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# AUDIT COMMITTEE CHARACTERISTICS, BOARD CHARACTERISTICS AND FINANCIAL REPORTING QUALITY IN NIGERIA

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**Abstract**

*Objective of the study is to examine the relationship between audit committee characteristics, board characteristics and financial reporting quality in the Nigerian banking sector. A sample of nine banks was selected using the simple random sampling technique. Data for the selected banks were analyzed by employing ordinary least square regression technique. The period under review is ten years. The result of the study shows there is positive relationship between audit committee meetings and financial reporting quality. The study also shows that there is a negative relationship between board composition financial reporting quality .However the study revealed that there is no significant relationship between board size, board expertise and financial reporting quality. The study recommended that Apex bank should mandate audit committee of banks to meet at least four times in an accounting year.*

*Keyword: Audit committee, audit committee expertise, financial reporting quality, board structure, Nigeria*

## INTRODUCTION

Financial reports are the most crucial components of an accounting transaction. Financial reporting is aimed at giving information to guide stakeholders' decisions. It serves as a prospectus for potential investors and a barometer for ascertaining manager's performance (Schipper & Vincent, 2003). Sloan (2001) opines that financial report is the first source of independent information that communicates the activities of a company to stakeholders. Base on this some scholars liken financial report to a report card that is used to assess management's activities for an accounting year. However other scholars argued that it is unrealistic to assess managers' performance base on the content of financial reports because they have great input in the preparation these reports. Yusoff (2010) argues that the credibility and the reliability financial report lies on integrity of those involved in its preparation (like directors and auditors).

Good corporate governance is referred to as one of the most veritable tools that enhance the quality and the reliability of financial reporting in extent literature. The foregoing has made financial reporting quality a topical issue in most countries especially in the developed nations. Most the of emphasis on corporate governance is specifically placed on board characteristics (Yeo et *al*., 2002; Han, 2005; Beekes et *al*., 2004; Bradbury et *al*., 2006; Petra, 2007) and audit committee characteristics (Agrawal & Chadha, 2005). Most countries have formulated governance codes and mandate all companies operating within their boundaries to comply with these codes. These codes differ from one nation to another. In Nigeria, the governance code for bank was reviewed in 2010 by the apex bank. This transformation came shortly after the shaking that took place in the banking sector that rendered some banks insolvent. Sanusi (2012) and Brownbridge (1996) among others have provided anecdotal evidences of accounting choices in the Nigerian banking sector. Anecdotal evidence shows that the entire failed banks in Nigeria in the last decade had wonderful audited financial reports. Most of these banks declared huge profit but went under few months after these declarations. According to Sanusi (2012) one of the eight reasons for banking crisis in 2008 was "inadequate disclosure and transparency about financial position of banks." Various terminologies have been used to describe it, "inadequate disclosure and transparency" smoothing, bath accounting and creative accounting. The crises that bedeviled the financial sector post publication of audited financial reports have call for the concern of indigenous researchers. Some have argued that lack formidable audit committee is responsible for this abysmal reporting quality. Other pointed out that the chief cause for this crisis is lack activate board.

This paper focuses on the impact of the board and audit committee in actualizing qualitative financial reports in the Nigerian banking sector.

## LITERATURE REVIEW

### Board Composition and Financial Reporting Quality

Board comprises both executives and non-executive directors. Non-executive directors act as mechanism that enhances efficient monitoring. Non-executive directors help to curtail managerial excesses that is capable of lowing the quality of accounting information conveyed to the users of financial statements (Higgs, 2003). Many scholars are of the opinion that independence board has impact on financial reporting quality. Fama and Jensen (1983) opine that one of the key functions of non-executive directors is to ensure that the board does not to collude with management. Prior studies (Beasley, 1996; Dechow et. al., 1996; Peasnell et al., 2000; Klein; 2002, Davidson et al., 2005) documented a positive relationship between board independence and financial reporting quality. Kao and Chen (2004) and Jaggi et al. (2007) report negative relationship between financial reporting quality of firms in Taiwan and Hong Kong. Park and Shin (2004) On the other hand, did not find any significant relationship between reporting quality and independence board for Canadian firms .Abdullah and Mohammed (2004) and Abdulrahman and Ali (2006) did not also find any significant association between board independence and financial reporting quality of Malaysian firms. Klein (1996) and Peasnell, Pope and Young (2005) document a positive relationship between the size of the board of directors and the accounting quality.

### Audit Committee Financial Expertise and Financial Reporting Quality

Felo and Solieri (2009) termed audit committee members with financial experts to members that have past employment experience in finance or accounting, have professional certification in accounting, or any other financial oversight experience or backgrounds which result in financial sophistication. Song and Windram (2000) suggest that high level of financial literacy is needed for audit committee to effectively perform it oversight function of monitoring. The role of an audit committee in overseeing accountability of the management covers a wide scope, which include the overall process of corporate reporting. This demands the audit committee to possess accounting knowledge in order understand the financial report and make positive contribution that will lead to improved financial report. Financial literacy of audit committee member will go a long way to help in reducing fraud in corporate financial reporting. A formal recognition of this requirement was made in the U.S. by including a clause in Sarbanes-Oxley Act (2002) which stipulates every public listed company to disclose whether or not it has a financial expert in its audit committee.

Previous studies show that the fraudulent financial reporting companies have few members that have expertise in accounting (McMullen & Raghunandan, 1996; Beasley,

Carcello & Hermanson, 1999). DeZoort and Salterio (2001) document that audit committee members with accounting know- how are more likely to make better professional judgments than those without. Xie (2003), Abbott (2004) and Bédard (2004) document that audit committee financial expertise reduces financial restatements or constrains the tendencies of manager manipulating financial report. Krishnan (2005) and Zhang, Zhou and Zhou (2007) find that firms are more likely to be identified with deficiencies in internal control over financial reporting if their audit committees have less financial expertise. All, these studies suggest that financially knowledgeable audit committee members are more likely to prevent and detect material misstatements. Cohen et al. (2000) found that experienced external auditors believe that the lack of financial expertise of audit committee members negates the effectiveness of the committee.

Baxter and Cotter (2009) and Bédard *et al.* (2001) investigated the relationship between audit committee expertise and financial reporting quality in Austral and US. They both found negative relationship between the audit accounting expertise and financial reporting. However, some authors reported that an audit committee flooded with accounting expertise member is less productive, given that the audit committee members do not have a sufficiently broad range to detect financial irregularities

**Board Size and Financial Reporting Quality**

Fama and Jensen (1983) view the board as the firm's highest-level control mechanism, with ultimate responsibility of overseeing the activities of the firm. The literature on restatement, fraudulent financial statements, and financial reporting quality in general indicates that the composition and characteristics of the board influence its effectiveness in this regard. Board size is another determinant of financial reporting quality, the larger the board the more complex it will be as regard decision making. The size of the board of directors is often used by some scholars to measure the quality of corporate governance. Many scholars argued that the assertion that larger board size connotes viable governance is a misconception. On the contrary other scholars debunked the assertion that larger size boards are better off. Extant literature shows that board size play a significant role in directors' viability to check on managers . Lipton and Lorsch (1992) and Jensen (1993) argue that large board gives room for rowdiness which in turn lowers the monitoring function of the board. Contrary to this Adams and Mehran (2002) and Yermack (1996) argue that some organizations need larger boards for effective monitoring. This is also supported by Chaganti et al. (1985) who opine that large boards are useful for the breadth of their function. Klein (2002) finds that disintegration of board members into different committees largely depends on the size of the board. Monks and Minow (1995)

and Lipton and Lorsch (1992) further suggest that larger boards are able to commit more time and effort to monitor management. Beasley (1996) reports that board size has positive relationship with the likelihood of financial statement fraud while Uzun *et al*. (2004), Carcello and Nagy (2004a) and Farber (2005) found negative relationship between financial quality and board size. Jensen (1993) and Lipton and Lorsch (1992) report that large boards of directors are less amenable to effective monitoring and easier to be controlled by the CEO. Xie, Davidson and Dalt (2003) document an inverse relationship between the size of the board and the quality of financial reporting. Eisenberg, Sundgren and Wells (1998) and Yermack (1996) also found a negative relationship between the size of the board and the value of the company.

**Audit Committee Meetings and Financial Reporting Quality**

The effectiveness of audit committee depends on the extent to which the committee is able to resolve issues and problems faced by the company and to improve their monitoring functions of the company (Abbott, Park and Parker 2000). A more active audit committee is expected to provide an effective monitoring mechanism. Adeyemi, Okpala and Dabor (2012) observed that the more frequent the audit committee meets, the more opportunity it has to discuss current issues faced by the company. A more active audit committee is expected to provide an effective monitoring mechanism.

Beasley et al., (2009) suggest that audit committee meetings are not mere rituals devoid of interest to managers and auditors instead meaningful and substantive meetings are consistent with an agency perspective. Chen and Zhou (2008) noted number audit committee meeting as an important mechanism of corporate governance. Menon and Williams (1994) suggest a minimum of two meetings a year. This recommendation as to a minimum meeting frequency to guarantee effective audit committee control are supported by empirical evidence of a positive relationship between meeting frequency and the quality of a firm's accounting information (Abbot et al., 2004; Xie et al., 2003). It is argued that effective control is unlikely to occur if an audit committee holds a single yearly meeting, or none at all (Deli & Gillan, 2000; Klein & Garcia, 2007). Abbott et al. (2007) noted that an effective Audit committee should meet at least four times annually.

**METHODOLOGY**

**The study and the Data**

In this study, secondary data were drawn from annual reports and accounts of the selected firms for nine years (2006- 2014). The study employed ordinary least squares regression analysis technique. Gujarati (2003) suggests four critical assumptions that must be met before

utilizing the OLS regression. Firstly is the assumption of normality which requires that samples must be drawn from normally distributed populations and this will be examined using the Jacque-bera statistics.

Second is the assumption of linearity of the model parameters. A numerical test of linearity (White, 1980) will also be conducted.

Third, is the assumption of homoscedasticity which requires the variance or standard deviation of the dependent variable within the group to be equal and fourthly is the assumption of independence of error terms. Under this assumption the error terms are independent from one another and therefore no serial correlation exists. To test the homoscedasticity assumption, the auto regressive conditional heteroskedasticity (ARCH) test is utilized.

Finally, to test for multicollinearity, this study applies correlation coefficient and variance inflation factors (VIF) tests. Given the above discussion, the various tests are conducted to test the data against the OLS assumptions.

Thereafter preliminary analysis was conducted and then the regression estimates was computed. Indicators of the models statistical fit such as the $R^2$ and parameter significance such as the t-test and the probability values were examined.

**Model Specification**

The model is specified below;

FRQ = F (BSIZE, BCOMP, AUCMCA, AUCEXPT)

This can be re-specified in regression form as;

$FRQ = a + \beta_1 BSIZE + \beta_2 BCOMP + \beta_3 AUCMCA + \beta_4 AUEXPT + u$…… ……..(1)

Where: FRQ = Financial reporting quality

BSIZE = Board size

BCOMP= Board composition

AUCMCA=Audit committee activities

AUEXPT= Audit committee expertise

$U_t$ = Stochastic term

The a priori signs are $B_1 > 0$, $B_2 > 0$, $B_3 > 0$, and $B_4 > 0$

## ANALYSIS AND FINDINGS

Table 1 Descriptive statistics

| | ALLP | BSIZE | BCOMP | AUCMCA | AUCEXPT |
|---|---|---|---|---|---|
| **Mean** | 9487595 | 14.15152 | 0524848 | 4.0293242 | 3.12112 |
| **Median** | 4038847 | 14.00000 | 0.53000 | 3.300000 | 3.00000 |
| **Maximum** | 9964283 | 24.00000 | 0.79000 | 6.059000 | 6.00000 |
| **Minimum** | -9352220 | 7.000000 | 0.17000 | 2.030000 | 1.00000 |
| **Std. Dev.** | 31614502 | 0.466 | 0.13305 | 0.170787 | 0.98000 |
| **Jarque-Bera** | 14.63333 | 5.869665 | 8.21587 | 4.886940 | 1.260590 |
| **Probability** | 0.00064 | 0.053140 | 0.016446 | 0.086861 | 0.532435 |
| **Observations** | 99 | 99 | 99 | 99 | 99 |

From the descriptive statistics of the variables as shown in table 1 above, it is observed that ALLP as a mean value of 9487595 with maximum and minimum values of 9964283 and -9352220 respectively. The standard deviation measuring the spread of the distribution stood at 31614502 which is large suggest considerable dispersion in values for abnormal loan loss provision from the mean across the sample banks. BCOMP is observed with a mean value of 0.52 indicating that 52% of the board members are non executive members. This practice is still quite prevalent in financial institutions as there are regulations t in this regards. The standard deviation value of 0.46 indicates average clustering around the mean. The mean for BSIZE stood at 14.1. The standard deviation of 0.46 shows evidence of clustering of firm size around the mean. The mean value for AUDCMCA is 4.03 with maximum and minimum values of 6 and 2 respectively. The standard deviation stood at 0.17. Finally, the mean value for AUCEXPT stood at 3.12 with maximum and minimum values of 6 and 1 respectively. The standard deviation stood at 0.98. An evaluation of the Jarque-Bera statistics and probability show that only BDCOMP appears to be normal (P=0.0164).

Table 2 Pearson Correlation result

| | ***ALLP*** | ***BDCOMP*** | ***BSIZE*** | ***AUCMA*** | ***AUCEXPT*** |
|---|---|---|---|---|---|
| ALLP | 1 | | | | |
| BDCOMP | -0.005. | 1 | | | |
| BSIZE | -0.001 | 0.068 | | | |
| AUCMA | --0.003 | 0.008 | 0.006 | 1 | |
| **AUCEXPT** | 0.009 | 0.213 | 0.085 | 0.415 | 1 |

Table 2 above presents the Pearson correlation coefficient result for the variables. As observed, ALLP and BCOMP appear to be negatively associated as depicted by the correlation coefficient (-0.005). AUCMA also shows negatively correlated with ALLP (-0.003) and with BCOMP (0.068). BSIZE is observed to be negatively correlated with ALLP (-0.001), positively with BCOMP (0.008). Finally, AUCEXPT is observed to be positively correlated with ALLP (0.009), positively with BCOMP (0.213), positively with AUDCMA (0.415). The correlation coefficient results show that none of the variables are strongly correlated and this indicates that the problem of multicollinearity is unlikely and hence the variables are suitable for conducting regression analysis.

Table 3: Diagnostic Test

| Heteroskedasticity | Serial correlation(LM test) | Ramsey reset test |
|---|---|---|
| f-statistic =1.646 | f-statistic =0.6051 | f-statistic = 1.568 |
| Prob. F(6,672)=0.209 | Prob. F(6,672)=0558 | Prob. F(6,672)=0.136 |

The diagnostics tests for the regression results indicates the absence of in the model as the Breusch-pagan-Godfrey test was performed on the residuals as a precaution. The results showed probabilities in excess of 0.05, which leads us to reject the presence of heteroscedasticity in the residuals and hence we conclude that the assumption of uniform variance of the residuals is satisfied and the estimates are not biased. The LM test for high order autocorrelation shows that the likelihood of autocorrelation in the residuals is rejected and hence the regression estimates are not biased as the probabilities are greater than 0.05. The Ramsey RESET test was performed to determine whether there were specification errors. The results showed high probability values that were greater than 0.05, meaning that there was no significant evidence of miss-specification.

Table 4. Regression Result

| **Dependent Variable: DISACC** | | | | |
|---|---|---|---|---|
| Method: Least Squares | | | | |
| Convergence achieved after 8 iterations | | | | |
| **Variable** | **Coefficient** | **Std. Error** | **t-Statistic** | **Prob.** |
| C | 56158094 | 2517582 | 2.230666 | 0.0281 |
| BSIZE | -667552.1 | 986470.2 | -0.676708 | 0.5003 |
| BDCOMP | -59166691 | 25053825 | -2.361583 | 0.0203 |
| AUCMA | -1256280 | 3280491 | 2.382955 | 0.0201 |
| AUDEXPT | -577928.7 | 3606086 | -0.160265 | 0.8730 |
| R-squared | 0.6024 | | | |
| Adjusted R-squared | 0.5100 | | | |
| S.E. of regression | 3142359 | | | |
| F-statistic | 1.2190 | | | |
| Prob(F-statistic) | 0.029 | | | |
| Durbin-Watson stat | 2.0159 | | | |

Table 4 above shows the ordinary least squares regression result conducted using Eviews , $R^2$ and coefficient is 0.60 which indicates that the model explains about 60% of the systematic variations in the dependent variable. The F-stat value of 1.21 and the associated p-value of 0.029 is significant and depicts a linear relationship between the dependent and independent variables. This does not provide the basis for rejecting the hypothesis of a joint statistical significance of the model in addition to the assumption of linearity of the model at 5%. The shows there is negative though insignificant relationship between BSIZE and financial reporting quality (ALLP) since at 5% $t_{cal} < t_{cri}$ (-0.67<2). The finding is in variance with a prior expectation. The result is also in variance with Adams and Mehran (2002) and Yermack (1996) who discovered a negative relationship between board size and financial reporting quality. Furthermore, it also contrary to Chaganti et al. (1985) that shows that there is a positive relationship between board and financial reporting quality.

The result also shows that there is a negative and significant relationship between board composition and financial reporting quality since calculated t-value of 2.36 is greater critical value of 2 ($t_{cal} >$ tcri, 2.36>2). This was further validated by comparing p- value with 0.05. (p=0.0203<0.05). The finding suggests that the nature of the board composition exerts a significant influence on the level of reporting quality and that the existence of a higher number of external directors could be related to higher reporting quality. The finding is in variance with extant positive of Beasley (1996), Dechow et. al., (1996) , Peasnell et al., (2000) ,Klein (2002) and Davidson et al.( 2005) and corroborate with negative reported by Kao and Chen (2004)

and Jaggi et al. (2007). This suggests that higher number of independent board members will increase monitoring of management enhance improved reporting quality financial . The Durbin Watson statistic of 2.0 suggests that the presence of serial correlation between the residuals is unlikely.

The impact of audit committee expertise on financial reporting quality (ALLP) appears to be negative. However the relationship is not statistically significant at 5% .Since the value of calculated t is less than critical value of t (tcal= 0.16,<tcri=2) To further ascertain the result we compare p-value with 0.05 ( =0.08< 0.05). The result confirms also that a negative but statistically significant relationship between audit committee expertise and financial reporting quality in the Nigerian banking sector. The finding is consistent Xie (2003), Abbott (2004) and Bédard (2004) which show that audit committee financial expertise reduces financial restatements or constrains the tendencies manager of manipulating financial report.

Finally, the result shows that there is a positive and significant relationship between Auditor committee meetings on financial reporting quality (ALLP) at 5%. Since calculated value of t is greater than the critical value t ($t_{cal}$=-2.38, $t_{cri}$=0.0201< 0.09). The finding is in line with extant negative of Deli and Gillan( 2000) and Klein and Garcia (2007). Therefore, with regards to the theoretical expectations on the relationship between audit committee meetings and the level of financial reporting process, the expectations could be inconclusive The Durbin-Watson value of 1.78 indicates that stochastic dependence between successive units of the error term is unlikely in the model.

## SUMMARY AND CONCLUSION

The widespread failure in the financial crisis has created the need to improve the financial information quality. Consequently, the factors influencing financial reporting quality have been an intense and inconclusive area of research and an interesting issue of discourse. The study found the existence of negative though insignificant relationship between Board size and financial reporting quality in the Nigerian banking sector. The reform within the sector is responsible for this. The power of the board has been whittle down by regulatory bodies that its impact in financial reporting cannot be felt. The influence of Board composition on financial quality in the Nigerian banking sector appears to also be negative and significant. This implies that more executive members led reduction in financial reporting quality. This is based on the argument that non-executive member that constitute more than 50% of board are not familiar with the reporting ecosystems of the Nigerian banks. Most of them are appointed based on political reasons and not on merit. The impact t of auditor committee meetings on financial reporting quality appears to be positive and significant. This implies that activated audit

committee leads to qualitative financial reporting. Finally, the audit committee expertise on financial appears to be insignificant.

The study recommends that the regulatory bodies should ensure that nomination of non-executive directors should be on merit basis and not on political affiliations. The apex bank should also ensure that large portion of these directors is schooled in finance. Finally, there is a need to make audit committee activate by regular meetings. Apex bank should mandate audit committee of banks to meet at least four times in an accounting year.

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## APPENDICES

## APPENDIX 1

Dependent Variable: ALLP
Method: Panel Least Squares
Date: 09/30/15 Time: 20:37
Sample: 2006 2014
Periods included: 9
Cross-sections included: 11
Total panel (balanced) observations: 99

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| C | 56158094 | 25175482 | 2.230666 | 0.0281 |
| BSIZE | -667552.1 | 986470.2 | -0.676708 | 0.5003 |
| BCOMP | -59166691 | 25053825 | -2.361583 | 0.0203 |
| AUDCUM | -1256280. | 3280491. | -2.382955 | 0.0201 |
| AUEXPT | -577928.7 | 3606086. | -0.160265 | 0.8730 |

| | | | |
|---|---|---|---|
| R-squared | 0.602467 | Mean dependent var | 9487595. |
| Adjusted R-squared | 0.510062 | S.D. dependent var | 31614502 |
| S.E. of regression | 31423259 | Akaike info criterion | 37.42269 |
| Sum squared resid | 9.18E+16 | Schwarz criterion | 37.57997 |
| Log likelihood | -1846.423 | Hannan-Quinn criter. | 37.48632 |
| F-statistic | 1.239299 | Durbin-Watson stat | 1.785992 |
| Prob(F-statistic) | 0.029138 | | |

## APPENDIX 2

**CORRELATION**

| | ALLP | BSIZE | BCOMP | AUCMS | BEXPT |
|---|---|---|---|---|---|
| ALLP | 1.000000 | | | | |
| BSIZE | 0.006885 | 1.000000 | | | |
| BIND | -0.223853 | -0.283528 | 1.000000 | | |
| BGD | -0.052626 | 0.014442 | 0.012425 | 1.000000 | |
| BEXPT | -0.022542 | 0.067473 | -0.112467 | 0.145412 | 1.000000 |

## APPENDIX 3

**DESCRIPTIVE STATISTICS**

| | ALLP | BSIZE | BCOMP | AUCM | BEXPT |
|---|---|---|---|---|---|
| Mean | 9487595. | 14.15152 | 0.524848 | 0.293242 | 3.121212 |
| Median | 4038847. | 14.00000 | 0.530000 | 0.300000 | 3.000000 |
| Maximum | 99642830 | 24.00000 | 0.790000 | 0.590000 | 6.000000 |
| Minimum | -93522200 | 7.000000 | 0.170000 | 0.030000 | 1.000000 |
| Std. Dev. | 31614502 | 3.408763 | 0.133059 | 0.170787 | 0.939743 |
| Skewness | 0.101318 | 0.536265 | -0.673511 | 0.142413 | 0.276236 |
| Kurtosis | 4.872545 | 3.522140 | 3.420853 | 1.949488 | 2.980682 |
| | | | | | |
| Jarque-Bera | 14.63338 | 5.869665 | 8.215287 | 4.886894 | 1.260590 |
| Probability | 0.000664 | 0.053140 | 0.016446 | 0.086861 | 0.532435 |
| | | | | | |
| Sum | 9.39E+08 | 1401.000 | 51.96000 | 29.03100 | 309.0000 |
| Sum Sq. Dev. | 9.79E+16 | 1138.727 | 1.735073 | 2.858488 | 86.54545 |
| | | | | | |
| Observations | 99 | 99 | 99 | 99 | 99 |