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EFFECTIVENESS OF AUDIT COMMITTEE AND FINANCIAL PERFORMANCE OF DEPOSIT MONEY BANKS IN NIGERIA

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Abstract

Audit committee has been adjudged to be an instrument of good corporate governance which influences financial reporting process for better performance. This study empirically examined how the effectiveness of an audit committee impacts financial performance of deposit money banks in Nigeria. Using return on equity (ROE) as measure of financial performance, independence, financial expertise and frequency of meetings were identified as possibly having effects on financial performance. Correlation and ordinary least squares (OLS) regression were used to estimate the relationship between audit committee characteristics and financial performance. Findings revealed that audit committee financial expertise and audit committee meetings significantly influence deposit money banks' financial performance. The study recommends that frequency of meetings of audit committee members should be improved by ensuring that adequate and sufficient time is dedicated to pressing and current issues as it relates to each deposit money bank.

Keywords: Audit committee, Deposit money banks in Nigeria

1. INTRODUCTION

The audit committee is one of statutory committees established by the board of directors in the financial sector, whose major responsibility is to oversee the financial and other reporting process of an organization in order to enhance credibility, integrity and transparency in their operations, including financial reporting. However, massive corporate accounting scandals have sent shock waves down the spines of investors across the world. The scandals affected investors' confidence and made it difficult for companies to raise equity from the stock market.

Such scandals are not peculiar to a particular industry or sector. For instance the Houston-based publicly traded waste management company in 1998 reported $1.7 billion in fake earnings, yet having Arthur Andersen as the company auditors. Enron scandal of 2001 was another Houston-based commodities, energy and service corporation; wherein shareholders lost $74 billion, employees lost their source of livelihood, likewise thousands of investors and employees lost their retirement accounts. Arthur Andersen was also the company auditors. Worldcom was a telecommunication company rocked by financial scandal

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in 2002. Investors lost $180 billion and assets were inflated by $11 billion; 30,000 jobs were lost in the process. Another scandal was by Tyco in 2002, a New Jersey based security systems' company where both the CEO and the CFO stole $150 million and inflated company's income by $500 million. Healthsouth was the largest publicly traded heath care company in the US. Yet, in 2003 it was embroiled by financial scandal when earnings were inflated by $1.4 billion just to meet stockholders' expectations. Freddie Mac was a federally backed mortgage financing giant. In 2003, the bubble busted when it was discovered that $5 billion in earnings were misstated. Furthermore, American Insurance Group, a multinational insurance corporation in 2005 was caught in massive accounting fraud amounting to $3.9 billion in addition to rigging of bids and stock price manipulation. Lehman Brothers was a global financial services firm was caught in 2008 hiding over $50 billion in loans disguised as sales. Ernst & Young were the auditors. Satyam was an Indian IT services and back-office accounting firm caught in 2009, the company falsely increased revenue by $1.5 billion (Agrawal, 2005).

In Nigeria, Chief Executives of Oceanic, Afribank and Intercontinental Banks were found guilty of high level fraud running into billions and money laundering cases while the CEO of Cadbury Plc and Lever Brothers (now Unilever Plc), an Anglo-Dutch company were accused of doctoring their financial statements (Afolabi & Amupitan, 2015; Chukwunedu, Okafor & Ofoegbu, 2013) . Various reports on the scandals are of the view that the board of directors and the committees do not have a good supervision on the management. For instance, many of the companies involved in financial scandals manipulated the financial statements through off-balance sheet financing and overstating of their earnings before finally filing for bankruptcy. Therefore, the boards were unable to disclose the distorted statements because they apparently lacked independence from senior executives (Deakin & Konzelmann, 2004). The investigations often show that the audit committees failed to effectively oversee the managers' duties (Weiss, 2005).

In Nigeria, the cases of insider trading, massive and prevalent frauds, mandatory retirement of CEOs of some banks, due to corrupt practices and inefficient rubber-stamped boards, have combined to signal the absence of, or failure of existing corporate governance structure (Quadri, 2010). Therefore, the trust which investors had on the credibility and the quality of financial report presented by the management of companies could no longer be sustained as they were reported to be misleading. Hence, a higher need to protect stakeholders' interest so as not to have another overwhelming shock becomes imperative. The responsibilities bestowed on them due to information asymmetry between the management and the owners of the business was expected to ease the agency problems which would invariably lead to the reduction of agency cost when the substantial interests of the management are aligned with the company's interests (Yayah, Abdullah, Faudziah & Ebrahim, 2012). However, this objective seems not to have been realized in Nigeria.

Constitutionally, deposit money banks are to put in place an audit committee as specified by the Company and Allied Matters Act (2014) and Code of Corporate Governance (2011) in order to aid good governance. In the light of the foregoing, various authors have come to the conclusion that the audit committee is an instrument of good corporate governance (Owolabi & Dada, 2011; Kumar & Singh, 2012) and that they influence the financial reporting process for better performance. In their study, Mohiuddin and Karbhari (2010) posited that an audit committee that will influence corporate and financial reporting positively and effectively must possess certain attributes such as independence, financial expertise, membership mix, size and number of meetings. With the sudden failure of some

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banks in Nigeria however, one may wonder as to the effectiveness of the audit committee of such banks.

Therefore, this study gathered empirical evidence as to the effectiveness and the level of compliance in relation to the set-up of the audit committee of selected banks in Nigeria. Related study has been carried out by Uwuigbe (2013) in Nigeria but the study focused on corporate governance and the financial performance of firms in Nigeria excluding the financial sector. Ojeka, Iyoha and Obigbemi (2014) carried out a similar study but in relation to the manufacturing sector of the country. Thus, this research contributes to knowledge as it focused specifically on the impact of audit committee's effectiveness on financial performance of deposit money banks in Nigeria. The selected banks' financial reports and accounts were consistently available for the period covered. The audit committee characteristics are decomposed into: independence, financial expertise, and meetings while performance is captured by return on equity (ROE). The study covers a period of five (5) years spanning 2013 to 2017. The rest of this paper is divided into literature review section, followed by methodology. The analysis of data and interpretation follows that immediately while the last section covers the conclusion and recommendations based on findings from the study.

2. LITERATURE REVIEW

2.1 Conceptual Issues

Audit committee has been defined by various authors as it relates to what they perceived of the committee. Birkett (1986), Cadbury Committee (1992) and Collier (1992) defined audit committee as a sub-committee of the main board comprised mostly of non-executive or independent directors with responsibility for oversight of auditing activities. According to the Canadian Institute of Chartered Accountants (1992), the audit committee is defined as a "committee of directors of an organization whose specific responsibility is to review the annual financial statements before submission to the board of directors. The committee generally acts as liaison between the auditor and the board of directors and its activities may include the review of nomination of the auditor, overall scope of the audit, results of the audit, internal financial controls, and financial information for publication.

The audit committee is very crucial to a listed company because they are to report on the work done by the external auditors. Not only that, Company and Allied Matters Act (2014) stated that the audit committee are to certify that the scope and planning of the audit were adequate in their opinion; account and that the reporting policies of the Bank conforms to the statutory requirements and agreed ethical practices; that internal control system is being constantly and effectively monitored; whistle blowing channel run by an external and independent third party is found adequate; and external auditor's management controls report receives satisfactory response from the management.

Every public company in Nigeria is mandated under Section 359 (3) and (4) of CAMA to establish an audit committee. It is the responsibility and the function of the Board to make sure that the committee is constituted according to the laid down policies which would make it able to effectively carry out its statutory duties and responsibilities. There are many indicators or variables that may form yardsticks by which audit committee can be measured in an organization. Some of these yardsticks are briefly discussed below:

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2.1.1 Audit Committee Independence

An independent director is described as an individual who has no significant personal interests in the company, such as a significant contractual relationship with the company. An independent audit committee is expected to provide an unbiased assessment and judgment and able to monitor management effectively. Moreover, Erickson, Park, Reising and Shin (2005) asserted that independent directors can reduce agency problems. Based on the argument provided by Erickson et al (2005) that directors' independence can reduce the agency problem, it can be similarly agreed on that independent audit committee can also reduce the agency problems. In other words, a positive relationship between audit committee independence and firm performance is expected and justified. Assenga, Aly and Hussainey (2018) submitted that large proportion of independent directors safeguards owners' resources from management conflicts of interest.

2.1.2 Audit Committee Financial Expertise

The issue of financial expertise for at least one audit committee member was first recognized under Section 359 (3) and (4) of CAMA 2004 (as amended). This was further re-echoed in the SEC code of 2011. At least one of the audit committee members should have sound knowledge in financial and accounting matters. Financial reporting and its related internal control processes is complex, and only those members that have the relevant competency or expertise in accounting, finance, or business are capable of understanding them (Xie, Davidson & DaDalt, 2003).

Audit committee members with financial or accounting expertise are thought to be able to unveil any opportunistic earnings management activities more effectively. Audit committees with financial expertise have greater interaction with their internal auditors (Raghunandan, Read, & Rama, 2001) and are less likely to witness internal control problems (Krishnan, 2005). They are more likely to understand external auditors and support the auditors in conflict situations with management (Dezoort, 2001).

2.1.3 Audit Committee Meeting

The frequency of audit committee meetings can be used as a measure of their effectiveness. Code of best practice (2003) in Nigeria recommends that the audit committee meets not less than three times a year. Zhou and Chen (2004) noted that audit committee meetings serve as an important mechanism for improving and promoting corporate governance in firms. There is likelihood that financial fraud would be reduced if the audit committee meets frequently and carry out its duties as required (Stewart & Munro, 2007). Salawu, Okpanachi, Yahaya and Dikki (2017) posited that audit committee that meets frequently are up to date with challenges in the business environment and are more proactive in the discharge of their responsibilities.

2.2 Theoretical Framework

The theoretical framework for the understanding of the effectiveness of the audit committee is underpinned by the Agency theory as propounded by Jensen and Meckling (1976). Agency theory states that the separation of corporate management and ownership results in an agency problem: the management (agents) may not always act in the interests of the shareholders (principals) (Fama & Jensen, 1983). In order to solve the agency problem,

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boards of directors through their oversight roles are involved in appointing the CEO, approving business strategy, monitoring control systems, liaising with external auditors, among others. Given their diverse responsibilities, the board of directors typically delegate their oversight activities to different committees.

One of these committees is the audit committee vested mainly with the responsibility to oversee financial reporting. In line with the agency theory, effectiveness of audit committee is associated with the monitoring and control need of a firm. The audit committee is put in place to make sure that the executive management is acting in the best interests of the shareholders and are not in any way hiding anything from the owners of the company.

2.3 Empirical Evidence

Chan and Li (2008) found that independence of the audit committee (i.e. to have at least 50 per cent of expert-independent directors serve on audit committee) positively impacts the firm performance as measured by Tobin's Q. Similarly, Ilona (2008) showed that there is a positive relationship between audit committee independence and firm performance as measured by return on equity.

Klein (2002) found that having outside directors on the board enhances and promotes corporate performance and the returns to shareholders. Similarly, independent directors are better monitors of management than are inside directors (DeFond & Francis, 2005). Anderson, Mansi and Reeb (2004) found that full independent audit committees brings about lower debt financing costs which indicates that all the members must be independent before there could be any significant impact. Carcello, Hollingsworth, Klein, and Neal (2006) discovered that audit committee independence is significantly related to financial reporting quality, since financial statement fraud is more likely to happen in firms with less audit committee independence.

In relation to financial expertise, Qin (2007) observed that firms with higher quality of earning are more associated with audit committee members who have financial expertise. Bouaziz (2012) found that audit committee financial expertise has a significant impact on returns on equity and return on asset. DeFond & Francis (2005) investigated how markets react to the appointment of an audit committee member with a different level of accounting and financial expertise and found a positive market reaction to appointing accounting and financial expert.

Carcello, Hollingsworth, Klein, and Neal (2006) studied the association between financial expertise and earnings management proxy by abnormal accruals and found that accounting and financial experts are consistently associated with less earnings management especially in firms where the corporate governance mechanisms are weak. Dhaliwal, Naiker, and Navissi (2010) found a positive relationship between accounting and financial expertise in audit committees and financial reporting quality.

The numbers of audit committee meetings are considered to be an important attribute for their monitoring effectiveness (Lin, Li & Yang, 2006). Financial statement users perceive fewer meetings as an indicator of less commitment and insufficient time to oversee the financial reporting process. Xie et al. (2003) showed that increased audit committee activity as proxies by the number of committee meetings is associated with reduced levels of earnings management. Bryan, Liv, and Tiras (2004) posited that audit committees that meet regularly

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improve the transparency and openness of reported earnings and therefore improve financial performance. Audit committees' members who meet regularly are often expected to be able to perform monitoring tasks more effectively than otherwise. Zhang, Zhou, and Zhou (2007) used the number of meetings to measure whether the frequency influences financial reporting quality and found a positive correlation.

3. METHODOLOGY

3.1 Model Specification

The econometric model for this research was specified in line with previous study of Ojeka *et. al* (2014) to analyse the relationship that exists between banks' financial performance and audit committee effectiveness:

$ROAit= \beta 0+\beta 1ACINDit+ \beta 2ACFEXPit+ \beta 3ACMEET\ it+\beta 4ACSIZEit + BSit +\mu it$ ....equation 1

Where ROA =return on asset, ACIND =audit committee independence, ACFEXP=Audit committee financial expertise, ACMEET=Audit committee meeting, ACSIZE=Audit committee size, BS=Board size.

Modifying the model results in the specified equation below:

$ROE_{it} = \beta_0+ \beta_1 ACIND_{\ it} + \beta_2 ACFEXP_{\ it} + \beta_3 ACMEET_{\ it} + \beta_3 ACSIZE_{it} +\mu_{it}$.........equation 2

β_0 = slope of the model
$\beta_1, \beta_2, \beta_3$ = coefficient of parameter
ACIND = audit committee independence
ACFEXP = audit committee financial expertise
ACMEET= audit committee meetings
ROE= return on equity
ACSIZE = audit committee size (control variable)
μ_{it} = error term

The subscripts *i* and *t* refers to the cross- dimension and time series dimension of the model respectively, explaining the panel nature of the model. Return on equity (ROE) refers to the earnings generated by shareholders' equity over a period of one financial year. It is a composite measure of the management team's ability to balance between profitability, asset management and financial leverage which indicate the financial health of a bank and effectiveness of management. In line with the objectives and the theory underpinning the study, three hypotheses were formulated in the null (H_o) form:

H_{01}: Independence of audit committee has no significant impact on return on equity of deposit money banks in Nigeria

H_{02}: Financial expertise of audit committee members has no significant effect on return on equity of deposit money banks in Nigeria

H_{03}: Frequency of audit committee meetings has no significant influence on return of equity of deposit money banks in Nigeria.

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3.2 Nature and Sources of Data

The study used secondary data which is gotten from the annual reports of the selected banks for a period of five years from 2013 to 2017. We choose to start in 2013 since it is the first year after the mandatory compliance with the International Financial Reporting Standards in Nigeria and 2017 was chosen as the end-year because it is the most recent year for which data were available. From the Nigerian Stock Exchange listings, the total number of banks is twenty-one (21). In obtaining the sample for this study, the random sampling technique was used. As a result, a sample size of 9 banks was chosen which are banks that are fully owned by Nigerians and have maintained a consistent year end in the preparation of the published accounts and these are; Access Bank, Diamond Bank, First Bank, First City Monument Bank, Fidelity Bank, Guaranty Trust Bank, United Bank of Africa, Sterling Bank and Zenith Bank.

4. FINDINGS AND DISCUSSION

4.1 Correlation Analysis

Pearson Moment Correlation was carried out on both the dependent and explanatory variables to check for multicollinearity and relationship between the various variables in the study. Gujarati and Porter (2009); Hair, Black, Babin and Anderson (2010) reasoned 0.8 as the threshold at which multicollinearity concerns can be harmful to the regression analysis and make the reliability or the positive power of the model as a whole to be reduced. The correlation matrix as shown in Table 1 indicates that the assumption of multicollinearity has not been violated because none of the variables is greater than 0.8. The result showed that all the independent variables: audit committee independence, financial expertise, meetings and size have positive correlation with the dependent variable: return on equity.

Table 1: Result of Pearson Correlation Analysis of independent variables and ROE

Return on Equity (ROE) as dependent variable					
Variables	ROE	ACFEXP	ACMEET	ACIND	ACSIZE
ROE	1				
ACFEXP	0.530	1			
ACMEET	0.430	0.321	1		
ACIND	0.010	0.322	-0.15	1	
ACSIZE	0.287	0.293	0.180	0.259	1

Source: Authors' computation (2018)

Table 2 shows the descriptive statistics of all the variables used in the study. It was revealed that the mean of the dependent variable, return on equity (ROE) is 10.46, with maximum value of 25, minimum value of 1 and a standard deviation of 8.049 from the mean value. This implies that the sampled banks have a moderately low utilization of shareholders' equity. The mean value of the audit committee independence (ACIND) is 1.22 with a maximum value of 3, minimum value of 0 and a standard deviation of 0.704 from the mean value. This indicates that there are audit committees that lack the presence of an independent director in some of the sampled banks. The mean value of audit committee size (ACSIZE) is 5.56 with a maximum value of 7, minimum value of 3 and a standard deviation of 1.179 from the mean value. This implies that the size of the audit committee of the banks studied was

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considered well constituted and there are sufficient members to make effective decisions. The mean value of the audit committee meeting (ACMEET) is 4.04 with a maximum value of 6, minimum value of 2 and a standard deviation of 0.952 from the mean value. This invariably implies that none of the audit committee of banks studied met less than thrice in a financial year. The mean value of the audit committee financial expertise (ACFEXP) is 1.33 with a maximum value of 3, minimum value of 0 and a standard deviation of 0.769 from the mean value. This implies that there are audit committees without a financial expert in some of the sampled banks.

Table 2 **Descriptive Statistics**

	N	Minimum	Maximum	Mean	Std. Deviation
ACIND	45	0	3	1.22	.704
ACSIZE	45	3	7	5.56	1.179
ACMEET	45	2	6	4.04	.952
ACFEXP	45	0	3	1.33	.769
ROE	45	1	25	10.46	8.049

Source: Authors' computation (2018)

4.2 Regression Analysis

Linear regression technique was used in the estimation of the various parameters selected in the model. Hence, table 3 revealed R square of the model to be 0.394 indicating that 39.4% of the changes in the regressed (return on equity) can be explained by the regressors (audit committee characteristics) which implies that 60.6% of the variation in return on equity can be explained by some other factors/variables not considered in this study.

Table 3: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.628[a]	.394	.334	6.570

a. Predictors: (Constant), ACFEXP, ACSIZE, ACMEET, ACIND

Source: Authors' computation (2018)

Table 4: Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	-7.909	5.987		-1.321	.194
	ACIND	-1.986	1.530	-.174	-1.297	.202
	ACSIZE	1.034	.901	.151	1.148	.258
	ACMEET	2.131	1.116	.252	1.910	.063
	ACFEXP	4.824	1.473	.461	3.275	.002

a. Dependent Variable: ROE

Source: Author's Computation (2018)

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From table 4, the model can be expressed in econometric form as follows:

$$ROE= -7.909 -1.1986ACIND + 4.824ACFEXP+ 2.131ACMEET+ 1.034ACSIZE$$

Audit committee independence (ACIND) was observed to be inversely related with the return on equity and is also not statistically significant, therefore, the study fails to reject the null hypothesis that independence of audit committee has no significant impact on return on equity of deposit money banks in Nigeria. This result contradicts that of Chan and Li (2008), whose result shows that a significant positive relationship exists between Tobin's Q and independence of the audit committee.

From the regression results, audit committee financial expertise (ACFEXP) is statistically significant in explaining changes in the return on equity. There is also a significant positive relationship between audit committee financial expertise and return on equity. Specifically, an increase in audit committee financial expertise (ACFEXP) will lead to an increase in the return on equity and a decrease in audit committee financial expertise (ACFEXP)conversely results in a decrease in the return on equity. Thus, the null hypothesis was rejected in favour of the alternative hypothesis that financial expertise of audit committee members has significant effect on return on equity of deposit money banks in Nigeria.

This result is consistent with the findings of Ojeka, Iyoha and Asaolu (2015) indicating audit committee financial expertise as the most prominent and impactful determinant of preserving financial integrity and reliability of financial reporting. This confirms the position of regulators (e.g. Sarbanes Oxley Act, Nig. SEC Codes, 2011) and stakeholders in the financial sector across the world and particularly in Nigeria on the need to have financial experts in the audit committee bearing in mind the recent high profile fraudulent cases as observed in the Nigeria banking sector and across the world.

Furthermore, audit committee meeting (ACMEET) is statistically significant in explaining changes in the return on equity. There is also a significant positive relationship between audit committee meeting and return on equity. Specifically, an increase in audit committee meeting (ACMEET) will lead to an increase in the return on equity and a decrease in audit committee meeting (ACMEET) conversely results in a decrease in the return on equity. Thus, the null hypothesis was rejected in favour of the alternative hypothesis that frequency of audit committee meetings has significant influence on return of equity of deposit money banks in Nigeria.

This finding is in agreement with the previous study by Menon and Williams (1994) and Azam, Hoque and Yeasmin(2010) who found that inactive audit committees with fewer numbers of meetings are unlikely to supervise management effectively; and that the frequency of audit committee meetings has been observed to have positive influence on return on equity. The control variable, audit committee size (ACSIZE) exhibited a positive relationship with return on equity though not statistically significant in explaining the variations in return on equity.

5. CONCLUSION AND RECOMMENDATIONS

This study investigated the relationship between audit committee effectiveness and commercial banks' financial performance in Nigeria. The results showed that out of all the measures of audit committee effectiveness studied, only audit committee financial expertise

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and audit committee meetings have positive coefficients and significantly influence deposit money banks' financial performance.

The results suggest important implications for practitioners and policy makers in Nigeria. One important and major implication is that audit committee members with financial expertise do contribute significantly to the financial performance of deposit money banks and likewise the frequency of the audit committee meetings. Therefore, Nigeria needs to strengthen existing policies by ensuring that the provision made in th Company and Allied Matters Act (2014) about the financial expertise of audit committee members is made compulsory particularly when new members are being considered. It is also recommended that the particulars and biographical data of members of the audit committee with required experience and expertise should as a matter of compulsion, be disclosed in the annual financial reports of the deposit money banks. In addition, frequency of meetings of audit committee members should be improved by ensuring that adequate and sufficient time is dedicated to pressing and current issues as it relates to each deposit money bank.

This study, like other previous studies, does have its limitations and therefore, the conclusions drawn should be interpreted with caution which would invariably serve as opportunities for future research in this area. First, this study adopted the general definition of financial expertise; however, future research could consider the narrower definition by decomposing it into accounting, finance and managerial expertise. Second, only three characteristics of the audit committee were considered in the study. Hence, future study could investigate other audit committee characteristics that are not included in this study such as number of female members in an audit committee.

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