



Audit committee attendance and Earnings Management in Nigeria

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Abstract

Purpose- The aim of this study is to examine whether audit committee meetings and attendance during audit committee is associated with accrual earnings management.

Design/methodology/approach- The sample of the study is 14 companies under the Industrial Goods sub-sector listed under the Nigerian Stock Exchange (NSE) for the years 2012-2014. Modified Jones Model (1995) was used to measure earnings management proxied by discretionary accruals.

Findings- The findings show that frequency of audit committee meetings and attendance during the meetings negatively and significantly associated with discretionary accruals.

Theoretical implications- This study extends the previous related literature by examining the association between audit committee meeting and attendance and earnings management.

Practical implications- Regulators might use the findings of the study to regulate and further control the attendance of audit committee members during audit committee meetings

Originality/value- This paper uses agency theory to provide empirical evidence on the importance of frequent audit committee meetings and higher attendance in audit committee meetings.

Keywords- earnings management, corporate governance, audit committee meeting, audit committee attendance, discretionary accruals,

1. Introduction

Several researchers studied audit committee considering its role in mitigating earnings management (Amar, 2014; Crisan & Fulop, 2014; Fang, Huang, & Karpoff, 2015; Miko, 2016). The committee is very important because its primary assignment has to do with financial reporting process (Crisan & Fülöp, 2014). The committee is responsible for vetting of financial statements and

engagement with external auditors on behalf of the board to prevent occurrence of managerial opportunism. Managers utilized information asymmetry advantage and flexibility allowed by the Generally Accepted Accounting Principles (GAAP) to manipulate earnings for personal benefits (Healy & Wahlen, 1999). Audit committee is expected to verify the accounting numbers prepared by the managers in order to reestablish the confidence of shareholders. Action or inaction of audit committee led to financial scandal and collapse of many companies around the world such as Enron and Xerox (Pacot, Ruiz, & Virador, 2013; Ronen & Yaari, 2008). Therefore, the presence of an audit committee may not be the solution to managerial opportunism rather the effectiveness of the committee. The effectiveness of the audit committee is a function of its competence, diligent, independence and activity (Piot and Kermiche 2009; Bédard and Gendron 2010). Sarbanes Oxley Act (SOX hereafter) of 2002 addresses features of audit committee including its composition and authority but did not address the aspect of frequency of meeting (Braswell, Daniels, Landis and Ching (2012). However, regulators have made recommendations on a minimum number of meetings to be held by the audit committee.

The belief is that audit committee meetings show how serious the committee is and gives the committee chance to engage the external auditors, which can lead to lower accounting manipulation (Saleh *et al.*, 2007; Xie *et al.*, 2003). Many prior studies used absolute number of meetings to measure audit committee activity (Abbott *et al.*, 2004; Sáenz González & García-Meca, 2014; Soliman and Ragab, 2014). However, sometimes the members do not attend the meetings. When this happens, only few members may end up taking important decisions that can affect the whole company. The aim of this paper is to find out whether absenteeism by the audit committee members during meetings impedes the committee from mitigating earnings management practice in Nigeria. The Code of Corporate Governance 2003



in Nigeria recommends minimum of three meetings per annum, while the revised Code 2011 only recommends disclosure of audit committee attendance in financial report. This shows that the attendance is very important not only the number or frequency of meetings.

1. Corporate Governance Reform in Nigeria

Companies and Allied Matters Act (CAMA 1990) is the bedrock of corporate governance in Nigeria (Idigbe, 2007). However, the first generic Code of Corporate Governance for public firms came into effect in 2003. Afterwards, Corporate Governance Codes for specific industries such as banks, Insurance and pension were released. Okike (2007) points out that the multiplicity of Corporate Governance Codes in Nigeria brought more confusion into the system. The report of ROSC in 2011 found the generic Code of 2003 ineffective after the joint review of corporate governance system by IMF and World Bank. That led to the birth of 2011 Code in order to strengthen the system and to curtail managerial opportunism. The ROSC (2011) report identified serious gap in the 2003 Code, which public companies especially banks capitalized upon to swell their earnings opportunistically. So many banks collapsed during the period (Sanusi, 2010) and so many financial scandals happened such as Cadbury's case (Abdullahi, Enyinna, & Stella, 2010)

To further strengthen the audit committee, the revised Code 2011 specifically requested disclosure of number of meetings held by audit committee and the attendance of each member. This is to encourage and track the attendance of members. It is expected that attendance could enhance monitoring.

2. Theoretical framework

Agency theory suggests that increasing monitoring of managers would minimize their tendency for earnings manipulation (Jensen & Meckling, 1976). Accordingly, Vafeas (1999) points out that agency theory supports an active audit committee who constantly engage the management, external and internal auditors to ensure that financial figures prepared by the managers are accurate. Therefore, an inactive audit committee cannot monitor management or engage the external auditors. Furthermore, when audit committee members are inactive and do not attend meetings, the monitoring role of that committee may reduce allowing for opportunistic earnings management.

4. Literature Review and Hypothesis Development

4.1 Earnings Management

Schipper (1989, p.92) defines earnings management practice as "purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain". This is possible because of the flexibility and level of discretion managers of companies have in reporting the financial performance of their firms. Secondly, the managers have more access to information concerning the company than the shareholders who are outsiders (Spohr, 2005). Managerial opportunism as explained by the agency theory is the outcome of the natural conflict of interest between managers and owners of business (Jensen & Meckling, 1976). Managers being human and rational may be motivated to protect their personal interest not that of the shareholders who are the owners of the business. Managers get motivated to manipulate earnings because shareholders and other stakeholders consider earnings as the most important indicator of good performance (Xiong 2006). They also want to maximize their bonus because managerial bonuses and allowances are tight to earnings.

4.2 Frequency of Audit Committee Meetings and Earnings Management

Bank Britain defined audit committee as "a subcommittee of the board of directors that is responsible to follow-up financial matters in the company and to assist the board in making financial decisions, in which the board may not have the time and expertise to know its details" (cited in Alkdai & Hanefah, 2012, p.54). Audit committee can only discharge its duties diligently only if it is active (Dezoort *et al.*, 2002). Many studies established negative relationship between earnings management and frequency of meeting (Abbott *et al.*, 2003; Abbott, & Parker 2000; Garven, 2015; Ioualalen *et al.*, 2015; Menon & Williams, 1994; Saleh *et al.*, 2007; Stewart & Munro, 2007; Vafeas, 1999; Xie *et al.*, 2003).

However, other studies established that frequency of audit committee meeting do not make the committee effective and do not mitigate earnings management (Bédard *et al.*, 2004; Goodwin-Stewart & Kent, 2006). The argument is that other factors like independence and expertise of the audit committee mitigate earnings management not frequency of meeting. It was argued that audit committee independence, expertise and frequency of meeting compliment each other (Goodwin-Stewart & Kent, 2006). Others document that audit committee in general has no relationship with earnings management (Kim, & Yoon. 2016). They provide evidence that there is no difference in earnings management between companies with audit committee and those without audit committee in Korea. Based on these conflicting results, this study hypothesizes that frequency of audit



committee meetings would lead to lower earnings management.

H1: The more frequent the audit committee (AC) meeting, the lower the earnings management (EM)

4.3 Audit Committee Attendance and Earnings Management

The argument is that whether absolute number of audit committee meeting guarantee its effectiveness in curbing earnings management. Most previous studies used number of meetings as a yardstick for effective audit committee (Sáenz González & García-Meca, 2014; Soliman & Ragab, 2014). However, in the real sense not all audit committee members attend meetings at a time. It was argued that the annual number of meeting is not the precise yardstick of the effectiveness of audit committee (Menon & Williams, 1994). Maraghni and Nekhili (2014) noted that audit committee that sits frequently but with different set of people due absenteeism could not be diligent. In order to encourage attendance during audit committee, the Nigerian corporate governance Code 2011 mandates all public companies to disclose the number of meetings held during the year and the

attendance of each director at the meetings. However, no empirical study examines whether the percentage of attendance is associated with earnings management.

Furthermore, Maraghni and Nekhili (2014) used three different measurements for audit committee diligent. One of them is the percentage of audit committee member's attendance. This study adopts this measurement and hypothesizes that high attendance in audit committee would lead to lower earnings management.

H2: The higher the attendance in audit committee (AC) meetings, the lower the earnings management (EM).

5. Research Methodology and Sample Selection

This research is carried out among public companies listed on the Nigerian Stock exchange (NSE); Secondary data is collected from 14 companies under the industrial goods sub-sector from 2012 – 2014. These are the years when disclosure of number of meetings along with attendance of each director was made compulsory. The year 2011 is not considered being an inception year.

Table 5.1 *Sample Size*

Industry Type	Industry Code	Number of Companies	Observations
Industrial Goods	1	14	42

5.1 Measurement of Earnings Management

Discretionary accruals is used to measure earnings management. Modified Jones model (1995) is applied. This model calculates discretionary accrual as follows:

$$DA = TA - NDA$$

Where:

TA = Total accruals, which is the variation between net income and cashflow from operating activities

DA = Discretionary accruals

NDA = Nondiscretionary accruals

The model used the following equation:

$$TAC/Ait-1 = \alpha_1 (1/Ait-1) + \alpha_2 (\Delta REVi/Ait-1) + \alpha_3 (PPEi/Ait-1) + \mu it.$$

Where:

TACit= total accruals for firm i in year t.

NDAi,t = nondiscretionary accruals for company i in year t

Ai,t-1 = lagged (one year) total assets

$\Delta REVi,t$ = change in revenues for company i in year t

$\Delta ARi,t$ = change in net receivables for company i in year t

$PPEi,t$ = property, plant and equipment for company i in year t

Control Variables: This study uses a number of control variables - firm size, leverage and profitability as has been used by previous studies (Ioualalen et al., 2015; Machuga & Teitel, 2009; Sáenz González & García-Meca, 2014; Saleh et al., 2005).

Firm Size (FS):

This study measures firm size (FS) by the natural logarithm of total assets at the end of the year (Sáenz González & García-Meca, 2014). To avoid political costs such as stringent regulations, big size firms disclose more financial and non-financial information (Jensen & Meckling, 1976).

Leverage (LEV):

This study measures leverage as a percentage of debt to total assets (Saleh et al., 2005). Highly leveraged firms are assumed to have higher discretionary accruals (Watts & Zimmerman, 1978).

Profitability (PROFIT)



This study used Return on Assets (ROA) to measure profitability (Machuga & Teitel, 2009). It is the Net income in year t-1 scaled by total assets
Table 5.2

at year t-1. The assumption is that highly profitable firms have lower discretionary accruals.

Measurement of Variables

Variables	Definition	Measurement	Adopted from	Predicted Sign
EM	Earnings Management	Discretionary Accruals	Modified Jones Model (1995)	
AC_MEET	Audit Committee Meeting	Number of meetings held in a year	Xie <i>et al.</i> (2003)	Negative (-)
AC_ATTEND	Audit Committee Meeting Attendance	Percentage of Attendance during AC	Maraghni & Nekhili (2014)	Negative (-)
FS	Firm Size	natural logarithm of total assets at the end of the year	Sáenz González & García-Meca, 2014	Negative (-)
LEV	Leverage	proportion of total debt to total assets	Saleh <i>et al.</i> (2005), Habbash <i>et al.</i> (2014)	Positive (+)
PROFIT	Return on Assets	Net income in year t-1 scaled by total assets at year t-1	Machuga & Teitel, (2009)	Negative (-)

EM is earnings management, AC_MEET is audit committee meeting, AC_ATTEND is audit committee attendance, FS is firm size, LEV is leverage, PROFIT is profitability
The model of the study is:

$$DAC_{it} = \beta_0 + \beta_1 (AC_MEET)_{it} + \beta_2 (AC_ATTEND)_{it} + (\text{Control})_{it} + e_{it} \quad (1)$$

Where: AC_MEET = Audit committee meeting

AC_ATTEND = Percentage of attendance of audit committee meetings

6. Empirical Findings and Discussion

The result of the descriptive analysis as per Table 6.1 reveals that the mean of the audit committee meeting is 3.5, minimum of 2 and maximum of 7. The code of corporate governance 2003 recommends minimum of 3 meetings annually. This shows that on the average all the companies comply with this criteria. However, some companies violate the recommendation and held only 2 meetings. The mean of the audit committee attendance is 66% suggesting that 34% of the audit committee members failed to attend meetings. The minimum percentage of attendance is 30% and maximum attendance is 100%. The Codes of corporate governance 2003 and 2011 did not mention how many audit committee members can form a quorum. It is left for the companies to set the quorum.

Table 6.1
Descriptive Statistics of Variables

Variables	Minimum	Maximum	Mean	SD	Skewness	Kurtosis
DAC	-3.882	1.610	-0.453	0.971	-1.627	4.363
AC_MEET	2.000	7.000	3.500	0.804	1.774	7.759
AC_ATTEND	0.300	1.000	0.663	0.201	0.384	-1.014
FS	8.709	11.984	9.946	0.891	0.814	-0.169
LEVE	0.195	1.530	0.586	0.311	1.692	2.924
PROFIT	-0.321	0.403	0.079	0.141	-0.769	1.504

DAC is the absolute discretionary accruals, AC_MEET is audit committee meeting, AC_ATTEND is audit committee attendance, FS is firm size, LEV is leverage, PROFIT is profitability



Normality assumption was tested using skewness and kurtosis. According to Hair, Tatham, Anderson and Black (2006) the benchmark for skewness is ± 3 , while that of Kurtosis is ± 10 according to Kline (1998). The result as shown in table 6.1 shows that the dataset is distributed normally. Similarly, to ascertain absence of multicollinearity, Pearson correlation is used to determine correlation matrix between the variables. Table 6.2 shows that no correlation is higher than 0.80, which means absence of multicollinearity (Hair et al., 2006).

Table 6.2
Correlation Matrix of Variables

	DAC	AC_MEET	AC_ATTEND	FS	LEV	PROFIT
DAC	1					
AC_MEET	-0.2427*	1				
AC_ATTEND	0.2132	-0.430	1			
FS	-0.1399	0.328	0.0538**	1		
LEV	-0.0294	-0.024	0.012**	-2798	1	
PROFIT	-0.0813	0.143	-0.150	0.301	0.084**	1

***, **, * is significant at 1%, 5% and 10%, respectively. DAC is the absolute discretionary accruals, ACMEET is audit committee meeting, ACATTEND is audit committee attendance, FS is firm size, LEV is leverage, PROFIT is profitability

Additional t-test is carried out by to find out whether companies with high percentage of attendance have lower discretionary accruals. A company falls under low attendance if the average attendance of members is 50% and below. On the other hand, if the average attendance of audit committee members during meetings is above 51%, the company falls under high attendance. Table 6.3 reveals that that companies with high audit committee attendance have lower discretionary accruals (-0.085) compared to those with lower attendance (-0.601). The result confirmed the expectation of this study that high attendance during audit committee meetings reduce discretionary accruals. The members including the expertise are all around to engage the external auditors and verify the figures submitted by the management. This in line with the findings of Maraghni and Nekhili (2014).

Table 6.3
level of DAC based on percentage of attendance in audit committee

Group	Mean	SD	F-Value	Sig
High attendance	-0.086	0.686	0.88	0.000***
Low attendance	-0.601	1.354	1.85	

Data analysis was carried out using OLS regression to check the model fit. The R-squared is 0.68; F-value is 0.86 at 1% level of significance.

Table 6.4
Multiple Regression Results (OLS)

Variable	Sign	Coefficient	t- statistics	P-value
Cons	±	0.005	-1.11	0.710
AC_MEET	-	-0.267	-1.23	0.066*
AC_ATTEND	-	-0.084	1.54	0.00***
FS	±	-0.101	-0.47	0.036**
LEV	±	0.018	0.05	0.321
PROFIT	±	0.058	0.70	0.669
R- Squared			0.680	
Sig			0.000	
F-value			0.860	

N = 42. ***, **, * is significant at 1%, 5% and 10%, respectively. Note: Absolute discretionary accrual is the dependent variable, AC_MEET is audit committee meeting, AC_ATTEND is audit

committee attendance, FS is firm size, LEV is leverage, PROFIT is profitability.

Table 6.4 reveals the relationship between the explanatory variables and the explained variables.



Audit committee meeting (AC_MEET) has a coefficient of -0.267, $t = -1.23$ and P-value of 0.066. This suggests a negative relation at 10% significance. This indicates support for H1. The result means that for every one unit increase in audit committee meeting, DAC reduces by 0.267. In other words, an increase in number of audit committee meeting leads to lower discretionary accruals in line with the expectation of the study. The result is in agreement with the agency theory and findings from previous researches (Al-Matari et al., 2016; Garven, 2015; Ioualale et al., 2015; Mishra & Malhotra, 2016; Soliman & Ragab, 2014). The result however contradicts that of Kent et al. (2010).

The second hypothesis, Table 6.4 shows a significant relationship between audit committee (AC_ATTEND) and DAC, equally supporting H2. The coefficient is -0.084, t is 1.54 and P-value of 0.000. The result supports the agency theory and findings from previous studies (Maraghni & Nekhili (2014) and contradicts that of Haji-Abdullah, Wan-Hussin, & Hussin, (2016).

7. Summary and Conclusion

The aim of this study is to examine the relationship between audit committee meeting and attendance on earnings management. The result provides evidence that high frequency of audit committee meetings and attendance reduce earnings management, which support both hypotheses.

Furthermore, the study contributes to the understanding of agency theory in developing economy. In Nigeria, the Codes of Corporate governance both 2003 and 2011 recommend minimum of three meetings annually and disclosure of the members attendance respectively. The results show how importance both the frequency of meetings and the attendance are in reducing managerial opportunism. Therefore, this study provides practical implications expected to help regulators, investors, and other market participants to improve the financial reporting quality. Securities and Exchange Commission (SEC) would find the result handy in ensuring that companies comply with the requirements of the Codes with regards to the number of meetings and attendance. Nonetheless, this study is restricted to only one sub-sector (Industrial goods) from 2012-2014 among the ten to sub-sectors under the non-financial companies listed on the Nigerian Stock Exchange (NSE). Therefore, the researchers recommend further study to cover the entire non-financial sector.

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