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Impact of Audit Committee and Audit Quality on Preventing Earnings Management in the Pre- and Post- Nigerian Corporate Governance Code 2011

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Abstract

Earnings management have been considered as one of the methods used by the business leaders to mislead their stakeholders to report unrealistic numbers, despite the various check and balances (e.g. corporate governance code) on the process. Nigeria experienced two corporate governance codes issued by SEC, code 2003 and code 2011. This study tends to measure the effectiveness of these two codes and make comparisons using audit committee and audit quality against earnings management in the pre- and post-code 2011.

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1. Introduction

Series of corporate scandals around the world eroded the trust in the financial statement, and placed a doubt in the mind of investors, which resulted to the loss of confidence by investors worldwide. For example Enron, WorldCom, and Xerox in developed nations (Fodio, Ibikunle and Oba, 2013), in Nigeria, Cadbury Nigerian plc, Lever Brothers plc (Ajibolade, 2008), called attentions for the investors, because, they suffered loss of their investments.

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Managers use earnings management to inflate the volume of reported earnings, for example, managers use different earning management method to meet the target to avoid reporting losses annually (Beyer, Cohen, Lys, & Walther, 2010). Usually, this kind of earnings management last for a short time, the subsequent period will go down, which cause a negative effect to the owners of businesses. Similarly, the number of financial fraud increase from 18.2% in 2008 to 31.0% in 2012, which is a serious issue that will call the attention of researchers and the authorities for the reasons behind this scenario (NDIC, 2014).

On the process to restore the confidence to the investors, different laws were puts in place, for example, Sarbanes-Oxley Act Code 2000 in US, corporate governance code 2011 in Nigeria. The central objective of corporate governance code was to restore the reliability of financial statements by curbing earnings management and accounting fraud (Cohen, Dey, & Lys, 2008). Launching of governance mechanisms (Code, 2003) in Nigeria is expected to mitigate corporate scandals and other related issues. However, corporate failure and scandals are still there, for instance the case of Wema Bank plc and Spring Bank plc in Nigeria (The case of mismanagement of capital) was the sufferer of poor corporate governance practice (Demaki, 2011).

Even though, many researches have been carried out on corporate governance and earnings management (Berthelot, 2012; Chang & Sun, 2010; Demirkan & Platt, 2009; Iyengar, Land and Zampelli, 2010; Jiang & Anandarajan, 2009; Machuga & Teitel, 2007; Oei, Ramsay, & Mather, 2008; Sivaramakrishnan & Yu, 2008), auditors reputations (Agrawal & Chadha, 2005), audit committee (Piot & Janin, 2007), audit quality (Jere R. Francis, 2011). Studies on pre- and post- code such as Chang and Sun (2009); Arping and Zacharias (2010); Chang and Sun (2010) compared the effect of corporate governance mechanism on the earnings managements in the post- code period with the earnings management in pre-code period. This study placed emphasis on specific mechanisms such as audit committee and audit quality in preventing earnings management in the pre- and post- code 2011 in Nigeria, and compare the association between earnings management and corporate governance mechanism in the pre-code 2011 (post-code 2003) with the association between earnings managements and corporate mechanism in the post-code 2011.

2. Literature development

Audit committee is a committee which oversee the financial reporting process (DeZoort & Hermanson, 2002). Audit quality sees as the combined possibility that the external auditor discovers irregularity in financial statements and discloses it to the stakeholders of the financial statements (DeAngelo, 1981). Both audit committee and quality can minimize agency cost. Scholars opined that agency problems usually exist because of the following issues i- Asymmetric information where principal could not recognize or predict behaviors of the agent, ii- conflict of interest among the goals of the principal and goals of the agent, for instance principal objective is wealth maximization while the managers objective is sustainability of the business (Eisenhardt, 1989). Jensen and Meckling (1976) stated that agency problems exist between principal and agent because of the differences of goal to achieve. In the case of this study audit committee (financial expert, audit committee independence and audit committee size) and audit quality (big 4, audit tenure and audit fee) were employed to test their effect in minimizing the agency cost between the investors (owners) and the managers.

2.1 *Financial expert in audit committee and earnings management*

Financial reporting process comprises knowledge of technical rules and accounting standards. Directors whom will monitor the process with sophisticated financial background are more likely to be successful in constraining earnings management. Previous studies such as Bedard et al. (2004) and Carcello et al. (2006) find that the presence of at least one member with financial expertise is associated with a lower possibility of destructive earnings management. Defond, Hann and Hu (2005) in their study related to the markets show favoritism only to financial experts with an accounting background or expertise on the audit committee. Akhigbe and Martin (2006) find a favorable valuation effect of the audit committee members with financial expertise in the pre-SOX financial services industry. Dhaliwal et al. (2007) investigate three types of financial experts (accounting, finance, and supervisory) in the audit committee and find a positive relation between accruals quality and accounting experts. However, they do not find a significance relation between accruals quality and non-accounting experts. Chang and Sun (2009) find that the market reacts positively to financial experts on audit committees after SOX. Marra et al. (2011) find that the financial expertise of

the audit committee has a negative relationship with earnings management. It's required a high degree of financial sophistication for audit committee member to improve audit committee's effectiveness in monitoring discretionary accruals. The study hypothesis that:

There is a negative relationship between financial experts in audit committees and discretionary accruals in the pre- and post-code 2011

2.2 Audit committee independence and earnings managements

The role of the audit committee is certifying the quality of financial reporting, contributing to minimizing earnings manipulations. Act imposes obligations on a fully independent audit committee to be in charge of observing the financial reporting that the audit committee has not done previously (Klein, 2002). For the audit committee to be fully independent and effective committee, the majority of the members must be independent directors or non-executive directors (SEC Code, 2011).

Post-SOX empirical studies have find that an effective audit committee is positively associated with high-quality financial reports (Goh, 2009). Chang and Sun (2009) find that the markets react positively to the disclosure of a fully independent audit committee after SOX. Carcello et al. (2006) find that independent audit committee members with financial expertise has better effective in mitigating earnings management. Petra (2007) finds no association between the earnings informativeness and independent audit committees. Sun (2013) find a negative and significant on the interaction of audit committee independence and audit industry specialization. Fodio et al. (2013) revealed that audit committee independence has a positive association with discretionary accruals, which indicates that these variables might not decrease the extent of earnings manipulation by managers. Independence of audit committee and earnings management has a mixed result, this study hypothesis that:

There is a negative relationship between audit committees independence and discretionary accruals in the pre- and post-code 2011.

2.3 Audit committee size and earnings management

Reports indicated that many members in the committee enhance the performance, because there is availability of members whom to draw to carry out the services. Studies reported that a large audit committee inclines to improve the audit committee's status and power within an organization (Kalbers & Fogarty, 1993), to receive more resources (Karen Pincus, Rusbarsky and Wong, 1989), and to lower the cost of debt financing (Anderson et al., 2004).

Previous empirical studies such as Xie *et al.* (2003) reveal insignificant relationship between audit committee size and discretionary accruals. Vafeas (2005) reports that audit committee's performance determined by committee size. Ghosh, Marra and Moon (2010) in their studies corporate boards, audit committee and earnings management: pre and post-SOX evidence find that audit committee size is influencing discretionary accruals at the pre-period and not at the post period. Fodio *et al.* (2013) find that audit committee size is significance and negatively associated with discretionary accruals. The study hypothesis that:

There is a negative relationship between audit committees size and discretionary accruals in the pre- and post-code 2011.

2.4 Big 4 auditors and earnings management

Appointing top class audit firms provide good quality audit because, it generally agrees that quality of audit differs among the classes of the auditors (DeAngelo, 1981; Francis, Maydew and Sparks, 1999). Top audit firms like Big 4 can deliver higher quality audit than non-Big 4 auditors (Becker, Defond, & California, 1998; DeAngelo, 1981; Van Caneghem, 2004; Watts & Zimmerman, 1986).

Empirical studies like Teoh and Wong (1993) investigated investors' perception of the quality of big 8, client accounting numbers vs that of non-big 8 clients, find that big 8 auditors are seem to provide greater audit quality. Kinney and Libby (2002) conclude a positive relationship between earnings management and a higher proportion of external auditors' non-audit services. Klein (2003) submits that big 4 auditors may shift some of their responsibility

of monitoring financially reporting to firms' audit committees after SOX. It is found that appointing top class auditors provide qualitative audit. Furthermore, the Big 4 auditors have capacity to provide higher audit quality because of the following reasons: they have many numbers of clients, many resources, technology and trained staff for the audit work and they will not care to lose any client due to his insincerity and breach of the process (Shen & Chih, 2005; Van Caneghem, 2004). The study put forward the following hypothesis:

There is a negative relationship between Big 4 Auditors and discretionary accruals in the pre- and post-code 2011.

2.5 Auditors tenure and earnings management

Rotation of auditors has been regulated to a smaller number of years depending on the nation, for example in US Sarbanes-Oxley Act decreases the tenure period of an auditor from seven to five years. In Nigeria corporate governance code 2011 provision provided that external auditors should be retained for not more than ten years (SEC Code, 2011).

Empirical research such as Lys and Watts (1994) opined that the possibility of an auditor being subjected to lawful deed is not correlated to his tenure. Kinney and Libby (2002)'s study find that association between auditors tenure and abnormal accruals in total value is negative. Auditor's tenure decreases accruals (abnormal) it can be positive or negative (Myers, Myers, & Omer 2003). Similarly, numerous studies examine the association between auditors tenure and various measurements of audit quality, majority of the outcomes show that auditors tenure increase audit quality (Ghosh & Moon, 2005; Johnson, Nelson, & Frankel, 2002; Mansi, Maxwell, & Miller, 2004).

Manry, Mock and Turner (2008) reported audit tenure increase audit quality with small audit partner for the periods greater than seven years. In other hand, fact indicated that long auditor's tenure decreases audit quality (Carey & Simnett, 2006), it can be at earlier or later part of the auditors tenure (Davis, Soo and Trompeter, 2009). We hypothesize that:

There is a negative relationship between auditor's tenure and discretionary accruals in the pre- and post-code 2011.

2.6 Audit fee and earnings management

Every auditor should be financially independent of his clients, but where audit firm relied on a specific client, economic theory put forward that auditors collected a great percentage of income from a specific client, that auditor may lose his objective because, he created economic bonds with the client, he cannot provide reports against the client due to the reliance on the him (DeAngelo, 1981). In line of that, we hypothesize that:

There is a negative association between the audit fee and discretionary accruals in the pre- and post-code 2011.

2.7 Pre-and post-corporate governance code 2011 and earnings management

Several studies have been carried out on the association between earnings management in the pre-corporate governance code periods and how corporate governance code affects earnings management in the post periods. Empirical studies like, Anderson, Deli and Gillan (2003); Bryan, Liu and Tiras (2004); Cohen et al. (2008); Jenkins (2002); Klein (2002); Petra (2007) find different results on the association between corporate governance and earnings management, earnings formativeness in the post-period.

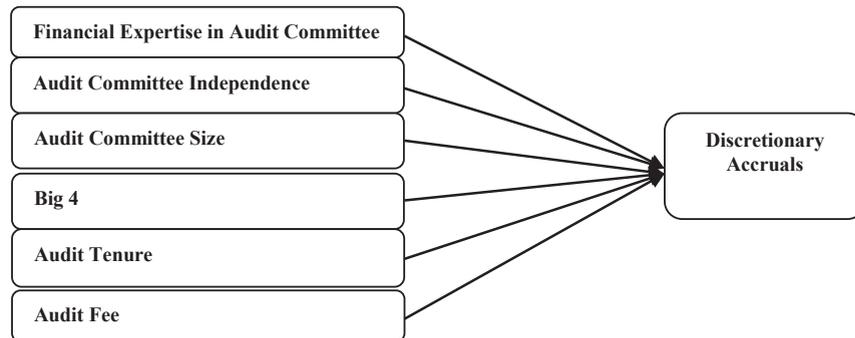
Chang and Sun (2009) find that SOX mechanisms improve the effectiveness of foreign firms corporate governance improves the quality of accounting earnings. Similarly, Arping and Zacharias (2010) find that firms are more transparent in corporate governance disclosure after SOX. Chang and Sun (2010) find that effective corporate governance improved earnings management after mandated disclosure. Most of the studies linked the effect of corporate governance mechanism on the earnings managements in the post- code period with the earnings management in pre code period. This study hypothesis that:

Corporate governance code 2011 provisions impacted negatively on discretionary accruals more than corporate governance code 2003.

3. Conceptual framework

The framework 3.1 below is the conceptual framework of the study that showed how the relationship between dependent variable (discretionary accruals) and independent variables audit committee (financial expert, audit committee independence and audit committee size) and audit quality (big 4, audit tenure and audit fee) in the study.

Framework 3.1



Discretionary accruals serve as the dependent variable while financial expertise in audit; audit committee independence; audit committee size; big 4; audit tenure and audit fee are the independent variables of the study.

4. Methodology

This study will use multiple regressions to measure the association between audit committee, audit quality and discretionary accruals in both periods. The study will also employ T-test for independent sample to compare the results of the pre- and post- code 2011 periods. The measurements of the variables are: discretionary accruals measured using modified Jones by Dechow, Sloan and Sweeney (1995); Financial Expert in Audit Committee is the proportion of audit committee directors who qualify as accounting financial expert to the total number of directors in the audit committee; Audit Committee Independent is the proportion of non-executive audit committee members to the total audit committee members; Audit Committee Size is measure as the number of audit committee members to the total of board numbers; Big 4 is measure as one if audited by big 4 otherwise zero; Audit Fee is measure as non-audit fee divided by audit fee paid to an auditor; Auditor's Tenure is measure as one if the auditor's tenure is greater than the sample average otherwise zero.

5. Conclusions

Discretionary accruals have been using to manipulate accounts and mislead investors, audit committee and audit quality believed will contribute in reducing earnings management drastically, this study highlighted how audit committee and audit quality will reduce manipulation of accounts through discretionary accruals in the pre- and post-code 2011 and compare the out-comes of the two periods (pre- and post- code 2011) for the performance measurement of the codes.

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