

## The impact of Female Overlapping Audit Committee Member on Earnings Management in Nigeria

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**Abstract:** Managers have been managing earnings especially through accruals for their personal benefits. This led to collapse of companies and loss of investments around the world. Audit committee is identified as an internal corporate governance mechanism that can monitor the managers and mitigate earnings management though with mixed result. The focus of this study is to examine whether female audit committee member who is also members of other board committee have a role in curbing opportunistic earnings management. However, some argue that gender has no additional value and overlapping overburden the audit committee members, which affect their monitoring performance and ability to mitigate earning management. This study uses modified Jones model as a proxy for earning management and document how inclusion of female overlapping director in an audit committee mitigates opportunistic earning management.

Key Words: Earnings management, Audit Committee, Overlapping, Discretionary accruals

### 1. Introduction

In the process of conveying firm performance to shareholders and other stakeholders through financial reporting, managers are motivated to influence that process for their own personal benefit (Healy & Wahlen, 1999). The series of financial scandals and frauds such as Xerox and Enron were typical examples (Stubben, 2010). In Nigeria, the financial scandal at African Petroleum (AP) in 2009, Cadbury in 2006, collapse of 36 banks between 1994 and 2003, and additional eight banks in 2009 were examples of earnings management (Abdullahi, Enyinna, & Stella, 2010; Gunu, 2009; Sanusi, 2010; Okaro & Okafor, 2013). Equally, the increase in financial fraud from 18.2 % in 2008 to 31% in 2012 (NDIC, 2014) is another source of concern. Earnings management became rampant due to the over reliance on earnings as a yardstick for investment decisions and basis for rewarding management (Schipper, 1989; Watts & Zimmerman, 1978; Xiong, 2006). To achieve this, managers use different methods such as changes in accounting methods (for example changing methods of calculating depreciation), overproduction to reduce cost of goods sold (COGS), and accruals (Dechow, 1994; Roychowdhury, 2006; Spohr, 2005). However, changes in accounting methods is decried as unpopular because it cannot last long before the users of financial reports detect it ( Spohr, 2005). Hence, shifting to the use of accruals method. The discretionary accrual will be used to measure earnings management in this study.

In an effort to find a solution to earnings management and to reestablish the confidence of

investors', researchers and regulators have recommend the institutionalization of good corporate governance (Man & Wong, 2013). In view of this, many countries came up with code of corporate governance. Examples of these codes are the Blue Ribbon Committee (BRC) 1999 , Sarbanes-Oxely Act (U.S. Congress, 2002, Sec. 407) in the US, Smith Committee and Cadbury reports in the United Kingdom 2003, and the "Viénot, 1995, 1999", Bouton 2002 reports in France. In Nigeria, the formal code of corporate governance was issued in 2003. These codes emphasized the importance of board of directors that oversee the activities of the management. According to Dobija (2015), due to the diverse roles and functions of the board of directors, the board delegates the oversight functions of overseeing financial reporting process including external audit to the audit committee.

Financial reporting process involves the procedure of producing financial statements, which is subject to audit. The reason why shareholders and regulatory agencies insist on having an external person believe to be "independent" to audit the books of accounts of a firm, is that they do not trust the reliability of the report prepared by the managers (Lambert, 2001). Therefore, audit committee provides an interface between the external auditors and the managers. It monitors the management actions on behalf of the board. According to Crişan and Fülöp (2014), Klein (2002), and Vafeas (2005), audit committee effectiveness depends on its characteristics. These characteristics include but not limited to gender balance and overlapping. In this regard, prior

studies have been conducted on the association between audit committee gender and overlapping on one hand, and earnings management on the other though in isolation (For example, Arun and Arabi, 2015; Lakhali, Aguir, Lakhali and Malek , 2015; Habib and Bhuiyan, 2016; Kyaw, Olugbode and Petracci , 2015; Sáenz González and García-Meca, 2014). However, there is dearth of study on the effect of overlapping female director on earnings management. This study focuses on female audit committee members who are at the same time members of other board committee in association with earnings management.

The results of this study are expected to benefit investors and policy makers who want to look at corporate governance especially effectiveness of audit committee from different perspective prior to investment decisions or policy initiative.

## 2. Literature Review and Hypothesis Development

The introduction of audit committee in the 20<sup>th</sup> century is to offer an interface between external auditors and managers with the aim of enhancing the quality and integrity of financial reports prepared by the managers (Crişan & Fülöp, 2014; Imhoff, 2003). This is as result of mistrust between the shareholders and the managers envisaged by the agency theory (Jensen and Meckling , 1976). The mistrust necessitates independent verification of the financial reports prepared by the managers with the aim of enhancing their integrity. The shareholders see managers as “necessary evils” engaged due to the separation of ownership and control in a large organization (Fama & Jensen, 1983). In Nigeria audit committee was first introduced in 1990 by the Companies and Allied Matters Act (CAMA, 1990), being the general corporate governance law. However, the formal code of corporate governance came into existence in 2003 and revised in 2011 issued by the Security and Exchange Commission (SEC).

To emphasize the importance of audit committee in mitigating earnings management, Dechow, Sloan, & Sweeney (1996) argue that the likelihood for firms with an audit committee to manage earnings is lower, compared to those without. Nevertheless, other studies argue that mere presence of audit committee without the committee possessing some qualities hardly mitigate earnings management (Vafeas, 2005). These qualities include the inclusion of female in the audit committee. However, extant studies document inconsistency on the effect of gender on the audit committee and earnings management. Some studies argue that audit committee functions effectively when it is gender balanced especially in favor of women. Diverse boards according to Adams and Ferreira (2008) are tougher monitors on management. Another research by Wilson and Altanlar (2009) in UK documents that a female director on the board of directors lessens the risk of insolvency and

increase accountability. Therefore, with increased accountability the possibility of engaging in earnings management decreases. Accordingly, Ittonen, Miettinen and Vahama (2009) exert that when women chair the audit committee , the confidence of external auditors increases which decrease the need for assurance. Additionally, Thiruvadi and Huang (2011) opined that female audit committee member increased negative accruals. In the same vein, a negative association between audit committee gender and earnings management has been established by many researchers (For example, Arun & Arabi, 2015; Lakhali, Aguir, Lakhali & Malek , 2015; Kyaw, Olugbode & Petracci , 2015).

On the other hand, Kesner (1988) contends that the issue of gender is just for the women’s progress to climb the top of the corporate ladder, not necessary their prospective contribution. Equally, Brancato and Patterson (1999) argued that diversity in favor of women has nothing to do with additional value but mere tokenism to reflect equality

Similarly, divergent views were established on the impact of audit committee overlapping on earnings management. Overlapping is said to occur when a director is a member of more than one board committee including audit committee. It is a tradition of the board to form smaller committees including the statutory audit committee as most significant resolutions take place made within such smaller groups (Kesner, 1988). Audit committee being a statutory committee requires a commitment of time by members in order to provide the needed monitoring and interface between external auditors and the management. In a situation where members are over burden by other sub-committee assignment, that commitment of time may likely reduce, which can give way to opportunistic earnings management by the managers. It is argued that overlapping could affect the frequency of meetings by the audit committee especially when the chair of the other committees happen to be more proactive compared to that of the audit committee. Therefore, as the number of audit committee meetings reduce to engage the auditors and monitor the management, the possibility of earnings management increases (Sáenz González & García-Meca, 2014; Soliman & Ragab , 2014) .

In contrast, Habib and Bhuiyan (2016) established a strong positive relationship between audit committee overlapping and financial reporting quality using discretionary accrual as a proxy for financial reporting quality. Additionally, Ferris et al. (2003) find that overlapping directors attend more meetings than the non-overlapping ones. Their study also rejected the busyness hypothesis that overlapping directors become overcommitted which affect their monitoring performance negatively. These suggest that overlapping allows a director to acquire information from other committees that can enhance his role as an audit

committee member. Since managers engage in earnings management to maximize their compensation in an incentive-based agreement, coordination between compensation and audit committee through overlapping allow the later to be an effective monitor (Liao & Hsu, 2013).

Therefore, based on the opposing arguments on the isolated impact of gender and overlapping of the audit committee on earnings management, this study assumes that overlapping female audit committee might have an impact on earnings management.

The following non-directional hypothesis is developed:

H1: There is association between overlapping female audit committee member and earnings management in Nigeria.

### 3. Conceptual Framework

The framework 3.1 below presents the conceptual framework of the study. It depicts the relationship between the independent variable and the dependent variable.



Framework 3.1

### 4. Methodology

This study will employ multiple regressions to measure the relationship between audit committee gender, audit committee overlapping and earnings management. The modified Jones model (1995) is to be used to measure discretionary accruals; audit committee gender is the number of female directors on the audit committee, audit committee overlapping is the percentage of audit committee members who are members of another committee.

### 5. Conclusion

Prior studies have examined the role of gender and overlapping of audit committee in mitigating earnings

management in isolation. This study is unique being the first to research on the impact of female overlapping audit committee members in mitigating earnings management in Nigeria. This study helps investors in assessing the strength of audit committee prior to investment decisions. The regulators will find the result useful and as a basis for encouraging the involvement of women in audit committee along other, various board committees. This would enhance their capability and experience; thereby improve their ability to monitor management. However, the study is not specific as to what board committee is more relevant to female director to belong apart from the audit committee.

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