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Audit Committee Characteristics and Financial Reporting Quality: Evidence from Nigerian Listed Companies

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Abstract

This research examines whether audit committees characteristics are associated with an improved financial reporting quality. The sample of the study is the Nigerian listed companies for the year ended 2010. Data was gathered from annual reports and SBAInteractive. Findings show that there was a weak association between the characteristics of audit committee and improved financial reporting quality. The audit committee independence and expertise are found to significantly associate with improved financial reporting quality. Audit committee meets 4 to 5 times a year and audit committee size consists of 4 members. The result also shows that 70% of the sample firms employed Non-Big 4 auditors. These findings provide evidence on the mandatory audit committee requirement under the NSE listing rules on how the companies respond towards The Code.

Keywords: *Audit committees, Financial reporting quality, Nigerian listed companies*

1. INTRODUCTION

Corporate failures in Nigeria have raised great concern in the development of corporate businesses. In the banking sector alone, 45 banks were liquidated in between 1994 to 2006, while in 2007, 14 banks were liquidated. There was also a case on the falsification of company financial statements in Cadbury Nigerian Public Listed Companies in 2006. Public corporations such as Nigerian Telecommunications Plc (NITEL), Nigerian National Shipping Line (NNSL), National Electric Power Authority (NEPA) and Nigeria Railway Corporation (NRC) were either dead or simply drain pipes of public resources (Olusa, 2007).

In 2009, the Central Bank of Nigeria (CBN) has sacked the managing directors and Chief Executives Officers (CEOs) of five commercial banks along with their executive directors. Forty eight days later, precisely on October 2, 2009, the Central Bank of Nigeria announced an additional sack of three bank CEOs and their respective board of directors all due to excessive high level of non-performing loans, which was attributable to poor corporate governance practices, lack of credit administration process, the unethical practices by the management and the bank credit risk management practices (Economic Confidential, 2009). As a of these and other scandals recorded in Nigeria in recent times, international organizations, financial regulatory authorities and academicians became much concerned about corporate governance issues in Nigeria.

In Nigeria for instance, the Securities and Exchange Commission (SEC) in collaboration with the Corporate Affairs Commission (CAC) inaugurated 17 committee members to identify the weaknesses in the corporate governance practices and suggest changes for improvement. The SEC Code of Governance (2003) in Nigeria requires that all listed companies should establish an audit committee with the key objective of raising standards of corporate governance and it goes further to state that audit committees should be established in accordance with Companies and Allied Matters Act(CAMA) Section 359 (3&4). These high profile corporate collapses in Nigeria have created a considerable concern among investors and financial regulators about the quality of company financial reporting practices. Thus, this research intends to examine the audit committee characteristics and their effect on the financial reporting quality.

In terms of significance of the study, this study wills contribute to the literatures on audit committees and financial reporting quality. Further the findings might be useful to regulators of Nigeria capital market in increasing the effectiveness of the audit committee listing rules. Hopefully, this finding would give a better picture on the compliance level of Nigerian Stock Exchange operators towards the rules.

2. LITERATURE REVIEW

2.1 Financial reporting quality

Financial reporting has been a principal means of communicating financial information to outside users (Johnson, Khurana and Reynalds, 2002). Prior studies have shown the usefulness of financial statements to the market participants (Cheung and Sami, 2000), have shown that market react positively to favourable earnings and negatively to unfavourable earnings in the financial statements. Besides the markets, the users of financial information include customers, supplies, government, creditors, employees, competitors, and investment analysts (Atrill and Mclaney, 2001). Since the financial reports are prepared to meet the varying needs of all interested parties. Atrill and Mclaney (2001) outlines certain key characteristics that should be meet by the financial reporting in order to meet the needs of users which are identified as understandability, comparability, reliability, relevance and timeliness.

Jonas and Blanchet (2000) describe two general perspective widely used in assessing the quality of financial reporting. The first perspective is based on the needs of the users. Under this perspective, financial reporting quality is determined relative to the usefulness of the financial information to the users of information. General purpose financial reporting states that the primary objective of financial reporting is to “provide information to users that is useful for making and evaluating decisions about allocation of scarce resources” (CPA, Australia, 2006, p.15, cited by Baxter, 2007). The AASB framework explains the qualitative characteristics that make financial reporting information useful to users. These are understandability, relevance, reliability, and comparability of the information (CPA Australia, 2006). The second perspective of financial reporting quality is focused on the notion of shareholders/investors protection. This perspective defines quality of financial reporting as “full and transparent financial information that is not designed to mislead users” (Jonas and Blanchet, 2000, p.357, cited by Baxter, 2007). There is a fundamental distinction between these two perspectives of financial reporting quality. The user’s needs perspective is mainly concerned with providing relevant information to users for making decisions. Whereas the shareholder/investor protection perspective aims to ensure the information provided to users is sufficient for their needs, transparent and competent (Jonas and Blanchet, 2000, cited by Baxter, 2007).

2.2 Audit committee characteristics

Previous studies concerning corporate governance and financial reporting quality had focus on board characteristics rather than audit committee characteristics. Beasley (1996) finds that firms committing financial statement frauds have a significant lower percentage of outside directors than comparable firms not committing financial statement frauds. Other researchers have investigated the impact of having audit committee on financial reporting quality. Pincus, Rubarsky and Wong (1989) show that before audit committees were form larger firms with Big 8 auditor and firms with greater proportion of outside directors were more likely to form audit committees. Dechow, Sloan and Sweeney (1996) find evidence that firms committing financial frauds are less likely to have audit committees at the time of the fraud than other firms without audit committees. While these studies show that the existence of an audit committee impacts on financial reporting quality. Dezoort *et al.* (2002) identified several characteristics that contributed to the effectiveness of the audit committee. These section overviews the prior research on these characteristics.

2.3 Audit committee independence

The benefit of having independent chair of audit committee shows mixed results. Prior studies have found that it is easier for an audit committee that has no ties to management to critically evaluate their work (Abbott, *et al.,* 2003). The presence of independent audit committee reduces the likelihood of earnings management (Bedard *et al.,* 2004). McMullen and Raghunandan, (1996) examined companies that experience reporting problems and find that those are much less likely to have fully independent audit committee.

However, other studies report no evidence of relationship between the audit committee having all independent members and the occurrence of earnings restatement (Lin *et al.,* 2006). Further studies that find no significant influence of independence of audit committee members and financial reporting (Broson *et al.,* 2006; Kent and Stewart, 2008). However, the former does not find a positive relationship when examining the independence of the chair of audit committee irrespective of the independence of the rest of the committee members. This lead to the second hypothesis;

H_1: The independence of an audit committee is associated with financial reporting quality.

2.4 Audit committee size

Size is one of the audit committee characteristics that is investigated in many prior research. Larger committees are commonly expected to be more effective. Lin *et al.* (2006) find that companies with audit committee consisting of at least four members are less likely to experience earnings restatements. Felo *et al.* (2003) report that larger audit committee increases financial reporting quality as measured by analyst’s scores.

Research to date find mixed results as to whether size really matters. Xie *et al.* (2001) find weak relationship between audit committee size and earnings management. Furthermore, Abbott *et al.* (2004) find no evidence of an association between audit committee size and earnings restatements. Given the mixed results from the previous studies lead to the formulation of the following hypothesis:

H_2: The size of an audit committee is associated with financial reporting quality.

2.5 Audit committee expertise

Nigeria Code of Corporate Governance requires that at least one member of the audit committee have an accounting, finance or industry expertise. Such an audit committee member has been found to be in a better position to monitor internal controls and to understand the various financial and operational issues that can arise (Zhang *et al.,* 2007). Additionally it has been shown that audit committee members with financial reporting knowledge are more likely to understand external auditor judgment (Dezort and Salterio, 2001). Furthermore, audit committee that have financial experts have greater interaction with their internal auditors (Raghunandan et al., 2001) and less associated with the occurrence of internal control problems (Krishnan, 2005). However, Yang and Krishnan (2005), and Lin et al. (2006) fail to find any significant association between financial experts and financial reporting quality measured as the level of earnings managements. For this the following hypothesis has been developed:

H_3: The expertise of an audit committee member is associated with financial reporting quality.

2.6 Audit committee meetings

Empirical evidence on the impact of the frequency of audit committee meetings on the level of financial reporting quality is n mixed. Bryan *et al*. (2004) found that audit committees that meet regularly improve transparency of reported earnings and therefore enhance earnings quality. When audit committee meets more often the level of disclosure increases (Bronson *et al.,* 2006). While the chance of restatements or reporting problems decreases (Abbott *et al.,* 2004). However, Vafeas (2005) finds a negative relationship between the number of audit committee meetings and earning management. He *et al.* (2007) find no evidence of a significant relationship between the number of audit committee meetings frequency and earnings management. Other studies that fail to find a significant relation between audit committee meeting frequency and earnings management are (Yang and Krishnan, 2005; Davidson *et al.,* 2004). To further examine the impact of audit committee meeting frequency on financial reporting quality this study tests the following hypothesis:

H_4: The meeting frequency of an audit committee is associated with an increased financial reporting quality.

3. RESEARCH METHODOLOGY

3.1 Population and sample selection

The population from which the sample was drawn was 202 companies listed on the Nigerian Stock Exchange (NSE) with financial year ending 2010 was chosen as the base year for the collection of necessary data for measuring the audit committee characteristics. Data for financial years ending 2009 and 2011 was also required to measure the earnings quality based on the Dechow and Dichev (2002) model. The study used an archival data in the form of company annual reports and SBAinteractive.com. Sample selection procedure and final sample are shown in Table 1.

Table 1: Summary of sample selection

Item	Frequency
NSE Listed Companies	202
Less:	
Banks and foreign companies	34
Insurance and Mortgage companies	43
Companies that annual report are not available	55
Final sample	70

Based on the data collection, 55 companies were excluded because the annual reports data for 2011 were not available due to time variation in the financial year. Also 34 banks and foreign companies are also excluded because financial reporting requirements for these companies differ from companies listed on the NSE. For insurance and mortgage companies, 43 companies were excluded because they do not generate sales revenue which is needed to calculate our earning quality variables. The final sample size of 70 companies was available for testing the hypotheses between audit committee formation and audit committee characteristics. Table 3.2 shows the industry break down of the sample by industry.

Table 2: Sample composition by industry group

Industry group	Number	Percentages
Household's durables	4	5.7
Health care and pharmaceuticals	8	11.4
Information telecommunication technology	5	7.1
Building materials	9	12.9
Packaging and containers	5	7.1
Printing and publishing	4	5.7
Hotels and hospitality	4	5.7
Petroleum products and marketing	2	2.9
Agriculture	4	5.7
Conglomerates	5	7.1
Constructions	6	8.6
Beverages /breweries	6	8.6
Food products	8	11.4
Total	70	100

3.2 Regression models

The dependent variable (earnings quality) is based on the accrual estimation error model developed in Dechew and Dichev (2002). The EQDD was estimated based on the following regression:

$$\Delta WC_t = \beta_0 + \beta_1 CFO_{t-1} + \beta_2 CFO_t + \beta_3 CFO_{t+1} + \beta_4 \Delta Sales_t + \beta_5 PPE_t + \varepsilon_{t'} \quad (1)$$

Where by:

ΔWC_t	=	Δ Working capital year t, i.e. Δ Accounts receivables + Δ Inventory – Δ Accounts payable - Δ Taxes payable + Δ Other assets (net)
CFO_{t-1}	=	Cash flows from operations in year t – 1
CFO_t	=	Cash flow from operations in year t
CFO_{t+1}	=	Cash flows from operations in year t + 1
$\Delta Sales_t$	=	Sales in year t less sales in year t -1;
PPE_t	=	Gross property, plants and equipment in year t

The following equation model is used for audit committee characteristics and financial reporting quality.

$$EQDD = \alpha + \beta_1 ACIND + \beta_2 ACMEET + \beta_3 ACSIZE + \beta_4 ACEXP + \beta_5 LEV + \beta_6 AUDITOR + \beta_7 FIRMSIZE \quad (2)$$

3.3 Measurement of variables

Table 3: Measurement of variables

	Variable name	Variable measurement
Dependent Variable	EQDD	Δ Working capital year t, i.e. Δ Accounts receivables + Δ Inventory – Δ Accounts payable - Δ Taxes payable + Δ Other assets (net)
Independent Variables	AC Independence	Existence of an independent chair
	AC Expertise	The proportion of audit committee members with accounting or financial qualification

	AC Meetings	The number of audit committee meetings held during the year
	AC Size	The number of audit committee members at the year end
Control variables	Auditor type	1 = a company auditor was Big 4 and 0 otherwise
	Leverage	The ratio of total assets to total liabilities
	Firm size	The natural log of total assets

4. FINDINGS AND DISCUSSION

Table 4: Descriptive statistics for audit committee characteristics and financial reporting quality

Variable	Mean	Median	Minimum	Maximum	Std. Dev.
EQDD	2.19	2.52	2.79	3.18	6.74
ACIND	0.84	1.00	0.00	1.00	0.37
ACEXP	0.51	0.50	0.20	0.80	0.42
ACSIZE	5.08	6.00	4.00	6.00	1.00
ACMEET	3.74	4.00	2.0	4.00	0.56
LEV	0.5	0.48	0.25	0.94	0.13
AUDTYPE	0.70	1.00	0.00	1.00	0.46
FIRMSIZE	2.3	7.47	2.7	1.50	3.62

Table 4 reveals that 84% of the firms have an independent audit committee chair. On the average 51% of the audit committee members were accounting or financial experts. Result found that the average size of the audit committee members to be 5 members and meet at least 4 times a year. This study also shows that 70% of the sample firms employ Non-Big 4 audit firms.

Table 5: Correlation coefficients

	EQDD	AC_IND	AC_EXP	AC_SIZE	AC_MEET	TYPE_AUD	FIRM_SIZE	LEV
EQDD	1.0000	-0.3184	-0.0449	-0.2460	-0.0858	-0.2082	-0.6769	0.0695
AC_IND		1.0000	-0.0788	0.1553	-0.0589	0.0600	0.2422	0.0318
AC_EXP			1.0000	0.0039	0.0281	0.2301	0.1024	0.1784
AC_SIZE				1.0000	0.4552	0.2753	0.3700	0.0827
AC_MEET					1.0000	0.3724	0.1779	0.0395
TYPE_AUD						1.0000	0.3033	0.1070
FIRM_SIZE							1.0000	0.0001
LEV								1.0000

With reference to Table 5, findings show evidence on the relationship between audit committee characteristics and financial reporting quality. The results indicate that EQDD is positively correlated with ACIND, ACEXP, ACSIZE, and ACMEET. Finding indicates that this measure of earning quality is higher when there are greater proportion of audit committee members with accounting expertise, independent audit committee chair, at least minimum of 4 audit committee members and hold 4 meeting during the year. The result for control variables indicate significant positive association between EQDD and firm size and auditor type as well as negatively insignificant association with leverage.

Table 6 explains that the audit committee independence show a significant relationship between audit committee independence and earning quality at 1% level. This finding is consistent with the finding by Beasley (2000) that audit committee independence is significantly related to financial reporting quality.

Table 6: Regression for audit committee characteristics and earning quality

	Coefficient	Std. Error	t-ratio	p-value
Const	2.53907e+07	1.76279e+06	14.4038	<0.00001***
AC_IND	-1.86098e+06	438163	-4.2472	0.00007***
AC_EXP	1.32533e+06	723538	1.8317	0.07180*
AC_SIZE	29542.6	127981	0.2308	0.81820
AC_MEET	-89611.4	404043	-0.2218	0.82521
TYPE_AUD	-396596	242903	-1.6327	0.10759
FIRM_SIZE	-0.142373	0.009666	-14.7292	<0.00001***
LEV	3.52692e+06	1.05207e+06	3.3524	0.00137***
R-squared	0.857693			

The relationship between audit committee members with accounting or financial back and earning quality is found to be significant at 10% in this study. This finding is similar to that of Bedard *et al.* (2004) and Xie *et al.* (2003). Their studies show that audit committee members with accounting or financial backgrounds are effective monitors in reducing earning management. However, this finding contradict Yang and Krishnan (2005) and Lin *et al.* (2006) who fail to find any significant association between accounting or financial experts and financial reporting quality measured as the level of earning management.

The relationship between audit committee members and meeting frequency is found to be insignificant in this study. In this regard, the finding is similar to Vafes (2005) and Lin *et al.* (2006) who found no relationship between the numbers of audit committee meetings and financial reporting quality. This finding is in contrast to what Zhang *et al.* (2007) and Xie *et al.* (2003) findings. Similarly, this study also found no significant relationship between audit committee size and financial reporting quality. Among the control variables, firm size and leverage are found to be associated with financial reporting quality. This finding are consistent with those found by Xie *et al.* (2003), and Yang and Krishnan (2005) who reported that firm size is significantly related to earning quality. This study uses the following regression model to test our second hypothesis that financial reporting quality is associated with audit committee independence, expertise, size and meeting frequency. EQ denotes earning quality measures. This model is estimated on our sample of listed Nigerian companies.

5. CONCLUSION

In the last decade the world have witness a lot of corporate scandals involving accounting manipulations, and thus the issue of corporate governance has become prominent among researchers, regulators, and practitioners. As such the situation has pushed many countries to involve in series of reforms to improve the way in which corporations are managed and governed. Consequently, a series of recommendations and best practices of corporate governance has been suggested and mandated worldwide. Following the practices of different countries, Nigeria was involved recently in 2003 and issue guidelines on corporate governance best practices and required all listed companies on the NSE to comply with such practices.

Findings from this work show that there was a significant association between audit committee independence and financial reporting quality. Also, a significant positive association was found between members of audit committee having accounting and financial expertise and financial reporting quality. However, this study fails to find any significant association between audit committee meeting frequency and audit committee size with financial reporting quality.

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