

Audit Committee Independence, Size and Financial Reporting Quality of Listed Deposit Money Banks In Nigeria

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Abstract: *This study examines the effect of audit committee independence and size on financial reporting quality of listed deposit money banks (DMB) in Nigeria. Cross sectional data was obtained from the Nigerian Stock Exchange fact books and the financial statements of fifteen (15) listed deposit money banks over a period of ten years (2007-2016). The modified Jones (1991) model was adopted to measure financial reporting quality. The data was analyzed using STATA 13. The study reveals that audit committee independence has a negative but significant effect on financial reporting quality of listed deposit money banks in Nigeria. Also, audit committee size has no significant effect on the financial reporting quality of listed deposit money banks in Nigeria. The study concludes that audit committee independence has a negative and significant effect while audit committee size is positive and has an insignificant effect on financial reporting quality of listed deposit money banks in Nigeria. Based on the conclusion, the study recommends that (i) Deposit money banks in Nigeria should ensure that their boards are independent as this is likely to enhance financial reporting quality; and (ii) Management of deposit money banks in Nigeria should consider the provisions of the Nigerian code of corporate governance in audit committee composition. This will improve the financial reporting quality of DMB's.*

Keywords: *Audit Committee Independence, Size, Financial Reporting Quality, Discretionary Accruals.*

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I. Introduction

Financial reporting are the most crucial components of the accounting information system. In a contemporary financial world today, it is aimed at giving information to guide stakeholders' decisions. Financial reporting in banks is essentially the responsibility of directors and this is carried out by accountants and verified by auditors. It is targeted at producing reliable in addition accurate information to assist users in taking a good stand. Financial statements should be capable of revealing relevant, reliable, comparable and comprehensive information and this primarily possible by the effective and efficient working of audit committee. Hence, Audit committee is the organic to quality financial reporting. An audit committee is an operating committee of the board of directors charged with oversight of financial reporting and disclosure. Committee members are drawn from members of the company's board of directors, with a Chairperson selected from among the committee members. Audit committee guarantees the protection of the shareholders welfare by way of ensuring financial reporting quality (Krishnan, 2005). Basically, audit committee monitors the procedures involved in financial reporting and to check the likelihood of managers to control earnings. Recently, audit committee has become obligatory for listed companies particularly, banks. Audit committee supervises operations in large firms in capital market. This makes the audit committee a system of respectable structure of procedures, practices and methods by which a company is directed and well-ordered.

The search for mechanism to ensure reliable, high quality financial reporting has largely focused on the structure of audit committee, whose function is to oversee the financial reporting process as well as the audit of financial statements. Quite understandably, expectations will be high on the audit committees to be more active and participative in ensuring the proper management of the companies. Audit committees are expected to resolve the agency conflicts between the managers and the fund providers and thus enhance the quality of financial reporting.

However, several corporate collapses such as Enron and Arthur Anderson as well as fluctuating economic climate propelled the development of good corporate governance for disciplining listed companies

(Barrier, 2002 and Cadbury Report, 1992). The Cadbury Report (1992) was concerned with corporate governance mechanisms being compromised by reduced Financial Reporting Quality. Barrier (2002) argues that the credibility and the reliability on financial report lies on integrity of those involved in its preparation (like directors and auditors). The prevailing weak internal control and fraudulent activities among others that are visible within deposit money banks have posited an inimical cordiality to the general public.

The crises that bedeviled the financial sector post publication of audited financial reports have called for the concern of indigenous researchers. Some have argued that the lack of formidable audit committee is responsible for this abysmal reporting quality. Though audit committees have been argued to improve a firm's financial reporting processes, as only few countries, Nigeria inclusive have actually incorporated audit committee formation in their Companies Act. Section 359(3) of CAMA 1990 provides for the establishment of audit committee in public companies in Nigeria. Section 359(4) CAMA elaborates this provision further by providing that membership of the committee be comprised of equal number of directors and shareholders' representatives and that the maximum members of the committee shall not exceed six. In 2003, the Nigeria security and exchange commission (SEC) issued a code of Best Practices of Corporate Governance and this code in S. 11(a) provides for the establishment of audit committee in public companies in Nigeria. It specifies further that directors' representatives in the audit committee should mainly be Non-Executive Directors (NED) with not more than one executive member S. 12(a) SEC code (2003), (Gabriel, 2012).

The CBN also a regulatory agency of the banking sector issued a Code of Corporate Governance for Banks in Nigeria Post Consolidation effective from 3rd April, 2006. In S. 5.3.12, this code provides for the establishment of an audit committee as one of the board committees for all banks operating in Nigeria. It is important to state that in S. 8.1.4 of this code, it provides that audit committee be comprised of Non-Executive Directors (NED) and ordinary shareholders' representatives appointed at Annual General Meeting (AGM). This code does not specify the maximum members that a committee must have.

Nigeria has witnessed a series of corporate collapses and related frauds that have raised doubts about the credibility of corporate governance in the country. A number of professional and regulatory bodies thus recommended reforms to improve the quality of financial reporting in the management and control of corporations. One specific area of concern is the monitoring function of audit committees in improving the quality of financial reporting of companies. The search for a mechanism to ensure reliable and high quality financial reporting has largely focused on the structure of audit committees whose function is to oversee the financial reporting process and to review audited financial statements. Given the importance of audit committees, listed companies including banks in Nigeria are required to include in their annual reports a summary of activities carried out by their audit committees.

Several studies examines audit independence and size, (Klein, 2002; Carcello& Neale, 2000, 2003; Martinez & Fuentes, 2007 and Mangena&Tauringana, 2008; Abbott *et al.*, 2003; Hoitash&Hoitash, 2009 and Zaman *et al.*, 201) document the benefits associated with higher levels of audit committee independence and size. However, Baber *et al.* (2005), O'Sullivan (2005) and Baxter and Cotter (2009) failed to find any significant association between audit committee independence and financial reporting quality measures. An important point to note here is that prior research, with a few exceptions (Bedard, Chtourou, & Courteau, 2004; Bronson, 2009 and Lin & Hwang, 2010), have not provided a clear guidance on how much audit committee independence and size is enough. Bronson (2009) reports that benefits of audit committee independence and size are consistently achieved only when the audit committee is completely independent, providing support for the Combined Code (2008) & SOX (2002) requirements. On this note, this study examines whether audit committee independence and size of listed deposit money banks in Nigeria affect financial reporting quality (FRQ) which adopted a discretionary accrual as amended by Jones (1991) model DACC). Two audit committee variable (independent and size) are selected as proxies for audit's characteristics. Again, the study utilized some firm characteristics which served as control variable that influenced the audit committee characteristics, they are: market value/book value, leverage, return on asset, growth, size and risk. The study covers a period of 10 years from 2007 - 2016. In the light of the above, the following hypotheses guide the study:

H₁: Audit committee independence has no significant effect on financial reporting quality of listed deposit money banks in Nigeria.

H₂: Audit committee size has no significant effect on financial reporting quality of listed deposit money banks in Nigeria.

The remaining part of the study is structured into literature review, methodology, results and discussion and conclusion and recommendations.

II. Literature Review

This section presents the conceptual framework, empirical review and theoretical issues on the effect of audit committee independence and size on financial reporting quality. The earliest evidence of the use of audit committees was in the United States in the late 1930s when the New York Stock Exchange advised corporations to set up audit committees (Armitage & Bradley, 1994). By 1978, the establishment of audit committees had become mandatory for all companies listed in the New York Stock Exchange (Williams, 1977). According to the SOX 2002, an audit committee refers to a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and if no such committee exists with respect to an issuer, the entire board of directors of the issuer.

Ayinde (2002) opines that the audit committee is a standing committee established to enhance corporate accountability by working with the internal auditors and management to improve and strengthen the financial reporting practices of an entity and ensure proper conduct of corporate affairs in accordance with generally accepted ethical and legal standards. Nnadi (1999) asserts that audit committees were originally conceived as a means of ensuring the independence and effectiveness of the external auditor. Furthermore, Knapp (1991) observes that an audit committee is more likely to support the auditor rather than management in audit disputes and the level of support is consistent across members of the committee.

Audit committee is made up of an equal number of directors and shareholders. This enables it to effectively check the powers of the executive directors, with particular reference to the accounting and financial reporting functions. It further strengthens the reporting functions as it enhances the independence of auditors by allowing them to report to a body that is independent of the executive directors. Audit committees serve as a bridge in the communication network between internal and external auditors and the board of directors. Their activities include the review of nominated auditors, overall monitoring of the audit assignment, results of the audit, internal financial controls and financial information for publication (Federal Committee on Corporate Governance (FCCG), 1999). Indeed, the existence of an audit committee in a company would provide a critical oversight of the company's financial reporting and auditing processes (FCCG, 1999 and Walker, 2004).

Empirically, Krishnan, 2005 examines the independence of the audit committee is another key characteristic for effective monitoring of the financial reporting process. It is assumed that independent directors within the audit committee are better at monitoring than their insider counterparts (DeFond & Francis, 2005). The independence of the audit committee is also a subject of increasing regulatory interest. One common focus of their efforts has been to increase audit committee independence. The Combined Code (2008) recommends and the SOX Act (2002) requires all listed companies to establish and maintain a fully independent audit committee.

The size of the audit committee is an important factor in enhancing financial reporting quality as larger audit committees are likely to have the advantage of relying on a wider knowledge base and varied expertise and thereby undertake their role more effectively (Vafeas, 2005). The evidence provided by empirical studies is rather interesting on the association between audit committee size and financial reporting quality. Baxter & Cotter (2009) show no significant association between audit committee size and financial reporting measures. However, none of the above studies have examined the optimal size of audit committees for overseeing the financial reporting process.

The studies that suggest an appropriate audit committee size in relation to other financial reporting outcomes find inconclusive and conflicting results. For example, some studies have shown larger audit committees are more likely to withstand pressures of management collusion (Dezoort & Salterio, 2001) and being able to pay more attention to the overall financial accounting process (Anderson *et al.*, 2004), other studies conceive larger audit committees as increasing the risk of material misstatement (Boo & Sharma, 2008). Regulatory bodies also deem audit committee size as an integral attribute in controlling the accounting process. The Blue Ribbon Committee (1999) in the US, ASX Corporate Governance Council (2003) in Australia and Combined Code (2008) in the UK put great emphasis on the size of audit committees, and all recommend at least three members within audit committees. The suggestions of a minimum number of members on the audit committee, without an upper limit, suggests the bodies place great emphasis in ensuring the audit committees are sufficiently staffed. However the lack of clear guidance on a preferable size gives rise to uncertainty as to what size audit committee better serve the interests of shareholders in enhancing the overall financial reporting process.

Similarly, Lin *et al.* (2006,) note that 'larger audit committees seem to improve earnings quality by reducing the probability of restating financial statements and hence provide more oversight over the financial reporting processes. Finally, Hoitash and Hoitash (2009) have also found that audit committee size is negatively associated with non-audit fee ratio highlighting the importance of audit committee size in maintaining auditor independence.

III. Methodology

This study adopts correlational research design to examine the relationships as well as the effect of the audit committee independence and size on the financial reporting quality of listed deposit money banks in Nigeria. This design is chosen because of its effectiveness in assessing the relationships and the effect of two or more variables (that is, the dependent and independent variables). The data used in this study are obtained from the Nigerian Stock Exchange and the annual reports and accounts of the fifteen (15) listed deposit money banks under study for a period of ten years (2007 to 2016). In line with the research paradigm underpinning this study and in consistent with the objective of this study, Ordinary Least Square (OLS), Fixed Effect and Random Effect Regression technique of data analysis are employed. The choice of regression as the tool of analysis in this study is informed by the fact that, the technique is effective in estimating the effect of one variable on another.

Below is the models specification, variables definition and measurement:

$$DACC_{it} = \beta_0 + \beta_1 ACIN_{it} + \beta_2 ACSZ_{it} + \beta_3 MVBV_{it} + \beta_4 LEVG_{it} + \beta_5 ROTA_{it} + \beta_6 GROW_{it} + \beta_7 SIZE_{it} + \beta_8 RISK_{it} + e_{it}$$

Whereas;

α = is the intercept

$\beta_1 - \beta_8$ = are the parameters to be estimated in the equation

DACC = Financial reporting quality (discretionary accrual), measured using the absolute value of residuals in discretionary accrual model based on Jones (1991) as used by Dechow & Dichev (2002), Yahaya (2016).

ACIN = Audit committee independence, measured by the number of years the audit committee members have served as directors of the firm (Geiger, Lennox, & North, 2008).

ACSZ = Audit committee size, measured as a percentage of audit committee members on the board (Geiger, Lennox, & North, 2008).

MVBV = Market value to book value of equity, measured by market value of equity divided by book value of equity, often referred to as Tobin Q (Skinner & Sloan, 2002).

LEVG = Leverage is measured as the ratio of debt to equity (DeFond & Jiambalvo, 1994; Sweeney, 1994; Beatty & Weber, 2002).

ROTA = Return on Total Asset is measured as earnings before interest and taxes divided by total asset (Adeniyi & Mieseigha, 2013).

GROW = Growth is measured as relative change in total asset (Blokdijs et al. (2003)).

SIZE = Firm size is measured by natural logarithm of Total Asset (Skinner & Sloan, 2002)

RISK – Risk is measured as non-performing loan divided total loan (Bell 2002; Peecher & Solomon, 2002).

i = Firm intercept (in this case 15)

t = Time intercept (in this case 10 years)

e = Stochastic error term

2. Results And Discussions

This section presents the results and analysis of data using STATA 13 as well as the interpretation and discussion of findings.

Table 1: Descriptive Statistics

| Variable | Min | Max | Mean | SD | Obs |
|----------|----------|----------|----------|----------|-----|
| DACC | .3402667 | .01 | .91 | .3255907 | 150 |
| ACIN | .33 | .63 | .5008 | .027356 | 150 |
| ACSZ | 5 | 8 | 6.5 | .20067 | 150 |
| MVBV | -7.59 | 5.88 | 1.2222 | 1.452113 | 150 |
| LEVG | .01 | .37 | .1796 | .1244525 | 150 |
| ROTA | -29.64 | 11.52 | 1.434133 | 4.068342 | 150 |
| GROW | -.33645 | 4.403849 | .2883199 | .5026892 | 150 |
| SIZE | 8.108934 | 9.675762 | 8.947092 | .3629037 | 150 |
| RISK | .000491 | .457702 | .0428137 | .0628219 | 150 |

Source: STATA 13 Output based on study data (see Appendix B1).

Table 1 shows that the measure of financial reporting quality (DACC) which is the absolute value of residuals in discretionary accrual model based on Jones (1991) as used by Dechow & Dichev (2002), has a mean value of .91, min and max value of .3402667 and 0.01 with a standard deviation of 0.3255907 and financial reporting quality (DACC) with a mean value of .1549333, min and max value of .01 and 1.92 respectively. Similarly, the average statistic value of audit committee independence is 0.5008 with standard deviation of 0.027356. The minimum and maximum mean values are 0.33 and 0.63 while the mean statistic value of audit

committee size is 6.5 with a standard deviation of 0.20067. The minimum and maximum mean values are 5% and 8% respectively.

Also, the mean statistic value of market value/book value average is 1.2222 with a standard deviation of 1.452113. The minimum and maximum mean values are -7.59 and 5.88. The average statistic value of leverage is 0.1796 with a standard deviation of 4.068342. The minimum and maximum values are 0.01% and 0.37% respectively. Similarly, the mean statistic value of return on asset is 1.434133 with a standard deviation of 4.068342. The minimum and maximum values are -29.64 and 11.52 respectively.

Furthermore, the average statistic value of growth is 29% with a standard deviation of 50%. The minimum and maximum values are -33645 and 4403849. The average statistic value of size is 8.947092 with a standard deviation of 0.3629037. The minimum and maximum mean values are 8.108934 and 9.675762 respectively. Similarly, the average statistic value of risk is 0.0428137 with a standard deviation of 0.0628219. The minimum and maximum mean values are 0.000491 and 0.457702 respectively.

Table 2

Correlation Results

| Variables | FRQ1 | ACIN | ACSZ | MVBV | LEVG | ROTA | GROW | SIZE | RISK |
|-----------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|--------|
| DACC | 1.0000 | | | | | | | | |
| ACIN | -0.1519 0.0635 | 1.0000 | | | | | | | |
| ACSZ | 0.0842 0.3055 | 0.0734 0.3723 | 1.0000 | | | | | | |
| MVBV | 0.2173* 0.0076 | 0.2249* 0.0057 | -0.0977 0.2341 | 1.0000 | | | | | |
| LEVG | 0.8925* 0.0000 | -0.0898 0.2745 | 0.1075 0.1904 | 0.2437* 0.0027 | 1.0000 | | | | |
| ROTA | 0.1995* 0.0144 | 0.0213 0.7959 | 0.0173 0.8331 | 0.3860* 0.0000 | -0.1067 0.1939 | 1.0000 | | | |
| GROW | -0.0141 0.8640 | -0.0431 0.6006 | 0.1795* 0.0279 | 0.3199* 0.0001 | -0.0428 0.6029 | 0.0710 0.3879 | 1.0000 | | |
| SIZE | 0.2629* 0.0012 | 0.1850* 0.0235 | 0.1673* 0.0407 | 0.2234* 0.0060 | 0.2215* 0.0064 | 0.1902* 0.0197 | -0.1241 0.1301 | 1.0000 | |
| RISK | 0.3557* 0.0000 | -0.0321 0.6962 | 0.0145 0.8599 | -0.0592 0.4718 | 0.3104* 0.0001 | 0.2726* 0.0007 | 0.2712* 0.0008 | 0.3583* 0.0000 | 1.0000 |

Sources; STATA 13 Output based on Study Data (See Appendix B2)

As shown in table 2 the correlation coefficients was calculated to ascertain the pairwise association between the dependent variables and explanatory and identify both the direction and quantum of the relationship. It should be noted that correlation greater than 0.80 indicate multicollinearity problem. In table 2, result shows a correlation coefficient of 0.1572 in DACC. In the three cases the result suggest good relation except ACIN; -0.1519. In the four cases the result suggest good relationship except DACC, -0.0499 and ACSZ; -0.0977. ACSZ; 0.0842 between ACIN; 0.0734 and MVBV 0.2173* between DACC; 0.2168* respectively. In the five cases the result suggest good relationship LEVG and DACC; 0.8925*. LEVG and ACIN; -0.0898 and ACSZ; 0.1075. LEVG and MVBV; 0.2437.

In the six cases the result suggest good relationship, ROTA and DACC; 0.1995*; ROTA and ACIN; 0.0213, between ROTA and ACSZ; 0.0173; between ROTA and MVBV 0.3860*; ROTA and LEVG; -0.1067 respectively. In the seven cases the result suggest good relationship except GROW and DACC; -0.0141; between GROW and ACIN; -0.0431. GROW and ACSZ; 0.1795*; also GROW and MVBV; 0.3199*; between GROW and LEVG; -0.0428; GROW and ROTA; 0.0710 respectively. In the eight cases the result suggest good relationship SIZE and DACC; 0.2629* between SIZE and ACIN; 0.1850*; between SIZE and ACSZ; 0.1673*; also SIZE and MVBV; 0.2234*; between SIZE and LEVG; 0.2215*; SIZE and ROTA; 0.1902*; between SIZE and GROW; -0.1241. In the nine cases the result suggest good relationship except RISK and ACIN; -0.0321; RISK and MVBV; -0.0592. RISK and DACC; 0.3557*; RISK and ACSZ; 0.0145; between RISK and LEVG; 0.3104*. RISK and ROTA; 0.2726*; between RISK and GROW; 0.2712*. RISK and SIZE; 0.3583* respectively. Table 2 also shows that there is no presence of multicollinearity among the independent variables since none of the correlation coefficients is equal to 0.80.

Table 3: Shapiro-Wilk W Test for Normal Data

| Variables | OBS | W | V | Z | Pro>Z |
|-----------|-----|---------|--------|-------|---------|
| DACC | 150 | 0.86239 | 16.012 | 6.287 | 0.00000 |
| ACIN | 150 | 0.98087 | 2.226 | 1.814 | 0.03482 |
| ACSZ | 150 | 0.75218 | 28.835 | 7.621 | 0.00000 |
| MVBV | 150 | 0.77030 | 26.726 | 7.449 | 0.00000 |
| LEVG | 150 | 0.92599 | 8.612 | 4.881 | 0.00000 |
| ROTA | 150 | 0.63758 | 42.170 | 8.483 | 0.00000 |
| GROW | 150 | 0.62851 | 43.225 | 8.539 | 0.00000 |
| SIZE | 150 | 0.98471 | 1.779 | 1.306 | 0.09585 |
| RISK | 150 | 0.60297 | 46.197 | 8.689 | 0.00000 |

Sources: STATA 13 Output based on Study Data (See Appendix B3).

Table 3 shows the result of normality test using Shapiro-Wilk W test. As shown in table 3, the Shapiro Wilk test for all the variables show p-values less than 0.05 except ACIN and SIZE which is above 0.05. This indicate that at 5% level of significant, the residual are not normally distributed except ACIN and SIZE that is normally distributed.

Table 4: Heteroscedasticity and Variance Inflation Factor Test

| Model | Chi ² (1) | Prob> Chi ² | VIF |
|-------|----------------------|------------------------|------|
| DACC | 18.06 | 0.0000 | 1.34 |

Sources: STATA 13 Output based on Study Data (See Appendix B5&B6).

As shown in table 4, the p-value for model DACC of less than 0.05 is significant which suggests that there is heteroscedasticity problem in their data set. Therefore the solution to the normality and heteroscedasticity problem is to use to robust standard error in their regression analysis. The VIF of 1.34 means that there is no correlation among the predictor variables, therefore there is no presence of multicollinearity among the variables.

Table 5 : Summary of Regression Results (Fixed Effect)

| Variables | Coefficient | Z-Statistics | P-values |
|------------------------|-------------|--------------|----------|
| ACIN | -.7751843 | -2.11 | 0.037 |
| ACSZ | .005623 | -0.24 | 0.811 |
| MVBV | .0019925 | 1.05 | 0.297 |
| LEVG | 2.243611 | 21.39 | 0.000 |
| ROTA | -.0073634 | -3.08 | 0.003 |
| GROW | .0045335 | 0.42 | 0.677 |
| SIZE | -.0198043 | -1.14 | 0.258 |
| RISK | .2749051 | 1.36 | 0.175 |
| R ² Within | | | 0.8377 |
| R ² Between | | | 0.0676 |
| R ² Overall | | | 0.8166 |
| Wald Chi ² | | | 85.16 |
| Wald-Significance | | | 0.0000 |

Source: STATA Output based on study data (Appendix B7, B8, B9 & B10)

Table 5, shows that audit committee independence has a negative and significant effect on financial report quality ($\beta = -0.5014639$; p-value = 0.037). Therefore, the study failed to accept hypothesis 1, which states that audit committee independence has no significant effect on financial reporting quality of listed deposit money banks in Nigeria. Also, audit committee size has a negative but insignificant effect on financial reporting quality ($\beta = -0.0144127$; p-value = 0.811) and therefore the study failed to reject hypothesis 2, which states that audit committee size has no significant effect on financial reporting quality of listed deposit money banks in Nigeria.

Table 5, further shows that leverage and profitability have significant effect on financial reporting quality while Tobin's Q, growth, firm size and risk have no significant effect on financial reporting quality. The R² Overall(0.8166) which is the multiple coefficient of determination gives the proportion of the total variation in the dependent variable explained by the independent variables. Hence, it signifies that approximately 82% of the total variation in the financial reporting quality of listed deposit money banks in Nigeria is explained by audit committee independence, size, market value/book value, leverage, return on asset, growth, firm size, as well as risk. The Wald chi² value is 85.16 with Wald Significance value of 0.000 suggests that the model is perfectly fit. This indicates that the independent variables are properly selected.

IV. Conclusion And Recommendations

This study explores how the two audit committee characteristics (independence and size) influence financial reporting quality of listed deposit money banks in Nigeria for the period from 2007-2016. The study concludes that audit committee independence has a negative and significant effect, while audit committee size is positive and has insignificant effect on financial reporting quality of listed deposit money banks in Nigeria. Based on the conclusion, the study recommends that (i) Deposit money banks in Nigeria should ensure that their boards are independent as this is likely to enhance financial reporting quality; and (ii) Management of deposit money banks in Nigeria should consider the provisions of the Nigerian code of corporate governance in audit committee composition because it will improve the financial reporting quality in deposit money banks in Nigeria.

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