

The Effect of Board Composition on The Informativeness of Financial Reporting Quality: Empirical Evidence from Nigeria

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Abstract : Using data on 576 Nigerian firms between 2011 and 2016 to examine the relationship between board composition and financial reporting quality, we underscored that the independence component of board composition is twofold : non-executive directors, and independent non-executive directors. Our multivariate regression results suggest that the proportions of the non-executive directors as well as that of the independent non-executive directors have a negative and significant relation with abnormal accruals, which in turn improves the quality of financial reporting. But the coefficient of board size did not show any significance. This is consistent with the prognosis of the agency theory. This study therefore, contributes to existing knowledge by expanding the independence of board of directors into two variable measures, and specifically detecting the significant components. The study is limited to our proxy of FRQ (abnormal accruals), and did not consider the sensitivity of contemporaneous IFRS adoption within the period.

Keywords : Abnormal accruals, board composition, board size, financial reporting quality, independent directors

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I. Introduction

The role of board of directors in corporate governance, specifically their responsibility to monitor the quality of the informational content of financial statements cannot be overemphasised. This is so because the informational quality of financial reports varies in accordance with the composition and sizes of corporate boards of listed firms (Dimitropoulos & Asteriou, 2010). The board is responsible for controlling senior managers' behaviour to ensure alignment with the interests of investors, creditors and other stakeholders.

While extant literatures suggest that board composition is related to the quality of financial reporting (Abdulmalik & Ahmad, 2016; Dimitropoulos & Asteriou, 2010; Park & Shin, 2004), little attention is paid to an important internal monitoring mechanism – independence. Independence in this context does not only refer to the board mix of non-executive directors, but in addition, requires that a separate class of directors designated as independent non-executive directors, should exist on a corporate board. This study expands on this distinction of independence. Within the Nigerian corporate governance law, this aimed to ensure that no single individual or group has dominance on the board, hence the shareholder is protected.

Agency theory provides that corporate boards have the fiduciary responsibility to protect investors interests by monitoring the management. Yet, there is a generally held concern that the board might lack the ability to ensure that managerial actions are in the interest of investors. This concern stems out of the notion that managers of listed firms often dominate their boards who play a passive role in their monitoring function. As abnormal discretionary accruals portend earnings management fraud that mislead investors with false information, boards are obliged to constrain such unethical practice.

The motivation for this research on the relationship between board composition and financial reporting quality (FRQ) in Nigeria is twofold. First, the background work of Abdulmalik and Ahmad (2016) who in their generalised methods of moments (GMM) model estimates, found a significant positive association between board composition (as proxied by board independence, and non-executive directors) and FRQ. But their fixed effect estimation showed a negative and significant coefficient for board independence, and a negative but not significant coefficient for non-executive directors. It means, board composition reduces abnormal discretionary accruals in Nigerian listed firms, thereby enhancing FRQ. Their findings could be attributed to the effect of corporate governance code issued in 2011, and probably the phased adoption of the international financial reporting standards (IFRS) in 2012, 2013 and 2014 as well. Also, Dimitropoulos and Asteriou (2010) suggested a further research to comprehend non-executive directors' role on the informativeness of the quality of earnings. Hence, our findings can potentially give further insight on the issue of accrual management by specifically investigating the effect of board composition on the informativeness of FRQ.

The second motive for the research in this area is the increased relevance that contemporary corporate governance has gained from investors, regulatory agencies and capital market operators. And specifically, the recent controversial national code of corporate governance issued by the financial reporting council (FRC) of Nigeria in 2016, provides detailed standards for the structure and composition of corporate boards, to function effectively. Composition of the board should ensure best practices, diversity of experience, independence, competence and integrity. This 2016 governance code was meant to replace an earlier code issued by the Securities and Exchange Commission (SEC) in 2011. These provisions determine the calibre of individuals that make up corporate boards, including what they bring on the decision table in protecting shareholders' interests. Accordingly, our findings can potentially provide useful insights on managerial quality to capital market participants.

Study of the Nigerian boards can be quite interesting because in addition to non-executive directors on the board who are required to be independent, another category of directors on the board are specifically required to be designated "independent non-executive directors". This is to ensure that no individual or any group of individuals dominate boards' decision-making. And, to enhance boards' effectiveness the provision is for boards to be constituted such that the proportion of non-executive directors are not less than two-third of the board size, and that the size of independent non-executive directors is not less than a half of the non-executive directors.

The purpose of this study is to examine the association between board composition and FRQ. The study contributes to research on the relationship between abnormal accruals (proxy for FRQ) and board composition, with emphasis on the independence of directors in the Nigerian context. The institutional environment, as in similar emerging capital markets, until of recent, is characterised by fewer governance regulations, thereby featuring some considerable accounting discretion. Specifically, corporate governance code has been generally voluntary until 2016.

As expected we found a negative and significant relation between the proportion of independent non-executive directors and abnormal accruals (proxy as FRQ). It means, the presence of at least one independent non-executive director on a corporate board helps to improve FRQ. Also, the coefficient of board size was found to be negative but insignificant. The paper continues as follows: literature review Section 2, research design in Section 3, empirical results in Section 4. The conclusion in Section 5 ends this paper.

II. Literature Review

Several studies have considered the issue of corporate board composition's effect on financial reporting quality (Alzoubi, 2014; Dimitropoulos & Asteriou, 2010; Johl, Johl, Subramaniam, & Cooper, 2013; Wu, Wang, & Yin, 2007). Accrual-based earnings management indicate that the corporate board at times establish policies that potentially gears toward achievement of desired financial results. Accordingly, the implication on investor protection resides primarily on the board of directors to fulfil their fiduciary responsibility. In this study, we focused on two aspects of board composition specificity to Nigerian context, as enshrined in the corporate governance code: board size and independence.

2.1 Financial reporting quality

Financial reporting quality can be referred to as the precision with which financial reporting presents information about a firm's operations (Biddle, Hilary, & Verdi, 2009). This process at times is beclouded with opportunistic reporting by manipulating accounting numbers of firm performance, against shareholders' value, where they get false information (Klein, 2002). This is possible in a system where managers have the incentive to manage earnings using abnormal discretionary accruals, or any fraudulent manipulation. Fortunately, corporate governance mechanisms works to ensure quality financial reporting (Cohen, Krishnamoorthy, & Wright, 2004).

Financial reporting of higher quality is assumed to be fundamental to capital markets, so, information disclosure determines the efficiency with which resources are allocated (Bekiris & Doukakis, 2011). Users of financial statements are interested in the quality of earnings as well as the quality of reporting (information disclosed), because such information influences their decision-making. And, several corporate governance factors play out to affect FRQ such as board quality, audit committee, external and internal auditors and managerial impact (Johl et al., 2013).

In this study, we employ absolute abnormal accruals as proxy for FRQ. Accrual accounting is so flexible that the accrual component of earnings are rendered less reliable compared to the cashflow portion of earnings (Larcker, Richardson, & Tuna, 2007). And, to separate total accruals into their discretionary (abnormal) and non-discretionary (normal) components, we use the Kothari, Leone, and Wasley (2005) model. This model has the advantage of focusing on the earnings generated by lagged assets, as it is performance-matched.

2.2 Board composition

There are evidences that board composition is significant in determining the extent of earnings manipulation thus affecting reporting quality (Klein, 2002; Osma & Noguer, 2007). Board composition aim at ensuring independence, and gender diversity without compromising competence and experience. Within the Nigerian corporate governance environment, independence is expressed in two components: non-executive directors, and independent non-executive directors.

Classical governance theory presumes that since independent directors are motivated to build their own reputations, their presence is likely to improve board's efficiency in their supervisor function (Fama & Jensen, 1983; Wu et al., 2007). Studies show that a higher proportion of independent directors on a corporate board can significantly mitigate the likelihood of financial fraud (Abdulmalik & Ahmad, 2016; Beasley, 1996). This indicates the active role the independent directors played in monitoring the financial reporting process.

2.3 Hypotheses development

2.3.1. Board size and financial reporting quality

Board size usually exerts effect on management from at least two perspectives: first, its professional and educational qualifications and its capabilities; second, the efficiency with which it communicates and the quality of its decisions. Arguably, larger corporate boards are less efficient monitors than small boards, because they have a lower level of membership coordination and a higher incidence of free-rider related issues (Dimitropoulos & Asteriou, 2010). In addition, Vafeas (2005) argued that the monitoring role of larger boards becomes more difficult which lead to lower quality financial reporting.

Obviously, empirical evidence have been inconsistent. Bradbury, Mak, and Tan (2006) found a relationship between board size and abnormal accruals. The coefficient of board size was significant at 1%. However, board size is not related to accounting earnings and it appears the capital market prefers corporate boards independence as it enhances the value relevance and quality of published financial data (Dimitropoulos & Asteriou, 2010). Specifically, the relationship between board size and FRQ are found to be in threefold: negative relationship (Anderson, Mansi, & Reeb, 2004; Xie, Davidson III, & DaDalt, 2003), positive relationship (Alzoubi, 2014; Beasley, 1996), and no relationship (Abbott, Parker, & Peters, 2004).

Considering the preceding findings and arguments we hypothesised that:

H₁: Corporate board size has positive effect on financial reporting quality.

2.3.2. Non-executive directors and financial reporting quality

Non-executive directors are that category of directors that are not involved in the day-to-day running of firm's operations. They are expected to bring independence of opinions to the decision table. Boards dominated by executive directors are perceived to align their interests to that of management, as far as the quality of financial reporting is concerned (Dimitropoulos & Asteriou, 2010). Contrariwise, larger non-executive directors increase the probability that the quality of financial reporting will be better. Hence, the interests of shareholders are better protected in non-executive directors' dominated boards, which in turn leads to improved FRQ.

Scholars continue to differ in their findings in this area. Abdulmalik and Ahmad (2016) showed a significant positive relation between proportion of non-executive directors and FRQ. Yet the addition of a non-executive (independent) director has proved to be an inefficient mechanism for corporate governance (Osma & Noguer, 2007).

Considering the preceding findings and arguments we hypothesised that:

H₂: The composition of non-executive directors on a corporate board has positive effect on financial reporting quality.

2.3.3. Independent non-executive directors and financial reporting quality

Composition of corporate boards continue to evolve across different jurisdictions, with independence of directors becoming more pronounced. In Nigeria, all the non-executive directors are required to be independent, but in addition to that, some among them are required to bear the designation – independent non-executive directors. It means they own no share in the firm. While independent directors come on board to represent and to protect the minority shareholders' interests, and to lend their expertise to firm strategy development, institutional directors on the other hand represent the interests of blockholders in the firm (Osma & Noguer, 2007). This buttress the fact that the effectiveness of the board is a function of its make-up (Fama, 1980; Fama & Jensen, 1983).

Some scholars presumed that many listed firms include independent directors on their corporate boards as a mere compliance to regulatory requirement (Wu et al., 2007). But, extant research shows that independent

directors are capable of constraining earnings management practices (Beasley, 1996; Klein, 2002; Peasnell, Pope, & Young, 2005). Accordingly, findings remain inconsistent.

Several studies show evidence of a negative relation between the proportion of independent directors and earnings management (Klein, 2002; Osma & Noguer, 2007; Xie et al., 2003). On the contrary, Dimitropoulos and Asteriou (2010) showed that outside directors (independent directors) have a positive nexus with annual accounting earnings. Yet some others indicate no correlation between earnings management and board independence (Bradbury et al., 2006; Park & Shin, 2004).

Considering the preceding findings and arguments we hypothesised that:

H₃: The presence of independent non-executive directors on corporate board has positive effect on financial reporting quality

III. Research Design

Our study employs archival data extracted from annual reports of non-financial firms listed on the Nigerian Stock Exchange (NSE). The financial firms were excluded because the industry have separate regulatory body with its set of corporate governance code. The study covers 2011 to 2016 period in which regulatory agencies had issued the most recent corporate governance codes. As at 2016-year end, there were 189 non-financial firms quoted on the NSE. Our final sample was reduced to 96 after dropping out firms that do not have complete data. Accordingly, we obtained 576 firm-years observations.

Consistent with prior studies (Abbott, Daugherty, Parker, & Peters, 2016; Abdulmalik & Ahmad, 2016), we use abnormal accruals to serve as proxy for FRQ. Abnormal accruals is measured by the performance-matched cross-sectional version of the modified Jones model defined by Kothari et al (2005).

$$[TA_{it}/A_{it-1}] = \beta_0 + \beta_1[1/A_{it-1}] + \beta_2[(\Delta REV_{it} - \Delta AR_{it})/A_{it-1}] + \beta_3[PPE_{it}/A_{it-1}] + \beta_4[NP_{it}/A_{it-1}] + \varepsilon_{it}, \quad (1)$$

Where; TA_{it} = Total Accruals: is defined as income before extraordinary items less operating cashflows. A_{it-1} = total assets at t-1 for firm i; ΔREV_{it} = the change in revenue of firm i in year t; ΔAR_{it} = the change in accounts receivable of firm i in year t; PPE_{it} = gross property, plant, and equipment of firm i in year t; NP_{it} = net profit of firm i in year t; ε_{it} = the residuals; β_0 = the intercept; $\beta_1-\beta_4$ = the coefficients of independent variables.

Our regression model for testing the relationship between the explanatory variables and FRQ is presented as follows:

$$FRQ_{it} = \alpha_{it}0 + \beta_1BSIZE_{it} + \beta_2BCNEX_{it} + \beta_3BCIND_{it} + \beta_4LEV_{it} + \beta_5ROA_{it} + \beta_6FAGE_{it} + YEAR_D + INDUSTRY_D + \varepsilon_{it} \quad (2)$$

Where; FRQ = financial reporting quality, BSIZE = board size, BCNEX = board composition of non-executive directors, BCIND = board composition of independent directors, LEV = leverage, ROA = return on asset, FAGE = firm age, YEAR_D = year dummy, INDUSTRY_D = industry dummy.

These variables are secondary data handpicked from annual reports of sampled listed firms on the NSE. Accordingly, the dependent variable (FRQ), and the independent variables (board characteristics), as well as the control variables (firm characteristics) were obtained. The data is available on the NSE website.

IV. Empirical Results

Table 1 shows the descriptive statistics of the research variables. The result show that there is on the average 9 persons on the board on Nigerian firms. Whereas this indicates a general compliance with the 2011 corporate governance code which requires at least 5 members on a corporate board, it meets the 2016 code requirement of at least 8 members. However, some companies have only 4 board members which is below the requirement. It also shows that 59% of the board members are non-executive directors, while 24% are independent non-executive directors. This is well over the requirement of the 2011 code which stipulates that most of the board members be non-executive directors. Interestingly, the proportion of independent non-executive directors is less than half of the number of non-executive directors, as against the 2016 governance code. The firms are quite old with an average of 38 years.

Table 1: Descriptive statistics					
VARIABLE	MIN	MAX	MEAN	MEDIAN	SD
FRQ	.0067	1.780	.7324	.7222	.4184
BSIZE	4	15	8.538	9	2.329
BCNEX	.2307	.9230	.5941	.625	.1985
BCIND	.0666	.5555	.2424	.2347	.1063
LEV	.0004	2.852	.5824	.5611	.2706
ROA	-1.193	.7926	.0409	.0466	.1493
FAGE	2	93	38.34	40	19.57

Where FRQ = financial reporting quality, BSIZE = board size, BCNEX = the proportion of non-executive directors on the board, BCIND = the proportion of independent non-executive directors on the board, LEV = leverage, ROA = return on asset, FAGE = firm age.

4.1 Diagnostic tests

Summary of the diagnostic tests is shown on Table 2 below. The tests of hypotheses in a multivariate analysis requires satisfaction of the normality, multicollinearity, and homoscedasticity conditions. Therefore, we carried out diagnostic tests on pooled OLS, random effect, as well as fixed effect. To test for normality, the dependent variable was winsorised at 1% to take care of outliers. Consequently, the Cameron and Trivedi's test for heteroskedasticity, skewness, and kurtosis showed a total chi-square value of 42.26 that is non-significant (0.1562), which indicate that the data are normal. Using the Hausman test, we compared between the fixed effect model and the random effect model. Since P-value is (0.9954) >0.10, we based our analysis on the random effect. The model indicates that there is no omitted variable, based on Ramsey test (0.1663). And the Breusch-Pagan test (0.4946) showed that there is no heteroscedasticity, thus meeting the homoscedasticity requirement. Also, as suggested by Hair, Black, Babin, and Anderson, (2014), the mean variance inflation factor (1.19) is <2.0, which shows there is no multicollinearity between the variables. The Wooldridge test (0.1445) also indicate that there is no autocorrelation problem. In addition, the model specification test showed that all the explanatory variables were correctly specified. Accordingly, the Wald test value of 19.48, with a statistical significant at 0.0034 indicates the model fitness.

Table 2: Diagnostic tests		
Tests	x ²	P
Breusch-Pagan test	0.47	0.4946
Ramsey test	1.70	0.1663
Wald	19.48	0.0034
Wooldridge test	2.164	0.1445
Cameron & Trivedi	42.26	0.1562
VIF		1.19

Source: Stata diagnostic output

4.2 Regression results

Table 3 presents the regression results that examined the effect of board composition on FRQ. The result shows an overall R-squared (r^2) value (0.04) of the random effect model. This reflects the proportion of variation in the dependent variable affected by the explanatory variables. It means 4% of the variation in financial reporting quality of listed Nigerian firms is influenced by their board size, proportion of non-executive directors, proportion of independent non-executive directors, leverage, return on asset, and firm age.

The results on board size (BSIZE) indicate an insignificant but negative relationship with FRQ (proxy by abnormal accruals). Thus, an additional member on the board would reduce abnormal accruals thereby increasing FRQ of a company by 0.0182. So, the hypothesis H_1 is not rejected. However, the coefficient for non-executive directors (BCNEX) show a negative (-0.109) relationship, significant at 10%. Accordingly, an addition of a non-executive director on the board will reduce abnormal accrual by 0.11 thereby improving FRQ. So, the hypothesis H_2 is not rejected.

Similarly, the coefficient of the proportion of independent non-executive directors (BCIND) indicate a negative relationship with FRQ at 5% level of significance. This evidence shows that an increase in the number of independent non-executive directors would correspond to a decrease in abnormal accrual (earnings management) by 0.478, which in turn lead to improvement of FRQ. Hence, this result is consistent with the findings of Abdulmalik and Ahmad (2016), that having independent non-executive directors on the board bring the independence in their contributions which effectively enhance the financial reporting process. So, the hypothesis H_3 is not rejected.

Following previous studies (Abbott et al., 2016; Alzoubi, 2014; Johl et al., 2013), we control for leverage (LEV), return on asset (ROA), and firm age (FAGE). The coefficients for firm age is negative and insignificant (-0.0002). It means an increase in firm age causes a corresponding reduction in earnings management accordingly, hence improves FRQ.

Leverage and return on asset on the other hand both indicate positive coefficients that have significance at 1% and 10% respectively. It means any increase in a firm's leverage or ROA causes a corresponding increase in abnormal accrual (earnings management) by 0.258 and 0.249 respectively. This also indicates that firms with higher leverage or ROA have the motivation to use abnormal accruals to increase FRQ of their firms.

VARIABLES	POOLED OLS	RANDOM EFFECT	FIXED EFFECT
BSIZE	-0.0182 (0.0114)	-0.0182 (0.0114)	-0.0238 (0.0159)
BCNEX	-0.109* (0.0662)	-0.109* (0.0662)	-0.102 (0.0679)
BCIND	-0.478** (0.228)	-0.478** (0.228)	-0.485* (0.273)
LEV	0.258*** (0.0785)	0.258*** (0.0785)	0.253*** (0.0868)
ROA	0.249* (0.135)	0.249* (0.135)	0.236 (0.150)
FAGE	-0.000202 (0.00181)	-0.000202 (0.00181)	-0.000694 (0.00715)
Constant	0.881*** (0.139)	0.881*** (0.139)	0.948*** (0.272)
YEAR_D	YES	YES	YES
Observations	576	576	576
R-squared	0.04	0.04	0.03
Number of ID	96	96	96

Standard errors in parentheses at *** p<0.01, ** p<0.05, * p<0.1 respectively. The p-values are one-sided. The models are pooled OLS, random effect model, and fixed effect model respectively. Where FRQ = financial reporting quality, BSIZE = board size, BCNEX = the proportion of non-executive directors on the board, BCIND = the proportion of independent non-executive directors on the board, LEV = leverage, ROA = return on asset, FAGE = firm age.

V. Conclusion

This study examined the effect of board composition on abnormal accrual (proxy for FRQ), and found that board composition is informative of FRQ. The study contributes to knowledge by detecting earnings management through abnormal accruals. Corporate governance variables specific to Nigerian context of board composition to ensure independence were considered. The study found that both the proportions of non-executive directors and that of the independent non-executive directors have negative and significant effects on abnormal accruals, which in turn improve FRQ.

The findings from this research have some implications for regulatory bodies, practitioners, and professionals. Various regulatory agencies often differ on what the size and independence of a corporate board should be, depending on the industry. Firms would therefore better appreciate the necessary mix their corporate boards should take to ensure independence of opinion in the financial reporting process.

Further studies might consider the use of firm size to as a moderator variable. The quality of financial reporting might owe its informativeness to the size of a firm within its industry. Similarly, more board variables such as gender and ethnic diversity could be informative of board composition as applicable to corporate governance code in Nigeria. Although findings from this study showed evidence of the effect of board independence on FRQ, the findings thereof are limited to our proxy of FRQ (abnormal accruals). Our study is also limited because it did not consider the sensitivity of contemporaneous IFRS adoption within the period. We suggest therefore that further studies could explore other FRQ proxies like restatement, fraud, accruals quality, and other earnings management proxies.

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