SHAREHOLDERS' REPRESENTATIVES IN THE AUDIT COMMITTEE AND DISCRETIONARY ACCRUALS AMONG NIGERIAN STOCK EXCHANGE COMPANIES

[1]MAZRAH MALEK, [2]ISHAQ AHMED MOHAMMED, [3]AYOIB CHE AHMAD

[1,3]Tunku Puteri Intan Safinaz School of Accountancy, Universiti Utara Malaysia
[2]Othman Yeop Abdullah Graduate School of Business, Universiti Utara Malaysia
E-mail: [1]mazrah@uum.edu.my, [2]isyakubolari@gmail.com, [3]ayoib@uum.edu.my

Abstract - Audit committee plays a vital role in the quality of financial reporting. Its effectiveness is affected by the characteristics of the committee. This paper examines whether participation of shareholders as members of the audit committee is effective in constraining earnings' management practices. Data was collected from annual reports of 101 companies listed on the Nigerian Stock Exchange from 2011 to 2015. Generalized Method of Moment is used as the main statistical analysis in analyzing the relationship. Findings indicate that shareholder-members with financial expertise could significantly influence lower discretionary accruals. In addition, the results also show that shareholder-members provide effective leadership roles by chairing the audit committee which suppress the extent of discretionary accruals. However, the blockholder-members are found to have limited effect to discretionary accruals. This study is based on the requirement for Nigerian Stock Exchange for audit committee to be composed of shareholders. Future studies can explore a more detailed characteristics of the shareholders' participation as members.

Keywords - Accrual, Audit Committee, Earnings Management, Shareholders.

I. INTRODUCTION

The collapses of high-profile corporations across the globe occasioned by monumental accounting scandals have raised grave concern on the potency of corporate governance mechanisms and strategies hitherto used by firms to monitor and protect the interests of investors [1,2]. These scandals have sparked off the promulgation of new regulations all over the world such as the Sarbanes-Oxley Act of 2002 in the U.S and the Combined Code in the U.K [3], to name a few. Specifically, SOX has transformed audit industry successfully from self-regulation to a controlled sector through established laws that would suppress earnings management practices [4,5]. Similarly, Nigeria was also hit by the global failures that led to earnings management practices involving several firms in both financial and non-financial sectors of the economy [6,7]. Consequent upon the ugly situation, several codes of corporate governance were released in 2003 and 2011 respectively by the SEC.

This present study therefore, focuses on the 2011 revised Nigerian Code of Corporate Governance released on 1st April 2011. The new Code without prejudice to the Company and Allied Matters Act, 2004, supports the requirement of an audit committee with equal number of three shareholders and three directors [8]. The Code also emphasizes that at least one member of the audit committee should have financial expertise such as accounting or financial management knowledge and least a member should also be independent [8]. Furthermore, Part C, Article no. 27 of the new Code has empowered institutional investors to monitor firms' activities through board representation. The Code has also advocated the establishment of other committees such as corporate governance committee, risk management committee and whistle-blowing policies to improve and strengthen financial reporting process. Although the Code makes sufficient provisions to increase investors' confidence in the capital market, compliance with the Code remains voluntary till 2013. However, due to non-compliance by most of the firms, the Code became mandatory in 2014 via Part 1 Article 1b (1) with a fine provision of N500,000.00 for any company that breaches any of the Code. There is also an additional N5,000.00 for each day the violation continues as stated under Article 1(c). The Code further places responsibility on the board to ascertain performance and is also liable for compliance under Article 2(1-3).

This study contributes in two folds. First, this study presents the pioneer effort in investigating earnings management practices reflecting the unique characteristics of the 2011 revised Code of Corporate Governance in Nigeria. Second, the involvement of shareholders in the audit committee is a distinct composition as compare to other countries that adds value to this study. The remainder of the paper is as follows; the next section presents the literature review and hypothesis development, data and methodology, empirical results and conclusion.

II. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

Financial reporting is used by different types of users in many economics decision-making process [9,10,11]. Therefore, quality financial reporting is essential for the success of corporate organization, whereby lack of of quality may mislead users' judgement [12]. Audit committee is an internal mechanism which plays a vital roles in ensuring the

quality of financial reporting. In most jurisdictions, the committee is a sub-committee to the board of directors, which is discharge with the responsibility to oversee the financial reporting process such as monitoring the internal and external audit and reviewing the financial report [13]. Despite the formation of audit committee is compulsory for listed companies in most countries, financial reporting scandals are still unstoppable. Researchers have postulated that composition of audit committee may affect its effectiveness in discharging its duties. Among the usually discussed are the number of members, composition of independent directors, frequency of meetings and the expertise of the members [12,13].

In Nigeria, the 1990 Companies and Allied Matter Act mandated the audit committee to be composed of three shareholders and three directors. Shareholders seating in the audit committee are expected to institute good corporate practices and higher levels of dedication to enhance audit committee performance [14]. Some evidence indicates that audit committee with shareholdings can reduce the extent of earnings management and protect auditors' independence [15]. Thus, appointment of shareholders as the committee members certainly open a debate in the accounting research. They are, therefore, expected to play dual roles of being owners and effectively demonstrate the ability to monitor financial reporting process; as well as audit committee members that can limit the extent of earnings management [16].

Meanwhile, in a monitoring committee, the chairman has been regarded as the most importance features [17,18]. Shareholders should also hold the leadership position of the audit committee as the chairman, whom is responsible in overseeing the committee's function [19] and liable to the breakdown of the reporting process [20]. Additionally, [21] argues that the chair of the audit committee determines the ability of the committee. Similarly, the primary contact point between the committee and the stakeholders is the chairman [22]. Prior literature suggests that chairman of audit committee represents one of the firm's top positions and the hierarchy acts as a dependable source of power [23]. Consequently, [24] considers audit committee chairman as a person with sufficient power as compared to members without chairing portfolios. Thus, the involvement of shareholders in the audit committee can uniquely play essential roles as chair of the committee by exploring different approach in enhancing effective performance of the audit committee [25].

H1: Audit committee chaired by shareholder can constrain earnings management.

Furthermore, one of the essential features of audit committee members is financial expertise [26]. As responsible to oversee the financial reporting process, expertise in the area of accounting is important for the members. Prior research argued that audit committees with financial experts constrain earnings management [27]. Financial knowledge (expertise) is described as a person with education and experience in accounting, auditing or financial management [28]. Previous studies suggest that the fall of Enron due to high profile corporate scandals was as a result of audit committee chair lacks relevant expertise [29]. Therefore, the financial expert shareholders in the audit committee is expected to result in lower extent of earnings management.

H2: Financial expertise shareholder in the audit committee can suppress earnings management.

In addition, block shareholders in the audit committee has the potential to render adequate audit committee performance due to the volume of shares held [30]. Therefore, block shareholders are in a better position to constraint managerial myopia by encouraging managers to invest in long-term and profitable portfolios [31].

H3: Blockholders in the audit committee can limit earnings management.

III. DATA AND METHODOLOGY

The study utilizes data from a sample of listed firms in Nigeria from 2011–2015. Shareholders' information, institutional shareholdings and financial data were collected from annual reports. Firms included in the sample must adhere to the following criterias; first, firms must be listed on the Nigerian Stock Market as at 31st December 2011 with sufficient data within the study period. Second, firms involved in merger or acquisition are excluded. Third, financial institutions were also not included due to their unique and high regulations [32]. This process yields a final sample of 505 firm-year observations, representing 101 firms from initial population of 204 firms. The data collected from the sample was estimated using the Generalized Method of Moment (GMM) regression method.

Following [33] and [34] this study uses board size, leverage, return on assets and firm size as control variables. Thus, the following model is proposed.

$$ABDA_{it} = \beta_0 + \beta_1 SHFEXPit + \beta_2 SHACRit + \beta_3 BLKSH + \beta_4 AUDFEEit + \beta_5 IOit + \beta_6 BSIZEit + \beta_7 LEVit + \beta_8 ROAit + \beta_9 LFSIZit + \varepsilon it \quad (1)$$

Where:

ABDA: Absolute values of discretionary accruals;

SHFEXP: Shareholders with financial expertise, measured using dummy variable 1, if shareholders have financial expertise and 0 otherwise;

SHACHR: Shareholder as audit committee chairman, measured using dummy variable 1, if shareholder is the chairman and 0 otherwise;

BLKSH: Block shareholders as audit committee member, measured using dummy variable 1, if one of the shareholder-members holding 5% or more shares and 0 otherwise;

IO: Institutional investors, measured using percentage of shares held by institutions of 5% and above;

AUDFEE: Natural logarithm of audit fees;
BSIZE: The number of directors on the board;
LEV: Total liability divided by total assets;
ROA: Net income divided by total assets;
FSIZE: Natural logarithm of total assets;
β: Coefficients in the regression model;
Ɛ: Error term;
i: Entity (firm).
The modified-Jones accrual model by [33] is used to measure ABDA and is as follows:

$$TAC_{it} = EBIT_{it} - CFO_{it} \quad (2)$$

$$\frac{TAC_{it}}{TA_{it-1}} = \alpha_0 + \alpha_1\left(\frac{1}{TA_{it-1}}\right) + \alpha_2\left[\frac{(\Delta REV_{it} - \Delta REC_{it})}{TA_{it-1}}\right] + \alpha_3\left(\frac{PPE_{it}}{TA_{it-1}}\right) + \varepsilon_{it} \quad (3)$$

$$NDAit = \alpha_0 + \alpha_1\left(\frac{1}{TA_{it-1}}\right) + \alpha_2\left[\frac{(\Delta REV_{it} - \Delta REC_{it})}{TA_{it-1}}\right] + \alpha_3\left(\frac{PPE_{it}}{TA_{it-1}}\right) + \varepsilon_{it} \quad (4)$$

$$DA_{it} = ACC_{it} - NDA_{it} \quad (5)$$

Where:
TAC: is total accruals;
EBIT: earnings before interest and tax;
CFO: cash flow from operation;
DA: Discretionary accruals;
ACC: Accruals;
NDA: Non-discretionary accruals;
i: industry;
t: year.

IV. RESULTS

A. Descriptive Analysis

The descriptive statistics of the continuous variables is depicted in Table 1. It shows that the mean of ABDA is 0.27 with a standard deviation of 0.18, while the minimum and maximum value indicate 0.01 and 0.55 respectively. Earlier studies by [7] and [35] both in Nigeria reported ABDA of 0.10 and 0.19 respectively. Thus, implies that the extent of earnings management practices among firms listed on the Nigerian Stock Exchange during the period is considerably high, hence calls for further concerns. The mean of AUDFEE stood at N$14,953,000 while the minimum stood at N400,000 and maximum N$145,000,000 respectively. Furthermore, the mean for IO is 0.15 and the standard deviation reveals a 0.14; while the maximum indicates 0.49. The mean value of BSIZE is 9, with a range of 5 and 20 board members. The mean value of ROA is 8%, with the minimum of -2% and maximum of 33%. Meanwhile, the minimum value of LFSIZ is N$2.54 billion and the maximum amount is N$7.45 billion, while the mean is N$4.79 billion.

Table 1: Descriptive statistics of continuous variables

Variable	Mean	Std deviation	Minimum	Maximum
ABDA	0.27	0.18	0.01	0.55
AUDFEE	14,953	18,352	400	145,000
IO	0.15	0.14	0	0.49
BSIZE	9	3	5	20
LEV	0.03	0.02	0.01	0.17
ROA	0.08	0.05	-0.02	0.33
LFSIZ	4.79	0.84	2.54	7.45

ABDA: Absolute values of discretionary accrual, AUDFEE: Audit fees, IO: Institutional ownership, BSIZE: Board size, ROA: Return on assets, LEV: Leverage, LFSIZ: Firm size.

On the other hand, Table 2 shows the frequency statistics of the dummy variables. As can be seen, the result suggests that 86% of companies have financially expert shareholders on the audit committee. Thus, most of the Nigerian listed firms are said to have complied with the regulatory requirement of having at least one member with knowledge of accounting or financial management. Also, 95% of the listed firms' audit committee is chaired by shareholders, but only 30% of the audit committee have block shareholders as their members.

Table 2: Descriptive Statistics of Dichotomous variables

	Frequency		Percentage	
Variable	1	0	1	0
SHFEXP	435	70	86	14
SHACHR	480	25	95	5
BLKSH	151	354	30	70

SHFEXP: Shareholder with financial expertise, SHACHR: Shareholder as audit committee chair, BLKSH: Block shareholder in audit committee.

B. Correlation Analysis

Table 3 presents the correlation among all variables. In general, all variables have a weak correlation with ABDA as the value of coefficient is below 0.3 and insignificant. The correlations between SHFEXP, SHACHR and AUDFEE with ABDA are negative, while the correlations between BLKSH and IO with ABDA are positive. Meanwhile, the highest correlation among independent variables is 0.46 between LFSIZ and BSIZE, but is far below the threshold of 0.8 for indication of possible multicollinearity as suggested by Field (2009).

Table 3: Correlation Matrix

Variable	ABDA	SHFEXP	SHACR	BLKSH	AUDFEE	IO	BSIZE	LEV	ROA
SHFEXP	-0.01								
SHACR	-0.05	***-0.41							
BLKSH	0.00	**0.11	-0.01						
AUDFEE	-0.02	0.00	0.01	***-0.25					
IO	0.01	***0.18	-0.02	**0.11	***-0.12				
BSIZE	0.01	***0.20	**-0.09	-0.07	***0.24	-0.07			
LEV	0.03	0.09	-0.08	0.03	0.03	0.08	-0.04		
ROA	0.06	-0.03	0.01	-0.06	***0.12	-0.02	-0.01	0.01	
LFSIZ	-0.01	***0.18	-0.06	***-0.12	***0.35	**-0.10	***0.46	**-0.09	0.03

Note: ABDA: Absolute value of discretionary accrual, SHFEXP: Shareholder financial expertise, SHACHR: Shareholder audit committee chair, BLKSH: Block shareholder, AUDFEE: Audit fee, IO: Institutional ownership: BSIZE: Board size, LEV: Leverage, ROA: Return on assets, FSIZE: Firm size.

C. Regression Analysis

Table 4 presents the results of the panel regression using GMM. Overall, the model of the study is correctly specified as the second order correlation (AR2) and overidentifying restriction test of Hansen/Sagan J-statistic test have indicated a p-value of 0.143 and 0.520, respectively. The statistics indicate that the model is free from heteroskedasticity and autocorrelation. The model is also free from multicollinearity, with a mean value of 1.19. Consequently, the null hypothesis of no second order

correlation cannot be rejected. In the same vein, the Wald chi2 is 81.67 and statistically significant at 1 percent, thus indicating that the model is fit.

Table 4: Dynamic Panel Regression

Variable	Standard error	Coefficient	VIF
L.ABDA	(-0.0701)	-0.00369	
SHFEXP	(-0.105)	-0.360*	1.34
SHACHR	(-0.13)	-0.307**	1.21
BLKSH	(-0.0337)	0.0306	1.09
LAUDFEE	(-0.116)	-0.547*	1.24
IO	(-0.149)	0.744*	1.07
BSIZE	(-0.00665)	-0.0129	1.31
LEV	(-0.00633)	-0.00066	1.03
ROA	(-0.153)	0.295	1.02
LFSIZ	(-0.0249)	0.0668*	1.42
Constant	(-0.395)	1.703*	
AR1		0.000	
AR2		0.143	
Hansen J.		0.520	
Prob > chi2		0.000	
Mean VIF			1.19

Note: Standard errors in parentheses, * p<0.01, ** p<0.05

It shows that the coefficient of SHFEXP is negative and statistically significant at 1 percent. The result implies that the presence of shareholders with financial expertise resulted in lower magnitude of discretionary accruals, which is consistent with [36] and [37] whom both had found that financial expertise among audit committee members may result in lower discretionary accruals. Thus, this supports our first hypothesis.

Meanwhile, the coefficient of SHACHR is negative and statistically significant at 5 percent, which implies that the audit committee chaired by shareholder is more likely to have lower discretionary accruals. It is consistent with the suggestion by [14] that shareholders as chairman of the audit committee can enhance efforts in enhancing the financial reporting quality. This result corroborates with hypothesis two of this study.

However, the coefficient of BLKSH is not statistically significant, thus implying that the presence of block shareholders in audit committee could not be effective in monitoring managers' opportunistic behaviour. This result could be compared with those of [30] whom also failed to find any significant relationship between block shareholders and monitoring. Additionally, [38] and [39] also argued that block shareholders may connive with managers to smooth earnings for their self-interest.

Meanwhile, for the control variables, the coefficient of AUDFEE is negative and statistically significant at 1 percent, thus suggesting that quality audit can reduce the extent of discretionary accruals which is consistent with the finding by earlier studies [40]. The results show that IO is statistically significant at 1 percent, thus implying that institutional ownership has the ability to renders effective monitoring. This result could also be compared with those of [30] and [41] whom all reported that institutional investors adequately monitor managers' opportunistic tendencies. FSIZE are positive and statistically significant at 1 percent. However, coefficients of BSIZE, LEV and ROA are insignificant.

CONCLUSION

The effectiveness of audit committee in curbing the practices of earnings management remains a continuous debate and requires considerable attention among all stakeholders. Many researchers have believed that the formation of audit committee solely may not ensure its effectiveness, however the characteristics of the committee may be able to bring much differentiation. The current study symbolizes the pioneer attempt to investigate shareholders' presence in the audit committee. Using the data of Nigerian non-financial listed companies and Generalised Method of Moments, it is found that the presence of financially-expert shareholders will result in lower earnings management. At the same time, the appointment of shareholder as chairman in the audit committee would also limit earnings management. However, the presence of block shareholders in the committee was found to have very limited effect on the earnings management. Overall, the findings are consistent with earlier studies which postulated that the effectiveness of an audit committee can be reflected by the characteristics of the committee. While the appointment of shareholders as members can be related to their independency, their financial expertise should also be considered. Furthermore, shareholders as members may also need substantive power in the committee to ensure that the committee can perform effectively. The findings may be limited to Nigerian companies only, where the appointment of shareholders as audit committee members is mandatory. Future study can explore other characteristics of shareholders as members.

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