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Audit Committee Characteristics and Financial Statement Quality of Deposit Money Banks in Nigeria

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ABSTRACT

Audit committee serves as watchdogs or security, and users of financial statements will usually make decisions based on the analysis of the various reports presented by the audit committee, emphasizing the level of the duty of care auditors are obligated to exercise to the board of directors and general public alike. However, there are disagreements and criticisms on the relevance of audit committees and their practices and the analysis of their reports in the financial statement. It is in the light of this development that this study evaluates the impact of audit committee function on the quality of financial statement of manufacturing firms in Nigeria. Panel regression analysis was employed as an analytical tool, and the result shows that audit committee expertise, audit committee meeting, audit committee size and audit committee independence have significant impact on quality of financial statement of manufacturing firms in Nigeria. The study then concluded that audit committee contributes positively to the quality of financial statement of manufacturing firms in Nigeria. The study therefore, recommends that Nigerian manufacturing firms should increase the number directors with accounting or financial background in the composition of audit committee, Number of meeting held in year, maintain the size of audit committee and increase the number of independent directors with in the composition of audit committee in order to improve more on the quality of financial statement.

Keywords: **Audit Committee Characteristics, Quality of Financial Statement, Audit Committee Independent, Audit Committee Expertise; Audit Committee Size, Audit Committee Meeting.**

1. INTRODUCTION

Nigeria has witnessed a series of corporate collapses and related frauds that have raised doubts about the credibility of corporate governance in the country. This gives rise to the importance of audit committee being present in every business environment in the country to improve the quality of financial statements and also to promote credibility, accountability, professionalism, transparency, reasonable assurance to the board of directors through the expression of a qualified opinion, a disclaimer of opinion, or an adverse opinion as the case may be. Given the importance of audit committees, listed companies in Nigeria are required to include in their annual reports a summary of activities carried out by their audit committees.

Accountability is realized through the issuance of periodic financial reports. However, since this information provided by the management may be biased, and outside parties have no direct means of monitoring, an audit is required to assure the reliability of this information. The role of auditing in firms is very essential in determining whether the overall financial statement is presented fairly in accordance with the established standards which facilitate asset identification and assist in thedetecting of management funds misappropriated. The main goals of an audit is for the auditor to express opinion as to whether the financial statement as a whole presents a true and fair view and free from material misstatement.

Audit committee as an integral part of corporate governance structure and one of the mandatory committees of the board of directors is established to provide support to the board by offering objective advice on issues concerning risk, control and governance of the organization in order to promote good governance. Traditionally, the primary role of audit committee is to monitor the integrity of the financial statements produced by management. In recent times, this major role has been expanded beyond enhancing the quality of annual financial statements to encompass the quarterly financial reports. Owing to this, audit committees are becoming more involved in the oversight of corporate reporting matters as contrasted with financial reporting. According to Owolabi& Dada (2011), considering the quantum of corporate collapses and failure, it is imperative that audit committee is taken more seriously in every corporate organization. The audit committee serves as a liaison between the external auditor and the board of directors, and facilitates the monitoring process by reducing information asymmetry between the external auditor and the board.

In firm, the shareholders are the ones who ultimately approve the auditors' appointment, and the auditors are primarily responsible to oversee the activities of those representing the shareholders interest with regards to financial reporting and internal control. Essentially, an audit committee, acting as a largely independent body being charged with representing the shareholders interest. The audit committee is a sub-committee of those charged with governance, and is typically made of a majority of non-executive directors who are the shareholder's representatives in relation to the external audit. They are usually responsible for overseeing the audit and evaluating the independence and performance of the auditors.

The primary role and responsibility of audit committees is to make recommendations on the appointment and change of external auditor; it covers wider areas including the monitoring of managers and review of the company's internal control system (DeZoort, Hermanson, Archambeault, Reed, 2002), (Aldamen, Duncan, Kelly, McNamara, Nagel, 2012). It has been found that knowledgeable audit committees help enhance the company's performance; therefore, good characteristics of audit committees are associated with good company performance (Shafie Mohamed Zabri et al. 2016).

Evidence has shown a significant rise and harmonization in the use of audit committees internationally, including the European Commission's requirement that all public-interest entities in the European Union have an audit committee (Collier &Zaman, 2005).In Nigeria, the audit committee is referred to as a "committee of directors and the enterprises shareholders representatives whose specific responsibility is to review the annual financial statements before submission to the Board of Director. In Nigeria, SEC, under the provisions of the Companies and Allied Matters Act (CAMA 2004: Section 359, sub-section 3&4), requires all listed companies on the Nigerian stock exchange (NSE) to establish audit committees (SEC, 2003).

Likewise, in the United States (US), in 2002, the Sarbanes-Oxley Act (SOX) also known as the Corporate Oversight Bill containing eleven sections was passed by the United States Congress due to a series of well publicized accounting scandals including Enron and Worldcom. This Act required, among other things, that companies use audit committees and disclose the composition of their audit committees in their annual reports. Essentially, the role of audit committee continues to evolve as a result of this Act.

Audit committees have been in existence for decades. However, there are criticisms of the practices of audit committees and their relevance. This committee consists of shareholders and directors who are expected to carry out oversight functions and present their report to shareholders contained in the financial statement (CAMA, 2004). However, these committee members might not be capable of handling the expected responsibilities since the same law is silent as to their professional capacity or qualifications. In addition there are disagreements and criticisms on the relevance of audit committees and their practices and the analysis of their reports in the financial statement. Therefore, this study evaluate the role audit committee characteristics play on the quality of financial reporting, and specifically focused on the effectiveness of audit committee independence, diversity, financial competence and meetings on financial statement quality of deposit money banks in Nigeria.

2. LITERATURE REVIEW

Financial Statement quality

Baxter (2007) defines financial reporting quality as the precision with which financial reports convey information about the firm's operations, in particular its cash flows, in order to inform equity investors. Zubair (2016) defines financial reporting quality as the extent to which the financial statements provide true and fair information about the underlying performance of financial reporting quality. Jonas & Blanchet (2000) state that quality financial reporting is full and transparent financial information that is not designed to confuse or misinform users. International Accounting Standards Board (2008) states that the objective of financial reporting is to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders and other creditors in making decisions in their capacity as capital providers.

The qualitative characteristics of financial reporting quality include: relevance, faithful representation, understandability, comparability, verifiability, and timeliness. They are divided into fundamental qualitative characteristics and enhancing qualitative characteristics. A theoretical explanation for each of these terms emphasizes their importance as qualitative characteristics, and also indicates what qualities are considered fundamental among different frameworks.

Audit Committee Characteristics

The audit committee has the responsibility for hiring, evaluating performance, and compensating external auditors in entities. Also, the audit committees oversee and supervise financial reports and disclosures of entities by monitoring choices of policies and accounting principles, and what internal control designs managements have used. Audit committees have contributed to enhancing the quality of financial reporting. The more independent, more capable, and more qualified the audit committees are, the better their ability to detect material misstatements in the financial information, and the better their ability to deter any opportunities for managements to manipulate reporting. Thus, the audit committee attributes have fundamental impacts on both financial reporting quality and audit inputs. Furthermore, changes in the audit committee governance are associated with enhancements of financial reporting quality (Zang, Kim, Benjamin& Dan, 2013). Omokhudu&Amake (2018) view audit committee as an intermediary or a watch dog. The financial statement users will normally take actions based on the analysis of the various reports contained in financial statements

Audit Committee Independence

Independence of audit committees helps to ensure that management is transparent and will be held accountable to stakeholders (Treadway Commission, 1987; Cadbury Committee, 1992; Blue Ribbon Committee, 1999). It is expected that independent audit committee members will be more objective and less likely to overlook possible deficiencies in the misappropriation and manipulation of financial reporting. Abbott et al. (2004) found evidence to support this interpretation within the context of financial reporting misstatements. After the passage of SOX in 2002, audit committees in the US must consist entirely of independent members to pre-approve audit and non-audit services and to set procedures for handling complaints related to accounting and auditing issues. Klein (2002) posited that independence of audit committees increases with board size and board independence. Beasley, Carcello, Hermanson& Neal (2000) found that audit committee independence is significantly related to financial reporting quality, since financial statement fraud is more likely to happen in firms with less audit committee independence.

Audit committee expertise

De Fond, Hann& Hu (2005) investigated how markets react to the appointment of an audit committee member with a different level of accounting and financial expertise and found a positive market reaction to appointing accounting and financial expert.Carcello, Hollingsworth, Klein & Neal (2006) studied the association between financial expertise and earnings management proxy by abnormal accruals and found that accounting and financial experts are consistently associated with less earnings management. Dhaliwal, Naiker&Navissi (2010) found a positive relationship between accounting and financial expertise in audit committees and financial reporting quality.

Audit committees that have financial expertise have greater interaction with their internal auditors (Raghunandan, Read& Rama, 2001) and are less likely to witness internal control problems (Krishnan, 2005).Davidson, Xie&Xu (2004) investigated the impact of financial expertise of audit committees on stock returns at the time of appointment of audit committee members and found a positive stock price reaction when new members have accounting or financial expertise. On the other hand, Yang and Krishnan (2005) and Lin et al. (2006) found no significant association between financial expertise and financial reporting quality measured as the level of earnings management.

Audit committee size

Previous researches have investigated the role of the size of audit committees as an effective mechanism for monitoring and controlling financial reporting. Yermack (1996) found that a small board size enhances firm value. Jensen (1993) asserted that having a small number of board members improves the efficiency of audit committee monitoring and control. Goodstein, Gautam, &Boeker (1994) posited that large board size is associated with delays and administrative bottlenecks. However, other studies suggested that smaller boards may be less encumbered with bureaucratic problems. Anderson, Mansi&Reeb (2004) stated that large boards can devote more time and resources to monitor the financial reporting process and the internal control systems. This implies that an increase in audit committee size enables members to distribute the workload and commit more time and resources to monitor management and detect fraudulent behavior.

Stewardship Theory

Stewardship theory has its root from psychology and sociology and it stresses the role of top management being as stewards, integrating their goals as part of the organization as opposed to the agency theory perspective. The stewardship perspective suggests that stewards are satisfied and motivated when organizational success is attained. It is based on a model of man where a steward perceives greater utility in cooperative, pro-organizational behavior than in self-servingbehaviour, the theory assumes a strong relationship between organizational success and a principal's satisfaction. Hence, a steward overcomes the trade-off by believing that working towards organizational, collective ends meet personal needs as well (Penman,2007).

The theory recognizes the important of structures that empower the steward and offers maximum autonomy built on trust. In order to protect their reputation as decision makers in organizations, executives and directors are inclined to operate the firm to maximize financial performance as well as shareholders' profit. In this sense, it is believed that the firm's performance can directly impact perceptions of their individual performance. Abdullah & Valentine (2009) contend that executives and directors are also managing their careers in order to be seen as effective stewards of their organization. The international accounting and standards board(IASB) and financial accounting standards board (FASB) are currently developing a common conceptual framework which reflects financial statements as a sign of stewardship of the agents to the principals.

Empirical Review

Peter &Hannu (2017) examined the link between audit committee adoption and financial value in UK as well as their impact on firm value during the pre/post global financial crisis era. The regression result revealed that the adoption of audit committee by firms has a positive and statistically significant effect the value of the firm.

Berkman&Zuta (2017) evaluated the link between attributes of the audit committee of firm and the likelihood of negative events occurring in the firm's life in Israel using hand-collected data from 2010-2014. The regression result revealed that the larger the audit committee size, the larger the likelihood of negative events, consistent with cumbersome working and likely conflict of interests of a large audit committee.

Maina&Oluoch (2018) examines the effect of corporate Audit Committee characteristics on financial performance of manufacturing firms in Kenya. The study revealed that there exists a significant relationship between Audit Committee composition and Audit Committee meetings frequency and firms Financial Performance.

Orjinta&Ikueze (2018) examined the effect of Audit Committee characteristics on performance of selected non-financial firms quoted in Nigerian Stock Exchange. A sample of 50 listed firms was used for the period 2007 to 2016. The result revealed that there is a significant positive relationship between Audit Committee independence, Audit Committee meeting and firm performance at 5% level of significant.

Olayinka (2019) examined the effect of Audit Committee Effectiveness on the growth of Firms Performance in Nigeria with emphasis on Eight Public Quoted Banks in Nigeria. The findings revealed that Audit Committee size, frequency of Audit Committee's meetings and financial literacy of Audit Committee members have no significant effect on firms' performance in Nigeria.

Olowookere, Oyewole&Lamidi(2020) study examined the effect of audit committee gender diversity on financial reporting quality of consumer goods companies listed on the Nigerian Stock Exchange from 2009 to 2019. The result shows that having a diverse member in audit committee increases financial reporting quality.

Abiola &Arowolo (2020)examines internal audit committee and corporate governance of selected firms in Nigerian manufacturing sector from 2008 to 2017. The study found that audit committee size has no significant impact on the board size; audit committee size has a positive effect on non-executive director size but there is no significant effect; there is no positive and significant effect of audit committee size on executive director size of firms in the manufacturing sector. The study concluded that audit committee size has no significant effect on corporate governance.

Daniel, Eguasa& Excellence (2021)examined the impact of audit committee characteristics on the financial performance of eighteen listed consumer goods companies in Nigeria spanning from 2010-2019. The study found that frequency of audit committee meetings, independence of audit committee and audit committee size have significant effect on financial performance. The study concluded that the presence of audit committee is vital in companies.

Iheyen (2021) investigated the relationship between audit committee attributes and the value of the firm of listed insurance companies in Nigeria, from 2012-2019. The result revealed that audit committee independence havepositive and significant effects on firm value, audit committee remuneration and audit committee size haveno significance effect on the firm value of insurance companies in Nigeria.

3. RESEARCH METHODOLOGY

This study applied ex-post facto design by using the already existing secondary data involving listed deposit money banks in Nigeria. The design ensures the reliability of the data since the data were obtained outside the influence of the researcher.

The study population refers to the entire elements under study; thus, the study population comprised of all listed deposit money banks on the Nigerian Stock Exchange (NSE) as at 31st December, 2021.

The purposive sampling technique was adopted in selecting ten (10) listed deposit money banks on the NSE with complete dataset required for the investigation. The complete dataset implies banksthat disclosed audit committee attributes measures like audit committee size, audit committee independence, audit committeeexpertise and audit committee number of meetings. Thus, annual data in respect of the sampled listed deposit money banks were obtained for a period of 5years spanning from 2016 – 2021.

The sources of data in this study emanated from secondary; the secondary data includes those obtained from NSE Fact-book and the annual reports and accounts. These data are deemed valid by the regulatory framework of business and capital markets operations in Nigeria; hence there was no need for validity and reliability of the research instruments of the study.

The study employed secondary data from the annual reports and accounts and Nigerian Stock Exchange Factbook of quoted insurance companies in Nigeria. However, due to the nature of data that obtained, a panel regression statistical analysis was employed.

Emanating from existing literature, audit committee independence, audit committee expertise, audit committee frequency of meetings and audit committee size are observed to have effect on financial reporting quality**.**Audit committee independent was measured by the number of independent members in each audit committee.Audit committee expertise was measured by the number of members with financial and accounting expertise over total audit committee members. Audit committee frequency of meetings was measured by the number of audit committee meetings per year. Audit committee size was measured by the number of members in each audit committee for the selected companies. Discretionary accrual was adopted as a proxy for financial reporting quality. The model is expressed as;

$DACCR_{it} = b_0 + b_1ACI_{it} + b_2ACE_{it} + b_3ACFM_{it} + b_4ACS_{it} + e_{it}$

Where;

DACCR=discretionary accruals as proxy for financial reporting quality, measured as follows

$DACCR_{it} = (\Delta CA_{it} - \Delta CL_{it} - \Delta Cash_{it} + \Delta STD_{it} - CF_{it})/(A_{it-1})$

Where TAS = total accruals, ΔCA = change in current assets ΔCL = change in current liabilities ΔCash = change in cash and cash equivalents ΔSTD = change in debt included in non-current liabilities CF = cash flows, A = total assets.

ACI=audit committee independence,*ACE*= audit committee expertise, ACFM= audit committee frequency of meetings, ACS= audit committee size

B_0 = Intercept, $b_{1,2,3,4}$= coefficient of the independent variables, e_{it} =error term of the model

4. RESULTS AND DISCUSSIONS

Table 1: Multi-collinearityTest - Variance Inflation Factors

Variable	VIF	1/VIF
ACS	2.07	0.4837
ACI	1.87	0.5361
ACFM	1.19	0.8426
ACE	1.29	0.7778
Mean VIF	1.60	

Source: Author's Computations, 2022

In table 1, the Variance inflation factor of multicollinearity for detection of possible strong relationship between independent variables the presence of which violates the assumption estimation techniques. VIF shows the existence of which the standard error is inflated due to relationship between dependent variables. As a general rule of thumb the higher the VIF the more troublesome or the more likely there is multicollinearity. On the other a VIF in excess of 5 calls for further investigation. If VIF exceeds 10, it suggests serious multicollinearity requiring correlation. Gujarati (2004) states that the closer the value to zero, the greater the degrees of multicollinearity while the closer to 1, the greater the evidence that the regressors are not collinear. However, from the result, the value of independent variables exceed 1, therefore, there is absence of multicollinearity. In lieu of this, there are no multicollinearity issues between the independent variables within this model as all the VIF's are less than 10. The VIF and tolerance can be used interchangeably to determine multicollinearity as the VIF is an inversely related to tolerance. The VIF represents a measure of the amount of multicollinearity in a multiple regression framework. Tolerance is a measure of the scale of the predictability of the specified variable not explained by other predicted variables in the model.

Table 2: Breusch-Pagan/ Cook-Weisberg Test for Heteroskedasticity

Variable	**Chi^2**	**P-value**
Model	1.43	0.3653

Source: Author's Computations, 2022

Heteroskedasticity shows in a model if the variances of the error- term of the different observation are different. This study analyze Breusch-pagan test to check if there is problem of heteroskedasticity. The Breusch-pagan tests of the null hypothesis that the error variances are all equal against the alternative that the error variance are a multiplicative function of one or more variables. The result of P-value (0.3653) is greater than 5% significance level, the null hypothesis was rejected. Therefore, these models do not face any heteroskedasticity problem. This implies that the variations between independent variables are fairly small.

Table 3: Regression Result: Audit Committee and quality of Financial Statement

Variables	**Pooled OLS Model**	**Fixed-effects Model**	**Random-effects Model**
Constant	-0.6609 (0.386)	-0.1079 (0.883)	-0.6609 (0.931)
ACS	0.4238*** (0.007)	0.0523** (0.030)	0.4669*** (0.005)
ACI	1.1732*** (0.000)	0.0518** (0.029)	1.1611*** (0.000)
ACFM	0.0576** (0.010)	0.0291 (0.879)	0.0675** (0.010)
ACE	0.0583** (0.030)	0.1582 (0.478)	0.0547** (0.029)
R-Square	0.7555	0.6012	0.7355
Error term	0.0885		
F-stat	10.20*** (0.0000)	4.29*** (0.0075)	
Wald X^2			24.82*** (0.0001)
Hausman Test		0.27 (0.8752)	
Breusch and Pagan Lagrangian Multiplier Test	15.57*** (0.006)		

*, **, *** : denotes Significant at 10%, 5% and 1% level respectively.

Bracket: denotes P-value, while the value denotes Coefficients

Source: Author's Computations 2022

Table3 presents the linear relationship between audit committee and quality of financial statement of deposit money banks in Nigeria, with the use of panel regression analysis. The table shows the result of the pool OLS, fixed-effects and random-effects of the model and post estimation test ofBreusch and Pagan Lagrangian multiplier test (poolability test) and hausman test .

Poolability test was conducted with the use of Breusch and pagan Lagrangian multiplier test to check the model that appropriate between pool OLS model and random-effects model, the result shows that random-effects is appropriate as indicated by P-value 0.000 less than 0.05 significance level.

Hausman was also computed to check which model is appropriate between fixed-effects and random-effects, the result shows that random-effects model is appropriate as indicated by P-value 0.8752 higher than 0.05 level of significant.

The sign of the coefficient that signify the impact of audit committee and quality of financial statement of deposit money banks in Nigeria, it shows that all variables have positive sign, this implies that there in direct relationship between dependent variables and quality financial statement. The sign and magnitude of the coefficient of each characteristics of audit committee were present as follows:

Audit committee expertise (ACE) has positive significant effect on quality of financial statement of deposit money banks in Nigeria, as indicated by coefficient (0.0547) with P-value (0.029) less than 0.05 significance level. The null hypothesis was rejected; this implies that an increase in the number of audit committee expertise of deposit money bankss in Nigeria will induce 0.05% improvement in the quality of financial statement.

Audit committee meeting (ACFM) also has positive significant effect on quality of financial statement of deposit money banks in Nigeria, as indicated by coefficient (0.0675) with P-value (0.010) less than 0.05 significance level. The null hypothesis was also rejected; this implies that an increase in the number of audit committee meeting of deposit money banks in Nigeria will induce 0.07% improvement in the quality of financial statement.

Audit committee size (ACS) also has positive significant effect on quality of financial statement of deposit money banks in Nigeria, as indicated by coefficient (0.4669) with P-value (0.005) less than 0.05 significance level. The null hypothesis was also rejected; this implies that an increase in the size of audit committee of deposit money banks in Nigeria will induce 0.47% improvement in the quality of financial statement.

Audit committee independence (ACS) also has positive significant effect on quality of financial statement of deposit money banks in Nigeria, as indicated by coefficient (1.1611) with P-value (0.000) less than 0.05 significance level. The null hypothesis was also rejected; this implies that an increase in the number independent director of audit committee will induce 1.16% improvement in the quality of financial statement of deposit money banks in Nigeria.

Overall, the result of the Wald X^2 (24.82) with P-value (0.0001) at 5% level of significant, this indicate that audit committee characteristic of deposit money banks in Nigeria have significant effect on quality of financial statement. This implies that audit committee characteristics of manufacturing firms in Nigeria contribute positively to the quality of financial statement.

Conclusion

Based on the result of the study, it was concluded that the characteristics of audit committee put in place by the board of director and shareholders of deposit money banks in Nigeria influences the quality of financial statement that will be presented. When individual characteristics of audit committee is considered, it was concluded that: audit committee expertise, number of meeting held by audit committee, size of audit committee and audit committee independence influences the quality of financial statement positively and significantly.

Recommendations

Based on the conclusion, it was recommended that: Nigerian deposit money banks should increase the number directors with accounting or financial background in the composition of audit committee, number of meeting held in year a by should be increased, maintain the size of audit committee recommended by the Sarbanes-Oxley (at least 6 members) Act and finally increase the number of independent directors with (non-executive) in the composition of audit committee in order to improve more on the quality of financial statement that will be presented to their shareholders.

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