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Audit Committee and Banking System Stability: A Conceptual Framework

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Abstract

The functioning of board committees in Nigerian banks has generated interests in recent times. Concerns have been raised on the effectiveness of these committees especially their roles in the promotion of stable banks. One of the committees which attracted both research and regulatory interests is the audit. The efficiency of audit committees in the Nigerian banking system has been questioned. This is a proposed framework aimed at studying the roles of audit committees in the Nigerian banking system especially the impact on bank stability. The framework is focused on the attributes of the committee which include the frequency of meetings, expertise, independence and the size. The study proposed that these attributes could influence the stability of the banking system. The key attributes of the audit committee and how they impact bank stability have been reviewed. It is shown in the review that the audit committee is a vital element in bank stability which demands that more attention should be paid to the behaviour of its characteristics in ensuring bank soundness. The outcome of the research is expected to impact policy formulation on the functioning of the audit committee and equally have implications on bank risk governance structure. It would also be relevant to other researchers undertaking studies relating to board committee functioning in banks, risk governance and bank stability. This study is unique in that previous studies on audit committee did not focus on its roles in banking system stability.

Keywords: Banking System, Audit Committee, Agency Theory, Bank Stability, Risk Governance.

Introduction

Banks differ from other financial firms as a result of the uniqueness of the deposit acceptance duty and offer of credits to borrowers. Through these services, banks perform asset transformation, respond to the financial needs of different sectors of the society and ensure the smooth running of the economy (Heffernan, 2005). Further, and as an extension of the intermediation function, banks facilitate payments for their customers within and outside their national boundaries. Banks are also unique in that their services are opaque and subject to asymmetric information. Opacity is concerned with the lack of public knowledge on the stability of banks. The financial health of a bank is often mainly known to the managers and to a lesser extent the regulators and external auditors while depositors possess the least knowledge (Heffernan, 2005). Thus, without regulatory disclosures, it could be challenging for the public to detect the current state of any bank. Given the importance of banks in the economy, regulators pay much attention to the state of banks (Gup, 1998; Heffernan, 2005) as they scrutinize bank reports, and conduct periodic examinations to determine if banks are in good health.

The concern to ensure that banks remain in sound health stems from the economic and social implications of bank instability. Bank instability could arise when a few banks become insolvent or through the insolvency of a single but systematically important large institution (Kickpatrick, 2009). Healthy banks are not immune from instability because of the interbank transactions in the banking system. The instability of several banks could occur due to the interconnectedness of the banking system (Scott, 2016). Interconnectedness accelerates the transmission of crisis from one institution to multiple banks and produce a contagion effect (Heffernan, 2005; Scott, 2016). Once it begins, contagion could result in bank runs especially when not quickly curtailed and this could trigger the failure of several banks in particular, financially weak institutions. Thus, banks are surrounded with regulatory provisions to monitor and ensure their safety and protect depositors and the economy.

In furtherance of the goal of protecting the health of banks, mechanisms of protection are designed to reduce the agency problem of asymmetric information and moral hazards which are often at the root of bank instability. In the literature, the board of directors and its committees are recognised as instruments for managerial restraint (Ellul, 2015; Sun & Liu, 2014). One of the important committees is the audit. Audit committees are delegated by the board to provide support and guide in the oversight of the management. In this respect, the committee has responsibility for the oversight of the financial reporting systems and processes. It is to monitor internal control systems and ensures that they are adequate and sound. (DeZoort et al., 2002). The committee also has a role to play in risk management and control as part of the internal control oversight. While the risk management committee sets the policies and strategies for risk management, the audit is involved in the review of the implementation of the processes (BCBS, 2015). This is to ensure that all procedures for risk management have been adequately observed. In doing its work, loopholes or system weaknesses discovered are to be reported with recommendations on how to plug them. Thus, audit committees are important towards ensuring a sound and stable banking system (Centre for Advanced Research and Learning (CARL), 2012).

The products of banks are opaque with the possibility of suddenly transforming as a result of unexpected events surrounding a customer or in the economy. This sudden change in the assets of banks is at the root of bank instability (Scott, 2016). This is because a bank with seemingly good assets could suddenly find itself in insolvency if several large credits turn delinquent. There is thus a need for effective measures to ensure sound internal controls and risk management. The audit committee is established to serve this purpose (DeZoort et al., 2002). For the committee to perform well in the review of risk processes, it requires an understanding of risks, how they are measured and the policies and strategies it intends to review. Without this understanding, the work of the committee on the review of risk management and control would be ineffective.

Banks have become dependent on sophisticated and complex technology especially software for their operations including accounting processes and risk modeling. These techniques and technologies have made banking processes to become complex and highly prone to fraud and would require increasing level of oversight. Therefore, audit committees are vital to provide support to the board to monitor these sophisticated processes (BCBS, 2015).

Banks provide essential services that make them closely linked to personal and business activities. In Nigeria, banks are central to fund intermediation and credit supply for economic growth which requires the necessity for a close watch over the health of banks (Ogunleye, 2015). In recent times, concerns have been raised on the health of Nigerian banks due to the weaknesses observed while the roles of the board audit committees have been called to question (Musa, 2014; Ojeka, Iyoha & Obigbemi, 2014; Otusanya & Lauwo, 2010; Sanusi, 2010). While the key goal of setting up the audit committee in banks is the oversight of risk and the financial reporting process, reports indicate that the committees seem to have underperformed (Abiola, 2012; Musa, Oloruntoba & Oba, 2014; Owolabi, 2011; Sanusi, 2010). The reports include collusions between the boards and executives of banks. Also, there are instances of suspicious accounting records. For instance, there were reports on the manipulations of the financial reports of Afribank and other connected financial frauds (Ogunleye, 2015; Owolabi, 2011; Sanusi, 2010). Musa et al. (2014) show that the audit committees in Nigerian banks are unable to effectively supervise the accounting reports of their banks which are likely to have enhanced financial malpractices in these banks and exposed the institutions to instability. Further, reports show that the audit committees seemed to have looked the other way while the executives in the banks engaged in various forms of unethical practices (Sanusi, 2010). Several banks were reported to have engaged in financial and corporate frauds in addition to diversion of bank funds for personal gains (Otusanya & Lauwo, 2010; Sanusi, 2010). Abiola (2012) documented evidences of corporate frauds and unethical practices which suggested that there were lapses in the internal control processes of several banks. Further, in 2015, the Financial Reporting Council of Nigeria (FRCN) penalized some directors and auditors of StanbicIBTC bank in Nigeria on issues connected with manipulations in the 2014 and 2015 financial reports. These lapses concern the core duties of the bank audit committees.

The study becomes necessary in the light of the cycles of instability the Nigerian banking system has experienced in recent time. From the early 1990s the Nigerian baking system has not been able to maintain a decade free of crisis (Ogunleye, 2015; Sanusi, 2010).

The instability that engulfed banks in Nigeria over these years resulted in massive fiscal support from the treasury, loss of depositors' funds and disturbances to the credit and payment system with far reaching implication for the economy. Official reports point to board committees' slackness as part of the factors that contributed to the instability (Sanusi, 2010). However, there has not been any major study to conduct an empirical finding on the actual roles of these committees. Nevertheless, it seems that the audit committees in these banks have been unable to carry out their oversight duties to restrain management from acts that promote crises in banks. Given the important place of banks in economic development and the implications of repeated experiences of bank crises on individuals, businesses and the economy, it is important to understand the factors behind the problems in the Nigerian banking system especially in connection with board committees.

This proposed study is therefore aimed at investigating the roles of the board audit committees and to determine if they have any link with the instability in the Nigerian banking system. The study is divided into the following sections: section I covers the introduction. Literature review is considered in section II while the proposed framework comes up in III. The conclusion and likely contributions of the study are presented in Section IV.

Literature Review

The Importance of Bank Stability

Banks render services that are connected with the daily transactions of individuals and firms. The main service is financial intermediation through deposit taking and lending. Banks therefore serve the needs of savers of funds and business and personal credits of borrowers (American Bankers' Association (ABA), 2015). Through the payment system, banks ensure the smooth flow of economic transactions by facilitating payments. Therefore, any disruption to banking operations would create disturbances to the free flow of goods and services. Banks also interact locally and internationally. Indeed, the international operations of banks is the back bone of foreign trade (ABA, 2015). The interaction of banks also extends to their inter-bank activities. Banks are closely connected through the interbank market. This interconnectedness is a major factor behind the vulnerability of one bank to other banks. It is also at the root of the close watch of the banking system by the financial authorities (Scott, 2014). The disturbance to the banking system when one bank is in crisis especially a systemically important bank underscores the implications of bank interconnection. In the event of such occurrence, substantial set back could be encountered in the implementation of monetary policies. Also, personal and business financial transactions could face immense tension or massive disruptions. Therefore, banks differ from other firms owing to the economic and social implications of disturbances to their services. It thus becomes imperative for financial authorities to keenly monitor the financial status of banks, their exposure to risks and signals that would alert regulators to impending banking system instability (Scott, 2014).

Audit Committee and Bank Stability

The search for improved risk management and concerns for the safety of banks has directed attention to the roles of audit committees in bank risk management (Sun & Liu, 2014). Audit committees are considered as part of the board governance mechanisms for constraining managerial decisions on risk taking (Salloum, Azzi, & Gebrayel, 2014; Sun & Liu, 2014). The presence of audit committees is considered to be a signal of good governance given that the committee is more likely to contribute towards enhancing the oversight duties of the board (DeZoort et al., 2002). Choi (2013) regards the audit committee as a vital arm of bank risk governance and a compliment to the risk committee in the oversight of risk management. Choi (2013) further indicate that there is a strong link between audit committees and corporate survival which suggests that audit committees in banks could strengthen the monitoring power of the board, enhance risk control and promote the stability of banks. The attributes that support the functioning of the audit committee include the frequency of meetings, expertise of members, the independence and size of the committee (DeZoort et al., 2002; Sun & Liu, 2014). This study would explore the roles of these characteristics of the audit committee and how they contribute to bank stability.

Frequency of Meetings of the Audit Committee

Vefeas (1999) notes that meeting frequency is an important attribute that could have implications on the performance of the audit committee. This is because, meetings provide opportunity for members of groups such as committees to come together and perform their duties. In the audit committee, it creates the means through which the members could render their advisory services to the board and management (Brick & Chidambaran, 2010). Lack of frequent meeting by the audit committee could create room for financial fraud given that there would be less monitoring of the internal audit and control processes (Beasley et al., 2000). However, Adam and Mehran (2005) and Vafeas (1999) suggest that increased activity through frequent meetings could be a signal that a firm is facing challenges or crisis. Nevertheless, meetings create a forum for members of the audit committee to take important decisions that could contribute to better risk management and improved bank stability. Alzharani & Aljaaidi (2015) report a negative and significant relationship between audit committee meetings and risk management. Beaseley et al. (2000) show that in companies with the high occurrence of fraud, the audit committees fail to hold regular meetings. Lack of frequent meetings could hinder the proper scrutiny of reports and prevent timely detection of infractions. Thus, increased committee meetings could enhance the performance of the audit committee by providing more time for careful review of executive proposals, check excesses and thereby contribute to bank stability.

Financial Expertise of the Audit Committee

The presence of financial experts on the audit committee is important because of the nature of the reports and proposals the management would present for consideration. Thus, standards and codes recommend financial experts for the committee (Basel Committee for Bank Supervision (BCBS), 2015; Committee of Sponsoring Organisations of the Threadway Commission (COSO), 2009; Central Bank of Nigeria (CBN), 2014;

International Finance Corporation (IFC), 2012). The modern banking business has become complex and sophisticated with highly technical reports that necessitate adequate financial knowledge by committee members (Garcia-Sanchez et al., 2017; IFC, 2012). Thus, members of the audit committee would likely be more effective when they possess the technical knowledge to understand the complex reports presented to them. Fernandes and Fich (2016) found that when financial experts serve on the audit committee, there is a reduction in the exposure to risk and they linked it with the monitoring advantage hypothesis. Also. García-Sánchez, García-Meca, & Cuadrado-Ballesteros, (2017) found that audit committee financial expertise contribute to the reduction of risks which enables the committee to contribute to the stability of banks. It suggests that the presence of financial experts does not only provide monitoring advantage for the audit committee, it also serves as a check on the risk taking actions that often cause instability.

In a 2004 study conducted on over 1000 US commercial banks with a median asset of $50m, Noland, Nichols and Flesher (2004) found that possession of financial knowledge or experience in the banking or financial services industry is important for the effectiveness of a bank's audit committee. The survey report show that audit committees with members who possess banking experience or expertise in financial matters had few demands for the amendment of their call reports with regulators. Also, they were less likely to be cited for regulatory violations and had fewer staff dismissed for involvement in frauds. In addition, they had less problems with regulatory technical exceptions (Noland, Nichols & Flesher 2004). Thus, the presence of experts in finance or with banking and finance experience on a bank's audit committee is likely to contribute to improved stability through the reduction of moral hazards and risk-taking. Hence, bank stability could likely be better protected when bank audit committee members possess expertise in banking, finance or have some level of financial knowledge.

Independence of the Audit Committee

The number of independent directors appointed to serve on an audit committee is considered as a determinant of its independence (Bouaziz, 2012; Bronson et al., 2009; Sun & Liu, 2014). One of the outcomes of the reforms that followed the financial scandals of corporate giants such as WorldCom and Enron was the demand for increase in the number of independent members of the audit committee (Bronson et al., 2009). In the US, the Sarbanes Oxley Act of 2002 specifically provided for majority independent members on the audit committee. The reason for this is the assumption that the independent members have greater leverage to perform the oversight of management given their detachment from the executives (Defond & Francis, 2006). However, Bronson et al. (2009) note that insider director could also be vital especially in the supply of important information that independent outside directors may not be able to access. Bouaziz (2012) found a significant and positive relationship between independent audit committee members and the financial performance of firms in Tunisia. The result is in support of the findings of Klein (2002) which report that the services of audit committee independent members could improve corporate performance. Bronson et al. (2009) report that audit committees that are composed mainly of independent directors are linked with high level effectiveness. The foregoing suggests that in banks, the presence of such members on the audit committee would provoke increased scrutiny and aid better risk management which would enhance bank stability.

The Size of the Audit Management Committee

The number of members on the audit committee is the measure of its size (Al-Matar, Al-Swidi, & Fadzil, 2014). The size is a vital attribute of the audit committee and the number of members serving on it could determine its effectiveness. The resource dependence theory posits that more members in groups would increase effectiveness given that more resources could be available such as technical knowledge, expertise and diversity of members (Al-Matar et al., 2014). However, there are claims that an increase in membership could be counter-productive as it is likely to result in free-rider and difficulty of coordination (Upadhyay, Bhargava & Faircloth, 2013). Nevertheless, while a large size could have its challenges, a small committee may limit performance if adequate number of members is lacking because absentee could hinder regular meetings in such a small group. A large size would have access to more talents and skills and in the banking industry with complex and sophisticated systems and operations, this could be a key factor in the audit committee. Bouaziz (2012) found a positive and significant association between the size of the audit committee and firm performance in a Tunisian study. The foregoing is consistent with prior studies which report that an audit committee with a large size could better protect accounting processes (Abbott, Park, & Parker, 2000; Anderson, Gillan, & Deli, 2003). Thus, given that a large size is associated with more resources, the size of an audit committee in a bank could contribute to its effectiveness as more resources for effective services could be provided. These resources are more likely to aid better appraisal of management proposals and empower the board to be able to take informed decisions that could be vital in promoting stability in banks.

Proposed Research Framework

The separation of firm ownership from managerial control is considered as the underlying factor responsible for the agency problems in corporate organisations (Jensen & Meckling, 1976). Corporate managers thus possess considerable freedoms and powers which require that they are well supervised. If not well supervised, the executive could diverge from the interests of owners and pursue their own agenda. Thus, the board is suggested as a device to constrain managerial decisions and actions (Zahra & Pearce, 1989). The board could therefore be described as a tool for managerial control. To aid board effectiveness, committees such as the audit are set up. DeZoort et al. (2002) note that the audit committee is important as an aid to support the board in reducing the agency problem. By aiding good reporting, effective internal control and risk management, the audit committee serves as an instrument for the reduction of the agency problem. Thus, this proposed study aims to employ the agency and resource dependence theories as underpinning theories.

The audit committee is part of the agency theory proposition under the board directors as a mechanism that could constrain managerial excesses (Blue Ribbon Committee (BRC), 1999; COSO, 2009; DeZoort, et al., 2002). The agency theory has implications for risk management and governance. Eisehdhart (1989) argues that firms are going concerns with uncertain future outcome which in the case of banks could end in survival or failure. These uncertainties are tied to managerial decisions. Where the management of a bank implements decisions that diverge from the interest of the owners, it results in conflicts and agency problems (Ellul, 2015; Zahra & Pearce, 1989). Therefore, the agency theory suggests the necessity for the oversight of management through mechanisms of control one of which is the audit committee (Sun & Liu, 2014). The theory rests on the assumption that if management is well monitored, it could check decisions that could undermine the interest of the owners or actions that could expose a bank to high risk and potential instability.

The framework proposed for this study is shown in Figure 1. It illustrates the expected relationship between the audit committee and bank stability. Given that the audit committee is set up to ensure effective risk control and management (Sun & Liu, 2014) and to implement sound internal controls (DeZoort et al., 2002), a positive relationship is expected.

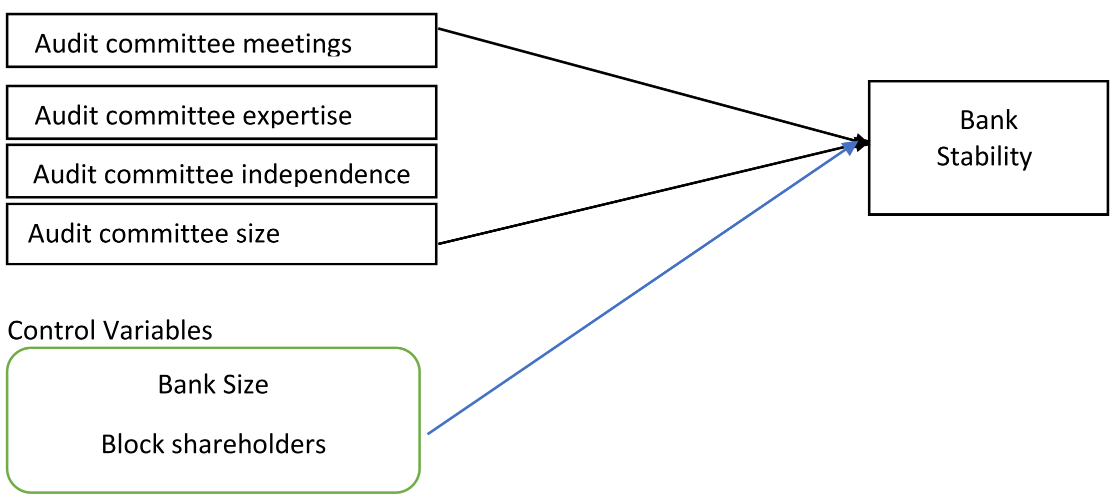

Figure 1. The proposed research framework

Conclusion

This proposed study is centred on the investigation of the relationship between the audit committee and bank stability. The focus of the study is to determine if audit committee has influence on the behavior of banks in Nigeria and if the stability of banks has association with the attributes of the committee. The expected results are to aid in improving bank risk governance especially the effectiveness of the audit committee. The stability of banks has vital economic implications on the flow of funds, investment and growth. Thus, it is necessary to determine the roles of board committees such as the audit in bank stability. The effectiveness of the audit committee could promote sound internal controls, contribute to better decision making by management and reduce the likelihood of exposing banks to high risk which could result in bank instability.

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