria code of corporate governance did not state clearly the exact number for the size of the audit committee members, through the Companies and Allied Matters Act (CAMA) 1990 specifies that the maximum number of audit committee members should be six. Aroonjit (2005) argues that the number of audit committee members could be used as indication or proxy for the amount of resources available for such committee. If an audit committee has just a member, it only makes it easier for him to be cajoled by management. Felo (2003) documents a positive association between audit committee size and financial reporting quality.

We thus hypothesize in null form that :

H_1- Audit committee characteristics have no significant effect on the quality of financial reporting by banks in Nigeria.

It is expected that the expertise of the audit committee members play an important role in the way they discharge their duties (Kalbers and Fogarty, 1993). Carcello and Neal (2000) observed that firms that have financial experts in their audit committees were more likely to reduce earnings management. Raghunandan (1996) found that companies with financial reporting problems were less likely to have members who have at least one member that is knowledgeable in accounting or finance in their audit committees. Evidence from prior literature suggests that having an accounting expert on the audit committee is associated with strong financial reporting practices. Accounting expertise should relate to an audit committee member's ability to oversee the financial reporting process. Given the increasing complex nature of accounting transactions, experience in preparing and reviewing financial statements increases the ability of audit committee members to ask management investigative question and effectively evaluate responses. As such, being experts in the preparation of financial statements encumbers them from credibly pleading ignorance with regards to creative accounting practices.

We thus hypothesize in null form that:

H_2 – There is no significant relationship between expertise of audit committee and quality of financial reporting by banks in Nigeria.

Independence is the crux of accountability. Godwin and Yeow (2001) define independence as not having a relationship which would interfere with the exercise of objective judgment in carrying out the functions of the committees. Abott (2000) proposed that audit committees consisting solely of independent directors would be more effective and are likely to call for greater depth and scope of internal audit activities and procedures, which eventually enhances the efficiency of the audit function. Independent audit committee members are more likely to demand higher audit quality in order to protect their reputation (Abott, 2000). Thus, the more independent the audit committee, the more likely they will demand a higher level of internal audit quality in order to identify financial misstatements and avoid reputation damage.

We thus hypothesize in null form:

H_3 – There is no significant relationship between audit committee independence and quality of financial reporting of banks in Nigeria.

Basically, the role of the audit committee is to reduce information asymmetry on accounting numbers, and to minimize residual loss resulting from managers' opportunism in financial reporting (Crowther and Jatana, 2005). The traits of an audit committee comprehensively go a long way in determining the extent of effectiveness of such a committee which has a resultant effect on the quality of financial reports.

We hypothesize in null form that:

H_4 – There is no aggregate significant relationship of audit committee characteristics on the quality of financial reporting by banks in Nigeria.

3 Methodology

3.1 Population and Sampling Procedure

The population of the study is made up of all banks quoted on the Nigeria Stock Exchange (NSE). As at December 2010, there were twenty four (24) commercial banks listed on the NSE. The sample selection for this study is based on certain filters employed by Vanasco (1994). The filters are

a) Banks with audit committee members for the study period 2007-2010.

b) Banks with non executive directors as part of audit committee for the period under study.

c) Banks that have at least an audit committee member that is knowledgeable in accounting, finance or internal control. Based on the above filters, a total of seven (7) banks have been selected for this study.

3.2 Data Source and Technique of Analysis

Data was obtained from the statistical bulletin of the Central Bank of Nigeria, Annual abstracts of statistics from the Nigeria Bureau of Statistics, the Statistical fact book of the Nigeria Stock Exchange as well as the annual financial reports and statement of accounts for the selected banks covering the period under study. The ordinary least squares (OLS) technique is used to estimate and test the relationship between audit committee characteristics and quality of financial reporting banks in Nigeria. Estimation is made possible by getting a sample of observed values of both variables so that the ordinary least squares regression line is fitted through the observations of the sample which are considered as correct approximation to the true population parameter. This test would provide an empirical platform for drawing generalizations for the study.

3.3 Model Specification/Measurement of Variables

The model of this study attempts to establish the relationship between audit committee characteristics and financial reporting quality. Total accrual was employed as the dependent variable and has been used as a proxy for financial reporting quality while the independent variables include audit committee size, audit committee independence and audit committee expertise. The model in its econometric form is shown below:

$$TACC = b_0 + b_1ACS + b_2ACInd + b_3ACExp + eit \qquad (1)$$

Where TACC = Total accruals, which is a regression of working capital accruals on current and future cash flows plus the change in revenue and property plant and equipment. It is stated as follows:

$$TACC = b_0 + b_1Cashflow_{it} + b_2Cashflow_{it+1} + b_3\Delta Revenue_{it} + b_4\Delta PPE_{it} + e_{it} \qquad (2)$$

Where

$$TACC = (\Delta\ CA - \Delta\ cash) - (\Delta CL - \Delta\ STD) - Dep \qquad (3)$$

ΔCA = change in current assets
Δ Cash = change in cash/ cash equivalents
Δ CL = change in current liabilities
ΔSTD = change in short term debt

Dep = Depreciation and amortization expense
Cashflow = net income before extraordinary item
Δ Revenue = change in revenue
PPE = gross property, plant and equipment.

In equation 1, ACS represents the size of audit committee members

ACInd represents the independence of audit committee (denoted by the proportion of non-executive directors in the audit committee to total number of audit committee members for the period under study. While ACExp represents the expertise of audit committee members (proportion of those with accounting knowledge).

Since these variables do not have a common unit of measurement and to forestall the usual associated problem of heteroscedasticity, their natural logarithms are taken to ensure harmonization and ease computation as follows:

$$TACC = b_0 + b_1 \log ACS + b_2 \log ACInd + b_3 \log ACExp + e_{it} \quad (4)$$

4 Results and Discussions

Table 1 shows the correlation matrix for the sample observations. A general rule for detecting the presence of multicollinearity amongst the variables is to examine if there exists high correlation (generally those of .90 and above) among the independent variables. Multicollinearity renders estimates from the regression indeterminate. A cursory look at the correlation table shows the absence of multicollinearity . The correlation matrix also shows that there is a positive significant relationship between audit committee independence and financial reporting quality.

Table 1 Correlation Matrix for the Sample Observations

		Accruals 2	AC SIZE	AC EXP	AC IND
Accruals 2	Pearson Correlation	1			
	Sig. (2-tailed)				
	N	28			
AC Size	Pearson Correlation	-.298	1		
	Sig. (2-tailed)	.124			
	N	28	28		
AC EXP	Pearson Correlation	-0.007	-070	1	
	Sig. (2-tailed)	.972	.722		
	N	28	28	28	
AC IND	Pearson Correlation	.706**	-.003	-.091	1
	Sig. (2-tailed)	.000	.987	.646	
	N	28	28	28	28

**Sig at 1% level

Source: SPSS Version 17 Output

Table 2 below presents the summary of the regression results for model 2 (estimation of total accruals).

Table 2 Estimation of Accruals

Constant	Cash Flow	Cash Flow$_{it+1}$	Gross Earning	Property Plant and Equipment	R^2	F Stat
9981.507	-.999**	.006**	.151**	-.048**	.998	2749.94**
(1.586)	(-96.476)	(.420)	(2.423)	(-.256)		

The t- values are in parenthesis.
*, * * indicate 5% and 1% level of significance respectively.
Source: SPSS Output

The result reveals that 99% of the variation in the dependent variable (accruals) is explained by the combined effect of the four independent variables (current cash flow, future cash flow, gross earnings and property, plant and equipment (PPE). The coefficient of determination shows that the model is well fitted. Estimated relationship formulated for this model then appears as:

$$TACC = 9981.507 - 0.999\ (CF_{it}) + 0.006\ (CF_{it+1}) + 0.151\ Rev_{it} - 0.048\ PPE_{it}$$

The fitness of the model provides justification for the use of the model in estimating the value of accruals variable in the base model of the study.

Table 3 presents the regression results of the base model. The model examines the relationship between audit committee characteristics and quality of financial reporting of banks in Nigeria.

Table 3 Regression Results

Constant	AC Size	AC EXP	AC IND	R^2	F Stat
-813616.168	-21668.67	313003.05**	889906.85**	0.638	14.123**
(-1.214)	(-.204)	(2.982)	(5.436)		

The results provide evidence for the rejection of the first null hypothesis which states that audit committee characteristics have no significant effect on the quality of financial reporting of banks in Nigeria. The overall model is significant based on the F statistics which stood at 14.123 and significant at 1%. In this light, the null hypothesis which states that audit committee characteristics have no significant effect on the quality of financial reporting of banks in Nigeria is rejected. Our result corroborates the findings of McMullen (1996) that the presence and nature of an audit committee is a factor in an overall monitoring environment usually associated with financial reporting quality. From table 3, it is abundantly clear that there is no statistically significant relationship between audit committee size and quality of financial reporting. This finding contravenes results from the work of Felo (2003) who documented a positive association between audit committee size and quality of financial reporting. However, this result is in line with the results of the study conducted by Mengena and Pike (2005). Their results as well show that the size of an audit committee has no impact on financial reporting quality. Our result provides a basis for the acceptance of the second null hypothesis that audit committee size has no significant effect on the quality of financial reporting of banks in Nigeria.

Table 3 reveals that there exists a positive relationship between audit committee expertise and quality of financial reporting. In other words, the presence of members knowledgeable in finance will improve the quality of financial reporting. Our results lend support to the findings and Raghunandan (1996) who demonstrated that banks with financial reporting problems were less likely to have a Certified Public Accountant (CPA) on their audit committee, therefore we reject the null hypothesis that audit committee expertise has no significant effect on quality of financial reporting by banks in Nigeria. Our results also document a positive relationship between audit committee independence and quality of financial reporting. The findings corroborate the work of Abott (2000) who demonstrated in his seminal study that banks with independent audit committees, that is, committees with higher member of non-executive directors were less likely to have problems with their financial reporting. On the basis of the findings, we reject null hypothesis 3 and accept the alternative that audit committee independence has a significant effect on the quality of financial reporting by banks in Nigeria. This study documents that audit committee characteristics have an aggregate impact on financial reporting quality. Results of the study have provided insight into how policy makers in the private and public sectors can design and implement decisions on audit committee characteristics that will improve the quality of financial reporting of Nigerian banks.

5 Conclusion

This study has provided empirical evidence on the effects of audit committee characteristics on size, expertise and independence on financial reporting by banks in Nigeria. We conclude that audit committee size has an insignificant effect on the quality of financial reporting. Second, we demonstrate that expertise of the members of an audit committee and the independence of the committee has a positive significant effect on the quality of financial reporting.

On the basis of our findings, we recommend that the board of directors who are responsible for overseeing banks' quality of financial reporting and appointing audit committee members should ensure that only qualified members with the required wealth of experience are appointed as audit committee members. They should also strengthen the audit committee independence by ensuring that the number of non-executive directors exceeds executive directors as members of the audit committee. This would as well go to enforce the principle of independence of the audit committee which also stands out as a recommendation of the Central Bank of Nigeria Code of Corporate Governance. Further studies can be carried out along this research focus. Similar studies can be replicated in other sectors of the economy like the insurance companies, conglomerates, amongst others in Nigeria with a view to ascertain if there is difference in the extent to which audit committee characteristics influence the credibility of financial reports in these sectors. More so, other audit committee fees, frequency of audit committee meetings, etc can be incorporated into the model. Other surrogates for financial reporting other than accruals could also be examined to identify if the results might differ when different proxies are used to denote the dependent variable- financial reporting.

6 Appendix

List of Sample Banks

1. Access Bank

2. Eco Bank
3. Fidelity Bank
4. First Bank of Nigeria Plc
5. Guaranty Trust Bank
6. United Bank for Africa
7. Zenith Bank

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