ATTRIBUTES OF AUDIT COMMITTEE MEMBERS AND QUALITY OF FINANCIAL REPORTING IN BANKS IN NIGERIA

BY:

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BEING A THESIS SUBMITTED TO THE POSTGRADUATE SCHOOL OF AHMADU BELLO UNIVERSITY, ZARIA, IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR THE AWARD OF MASTER OF SCIENCE (M.Sc.) DEGREE IN ACCOUNTING AND FINANCE.

APRIL, 2012.

DECLARATION

I hereby declare that this research work, the ideas, results, analyses and conclusions reported therein are solely conducted by me (except where otherwise acknowledged) under the supervision of Mallam Shehu, Usman Hassan and Mr. A. Silva all of Ahmadu Bello University, Zaria. To the best of my knowledge and conviction, this work has never been submitted in any Institution for an award of degree or certificate of any nature. All sourced documents are sufficiently and appropriately acknowledged. I take full responsibility for all errors and omissions contained in this work.

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CERTIFICATION

This thesis titled "Attributes of Audit Committee Members and Quality of Financial Reporting in Nigerian Banks" by Gabriel Samuel (M.Sc./ADMIN/00990/08-09) satisfies the rules and regulations governing the award of degree of Master of Science (Accounting and Finance) of Ahmadu Bello University, Zaria and is approved for its knowledge and literary contributions.

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DEDICATION

This research work is dedicated to the Almighty God, the Alpha and Omega, the custodian and giver of wisdom, knowledge and power, the all-sufficient God. It is with Him, through Him and by Him that this work became a success. To Him alone is glory forever and ever, amen. It is also dedicated to my loving and caring wife, Mrs. Juliana Gabriel whose support and commitment I enjoyed throughout the period of this work.

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ABSTRACT

This research investigated the impact of audit committees attributes on financial reporting quality of Banks in Nigeria. Modified Jones model (1991) provided the measures of earnings quality, which were used to proxy for financial reporting quality. The audit committee attributes investigated were: independence, financial expertise, frequency of meetings, and multiple directorship. The population of our study is all the twenty-two (22) quoted banks on the Nigerian Stock Exchange as at 31st December, 2010 filtered to eleven (11) banks considering only banks declared healthy by the CBN and having the relevant data required for the study. Secondary data were used obtained from secondary sources, i.e., annual reports and returns filed with SEC. The research design used is correlation research design. The effectiveness of Audit committee attributes is one of the significant themes in corporate governance debates. We contribute to the debate by examining empirically whether audit committee attributes are associated with financial reporting quality in Nigerian banks. By using a measure of financial reporting quality, Jones (1991) model this study is one of the few studies that overcome the imprecision inherent in the abnormal accruals/earnings management. We show that after controlling for bank size and bank market penetration, the percentage of audit committee members having financial expertise is positively related to financial reporting quality. We also find some evidence of a positive relationship between the independence, frequency of meeting and multiple directorship of the audit committee and financial reporting quality. We also verify that our results are robust across the measures of financial reporting quality. Our results suggest that mandating greater expertise on audit committees rather than simply requiring one expert on the audit committee may be beneficial to investors. We equally suggested training and re-training of audit committee members to guarantee meaningful contributions.

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CHAPTER ONE
INTRODUCTION

1.1. Background to the Study

Corporate fraud has become a monster, frustrating the growth and development strategies in most organizations. It is not a respecter of size or potentials of an organization. It has consumed both small and the mighty as well as local and international organizations. It is obvious that the only mirror through which corporate integrity can be viewed is its financial report. The integrity of this report is therefore crucial in all ramifications. Therefore, efforts must be made to protect this integrity and part of it is the establishments of a sound corporate governance mechanism, part of which is the audit committee to safeguard public interest and protect stakeholders' interest.

One of the most important functions that corporate governance can play is in ensuring the quality of the financial reporting process. Levitt (1999) stated in a speech to directors, "the link between a company's directors and its financial reporting system has never been more crucial." Further, the Blue Ribbon Commission (1999) called for auditors to discuss with the audit committee the quality and not just the acceptability of corporate financial report.

The issue of audit committees evolved in the US following the stock market crash in 1939. However, the New York Stock Exchange (NYSE) only made the establishment of audit committees mandatory in 1987. The Treadway Committee (1987) argues that an audit committee could enhance a firm's financial reporting process. To ensure its independence and effectiveness, the Cadbury Report (1992) recommends audit committees be established with at least three non-executive directors with written terms of reference with regard to their authority and duties. In

line with the recommendation of the Cadbury Report, the London Stock Exchange in 1993 made the formation of audit committees by the listed companies mandatory. In Malaysia, the audit committee issue surfaced in the middle of the 1980s with the financial crisis of Bumiputra Malaysian Finance Ltd (BMF). The Central Bank of Malaysia (BNM) required all finance institutions under its jurisdiction to form audit committees through its BNM/GP1 issued in 1986. This requirement was extended to all insurance companies in 1990. In 1993, the Kuala Lumpur Stock Exchange (KLSE) took an important step by making audit committee formation mandatory as was earlier done by the NYSE in 1978 and the London Stock Exchange (LSE) in June 1993.

Though audit committees have been argued to improve a firm's financial reporting processes, only few countries Nigeria inclusive have actually incorporated audit committee formation in their Companies Act. Section 359(3) of CAMA 1990 provides for the establishment of audit committee in public companies in Nigeria. S. 359(4) CAMA elaborates this provision further by providing that membership of the committee be comprised of equal number of directors and shareholders' representatives and that the maximum members of the committee shall not exceed six.

In 2003, the Nigeria security and exchange commission (SEC) issued a code of Best Practices of Corporate Governance and this code in S. 11(a) provides for the establishment of audit committee in public companies in Nigeria. It specifies further that directors' representatives in the audit committee should mainly be Non-Executive Directors (NED) with not more than one executive member S. 12(a) SEC code (2003).

The CBN also a regulatory agency of the banking sector issued a Code of Corporate Governance for Banks in Nigeria Post Consolidation effective from 3rd April, 2006. In S. 5.3.12, this code provides for the establishment of an audit committee as one of the board committees for all banks operating in Nigeria. It is important to state that in S. 8.1.4 of this code, it provides that audit committee be comprised of Non-Executive Directors NED and ordinary shareholders' representatives appointed at annual general meeting (AGM). This code does not specify the maximum members that a committee must have.

Furthermore, NAICOM a regulator of the insurance companies in Nigeria issued a Code of Corporate Governance for Insurance Industry applicable to all insurance and re-insurance companies effective date 1st March, 2009. In S. 7.01 of this code, it also provides for the establishment of audit committee in insurance companies operating in Nigeria. The membership of this committee shall be in accordance with the provisions of CAMA 1990 allowing for not more than one executive director to be on the committee (S. 7.02. NAICOM code 2009).

Evidence about firms' incentives to form an audit committee and its effectiveness in carrying out its duties so far is mixed. It is argued that the level of audit committee independence was an important criterion for its effectiveness. Cobb (1993) found evidence of a negative association between the number of independent members of a firm's audit committee and the likelihood of fraudulent financial reporting. In Malaysia, Shamsul Nahar Abdullah (1999) found evidence that audit committee independence was effective in carrying out its financial reporting oversight functions. Smith Report (2003) argued that having an effective sound audit committee structure would lead to a better monitoring of financial reporting process which could, invariably, lead to the management pursuing activities that promotes the long-term value of the company. It further

emphasized that an effective and independent audit committee can only be guaranteed when there exist an effective and independent board of directors. Having an effective audit committee means that there exist appropriate checks and balances to ensure that management performs their roles (of preparing quality financial report) as expected by the shareholders and other stakeholders (Solomon and Solomon, 2004).

In today's modern businesses, a company is typically headed by board of directors, which is regarded as the peak of a firm's corporate governance (CAMA 1990). In fact, the Cadbury Report (1992), which was published in the UK, has discussed extensively the roles of board of directors and the importance of it being independent of management. It requires a board consisting of a sufficient number of non-executive directors and this was re-emphasised by Higgs Report (2003) which sought for a change to the Combined Code (1998) definition of independence to include the following general statement: 'A non-executive director is considered independent when the board determines that the director is independent in character and judgement and there are no relationships or circumstances which could affect, or appear to affect, the director's judgement' (Higgs Report, 2003). Several studies abound that shows the extent to which having non-executive directors on the board was effective in ensuring quality of financial reporting (Peasnell et al 2000; Beasley, 1997).

1.2. Statement of the Research Problem

Quality financial reporting has of recent received increasing attention both locally and internationally, in practice and in academic research (e.g., Blue Ribbon Committee Report 1999; Ramsay Report 2001; Sarbanes-Oxley 2002; CAMA 2004; Bebchuk and Cohen 2004). This is because financial reporting is an important element in the corporate structure, by relieving a

fundamental asymmetry information between managers/directors and providers of finance (Whittington, 1993). The limited access to managerial information causes the providers of finance such as shareholders and debt holders, to be forced to rely on the financial reporting.

As financial reporting provides value-relevant information to the external parties of the organization, the heavy reliance placed on accounting numbers create powerful incentives for managers to manipulate earnings to their own advantage (Rahman and Ali, 2006). Hence, it is important for the financial accounts to provide truthful/accurate financial information to enable the shareholders to make wise decisions. The lack of accuracy in the financial results will lead to the shareholders' making wrong judgments concerning their decisions.

This emphasis is due in part, to the prevalence of highly publicized and detestable financial reporting frauds such as those witnessed in cases like Enron, WorldCom, Aldelphia, Parmalat, and Cadbury Nigeria to mention but a few. An unprecedented number of earnings restatements (Loomis 1999; Wu 2002; Palmrose and Scholz 2002; Larcker et al. 2004), claims of blatant earnings manipulation by corporate management (Krugman 2002), and the unprecedented cases of non-performing loan that almost recently ruined the Nigerian banking industry involving banks such as Intercontinental Bank plc, Oceanic Bank plc, Bank PHB, Afribank plc etc which has been described in various quarters as 'Tsunami' (Sanusi, 2010). Further, academic research has found an association between weaknesses in governance and poor financial reporting quality, earnings manipulation, financial statement fraud, and weaker internal controls (Dechow et al. 1996; Beasley 1996; McMullen 1996; Beasley et al. 1999; Beasley et al. 2000; Carcello and Neal 2000; Krishnan 2001; Klein 2002b).

The concerns regarding the quality of financial reporting have raised questions regarding the effectiveness of the monitoring mechanism of a bank. Fama (1980) suggests that the credibility and transparency of financial reporting of a company depends upon the monitoring mechanism of the company itself. Effective corporate governance mechanisms (i.e. audit committee) safeguard the rights of investors in getting true and fair information of the company (Rahman and Ali, 2006). One high-level governance device, which has been mandated to ensuring the quality of financial reporting, is the audit committee. This is because board of directors often delegates the responsibility for oversight of the financial statement reporting process to an audit committee (Beasley, 1996). Given these developments, there has been an emphasis on the need to improve corporate governance mechanism i.e. audit committee which is saddled with the responsibility of ensuring quality financial reporting process (Levitt 1998, 1999, 2000) such as enacting reforms in Nigeria to improve the effectiveness of the audit committee and to make the board of directors and management more accountable for ensuring the integrity of the financial reports as was done in the US and the UK (Blue Ribbon Committee 1999; Sarbanes-Oxley Act 2002; SEC 2002; The Business Roundtable 2002; The Higgs Report 2003; The Smith Report 2003) as well as a rapid expansion of research on board and audit committee attributes.

The Federal Government of Nigeria in its reform agenda since 1999 with the aim of attracting new and sustainable foreign investments has established commission to review the existence, adequacy and relevance of audit committee in Nigeria relative to the international best practices in response to the New International Economic Order (NIEO) and the desire to adopt the International Financial Reporting Standard (IFRS). Thus, the Nigerian Code of Corporate Governance Practices 2003, coupled with other codes issued by other regulatory agencies were developed based on unitary board structure (as in UK and USA) with emphasis on the identified

triple constraints: the role of board of directors and management, shareholders rights and privileges, and the audit committee (Oyebode, 2009). Concerted efforts are being made to review the current codes in existence and in no distance time this will soon become public document.

This study will therefore look at the attributes of audit committee members vis-à-vis its independence etc and the quality of financial reporting in Nigerian banks.

1.3. Objectives of the Study

The major objective of this study is to examine the impact of the attributes of audit committee on the quality of financial reporting in Nigerian banks. The study specifically set forth the following objectives:

i. To determine the impact of non-executive directors in audit committee on the quality of financial reporting in Nigerian banks.

ii. To examine the influence of multiple directorship of audit committee members on quality of financial reporting within the Nigerian banking sector.

iii. To determine the contributions of financial literacy of audit committee members on the quality of financial reporting in Nigerian banks.

iv. To evaluate the effect of number of meetings of audit committee members on the quality of financial reporting in Nigerian banks.

1.4. Research Hypotheses

In view of the objectives of the study, the following hypotheses were formulated in null form:

H1: The presence of Non-executive members in the audit committee has no significant impact on the quality of financial reporting by Nigerian banks.

H2: Multiple directorships of audit committee members within the banking sector has no significant effect on the quality of financial reporting by Nigerian banks.

H3: Financial literacy of audit committee members has no significant contributions to the quality of financial reporting by Nigerian banks.

H4: Frequency of audit committee meeting does not affect the quality of financial reporting by Nigerian banks.

1.5. Significance of the Study

This study will be of great significance to regulators, legislators, investing public and other stakeholders who will be at the receiving end if quality attributes of audit committee and financial reporting in Nigerian banks is not achieved. It will be a valuable companion to fellow researchers in the academia who have passion for ensuring that sound audit committee membership is enshrined in corporate entities worldwide and Nigeria in particular. The work may serve as reference material to those interested in carrying out similar studies.

1.6. Scope of the Study

There are two main delimitations of scope placed on this research. First, the population from which the sample size of eleven banks were drawn was all the twenty two quoted banks on the Nigerian Stock Exchange as at 31st December, 2010

Second, the period covered was between 2004 to 2010. This is because this was the period in which most of the code of corporate governance operating in Nigeria economy came into effect in order to safeguard and protect corporate existence and integrity.

CHAPTER TWO
LITERATURE REVIEW

2.1 Introduction

The main aim of this chapter is to review the literature relevant to this research and to develop a platform upon which the study will be based. The chapter specifically covers the concept of audit committee; the audit committee attributes; the concept of corporate governance structure; the concept of annual financial reports; an overview of the banking system in Nigeria; review of empirical studies and theoretical framework.

2.2. The Concept of Audit Committee

In the corporate board structure, there are two different parties involved; the management and the providers of funds, and therefore potential conflicts of interest among these participants may arise (Gillian and Starks, 1998). These conflicts of interest, often referred to as agency problem, arises from two main sources; different participants have different goals and preferences; and the participants have imperfect information as to each others' actions, knowledge and preferences (Gillian and Starks, 1998). Audit committee is one mechanism available to the board of directors to limit conflicts of interest between managers and stockholders (Menon and William, 1994). The wide acceptance of the formation of audit committees around the world improves the functions and strengthens the effectiveness of audit committee.

The debate on the need for better corporate governance in Malaysia had actually began to be highlighted much earlier following the Bumiputra Malaysia Finance Limited (BMF) scandal in mid-1982 causing a loss of RM 2.5 billion (Ling, 1992). BMF, a subsidiary of Bank Bumiputra

Malaysia Finance Berhad (BBMB) at that time, was a license-deposit-taking in Hong Kong. The nearly collapsed of BBMB, the largest domestic bank in the country at that time, could be said as the start of the audit committee development in Malaysia (Abdullah and Al-Murisi, 1997). In 1985, the Bank Negara required all financial institutions under its supervision to have an audit committee to be chaired by a non-executive director. The requirements were made clear through the "BNM/GP1 – Guideline on Duties and Responsibilities of Directors and Appointment of Chief Executives" which was issued on 1st November 1985. Responsibilities were placed on the board of directors of financial institutions to establish audit committees through Section 2(ii) of the guideline which states that the board must "establish an audit and examination Committee of Directors comprising of non-executive directors".

Prior literature on the effectiveness of audit committee associated the existence of audit committee with the quality of corporate financial reporting (Beasley, 1996; McMullen and Raghunandan, 1996; McMullen, 1996; Song and Windram, 2000). However, the results were mixed. For instance, in Beasley (1996), McMullen and Raghunandan (1996), McMullen (1996), and Song and Windram (2000) studies, the existence of audit committee reduces reporting problems. In Menon and Williams (1994), however, the existence of audit committee has no significant relationship with the reporting problem. Menon and Williams (1994) suggest that the existence of audit committee is more for cosmetic reason and does not provide an assurance for unbiased and effective management. In Malaysia, very few studies have examined the effectiveness of the committee although the committee has been made compulsory for all listed companies since 1994.

In more recent studies, Norman et al (2006) assess the effectiveness of some audit committee characteristics to monitor management behavior with respect to their incentives to manage earnings. The study finds that the presence of a fully independent audit committee reduces earnings management practices.

The existence of audit committees in public companies of Nigeria following the enactment of the CAMA about 20 years ago has been uneventful. Following the failures of some public quoted companies in Nigeria, it is obvious that some gate-keepers (including the audit committees of such companies) were caught napping (Ofo, 2010).

In Nigeria, the audit committees were created by the Companies and Allied Matters Decree, CAMD '90 (now CAMA 2004). Section 359(3) states; inter alia, 'the audit shall in the case of a public company also make a report to an audit committee which shall be established by the public company'. According to sub-section (4) of the above section, the make-up of the committees shall consist of an equal number of directors and representatives of the shareholders of the company (subject to a maximum number of six members), and shall examine the auditor's report and make commendations thereon to the annual general meeting as it may think fit; Provided however, that such member of the audit committees shall not be entitled to any remuneration and shall be subject to re-election annually.

2.3. Audit Committee Attributes

This is one of the variables being investigated by this research and the main objective is to find out whether certain audit committee attributes are associated with improved financial reporting quality? This concerns the issue of the effectiveness of the audit committee at accomplishing one

of its main suggested functions, i.e., improving financial reporting quality (DeZoort et al. 2002). Prior researches identified several attributes that they believed contributed to the effectiveness of the audit committee. This section provides an overview of some prior research on those attributes identified and examined in this research, i.e., audit committee independence, financial expertise, frequency of meetings and multiple directorship.

2.3.1. Audit Committee Independence (ACIND)

The independence of the audit committee is affected primarily by the structure of the board and the audit committee, the balance between executive and non-executive directors, the chairperson of the audit committee and the integrity and independence and objectivity of individual committee members.

Sawyer, Dittenhofer and Scheiner (2003) indicate that "audit committees composed of directors from within the organization may be affected by their direct involvement with the matters reported". Therefore, to ensure the independence of audit committees, the American Institute of Certified Public Accountants (AICPA) (1978) and Braiotta (2004) stipulated that an audit committee should be organized as a standing committee of the board composed mainly of non-officer directors or outside directors, that is, non-executive directors. The US Congress reaffirmed this through the Sarbanes-Oxley Act (2002:s 2(a)(3)), which defines the audit committee as "a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of financial statements of the issuer".

According to the King II Report (IOD 2002), a "non-executive director is an individual not involved in the day-to-day management and not a full-time salaried employee of the company or its subsidiaries. An individual in the full-time employment of the holding company or of its subsidiaries, other than the company concerned, would also be considered to be a non-executive director unless such individual by his/her conduct or executive authority could be construed to be directing the day-to-day management of the company and its subsidiaries".

The King II Report (IOD 2002) further states that an independent director is a non-executive director who:

(i) is not a representative of a shareholder who has the ability to control or significantly influence management;

(ii) has not been employed by the company or the group of which it currently forms part, in any executive capacity for the preceding three financial years;

(iii) is not a member of the immediate family of an individual who is, or has been in any of the past three financial years, employed by the company or the group in an executive capacity;

(iv) is not a professional advisor to the company or the group, other than in a director capacity;

(v) is not a significant supplier to, or customer of the company or group;

(vi) has no significant contractual relationship with the company or group; and

(vii) is free from any business or other relationship which could be seen to materially interfere with the individual's capacity to act in an independent manner.

The Ferreira study recommends that the independence requirements of audit committees and the individual members of such committees should be the main requirement and first consideration when recruiting new audit committee members. The ideal skills and competency requirements

and competency mix for the specific organization should then be considered, and finally, the general characteristics or attributes of individual members should be taken into account.

The Oxford English dictionary online (2007) defines independence as freedom from subjection or the control or influence of another or others, and the AICPA (2005) as the ability to act with integrity and at the same time exercise objectivity and professional skepticism. The Institute of Internal Auditors (IIA 2004) defines independence as "the freedom from conditions that threaten objectivity or the appearance of objectivity". When this definition is applied to the audit committee, it reflects on the committee's ability to challenge management decisions, evaluate corporate performance and exercise judgement freely and objectively in order to fulfil their responsibilities properly (ACF 2006; Bromilow & Berlin 2005).

The Blue Ribbon Committee Report (1999) states that "independence is critical to ensuring that the board fulfils its objective and oversight role and holds management accountable to shareholders". To achieve this, Matraia (2005) reiterates the statement made by Securities and Exchange Commission (SEC) Chairman, William H. Donaldson, that "an important element of strengthened corporate governance is not only a stronger, more active board of directors, but also a board that is independent of management in both appearance and in reality". This is equally applicable to audit committee members, who form a subcommittee of the board.

Terrell (2001) suggests the introduction of another test of independence. This is a test based on the "appearance" from a reasonable investor's perspective. According to O'Kelly (2003), this implies that members of the audit committee should be free to act upon what they see and the information they receive, and then render a professional judgement. Independence allows committee members to be objective in their decision-making. It also suggests a willingness to

challenge management's decisions and evaluate overall corporate performance from a completely free and objective perspective, without undue influence from management (Burke & Guy 2002; Gregory 2000; Rock 1996).

There has been a significant change in the New York Stock Exchange (NYSE) governance rules approved by the SEC in 2004 with regard to director independence requirements relating primarily to relationships between directors and the company's internal and external auditors. Specifically, a director is not considered independent if any of the following apply (NYSE 2004:s303A):

i. The director or an immediate family member is a current partner of the company's internal or external audit firm.

ii. The director is a current employee of the company's internal or external audit firm.

iii. The director has an immediate family member who is a current employee of the internal or external audit firm and participates in the firm's audit, assurance or tax compliance (but not tax planning) practice.

iv. The director or an immediate family member was, in the last three years (but is no longer), a partner or employee of the internal or external audit firm and personally worked on the company's audit within that time.

Klein (2002) provides empirical evidence that audit committee independence is associated with certain economic factors, such as that the independence increases with board size and board independence and decreases with the firm's growth opportunities and for firms that report consecutive losses.

2.3.2. Audit Committee Frequency of Meetings (ACMTG)

The effectiveness of audit committee depends on the extent the committee is able to resolve issues and problems faced by the company and to improve their monitoring function of company activities (Abbott, Park and Parker, 2000). A more active audit committee is expected to provide an effective monitoring mechanism. The more frequent the audit committee meets, the more opportunity it has to discuss current issues faced by the company. Evidence shows that companies with less audit committee meetings are often found to have problems of reporting (McMullen and Raghunandan, 1996). There is evidence that inactive audit committee is associated with non-compliance with regulatory requirements and accounting standards (Menon and Williams, 1994). Menon and Williams (1994) find that an audit committee, which holds fewer meetings than the minimum of two per year as suggested by the American Bar Association, is less likely to pursue their duties diligently. Kalbers and Fogarty (1993) reinforce this notion by positing that audit committee effectiveness is a function of audit committee members' desire to carry out their duties.

Since the level of audit committee activity reflects good governance, it should enhance the reliability of financial reporting. The Code of Corporate Governance states that the provision of an institutionalized forum (audit committee) encourages the external auditor to raise potentially troublesome issues at a relatively early stage. As a best practice, audit committee meeting should be conducted at least once a year without the presence of executive board members. However, the total number of meetings depends on the company's terms of reference and the complexity of the company's operations. At least three or four meetings should be planned to coincide with the audit cycle and the timing of published annual reports in addition to other meetings held in response to circumstances that arise during the financial year (FCCG, 2001).

Consistent with this argument, Abbott, Parker and Peters (2004) found a lower likelihood of prior period financial statement restatements (a proxy for low quality reporting) in firms with more active audit committees. A study by Anderson, Mansi and Reeb (2004) indicates that the costs of debt decreases when the frequency of audit committee meeting increases. Xie et al. (2003) find the number of audit meeting is negatively related to discretionary accruals. The finding suggests as the frequency of meeting increases, discretionary accruals (earnings management) decreases.

In Malaysia, Ruzaidah and Takiah (2004) also find that the good reporting companies meet more often than the poor reporting companies. The more frequent audit committees meet, the better the quality of financial reporting because they can monitor the management activities more promptly and effectively in the meeting (Ruzaidah and Takiah, 2004). These studies regard the frequency of meeting as a proxy for audit committee activity. Although the number of meetings may not provide any indication about the extent of work accomplished during the meeting, it is noted that audit committee without any meeting or with small number of meetings is less likely to be a good monitor (Menon and Williams, 1994).

2.3.3. Audit Committee Multiple Directorship (ACMDR)

Multiple directorships refers to the number of director positions held by audit committee members. Shivdasani (1993) and Song and Windram (2000) argue that multiple directorships may cause limitations of time and commitment for audit committee members from performing effectively. Audit committee members who hold director posts of too many companies may have limited time fulfilling their responsibilities (Lipton and Lorch, 1992; Core, Holthausen and Larker, 1999).

However, there are studies which show that multiple directorships may enhance the contribution of audit committee members towards discharging their duties effectively. For example, audit committees with multiple directorships demand a more extensive audit to protect their reputation capital (Boo and Sharma, 2008), hence, contributing to better reporting quality. Kiel and Nicholson (2003) find multiple directorship is positively associated with market capitalization and performance of Australian listed companies. Multiple directorships enrich audit committee members with experience and knowledge of management of companies of different business background. The experience from managing other companies exposes audit committee members to economic trends and aspects of international business besides providing the opportunity to compare management policies and practices.

In Malaysia, the importance of experience of audit committee members gained through director positions in other companies is evident in the Ruzaidah and Takiah (2004) study. They argue that multiple directorships would enhance audit committee expertise and enable them to monitor the companies to produce high quality reporting. Among Malaysian corporations, multiple directorships of audit committee members are also found to have significant positive relationships with corporate social reporting practices (Haniffa and Cooke, 2005) and corporate performance (Haniffa and Hudaib, 2006). This suggests that audit committee with multiple directorships provides an effective monitoring mechanism. Given that studies on multiple directorships of audit committee of Malaysian corporations have shown positive results.

Due to the costs and benefits associated with MDR, there are both potentially positive and negative effects of ACMDR on audit committee effectiveness. An audit committee member with high MDR might be overcommitted and therefore contribute less time and effort to audit

committee service. On the other hand, an audit committee member with high MDR might contribute to its effective functioning as he or she might bring more experience (knowledge transfer effect) and have stronger incentives to monitor because of higher reputational capital at stake (labor market effect). Both time commitment and expertise are important to audit committee effectiveness. Therefore, the overall effect of multiple directorship (MDR) on audit committee effectiveness is uncertain. Based on the foregoing, the direction of the relation between the ACMDR and financial reporting quality is ambiguous.

2.3.4. Audit Committee Financial Literacy (ACFLT)

The need for a high degree of financial literacy is necessary for an audit committee to effectively oversee a corporation's financial controls and reporting. The role of an audit committee in overseeing accountability of the management covers a wide scope to include the overall process of corporate reporting. This role requires the audit committee to have accounting knowledge in order to acquire an in-depth understanding of corporate reporting and, hence, improve compliance with regulatory requirements. The need to comprehend the overall financial and non-financial contents of corporate reports is greater considering that listed companies are operating as conglomerates with some having complex group structures and therefore, presenting technically advanced financial reporting contents. Knowledge and experience in the areas of accounting, auditing and or finance are found to have reduced fraud in corporate financial reporting (Song and Windram, 2000). A formal recognition of this requirement was recently made in the U.S. with the passing of the Sarbanes-Oxley Act 2002 which requires each public listed company to disclose whether or not it has a financial expert in the audit committee.

The Blue Ribbon Committee2 (1999) raised the issue of the background and experience of audit committee that can affect their effectiveness. The Committee suggests that audit committee members should be financially literate. In Malaysia, members of audit committees are required to have a sufficient understanding of financial reporting issues (FCCG, 2001).

S.13(a) SEC code requires members of audit committee in Nigeria to be able to read and understand basic financial statements while the Listing Requirements of Bursa Malaysia recently suggest that audit committees should have at least one member registered with the local accounting professional body, the Malaysian Institute of Accountants (MIA), or at least three years experience after passing a professional examination and must be a member of one of the specified accounting associations (Shamser and Zulkarnain, 2001). Ruzaidah and Takiah (2004) find that, in Malaysia, public listed companies with financially literate audit committees have a higher ability to produce good annual reports. They argue that audit committee members who have the knowledge in the areas of accounting, auditing, and finance are capable of meeting their responsibilities of monitoring internal control and financial reporting.

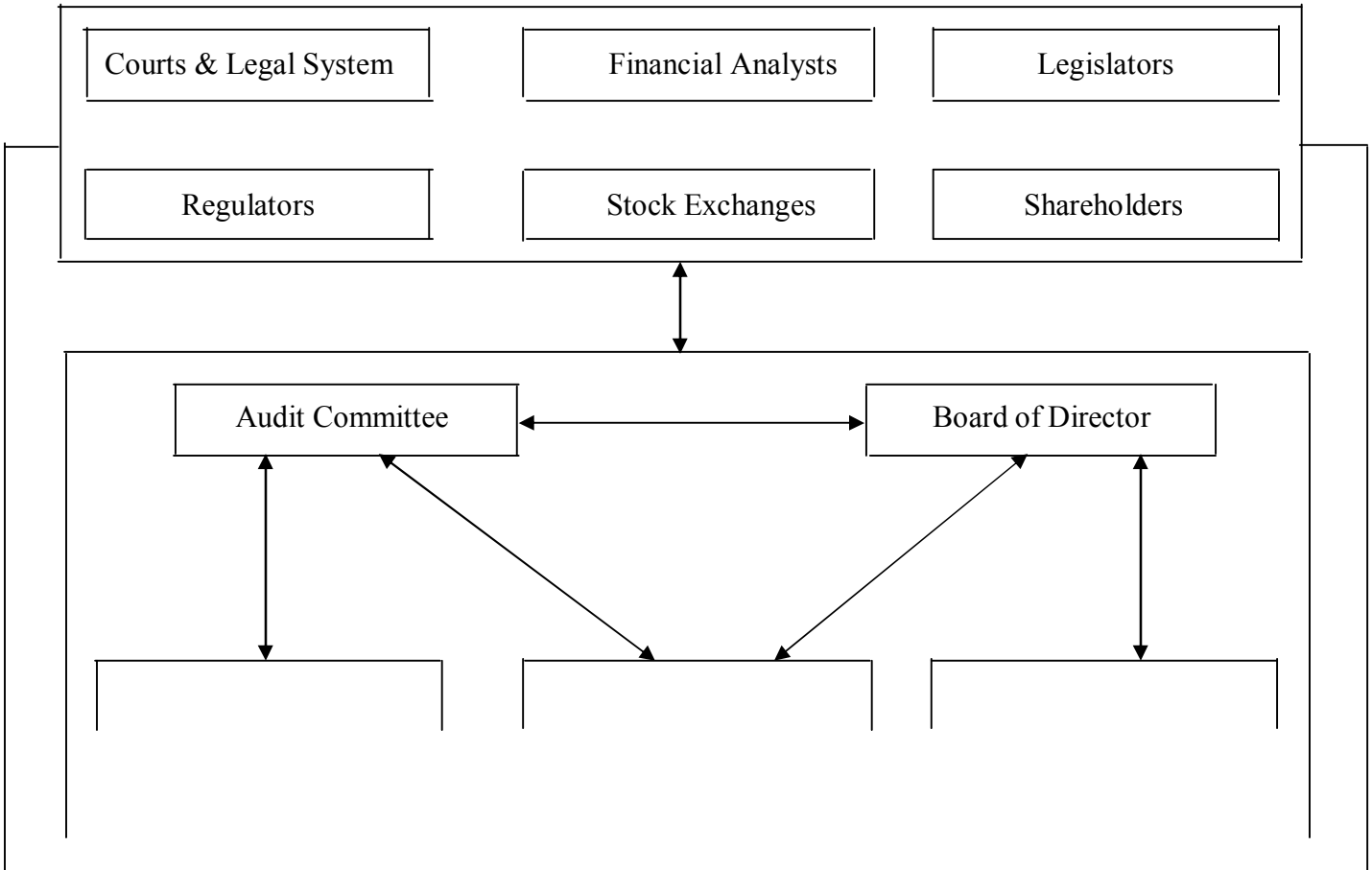
The focus of discussions is that financial reporting quality is better when financial experts are part of the committee (McDaniel, Martin and Maines, 2002; and Collier, 1993). The absence of financial experts in the audit committee has led the company to have financial problems (McMullen and Raghunandan, 1996). They found firms with financial problems are unlikely to have audit committee members with financial expertise. The lack of knowledge in financial reporting and internal control among audit committee members are perceived by external auditors as the hindrance for effective interactions between external auditors and audit committees (Kalbers, 1992). Also, the expertise among members of the audit committee is

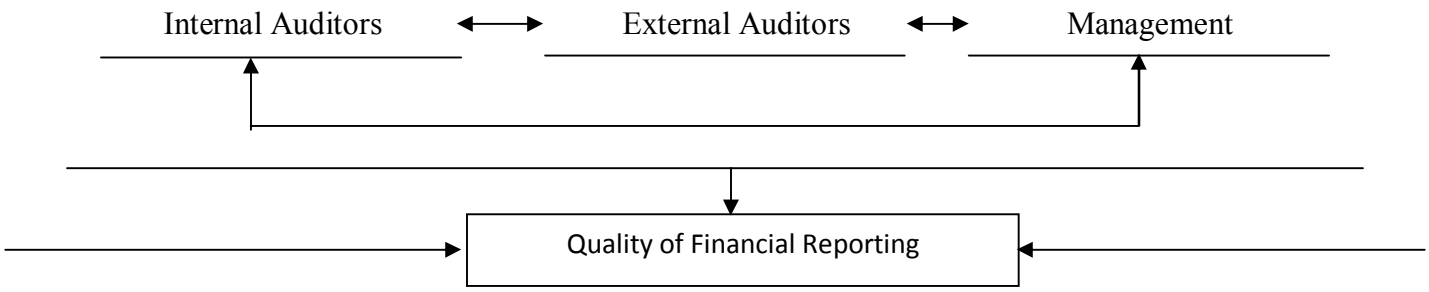
expected to minimize the manipulation of financial reporting by the management or other interested parties in the companies (Ruzaidah and Takiah, 2004).

The market reacts positively to the appointment of audit committee with financial expertise. This is because members of the committee equipped with financial experience and training are able to understand earnings management and act accordingly (Xie, Davidson and DaDolt, 2003). Hence, it is expected that the higher the number of audit committee with financial literacy, the better the quality of corporate reporting.

FIGURE 1.

CORPORATE GOVERNANCE STRUCTURE AND QUALITY OF FINANCIAL REPORTING





Source: Cohen, Krishnamoorthy Wright (2004)

2.4. Annual Financial Reports (AFRs)

Judd and Timms (1991) view annual financial reports (AFRs) as communication tools which provide links between the management of corporations and its various stakeholders including customers, shareholders, employees, suppliers, media and the government. Although the annual report is primarily addressed to the shareholders, its reach is beyond the members only. Hence, it is essential that the quality of AFRs be maintained in order to ensure some measure of credibility on the information contained therein. Bartlett and Jones (1997) observe that over the period from 1970 to 1990, total mandatory contents of AFRs have increased rapidly as a result of changing demands from several regulatory bodies. In Malaysia, the quality of the information in an annual report takes on a more important dimension in view of the implementation of the Code of Corporate Governance effective 1 January 2002, which amongst other things, require directors to disclose how the company complies with, what the Code identifies, as "best practices" of corporate governance and to explain for any non-compliance. Many perspectives have been used in researching AFRs (Stanton and Stanton, 2002).

The accountability perspective views corporations as reacting to concerns of external parties (Keasey and Wright, 1993). Accountability involves monitoring, evaluation and control of organizational agents (in this case, the management) to ensure they behave in the interests of

both shareholders and that of other stakeholders (Keasey et al 1993). Studies of modern day capital market which examine the relationship between corporate information and share prices conclude that regulated reports provide new and relevant information to investors (Kothari, 2001).

2.4.1. Financial Reporting

Financial reporting is an important element of the system of corporate governance and some failures of corporate governance may therefore be due to inadequate financial reports (Whittington, 1993). This is because, the financial reporting serves as the main means of communication between companies and stakeholders by relieving fundamental asymmetry information between the directors, who have access to management information, and providers of finance who are external to the company (Whittington, 1993). Published corporate annual reports are one of the many forms of accounting reports made available to third parties and probably the most common and well-known form (Stone, 1967).

Accounting data clearly furnishes one type of quantitative data that can be used as basis for making some of the choices that have to be made from among the alternatives available and for checking and evaluating progress and results (Stone, 1967). Audited financial statements also provide a common ground for investors to compare firms within or across time periods (Hodge, 2001). Therefore, financial reporting is a crucial link in enabling providers of finance to monitor directors (Whittington, 1993) and therefore help them to make economic decisions (Razman and Iskandar, 2003).

However, with the widespread manifestation of fraudulent or misleading financial reporting in the most recent spate of corporate disasters, this have given impetus to inquiries concerned with the integrity of the financial reporting process, the responsibilities of those involved in it and the truthfulness of financial statements (Wolnizer, 1995). This is because the credibility and transparency of financial reporting of a company depends on the monitoring mechanism of that company (Fama, 1980).

In Nigeria, under the Companies and Allied Matters Act LFN Cap 2004, every company registered under the Act is required to produce financial accounts for every financial year. The Act also requires that this annual financial account be audited by an external independent auditor referred to as the approved company auditor. An audited financial statement increases the reliability of financial information for users which is necessary if managers, investors, creditors and regulatory agencies are to make informed decisions about resource allocation (Messier and Boh, 2002). Therefore, by adding the audit function by an external independent auditor in the business environment, the users of the financial statements have reasonable assurance that the financial statements do not contain material misstatements or omissions and shall enhance the credibility of the audit report (Messier and Boh, 2002). The auditor's report, which accompanies the financial statements, attests to the truth and fairness of such statements and in doing so provides a degree of assurance to users of the financial statements that the statements are free of material misstatements (Ismail and Iskandar, 2003). In addition to this, the Listing Requirements of Nigeria Stock Exchange listed companies are also required to produce their annual audited accounts no later than four (4) months by the end of their financial year and their annual reports no later than six (6) months by the end of their financial year.

In Nigeria, besides being required to comply with the Companies and Allied Matters Act 2004, listed companies are also required to comply with the Listing Requirements of the Nigerian Stock Exchange, where all listed companies are required to produce quarterly financial accounts. The purpose of this requirement is to ensure that shareholders can be informed more regularly (without having to wait for the companies' annual audited accounts) and therefore, will enable them to monitor the performance of companies on a regular basis. In addition to this, the requirement also states that all listed companies are required to produce this report no later than two (2) months by the end of each quarter of their financial year.

2.4.2. Financial Reporting Quality (FRQ)

Although one should expect that "better" corporate governance leads to improved financial reporting, there is a lack of consensus as to what constitutes "financial reporting quality." For example, although, the BRC (1999) and Sarbanes-Oxley (2002) require auditors to discuss the quality of the financial reporting methods and not just their acceptability, the notion of financial reporting quality remains a vague concept. As Jonas and Blanchet (2000) state, "in light of these new requirement, auditors, audit committee members, and management are now struggling to define "quality of financial reporting."

Rather than define "quality of financial reporting," prior literature has focused on factors such as earnings management, financial restatements, and fraud that clearly inhibit the attainment of high quality financial reports and have used the presence of these factors as evidence of a breakdown in the financial reporting process. Specifically, prior literature has examined the role of the various players in the governance structure (e.g., board, audit committees, external auditor, and internal auditors) and the extent to which these players have either individually or collectively

influenced the attainment of quality financial reports that are free from material misstatements and misrepresentations. The principal players identified in prior literature include the board of directors, the audit committee, the external auditor, and the internal auditors.

Several determinants have been used by previous researchers as proxies for quality financial reporting in their studies. Among the proxies that have been used are compliance with accounting or auditing standards (Abbott, Park and Parker, 2000; Beasley, 1996; McMullen and Raghunandan, 1996; Song and Windram, 2004), accuracy of accounts (Abbott, Parker and Peters, 2004; McMullen and Raghunandan, 1996), manipulation of accounting treatments (Davidson, Stewart and Kent, 2005; Klein, 2002b; Rahman and Ali, 2006; Xie, Davidson and DaDalt, 2002; Yang and Krishnan, 2005) and disclosure (Alsaeed, 2006; Craig and Diga, 1998; Haniffa and Cooke, 2002). Most of the earlier studies have used compliance of financial reporting with accounting and auditing standards as proxy for quality of financial reporting. Motivated by earlier studies, Beasley (1996) used a sample of firms that were subject to regulatory enforcements as a proxy for low quality financial reporting, later studies by Abbott, Park and Parker (2000) and Song and Windram (2004) have replicated this approach. Besides that, since the need to restate financial accounts is only required if material information is misstated or omitted (Abbott, Parker and Peters, 2004), McMullen and Raghunandan (1996) also included firms that have restated their financial accounts into their sample. A recent study by Abbott, Parker and Peters (2004) had also used restatement of financial reporting as a proxy for low financial reporting quality in their study. In addition to this, based on the argument that even though the manipulation of accruals accounting is being done not in violation of the accounting standards but because it may lead to inaccurate information (Rahman and Ali, 2006), past researchers have also used accruals accounting manipulation as a proxy for financial reporting

quality in their studies. Xie, Davidson and DaDalt (2002), Klein (2002b), Yang and Krishnan (2005), Davidson, Stewart and Kent (2005), Rahman and Ali (2006) had implemented the level of accruals as a proxy for their financial reporting quality, in which firms with higher level of accruals are identified as having low quality financial accounts and vice versa. On the other hand, studies by Craig and Diga (1998), Haniffa and Cooke (2002) and Alsaeed (2006) had used the level of voluntary disclosures as their proxy for quality financial reporting. This is based on the argument that since there is inadequacy of compulsory information, the voluntary disclosures provide investors with necessary information to make more informed decisions (Alsaeed, 2006). While earlier studies have concentrated on the annual financial reporting, various concerns on quality financial reporting have recently been focused on quarterly reports (Yang and Krishnan, 2005). For the purpose of this study, the level of accruals is used to proxy financial reporting quality through adoption of modified Dehow and Dechev (2002) model of short time accruals.

Earnings quality can be expressed through earnings attributes that are market based or accounting based. Market based attributes of earnings are value relevance and timeliness of information. Accounting based attributes are predictability and accruals quality. Accrual quality identifies discretionary accruals through accounting disclosures and tests the abnormality of such accruals. Lower levels of abnormal accruals disclosed by accounting statements indicate higher earnings quality. The main objective of financial reporting being to provide decision makers with information that meets their expectation, an examination of earnings quality and its effect on firm's performance as well as governance code of conduct needs to be examined. Analysis of relationships between governance, earnings quality and firm performance improves confidence of decision makers with respect to usage of accounting information and would help in establishing best disclosure practices for firms. The significance of establishing reporting

standards in ensuring high earnings quality would help stakeholders to view accounting information as valuable decision tools.

Earnings quality is a theoretical concept that has a multidimensional orientation. Financial Accounting Standards Board (FASB, 1995) discusses primary earnings qualities as predictive value, feedback value, timeliness, verifiability, neutrality and representational ability.

Dechow et. al., (2010) in their elaborate review of earnings quality, their determinants and their consequences define earnings quality as higher quality earnings provide more features of a firm's financial performance that is relevant to a specific decision made by a specific decision-maker. Within this broad definition of earnings quality they have reviewed more than 300 research papers that have focused on attributes of earnings. The most common measure of earnings quality is the Jones (1991) model. Dechow et. al., (1995) brought out the modified Jones model that adjusts for growth in credit sales. Kothari et. al., (2005) modified the Jones model to identify performance based discretionary accruals. Francis et. al., (2005) decompose the standard deviation of residuals from the accruals model into one component that reflects the firm's operating environment and a discretionary component that reflects managerial choice. Each revenue and expense item in reported income has a discretionary and a nondiscretionary component. For many of these items, management can exercise discretion through accounting method choice, through operating, investing and financing policies, and through choice of estimates for a given accounting period (McNichols and Wilson 1988). Tests of earnings management generally assume that earnings are managed through changes in accounting procedures, through specific transactions such as write downs, and through discretion exercised over accounting accruals. Sloan (1996) finds that stock prices behave as if investors fail to

correctly consider the valuation implications of the accrual component of earnings, which is found to be less persistent compared to the cash component because of its reversal in subsequent periods. He concludes that the result is consistent with earnings fixation by at least some market participants. Investors adjust their trading decisions based on reported total earnings rather than on the analysis of different components of earnings, accruals and cash flow and their implications for future earnings.

The evidence of accrual mispricing by the market is also found by subsequent studies (Ali et al. 2000; Chambers 1999; Xie 2001; DeFond and Park 2001). They however, document that market participants understand the reversing implications of working capital accruals but do not fully impound its pricing implications at the earnings announcement dates leading to subsequent stock price adjustments. Moreover, auditors do not signal future earnings problem associated with high accruals through either their audit opinions or through auditor changes.

These findings favor the effectiveness of managing accruals by firms in order to mislead certain sections of investors or to loosen contractual constraints imposed on firms by outside stakeholders or to influence the contractual outcomes that depend on the reported accounting numbers. The accounting accruals reflect the summarized effects of managers' selection and application of accounting techniques.

2.4.3 Review of Financial Reporting Quality Models

The objective of accruals models is to dissect accruals into a component that measures accrual based earnings that will be associated with the firm's fundamental earnings process from

abnormal accruals, which are assumed to represent accruals that are discretionary or that are the result of intentional or unintentional accounting errors. Higher levels of accruals that are not associated with the firm's fundamental earnings process are assumed to reduce the quality of earnings. As reported in Figures 1, 2, and 3, abnormal accruals have been used as a proxy to test predictions in almost all of the determinants and consequences categories, hence we discuss the models. Exhibit 2 summarizes the most widely used accruals models. Jones (1991) explains working capital accruals and depreciation as a function of sales growth and PP&E. The explanatory power of the Jones model is low, explaining only about 10% of the variation in accruals. Consistent with the assumption that the residual represents greater discretion, as mentioned earlier, Xie (2001) documents that the residuals from the Jones model have lower predictive ability for year-ahead earnings than the non-discretionary (i.e., "normal") accruals. On the downside, the residuals are highly (80%) positively correlated with total accruals (Dechow, Richardson, and Tuna, 2005), and they are positively correlated with earnings performance and negatively correlated cash flow performance (Dechow, Sloan, and Sweeney, 1995). These correlations are an important concern when the residuals are used to test theories of the determinants or consequences of earnings quality, in which performance is an important potential omitted correlated variable. In addition, Dechow, Larson, Ge, and Sloan (2009) show that discretionary accruals are generally less powerful than total accruals at detecting earnings management in SEC enforcement releases. This finding suggests that the discretionary accruals modeling process could include some accruals representing earnings management in "normal" accruals. Dechow, Sloan, and Sweeney (1995) modify the Jones model to adjust for growth in credi sales. Credit sales are frequently manipulated, thus this modification increases the power of the Jones' model to yield a residual that is uncorrelated with expected (i.e., normal) revenue

accruals and better reflects revenue manipulation. The modified Jones model has many variants and adaptations. DeFond and Subramanyam (1998) estimate the regression by industry rather than by firm to lessen firm-year requirements. Chambers (1999) suggests adding lagged accruals to the model to capture predictable reversals. Dechow, Richardson, and Tuna (2003) estimate the normal relation between credit sales and total sales to control for nondiscretionary credit sales. They also add future sales growth to capture accruals made in anticipation of future growth. Their adjustments increase the R2 from around 9% to 20%. Guay, Kothari, and Watts (1996) provide a comparison of various models. 15 For example, assume ROA is 20% for firm A and B, with firm A using discretionary accruals to boost its ROA by 2% to report 20%. Firm B is not manipulating earnings; it has achieved 20% ROA because it has higher non-discretionary accruals than firm A. Matching firm B to firm A would suggest that firm A's level of non discretionary accruals should be the same as firm B, but this match is incorrect since the correct match should be a firm with ROA of 18%. However, this model suffers from the same performance related problems as described above for the Jones model.

Holthausen, Larcker and Sloan (1995) and Leone, Kothari, and Wasley (2005) suggest ways to combat concerns about the correlation between performance and the residuals from the Jones model and modified Jones model. They both suggest controlling for the normal level of accruals conditional on ROA. Leone et al. (2005) identify a firm from the same industry with the closest level of ROA to that of the sample firm and deduct the control firm's discretionary accruals (i.e., residuals) from those of the sample firm to generate "performance-matched" residuals. Because the models of normal accruals that generate the residuals explain only 10% - 12% of the variation in accruals, this approach is likely to add noise to the measure of discretionary accruals

and it is best applied when correlated performance is an important concern. In addition, the performance matching can extract too much discretion when earnings are being managed, resulting in low power tests.

Dechow and Dichev (2002) view the matching function of accruals to cash flows as being of primary importance and thus model accruals as a function of current, past, and future cash flows because accruals anticipate future cash collections/payments and reverse when cash previously recognized in accruals is received/paid. The R2s from their specification are higher than those of the modified Jones model (47% at the firm-level, 34% at the industry level, and 29% at the pooled level). The standard deviation of the residuals from the model is their proxy for earnings quality. They show that firms with larger standard deviations have less persistent earnings, longer operating cycles, larger accruals, and more volatile cash flows, accruals and earnings. They are smaller firms and the firms are more likely to report a loss. They suggest that these firm characteristics are indicative of a greater likelihood of estimation error in accruals and thus lower accrual quality. Francis, LaFond, Olsson, and Schipper (2005) modify and extend the Dechow and Dichev model in two ways. First, as suggested by McNichols (2002), they add growth in revenue and PP&E to the model of normal accruals. Second, they decompose the regression residual into firm-level measures of *innate* estimation errors and *discretionary* estimation errors, such that the discretionary error is meant to represent the outcome of "managerial choices" (i.e., intentional errors). Specifically, FLOS (2005) estimate their accruals prediction model by industry-year and calculate the standard deviation of the residuals for each firm *j* in year *t* [$\sigma(\varepsilon j)t$] based on the value of εj in year's t-4 through year t (five years). The standard deviation of the residuals $\sigma(\varepsilon j)t$ is a measure of accrual quality (AQ); higher standard deviations are lower

quality. To decompose AQ into an innate component and a discretionary component, FLOS model AQ as a function of firm characteristics identified in Dechow and Dichev (2002):

$$\sigma(\varepsilon j)t = \lambda 0,j+\lambda 1,jSizej,t-1+\lambda 2,j\sigma(CFO)j,t + \lambda 3,j\sigma(Sales)\ j,t + \lambda 4,jOperCyclej,t + \lambda 5,jNegEarnj,t + \nu j,t$$

The predicted value of $\sigma(\varepsilon j)t$ represents the quality of accruals associated with the inherent ability of an accrual system to capture the firm's fundamental earnings process, and the residual ($\nu j,t.$) represents discretionary accrual quality. An argument can be made that each of the innate characteristics could also reflect estimation errors and corrections that would reduce the power of $\nu j,t$ (or induce bias) as a proxy for discretion. All of the accruals models can be estimated at the firm-level, which allows variation across firms in the determinants of normal accruals. Firm level estimation, however, assumes time in variant parameter estimates and typically imposes sample survivorship biases. The models often are estimated at the industry-level. This specification assumes constant coefficient estimates within the industry.

Thus, some firms may have large residuals because of variation induced by industry classification rather than because of earnings management or errors. Measurement error in the residual will be related to industry characteristics, which can be a concern in some contexts. For example, the model may have a poorer fit in growth industries and growth may be correlated with the hypothesized determinant or consequence. Several studies develop models of specific accruals and for homogeneous samples in order to test the determinants or consequences of accrual quality. The motivation behind the research design is that a better model of the normal component of an accrual generates a less noisy estimate of the abnormal component (i.e., model

residual), resulting in more powerful tests. As an example, Miller and Skinner (1998) and Schrand and Wong (2003) both model the economic determinants of the valuation allowance for deferred tax assets (DTAs) required under SFAS 109. Miller and Skinner (1998) do not find much evidence of earnings management using the residual from their model estimated for firms with large DTAs. Schrand and Wong (2003), however, are able to find evidence of earnings management using a model of the DTA allowance specifically designed for banks. Of course, the construct validity benefits of modeling specific accruals, especially within specific industries, come at the expense of generalizability.

2.5. Review of Empirical Studies

The examination of financial records of an enterprise by an independent Audit firm and their report there on provides assurance to shareholders, investors, and other stakeholders about its financial health. Empirical evidence shows that independent audit reports increase investor confidence, lower cost of capital and boost firms' value, Macey and Sale 2003). Kane and Velury (2004) and Yi Meng et al (2005) examine the relationships between audit quality measured by industry specialization and the number of audit committee meetings in a year as a sign of good corporate governance practice. They find evidence that a relationship exist between the presence of an Audit Committee and industry specialist Audit firm. The conventional wisdom is that the Big-4 Audit firms provide a relatively high quality of auditing services; are more likely to control opportunistic Management behaviors; reduces agency cost and thus increase firm value. Recent evidence (Macey and Sale 2003) about the ignoble conduct of Arthur Anderson and Company in the audit of Enron, the commodification of Audit services and the change in the legal status of Audit firms in the U. S. to limited partnership combine to change the

approach and perception of the public to the integrity of Audit firms and their reports. Aljifri (2008) examines the level financial disclosure in UAE and find no significant difference in disclosure level between companies engaging with the Big-4 Audit firms and companies engaging with other firms.

Audit committees have been long seen as a vital institution in assisting the board of directors in enhancing the transparency and integrity of financial information reporting Dan (2007). The code provided that the audit committee will be responsible for the review of the integrity of the banks' financial reporting system and oversee the independence and objectivity of the external auditors. Specifically, effective audit committees are expected to enhance financial reporting quality by fulfilling its numerous responsibilities including, commenting on and approving accounting policies, reviewing the financial statements, and maintaining and reviewing the adequacy of internal controls. Moreover, audit committees are also expected to play an important role in enhancing the effectiveness of external auditors over financial reporting quality by, assuming responsibilities for the appointment and remuneration of external auditors, and discussing the scope of and reviewing the auditors work.

However, prior research indicates that the construct of audit committee effectiveness over financial reporting is multidimensional and is affected by variety of audit committee characteristics such as committee size (Anderson et al., 2004; DeZoort and Salterio, 2001), committee independence (Klein, 2002; Bedard et al., 2004) and committee number of meetings (Menon and Williams, 1994; Beasley et al., 2000). Audit committee member financial expertise is another important dimension of audit committee effectiveness that has gained the attention of regulators and academics (Treadway Commission, 1987; GAO, 1991; POB, 1993; Kalbers and

Fogarty, 1993; DeZoort, 1997, 1998; BRC, 1999; SOX, 2002). Advocates propose that the presence of financial experts in audit committees do assist the committee in, critically analyzing accounting policies and financial statements, identifying potential problems, and solving them. Carcello and Neal (2000) provide support for this argument by documenting a relation between greater audit committee independence and the quality of financial reporting.

However, accounting expertise may be more important for audit committee members than any other expertise, since banks Code of Best Practices (2006) suggest that audit committee members are responsible for tasks that require high degrees of accounting sophistication. Prior studies argue that financial reporting issues involve the highest level of technical detail among audit committee effective areas (Kalbers and Fogarty, 1993; Green, 1994), and ideal audit committee members should have knowledge of accounting concepts and the auditing process to enhance their understanding of the financial reporting process, recognize problems, ask probing questions of the management and auditor and make leadership contributions to audit committees (McDaniel et al., 2002; Libby and Luft, 1993; Bull and Sharp, 1989; Lipman, 2004; Scarpati, 2003). Archival evidence suggests that audit committee accounting expertise is negatively associated with SEC enforcements and restatements (McMullen and Raghunandan, 1996; Agrawal and Chadha, 2005) and suspicious auditor switches (Archambeault and DeZoort, 2001), and positively associated with firm credit ratings (Ashbaugh-Skaife et al., 2006) and the likelihood of supporting auditors in financial reporting disputes with management (DeZoort and Salterio, 2001).

DeFond et al. (2005) document positive market reactions to the appointment of new audit committee members with accounting expertise, but no reactions to the appointment of audit

committee members with non-accounting expertise. It is therefore likely that accounting expertise, relative to other expertise, can contribute more to the effectiveness of audit committees which in turn improve the quality of financial information.

2.6. The Banking System in Nigeria: An Overview

At the centre of Nigeria's economic development and growth has been an evolving banking system that has been in existence prior to the country's independence from Great Britain in October 1960. Nwankwo (1975) holds that formal banking began in Nigeria in 1892. From Nigeria's colonial era to present day fourth republic, the banking industry has witnessed vast transformations in character, structure and organization.

Goldsmith (1955), Cameron (1967), Mckinnon (1973) and Shaw (1973), agree to the recognition of a society's financial system (of which the banking sector is at the centre) as playing important roles in the economic development of that society. These authors believe further, that the financial sector could be a catalyst of economic growth if it is developed and healthy.

It can be said that the banking system in Nigeria, in conjunction with the non-banking sector e.g. securities market, form the core of Nigeria's economic development by playing vital roles. The functions of the banking system as such include and are not limited to:

(a) the development, administration and implementation of monetary policies that ensure stability in the Nigerian economy;

(b) the provision and management of financial resources and services to the Nigerian society in order to drive economic activities;

(c) the provision, management and storage of instruments of negotiation and exchange;

(d) the mobilization of financial resources from locations where they are least needed to where they are most needed; and

(e) the provision of information technology driven systems and platforms to support economic activities within and beyond the borders of Nigeria.

Thus, it can be said that the roles of banks, whether in a developed or developing economy, consist of financial intermediation, provision of an efficient payments system and serving as conduit for the implementation of monetary policies. Donli (2003) postulates that if these functions are efficiently carried out, the economy would be able to mobilize meaningful level of savings and channel these funds in an efficient and effective manner to ensure that no viable project is frustrated due to lack of funds.

2.6.1. Participants and their Roles in the Nigerian Banking System

The Nigerian Banking system is composed primarily of regulators (government), operators (different types of banks), support groups (the Mint, electronic switches and platforms) and depositors (individuals, corporate and governments). These actors and their roles in the Nigerian banking industry will be discussed below.

First are the Regulators, there are two regulators in the Nigerian Banking industry namely the CBN and the Nigerian Deposit Insurance Company (NDIC). These are government institutions set up by law to regulate, monitor and control the activities and actors in the banking, and entire financial sectors of Nigeria. They formulate policies and procedures that ensure a sound and stable financial system. They also ensure that other actors in the banking system operate within the defined policies and practices.

The NDIC on the other hand, is the government's agency responsible for guaranteeing the payment of deposits up to the maximum limit in accordance with its statue in the event of failure of an insured financial institution. It also supervises banks so as to protect depositors; fosters monetary stability; promotes an effective and efficient payment system; and promotes competition and innovation in the banking system. For the NDIC, banking supervision is an essential element of the Nigeria deposit insurance scheme as it seeks to reduce the potential risk of failure and ensures the unsafe and unsound banking practices do not go unchecked. A board of directors and a management team led by a managing director manage the NDIC.

The NDIC utilizes three types of supervision in the banking system namely transaction-based supervision, consolidated supervision and risk-based supervision. These types of supervision involve activities such as Offsite Surveillance and Onsite examination in the supervision of commercial banks while supervisory activities for Microfinance Banks (MFBs) and Primary Mortgage Institutions (PMIs) supervision are termed Supervision of Other Financial institutions.

Second are the operators, these are the various types of licensed banks providing financial services to the Nigerian public. Depending on the category of financial services provided, banks in Nigeria are grouped into Deposit Money Banks (Commercial Banks), Microfinance Banks (MFBs), Finance Companies (FCs), Bureau-de-change (BDCs), and Development Finance Institutions (DFI's). These operators provide distinct financial services to the private and public sectors of the Nigerian economy. Their services include deposit mobilization and storage, term loans, mortgage loans and other types of credit facilities, as well as financial advisory services and electronic payment cards and platforms etc. These institutions are individually managed by a

Board of Directors and a management team vetted and approved by the government regulators (CBN and NDIC).

Third are the support groups. These actors are the institutions that provide the services, media and platforms that support the activities of the banking system. They include:

i. The Nigerian Security Printing and Minting Plc (NSPM): production of coins, bank notes and other security documents used in the banking or financial industry e.g. cheques and stamps.

ii. Nigerian Inter-Bank Settlement System Plc: this is an institution owned by all licensed banks and the CBN. It operates an automated clearing platform (technology) that facilitates the clearing of cheques, electronic funds transfer, Automated Direct Credits and Automated Direct Debits between banks and between banks and the CBN.

iii. Private Owned Electronic Switches: These category of actors refer to the various privately owned electronic switches and platforms that process electronic payments and support card or Private Owned Switches (POS) terminal payments. Notable of them are InterSwitch, VISA, Etranzact and MasterCard.

iv. External Auditors: These actors are private institutions that provide periodic audits of the financial books and records of the operators. They usually give judgments as to the truthfulness of the published records and correctness of the method employed in the bookkeeping of transactions of these operators. Though engaged by the operators, they are vetted and approved by the regulators to provide these services to the operators.

Lastly, are the depositors, these refer to the beneficiaries of the services provided by the operators in the banking system. Depositors are individuals, formal and informal groups of persons, large and small corporate entities, as well as the three tiers of governments and their sub

agencies. They supply or demand financial resources to and from the operators, who in turn are supervised by the regulators.

Soludo (2009), states that the activities of banks accounts for over 90% of the Nigerian financial system assets and are an increasing dominant source of financing for the economy. These activities in the banking system form a significant part of, and determine to a great extent the economic fortunes of Nigeria. However, given the importance the banking system plays in the economic growth and development of Nigeria and the limitations of these interactions and activities among the above actors i.e. imperfections of market mechanism to mobilize and allocate financial resources to socially desirable economic activities of the nation, it becomes necessary for the Nigerian government (as with all governments), to regulate them more than any sector in the economy.

In addition, the nature of banking business; as one that is conducted with greater secrecy when compared with other real sector businesses provides added reason for its strict supervision. Such oversight is intended to assist supervisory authorities in the timely identification of deterioration in bank financial conditions before their degeneration threatens the stability of the banking system or even the economy.

2.6.2. The Quoted "Healthy Banks" in Nigeria

According to Cowry (2009) the recent test conducted on all commercial banks in Nigeria by the CBN Governor, Mallam Sanusi Lamido Sanusi in 2009 in which some of them were declared as unhealthy is still considered as a monumental phenomenon in recent times. The Nigeria

Financial market was thrown into a deeper turbulence having opened the year 2009 on a shaky note.

The new Central Bank of Nigeria (CBN) Governor, Mallam Lamido Sanusi wielded the big stick on some CEOs of commercial banks as a first step in his banking reforms shortly after assuming the leadership responsibility of the apex bank. He instituted a special examination to verify the quality of the assets of banks with the sole aim of assessing the wellness of these banks. He specifically focused on the followings:

- Liquidity must be above 25%
- Capital adequacy must be above 10%
- Corporate governance must be in line with code of corporate governance of financial institutions.

The first round of audit comprising ten banks resulted in five passing while five failed this was made available to the public on 14th August, 2009. the result revealed that the following banks have adequate capital and liquidity to support the level of their current operations and future growth: First Bank of Nigeria Plc; United Bank for Africa Plc; Skye Bank plc; Diamond Bank Plc; and Sterling Bank plc; The remaining five banks were found to be in a grave situation: Oceanic Bank ; International Plc Intercontinental Bank Plc; Union Bank Plc Afribank Plc; and Finbank plc.

Further audit conducted on other banks revealed the following banks to be sound in terms of capital adequacy and liquidity to support the level of their current operations and future growth: Access Bank Plc; Citibank Nigeria limited Ecobank Nigeria Plc; Fidelity Bank plc; First City Monument Bank Plc; Stanbic IBTC Bank Plc; Standard Charted Bank Limited; and Zenith Bank

Plc; these other four banks were found to be in grave situations too: Bank PHB Plc; Equatorial Trust Bank Ltd; Spring Bank Plc; and WEMA Bank Plc. Unity Bank Plc was adjudged to have insufficient capital but not in grave situation because it has a healthy liquidity position.

2.7. Theoretical Framework.

The existence of divergent and sometimes conflicting objectives between managers and shareholders has given rise to the design of many concepts and mechanisms to ensure that the cost associated with such divergent interest are minimised. One of the proposed arrangements is corporate governance in which audit committee is a vital mechanism, and it is not surprising that agency theory has been the dominant postulate in the corporate governance literature. However, several other theories have evolved in an attempt to highlight the objective of the firm and how it should respond to its different obligations. For the purpose of this study, Agency theory will serve as a leading theory since attainment of quality financial reporting is our base. Quality financial reporting also serve as a focal point in agency relationship as well. It is the tool by which the agent can be seen to be accountable to the principal, that is, when he renders quality financial report.

2.7.1. Agency Theory

It is an acknowledged fact that the principal-agent theory is generally considered the starting point for any debate on the issue of corporate governance emanating from the views of Berle and Means (1932). According to them, the fundamental agency problem in modern firms is primarily due to the separation between finance and management. Modern firms are seen to suffer from separation of ownership and control and therefore are managed by professional managers

(agents) who cannot be held accountable by dispersed shareholders. In this regard, the fundamental question is how to ensure that managers protect the interests of shareholders in order to reduce cost associated with principal-agent theory? The principals are confronted with two main problems. Apart from facing an adverse selection problem, in that they are faced with selecting the most capable managers, they are also confronted with a moral hazard problem: they must give agents (managers) the right incentives in order to make decisions that will align with shareholders' interests.

In further discussion of agency relationships and cost (Jensen and Meckling, 1976) describe agency relationship as a contract under which "one or more persons (principal) engage another person (agent) to perform some service on their behalf, which involves delegating some decision-making authority to the agent". In this scenario, there exists a conflict of interests between managers or controlling shareholders, and outside or minority shareholders leading to the tendency that the former may extract "perquisites" (or perks) out of a firm's resources and be less interested to pursue new profitable ventures. Agency costs include monitoring expenditures by the principal such as auditing, budgeting, control and compensation systems, bonding expenditures by the agent and residual loss due to divergence of interests between the principal and the agent. The share price that shareholders (principal) pay reflects such agency costs. To increase firm value, one must therefore reduce agency costs. The following represent the key issues towards addressing opportunistic behavior from managers within the agency theory:

• **Composition of board of directors**: The board of directors is expected to be made up of more non-executive directors (NEDs) for effective control. It is argued that this reduces conflict of

interest and ensures a board's independence in monitoring and passing fair and unbiased judgement on management.

• **CEO duality**: It is expected also that different individuals occupy the positions of CEO and board chairperson as this reduces the concentration of power in one individual and thus greatly reduces undue influence of particular management and board members.

CHAPTER THREE
RESEARCH METHODOLOGY

3.1 Introduction

The aim of this Chapter is to explain the method used to test the hypotheses developed in section 1.4 of Chapter 1. Correlation research design was employed in this study. The remaining part of the chapter is organised as follows: section 3.3 explains the population from which the sample was chosen and the sample selection methods used; section 3.4 identifies the data sources used; section 3.5 explains the measurement of the variables; section 3.7 discusses the techniques of analysis adopted.

3.2. Population and sample selection

3.2.1 Population

The population from which the sample was drawn was the twenty two banks quoted on the Nigerian Stock Exchange (NSE) as at 31st December, 2010. The year 2010 was selected as the base year for the collection of the necessary data because, when the data collection for this research commenced, 2010 was the most recent year for which full financial statement data was available for the sample banks.

3.2.2 Sample selection

Our sample size was obtained from our population filtered down to eleven by excluding the ten declared as unhealthy by the CBN (Cowry, 2009) and one which lack the relevant data for the period under consideration. We decided to use the whole filtered sample of eleven banks quoted on the Nigerian Stock Exchange as at 31st December, 2010 for this study.

3.3 Sources and Method of Data Collection

This research used (secondary) archival data in the form of banks annual reports for the period between 2004 to 2010. The data were obtained from a number of secondary sources. Annual report data were obtained from the banks published annual report and the half yearly Return submitted to SEC, (FS & CG Department). The data were used to measure the variables required to test the hypotheses developed in section 1.4 of Chapter 1. The annual report was used to gather the data on the dependent variable, control variables and some audit committee variables while the half yearly return was used only to gather data on audit committee variables especially those that could not be provided by the published annual reports.

3.4 Measurement of Variables

3.4.1. Dependent Variable

The construct investigated in this research was financial reporting quality. This construct was measured through the development of a proxy measure for earnings quality. Earnings quality is one way of capturing the construct of financial reporting quality. Alternatively, it could have been captured using third party assessments of the quality of the financial disclosures in annual reports or through surveys of stakeholders on their perceptions of financial reporting quality. However, these types of approaches inherently develop subjective measures of financial reporting quality and can be subject to a bias towards higher quality financial reporting.

The model developed by Jones (1991) to measure discretionary accruals (DACC) is used and applied earlier by Peasnell, Pope and Young (2000); Gore, Pope and Singh (2001) and Abdullah

and Nasir (2004). Peasnell et tal (2000) found that the model was almost indistinguishable from the Dechow, Sloan and Sweeny (1995) modified version in detecting the levels of earnings management.

Manipulation of accounts could be achieved by various means, such as the use of accruals, switches in accounting policies or changes in the capital structure (Jones, 1991). Compared to other methods, the use of accruals is argued to be the most attractive method as it is very difficult to detect. Total accruals are measured as the change in non-cash working capital before corporate tax payable less total depreciation expense, being defined as the change in current assets other than cash and short-term investments less current liabilities other than current maturities of long-term liabilities and corporate taxes payable. Several studies (DeAngelo, 1986; Healy, 1985) divided the total accruals into discretionary and non-discretionary components.

In this study, accrual management was measured as the abnormal (or discretionary) working capital accruals (i.e. DACC). Manipulation through working capital accruals is very attractive as it has no direct cash flow consequences and is relatively difficult to detect (Gore, Pope and Singh, 2001). This working definition of DACC is different from Jones' (1991) model, which used total accruals that included depreciation of fixed assets. According to DeFond and Jiambalvo (1994), working capital accruals, which exclude depreciation as employed by Jones (1991), are more susceptible to manipulation than non-working capital accruals. Moreover, according to Beneish (1998), the use of long-term accruals, such as depreciation, for manipulation is more transparent and economically implausible. Another variant of the Jones' model was used by Klein (2002) who defined accrual management as total accruals.

Working capital accruals (WCA) is defined as the change in non-cash working capital. Total working capital accruals estimation is, therefore, computed as follows:

- WCA = Δ(CA–CASH) - Δ(CL–CBORR), where CA is current assets, CASH is cash and cash equivalent, CL is current liabilities and CBORR is borrowings repayable in one year.

The total working capital accruals would then be divided into discretionary accruals (DACC) and non-discretionary accruals (NDACC) and the following ordinary least squares (OLS) regression is used to estimate the parameters needed to estimate DACC and NDACC:

$$\frac{WCA_{ijt}}{TA_{ijt-1}} = \beta_{ojt} + \beta_{1jt}\Delta\frac{REV_{ijt}}{TA_{ijt-1}} + \varepsilon_{ijt} \quad \ldots\ldots (1)$$

Where:

TA = Total assets

REV = Total sales

i, j, t = Firm, industry and year

The NDACC is the predicted component of the regression while the residual of the regression represents the DACC. Thus:

$$DACC_{ijt} = \frac{WCA_{IJT}}{TA_{ijt-1}} = NDACC_{ijt}$$

$$= \frac{WCA_{ijt}}{TA_{ijt-1}} - \beta_{ojt} + \beta_{1jt}\Delta\frac{REV_{ijt}}{TA_{ijt}} \quad \ldots\ldots (2)$$

3.4.2 Independent Variables

(i) Audit Committee Independence (ACIND)

There is considerable evidence depicting a positive relationship between audit committee independence and financial reporting quality (Klein, 2002; Bédard et al., 2004). Australian studies also find no evidence of a significant relation between the level of discretionary accruals and an independent audit committee measured by the proportion of non-executive members (Davidson et al. 2005). We code sample bank '1' if their audit committees are composed of three non-executive members in each year during the sample period and '0' if otherwise.

(ii) Audit committee Financial Literacy (ACFLT)

As a result of the 1999 exchange rules, both the NYSE and the NASDAQ require that all AC members are financially literate, the Nigeria CAMA (2004) also has similar provision, one of them is expected to be a financial expert. For the NYSE, financial literacy is subject to interpretation by the board of directors; while for the NASDAQ, financial literacy is defined as "being able to read and understand fundamental financial statements." As for financial expertise, current empirical evidence (Carcello et al. 2006, Defond et al. 2005, Bédard et al. 2004, Xie et al. 2003) is consistent with the expectation that an audit committee member with financial expertise enhances committee performance. However, these studies measure financial expertise differently. Our measure is operationalized by dichotomous variable ACFLT which is coded '1' if at least a member is a financial expert and all members are financially literate and have a basic knowledge of the business of the enterprise and '0' if otherwise.

(iii) Audit committee Frequency of Meetings (ACMTG)

Menon and Williams (1994) argue that audit committees that do not meet or meet only once are unlikely to be effective monitors while audit committees that meet several times exert more

serious efforts in monitoring managerial excessses. Other supporting evidence indicates that firms whose audit committees meet less often are more likely to engage in fraudulent practices (Beasley et al., 2000), face reporting problems (McMullen and Raghunandan, 1996), and make suspicious auditor switches (Archambeault and DeZoort, 2001). Dhaliwal, Naiker and Navissi (2007) code sample firms '1' if the audit committee met at least four times in each year during the sample period and '0' if otherwise. We use the actual number of audit committee meetings held in a year as stated in the published annual reports of some banks and half yearly reports of banks submitted to SEC.

(iv) Audit committee Multiple Directorship (ACMDR)

Denotes the number of audit committee members with board seats in other listed banks either as executive or non-executive director. Some studies (e.g., Yang and Krishnan 2005, Carcello and Neal 2003) include multiple directorships (measured by number of directorships) as one of the defining attributes of audit committees in examining the relationship between audit committee attributes and audit committee effectiveness. We measure by the number of director positions held by an audit committee member within the banking industry.

3.4.3 Control Variables

In addition to the above audit committee variables, we include variables to control for other factors that may be correlated with accruals management. As suggested in Chtourou, Bédard and Courteau (2003) and Bédard, Chtourou and Courteau (2004), we control for the fact that some banks may be in certain situations which give them incentives to manage earnings and which are unrelated to the quality of their audit committee attributes. This includes but not limited to

bank's size (BNKSZ) which is proxied by the natural log of total assets and bank market penetration (BNKMP) which is proxied by the natural log of total customers' deposit.

3.5 Empirical tests of hypotheses

This section explains the empirical tests carried out to test the hypotheses developed in Chapter 1. Section 3.7.1 explains the tests concerning the hypotheses relating to audit committee attributes and financial reporting quality.

Hypotheses 1, 2, 3, and 4 propose that financial reporting quality is negatively associated with these audit committee attributes: independence, financial literacy, frequency of meetings and multiple directorships. Therefore, to test this hypothesis, the following regression model was estimated for all banks *k* in the sample with an audit committee attribute for year *t*. This model was run on the sample of 11 banks listed on the Nigerian Stock Exchange as at 31st December,2010:

$$FRQ_{k,t} = a_t + b_{1t} ACIND + b_{2t} ACFLT + b_{3t} ACMTG + b_{4t} ACMDR + b_{5t} BNKSZ + b_{6t} BNKMP + \varepsilon_t \quad (8)$$

Where:

FRQ= Financial Reporting Quality

a = intercept

b = Coefficient of the Independent variable

ACIND= Audit Committee Independence

ACFLT= Audit Committee Financial Literacy

ACMTG= Audit Committee Meeting

ACMDR= Audit Committee Multiple Directorship

BNKSZ= Bank Size

BNKMP= Bank Market Penetration

ε = Error term

CHAPTER FOUR
DATA PRESENTATION AND ANALYSIS

4.1 Introduction

This chapter presents and analyses the data collected for this study and also discusses the results of data analysis. Multiple regression has been used to estimate the relationship between the independent variables (Attributes of Audit Committee of Nigerian Banks) and the dependent variable (Financial Reporting Quality). The technique of Ordinary Least Squares has been used to estimate the regression coefficient in the model of the form.

$$FRQ = X_0 + X_1ACI + X_2\,ACFL + X_3\,ACM + X_4ACMD + X_5BMP + X_6BSZ + E$$

The presentations and analyses were made in three sections. Section one present some basic statistics from the sample of banks used in the study. Section two present the regression results for the audit committee attributes of the sample banks, using Financial Reporting Quality (FRQ) as dependent Variable. Section three discusses the combine impact of audit committee attributes on the Financial Reporting Quality of the Banks.

The sample descriptive statistic is first presented in table 4.1; the correlation matrix is presented in table 4.2, while the tolerance and variable inflation factor are presented in table 4.3.

4.2. Descriptive Result

Table 4.1 provides the descriptive statistics for the variables used in the model analysing the association between audit committee attributes and financial reporting quality. The table shows

the mean, standard deviation, minimum and maximum values of the variables used in the study. The full results are contained in Appendix C.

Table 4.1 Descriptive Statistics of the Variables

Variable	Mean	Std.Devtn	Min.	Max.
ACIND	0.4675	0.50222	0.00	1.00
ACFLT	0.6234	0.48772	0.00	1.00
ACMTG	2.9351	0.84818	1.00	6.00
ACMDR	0.0519	0.22338	0.00	1.00
BNKMP	13.0181	9.17792	9.11	71.00
BNKSZ	11.3481	0.73701	9.28	12.54
FRQ	0.5658	0.05440	0.43	0.68

Source: Regression Result Using SPSS

ACIND=Audit Committee Independence; ACFLT= Audit Committee Financial Literacy; ACMTG=Audit Committee Meeting; ACMDR= Audit Committee Multiple Directorship; BNKMP= Bank Market Penetration; BNKSZ= Bank Size and FRQ= Financial Reporting Quality.

Table 4.1 indicate that, on the average, during the period of the study, the Financial Reporting Quality was 56.58%, while Audit Committee Independent 47%, Audit Committee Financial Literacy 62%, Audit Committee Meetings 3meetings, Audit Committee Multiple Directorship 5%, Bank Market Penetration 11.34, and Bank Size 11.35 respectively. The control variable, Bank Market Penetration as measured by Bank deposit has the highest standard deviation of 9.17 signifying its low contribution to the Financial Reporting Quality model, while Audit Committee

Multiple Directorship has the lowest standard deviation (0.22) which indicates its higher significant to the model.

4.2.2. Robustness Test

Table 4.2. Collinearity Statistics

Variable	Tolerance	VIF
ACIND	0.591	1.693
ACFLT	0.824	1.214
ACMTG	0.855	1.169
ACMDR	0.976	1.025
BNKMP	0.875	1.143
BNKSZ	0.691	1.447

Source: Regression Result Using SPSS

The Tolerance value and the Variance Inflation Factors (VIF) are two advanced measures of assessing multi-collinearity between the independent variables of the study. From Table 4.2, the variance inflation factors were consistently Smaller than ten indicating complete absence of multi-collinearity (e.g. Neter et al; 1996 and Cassey, et al; 1999). This shows the appropriateness of fitting the model of the study with the six independent variables. In addition, the tolerance values are consistently smaller than 1.00 thus further substantiating the fact that there is complete absence of multicollinearity between independent variables (Tobachmel and fidell, 1996).

4.2.3 Correlation Matrix

Table 4.3 reports the Pearson correlation coefficients between all combinations of dependent and independent variables. The correlation matrix is used to determine the relationship between the dependent and independent variable of the study. The full results are contained in Appendix C attached hereafter.

Table 4.3 Correlation Matrix of the Independent and Dependent Variables

Variable	FRQ	ACIND	ACFLT	ACMTG	ACMDR	BNKSZ	BNKMP
FRQ	1.000						
ACIND	0.726	1.000					
ACFLT	0.521	0.352	1.000				
ACMTG	0.639	0.319	0.229	1.000			
ACMDR	0.712	-0.102	0.061	0.018	1.000		
BNKSZ	0.521	0.469	0.011	0.013	-0.062	1.000	
BNKMP	0.519	0.248	0.119	0.137	-0.053	0.311	1.000

Source: Regression Result Using SPSS

Table 4.3 above reveals there were positive correlations between the dependent variable and all of the independent variables. It indicates that there is a positive relationship between Financial Reporting Quality and Audit Committee Independent, Audit Committee Financial Literacy, Audit Committee Meetings, Audit Committee Multiple Directorship, Bank Size and Bank Market Penetration. This implies that audit committee attributes are contributing positively to the financial reporting quality of Nigerian banks. The correlations between the independent variables are not all positive and not highly significant; the correlation between Audit Committee Multiple Directorship and Audit Committee Independent is negative and it equally has a negative

correlation with both bank size and bank market penetration. The correlation between other independent variables are all positive but significantly low. This implies that there is no collinearity between the independent variables.

However, the correlations between the dependent variable (FRQ) and independent variables (ACIND, ACFLT, ACMTG, ACMDR, BNKMP and BNKSZ) despite being positive, they are not significant at 5% level of significance. This is for the fact that the calculated correlations are all less than the tabulated correlation value (0.88) at 5% level of significance.

4.3 The Regression results.

The results of OLS in relation to the impact of audit committee attributes on the Financial Reporting Quality of Nigerian banks are discussed here. The study used four audit committee proxies; Audit Committee Independent, Audit Committee Financial Literacy, Audit Committee Meetings and Audit Committee Multiple Directorship. The regression results are presented in Table 4.4.

Table 4.4: Audit Committee Attributes and FRQ of Nigerian Banks.

Audit Committee Attributes	
Variables	FRQ
Intercept	0.004*** (2.952)
ACIND	0.022** (2.345)
ACFLT	0.049** (1.269)
ACMTG	0.012*** (2.564)
ACMDR	0.042** (1.162)
BNKMP	0.006***

	(1.916)
BNKSZ	0.001*** (3.574)
R^2	0.733
Adj. R^2	0.627
F. Stat	0.000
Durbin Watson	1.261

Source: Regression Result Using SPSS

Table 4.3 relates audit committee proxies to bank financial reporting quality variables. The estimated relationship for the model is presented as in appendix C:

FRQ =0.296 + 0.032(ACIND) + 0.003(ACFLT) + 0.017(ACMTG) + 0.028(ACMDR) + 0.001(BNKMP) + 0.031(BNKSZ)

The model indicates that all the 4 proxies of audit committee attributes (ACIND, ACFLT, ACMTG, and ACMDR) have positive impact on sample banks financial reporting quality as measured by FRQ. Thus, ACMTG, BNKMP, and BNKSZ have a significant positive effect at 1% level each on financial reporting quality, while ACMFLT, ACIND and ACMDR have positive impact at 5% level each on financial reporting quality. The implication of this result is that the higher the level of audit committee attributes the higher the financial reporting quality of the Nigerian banks. The Durbin – Watson Statistic value of 1.261 indicates that the presence of serial correlation does not pose a problem to our result (Keller and Warracks, 2003). Our result provides the basis for the rejection of the hypothesis 1, 2, 3 and 4 of the study which states that Audit Committee Independent, Audit Committee Financial Literacy, Audit Committee Meeting and Audit Committee Multiple Directorship have no significant impact on the financial reporting quality of the Nigerian banks.

Finally, the combined impact of the proxies of audit committee attributes on the financial reporting quality of Nigerian banks is indicated in the model summary of the regression result. The combined relationship between the dependent and independent variables of the study is 86% which implies strong positive relationship. While the adjusted R^2 of 0.63 shows that audit committee attributes and control variables account for not less than 63% of the variations in the financial reporting quality of Nigerian banks and the remaining 37% is covered by other factors.

4.4 Discussions of Major Findings

There are several implications of this research for policy and practice. The Nigerian Stock Exchange (NSE), Central Bank of Nigeria (CBN), Nigeria Deposit Insurance Commission (NDIC) and Security and Exchange Commission (SEC) will find the results useful in policy review especially now that SEC is considering the review of its code of corporate governance issued in 2003.

1. The policy of having equal number of non-executive directors and shareholders as members of AC in Nigeria needs consideration. The introduction of Independent directors as members of AC has received greater attention the world over. A lot of studies have shifted from the use of non-executive directors (NED) to the use of Independent directors as a measure of AC independence because of its preference in audit committee composition in most advance countries of the world. Independent director is strange to Nigerian corporate statutory documents.

2. Financial Literacy of audit committee is of significance but from this study it is found that the policy of recommending election of three shareholders who in some cases may neither be

financially literate nor have any basic knowledge of the organisation's business is given priority. We observed that some banks have two types of audit committee i.e. Statutory audit committee (to satisfy Statutory requirement) and board audit committee (to satisfy the management's objectives). The later is mostly composed of men and women who are experts and sufficiently literate in both accounting and banking business.

3. Our study has revealed a very low and insignificant presence (5%) of multiple directors among audit committee members of our sample banks despite its positive impact. Literature has revealed divergent views in this regard, policy statements have also been silent in this regard. It is neither included in the Acts nor in any of the corporate governance codes in issue.

4. The activity of audit committee is measured by frequency of its meetings and our study reveals a minimum of one and a maximum of six meetings with an average of three meetings across the sample banks. Only few registered banks revealed in their annual reports, the number of meetings held and attendance at such meetings. There is no policy in place mandating all corporate entities to reveal in their annual report the number of meetings held and members' attendance at such meetings.

5. It is also observed from this study that the content of the audit committee report is similar among all the sample banks and lack the required information expected of the committee, especially now that freedom of information (FOI) has become a legislative Act. Audit committee members are not bold enough to publish their observations and recommendations in the bank annual reports.

4.5 Chapter Summary

In this chapter, the regression result on the determination of financial reporting quality of banks in Nigeria have been presented and analyzed for the sample banks used in the study. The analyses have been carried out in three sections.

In section one, some basic sample statistics are presented and analyzed. The basic statistics are the sample descriptive statistics, the correlation matrix and tolerance values as well as variance inflation factor indicating absence of multicollinearity. Thus, the appropriateness of constructing the model of the study using Audit Committee Independent, Audit Committee Financial Literacy, Audit Committee Meeting and Audit Committee Multiple Directorship as explanatory variables has been established.

In section two, the regression results dealing with determination of banks financial reporting quality have been presented and analyzed. All the proxies of audit committee attributes show positive impact on the financial reporting quality of the banks with Audit Committee Independent contributing higher impact and Audit Committee Financial Literacy lowest.

The third section reveals that audit committee attributes has significant impact on the financial reporting quality of Nigerian banks. The chapter was concluded by articulating some of the major findings of this research.

CHAPTER FIVE
SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1. Summary

This study has employed a multiple regression model for the purpose of explaining and predicting empirically the contribution of audit committee attributes to the financial reporting quality of Nigerian banks. Using the confirmatory specification approach to model development, the study estimates the relationship between four explanatory variables – Audit Committee Independent, Audit Committee Financial Literacy, Audit Committee Meeting and Audit Committee Multiple Directorship, and one explained variable – financial reporting quality as a measure of accountability by means of the ordinary least square technique. The study hypothesized a significant impact between the four explanatory variables and the financial reporting quality as a measure of accountability.

The findings of the research are based on the panel data collected for the period 2004 to 2010 from a sample of 11 banks. The result of the study reveals that the four predictor variables- Audit Committee Independent, Audit Committee Financial Literacy, Audit Committee Meeting and Audit Committee Multiple Directorship have an aggregate significant impact (at 1 percent level) on the financial reporting quality as a measure of accountability.

This study reveals that Audit Committee Independence has the highest impact on the financial reporting quality of banks followed by Audit Committee Multiple Directorship, Audit Committee Meeting and then Audit Committee Financial Literacy.

5.2 Conclusion

Based on the findings of the research, the study concludes as follows:

First, the study has provided both empirical and statistical evidence on the utility of four independent variables Audit Committee Independent, Audit Committee Financial Literacy, Audit Committee Meeting and Audit Committee Multiple Directorship in explaining and predicting Financial Reporting Quality of the sample banks. The results show that the four variables have a significant aggregate impact (at 1 percent) on the financial reporting quality of banks in Nigeria.

Second, among the predicting variables, Audit Committee Independence has the highest contribution to the financial reporting quality as a measure of accountability. On the other hand, Audit Committee Financial Literacy was identified to be the lowest contributor to the aggregate impact on the financial reporting quality of Nigerian banks.

Third, the study concludes that there is a complete absence of serial correlation between Audit Committee Independent, Audit Committee Financial Literacy, Audit Committee Meeting and Audit Committee Multiple Directorship of Nigerian banks as attributes of audit committee attributes. Also, the correlation matrix reveals that, Audit Committee Independent has the highest relationship with financial reporting quality which signifies more contribution to the quality of financial reporting of Nigerian banks.

5.3. Recommendations

In line with the findings and conclusions of the study, the following recommendations are proffered:

(i) The regulatory authorities like NSE and SEC should consider encouraging banks to have in addition to the three non-executive directors in their audit committee at least one independent director. This will further improve the financial reporting quality of banks in Nigeria as revealed by this study.

(ii) The regulatory authorities should also give attention to the issue of financial literacy of audit committee members. Efforts should be made to ensure that elected shareholders into the audit committee are financially literate. It was discovered that some banks have two separate audit committees i.e. Board Audit Committee and Statutory Audit Committee. The management tends to give more priority to the Board Audit Committee and virtually most of its members are financially literate. This study considers only the Statutory Audit Committee. The profiles of all audit committee members should be published in the bank's annual reports just as its being done for the board of directors.

(iii) The audit committee members should be encouraged to attend meetings regularly. It is discovered from this study that in some instances meetings are sparsely attended by members. This has the tendency of affecting the quality of contributions that would have been made if most or all members were to be in attendance. Attendance at meetings and the number of meetings held in a year should be made public. Regulatory authorities should consider sending delegates to attend and bring feedback at companies' audit committee meetings at least once in a year.

(iv) The regulatory authorities should ensure that all banks submit evidence of compliance to the audit committee mandate in the quarterly reports usually submitted to them. This is because it is discovered that some banks do not even submit their returns and in some cases where they are

submitted the contents are not detailed. Measures should be taken to ensure compliance so as to improve the audit committee attributes of Nigerian banks.

(v) Another better way of ensuring that audit committee members have clear understanding of their roles and responsibilities is for regulatory authorities to organise trainings and seminars for audit committee members as its being practiced in other civilised nations where audit committee institutions are even established to groom audit committee members.

(vi) Multiple directorship is not popular among Nigerian banks as revealed by this study. Banks should be encouraged to promote multiple directorships because of its positive impact on financial reporting quality from this study. In addition, multiple directorships provide directors with valuable experience and the ability to import knowledge and "best practices" from other firms. Restrictions may be placed on the number of seats that a director must not exceed as a director in other companies. For example, the National Association of Corporate Directors guidelines (NACD 1996) recommend that senior corporate executives and CEOs should hold no more than three outside directorships. The Council of Institutional Investors (CII 1998) is stricter in its recommendations, suggesting that individual board members with full-time jobs should not serve on more than two other boards.

(vii) Researchers in the academia should intensify research and document more on the dynamics of audit committee attributes in banking and other sectors of the economy. This will go a long way to assist regulatory authorities and other stakeholders to have access to different resources, materials and publications that can easily be available for existing and potential audit committee members and even for policy review and developments.

5.4. Limitations

While this research has several strengths, a number of limitations require mention.

First, the focus of this research was on healthy quoted Nigerian banks. The reason for this was that, the going concern status of these banks is guaranteed within the foreseeable future. Our study is intended to probe further the wellness of these healthy banks by examining an aspect of its corporate governance mechanism i.e. audit committee since corporate governance formed part of the tools used to arrive at this healthy status. Audit committee is expected to enhance or boost this going concern status by ensuring quality financial reporting.

Second, this research relied majorly on banks annual reports and returns for the data necessary to test the hypotheses. Consequently, it was not possible to develop a detailed knowledge of the inner workings of audit committees as no interviews or questionnaire were distributed to audit committee members of any of the sample banks.

Third, data on the tenure of individual audit committee members could not be collected, since this information was not available in annual reports, (only few of the banks have it in the quarterly returns submitted to SEC) which meant it was not possible to test the association between this variable and financial reporting quality.

Finally, this research used the modified Jones (1991) model to develop the measure of financial reporting quality. This model has been criticized by various scholars who prefer the use of other alternative models. However, our desire to use it is not to say that it is the best model to measure financial reporting quality.

While these limitations are acknowledged, they do not detract from the strengths of this research and the importance of its findings. The limitations merely provide platforms for further research, some of which are discussed in the next section.

5.5. Areas for Further Research

There are several areas for further research that arise from the limitations addressed in the previous section. First, the data collection could be extended to include even the unhealthy banks quoted on the Nigeria Stock Exchange. This would help to determine if the results from this research also hold for unhealthy banks as well.

Second, a number of case studies of audit committees in Nigerian companies could be undertaken to obtain a more detailed understanding of the inner workings of the committees. This could involve attending audit committee meetings and conducting interviews with committee members. Such case studies would require obtaining agreement from company management, which may be difficult to obtain.

Finally, other measure of financial reporting quality could be substituted for the modified Jones (1991) model used in our study, such as (Dechow and Dichev (2002) model; Dechow, Sloan and Sweeney (1995) model.). Some prior studies suggest that audit committees are an effective corporate governance mechanism, which can improve the quality of companies' financial reporting practices. This research found similar support for this notion based on our findings, however there are others who found otherwise. Therefore, the relationship between audit committees and financial reporting quality appears divergent and foundations have been set for further research about this relationship especially among the Nigerian corporate entities.

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APPENDIX A

Population of the Study

1. Access Bank Plc
2. Afribank Plc
3. Diamond Bank Plc
4. EcoBank Plc
5. Equatorial Trust Bank Plc
6. First City Monument Bank Plc
7. Fidelity Bank Plc
8. First Bank Plc
9. Finbank Plc
10. Guaranty Trust Bank Plc
11. Intercontinental Bank Plc
12. Oceanic Bank Plc
13. Platinum Bank Plc
14. Skye Bank Plc
15. Spring Bank Plc
16. Stanbic IBTC Bank Plc
17. United Bank of Africa Plc
18. Sterling Bank Plc
19. Union Bank Plc
20. Unity Bank Plc
21. Wema Bank Plc
22. Zennith Bank Plc.

APPENDIX B

Sample of the Study

1. Access Bank Plc
2. Diamond Bank Plc
3. EcoBank Plc
4. First City Monument Bank Plc
5. Fidelity Bank Plc
6. First Bank Plc
7. Guaranty Trust Bank Plc
8. Skye Bank Plc
9. United Bank of Africa Plc
10. Sterling Bank Plc
11. Zenith Bank Plc.