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Audit Committee Characteristics and Financial Reporting Quality: Nigerian Non-Financial Listed Firms

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Abstract

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This study aims to investigate the effect of audit committee characteristics on the quality of financial reporting of Nigerian listed firms. We employed multivariate regression analysis with a sample size of 101 and firms-year longitudinal panels of 505 observations of non-financial listed companies on Nigerian Stock Exchange for the period 2010 to 2014. We adopt McNicholas (2002) model to examine the monitoring mechanisms on the quality of financial reporting. The results show that control variables; company age and company size are statistically significant. Audit committee share ownership, and financial expertise are positive and statistically significant, indicating that audit committee monitoring mechanisms influence the financial reporting quality of listed non-financial firms in Nigeria. Regulatory bodies in Nigeria should mandate all the three board representatives on AC to be non-executive directors, while making a combination of financial and industrial expertise replace financial literacy to further improve the quality of the financial reporting.

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Keywords: Audit Committee; expertise; share ownership; accrual quality; independence; financial reporting.

1. Introduction

Financial information users mostly rely on the information made available to them through company annual report for decision-making. The report is expected to be credible, reliable, relevant and acceptable to enable potential investors, lenders, and creditors in making informed decisions. Therefore, the financial report should provide full, timely, transparent and reliable financial information that is not deliberately prepared to mislead users. Despite its importance, financial information may not always be credible and reliable because it may contain errors, deliberate

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manipulation of accounting numbers, as well as a misrepresentation of earnings, thus, question its credibility. In Nigeria, the responsibility for the regulation of the capital market is assign to the Nigerian Securities and Exchange Commission (NGSEC), the Nigerian Stock Exchange (NSE) is to ensure compliance with the listing rules reporting requirements for companies and provide a platform for equities and debt trading. Proponents of agency theory argue that ownership and control separation lead to moral hazard problems, where agents act to obtain its personal benefits at the expense of shareholders. To curtail such behaviour, effective control by the board would greatly help. The effectiveness of the board monitoring depends among others, on sub-committees of the Board (He & Yang, 2014). Also Shi and Zhou (2012) argue that board audit as a sub-committee and their financial expertise are found to affect the level of the way managers manipulates earnings to achieve corporate or personal benefit.

Similarly, Dechow, Ge, and Schrand (2010) posit that, the ability to adequately supervise the activities and constrain opportunistically managed earnings lies with effective internal corporate governance mechanism. Thus, internal governance mechanisms involve among others, the formation of independent AC that would supervise the activities of managers and ensure strict compliance with the financial regulations. Besides, studies on the AC provided evidence of the significant role of internal monitoring as a decision control mechanism by the board of directors (Rustam, Rashid, & Zaman, 2013; Sulaiman, Yasin, & Rusnah, 2014). However, this study considers agency theory as most appropriate in explaining the relationship between AC characteristics and financial reporting quality.

2. Literature Review and Hypotheses Development

Corporate governance (CG) is about the structures and processes for the control and direction of companies. It concerns with the board of directors, management relationships as well as shareholders and other stakeholders. Hence, corporate governance provides structures that monitor the performance of organizations. For this reason, corporate governance can be seen as a mechanism that is used to reduce the conflict of interests between managers and stakeholders. Thus, corporate governance is employed as a mechanism to decrease the agency cost caused by the conflict of interest between owners and managers. Early studies focused on the issues relating to determinants of the AC formation with the emphasis on the influence of specific governance characteristics (Bradbury, 1990). Similarly, Abbott, Parker and Peters (2004) and Coram, Ferguson, and Moroney (2006) provide evidence that effective AC can prevent earnings management (EM) in organizations. Similarly, if the AC has insufficient directors, it might influence their effectiveness due to the shortage of directors in fulfilling their duties (Vafeas, 2005).

2.1. Audit committee independence and financial reporting quality

There are empirical studies that provided evidences that AC independence is likely to associate with lower EM (Bedard, Chtourou, & Courteau, 2004; Davidson, Goodwin-Stewart, & Kent, 2005). The independence of AC is necessary for monitoring financial reporting process (Yang & Krishnan 2005; Koh et al. 2007). In an attempt to enhance the oversight function of the AC, the revised Nigerian SEC CCG 2011, adopted Section 359 (3) and (4) of Companies and Allied Matters Act (CAC, 2012) clearly

specify six-member AC formation by all public companies. The AC comprise of three non-executive board members and three shareholders representatives. The idea of splitting the AC membership into an equal number of representations is to ensure the independence of the committee, thereby creating more confidence in the board activities, enhanced financial control and more credibility to the workings of the committee and company's financial reporting process. From foregone discussions, this study formulates the following hypothesis:

H_1: Audit committee independence is positively related to financial reporting quality of Nigerian listed firms

2.2. Audit committee share ownership and financial reporting quality

AC share ownership represents the AC member proportion of shareholdings in the company. Previous studies have documented the potential benefits of AC members' share ownership in the monitoring of financial reporting process of a firm. These studies suggest the association between share ownership and FRQ effectiveness. It was argued (Lavelle, 2002) that the AC independent members with a high proportion of shareholdings could be questioned, given their percentage shareholding that may be used to influence firms operations to protect their investments. Similarly, Carcello & Neal (2003) argue that in the event that members of AC shareholdings in a firm becomes high, they may attempt to exert undue influence on the removal of an external auditor following going concern opinion (report) to protect their interest. However, prior studies (Jensen, 1993; Shivasani, 1993; Mangena & Pike, 2005;Vafeas, 2005) argued that the consequences of having AC members with share ownership can lead to higher vigilance and greater monitoring that may ultimately motivate them to ensure company performance. Therefore, any percentage increase in their shareholding would create more incentives to monitor and control management reporting. Based on the empirical support that established positive relationship between AC share ownership, also to the theoretical support of agency theory, this study formulated the following hypothesis:

H_2: There is a significant positive relationship between AC share ownership and FRQ of Nigerian listed firms.

2.3. Audit committee financial expertise and financial reporting quality

Accounting or financial expertise are attributes, qualification or experience acquired by a person before becoming a board member of a company. Carcello, Hollingsworth, Klein and Neal (2006) document that, there is a reduction in the use of discretionary accruals and income-increasing accruals when accounting expert is on the AC. Also, Xie, Davidson and DaDalt (2003) suggest that AC members need financial sophistication to curtail managers from engaging in earnings management (EM) practices. Further, Krishnan and Visvanathan (2007) argue that there is a positive association between accounting expertise and the ratio of AC members. Hence, the numbers of financial expertise on the AC reduces the level of fraudulent practices and strengthen the internal control process. Also, Zhang, Zhou and Zhou (2007) and Hoitash, Hoitash and Bedard (2009) document that firms with a high proportion of financial experts not necessarily accounting experts are unlikely to report weaknesses in the internal control over financial reporting. Consequently, Badolato, Donelson and Ege

(2014) argue that it is not enough to have accounting/ financial expert as a member of ACs in constraining EM, but a combination of financial expertise and high status of the AC members. In contrast, Hayes (2014) differ in the conclusions of Badolato *et al*. (2014) as such, argue that lower status has rendered ACs to be less efficient and irreconcilable with multiple decrease in misreporting. Furthermore, Cohen *et al*. (2014) argue along similar findings of Hayes (2014), but added that status might not be an issue, rather, AC members with accounting and industrial expertise tend to perform better than those with only accounting expertise. Therefore, it indicates that ACs play a greater role when AC members possess higher financial and industry expertise in enhancing financial reporting process. As such, this study formulates the following hypothesis:

H_3: There is a positive relationship between AC member financial expertise and FRQ of Nigerian listed firms

3. Research Design and Variable Measurement

The population of the study is the non-financial institutions listed by Nigerian Securities and Exchange Commission (NGSEC) where 101 companies constitute the sample of this study. Moreover, the 101 companies involved in this study emerged from 10 out of the 11 industry groups generated over a period of 5 years (2010 to 2014), which resulted in 505 firm-year observations. Further, we employed multiple regression analysis using OLS technique and Stata software in the analysis. Thus, in determining the FRQ of Nigerian listed companies' two steps regression was used by adopting McNicholas (2002) using residuals. The residuals represent FRQ proxy by accrual quality. The lower residuals indicate a higher quality of accruals and vice versa. The model depicts as in Equation [1]:

$$\Delta WC=\beta 0_{it}+\beta_1 CFO_{it-1} + \beta_2 CFO_{it} + \beta_3 CFO_{it+1} + \beta_4 \Delta REV_{it}+\Delta\ \beta_5 PPE_{it} +\varepsilon_{it}$$

Where ΔWC= change in working capital, $CFO_{it-1=}$ preceding year cash flow from operation CFO_t= current year cash flow from operation, $CFO_{it+1=}$ subsequent year cash flow from operation, ΔREV= change in revenue and PPE_{it}= Gross property, plant and equipment, β_0 = Intercept, β_1- β_5 =coefficients

Furthermore, corporate governance (AC) variables are mainly secondary data obtained from the annual reports of the sample companies. The variables were hand collected from the companies and the corporate office of the NGSEC. A linear regression model was used in measuring the strength of the relationship between the FRQ, and the regressors. The dependent variable is a measure of FRQ, while, the independent variables include measures of AC and control variables.

The model used to test the association between the FRQ and the explanatory variables is presented in equation [2]:

$$FRQ_{it}= \beta_{01t} + \beta_1 ACIND_{it} + \beta_2 ACSOW_{it}+ \beta_3 ACFE_{it} + \beta_4 FS_{it} + \beta_5 FA_{it}+ \beta_6 PRAT_{it}+ \varepsilon_{it}$$

FRQ = Financial reporting quality (accruals quality), ACSOW= Proportional share of non-executive members on audit committee /total company shareholdings, ACIND=Presence of at least on financially literate member on the AC=1, otherwise 0, ACFE = Presence of at least 1 financially literate member on the audit committee, otherwise 0, PRAT=Profit after tax, FS=Natural logarism of total assets, FA=Firm age.

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3.1. Data and empirical results

Table 1 presents descriptive statistics for the study variables. The table indicates the presence of at least one independent non-executive director on the AC with few companies comprising the NGSEC code of corporate governance mandatory requirement of the presence of at least one INED on each public company's AC, with an average of 16. Further, NGSEC CCG 2011 requires a minimum of one AC member to have skills and financial expertise or who can read and understand financial statements. The result shows the presence of a financial expert on the company's AC, with an average of 6. However, some of the company's AC do not have a financial expert. Besides, the proportion of AC member share ownership ranges from 0 to 31,000 units with a mean of 16 and variability of 1.40. Further, the sample firms constitute chronologically, between 1 to 49 years old from 2010 listing year.

Table 1. Descriptive Statistics

Variables	N	Mean	SD	Min	Max
FRQ	505	1.302	0.797	-0.0800	15.93
FA	505	21.15	12.90	1	49
FS	505	6.927	0.782	3.640	8.984
ACSOW	505	0.157	1.401	0	30.52
ACIND	505	0.998	0.0445	0	1
PRAT	505	-0.561	17.58	-369.2	82.98
ACFE	505	0.059	0.237	0	1

3.2. Result of diagnostic tests

Table 2 presents the diagnostic test of the model. Since the focus of the study is to examine the effect of AC on the quality of financial reporting in Nigerian non-financial firms using Equation [2]. To test the hypotheses, a multivariate regression requires the fulfilment of normality, multicollinearity homoscedasticity test. Diagnostic tests based on OLS and random effects were conducted to fulfil these requirements. The model of the study is free from omitted variables and well specified evidenced by (0.1424) as recommended (Ramsey 1969) specification test. Further, normality test was carried out using Sktest and Mardia (1970) tests with skewness (0.1391) and kurtosis (0.441) respectively, suggesting normality of the data. Again, the absence of heteroscedasticity using Breusch-Pagan (1979) test for heteroscedasticity was established (0.3342), justifying the existence of homoscedasticity or free from errors associated with the data. Furthermore, VIF result of independent and control variables of 1.02 is less than 2.0 as recommended (Hair., Black, Babin, & Anderson, 2014) provide no evidence of multicollinearity in the model. Also, model specification test equally evidenced the explanatory variables are well specified with no omitted variables. On the whole, Wald test results is found to be significant at 1% justifying the statistical significance of the model.

3.3. Regression results/hypotheses testing

Table 3 presents regression results, which examines the relationship between AC characteristics and FRQ of listed non-financial firms in Nigeria. The result clearly indicates a positive association between AC share ownership and FRQ at 1% level of significance. Therefore, an increase of 0.0313 in the AC

members' equity ownership would cause a correspondence increase in quality of the financial report. It, thus, support the findings of Mangena and Pike (2005) and Vafeas (2005). That, having AC members with share ownership can lead to higher vigilance and greater monitoring due to their stake in the company and as NED on the AC, they may be enthused as well as, effectively assist in improving the financial reporting process. Thus, hypothesis H_2 fail to be rejected.

Accordingly, the results on the relationship between AC financial expertise and FRQ show a significantly positive association at 10% level. It suggests, any additional AC financial member would result in equivalent improvement in the earnings quality of the firms. In particular, the presence of a member with financial literacy or knowledgeable in accounting, finance or financial management will enhance the quality of the financial report. It lend support to the findings of Mustapha and Che-Ahmad (2010), Lo *et al.* (2010), Chan *et al*. (2013) and Cohen *et al*. (2014). In other words, the result offers a basis for not rejecting hypothesis (H_3) of the study.

Nevertheless, results on the independence of AC reveal a statistically nonsignificant but positive relationship with FRQ. Suggesting a linear relationship that increases the quality of companies' earnings by 0.038. However, the result lends support to Bronson *et al.* (2009) who argued that AC independence would be beneficial only when the AC is entirely independent. Therefore, proportion or partial independence may not provide the necessary independence required of AC for an enhanced FRQ. Therefore, the statistical nonsignificant relationship could be attributed to differences in the industries with diversity in operations. The emerging nature of the economy distinct from western/ developed economies couple with streams of available data could be attributed to the differences in the outcome of our results. However, the study could not conduct sample mean differences on whether the revised CCG 2011 significantly enhanced the overall quality of financial reports of the sample firms. Further studies could investigate the effectiveness of such changes on the quality of financial report, with more sample size and financial expertise of AC shareholders representatives. The outcome might provide a wider perspectives on the impact of audit committee characteristics on the financial reporting quality in Nigeria.

Table 3. Regressions Analysis

Variables	Fixed	random	OLS	Randrobust
ACSOW	0.0251	0.0313	0.0313	0.0313***
	(0.0267)	(0.0235)	(0.0235)	(0.00643)
ACFE	0.0785	0.223	0.223	0.223*
	(0.458)	(0.177)	(0.177)	(0.117)
ACIND	0.143	0.0376	0.0376	0.0376
	(0.890)	(0.737)	(0.737)	(0.116)
FA	0.0257	0.00484	0.00484	0.00484
	(0.0200)	(0.00330)	(0.00330)	(0.00332)
FS	0.361**	0.376***	0.376***	0.376***
	(0.153)	(0.0535)	(0.0535)	(0.0557)
PRAT	-0.000709	-0.00129	-0.00129	-0.00129***
	(0.00189)	(0.00180)	(0.00180)	(0.000288)
CONSTANT	-1.892	-1.463*	-1.463*	-1.463***
	(1.354)	(0.813)	(0.813)	(0.338)
Observations	505	505	505	505
R-squared	0.0860	0.1417	0.1420	0.1417

Note: Standard errors in parentheses, *** p<0.01, ** p<0.05, * p<0.1, respectively.

4. Conclusion

This study examines the relationships between audit committee characteristics and financial reporting quality lends supports to previous studies with significant and positive relationships between audit committee variables and FRQ of listed non-financial firms in Nigeria. The results on AC independence prove to be insignificantly positive. It thus, suggests that the proportion of one INED on the AC is not enough in enhancing the FRQ. However, the percentage of financial expertise and share ownership required by NGSEC CCG 2011 is in line with scholarly findings have proved to improve the quality financial reporting in Nigeria. In this respect, our study contributes empirically to the literatures particularly on the effect of AC attributes on FRQ in the emerging economies. Financial literacy is not enough, but a combination of financial and industrial expertise would further improve the quality of the financial report. Equity ownership of AC would provide more vigilance, enthusiasm and proactive in their monitoring functions. However, future studies may consider investigating larger sample size on the effects on audit quality. Incorporating other AC variables, such as frequency of meetings, and financial expertise of shareholders representative on AC and its impact on the FRQ. Shareholders AC member should possess financial expertise.

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