



## **Audit Committee Independence, Financial Expertise, Share Ownership and Financial Reporting Quality: Further Evidence from Nigeria**

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### **ABSTRACT**

This study investigates the characteristics of audit committee (AC) and its effect on the quality of financial reporting of Nigerian listed firms. We employed multivariate regression as a tool for analysis. The sample for the study was 101 firm-years longitudinal panels of 505 observations of non-financial listed companies on the Nigerian Stock Exchange for the period 2010-2014. The McNichols (2002) measure of earnings quality was adopted to examine the monitoring mechanisms on the quality of financial reporting. The results show that control variables of company age and company size significantly affect the quality of financial reporting. The AC, share ownership, and financial expertise was also significant, indicating that AC monitoring mechanisms influence the quality financial reporting of listed non-financial firms in Nigeria. Share ownership proved to be a good motivator for AC members making them to be more vigilant, enthusiastic and active in their monitoring responsibilities.

**Keywords:** Audit Committee, Expertise, Share Ownership

**JEL Classifications:** E6, M4

### **1. INTRODUCTION**

The predominant tool used by investors, shareholders, creditors and other stakeholders is the financial information made available to them through company's annual report for decision-making. This report is prepared by the managers and subject to an audit by professionally qualified auditors who add to the credibility, reliability, relevance and acceptability of the information. Financial information serves as a powerful link between users and management in assessing the results of operations and the financial position of the firm. Therefore, a financial report should provide full, timely, transparent and reliable financial information that is not deliberately prepared to mislead users. Thus, "the objective of financial reporting is to provide financial information about the reporting entity that is useful to investors, guide potential equity investors, lenders, and other creditors in making informed decisions." (Alzoubi, 2012. p. 368). Despite its

importance, financial information may not always be credible and reliable because it may contain errors, deliberate manipulation of accounting numbers, as well as a misrepresentation of earnings that raise questions about the credibility of the financial information.

In Nigeria, several statutory bodies are vested with the responsibility for regulating financial and accounting reporting and dissemination/disclosure of adequate and reliable financial information to users. The responsibility for the company formation, incorporation and winding up is conferred upon the Corporate Affairs Commission (CAC). Responsibility for the regulation of the capital market is assigned to the Nigerian Securities and Exchange Commission (NGSEC). Similarly, the Nigerian stock exchange ensures compliance with the reporting requirements of the listing rules for companies and provides a platform for equities and debt trading. However, the Financial Reporting Council of Nigeria, which was established in 2011, is responsible for ensuring

the improvement, reliability and quality of financial statements to restore, safeguard, and enhance public confidence in financial reports. Proponents of agency theory argue that ownership and control separation lead to moral hazard problems, in which agents act to obtain personal benefits at the expense of shareholders. In curtailing such behavior, effective control of the board of directors would greatly help. The effectiveness of the board monitoring depends upon, among others, the sub-committees of the board (He and Yang, 2014). Also Dechow and Skinner (2000) and Shi and Zhou (2012) argue that a board audit sub-committee and the financial expertise of its members affect the way managers manipulate earnings to achieve corporate or personal benefits.

Similarly, Dechow et al., (2010) posits that the ability to adequately supervise the activities and constrain opportunistically managed earnings lies with effective internal corporate governance (CG) mechanisms. Internal governance mechanisms involve among others, the formation of an independent audit committee (AC) that would supervise the activities of managers and ensure strict compliance with the financial regulations. However, the effectiveness of the committee depends on its composition and the expertise of its members. Also, the impact of high status (Hayes, 2014), industry experience (He and Yang, 2014), accounting expertise (Carol et al., 2014), and accounting and industry experts (Cohen et al., 2014) have been subject to conflicting findings. The inconsistencies in results and other governance variables unused by previous studies such as the financial and accounting expertise of AC members and AC share ownership that was among the elements of the revised Nigerian Code of CG (CCG) (Securities and Exchange Commission, 2011) need to be investigated. Previous studies have examined AC characteristics on an industry basis. This study, however, examines whether changes in AC characteristics (share ownership and accounting/financial expertise) after the NGSEC CCG 2011 have a positive association with the quality of financial reporting in Nigerian non-financial listed firms. It seeks to answer whether AC financial expertise, AC independence, and proportion of members share ownership affect the quality of financial reporting in Nigerian non-financial listed firms? This study utilized non-financial firms of Nigeria's emerging and non-Western economy in examining the relationship between the selected AC variables and their influence on the financial reporting quality (FRQ).

## 2. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

CG is about the structures and processes for the control and direction of companies. It is concerned with the board of directors, management relationships and shareholders and other stakeholders. Hence, CG provides structures that monitor the performance of organizations. For this reason, CG can be seen as a mechanism that is used to reduce the conflict of interests between managers and stakeholders. Thus, CG is employed as a mechanism to decrease the agency costs caused by the conflict of interest between owners and managers. However, to guarantee that good CG prevails, an independent board of directors, an effective AC, and sound internal control mechanisms should be in

place to provide effective monitoring and control of management activities. Shareholders and other stakeholders would put greater confidence and trust in companies with good CG practices. The AC is a sub-committee of the Board delegated with assigned financial oversight responsibilities (Menon and Williams, 1994). Early studies focused on the issues relating to determinants of AC formation with an emphasis on the influence of specific governance characteristics (Bradbury, 1990). These studies try to ascertain whether improvement in governance and accountability is a result of a firm's AC (Wild, 1994). However, new aspects of research, particularly on AC financial expertise, and AC managerial share ownership and its influence on the FRQ have developed. Studies by Abbott et al., (2004) and Coram et al., (2006) provide evidence that an effective AC can prevent earnings management (EM) in organizations. Similarly, if the AC has an insufficient number of directors, this insufficiency might influence its effectiveness due to the shortage of directors in fulfilling the duties of the committee (Vafeas, 2005).

### 2.1. AC Independence and FRQ

Empirical studies have provided evidence that AC independence which represents the percentage of independent non-executive directors (INEDs) on the total number of AC members is likely to be associated with lower EM (Bedard et al., 2004; Davidson et al., 2005). In an attempt to enhance the oversight function of the AC, the United Kingdom's CCG, Sec. C.3.1. Stipulates the establishments of an AC with at least three members (or two for smaller companies) comprising all INEDs (UKCCG, 2014). Meanwhile, the CCG in Malaysia (Securities, 2012) suggests three non-executive members be on the AC. In Australia, ASX CCG (Council Asx, 2010) provides for AC to comprise at least three NEDs, the majority of whom are independent directors to be headed by an independent chair, who is not the chair of the board. In contrast, the revised Nigerian SEC CCG 2011, adopted section 359 (3) and (4) of Companies and Allied Matters Act (CAC, 2012) clearly specifies the formation of a six-member AC for all public companies. Accordingly, the AC should comprise three non-executive board members and three shareholders elected from among themselves at each annual general meeting. However, the Board appoints AC representatives and presents them to shareholders for their approval at the annual general meeting. 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. Thus, AC independence is measured by the proportion of independent NEDs on a total number of AC members. From the preceding discussion, this study formulates the following hypothesis:

H<sub>1</sub>: AC independence is positively related to FRQ of Nigerian listed non-financial firms.

### 2.2. AC Share Ownership and FRQ

AC share ownership represents the proportion of shareholdings AC members in the company. Previous studies have documented the potential effects 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. Previous studies have documented the potential effects of AC members' share ownership in the monitoring of financial reporting process of a firm. These studies suggest an association between share ownership and FRQ effectiveness. It has been argued (Lavelle, 2002) that the actions of AC independent members having a high proportion of shareholdings could be questioned, given their high percentage of shareholding may be used to influence a firm's operations to protect their investments. Similarly Carcello and Neal (2003) argue that if members of AC shareholdings in a firm becomes high, they may attempt to exert undue influence on the removal of an external auditor following a going concern opinion (report) to protect their interests. However, prior studies (Jensen, 1993; Shivasani, 1993; Mangena and Pike, 2005; Vafeas, 2005) have also 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. However, AC share ownership is measured as a proportional share of AC members on the AC to total company shareholdings. Based on the empirical support that has established a positive relationship between AC share ownership and also to the theoretical support of agency theory, this study formulated the following hypothesis:

H<sub>2</sub>: There is a significant positive relationship between AC share ownership and the FRQ of Nigerian listed non-financial firms.

### 2.3. AC Financial Expertise and FRQ

Accounting or financial expertise are attributes/qualifications or experience acquired by a person before becoming a board member of a company. Previous studies support the existence of relationships between accounting expertise and the quality financial reporting. Carcello et al., (2006) document that a reduction in the use of discretionary accruals and income-increasing accruals occurs when an accounting expert is on the AC (Bedard et al., 2004) and when firms have at least one general financial expert on their AC. Also, (Xie et al., (2003) suggest that AC members need the financial sophistication necessary for curtailing the tendency of managers to engage in EM practices. Further, Krishnan and Visvanathan (2007) argue that a positive association exist between accounting expertise and the ratio of AC members. Hence, a greater number of members with financial expertise on the AC reduces the level of fraudulent practices and strengthens internal control processes. Also, Zhang et al., (2007) and Hoitash et al., (2009) document that firms with a high proportion of financial experts, though not necessarily accounting experts, are unlikely to report weaknesses in the internal control over financial reporting. Similarly, constraining irregularities is a significant challenge for ACs due to a manager's behavior of hiding fraudulent practices from monitors to avoid penalties for deliberate GAAP violations (Larcker et al., 2007; Schrand and Zechman, 2012). Therefore, the deliberate mix-up makes reports incomprehensible and prevents ACs from detecting and preventing irregularities. However, Badolato et al., (2014) argue that having an accounting/financial expert as a member of ACs is not enough for constraining EM, but that a combination of financial expertise and high status of

the AC members is necessary. In contrast, Hayes (2014) differ in the conclusions of Badolato et al. (2014) and, as such, argue that lower status has rendered ACs to be less efficient and irreconcilable with multiple decreases in misreporting. Furthermore, Cohen et al. (2014) argue along similar findings of Hayes (2014), agreeing with the Hayes position of having accounting/financial expert on the AC. Further, Cohen et al. (2014) added that status might not be an issue, rather that AC members with accounting and industrial expertise tend to perform better than those with only accounting expertise. Therefore, this indicates that ACs play a greater role when AC members possess higher financial and industry expertise in enhancing financial reporting process. However, AC financial expertise is measured by presence of at least one financially literate member on the AC as 1, if otherwise = 0. As such, this study formulates the following hypothesis:

H<sub>3</sub>: There is a positive relationship between AC member financial expertise and the FRQ of Nigerian listed non-financial firms.

## 3. THEORETICAL FRAMEWORK

CG issues have been one of the most current concepts in the governance literature. Spear (2004) document that the first work on governance originates in the research of (Berle and Means, 1932). While the fundamental governance issue of how corporations are to be governed could be traced to (Fama, 1980; Fama and Jensen, 1983) studies. The separation of control and ownership result in likely conflicts of interests between managers and owners, which consequently lead to costs associated with solving these conflicts (Eisenhardt, 1989). Similarly, previous studies on the AC provided evidence of the significant role of internal monitoring as a decision control mechanism by the board of directors (Fama and Jensen, 1983; Farber, 2005; Rustam et al., 2013; Sulaiman et al., 2014). Therefore, this current study considers agency theory in explaining the relationship between AC characteristics and quality financial reporting.

## 4. RESEARCH DESIGN AND VARIABLE MEASUREMENT

The population of the study is the non-financial institutions listed by the NGSEC. There were 130 non-financial NGSEC listed companies in 2010. Of 130 non-financial listed companies, 101 companies comprised the sample for this study because the remaining 29 companies failed to meet the filtering requirements of non-disclosure of CG variables, and missing or insufficient financial data for the relevant periods of the study. The 101 companies involved in this study including the data of 10 out of the 11 industry groups that were generated over a period of 5 years (2010-2014), which resulted in 505 company-year observations. The exclusion of the financial sector was due to the large number and multiplicity of regulations in Nigeria. The sector also has two divergent CG codes, one for the deposit money banks and the other for insurance companies, with a different earnings behavior, which requires methods other than McNicholas (2002). We employed multiple regression analysis using the OLS technique and Stata statistical software in the analysis. With various EM management



models for estimating DA portion, this study considers the nature of the industrial groups and uniqueness of different companies in selecting the EM model. Thus, in determining the FRQ of Nigerian listed non-financial companies two-step regression was used by adopting (McNichols, 2002) modified from the model of Dechow and Dichev (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 is depicted in Equation (1):

$$\Delta WC_{it} = \beta_0 + \beta_1 CFO_{it-1} + \beta_2 CFO_{it} + \beta_3 CFO_{it+1} + \beta_4 \Delta REV_{it} + \Delta \beta_5 PPE_{it} + \varepsilon_{it} \quad (1)$$

Where,  $\Delta WC$  = Change in working capital = Change in account receivables plus change in inventory less change in account payable less change in tax payable plus the change in other assets (net).  $CFO_{it-1}$  = Lag of cash flow from operations,  $CFO_{it}$  = Current year cash flow from operations,  $CFO_{it+1}$  = following year's cash flow from operations,  $\Delta REV$  = Change in revenue;  $PPE$  = Property plant and equipment,  $\varepsilon$  = Residuals,  $\beta_0$  = Intercept,  $\beta_1$ - $\beta_5$  = Coefficients of independent variables.

CG (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. Besides, three control variables of size, age, and profitability were used in the model. A linear regression model was used for 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):

$$FRQ_{it} = \alpha_{it} + \beta_1 ACIND_{it} + \beta_2 ACSOW_{it} + \beta_3 ACFE_{it} + \beta_4 FS_{it} + \beta_5 FA_{it} + \beta_6 PRAT_{it} + \varepsilon_{it} \quad (2)$$

Where, FRQ is financial reporting quality, ACSOW is the AC share ownership, ACFE is AC financial expertise, ACIND is AC independence, PRAT is profit after tax and extraordinary items, FS is firm size and FA is firm age.

#### 4.1. Data and Empirical Result

Table 1 presents the descriptive statistics for the study variables. The table indicates, on the average 16% presence of at least one INED on the AC. It further shows that few companies comply with the requirement of the NGSEC CCG for the presence of at least one INED on each public company's AC. Further, the NGSEC CCG 2011 requires a minimum of one AC member either to have skills and financial expertise or who can read and understand financial statements. The results show the presence of a financial expert on the company's AC, with an average of 6%. However, some company's ACs did not have a financial expert. The proportion of AC member share ownership ranged from 0 to 31,000 units with a mean of 16% and variability of 1.40. The sampled firms were from 1 to 49 years old from the 2010 listing year.

**Table 1: Descriptive statistics**

Variable	n	Mean	SD	Min	Max
FRQ	505	1.302	0.797	-0.080	15.93
ACSOW	505	0.157	1.401	0	30.52
ACIND	505	0.998	0.045	0	1
PRAT	505	-0.561	17.58	-369.2	82.98
ACFE	505	0.059	0.237	0	1
FA	505	21.15	12.90	1	49
FS	505	6.927	0.782	3.640	8.984

Where FRQ is financial reporting quality, ACSOW is the audit committee share ownership, ACFE is audit committee financial expertise, ACIND is audit committee independence, PRAT is profit after tax and extraordinary items, FS is firm size and FA is firm age

#### 4.2. Diagnostic Tests

The focus of the study is to examine the effect of the AC on the FRQ in Nigerian non-financial firms using Equation (2). To test the hypotheses, a multivariate regression requires fulfilling normality, multicollinearity, and homoscedasticity tests. Diagnostic tests based on OLS and random effects were conducted to fulfill 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, the normality test was carried out using the Sktest and Mardia tests with skewness (0.1391) and kurtosis (0.441) respectively, suggesting normality of the data. The absence of heteroscedasticity was established using the Breusch-Pagan test (0.3342), justifying the existence of homoscedasticity or freedom from errors associated with the data. Furthermore, the variance inflation factors result of independent and control variables of 1.02 was <2.0 as recommended (Hair et al., 2014), providing no evidence of multicollinearity in the model. Also, model specification test equally evidenced that the explanatory variables were well specified with no omitted variables. The Wald test results were found to be significant at 1% justifying the statistical significance of the model.

#### 4.3. Regression Results/Hypotheses Testing

The overall  $R^2$  (0.14) of the random robust as in Table 2 that is the coefficient of determination provides the proportion of the total variation in the outcome variable explained by the predictor variables collectively. Thus, signifies 14% of total variation in FRQ of Nigerian non-financial listed firms is caused by their AC independence, share ownership, proportions of shares held by AC members, profitability, firm size, and firm age. Table 3 presents the regression results, which examined the relationship between AC characteristics and the FRQ of listed non-financial firms in Nigeria. The results clearly indicate a positive association between AC share ownership and FRQ at the 1% level of significance. Suggesting an increase of 0.0313 in the AC members' equity ownership would cause a corresponding rise in the quality of the financial report by the same amount. Thus, this study supports the findings of Jensen (1993), Shivasani (1993), 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 an NED on the AC, they may be enthused and effectively assisting in improving the financial reporting process. Thus, hypothesis  $H_2$  was not rejected. Accordingly, the results on the relationship between AC financial expertise and FRQ show a significantly positive association at

**Table 2: Regression analysis**

Variables	Fixed	Random	OLS	Randrobust
ACSOW	0.0251 (0.0267)	0.0313 (0.0235)	0.0313 (0.0235)	0.0313*** (0.00643)
ACFE	0.0785 (0.458)	0.223 (0.177)	0.223 (0.177)	0.223* (0.117)
ACIND	0.143 (0.890)	0.0376 (0.737)	0.0376 (0.737)	0.0376 (0.116)
FA	0.0257 (0.0200)	0.00484 (0.00330)	0.00484 (0.00330)	0.00484* (0.00332)
FS	0.361** (0.153)	0.376*** (0.0535)	0.376*** (0.0535)	0.376*** (0.0557)
PRAT	-0.000709 (0.00189)	-0.00129 (0.00180)	-0.00129 (0.00180)	-0.00129*** (0.000288)
Constant	-1.892 (1.354)	-1.463* (0.813)	-1.463* (0.813)	-1.463*** (0.338)
Observations	505	505	505	505
R <sup>2</sup>	0.0860	0.1417	0.1420	0.1417

Standard errors are \*\*\*P<0.01, \*\*P<0.05, \*P<0.1, respectively. The P values are at one-tailed. Model 1 and 2 are fixed and random effects, while estimates under Model 3 and 4 are OLS and robust random effect. Where FRQ is financial reporting quality, ACSOW is the audit committee share ownership, ACFE is audit committee financial expertise, ACIND is audit committee independence, PRAT is profit after tax and extraordinary items, FS is firm size and FA is firm age

**Table 3: Diagnostic tests**

Tests	$\chi^2$	P
Breusch-Pagan	0.93	0.3342
Ramsey test	1.43	0.1424
Wald	102.60	0.000
Sktest		0.1391
Mardia test		0.4413
VIF		1.02

Sktest is the skewness and kurtosis test, Mardia test is the Mardia Skewness test.

VIF: Variance inflation factors

the 10% level. This suggests that any additional AC financial member would result in an equivalent improvement in the earnings quality of the firms. In particular, the presence of a member with financial literacy or knowledge in accounting, finance or financial management would enhance the quality of the financial report. This lends support to the findings of Xie et al. (2003), Carcello et al., (2006b), Krishnan and Visvanathan, (2007), Mustafa and Youssef (2010), Lo et al., (2010), Chan et al., (2013) and Cohen et al. (2014). In other words, the results offer a basis for not rejecting the hypothesis ( $H_3$ ) of the study.

However, the results for the independence of an AC reveal an insignificant but positive relationship with FRQ. Hence, any additional independent nonexecutive member of the AC would improve the quality of earnings thereby increasing the FRQ of the firm by 0.0376. 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, relative or partial independence may not provide the necessary independence required of AC for an enhanced FRQ. Furthermore, Bassett et al., (2007) and Kent et al., (2008) observed that higher FRQ would be achieved only when the AC is highly independent. Similarly, Lin and Hwang, (2010) could not find clear benefits of the AC independence. They argue that determining the desired level of AC independence is unclear. The insignificance relationship could be attributed to differences in the industries with diversity in operations. The emerging nature of the Nigerian economy as distinct from Western and developed economies coupled with the availability of data could have contributed to the differences in the outcome of our results. However, the association between FRQ and profitability provides a significant negative relationship at 1% level of significance. The result shows that firms with higher profitability motivate the use of discretionary accruals or EM that decrease the quality of earnings of the Nigerian listed nonfinancial firm.

Firm size was found to be positively significant at 1% level. The result indicates that firm size has a substantial impact on FRQ of Nigerian listed non-financial firms. This implies that the large companies report more reliable financial information over the small ones. Perhaps large companies mostly have sound internal control and effective governance mechanisms. It further, suggests high-quality external audit services and disquiet about its reputations. Consequently, the large companies may ploy earnings to suit its interest given its experienced management team that makes it effortless to manipulate earnings. The current study did not report sample mean differences on whether revised CCG 2011 significantly enhanced the overall quality of financial reports of the sampled firms. Further studies should investigate the effectiveness of such changes on the quality of the financial report, increase the sample size by incorporating all listed firms and consider whistleblowing attributes under the purview of the AC. The outcomes might provide insight into the impact of AC characteristics on the FRQ in Nigeria.

## 5. CONCLUSION

This study examines the relationships between AC characteristics and FRQ; that corroborates prior results of positively significant relationships between AC variables and FRQ of listed non-financial firms in Nigeria. The results for AC independence suggests that one INED on the AC is not enough to enhance the FRQ. However, the percentage of financial expertise and share ownership required by NGSEC CCG 2011 aligns with other scholarly findings that have proven that these factors improve the quality of financial reporting in Nigeria. In this respect, our study contributes empirically to the literature particularly in the effect of AC attributes on FRQ in the emerging economies.

Based on our findings, regulatory bodies in Nigeria should ensure that all three of the board representatives on AC are independent NEDs. Furthermore, financial literacy is not enough, but a combination of financial and industrial expertise would further improve the quality of financial reports. Even though owning equity in Nigerian listed firms is not a requirement for board members, such ownership has been proven to be a good motivator for AC members because of the resultant benefits accruable to firms. Members holding shares would be more vigilant, enthusiastic and active in their monitoring responsibilities. However, future studies may consider investigating all listed firms and the effects

on the quality of financial reports. Incorporating other AC variables, such as frequency of meetings, and financial expertise of shareholders' representatives on the AC would enhance the FRQ. The NGSEC should mandate shareholders' AC members to possess the financial expertise and require disclosure to be made available in the corporate reports of the firms. Moreover, other accrual/earnings quality models could examine the relationship to observe possible differences.

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