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Achieving Sustainable Development through Audit Committee Impact on Earnings Management: Evidence from Nigerian Firms

Njemanze Livingstone O.[1] and Amaramiro, Francis[2]
[1]Department of Accountancy
Abia State Polytechnic, Aba |
E-mail: livingstone_nje@yahoo.com
[2]Department of Accountancy
Abia State Polytechnic, Aba |
E-mail: frankcool2006@yahoo.com

Abstract: *This study investigated the relationship between audit committee composition and earnings management in a developing country, Nigeria. Content analysis of annual reports of thirty (30) listed companies on the Nigerian Stock Exchange (NSE) over a three (3) year period was carried out using both the descriptive and inferential statistics. The finding clearly revealed that opportunistic behavior of management is mitigated when an effective and properly structured audit committee is put in place. An audit committee with financial expertise serves as an independent supervision on the management in the use of accrual accounting on income adjustment. It is therefore recommended that financial expertise should be a pre- requisite for membership into audit committee and the relevant section (S359(4)) of the Companies and Allied Matters Act 1990 should be amended to reflect this.*

Key words: *Audit Committee, Accrual Accounting, Earnings Management.*

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Introduction

The generally accepted indicator of the profitability of an enterprise is the earnings often presented in the financial statements as " net profits". The use of accrual basis of accounting in the preparation of financial statements allows management a measure of discretion in the determination of accrual components of revenue and expenditure. The effect of this, according to Chandrasegaram R, et al (2013) has resulted in company's performance giving a rosy picture different from the underlying financial health. Rauf et al (2012) in his study indicated that earnings management practices with the intention to manage user's perceptions in firms are considered unethical even though no accounting standards are violated.

The motivation and opportunity to engage in earnings management however could be minimized if effective audit committee is put in place while the board on the other hand efficiently executes its oversight functions.

1.1 Statement of the problem

The separation of ownership and management in public companies places the management at privileged positions which could be used to achieve personal objectives at the detriment of the owners. More often than not, management through opportunistic behaviours enhances companies value which differ from the underlying financial status of the enterprises. This has resulted in the liquidation of some giant corporations in the time past. The collapse of once prestigious corporations such as Enron, world. Com has been attributed to the incidence of earnings management and poor corporate governance structure.

Earnings management Erodes the credibility of the financial reporting process by presenting a rosy financial position different form the underlying financial health of an organization. The collapse of these giant corporations triggered the need for regulatory authorities' world over to begin to lay emphasis on audit committee issues as well as the structure of the board of directors.

The absence of a properly constituted audit committee, meeting frequently to oversee the financial reporting process of the management creates an enabling environment for earnings management (sallh, Haat:2004).

Previous studies have shown that earnings management is more pronounced in firms where the audit committee members lack the necessary financial expertise to fulfill their responsibility of monitoring the internal control of the firm as well as overseeing the firms financial reporting process.

1.2 Study Objective

The broad objective of this study is to examine the impact of audit committee on earnings management

To achieve this, the following specific objectives are set;

1. To examine the extent to which frequent audit committee meetings influence earnings management.
2. To examine the extent to which audit committee financial expertise influences earnings management
3. To ascertain the effect of board structure on earnings management.

Literature Review

A review of the existing literature on audit committee, board structure and earnings management is presented with the aim of providing an in-depth understanding of the study. The review covers articles published in leading academic journals, related text books, periodicals and other published researches.

2.1 Conceptual Review

Bala and Kumal (2015) described earnings management as a deliberate misrepresentation of the financial condition of an enterprise accomplished through intentional misstatement or omission of amounts or disclosure in the financial statement to deceive financial statement users. More often than not, earnings management is accomplished through discretionary accruals. The nature of accrual accounting gives managers a significant amount of discretion in determining the actual earnings a firm reports in any given period (Epps and Ismail, 2008).

Hassan and Ahmed (2012) documented that accruals are the most important earnings management instrument used by managers to either increase or decrease reported income. This is because there are components of earnings not reflected in current cash flows and a great deal of managerial discretion goes into their construction.

Earnings management practices are viewed as unethical even though no accounting standards are violated. Dechow and skinner (2000) note that the border between earnings management and accrual accounting has become ambiguous. Earnings management may take the form of either income – increasing or income – decreasing accounting choices. Income-increasing manipulation means positive discretionary accruals (Yang, Chun, and Ramadili, 2009).

Effective audit committee and independent board structure are mechanisms that could be used by enterprises to check the use of earnings management in manipulating reported earnings. Audit committees are established to oversee company's accounting and financial reporting policies and practices with the aim of protecting the interest of shareholders. Several countries of the world have put in place various codes on corporate governance which provide guidelines on the formation of audit committees particularly with respect to size, independence, frequency of meetings and financial literacy of members to ensure good practices. In Nigeria, the Companies and Allied Matters Act 1990 (S359(4) stipulates that the audit committee shall consist of an equal number of directors and representatives of the shareholders of the company (subject to maximum number of six members) and shall examine the auditor's report and make recommendation thereon to the annual general meeting as it may think fit: provided however, that such member of the audit committee shall not be entitled to remuneration and shall be subject to re election annually.

The board of an enterprise ensures that the interest of shareholders and that of the managers are aligned. Klein (2002) in his work highlighted that board independence and competency are effective mechanisms in monitoring the management. Board structure refers to the proportion of non-executive directors manifest a distinct, characteristic form a board where the reverse is the case. Yang, Chun and Ramadili (2009) opine that independent non - executive directors provide independent judgment to the board as well as providing a check-and-balance to the activities of the executive directors. Earnings management is less likely to occur in companies whose board has more independent directors (Beatriz, 2008).

2.2 **Empirical / Academic Review**

Bola and Kumai (2015) in their study captioned "Board characteristics and Earnings Management of listed Food and Beverages Firms in Nigeria examined the impact of board size, board composition, board meetings and board financial expertise on earnings management. The study was prompted by the need to look up for indicators of earnings reliability after the global financial crises in 2008. The study covered a period of six years from 2009 to 2014. Data for the study were extracted from firm's annual reports and accounts. The ordinary least square regression was employed in testing the model of the study. The results of the analysis revealed an inverse relationship between board size, board meetings, board meetings, board financial expertise and earnings management while board composition is positively and significantly related to earnings management of listed food and beverages firms studied. In line with the findings, the study recommended among others that listed food and beverages firms in Nigeria should have as much directors as possible in order to reduce earnings manipulation and that the regulators such as Securities Exchange Commission (SEC) should increase the minimum number of members with financial expertise on the board and also they should have a statutory position on the maximum number of board meetings as SEC Code of Corporate Governance is silent on this. Salleh and Haat (2014) studied Audit Committee and Earnings Management: Pre and Post Malaysian Code of Corporate Governance (MCCG). The study examined the effectiveness of audit committee in constraining earnings management after the revised MCCG among listed forms in Malaysia. The study was informed by the need to ascertain the effectiveness of audit committee characteristics in mitigating earnings management between the pre and post revised MCCG periods. The sample for the study was drawn from 280 companies listed on Bursa Malaysia for a five year period of 2005 to 2009. The discretionary accrual was estimated using the Modified Jones Model (1995) which was used to proxy for earnings management.

The finding of the study showed that audit committees play an important and effective role in reducing earnings management after the revision of MCCG. Furthermore, audit committee size and audit committee that has meetings with external auditors without the presence of executive directors at least twice a year showed a significant association with earnings management. The study therefore concluded by indicating, that the MCCG has achieved its aim in improving the quality of audit committees.

Chandrasegram et al (2013) appraised the impact of audit committee characteristics on earnings management in Malaysian Public Listed companies. The negative impact of earnings management on Companies formed the crux of the study. According to the study, companies often portray a positive outlook of their business in order to provide confidence to shareholders and investors regarding the profitability and viability of the company and a key method used by the management to manage earnings and show better performance is through accrual accounting. This method of earnings management is not legally prohibited and is based mainly on the company's choice of accounting policies. The study utilized secondary sources of data derived form annual reports of year 2011 of 153 Malaysian public listed companies to ascertain the impact of audit committee characteristics, namely frequency of audit committee meetings, size and independence of the audit committee on earnings management. The study revealed that these audit committee characteristics are not negatively related to the magnitude of earnings management.

Reuf et al (2012) examined the impact of company and board characteristics on earnings management. The study observed that companies with poor performance tend to alter financial reports through the use of accruals to increase earnings thereby misleading some stakeholders about the underlying economic performance of the company. Data for the study were obtained from content analysis of annual reports of 214 listed companies for the year 2008. The study revealed that firm size has a positive significant relationship with earnings management while board size has no influence on the practice of earnings management. The researchers used board size in their study and finally recommended that future researchers could incorporate other board characteristics such as number of board meetings, competency etc in their study.

2.3 Theoretical Framework

Earnings management occurs because the interest of the managers vary from that of the shareholders. Bola & Kumai (2015) highlighted that managers can be influenced by some factors such as financial rewards, labour market opportunities and relationship with other parties that are not directly relevant to the interest of the shareholders. The shareholders in public enterprises engage agents to manage their enterprises and report back to them on the financial position of the firms at stipulated intervals. The agents, to continue to win the confidence of the shareholders more often than not engage in earnings management or income smoothening just to satisfy the owners that the firms under their control have been managed in their best interest. Agency theory provides a logical prediction of the attitudes of the agents and principals when placed in such a relationship while also proposing a series of mechanisms that seek to reconcile the interest of both parties. Hence the adop0tion of this theory as the underlying theoretical frame work.

Agency theory has emerged as a dominant model in financial literatures. It became popular in the early 1970's. This theory explains the relationship existing between the principals such as shareholders and agents such as company executive and seeks to address the problems which arise when the principal delegates decision making authority or hires another person to perform some services on his behalf. The two major issues addressed by this theory are:

1. Goal congruence: A problem usually arises when the interest or goals of the principal differ from that of the agent. Agency theory proposes various mechanisms that could be used to align the interests of the principals and the agents. One of such mechanisms is through the establishment of the board of directors, appointed through election in the annual general meeting, to safeguard the interests of the shareholders (Rauf, et al 2012). Other mechanisms include monitoring by non – executive directors monitoring by institutional shareholders, auditors and the incentive effects of executive share ownership (Bukit and Iskander, 2009).
2. Attitude to Risk: This problem arises when both the principal and agent have different attitude towards risks.

This theory therefore emphasizes that the goals and risk tolerance of both the principal and agent should not be in conflict. In order to synchronize the interest of both the principal and agents, expenses are incurred to sustain an effective agency relationship. Such expenses include offering management performance bonuses to encourage managers to acct in the interest of the shareholders etc.

Discussion

Discussion in this regard focuses on strategies that could result in the accomplishment of the stated objectives, gap identification in the literatures reviewed as well as the suitability, strengths and limitations of the theoretical framework.

3.1 Discussion of strategies

This study focused on the impact of audit committee and board structure on earnings management. To achieve the stated objective, this research set out to examine the extent to which the following variables namely:

- Frequent audit committee meetings
- Audit committee financial expertise and
- Board structure, impact of earnings management.

Frequent audit committee meetings as a control variable is determined by the number of meetings held by the committee during the year while audit committee financial expertise is measured by the proportion of audit committee members with financial knowledge to the total number of audit committee members.

Board structure is measured by the ratio of independent / non – executive directors to total board size. Some of the methods used to test for earnings management include the assessment of accounting policy changes and discretionary accruals. This study focuses on the discretionary accrual method developed by Jones (1991) and later modified by Dechow Sloan and Sweeney (1995). This model divided accrual (Total Accrual TAC) into two namely; discretionary and nondiscretionary components Discretionary accruals are the managerial interventions or subjective accounting choice made by managers. Discretionary accruals in the Modified Jones Model are primarily present in current items (e.g account receivables) rather than non – current items (e.g depreciation) Yang; Chun and Ramadily, 2009) Hence, the use of discretionary current accruals as a proxy for earnings management in this study.

$$DCA_{it} = \frac{1}{TA_{t.t-1}}\left(CA_{it} - NDCA_{it} \right)$$

Whore DCA_{it}= Discretional current Accruals for firm I in year t

CA_{it} = Current Accruals

$TA_{J.\,t-1}$ = Total Assets

$NDCA_{it}$ = Non-discretionary Current Accruals

3.2 Discussion on the Stated Theoretical Framework

The suitability of the agency theory used in this study as the underlying theoretical framework stems from the fact that this theory seeks to align the interest of the management with that of the shareholders by proposing a series of mechanism to reconcile reconcile the interest of both parties. A key mechanisms used by organizations in checking checking the opportunistic behavior of agents is the constitution of an independent board board of directors to safeguard the interest of the shareholders. Corporate governance governance framework has taken a step further by stipulating he formation of audit committees for better monitoring. Additional instrument of minimizing the conflict of of interest arising from shareholders and managers is the use of the incentive effects of of executive share ownership. Empirical studies that support the mitigation of earnings management by organizations that adopted this theory in reconciling the interest of both the principal and agents can be found in many prior studies and this has remained the strength of this theory. Earnings management is less likely to occur in companies whose board has more independent directors, and audit committee members with financial expertise, meeting frequently (Yang, Chun and Ramadili, 2009; Selleh Haat, 2014). The weakness of this theory usually manifests when performance bonus or executive compensation is adopted as a key measure in aligning the interest of the principal and agent as suggested by the theory. This strategy could encourage the management to engage in income increasing manipulations rather than serving as a deterrent.

3.3 Discussion on the Gaps Present in the Reviewed Literature

Bala and Kumai (2015) empirically researched on Board characteristics and Earnings management of listed Food and Beverages Firms in Nigeria. Board attributes such as board size, board composition, board meetings and board financial expertise were used as variables impacting on earning management. The first gap observed in their research is on the use of board size as earnings management variable. It is argued in this study, that regardless of the size of a board, once the composition of the board is not structured in favour of independent non – executive directors, collusion among the directors to engage in earnings management cannot be ruled out. Hence the use of board structure in this present study.

Board financial expertise not reflected in the composition of the audit committee would not have any visible impact on earnings management. This is another gap observed in the work of Bala and Kumai (2015). This indept financial reporting oversight function of the board has been delegated to the audit committee members. Hence, the committee's financial expertise should serve as a better variable impacting on earnings management.

Chandrasegram et al (2013) examined the impact of audit committee characteristics such as audit committee size, audit committee independence and frequency of audit committee meetings on earnings management. It is argued that earnings management could still continue undetected in enterprises having large audit committee size and audit committee independent of the management but lacking in financial expertise. The use of discretionary accrual for income smoothening is a technical issue in accounting and requires audit committee members with financial knowledge and expertise to understand and address this legal but unethical practice. This gap overcome by introducing audit committee financial expertise as a variable impacting on earnings management.

Conclusion

This study examines the need for achieving sustainable development through audit committee impact on earnings management: evidence from Nigerian firms. The use of accrual accounting gives the management some flexibility in adjusting earnings (profit) towards their desired level. The findings of this study show that this opportunistic behavior of the management is mitigated when an effective audit committee regularly meeting and having adequate number of members with financial expertise is put in place. It is also revealed that an efficient board with more independent and non executive members impacts significantly on such opportunistic tendencies of the management.

Recommendation

It is recommended in the Nigerian context that for audit committee to be effective in their oversight function, financial expertise of those to be appointed into membership of the committee must be a pre – requisite. Furthermore, board composition should be structured to tilt in favour of independent and non – executive directors.

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QUOTATION FOR REPOURING OF 500 KVN TRANSFORMER.

1. Transport to and fro 20,000	-	40,000	
2. 3 ½ drums of oil 110,000	-	385,000	
			180,000
3. 120 Lb of coils 1500	-	204,000	
4. 10 yard of insulation paper 700	-	7,000	
5. I tone of Shallack - 5000	-	5,000	
Total			617,000
Labour			50,000
Grand total			**667,000**

Thanks.
Yours faithfully,

AHAMEFULA OBIALOR
MANAGING DIRECTOR.