AUDIT COMMITTEE ATTRIBUTES AND REAL EARNINGS MANAGEMENT IN NIGERIA

Ahmad Haruna Abubakar¹, Abubakar Usman², Peter U Anuforo³ Baba Yagana Alhaji³

¹Faculty of Business and Management, Universiti Sultan Zainal Abidin, Malaysia
²Department of Accounting, Federal University Kashare, Nigeria
³Department of Accounting, University of Maiduguri, Nigeria

*Corresponding author: ahmadhabubakar@gmail.com

Received: 8 February 2021 • Accepted: 13 April 2021 • Published: 30 April 2021

Abstract

This study extends existing research on managers manipulative behaviour of the accounting earnings through real earnings management by examining the impacts of audit committee attributes in Nigeria. Quantitative analyses were implemented involving a sample of 72 non-financial firms with 360 firm-year observations for a five-year period (2014-2018). Data was obtained from the annual reports of these companies as well as from Thompson Reuters and Bloomberg databases. The Panel Corrected Standard Error was used to test the model studied. The finding shows that audit committee size prevents managers’ activities in earnings manipulations. Also, the result establishes that the audit committee independence presence on the audit committee control managers’ opportunistic behaviour while audit committee financial expertise was monitors in curtailing earnings manipulation practice. The findings shall give insight to financial analysts, investors, and regulators on the importance of AC in enhancing the quality of the financial report, also show the role of the audit committee characteristics to deter real earnings manipulations.

Keywords: Audit committee, size, independence, expertise, earnings management.

INTRODUCTION

The reported accounting numbers and earnings information to the stakeholders of any given company is very important since it evaluates the performance and financial status of a company. The accounting earnings are also the most vital items in financial statement that helps direct resource allocation in capital market. Based on this, the financial report should not be deliberately prepared to misinform users. Rather
the statement should provide reliable, relevant, and timely information to assist investors in decision making (Bala, Amran & Shaari, 2019; Rahman & Mansor, 2018). Recent literatures indicated that managers normally use to manipulate the financial statement with the intention to mislead investors to achieve private benefits (Bouaziz, Fakhfakh, & Jarboui, 2020; Lento & Yeung, 2017; Zhao, 2017; Lo, Ramos & Rogo, 2017). This managers’ action or behaviour is referred to as earnings management.

Earnings management has resulted to the collapse of prominent corporations such as Enron, WorldCom in US, and Transmile in Malaysia. Similarly, in Nigeria, recent cases of corporate scandals in 2017 include companies such as Oando oil Plc and Arik airline (Olowokudejo & Oladimeji, 2019). Therefore, to avoid corporate failures, corporate governance mechanisms, such as audit committee has been instituted to align the shareholders and managers interest to enhance the financial statement quality.

Agency theory explains that audit committee presence would make sure that managers behave in shareholders’ interest. Therefore, companies set up audit committee to increase the financial reporting quality (Saleh, Iskandar, & Rahmat, 2007). The basic functions of the audit committee are to discipline and monitor managers’ discretion and tendencies to manipulate the accounting earnings (Hamdan, Al-Hayale, & Aboagela, 2012). Similarly, the audit committee duty is to evaluate the financial reports of the firm and to confirm it reflect the true and actual economic performance of the firm (Klein, 2002). Furthermore, government and regulatory agencies portray the audit committee as a possible mechanism that can increase the transparency and the quality of the financial statement (Bamahros and Bhasin, 2016).

From the above-mentioned facts, this study extends existing research on managers manipulative behaviour of the accounting earnings through real earnings management by examining the impacts of audit committee attributes on real earnings management in Nigeria. The findings shall give insight to financial analysts, investors, and regulators on the significance of AC in enhancing the quality of the financial report, also whether the role of the AC contributes meaningfully to deter real earnings manipulations.

**Audit Committee Size and Earnings Management**

The AC size is considered to possess different skills, experiences, and expertise, thus enhancing the financial statements quality. There are mixed findings regarding the influence of AC size on REM. Past literatures have indicated that bigger AC size is more efficient in controlling and supervising the management. This was validated by the findings of Hamdan et al. (2013) who documented a negative association between size of the AC and earnings quality.

Similarly, Felo, Krishnamurthy, and Soller (2003) reported a negative correlation between AC size and earnings management. Also supported by the findings of literatures that reported a significant negative association between AC size and EM (Mishra & Malhotra, 2016: Lin, Lin, & Yang, 2006). This shows the usefulness of large AC size in decreasing earnings manipulation.

On the contrary, Ismail and Kamarudin (2017) indicated a positive association between the AC size and income smoothing behaviour of companies. In the same vein, Mohammed, Ahamed and Ji (2017) show a positive correlation between AC size and EM. In view of the foregoing, the study hypothesizes that:

**H1**: AC size is negatively associated with real earnings management.
Audit Committee Independence and Earnings Management

Prior literatures have reported that independent AC assist in preventing managers’ opportunistic behaviour. For instance, Jerubet, Chepng’eno, and Tenai, (2017) examined AC characteristics and quality of financial reporting among quoted firms in Kenya. The findings revealed a negative significant correlation between AC independence with FRQ. The finding is Similar to Klein (2002) who study the impact of AC, board of directors’ attributes, and EM. The study utilised 692 public US companies as a sample. The results show a negative significant association between abnormal accruals and the existence of independent AC. Also, Ismail and Kamarudin (2017) reported a negative significant correlation between independence AC and the income smoothing among Malaysian listed companies.

On the contrary, Fuad (2016) investigated impact of AC attributes on the real earnings management among Indonesian listed companies. The finding indicated that independence AC had a significant positive correlation with REM. This was supported by the finding of Gao & Huang (2016) which show that board with a greater percentage of independence AC is related with a greater discretionary accrual and the possibility of companies restate their financial statement. Also validated by Akhor and Oseghale (2017) who argued that independence AC has a positive significant influence on EM. Therefore, the study hypothesizes that:

H$_2$: AC independence is negatively associated with real earnings management.

Audit Committee Expertise and Earnings Management

The AC expertise is an important mechanism that assist a firm to reach its strategic goals (Cohen, Gaynor, Krishnamoorthy, & Wright, 2007). The presence of AC expertise will help the firms to ensure financial issues being managed efficiently and effectively. According to the agency theory AC expertise will provide proper monitoring, thereby, expected to reduce agency problem. Previous studies have recognised that audit committee with higher number of members with financial expertise would enable active controlling of managers’ opportunistic behaviour and improve the financial report.

For instance, Baxter and Cotter (2009) recommended that financial expertise on the AC reduce firm’s levels of EM. Likewise, Krishnain and Visvanathan (2008) suggested that a bigger number of financial experts on the AC improves monitoring function. Also, Felo, Krishnamurthy, and Solleri (2003) indicated a positive significant relation between the AC accounting expert and the FRQ of the US firms. In addition, Agrawal and Chadha (2005) studied corporate governance and accounting scandals among 318 listed firms in the US. The results of the study show that AC accounting experts reduce the possibility that a firm has to restate its earnings.

H$_3$: AC financial expertise is negatively associated with real earnings management.

METHODOLOGY

This paper is quantitative in nature and employs a correlational research design to investigate the study variables. The study population comprises of 169 listed firms on the Nigeria Stock Exchange from 2014-2018. Table 1 shows the procedure for sample selection. From the total of 169 companies, 57 banks and other financial services were removed. Additionally, the Nigerian stock exchange delisted 25 companies during the period. Finally, 15 firms with incomplete data were excluded bringing the total sample to 72
firms or 360 firm-year observations. Data were taken from financial report of these listed firms accessed from Thompson Reuters DataStream, Bloomberg DataStream, and annual reports of the listed firms. The data was analysed using Stata 14 software.

Table 1: Sample selection procedure

<table>
<thead>
<tr>
<th>No</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firm listed on Nigerian stock exchange as at 31/12/2018</td>
<td>169</td>
</tr>
<tr>
<td>Less:</td>
<td></td>
</tr>
<tr>
<td>Financial services</td>
<td>57</td>
</tr>
<tr>
<td>Delisted</td>
<td>25</td>
</tr>
<tr>
<td>Firm with incomplete data</td>
<td>15</td>
</tr>
<tr>
<td>Final sample</td>
<td>72</td>
</tr>
<tr>
<td>Years</td>
<td>5</td>
</tr>
<tr>
<td>Observation</td>
<td>360</td>
</tr>
</tbody>
</table>

**Dependent Variable**

**Abnormal Discretionary Expenses (Ab_DISEXP)**

DISEXP is the total of selling, general and administrative expenses, R&D and advertisement expenses. The disparity between the actual discretionary expenses and normal discretionary is the abnormal DISEXP. The unusual discretionary spending is computed by lagging with the total assets and is regressed against current year sales scaled by lagged total assets; Similar with Cohen et al. (2008), Ab_DISEXP is multiply with negative one (-1) to get Ab_ DEXP.

\[
\frac{DISEXP_{it}}{Assets_{it-1}} = a_0 + a_1 \left( \frac{1}{Assets_{it-1}} \right) + \beta_1 \left( \frac{Sales_{it-1}}{Assets_{it-1}} \right) + \varepsilon_{it} \tag{1}
\]

**Independent Variables**

AC Size proxied by Total number of AC members (Muhammed, Ahmed, & Ji, 2017) Also, AC Independence is assigned 1 if the ratio of independent non-executive directors on audit committee is greater than the mean value and 0 otherwise (Alqadasi & Abidin, 2018). And finally, AC Financial Expertise is measured as a dummy variable 1 if the Ratio of AC members who qualified as professional accountants with (ANAN or ICAN) is greater than the average value and 0 if otherwise (Krishnan, Wen, & Zhao, 2011).

**Control Variables**

Firm age is proxied as the number of years from the date the firm was listed (Kibiya, Ahmad, & Amran, 2016). Also, measured firm size as the natural logarithm of the total asset (Abdul Latif, Taufil Mohd, & Kamardin, 2016). Firm growth as the proportion changes of annual growth in total sales of the firm (Ho, Li, Tam, & Zhang, 2015).

**Model Specification**

The models used in this study were based on the reviewed literature and formulated as follows:

\[
Ab\_DIEXP = a_0 + \beta_1 ACS_{it} + \beta_2 ACIND_{it} + \beta_3 ACFEXP_{it} + \beta_4 FAGE_{it} + \beta_5FSIZE_{it} + \beta_6 FGRT_{it} + \varepsilon
\]
RESULT AND DISCUSSION

Descriptive Statistics
From the descriptive Table, Ab_DIEXP reveals an average mean of -0.011, minimum of -0.165 and a maximum of 0.242. It shows the presence of real earnings management using abnormal discretionary expenses and low earnings quality among listed firms in Nigeria. However, the mean value of AC size indicates an average value of 5 members, minimum and maximum of 2 and 6 members, respectively. The finding is similar to the studies Madawaki and Amran (2013). The table also reports an average mean of 61% of independent directors on the AC. Also, it indicates a minimum of 0 and maximum 1 independent directors on the AC, respectively. Table 2 also shows an average of 44% financial expertise in the AC, minimum and maximum of 0 and 1 respectively. The minimum value shows that some firms did not have financial expert representation in their AC.

In addition, firm age mean value is 24.41, indicating that the listed companies have been listed for an average of 24 years. Finally, FSIZE indicates an average mean of 7.21 with a maximum score of 9.169. Likewise, the average score of firm growth is 0.179. These results reveal that the growth on annual sales on average is 17% during the study period.

Table 2: Descriptive Statistics

<table>
<thead>
<tr>
<th>Variables</th>
<th>Obs</th>
<th>Mean</th>
<th>Std. Dev.</th>
<th>Min</th>
<th>Max</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ab_DIEXP</td>
<td>360</td>
<td>-0.011</td>
<td>0.112</td>
<td>-0.165</td>
<td>0.242</td>
</tr>
<tr>
<td>ACS</td>
<td>360</td>
<td>5.41</td>
<td>0.915</td>
<td>2</td>
<td>6</td>
</tr>
<tr>
<td>ACIND</td>
<td>360</td>
<td>0.617</td>
<td>0.487</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>ACFEXP</td>
<td>360</td>
<td>0.442</td>
<td>0.497</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>FAGE</td>
<td>360</td>
<td>24.412</td>
<td>13.58</td>
<td>4</td>
<td>53</td>
</tr>
<tr>
<td>FSIZE</td>
<td>360</td>
<td>7.21</td>
<td>0.756</td>
<td>5.42</td>
<td>9.169</td>
</tr>
<tr>
<td>FGRT</td>
<td>360</td>
<td>0.178</td>
<td>0.232</td>
<td>-0.020</td>
<td>1.82</td>
</tr>
</tbody>
</table>

Note. Ab_DIEXP = abnormal discretionary expenses; ACS = audit committee size; ACIND = audit committee independence; ACFEXP = audit committee financial expertise; FAGE = firm age; FSIZE = firm size; FGRT = firm growth

Correlation Matrix
Table below reveals the outcome of the correlation and none of the coefficients is greater than 0.9. In particular, the highest correlation is 0.4473 between ACS and FSIZE. Table 3 also indicates that ACS, ACIND, ACFEXP, FAGE, FSIZE, and FGRT have a negative correlation with Ab_DIEXP.

Table 3: Correlation of the Study Variables

<table>
<thead>
<tr>
<th>Variables</th>
<th>Ab_DIEXP</th>
<th>ACS</th>
<th>ACIND</th>
<th>ACFEXP</th>
<th>FAGE</th>
<th>FSIZE</th>
<th>FGRT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ab_DIEXP</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ACS</td>
<td>-0.0658*</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ACIND</td>
<td>-0.0239</td>
<td>-0.0662*</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ACFEXP</td>
<td>-0.0794</td>
<td>0.0826</td>
<td>-0.1382*</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FAGE</td>
<td>-0.1035*</td>
<td>0.2848*</td>
<td>0.0268</td>
<td>-0.0684</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>FSIZE</td>
<td>-0.1429</td>
<td>-0.4473*</td>
<td>0.0779*</td>
<td>-0.0533*</td>
<td>-0.0713</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>FGRT</td>
<td>-0.1331</td>
<td>-0.0329</td>
<td>-0.0629</td>
<td>-0.0046</td>
<td>0.0005</td>
<td>0.1855*</td>
<td>1</td>
</tr>
</tbody>
</table>

Note. Ab_DIEXP = abnormal discretionary expenses; ACS = audit committee size; ACIND = audit committee independence; ACFEXP = audit committee financial expertise; FAGE = firm age; FSIZE = firm size; FGRT = firm growth *** significant at 0.01 level, ** significant at 0.05 and * at 0.1 level

Regression Results
This study employed Panel Corrected Standard Error (PCSE) as advocated by Beck and Katz (1995).
PCSE was established as superior for panel data with heteroskedasticity, autocorrelation, and cross-sectional dependency (Moundigbaye, Rea, & Reed, 2018). According to the authors, PCSE handles simultaneously the problem of autocorrelation, heteroskedasticity and cross-sectional dependency and provides standardize coefficient that is more efficient for testing hypotheses.

Table 4 show the outcomes of the relationships between AC characteristics and the abnormal discretionary expenses (Ab_DIEXP). From the results, it indicated that AC size (ACS) has a negative association with the Ab_DIEXP. This indicates that a higher number of AC members are better to prevent the practices of earnings management in the form of real activities manipulation. The finding supports the first hypothesis that stated that, AC size is negatively associated with real earnings management. Also, similar with the findings of prior research which suggested that a greater AC size are more efficient in monitoring managers’ opportunistic behaviour (Miko, 2016; Setiany et al., 2017).

Also, the results reveal that AC independence has a significant negative influence on real earnings management. Thus, the existence of independent directors on the AC prevent management from manipulating the accounting earnings. The outcome is similar with the study of (Klein, 2002). Also, the result support hypothesis two that AC independence has a negative relationship with Ab_DIEXP. Furthermore, table 4 indicated that AC financial expertise (ACFEXP) has a negative significant association with the Ab_DIEXP. This show that members of the AC with financial expertise improve monitoring and oversight functions and thus, prevent earnings manipulation. The result also supports hypothesis three which assumed that ACFEXP is negatively associated with real earnings management. This is in line with the finding of Juhmani (2017) that indicated that the AC expertise have a negative influence on earnings management.

|       | Coefficient | Std. Err. | Z   | P>|Z| |
|-------|-------------|-----------|-----|-----|
| ACS   | -0.01210    | 0.0048313 | -2.51 | 0.012 |
| ACIND | -0.05352    | 0.0309095 | -1.73 | 0.083 |
| ACFEXP| -0.16483    | 0.0941693 | -1.75 | 0.080 |
| FAGE  | -0.00070    | 0.0003059 | -2.29 | 0.022 |
| FSIZE | -0.03048    | 0.0089603 | -3.40 | 0.001 |
| FGRT  | -0.04564    | 0.0271025 | -1.68 | 0.092 |
| CONS  | 0.04659     | 0.078096  | 0.60  | 0.551 |

Table 4: Panel Corr. Std Err. Regression

CONCLUSION

This paper investigates the influence of AC characteristics and real earnings activities of listed firms in Nigeria. The reason for this study is consistent with the need of regulators and investors for reliable financial statements. The results reveal that AC size, AC independence, and AC financial expertise were monitors in preventing earnings manipulation.
This study would benefit regulators and policymakers to have a better understanding of the importance of the AC characteristics in preventing earnings manipulations. However, the limitation of this study is that the conclusions are made from the non-financial companies, which could not be relevant in the financial services due to different rules and regulations governing them.

REFERENCES


Mishra, M., & Malhotra, A. K. (2016). Audit committee characteristics and earnings management:


