



EMPIRICAL EXAMINATION OF AUDIT COMMITTEE ACTIVITY ON AUDIT QUALITY OF NIGERIA MANUFACTURING FIRMS

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Abstract

Corporate scandals always wipe out investor's faith incorporation and give doubts on the independence of the auditors. This doubt in turn results into the loss of shareholder's confidence in the survival of their investment. Objective of this study is to examine the effect of audit committee characteristics on audit quality of manufacturing firms in Nigeria. Data for the study were obtained from audited annual reports and accounts of sampled manufacturing firms for the period of 2009-2018. The population of the study is the twenty two (22) listed manufacturing firms on the floor of the Nigeria stock exchange. Binary logistics regression was used to analyzed the data using stata 14.0. The study found out that audit committee accounting expertise, firm size and firm leverage have no significant on audit quality. The study concluded and recommended that accounting experts should be considered necessary in the committee in order to ensure the committee have carried out their duties effectively.

Keywords: *Audit committee, Audit quality, Accounting expert, Manufacturing firms, Auditors.*

Background of the Study

Audit committees are expected to support and enhance audit quality of a firm through their various diligent activities and responsibilities. The audit committee responsibilities towards audit quality among other are making recommendations on the procedure for selection and appointment of the auditors and approving the auditors' entitlements as overall audit fees. The audit committees are also charged with the responsibility for the oversight of the independence of the external auditor, as well as the approval of non-audit services to be provided by the auditor. So also, communication between the audit committee and the auditor is considered important paramount in enhancing the audit quality and in discharging the responsibilities of both parties, that is, the auditor and the audit committee. These oversight responsibilities can only be charged effectively if the audit committee is constituted with experts in accounting and equally members are regularly attending the committee meetings as scheduled.

Statement of the Problem

False profit declaration and weak governance remain the major problem in the corporate world. These problems can be seen in the case of Africa Glass Industry PLC and Paints and Coatings Manufacturers PLC that led to collapsed in 2016 and 2018 respectively with no prior notification of the problem in the auditor's reports. Corporate scandals always wipe out investor's faith incorporation and gives doubts on the independence of the auditors. This doubt in turn results into the loss of shareholders' confidence in the survival of their investments. Thus, audit quality has been recognized and caught the attention of regulators, academics, accounting profession and investors. Audit committees have been created to oversee the financial reporting processes so as to support and improve the audit quality of a firm. However, this overseeing role of audit committee is now in doubt as business entities collapses day by day. The manufacturing firm are one of the vital industries in the world, largely because of its contributions and roles in every nation's economy and the world at large. Manufacturing sector of Nigerian economy also faces the same problem

in their audit reporting processes and irregularities but researches on the audit committee accounting expertise and meeting attendance and audit quality are not conducted. Even the few studies in this area are conducted in other sectors of the economy and mostly neglected to consider the manufacturing sector.

Objective of the Study

To examine the effect of audit committee characteristics on audit quality of manufacturing firms in Nigeria.

Literature Review

Audit Committee

Audit committee members usually possess different expertise in area that is so important to the business. But however, the Code of Corporate Governance of 2018 mentioned and required audit committee members to have financial literacy. Thus, financial literacy can be among the fundamental characteristics of audit committees. Specifically, the code says that all members of the statutory audit committee should have financial knowledge, knowledge of internal control processes and able to read and understand financial statements of the company (CG, 2018). Accounting knowledge in audit committee gives members ability to understand and judge financial reporting processes, auditing standards and auditor independence requirements and so on and so forth. Therefore, audit committee members are expected to have a good understanding of financial statements, auditor's reports, and knowledge of the industry nature of business in which the company operates.

Audit Quality

Audit quality can be seen as an act of discovering a breach in the client's accounting system and reporting the breach faithfully (DeAngelo, 1981). This brings the issue of auditor's capacity of discovering a breach, and the auditor's independence that enables him to reports the breach objectively. Audit quality is expected to give the desired outcome from a

performed audit through utilization of auditor's capacity and independence. Audit quality can be seen in a way that relates to issues that can affect the auditor's ability in achieving audits' fundamental objective and equally to obtain reasonable assurance that the firm's financial reports as a whole are free of any material misstatements. The audit committee responsibilities towards audit quality among other are making recommendations on the procedure for selection and appointment of the auditors and approving the auditors' entitlements as overall audit fees. The audit committees are also charged with the responsibility for the oversight of the independence of the external auditor, as well as the approval of non-audit services to be provided by the auditor. So also, communication between the audit committee and the auditor is considered important paramount in enhancing the audit quality and in discharging the responsibilities of both parties, that is, the auditor and the audit committee. These oversight responsibilities can only be charged effectively if the audit committee is constituted with experts in accounting and equally members are regularly attending the committee meetings as scheduled. Audit committee accounting expertise means to an expert member in the audit committee with accounting education and auditing background. According to a recent code of corporate governance of 2018, it became a mandate for a public company to have at least one member in the audit committee with current accounting knowledge. Other international code of corporate governance like the Sarbanes-Oxley Act (SOX) mandated all listed companies to disclose whether their audit committees have accounting expert (Krishnan & Visvanathan, 2008). Tanyi and Smith (2014) conducted a study with the objective of examining the influence of audit committee accounting expertise on the quality of financial reporting. The study reported empirical evidence on the influence of accounting expertise in the audit committee on the quality of the reporting process of a firm. This indicates the advantage of having accounting experts in audit committee as their technical knowledge of accounting enhance the activities of the committee and in turn, helps to add quality in the process of reporting and audit quality of a firm at large.

Empirical Review

Studies have been conducted on audit committee and financial or firm performance such as Shehu (2017), Wakaba (2014) and so on. Other researchers examine audit committee with financial reporting quality such as Kibiya et al., (2016), Onyebe et al., (2018). Few studies are conducted on audit committee and audit quality like Asiriuwa et al., (2018), Salawu et al., (2018). To deviate from them, this study chose industrial goods sector of the Nigerian economy as the domain of the study as none of them considered the sector and also with different variables used in their studies. Literatures confirm that audit quality has become a matter of great concern to regulators, practitioners as well as accounting researchers (Okolie, 2014). However, Ghafran and O'Sullivan (2017) note that the impact of audit committees on the external audit process is an important issue about which there is limited research evidence and therefore, there is a need of more researches on audit quality. The use of audit committee accounting expertise in this study is in the response of the recent CG code of 2018 that requires audit committee to have a least one member with current accounting knowledge, and also in the response of suggestion for future research from the work of Zabochnikova (2016).

Farber et al. (2018) conducted a study on the relation between audit committee accounting expertise, analyst following, and market liquidity. Their results of the study indicate that analyst following increases subsequent as a result of appointing a member with an accounting expert to the audit committee. The study also provides evidence that accrual quality is low, as opposed to audit quality, that is, audit quality is high when there is a member in the audit committee with accounting expertise. More so, Abernathy et al., (2014) conducted a study with the objective to examine the association between characteristics of audit committee accounting experts, audit committee chairs, and financial reporting timeliness. Their results show a positive significant relationship between audit committee accounting expertise and financial reporting timeliness. This is also considered as an element that leads to having audit quality and efficiency in reporting processes. Another study by Krishnan

and Visvanathan (2008) conducted to find the answer of whether the SOX definition of an accounting expertise matters. They find that the accounting experts on the audit committee are able to effectively perform their monitoring function and promote reporting quality and strong governance (Krishnan & Visvanathan, 2008). In their work, DeFond et al., (2005) are with the view that accounting expertise is more important and especially for audit committee tasks which require a high degree of accounting sophistication. Beasley et al., (2009) suggest that companies should avail their audit committees with accounting experts because their skills are more involved with judgments, estimates, and assumptions inherent in GAAP which will all helps the audit processes and final audit reports.

A study conducted by Abdullah (2006) with the objective to investigate the relationship between the characteristics of the audit committee and the quality of financial reporting in Malaysia. The study reveals that audit committee meeting attendance is significantly and positively related to the quality of financial reporting. This reveals that an audit committee that its members attends audit committee meetings when so called are likely to carry out the responsibilities assigned to them effectively which in turn results to have qualitative financial reports. This also shows how impossible for any audit committee to carry their diligent functions even if there are high audit committee meetings while members are not attending the meetings and conclusively that must affect negatively the quality reporting processes of the firm and audit quality at final.

Theoretical Framework

Agency Theory

This study chose the agency theory as the most appropriate theory for the study. The relevant theory considered in this paper is agency theory as used in the work of Zabochnikova (2016). It has been acknowledged that the principal-agent theory is generally considered the starting point for any debate on the issue of corporate governance emanating from the classical thesis on the modern corporation and private property by Berle and Means (1932) as cited in Shehu (2017). The fundamental agency

problem in modern firms is primarily due to the separation between ownership and management. Therefore businesses are run by professional managers (agents) who cannot be held accountable by dispersed shareholders. In this regard, the fundamental question is how to ensure that managers follow the interests of shareholders in order to reduce cost associated with principal-agent theory. Shehu (2017) noted that 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 to make decisions aligned with shareholder interests. Agency Theory assumes that the interest of the principal and agent varies and that the principal can control or reduce this by giving incentives to the agent and incurring expenses from activities designed to monitor him. The principal will ensure that the agent acts in the interest of the principal by giving him the incentives and limit the self-interest activities of the agent.

Research Methodology

Data for the study were obtained from audited annual reports and accounts of sampled manufacturing firms for the periods of 2009-2018. The population of the study is the twenty two (22) listed manufacturing firms on the floor of the Nigeria stock exchange. Sample size of the study is nine (9) because the remaining thirteen (13) firms were delisted from Nigeria stock exchange during the period as a result of incomplete data set. Binary logistic regression was used to analyzed the data using stata 14.0.

The study model

$$AQ_{i,t} = \beta_0 + \beta_1 ACAE_{i,t} + \beta_2 ACMA_{i,t} + \beta_3 FLEV_{i,t} + u_{i,t} \dots \dots \dots (1) \text{ Whereas:}$$

AQ = Audit quality

ACAE = Audit committee accounting expert

FLEV = Firm leverage

β_0 = Intercept

β_1 -3 = Coefficient of independent and control variables

U = Error term
i = Firms
t = Years

Research Findings and Discussion

Descriptive Statistics

Variables	Mean	Std. Dev.	Min.	Max.	<u>Skewness</u>	Kurtosis
AQ	0.63	0.48	0	1	-0.55	1.31
ACAE	0.60	0.49	0	1	0.65	1.43
ACMA	0.81	0.14	0	1	0.47	2.62
<u>Flev</u>	0.53	0.27	0.04	2.29	0.63	2.92

Source: STATA 14 Output based on study data.

Table 1 presents the descriptive statistics (mean, standard deviation, minimum, maximum, skewness, and kurtosis) of the study variables (which are audit quality, audit committee accounting expertise, audit committee meeting attendance, and firm leverage) in this study. The result shows that audit quality (AQ) has a mean value of 0.63, a standard deviation of 0.48, minimum value of 0 (non-big four) and a maximum value of 1 (big four). This means on average 63% of listed industrial goods firms are audited by the Big 4 audit firms with wide dispersion of 48% from the mean. Regarding audit committee accounting expertise (ACAE), the mean value is 0.60, standard deviation of 0.49, minimum of 0 (non-member) and a maximum of 1 (member). This indicates that 60% on average are accounting experts while the standard deviation value of 0.49 indicates little dispersion from the mean. Moreover, Firm leverage (Flev), the mean value is 0.53, standard deviation is 0.27, minimum and maximum values are 0.04 and 2.29 respectively. This indicates the little dispersion from the mean. However, the skewness and kurtosis values for firm size and firm leverage are for normality test. According to West, Finch, and Curran (1995), skewness and kurtosis values should be less than 2 and less than 7

respectively. Hence, all the variables in this study are found to be normally distributed because the values of skewness ranges between -0.55 and 0.65, while kurtosis values ranges between 1.31 to 2.92 as shown in Table 1.

Table 2
Result of Logistic Regression

<u>Variables</u>	B	S.E.	Wald	<u>df</u>	Sig.	<u>Exp(B)</u>
ACAE	-.759	.502	2.287	1	.130	.468
ACMA	7.372	2.796	6.953	1	.008	1591.351
LEV	.342	.849	.162	1	.687	1.408
Constant	-5.123	2.227	5.292	1	.021	.006

Source: STATA 14 Output based on study data.

In order to test the hypothesis developed in this study, logistic regression model is utilized as delineated in Table 2. Binary logistic regression is used because the dependent variable (Audit Quality) of this study is binary/dichotomous in nature, that is, '1' if the financial report of a firm in the sample is audited by a 'Big-Four' audit firm, and '0' if otherwise. From the result of logistic regression in Table 2, the model indicates that out of the three variables used; only ACMA significant positive effect at even 5% on audit quality because of its significant value of 0.008 which is less than 0.05. However, the other two variables that is, audit committee accounting expertise, firm size and firm leverage have no significant on audit quality.

Conclusion and Recommendations

Policy-making organizations and regulators across the world progressively acknowledge the vital role of audit committees and their importance to audit quality of corporate firms. Auditors are charged with the responsibility of giving assurance to the shareholders of the company

on the status and health of their investment through audit reports. Thus, the auditor's reports of corporate bodies around the globe catch the attention of many concerned stakeholders. The manufacturing firm are one of the vital industries in the world, largely because of its contributions and roles in every nation's economy and the world at large. Manufacturing sector of Nigerian economy also faces the same problem in their audit reporting processes and irregularities but researches on the audit committee accounting expertise and meeting attendance and audit quality are not conducted. Even the few studies in this area are conducted in other sectors of the economy and mostly neglected to consider the manufacturing sector. Auditors are expected to play a critical role in ensuring that all stakeholders are well informed and can be confident when making investment decisions. This is the sole responsibility of the auditors to provide such reports through the utilization of their capacity and independence. Studies show that there is an existing link between financial reporting quality and audit quality. Therefore, audit quality supports financial reporting quality and successfully, a drawback in the firm's audit method is that the problem that affects its financial reporting quality, thus, an injury of audit quality is an injury of financial reporting quality. The study examines the effect of audit committee accounting expertise and meeting attendance and audit quality of listed industrial goods firms in Nigeria. Based on the findings of the study, it concluded that audit committee accounting expertise has no significant positive effect on Audit Quality of listed manufacturing goods firms in Nigeria. While on other hand, this study conclude a positive and significant effect of audit committee meeting attendance on audit quality of listed industrial goods firms. Thus, this study recommends that SEC, NSE and other regulatory authorities should encourage the manufacturing goods companies particularly; the members of audit committee to be attending the meeting regularly as it show a positive significant effect on audit quality. Looking at the complex nature of financial statements and the oversight roles and responsibilities of the audit committee. Accounting experts should be

considered necessary in the committee in order to ensure the committees have carried out their duties effectively.

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