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AUDIT COMMITTEE AND EARNINGS MANAGEMENT OF LISTED INDUSTRIAL GOODS FIRMS IN NIGERIA

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ABSTRACT:

The study examined the effect of audit committee on earnings management of quoted industrial goods firms in Nigeria from 2012-2022 using a sample of eleven (11) industrial goods firms. Ex-Post Facto research design was employed while secondary data were collected and subjected to Panel Least Square Regression Analysis and Pearson Correlation Analysis in order to achieve the study objectives. Audit committee, which is the independent variable, was measured using audit committee size and audit financial expertise; whereas, earnings management which is the dependent variable was measured using discretionary accruals. Results of this study revealed that audit committee size and audit committee independence have a significant positive effect on discretionary accruals at 5% level of significance. This study recommended among others that there is the need for regulators like Securities and Exchange Commission (SEC) to increase the minimum number of members with financial expertise in the audit committees, since audit financial expertise plays significant role in checkmating the financial reports provided by managers and in reducing the occurrence of earnings management..

1. INTRODUCTION

The transparency and reliability of financial information through reporting and disclosure practices is of paramount importance in corporate governance, as it allows stakeholders to make informed decisions to protect their interests (Securities and Exchange Commission, 2002; Nwoye, Adeniyi, & Abiahu, 2020). Since the corporate collapses of Enron in 2001 and WorldCom in 2002, there has been much criticism of and questions asked about the effectiveness of audit committees in overseeing the corporate reporting process and in monitoring the independence of external auditors. Meanwhile, earnings management has become a specific area of concern in quality financial reporting practices. Earnings management is defined as the use of management's discretion over operating decisions and accounting choices to decrease, stabilize or increase reported earnings for various purposes, such as beating financial analysts' forecasts, increasing managers' compensation and avoiding takeover attempts. Earnings management hides the true corporate performance from stakeholders and destroys organizational value; hence, it is an agency cost within the company (Rami, Usman & Ezeani, 2021). Earnings management has been described as the deliberate misrepresentation of the financial condition of an enterprise accomplished through intentional misstatement or omission of amounts or disclosure in the financial statement to deceive financial statement users. As a result of the fore goings, there are various provisions of codes and statutes that could be used to save and sanitize the financial system and improve financial reporting practices all over the world. In response to that, the regulatory authorities in Nigeria have responded by compelling companies to comply with stringent corporate governance codes. ThankGod and Onukogu (2018) reported that Nigeria has multiplicity of code of corporate governance with distinctive dissimilarities namely; Security and Exchange Commission (SEC) code of corporate governance 2003 to guide the operation of public companies listed on the Nigerian Stock Exchange, which was reviewed in 2011, Central Bank of Nigeria (CBN) code of 2006 and National Insurance Commission (NAICOM) code of 2009. Owing to the above, every public company in Nigeria is required under section 247 and 248 of the CAMA to have directors.

Real activity manipulation which is a deviation from firm normal operational practice motivated by manager's desire to achieve certain financial reporting objective which is achieved through sales manipulation by offering more lenient and favorable term than usual, reduction in discretionary expenditure to increase income and over production to report lower cost of goods actually sold, and they all have cash flow consequences to the firm. The role of audit committee in ensuring the quality of corporate financial reporting has received great attention in recent years by accounting and finance researchers. Financial statements are expected to provide users with factual not fictional, true and fair but not misleading information that will portray actual position and performance of the business. But where firm happens to manipulate its earnings through operational decision, information provided by their financial reports is no longer reliable and many stakeholders will be making decisions based on erroneous financial reports with manipulated earnings. This study examines whether Audit committee attributes (such as size of audit committee size and audit committee financial expertise) are associated with the propensity to engaging in earnings management of industrial goods firms in Nigeria. Although there are some studies on earnings management by Nigerian companies such as Haddad, El-Ammari and Bouri (2021); Namakavarani, Daryaei, Askarany and Askary (2021) with different findings, none of these studies examined the practice of earnings management in industrial goods firms to our best knowledge, therefore, creating a gap in knowledge. Furthermore, previous studies failed to determine the nature and direction of relationship between audit committee and earnings management.

1.1 Objectives of the Study

The main objectives of this study is investigate the effect of audit committee size and financial expertise on earnings management of listed industrial goods firms in Nigeria. The specific objectives are:

1. to determine the effect of audit committee size on discretionary accruals of listed industrial goods firms in Nigeria.
2. to ascertain the effect of audit committee financial expertise on discretionary accruals of listed industrial goods firms in Nigeria.

1.2 Research Hypotheses

The following hypotheses were thus envisaged;

H_{o1}: Audit committee size has no significant effect on discretionary accruals of listed industrial goods firms in Nigeria.

H_{o2}: Audit committee financial expertise has no significant effect on discretionary accruals of listed industrial goods firms in Nigeria.

2. LITERATURE REVIEW

2.1 Conceptual review

2.1.1 Audit Committee Size

Audit committee (AC) is a committee to be established by all listed companies in the Nigerian stock exchange, which is charged with the responsibility of overseeing the integrity of financial statements produced by the companies, as well as its compliance with legal requirement (SEC-CCG, 2003 in SEC 2011). An audit committee is a sub-committee of the board that specialises in, and is responsible for, ensuring the accuracy and reliability of the financial statements provided by management. Indeed, much of the blame and criticism for accounting irregularities is aimed at audit committees for not fulfilling their financial reporting oversight duties due to independence issues (Pergola, 2015). Bala (2014) defines audit committee as that which is composed of non-executive directors in the establishment". Arens, Elder and Besaly (2018) define audit committee as a group of persons selected from members of the board of directors who are responsible for retraining independence of auditors.

In order to perform their role effectively, audit committees should have adequate resources and authority to discharge their increasing responsibilities (FRC, 2008; Mangena & Pike, 2015).

Bédard, Chtourou and Courteau (2014) argue that the larger the audit committee, the more likely it is to uncover and resolve potential problems in the financial reporting process, because it is likely to provide the necessary strength and diversity of views and expertise to ensure effective monitoring. This suggests that audit committee size is an integral factor for firms in delivering meaningful corporate reporting (Mohammad, 2018). However, it can also be argued that as the number of audit committee members increases, each may be comforted by the presence of others and free riders emerge (Demaki, 2017). In addition, larger audit committees are also likely to suffer from process losses and diffusion of responsibility (Karamanou & Vafeas, 2015). The Smith Report (2003) recommends a minimum of three non-executive directors. According to SEC Code of Corporate Governance 2011, the audit committee should consist of not less than three directors of which independent directors should have the majority, and the committee is chaired by independent non-executive director.

2.1.2 Audit Committee Financial Expertise

Accounting or financial expertise are attributes/qualifications or experience acquired by a person before becoming a board member of a company (Marziel, Ali & Homayoon, 2017). Most of the global financial regulations mandate that at least one member of the audit committee should be a financial expert. And also, the provision of Companies and Allied Matters Act (CAMA) Section 359 (3) and (4) required that at least one board member of the audit committee should be financially literate. Apart from regulatory requirements, the existing literature also confirms that; for instance, Bouaziz, Fakhfakh and Jarboui (2020) documented that audit committees also face incentives to effectively monitor managers in form of legal liability in reputational work. Regulators from various countries realise the importance of financial expertise for improving the audit committee's effectiveness. They believe that the relevant experience or technical knowledge is crucial for effective accounting oversight (Olowokudejo & Oladimeji, 2019). For example, the Sarbanes-Oxley Act (2002) mandates that at least one member of the audit committee must be a financial expert. In the UK, the Smith report (2003) echoes the views of the Sarbanes-Oxley Act and specifies that at least one audit committee member must have significant, recent and relevant financial expertise.

2.1.3 Earnings Management

Moundigbaye, Rea and Reed (2018) opined that earnings management occurs when management has the opportunity to make accounting decisions that change reported income and exploit those opportunities. Additionally, Hassan and Bello (2013) indicated that earnings management occurs when managers use judgment in financial reporting and in structuring transaction to alter financial report either to mislead some stakeholders about the underlying economic performance of the company or influence contractual outcomes that depend on reported accounting numbers. Amahalu, Abiahu, Obi & Nweze (2018) defined earnings management as a gray area where the accounting is being perverted; where managers are cutting corners; and, where earnings reports reflect the desires of management rather than the underlying financial performance of the company. As such earnings management, creative accounting, financial engineering or aggressive accounting as they are being called are considered to be a deliberate attempts make by the management to arrive at a desired level of earnings, through whatever means, is an unethical practice (Akhor & Oseghale, 2017).

2.1.4 Discretionary Accrual

Abdullah, Ismail and Smith (2018) tested several models in order to partition total accruals into non-discretionary and discretional components. Therefore, the study concludes that the modified Jones model is the most effective in measuring discretionary accruals that mostly reflect earnings management. According to Ali and Fattahi (2020), the original Jones Model explains the influence of economic environment change on non-discretionary accruals. It does not take into account that different industries have different influencing factors on non-discretionary accruals of the listed companies, and if most of non-discretionary accruals changes are caused by enterprise specific environment factors, then the industry model, which ignores differences in enterprises within the same industry, cannot separate non-discretionary accruals and discretionary accruals accurately.

2.2 Theoretical Review

2.2.1 Agency Theory

This study adopts agency theory to explain the relationship between audit committee and earnings management of quoted industrial goods firms in Nigeria. Agency theory originated from the work of Berle and Means (1932). These scholars explored the concept of agency and the applications toward the development of large corporations. The researchers found out how the interest of the directors and managers differ from the owners of the firm, thereby using the concepts of agency-principal to explain the genesis of those conflicts. Jensen and Meckling (1976), further on the work of Berle and Means (1932), to develop agency theory as a formal concept. This means that there will always be partial goal conflict among parties, because efficiency is inseparable from effectiveness, and thus information will always be somewhat asymmetric between principal and agent. Agency theory is therefore concerned with contractual relationship between two or more persons called the agent(s) to perform some services on behalf of the principal. Both the agents and the principal are presumed to have entered into mutual agreement or contract motivated solely by self-interest. The principal delegates decision making responsibility to agents (Timea, 2019). It is a concept that explains why behavior or decisions vary when exhibited by members of a group. Specifically it describes the relationship between one party, called the principal that delegates work to another, called the agent. It explains their differences in behavior or decisions by noting the two parties often have different goals and, independent of their respective goals, different attitudes toward risk. Invariably, the agents' decision choices are assumed to have effect on both parties. These relationships, according to Achraf, El-Ammari and Bouri (2021), are perceived in economic and business life and also generate more problems of contracting between entities in the economy. This means that there is a contractual relationship between shareholders and directors and audit committee and shareholders or between audit committee and external auditors.

2.3 Empirical Review

Moradi, Salehi, Bighi, and Najari (2012) sought to find out the effects of characteristics including combined chairman-CEO roles, non-executive directors, board size, and change in the members of board director, type of their agency and presence of woman members in the board director on earnings management in listed companies on Tehran Stock Exchange during 2006-2009. In this research to determine discretionary accruals as earnings management indicator the Modified Jones Model was applied. Correlation and Multiple regression results showed that when operating cash flows in reducing the presence of non-executives and changes in the members of board director (or their agencies) account for effective factor in reducing management level. Also, it seem that conditions which govern in Iran have caused as increase firm size the management will have greater incentives to increase earnings for providing better figure of its performance to shareholders and authorities despite western results of researches. Although in situations which auditor organizations have been responsible to audit financial statements of corporation the firm size have not a significant relationship with earnings management level.

Baccouche, Hadriche and Omri (2013) examined the relationship between Audit Committee Multiple-Directorships and earnings management. Precisely, the study empirically investigated the effect of the multiple directorships held by audit committee directors on the level of earnings management of listed French companies. Investigation was achieved on a sample of 88 non financial French listed firms that belong to the SBF 120 index, for the financial year 2008. The results suggested that the accumulation of several outside directorships by audit committee members may lead to a higher degree of earnings management, as measured by the magnitude of discretionary accruals. Therefore, the findings showed that audit committee can't provide effective monitoring of earnings management when its members held many additional outside directorships.

El-Haddad, Ez-Zarzari, and Mohammed (2017) emphasizing the effect of the presence of audit committees on earnings management within the Moroccan context, and most specifically in the companies listed in the Casablanca stock exchange. The study adopted previous research embedded in the Dechow, Sloan and Sweeny (1995) model of earnings management that requires a maximum of 6 companies by sector, a condition that limited our sample to 27 companies dispatched only on 4 industry sectors. Given that the companies manipulate the accruals to show the increasing results or to maintain the stock price, the role of the audit committee is to ensure that this manipulation is to be reduced in order to provide investors with accurate information. In the Moroccan context, this reduction started appearing in 2014. The years 2011, 2012 and 2013 were marked by a preparation of implementation tools of these committees mainly the integration of independent administrators within the administrative boards.

Agwor, and Onukogu (2018) investigated the impact of audit committee expertise and earnings management practices of quoted food & beverages manufacturing firms in Nigeria. Secondary data were collected from the annual reports of 15 sampled firms using convenience sampling methodology which was mostly dictated by data availability. The study period covered 2006 to 2016. Earnings management was measured by discretionary accruals, using modified Jones (1991) model. Time series data was used to estimate discretionary accrual for each respective sampled firm as at 2016 financial year-end. Ordinary Least Square based regression was then applied on the cross-sectional estimates of the discretionary accruals, taking cross-section of audit committee quality dimensions (i.e. committee expertise, committee size and meeting frequency) as independent variables. Firm size was used as the contextual variable, which was measured by natural logarithm of tangible non-current assets value. It was found out that committee size was redundant due to constancy of data points, meeting frequency failed the test of statistical significance at 5% level, while the relationship between committee expertise and earnings management was not only significant at 5% level but negative.

3. MATERIAL AND METHOD

The study adopted ex-post facto research design to investigate the effect of audit committee on earnings management of listed industrial goods firms in Nigeria. The design is appropriate for this study because secondary data on audit committee and earnings management of listed industrial goods firms in Nigeria are already in the public domain through the annual reports and accounts. The population of the study consists of fifteen (15) Industrial Goods companies listed on Nigeria Exchange Group as at 31st December, 2022. The companies include;- African Paints (Nigeria) Plc, Ashaka Cement Plc, Austin Laz & Company Plc, Avon Crowncaps & Containers, Berger Paints

Plc, Beta Glass Co. Plc, CAP Plc, Cement Co. of North Nig. Plc, Cutix Plc, Dangote Cement Plc, First Aluminum Nigeria Plc, Lafarge Nigeria Plc, Meyer Plc, Paints and Coatings Manufacturers Plc, Portland Paints & Products Nigeria Plc. This study covered a ten (11) year period from 2012-2022. The reason for the period is because of the currency and availability of data for the period. Purposive sampling technique was adopted to select the companies with up to date and complete annual reports and accounts for the studied period (2012-2022). The sample size of this study consists of eleven (11) industrial goods firms that were continuously listed and actively trading on the Nigerian Stock Exchange (NSE) during the period 1st January 2012 to 31 December 2022 and whose financial statements are available and have been consistently submitted to Nigeria Stock Exchange (NSE) for the period under study. The selected firms are: Ashaka Cement Plc, Avon Crowncaps & Containers, Berger Paints Plc, Beta Glass Co. Plc, CAP Plc, Cutix Plc, Dangote Cement Plc, First Aluminum Nigeria Plc, Lafarge Nigeria Plc, Meyer Plc, Portland Paints & Products Nigeria Plc. The data used in this study were collected from secondary sources. These data were obtained from annual reports and account, fact books, Nigeria stock exchange publications for the sampled firms.

This study applied the quantitative approaches and ratio analysis to ascertain the effect of audit committee on earnings management of listed industrial goods firms in Nigeria during the period 2012-2022 and it includes the ratio analysis of the study variables using the panel data obtained from Nigeria Exchange Group (NGX) on the sampled industrial goods companies. Inferential statistics was employed in this study with the aid of E-Views using coefficient of correlation, which is a good measure of relationship between two variables that tell us about the strength of relationship and the direction of the relationship as well. Panel least square regression analysis was used for the study. Regression analysis predicts the value of a variable based on the value of the other variable and explains the effect of changes in the values of the variables.

This study adapted and modified the model of Yang and Krishnan (2015):

$EM = \beta_0 + \beta_1 ADCMIND + \beta_2 ADCMSIZE + \beta_3 ADCMMEET + \beta_4 AUDFSIZE + \epsilon$

Where:

EM = Earnings management

ADCMIND = Audit committee independence;

ADCMSIZE = Audit committee size

ADCMMEET = Audit committee meetings

AUDFSIZE = Audit firm size

The Modified Model used for the study is shown below as thus:

$DAC_{it} = \beta_0 + \beta_1 ACS_{it} + \beta_2 FSZ_{it} + \mu_{it}$ - - - - eqn 1

$DAC_{it} = \beta_0 + \beta_1 ACFE_{it} + \beta_2 FSZ_{it} + \mu_{it}$ - - - eqn 2

Where:

β_0 = Constant (intercept)

$\beta_1 - \beta_2$ = Coefficients of the independent variable

μ_{it} = Error term of firm ί in period t

DAC_{it} = Discretionary Accruals of firm ί in period t

FSZ_{it} = Firm Size of firm ί in period t

ACS_{it} = Audit Committee Size of firm ί in period t

$ACFE_{it}$ = Audit Committee Financial Expertise of firm ί in period t

4. RESULT AND DISCUSSIONS

4.1 Pearson Correlation Matrix

Table 1: Pearson Correlation Matrix

	DAC	ACS	ACFE	FSZ
DAC	1.000			
ACS	0.226	1.000		
ACM	-0.113	-0.129		
ACI	0.610	0.706		
ACFE	0.260	0.626	1.000	
FSZ	0.072	0.429	-0.103	1.000

Source: E-Views 9.0, Pearson correlation output, 2023

The result of the Pearson correlation matrix indicated a positive relationship between ACS (0.226), ACFE (0.260), FSZ (0.072) and DAC.

4.2 Test of Hypotheses

4.2.1 Hypothesis One

Ho: Audit committee size has no significant effect on discretionary accruals of listed industrial goods firms in Nigeria.

Table 2 Panel Least Square Regression analysis testing the effect of ACS on DAC

Dependent Variable: DAC

Method: Panel Least Squares

Date: 08/05/23 Time: 09:54

Sample: 2012 2022

Periods included: 11

Cross-sections included: 11

Total panel (balanced) observations: 110

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.384521	0.131280	2.929017	0.0042
ACS	0.018555	0.064846	2.826140	0.0047
FSZ	-0.021072	0.011961	-1.761763	0.0810

R-squared	0.430008	Mean dependent var	0.147273
Adjusted R-squared	0.311878	S.D. dependent var	0.156410
S.E. of regression	0.155478	Akaike info criterion	-0.857728
Sum squared resid	2.586562	Schwarz criterion	-0.784079
Log likelihood	50.17505	Hannan-Quinn criter.	-0.827856
F-statistic	11.65116	Durbin-Watson stat	1.371980
Prob(F-statistic)	0.000224		

Source: E-Views 9.0 Regression Output, 2023

Table 2 shows that there is a significant positive relationship between audit committee size and earnings management of listed industrial goods firms in Nigeria. This can be observed from the beta coefficient (β_1) of 0.018555 with p value of 0.0047 which is significant at 5%. This indicates that the size of audit committee members has a positive effect on earnings management of quoted industrial goods firms in Nigeria. Overall, the combined and the overall effect of the regressors-audit committee size and firm size on earnings management of quoted industrial goods firms in Nigeria, is shown on the model summary of the regression results. The Prob (F-statistic) of 11.65116 which is significant at 5% (0.000224) reveals that the model is well fitted, while the coefficient of determination R^2 of 0.311878, explains the individual variation of the dependent variable (discretionary accruals) as a result of the changes in the independent variables (audit committee size and firm size). It can be said that audit committee size and firm size have combined predictive power of 31.19% in affecting earnings management of quoted industrial goods firms in Nigeria, while the remaining 68.81% is accounted for by other factors which are not captured in the model.

4.2.1.1 Decision

Since the P-value of the test = 0.000224 is less than 0.05 (5%)., this study upholds that audit committee size has a significant and positive effect on discretionary accruals of listed industrial goods firms in Nigeria at 5% level of significance.

4.2.2 Hypothesis Two

Ho_2: Audit committee financial expertise has no significant effect on discretionary accruals of listed industrial goods firms in Nigeria.

Table 3 Panel Least Square Regression analysis testing the effect of ACFE on DAC

Dependent Variable: DAC
Method: Panel Least Squares
Date: 08/05/23 Time: 10:01
Sample: 2012 2022
Periods included: 11
Cross-sections included: 11
Total panel (balanced) observations: 110

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.401931	0.133434	3.012205	0.0032
ACFE	0.472584	0.675617	4.699485	0.0000
FSZ	-0.021568	0.011888	-1.814368	0.0724

R-squared	0.463685	Mean dependent var	0.147273
Adjusted R-squared	0.425623	S.D. dependent var	0.156410
S.E. of regression	0.155183	Akaike info criterion	-0.861526
Sum squared resid	2.576758	Schwarz criterion	-0.787876
Log likelihood	50.38391	Hannan-Quinn criter.	-0.831653
F-statistic	11.86959	Durbin-Watson stat	1.389371
Prob(F-statistic)	0.000113		

Source: E-Views 9.0 Regression Output, 2023

Table 3 shows that there is a significant positive relationship between audit committee financial expertise and earnings management of quoted industrial goods firms in Nigeria. This can be observed from the beta coefficient (β_1) of 0.472584 with P-value of 0.0000 which is significant at 5%. This implies that the size of audit committee financial expertise has a positive effect on earnings management of quoted industrial goods firms in Nigeria. Overall, the combined and the overall effect of the regressors- audit committee financial expertise and firm size on earnings management of quoted industrial goods firms in Nigeria, is shown on the model summary of the regression results. The Prob(F-statistic) of 11.86959 which is significant at 5% (0.000113) reveals that the model is well fitted, while the coefficient of determination R^2 of 0.425623, explains the individual variation of the dependent variable (discretionary accruals) as a result of the changes in the independent variables (audit committee financial expertise and firm size). It can be said that audit committee financial expertise and firm size have combined predictive power of 42.56% in affecting earnings management of quoted industrial goods firms in Nigeria, while the remaining 57.44% is accounted for by other factors which are not captured in the model.

4.2.2.1 Decision

Since the P-value of the test = 0.000113 is less than 0.05 (5%), this study upholds that audit committee financial expertise has a significant positive effect on discretionary accruals of quoted industrial goods firms in Nigeria at 5% level of significance.

CONCLUSION AND RECOMMENDATIONS

This study examined the effect of audit committee on earnings management of listed industrial goods firms in Nigeria. It obtained data from annual reports and account and publications from Nigeria stock exchange for the industrial goods firms that operated during 2012-2022. In addition, the effects of specific audit committee variables, such as audit committee size and audit committee financial expertise on discretionary accruals were assessed. The study concluded that audit committee size and audit committee financial expertise have a significant positive effect on discretionary accruals at 5% respectively. Based on this, the researcher recommend the following for future studies:

1. Industrial goods firms in Nigeria should ensure strict compliance with the provisions of Companies and Allied Matters act (CAMA) of having six members of equal representation three shareholders and three directors.
2. There is the need for regulators like SEC to increase the minimum number of members with financial expertise in the audit committees, since audit committee financial expertise plays significant role in checkmating the financial reports provided by managers and in reducing the likelihood of earnings management.

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