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IMPACT OF THE AUDIT COMMITTEE ON EARNINGS MANAGEMENT IN NIGERIAN DEPOSIT MONEY BANKS

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Abstract

Guaranteeing trustworthy and quality financial reporting has made audit committee a necessity in Nigerian Deposit Money Banks. However, amidst diverse cases of financial manipulations in these Banks, the effectiveness of audit committee mechanism in the quest for a dependable and high-quality financial reporting has been placed under doubt. To this end, this study investigates the impact of the audit committee on earnings management in Nigerian Deposit Money Banks. Ex-post facto research design was adopted and requisite data were derived through secondary source. Over a period of five (5) years, from 2013 to 2018, this study purposively selected ten (10) deposit money banks that are classified under the first and second tier bank category. Ordinary Least Square regression was applied on the variable estimates and results indicated a significant negative impact of audit committee independence on the earnings management, likewise a significant positive relationship between audit committee financial expertise and earnings management of selected deposit money banks in Nigeria. However, audit committee appears insignificant. The study concluded on a general ground that a link exists between audit committee and earnings management in selected Deposit Money Banks in Nigeria. And thus recommended that audit committee should include more independent directors with financial expertise because the independence of the committee significantly reduces earnings management.

Keywords: Earnings Management, Audit, Audit Committee, Deposit Money Bank, Nigeria.

1.0 Introduction

The battle for financial statement integrity is linked with the battle against earnings manipulation, distortion or management. Earnings management has long been a source of worry for a wide range of stakeholders, and it has gotten a lot of attention in the accounting literature. This is because it is an act that genuinely hides corporate financial facts, as well as information that stakeholders should be aware of. That is, it involves misusing discretionary judgment to reshape financial transactions in order to deceive stakeholders (Ishaku, Dandago, Muhammad & Barde, 2019). Moreover, insiders in firms frequently utilize it as a technique to alter financial information provided to outsiders in order to protect their self-interests and positions.

As a result of the adverse usage of earnings management in prior years, the activity of the audit committee has become increasingly important as standardized corporate scandals such as Enron and WorldCom have increased corporate governance requirements and expectations. The audit committee is a corporate governance tool since it oversees the financial statements' quality, objectivity and credibility (Oroud, 2019). As a result of growing worries about the quality of corporate financial reporting prompted by the recurrence of accounting scandals, the efficacy of audit committees has become a topic of increasing attention (Abata & Migiro, 2016; Uwuigbe, 2016).

The Companies and Allied Matters Act (CAMA 2004: Section 359, subsections 3 and 4) mandates the formation of an audit committee for all companies listed on the Nigerian Stock Exchange (NSE). The full acceptance of audit committees by publicly traded businesses indicates their relevance as part of corporate transparency and accountability, with audit committees expected to function as a watchdog for stakeholders' interests. The committee also keeps an eye on the financial reporting process and limits opportunistic managerial reporting. This function reflects agency theory's tenets and the need to keep an eye on managers in order to limit their potential to take rents from the company (Jensen & Meckling, 1976). Thus, many authorities have emphasized the necessity of audit committees as a result of their monitoring role.

An audit committee that is independent, well constituted, and contains at least one person with financial competence, according to Bala and Kumai (2015), is likely to mitigate earnings management. That is, the audit committee is supposed to have specific characteristics, such as independence, stipulated size, likewise financially groomed constituents (SEC, 2003). All of these are necessary for increasing economic efficiency and shareholder confidence in publicly traded organizations and adhering to financial regulatory standards. However, because of the prominence of earnings management instances around the world, this duty has been placed under a lot of criticism.

Investors in Nigeria are concerned about corporate reports due to apparent shortcomings in bank corporate governance and incidences of accounting/audit breaches which has increased irrespective of the formation of an audit committee to assure the financial statements' reliability. This was demonstrated in the cases of Skye Bank in 2018, Stanbic IBTC Bank plc in 2016, and others including Cadbury Nigeria plc, Savannah Bank and Oceanic Bank plc. These various scandals have provided a solid foundation for evaluating the relationship between the audit committee and deposit money banks' earnings management in Nigeria. In light of this, this study investigates the impact of the audit committee on earnings management. It looks deeply into the impact of audit committee independence, audit committee size, and audit committee financial expertise on Nigerian deposit money banks' earnings management. The empirical findings of this study will be useful to the banking industry as it is set to shed light on how the audit committee affects financial standards compliance, which is expected to prevent earnings management in Nigeria. Also, it will reveal the audit committee's ability to monitor and control management in day-to-day operations for compliance with rules and standards in achieving the bank's objectives. This study may also be valuable to bank management because it looks into the extent of their stewardship as portrayed by audit committee functions.

Furthermore, regulators like the Securities and Exchange Commission (SEC), the Corporate Affairs Commission (CAC) and the Central Bank of Nigeria (CBN) may find this study relevant in examining the series of interventions in deposit money banks through corporate governance processes. The study also gives academics another opportunity to stimulate and elicit ideas for future research while expanding the boundary of knowledge.

Over a five-year period, from 2013 to 2018, this study examines the impact of the audit committee on earnings management in ten (10) deposit money banks that are designated as first and second tier banks. The choice of this time period (2013) is based on the fact that it is period immediately following the banking industry's consolidation and reforms, i.e., when the banking sector was subjected to stringent rules and oversight, including the evaluation of a code of best practices on corporate governance.

2.0 Literature Review

Audit committee and Earnings Management

The audit committee has been described in multiple ways. It is a board subcommittee tasked with confirming the correctness and dependability of management's financial reporting. An audit committee, according to Eyenubo, Mohammed, and Ali (2017), is an important part of corporate governance because it improves the accuracy of financial reporting and provides support to the board of directors by rendering objective advice on issues concerning the organization's governance, risk, and control. The Sarbanes-Oxley Act (SOX 2002) defines an audit committee as a body set up by and among the board of directors to oversee the reporting, auditing and accounting procedures.

Earnings management is a misleading instrument used by the company to falsify its financial statements, which reflects the financial strength and success of the company in a false way, not in the best interests of other parties. It is the purposeful modification of financial data to make it appear like it is allowed under Generally Accepted Accounting Principles (GAAP) (Siddhath, 2011). Rahman, Muniruzzaman, and Sharif (2013) considered earnings management as the alteration of earnings reported through the use of diverse accounting techniques. It is the improper application of discretionary judgment to restructure financial

transactions in order to deceive stakeholders or sway the outcome of their agreements, as opined by Ishaku, Dandago, Muhammad and Barde (2019).
Accounting scandals have generated a number of concerns regarding the audit committee's function and its efficacy in limiting earnings management. The high-profile incidents of financial slip and fraud in companies such as Skye Bank in 2018, Intercontinental Bank Plc in 2009, Afribank Nigeria Plc in 2009 and Cadbury Nigeria Plc in 2006, have cast doubt on the financial reporting quality of Nigeria's listed corporations. According to Klein (2002), a totally independent audit committee's responsibility is to monitor financial reporting quality. As a result, the audit committee's function is to guarantee the quality of reporting, thereby reducing earnings manipulations.

The audit committee's features include, but are not limited to, independence, size, and financial expertise. An independent audit committee ensures the financial statements' reliability by effectively monitoring management's financial discretion. Allegrini and Greco (2013) define audit committee independence as the dominance of independent directors on the audit committee, giving them greater authority and limiting management's ability to use information for personal gains. In order to be highly independent and effective, the majority of audit committee members must be non-executive directors (SEC Code, 2011). With the relatively high percentage of independent directors on audit committee, it is therefore expected to increase the reliability, fairness and openness of financial disclosures (Duchin, John, & Ozbas 2010).

The audit committee's size refers to the number of audit committee members. Section 359(6) of the CAMA 2004 requires that all public enterprises have an audit commission with not more than six members, represented equally, by three shareholders and three directors. Thus, the committee shall be established in accordance with the CAMA 2004. However, a higher composition of more non-executive members is considered independent.

The audit committee's financial expertise, which explains the inclusion of members with experience in management and financial accounting, will increase the integrity of financial reporting while making it more difficult for management to engage in earnings management. Most global financial standards require at least one member of the audit committee to be a financial expert with relevant years of experience in audit, accounting and finance. In addition, CAMA 2004 Section 359 (3) and (4) mandated that at least one member of the audit committee be financially literate.

Theoretical Background

Audit committee and earnings management was investigated using agency theory. If managers have significant influence over earnings management in order to satisfy their own self-interests at the expense of their shareholders, there is a possible agency problem (Shu, Yeh, Chiu & Yang, 2015). In 1932, Adolf Berle and Gardener Means coined the term "agency theory." They explained the relationship between the owners (principals) and the agents. In 1976, Michael Jensen and William Meckling continued to work on and expand agency theory as a formal term. They also founded a school of thought that contends that businesses are organized to reduce the expenses of obtaining agents (agency costs) who will obey the proprietors' directions and interests. The theory basically acknowledges that different parties in a given situation with the same goal will have different motivations, which can manifest in a variety of ways. Because efficiency and effectiveness are inextricably linked, there will always be goal conflict among parties, and hence information will always be asymmetric between principal and agent.

Kazemian and Sanusi (2015) explained that monitoring systems can increase management and shareholder alignment while also mitigating opportunistic conduct caused by a conflict of interest. Managers are hired and given appropriate authority for the sake of productivity, implying that they are ultimately responsible for the shareholders' wealth maximization (Chen & Chu, 2005). In summary, the theory describes agent/principal relation in which the agent is delegated the authority to take decisions. When there is an opposition to the principal/agent arrangement, there is a good chance that the agent will not behave in the principal's best interests. This is referred to as opportunistic behaviour, resulting in a conflict of interest. Several research have employed agency theory as a foundation, emphasizing its general acceptability and applicability.

Empirical Studies

The impact of audit committee expertise on earnings management techniques in Nigeria was explored by Agwor and Osinachi (2018). Discretionary accruals were used to indicate earnings management via a modified Jones (1991) model. For each sampled firm, time series data was utilized to estimate discretionary accrual. Ordinary Least Squares regression findings demonstrated that audit committee expertise can limit earnings management techniques of listed manufacturing firms in Nigeria, and that the larger a firm becomes, the more likely its managers are to manage earnings.

Using the panel regression technique, Mohammad (2018) evaluated the impact of audit committee characteristics on firm performance in Jordan. The study's findings reveal that audit committee size, independence, and gender diversity have a strong positive link with business performance, whereas experience and meeting frequency have a negligible impact. The role of the audit committee and board of directors in reducing earnings management of firms listed on the Tehran stock exchange was investigated by Marziel, Alil and Homayoon (2017). According to the research, there is no link between board size, board director independence, audit committee, and earnings management.

Madugba and Ogbonnaya (2017) looked at corporate governance and earnings management in Nigerian money deposit banks. They used multiple regression analysis to analyze data from the banks' published financial statements. Corporate governance measures have a favourable and considerable impact. In India, Mishra (2016) used univariate correlations, multivariate linear regression, and logistic regression models to investigate the efficiency of audit committees in regulating earnings management. Evidence suggests that the size of the audit committee, the number of directorships held by audit committee members, and the frequency of audit committee meetings have a considerable impact on earnings quality. Other audit committee features do not appear to have a substantial effect on earnings management. Bala and Kumai (2015) looked into the characteristics of audit committees and the earnings quality of Nigerian publicly traded companies. The information was gathered from the companies' annual reports and analyzed using the multiple regression technique. The data revealed that the size of the audit committee, financial expertise, and earnings management have a negative connection. The independence of the audit committee and the frequency with which it meets has a good association with earnings management.

Salleh and Haat (2014) investigated the effectiveness of the audit committee in limiting earnings management among Malaysian listed companies following the revision of the Malaysian Code on Corporate Governance. The Modified Jones Model (1995), which was employed as a proxy for earnings management, was utilized to estimate the discretionary accrual. The findings demonstrated that the size of the audit committee and whether or not the audit committee met with the external auditor at least twice a year without the presence of executive directors had a substantial relationship with earnings management.

In Nigeria, Hussaini and Gugong (2014) used OLS regression to investigate the association between audit committee features and earnings quality. In order to determine the discretionary accrual of the sampled firms, the dependent variable was constructed using two-step regression. The findings demonstrated a strong link between the audit committee's features and the companies' profits quality. While the size of the audit committee and the financial skill of the committee had an inverse association with earnings management, the independence of the committee had a positive and substantial link with earnings management.

Mohamed and Aiman (2010) investigate the relationship between the effectiveness of audit committees, audit quality, and earnings management practices in Egypt. The findings of univariate and multivariate analyses revealed that audit committee members' experience, audit committee independence, audit quality and audit committee meetings, all have a substantial negative relationship with earnings management.

Literature Gap

Most of the studies in this field have considered period prior to the modified 2011 Corporate Governance Code and may therefore vary in results. In this respect, the study is interested in exploring only time periods after which Corporate Governance Code has been modified and periods when banking industry’s consolidation and reforms have emerged.

3.0 Methodology

In order to achieve the objectives of study, the ex-post facto research design was utilized to investigate the relationship between audit committee characteristics and earnings management. The collections of data to accomplish all objectives are derived through secondary data.

The model for this study is specified as:

$EMT_{it} = B_0 + B_1IND_{it} + B_2SIZ_{it} + B_3FEX_{it} + U_{it}$

Where;

EMT is earnings management, IND is independence, SIZ is size, FEX is financial expertise

The data for this study were extracted from secondary source. Data for each variable were sourced from audited financial statements of the selected deposit money banks over the requisite number of years. The population comprised fourteen deposit money banks that are listed on the Nigerian Stock Exchange market (NSE) as at 31st December, 2018. The study purposively selected ten (10) deposit money banks that are classified under the first and second tier bank category. Ordinary Least Square regression was applied on the estimates of explained and explanatory variables. A robustness test was also carried out using variance inflation factor (VIF), and Breusch-Godfrey correlation LM test for the validity of statistical inferences. The explained variable was generated using two steps regression in order to determine the discretionary accrual of the sampled banks.

Measurement of Variables

Earnings management (dependent variable) was measured by discretionary accruals, using modified Jones (1991) model

$TAC_{it}/TA_{it-1} = a_i + \beta_1 (1 / TA_{it-1}) + \beta_2 (\Delta REV_{it} - \Delta REC_{it}) / TA_{it-1} + \beta_3 (PPE_{it}/TA_{it-1}) + \mu_{it}$............(1)

$TAC_{it} = OI_{it} - OCFO_{it}$ ……………….. (2)

$DAC_{it} = TAC_{it} - NDAC_{it}$ …………….. (3)

The independent variable is audit committee and operationalized by audit committee independence, audit committee size, and audit committee financial expertise. This study measured audit committee size as the total number of members. The independence of the audit committee was measured by the proportion of independent directors (i.e non-executive audit committee members) to the total number of directors on the audit committee. Financial expertise was measured as the proportion of audit committee directors who qualify as accounting financial or accounting expert to the total number of directors in the audit committee (Agwor & Osinachi, 2018; Bala & Kumai, 2015; Kallamu & Saat 2015).

4.0 Data Analysis and Interpretation of Results

Table 4.1: Descriptive Statistics of the Variables

	EMT	IND	SIZ	FEX
Mean	0.051241	1.003333	6.155556	0.606667
Median	0.062025	1.000000	6.000000	0.666667
Maximum	0.220165	1.333333	8.000000	1.333333
Minimum	-0.084125	0.744445	6.000000	0.333333
Std. Dev.	0.079222	0.084112	0.467734	0.266752

Source: Author's computation

From table 4.1, the minimum value of earnings management (proxied by discretionary accruals) is -0.084125 and the maximum is 0.220165. This implies that the firm with high level of earnings management is a firm with highest discretionary accruals and vice-versa. Auditor independence shows a maximum value of 1.3333 and a minimum value of 0.74445. This implies that the smallest proportion of non-executive members to executive directors in the audit committee of the selected banks is 0.74445 while the highest proportion of non-executive members to executive directors in the audit committee is 1.333. On average, the proportion of non-executive members to executive directors in the audit committee is 1.003; this implies that the composition of audit committee with respect to executive and non-executive members is slightly balanced in the selected listed financial institutions in Nigeria.

The audit committee size shows a minimum and maximum value of six (6) and eight (8) members respectively. This means that the smallest number of the audit committee members of the selected listed financial institutions is six (6) while the largest number is eight (8). This is an indication that some banks might have violated the maximum requirement of six members as provided in Companies Allied Matters Acts Cap C20 LFN 2004 as well as the SEC code of corporate governance of 2011. However, the mean value revealed an approximately six (6) members in the audit committee of the selected listed banks. This implies that, on the average, the selected listed financial institutions comply with the requirement of CAMA 2004 and SEC code of corporate governance as to the audit committee numerical composition.

As regards financial expertise, table 4.1 shows a minimum value of 0.333333, a maximum value of 1.333333 and a mean value of 0.60667. This implies that there is at least one executive director with financial expertise out of every three or four executive members of the audit committee in the selected listed financial institutions. It could be further buttressed that the selected listed financial institutions might have complied with the provision of CAMA 2004 and SEC code of corporate governance (2011) stating that companies' audit committee members should have at least one member with financial literacy (not necessarily financial expertise).

Test for Multicollinearity

Table 4.2: Variance Inflation Factors

Variables	VIF
IND	1.040940
SIZ	1.080873
FEX	1.103672

Source: Author's computation

The test for multicollinearity was done through variance inflation factors (VIF). The rule is that the VIF for a variable must not be greater than 10. Table 4.2 presents the result of the VIF test which shows that all the variables have a VIF lesser than 10, thus, suggests the independent variables in the model are less correlated with one other.

Table 4.3: Regression Results

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.113412	0.203000	0.558683	0.5801
IND	-0.278949	0.132258	-2.109121	0.0426
SIZ	0.024003	0.031039	0.773313	0.4448
FEX	0.115136	0.054178	2.125137	0.0412

R-squared	0.613033	Mean dependent var	0.051241
Adjusted R-squared	0.576928	S.D. dependent var	0.079222
Log likelihood	74.32229	Hannan-Quinn criter.	-2.045334
F-statistic	2.172902	Durbin-Watson stat	1.935280
Prob(F-statistic)	0.029174		

Source: Author's computation

$EMT_{it} = \beta_0 + \beta_1 IND_{it} + \beta_2 SIZ_{it} + \beta_3 FEX_{it} + \mu_{it}$

$EMT = 0.113412 - 0.278949IND_{it} + 0.024003SIZ_{it} + 0.115136FEX_{it}$

Results and Discussion of Findings

Table 4.3 shows that there is a negative significant relationship between audit committee independence and earnings management of the selected listed financial institutions in Nigeria. This can be deduced from the co-efficient of -0.278949 with p-value of 0.0426 at 5% and 10% significant levels respectively. This implies that audit committee independence is inversely related to earnings management of the selected listed financial institutions in Nigeria. That is, a proportion increase in non-executive members to executive directors in the audit committee will reduce earnings management by 0.278949 indicating that audit committee independence serves as a means of reducing earnings manipulations in the selected financial institutions. Based on this evidence, the null hypothesis is rejected.

Furthermore, audit committee size is positively and insignificantly related to earnings management of listed commercial banks in Nigeria with a co-efficient of 0.024003 and p-value of 0.4448 at 10% significant level. This implies that audit committee size may neither serve as an indicator of earnings management nor a means of reducing earnings management of listed deposit money banks in Nigeria. Consequently, the second null hypothesis which states that audit committee size has no significant impact on earnings management is thus accepted.

In addition, financial expertise shows a significant positive relationship with earnings management (co-efficient value of 0.115136 with p-value of 0.0412) at both 5% and 10% significant levels. This implies that there is a positive link between audit committee financial expertise and earnings management of listed deposit money banks in Nigeria. That is, any addition of a director with financial expertise to the executive component of an audit committee will increase the chance to manipulate earnings of listed financial institutions by 0.115136. This result provides a basis for rejecting the third hypothesis formulated which states that audit committee financial expertise has no significant impact on earnings management of selected listed deposit money banks in Nigeria.

The F-statistics shows a value of 2.172902 with p-value of 0.029174. This reveals the fitness and significance of the model in linking audit committee with earnings management. The co-efficient of determination (R^2) of 61% explains that variation in earnings management is jointly accounted for by the three audit committee characteristics. In other words, audit committee independence, audit committee size and audit committee financial expertise have a combined explanatory power of 61% in explaining earnings management of the selected listed deposit money banks in Nigeria while the remaining 39% is accounted for by other factors which are not included in the model.

5.0 Conclusion and Recommendations

This study examined the influence of audit committee on earnings management and was hinged on agency theory. Specifically, the study highlighted the constructs of audit committee including: independence; size and financial expertise; likewise, investigated an association between these constructs and discretionary accruals in selected listed deposit money banks in Nigeria. Findings revealed that, out of the three constructs of audit committee, only audit committee size is not significant in explaining earnings management. This negates the finding of Salleh and Haat (2014); Bala and Kumai (2015) which revealed that there is a significant link between audit committee size and earnings management.

However, audit committee independence and financial expertise are significant in explaining earnings management. Findings revealed a significant negative impact of audit committee independence on the earnings management of deposit money banks in Nigeria. This is consonance with the findings of Hussaini and Gugong (2014) and Mohamed and Aiman (2010) that audit committee independence has a significant negative association with discretionary accruals. Furthermore, a significant positive relationship between audit committee financial expertise and earnings management of selected deposit money banks in Nigeria was established, same with Agwor and Osinachi (2018). The study thus concluded on a general ground that a link exists between audit committee and earnings management in selected Deposit Money Banks in Nigeria.

Recommendations

In line with the findings and the conclusions, the study recommends the following:

i. The audit committee should include more independent directors with financial expertise because the independence of the committee significantly reduces earnings management.
ii. Adequate attention and monitoring by regulatory bodies should be in order to enhance qualitative financial process.

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