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## **FINANCIAL REPORTING QUALITY AND CORPORATE GOVERNANCE: DO AUDIT COMMITTEE CHARACTERISTICS MATTER?**

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### **Abstract**

*The role of audit committee (a sub-set of the larger board) in corporate governance and whether its presence affects financial reporting quality have attracted a lot of research and diverse opinions. This study investigated the relationship between financial reporting quality proxied by earnings management and Audit Committee characteristics of listed manufacturing firms in Nigeria. The study covered a period of seven years from 2008 to 2014. Data for the study were extracted from the firms' annual reports and accounts. The dependent variable, earnings management was generated using two steps regression adopting the Modified Dechow and Dichev model as in Mc Nichols (2002) model in order to determine the earnings management of the sampled firms. Multiple regressions are used to run the data of the study using OLS estimation. The results from the analysis revealed significant association between audit committee characteristics of size, financial expertise and number of meetings with the dependent variable. However no significant association was found regarding the presence of a financial expert on the committee. In accordance with the findings, the study recommends that regulatory authorities should in line with current best practices ensure that all three director members on audit committee (as provided by the SEC, 2011 code of corporate governance) of firms should be outside independent directors as opposed to the*

*current requirement of only one independent director. It is also recommended that firms increase the number of audit committee meetings beyond the statutory requirement.*

## **1. Introduction**

Financial reporting quality and corporate governance have continued to receive significant attention from government regulators, shareholders, creditors, investors, employees and the public, especially following the high-profile corporate scandals of the last three decades. Financial accounting information is the product of corporate accounting and external reporting systems that measure and routinely disclose audited, quantitative data concerning the financial position and performance of publicly held firms (Bushman & Smith, 2003). Financial information is rendered in form of balance sheet, income statements and cash flow statements along with supporting disclosures. This forms the basis of information available to users or stakeholders, notably investors and regulators. For investors to commit their funds in firms, they must be reasonably satisfied that information conveyed through such statements are relevant, reliable, comparable and understandable (Kamaruzaman, Mazlifa and Maisara, 2009).

More so, the IASB in its conceptual framework 2008, recognizes that the objectives of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. To achieve this, the annual reports should contain full disclosure and higher levels of transparency (Shehu, 2013). Providing a full and frank account of a company's activities through financial disclosure is necessary if a company desires transparency in its financial activities. Bushman and Smith (200) are of the opinion that corporate transparency is all about widespread availability of relevant, reliable information about the periodic performance, financial position, investments opportunities, governance, value and risk of publicly traded firms. The Audit Committee of the board of directors plays an indispensable role in the current corporate governance environment. It can be argued that the committee is the most challenging sub-committee of any firm's board of directors. The Cadbury committee report (1992, p.67) rightly recognised that the audit committee "has the potential to improve the quality of financial reporting by reviewing the financial statements on behalf of the board". By the end of the 1990s, both the US and the UK had in place a system of regulation whereby listed companies were expected to possess independent audit committees. The sensational demise of Enron in the US in 2001, despite the

presence of a significant level of audit committee self-regulation, forced a re-think on the part of regulators and governments, not only in the US and UK, but throughout the developed world. Countries around the world have put in place regulations to guide the formation of audit committees to ensure sound quality of financial reports. Issues regulated include formation and composition of audit committees, required financial expertise/literacy of members, and responsibilities as regards the internal and external audit functions. Researchers have looked at the role of audit committees and financial statement quality. Studies have shown that companies with well functioning audit committees are less likely to have frauds or irregularities.

This study examines the characteristics of audit committees of listed manufacturing firms in Nigeria and the degree of association with the quality of their financial reporting. Audit committees are vital organs of the board of directors in assisting them to enhance the transparency and integrity of financial information and reporting. The audit committee is charged with the responsibility among other things to comment on and approve accounting policies, review the financial statements and maintain the adequacy of internal controls on a continuing basis. Researchers have investigated the impact of audit committees on financial reporting quality from the perspectives of their characteristics. These are committee size, committee independence, committee number of meetings and committee member's financial expertise. Most researchers place more emphasis on the independence and financial expertise of members. It has been documented that independent committee members are more likely to support the auditor in auditor-management disputes. Committee members with financial expertise render valuable assistance to the committee in analyzing financial statements with a view of fishing out problems and how to solve them. Evidences have also been documented about positive market reactions to committee appointments of a member with financial expertise while none has been reported for appointment one without any expertise. Some researchers have analyzed the relationship between audit committee characteristics and financial reporting quality in extreme circumstances such as financial statement fraud. They concluded that financial misstatements are more likely to occur in firms that committed financial statement fraud.

In Nigeria, every public company is required under Section 359(3) and (4) of the Companies and Allied Matters Act to establish an audit committee. The Act requires that at least one board member of the audit committee must be financially literate. Members of the committee should have basic financial literacy and

should be able to read financial statements. At least one member should have knowledge of accounting or financial management.

Researchers who have related audit committee to financial reporting quality includes Anderson, Mansi and Reeb (2004); DeZoort and Salterio, (2001); Klein, (2002); Berdard *et al*, (2004); Mennon and Williams, (1994); Beasley, Carcello, Hermanson and Lapidés (2000); Kalbers and Fogarty, (1993); Carcello and Neal, (2000); Mac Daniel, Martin and Maines (2002); Libby and Luft, (1993); Bull and Sharp, (1989); Lipman, (2004); Scarpati, (2003); Agrawal and Chadda, (2005); Abbott, Parker and Peters, (2004); Defond and Jiambalvo (1994); Macmullen and Rhaganandan, (1996). Hence, is there any significant impact by the audit committee characteristics on the financial reporting quality of listed manufacturing firms in Nigeria?

This study sheds more light on the financial reporting quality of companies in Nigeria and therefore serves as guide to investors and other stakeholders. Nigeria has in 2011 introduced corporate governance reforms and is committed towards the implementation of the International Financial Reporting Standards (IFRS) for financial reporting. It is therefore necessary for regulators and policy makers to have empirical information as to whether such policies have made any impact. The results of this study will also serve as a data base for further researchers in this field. Consequently, this paper investigates whether financial reporting quality proxied by earnings quality of listed manufacturing firms in Nigeria is likely to be influenced by audit committee characteristics. As guided by literature, four independent variables are selected as proxies for governance mechanisms. These variables are audit committee size, audit committee independence, audit committee financial expertise and audit committee number of meetings. Firm size and level of leverage serve as control variables.

The rest of the paper is organised as follows: Section 2 reviews the related studies and hypotheses development, Section 3 discusses the research methodology. Section 4 discusses the results. Finally, conclusions are drawn and recommendations made in Section 5.

## **2. Review of Related Studies and Hypotheses development.**

Corporate Governance and Financial reporting quality have been studied extensively by researchers for the purpose of determining the relationship between them. However because financial reporting quality is elusive, researchers have differently interpreted what it is and what determines it (Ball, Robin and

Wu, 2003). Consequently researchers have studied the determinants of and measures of financial reporting quality using different proxies (Salleh, 2009). These proxies include corporate governance structure and mechanisms, earnings quality, firm fundamental characteristics (size, listing status, age); external factors, accounting techniques, firm financial characteristics (financial/ operating leverage, growth, profitability); disclosure quality, political influence. This study focuses on the characteristics audit committee of the board of directors as a corporate governance mechanism and how they influence earnings quality as a proxy for financial reporting quality. Prior literature linking the relationship between financial reporting quality and the board audit committee, relate to the existence of and possession of the necessary characteristics required of an audit committee and their impact on the determinants or proxies for financial reporting quality. These characteristics include composition, independence, size, and expertise and meeting frequency. Researchers have tried to associate the impact of these characteristics or outputs in relation to roles played by audit committees in three ways (Ghaffran, 2013). First, a set of studies that focuses on instances of alleged fraud, misstatements and/ or restatements. Secondly, a reasonable majority of studies focus on analyzing actual reported numbers to assess earnings quality and thirdly, others focus on the firms practice and level of disclosure. This study is particularly interested in the second strand of studies.

### **2.1 Audit Committee Size and Financial Reporting Quality**

Size of an audit committee is one of the most important variables determining its effectiveness (Joshi and Wakil, 2004). In the opinion of Vafeas (2005), if the audit committee size is too small then there will not be sufficient number of directors to serve the committee. This will decrease its monitoring efficiency. Obviously, a small committee is not capable of fulfilling its duties efficiently especially if the operations of the firm are increasing. Evidence from previous studies suggests that firms with large audit committee are more effective in monitoring management. This may suggest that having a sufficient number of audit committee members increases the efficiency of its monitoring function in terms of financial reporting quality. However, when a committee size is too large, the directors' performance may decline because of the free-rider effect, coordination, and process problems. This may endanger weak monitoring (Jensen, 1993; Vafeas, 2005). For these reasons, some researchers are of the opinion that the perfect average size of the audit committee is between 3 and 4 members (Abbott *et al.*, 2004; Vafeas, 2005; Xie *et al.*, 2003).

The findings of prior studies for the effect of audit committee size on earnings management are mixed. Xie *et al.* (2003) investigated the relationship between earnings management and audit committee characteristics by using a sample of 282 US firms for the years 1992, 1994 and 1996. In the same vein, Bedard *et al.* (2004) used a sample of 300 US firms in the year 1996. Even though they applied different methods to capture earnings management incidence, and control for different factors, both found that there is no significant association between audit committee size and earnings. Lin, Li and Yang (2006) examined the association between reported earnings restatement (a measure of financial reporting quality) and audit committee characteristics of size, independence, and financial expertise for the year 2000 using a sample of 106 public corporations in the US. Their findings suggest a negative and significant association between the audit committees size and earnings restatement. Abbott *et al.* (2004) examined 41 firms that issued fraudulent reports and 88 firms which restated annual results in the period 1991-1999. They found that audit committee size had no significant impact on financial reporting quality. Yang and Krishnan (2005) tested the association between audit committee characteristics and measures of quarterly earnings management using a sample 896 firm year observations within 1996-2000. They reported that quarterly earnings management is lower for the firms that have large size of audit committee. Additionally, Abdul Rahman and Ali (2006) documented a positive non-significant relationship between audit committee effectiveness in reducing earnings management among 97 Malaysian listed firms over the period 2002-2003. Baxter and Cotter (2009) investigated whether the size of audit committees is associated with earnings quality for a sample of Australian listed companies in 2001. They use two measures of earnings quality base on the Jones (1991) and Dechow and Dichev (2002) models. Their results indicate no association between audit committee size and earnings quality in either measure. Based on above arguments the study hypothesizes thus:

*H0<sub>1</sub>: Audit Committee size has no significant impact on the quality of financial reporting of listed manufacturing firms in Nigeria.*

## **2.2 Audit Committee Independence and financial reporting quality**

Proxies for the audit committee's degree of independence include the percentage of outside directors on the committee indicating a majority or totality of independent directors (Klein, 2002a; Bédard *et al.*, 2004; Abbott *et al.*, 2004). Some researchers believe that a totally independent board may be best suited to perform the essential functions of corporate governance (Firstenberg and Malkiel, 1994). Beasley *et al* (2000) investigated fraudulent financial reporting in

technology, health care and financial services industries and found that in all these industries, firms committing fraud have less independent audit committees and boards than do other firms. Klein (2002a) investigated the cross sectional relation between earnings management and audit committee independence for S&P 500 firms in 1992 and 1993. She finds a negative association between the magnitude of abnormal accruals and two independence measures of percentage of outside directors, and the fact that the committee comprises a majority of outsiders. Jenkins and Krawczyk (2002) investigated the relation between earnings management and audit committee effectiveness, estimated as a factor score that is positively associated with four audit committee characteristics: (1) percentage of outside directors, (2) the percentage of financial experts, (3) number of meetings per year, and (4) size of the committee. With respect to earnings management, her findings are consistent with the mitigating effects of outside audit committee members.

Bedard *et al.* (2004) investigated the effect of audit committee characteristics, namely, expertise, independence and activity, on the extent of earnings management. They use the level of income increasing and income-decreasing discretionary accruals applying the modified Jones (1995) cross-sectional model for a sample of 300 US firms in the year 1996. The results obtained from logistic regression analyses suggest that aggressive earnings management is negatively related to fully independent audit committees. However, no significant association was found between audit committee size or the frequency of its meetings and aggressive earnings management. In Australia, Benkel, Marther and Ramsay (2006) studied the association between the presence of independent directors on audit committees and the incidence of earnings management. They used a sample of 666 firm-year observations for the fiscal years 2001, 2002 and 2003. They found that higher levels of audit committee independence are associated with reduced levels of earnings management. In similar context, Davidson *et al.* (2005) investigated the role of governance structure in reducing the level of discretionary accruals using a cross-sectional sample of 434 listed Australian firms for the financial year ending in 2000. Their findings support the view that independent audit committees are significantly associated with a lower likelihood of earnings management.

Overall, vast majority of empirical studies show that the independence of the audit committee is negatively associated with the occurrence of earnings management; some studies produce no results on tests of whether the existence or independence of audit committees reduces the incidence of earnings management.

Five US studies provide unresponsive results concerning the relation between FRQ and the percentage of outside directors on the audit committee (Xie *et al.* (2003) and Yang and Krishnan (2005) for short-term and quarterly earnings management, respectively; Uzun, Szewczyk and Varma (2004) regarding fraudulent reporting in the period 1978-2001; Agrawal and Chadha (2005) concerning the likelihood of earnings restatement for companies in 2000-2001, and Felo, Krishnamurthy and Solieri (2003) with respect to the AIMR scores of FRQ for companies in 1992-93 and 1995-96. In the UK, Peasnell, *et al.* (2005) examine whether the incidence of earnings management by UK listed firms in the fiscal years ending between 1993 to 1996 depends on outside board members and the audit committee. They found no evidence that the presence of an audit committee directly affects the extent of income-increasing manipulations to meet or exceed earnings management thresholds. Audit committees do not also appear to have a direct effect on the degree of downward manipulation, when pre-managed earnings exceed thresholds by a large margin. In France, Piot and Janin (2007) do not find any association between abnormal accruals and the existence of a majority independent audit committee; only the presence of an audit committee is associated with lower abnormal accruals. Additionally, Osma and Noguer (2007) test whether the existence of an audit committee is effective in constraining earnings manipulation for a Spanish sample of quoted companies during the period 1999–2001. They find that it does not do so. In a Nigerian study of listed manufacturing firms by Shehu (2013), results revealed that audit committee size, independence, and frequent meetings influence the strength and quality of financial information of the firms. For the committee independence it tallies with the findings of Klein, (2002); Bédard *et al.*, (2004) and Anderson *et al.* (2004) depicting a positive relationship between audit committee independence and financial reporting integrity. Based on above the study hypothesizes thus:

*H0<sub>2</sub> Audit committee independence has no significant impact on the financial reporting quality of listed manufacturing firms in Nigeria.*

### **2.3 Audit Committee member financial expertise and financial reporting quality**

Financial expertise or literacy of audit committee members is another characteristic that is a subject of study by researchers. Prior studies argue that financial reporting issues involve the highest level of technical detail among audit committee effective areas (Kalbers and Fogarty, 1993; Green, 1994), and ideal audit committee members should have knowledge of accounting concepts and the

auditing process to enhance their understanding of the financial reporting process, recognize problems, ask probing questions of the management and auditor and make leadership contributions to audit committees. Xie *et al.* (2003) investigated S&P 500 firms and documented negative associations between abnormal working capital accruals and two expertise variables namely, the percentage of audit committee members having executive positions in other listed companies, and the percentage of audit committee members with experience as investment bankers. Yang and Krishnan (2005), investigating the magnitude of quarterly earnings management reported insignificant effects regarding the presence of a financial expert on the audit committee but mitigating effects associated with governance and business expertise. Other studies have addressed FRQ surrogates other than earnings management. Farber (2005) found that the number of financial experts on the audit committee is, on average, significantly lower in a fraud firm sample, compared to a control sample of non-fraud firms. Abbott *et al.* (2004) found that the likelihood of earnings restatement significantly decreases if the audit committee includes at least one financial expert.

Bedard *et al.* (2004) investigated the effect of audit committee characteristics, namely, expertise, independence and activity, on the extent of earnings management. They use the level of income increasing and income-decreasing discretionary accruals, applying the modified Jones (1995) cross-sectional model for a sample of 300 US firms in the year 1996. They proved empirically, that the presence of at least one member with financial expertise on the audit committee is negatively related to the level of earnings management. Similarly, Agrawal and Chadha (2005) also provided evidence that firms whose audit committees include an independent director with financial expertise are less likely to restate earnings. It is therefore likely that accounting expertise, relative to other expertise, can contribute more to the effectiveness of audit committees which in turn improve the quality of financial information. The study hypothesizes thus:

*H0<sub>3</sub> Audit committee member financial expertise has no significant effect on the financial reporting quality of listed manufacturing firms in Nigeria.*

#### **2.4 Audit committee number of meetings and financial reporting quality.**

Number of meetings in a year held by the audit committee is another characteristic that is also a subject of investigation by researchers. Number of meetings is regarded as a proxy for the degree of effort the committee exerts in overseeing financial reporting. Inactive audit committees are unlikely to monitor management effectively (Menon & Williams, 1994). Regulators around the world

do not normally contain any specific rules regarding the frequency of audit committee meetings. It is widely believed that higher frequency of board meetings reduce the possibility of fraud since regular meetings allow the directors to identify and resolve potential problems, particularly those that are related to the FRQ. With the exception of the U.S, there are few prior studies that have considered the number of audit committee meetings. The few in the U.S have yielded mixed empirical findings.

Uzun *et al.* (2004) reported that the audit committee meeting frequency is not significantly associated with fraudulent financial reporting. Felo *et al.* (2003) find that meeting frequency has no effect on FRQ as perceived by AIMR analysts. Xie *et al.* (2003) found that the frequency of audit committee meetings is negatively associated with earning management, as measured by discretionary current accruals and the likelihood of enforcement action by SEC (McMullen and Raghunandan, 1996). Farber (2005) and Kent and Stewart (2008), Erena and Tehulu, (2012) state that an audit committee that meet frequently can reduce the incidence of financial reporting problem. Elsewhere, Abbott *et al.* (2004) found that a mitigating effect if the audit committee meets at least four times a year there is the possibility of mitigating occurrence of earnings restatements; but Lin *et al.* (2006) do not, using the number of meetings. Hwang and Lin (2010) employed a meta-analysis technique to integrate and evaluate results from 27 prior studies that related earnings management to Audit committee meetings among other characteristics. Their results showed a significantly negative relationship between earnings management and the number of meetings by audit committee. In an empirical study from Nigeria, Yadirichukwu and Ebimobowei (2013) studied the relationship between timeliness of financial reporting (a proxy of FRQ) and audit committee effectiveness. They used a sample of 35 firms listed on the Nigerian stock exchange employing panel data and regression analysis. Independent variables include audit committee independence, number of meetings, financial expertise and audit committee size. Results showed that the number of audit committee meetings and the audit committee size were not significantly influencing the timeliness of financial reports. From the above, the study hypothesizes thus:

*H0<sub>4</sub> Audit committee member number of meeting has no significant impact on the quality of financial reporting of listed manufacturing firms in Nigeria.*

### **3. Methodology and Robustness Test**

For the purpose of this study, correlational research design was used. The population of the study comprises of all 57 quoted manufacturing firms on the Nigerian Stock Exchange as at 31<sup>st</sup> December, 2014 classified into 4 sub-sectors. These are building materials (14) firms; chemicals and paints (10) firms; conglomerates (9) firms and food and beverages (24) firms. In view of the nature of the model used in this study, a filter is employed to eliminate some of the firms that have no complete records of all the data needed for measuring the variables of the study within the period (2008-2014). Consequently, 18 firms are eliminated leaving 39 firms as a result of the first criteria. The second filter eliminates all firms that have disappeared from the trading schedule of NSE as at 31<sup>st</sup> December, 2014 on the basis of this filter, 8 firms are eliminated. The remaining 31 firms that met both criteria are used as the sample of the study.

This study is quantitative with positivism paradigm. Therefore longitudinal balanced panel data from secondary sources is used with audited financial reports extracted from the selected sample of firms within the period of study. Multiple regressions is adopted to examine the model of the study. To account for individual heterogeneity of individual sample firms, longitudinal panel regression is used as a technique of data analysis us for the study. Two step regressions are used to determine the quality of financial reports of the Nigerian listed manufacturing firms using the modified DD model by McNichols (2002). The residuals of:

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

(Where  $\Delta$  in working capital in year  $t$  for firm  $i$  ( $\Delta WC_{it}$ ) =  $\Delta$ Accounts receivable +  $\Delta$ Inventory -  $\Delta$ Accounts payable -  $\Delta$ Taxes payable +  $\Delta$ Other assets (net). CFO is cash cash flow from operations;  $\Delta$  REV is change in revenue and PPE refers to Property, Plant and Equipment.

The residuals for the modified DD model after inserting the sampled firm's data represent financial reports quality in the second regression model for the study (Shehu, 2011). The larger the residuals, the lower the quality of accruals, vice versa as in McNichols (2002).

Based on the variables, the empirical model of the study is:

$$FRQ_{it} = \beta_{0it} + \beta_{1it} ACS_{it} + \beta_{2it} ACI_{it} + \beta_{3it} ACFE_{it} + \beta_{4it} ACM_{it} + \beta_{5it} FS_{it} + \beta_{6it} LEV_{it} + \mu_{it}$$

**Where:**

FRQ = Financial Reporting Quality

$\beta_0$  = Intercept

$\beta_{1-6}$  = Coefficients of the Independent variables

ACS = Audit Committee Size – TotalNumber of members of the committee.

ACI = Audit Committee Independence- measured as the number of independent directors on the committee.

ACFE = Audit Committee Financial Expertise- Number of directors with financial expertise on the committee.

ACM = Audit Committee number of Meetings- Number of audit committee meetings held within a financial year.

FS = Firm Size- Measured as log of total assets.

LEV = Leverage- Level of Debt

$\mu$  = Residual or error term.

The results of robustness tests (multicollinearity, heteroscedasticity, Hausman specification and histogram test of residuals) conducted in order to improve the validity of all statistical inferences for the study reveal favourable but not reported for brevity.

#### 4. Results and discussion

In this section, the study results are presented and discussed. A set of descriptive statistics are first presented, followed the correlation matrix and the regression result obtained from the model:

$$FRQ_{it} = \beta_0 + \beta_1 ACS_{it} + \beta_2 ACI_{it} + \beta_3 ACFE_{it} + \beta_4 ACM_{it} + \beta_5 FS_{it} + \beta_6 LEV_{it} + \mu_{it}$$

#### 4.1 Descriptive Statistics

**Table 4.1: Descriptive Statistics**

Variable	Min.	Max	Mean	Std Dev.	Obs.
FRQ	0.006	8.091	1.794	1.323	217
ACS	1.000	7.000	5.475	1.118	217
ACI	1.000	4.000	1.525	0.799	217
ACFE	0.000	3.000	1.129	0.483	217
ACM	0.000	6.000	2.567	1.486	217
FS	0.693	22.493	1.695	3.515	217
LEV	0.394	1.798	0.584	0.319	217

*Source: Minitab 17 OUTPUTS*

Table 4.1 shows that the minimum value of FRQ is 0.0064 and the maximum is 8.0910. This implies that the firm that has higher values signify higher earnings management and those with lower values have lower earnings management as pointed out by (McNichols, 2002) The FRQ values determine the accrual quality, the larger the residuals, the lower the quality of accruals and vice versa.

The audit committee size shows a minimum and maximum of one and seven respectively. This means that the smallest number of audit committee members of listed manufacturing firms in Nigeria is one and the largest number is seven. This shows that some firms have violated the minimum requirement of six members as provided in CAMA 1999 as well as the SEC code of corporate governance (2011). Also, the mean of the committee size is 5.474 which signify that on the average it can be said there are approximately five members on the audit committee of listed manufacturing firms in Nigeria. Thus, it can be said that on the average there is no compliance by some firms in respect of the requirement of CAMA 1999 and the SEC code of corporate governance (2011), with regards to the provision of equal representation of three shareholders and three directors.

For audit committee independence, the table shows a minimum and maximum of one and four respectively. This implies that the smallest number of non executive directors in the audit committee is one and up to four members in some firms in the composition of six members of the audit committee of all the sampled listed manufacturing firms. The mean shows a value of 1.5253. This means that on average, all firms have met the requirement of having at least one independent non-executive director sitting on the audit committee.

Additionally, the audit committee financial expertise shows a minimum of zero and maximum of three. This implies that there are some firms that do not have any member with financial expertise in their audit committees, while there are others that have up to three members with financial expertise out of required six members of the committee. This indicates that some listed manufacturing firms did not comply with the provision of CAMA (1990) and SEC code of corporate governance (2011) that requires the presence of at least one financial expert among the non-executive directors on the audit committee. The mean of 1.1290 however indicates compliance on average.

Similarly, for audit committee meetings, there is a minimum of zero and maximum of six meetings. This means that some listed manufacturing firms in Nigeria held no audit committee meetings during a year while some held six meetings exceeding the required minimum of four by the SEC code of corporate governance (2011). The mean number of committee meetings is 2.567. This implies that on average all firms did not meet the requirements. For the control variable of firm size, minimum and maximum sizes in terms of total log of assets are 0.693 and 22.493 respectively. This implies that the sampled firms are fairly large owning a minimum of 693 million naira and more than 22 billion naira worth of assets. Leverage shows a minimum and maximum of 0.0394 and 1.798 respectively. This shows that the firms are leveraged between the range of 0.03% and 17.98%.

#### **4.2: Correlation Matrix**

**Table 4.2: Correlation Matrix**

<b>Var</b>	<b>FRQ</b>	<b>ACS</b>	<b>ACI</b>	<b>ACFE</b>	<b>ACM</b>	<b>FS</b>	<b>LEV</b>
<b>FRQ</b>	1.0000						
<b>ACS</b>	(-0.061) 0.370	1.0000					
<b>ACI</b>	(-0.000) 0.994	(0.186) 0.006	1.0000				
<b>ACFE</b>	(0.023) 0.731	(0.375) 0.000	(0.123) 0.070	1.0000			
<b>ACM</b>	(-0.260)*** 0.000	(0.328) 0.000	(0.149) 0.028	(0.072) 0.293	1.0000		
<b>FS</b>	(0.218)* 0.001	(0.044) 0.520	(-0.014) 0.840	(-0.038) 0.575	(-0.082) 0.227	1.0000	
<b>LEV</b>	(0.035) 0.603	(0.110) 0.107	(0.038) 0.574	(-0.105) 0.123	(0.092) 0.177	(-0.131) 0.053	1.0000

From table 4.2, it can be observed that audit committee size, audit committee independence and audit committee meetings are all negatively correlated with the dependent variable financial reporting quality. Audit committee financial expertise and the two control variables are however positively correlated. The negative correlations indicates that increases in these variables will be associated with reductions in magnitudes of earnings and this increases the financial reporting quality and the reverse holds for variables with positive correlations. The correlation matrix will not serve as a basis for generalization on the actual

relationship between audit committee characteristics and earnings management as correlation matrix only gives a mere degree of association between the dependent variable and the independent variables themselves. It can be observed that most of the relationships between the independent variables themselves are not significant, an indication of absence of multi Colerarity. This can be clearly observed from the VIF measures as shown on table 4.3.

### 4.3: Regression Results

**Table 4.3: Regression Results**

Variable	Coefficients	Std. Error	T-Value	P- Value	VIF
FRQ	1.886	0.459	4.11	0.000***	
ACS	-0.2042	0.0460	-4.44	0.000***	1.36
ACI	0.069	0.110	0.62	0.533	1.05
ACFE	-0.2130	0.050	4.26	0.000***	1.21
ACM	-0.2241	0.0618	-3.62	0.000***	1.15
FS	-0.0807	0.0249	3.25	0.001***	1.04
LEV	0.411	0.278	1.48	0.141	1.07
<b>R-sq</b>	70.90%				
<b>R-sq(adj)</b>	69.38%				
<b>R-sq (predic.)</b>	68.00%				

*Source: Minitab 17 OUTPUTS* ('\*\*\*' indicate significant levels at 1% level)

Table 4.3 presents the regression results of dependent variable (FRQ) and the independent variables of the study (audit committee size, audit committee independence, audit committee financial expertise, audit committee number of meetings, firm size and level of leverage).

The OLS regression results puts the cumulative  $R^2$  which is the multiple coefficient of determination that gives the proportion or percentage of the total variation in the dependent variable explained by the explanatory variables jointly at 70.90%. This is the percentage of the total variation in financial reporting

quality of Nigerian listed manufacturing firms that is caused by their audit committee size, audit committee independence, audit committee financial expertise, audit committee number of meetings, firm size and level leverage. There is an indication that the model is fit and the explanatory variables are properly selected combined and used as evidenced by the value of F-statistic of 4.11 at 1% level of significance. The R-sq predicted of 68% does not fall off the cliff from both the R-sq and the R-sq adjusted of 69.38%. This also indites the fitness of the model validity of future predictions. Therefore the findings of the study can be relied on.

Audit committee size as shown by above table has a negative (-0.2042) significant effect on the financial reporting quality of listed Nigeria manufacturing firms at 1% level of significance. This implies that a one unit increase in the number of audit committee members other explanatory variables held constant, decrease the residuals and consequently improve financial reporting quality. The results indicate that larger audit committees are more effective in monitoring and checkmating managerial opportunism towards managing earnings. Practically more responsibilities can be shared compared to a smaller committee. This therefore produce an evidence for rejecting hypothesis one which proposes that audit committee size has no significant impact on the quality of financial reporting of listed manufacturing firms in Nigeria. The finding of this study has the support of prior studies that found larger audit committees significantly associated with high level of reporting quality. These include Yang and Krishnan (2005), Lin *et al.* (2006), Felo *et al.* (2003). Conversely, Yadirichukwu and Bbimobowei (2013), Abbot *et al.* (2004), Bedard *et al.* (2004), Davidson *et al.* (2005), Baxter and Cotter (2005), Habbash (2010) did not find any significant association.

With respect to the association between audit committee independence and financial reporting quality, the results indicate a positive but insignificant association with a coefficient of 0.069 and a p-value of 0.533. This implies that the presence of an independent director in the audit committee does not help in mitigating earnings management by managers. This produces an evidence for not rejecting the null hypothesis which says that audit committee independence has no significant impact on the financial reporting quality of listed manufacturing firms in Nigeria. Studies that have found insignificant association between audit committee independence and the quality of financial reporting include Agrawal and Chadda (2005), Yang and Krishnan (2005), Uzun *et al.* (2004), Felo *et al.* (2003). Other studies have found significant association between the variables

including Klein (2002a), Bedard *et al.* (2004), Benkel *et al.* (2006), Habbash (2010), Xie *et al.* (2001), and Yadirichukwu (2013).

The association between audit committee financial expertise and financial reporting quality is negative (coefficient of -2130) with a p-value of 1% level of significance. This implies that the presence of at least one independent director on the audit committee strongly and significantly curb managerial opportunistic tendency to manipulate earnings thereby improving financial reporting quality. This therefore produce an evidence for rejecting hypothesis three which proposes that audit committee member financial expertise has no significant effect on the financial reporting quality of listed manufacturing firms in Nigeria. This finding has the support of the SEC code of corporate governance (2011) which not only recommends that memmbers of the audit committee of a firm should be financially literate and be able to read financial statements , but must have at least one member who is a financial expert. This result is also consistent with the vast majority of the previous research that investigates the effect of financial experts on earnings management, such as that of Dhaliwal *et al.* (2007), Park and Shin (2003), Carcello *et al.* (2006), Baxter and Cotter (2009), Lo *et al.* (2010), Habbash (2010) and Song and Windram (2004). Adulrahman and Ali (2006) is the only known to the researcher who contradicts the findings of this with regards to the effect of a financial expertise on the audit committee.

Table 4.3 shows a negative coefficient of -0.2241 and a p-value of 0.000 for audit committee number of meetings. This signifies a statistically strong relationship with financial reporting quality at less than 1% level of significance. The implication of this result is that a meeting of the audit committee four times a year helps in improving the financial reporting quality of listed manufacturing firms in Nigeria. This is tenable for practical purposes because with more meetings, members can devote more time to effectively scrutinize reports with a view of detecting opportunistic manipulations of earnings. This result produces an evidence of not rejecting the null hypothesis which says that audit committee member number of meeting has no significant impact on the quality of financial reporting of listed manufacturing firms in Nigeria. Prior studies that support the stand of this study are Xie *et al.* (2003), Farber (2005), Kent and Stewart (2008), Erena and Tehulu, (2012), Abbott *et al.* (2004) and Hwang and Lin (2010). Other studies that failed to find significant association are Uzun *et al.* (2004), Felo *et al.* (2003), Lin *et al.* (2006), Yadirichukwu and Ebimobowei (2013), Davidson *et al.* (2005) and Baxter and Cotter (2009). The main argument offered by this group is

that audit committee meetings are largely ceremonial and that they are largely ineffective in improving financial reporting.

For the control variables, firm size, measured by the natural log of the total assets expectedly has a negative (coeff. -0.087) and significant impact on financial reporting quality at 1% level of significance. This means that larger firms produce more qualitative and reliable information in their financial statements than smaller firms. For a one unit increase in size, all other variables remaining constant, there is a decrease in the residuals and therefore more improvement in the financial reporting quality. Level of leverage shows a positive but insignificant association with financial reporting quality.

## **5. Conclusion and Recommendations**

Agency theory posits that the separation of ownership and control inevitably leads to agency conflicts and their attendant costs. Managers who are largely not owners are of necessity put in charge of corporations. These managers are inclined for some reasons to behave opportunistically when it comes to financial reporting. The Board of directors through its audit committee is charged with the responsibility of checkmating managerial tendencies to manipulate financial reports. This study, by examining the characteristics of the audit committee, provides several theoretical, practical and regulatory implications for users of financial reports. The study is able to establish empirically that larger audit committee, the presence of a director on the committee who is a financial expert and at least four meetings within a financial year by the audit committee significantly influence quality of financial reports as proxied by earnings management. The study did not find any significant relationship between the presence of an independent director on the committee and earnings management. In line with the results, this study recommends that regulatory authorities should in line with current best practices ensure that all three director members on audit committee (as provided by the SEC code) of firms should be outside independent directors as opposed to the current requirement of only one independent director. This is sure to make a difference. It is also recommended that firms increase the number of audit committee meetings beyond the statutory requirements.

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