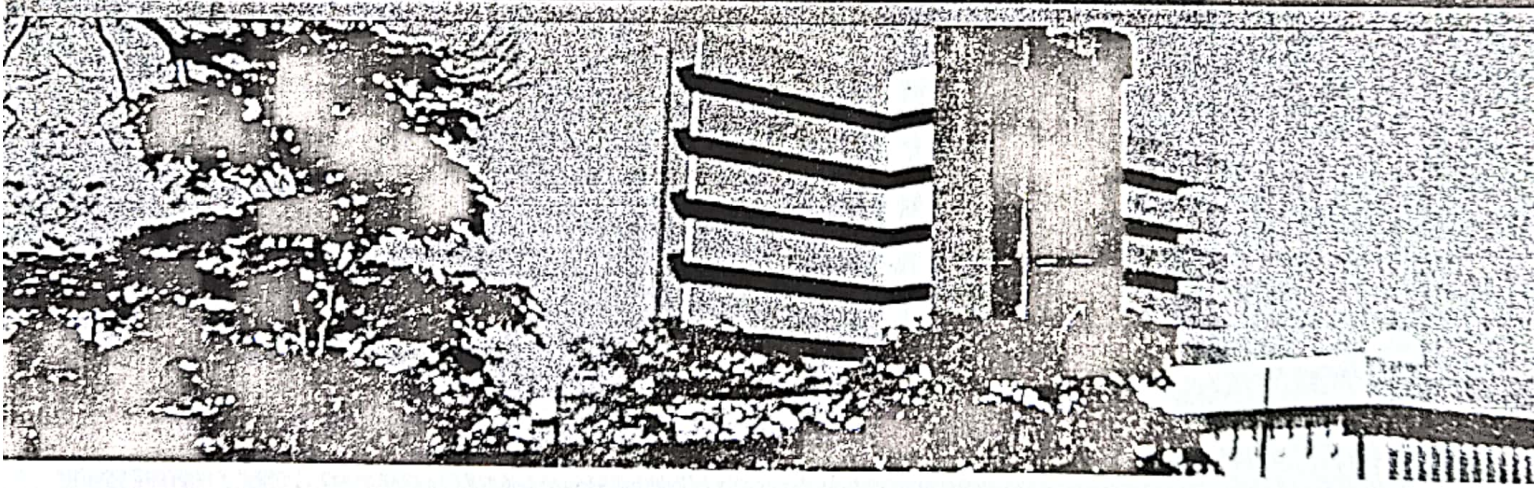
ISBN 978-978-52890-9-

Department of Management & Accounting
OAU, Ile-Ife

ACCOUNTABILITY AND SUSTAINABLE BUSINESS DEVELOPMENT IN EMERGING ECONOMIES

International Conference on Accounting, Finance and Management

JULY 9-11, 2014/OAU/NIGERIA



CONFERENCE PROCEEDING

Vol. 2

Edited by:
T.O. Asaolu
R.O. Salawu
O.O. Akinlo

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Peer-Reviewed Proceeding of the
2nd International Conference on Accounting, Finance and Management held 7th – 9th April 2014.

Volume II

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Organized by

Department of Management and Accounting,
Faculty of Administration, Obafemi Awolowo University, Ile-Ife, Nigeria



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Published By

Department of Management and Accounting,
Faculty of Administration, Obafemi Awolowo University, Ile-Ife, Nigeria

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Vol. II ISBN 978-978-52890-9-1

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Printed by
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THE RELATIONSHIP BETWEEN AUDIT COMMITTEES EFFECTIVENESS AND CORPORATE GOVERNANCE PRACTICES AMONG NIGERIAN BANKS

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Abstract

Companies still fail despite a clean auditor's report and this has called to question the impact of audit committee (AC), (auditor's supervisory body) effectiveness and corporate governance practices among Nigerian banks. This objective was investigated using ten (10) selected money deposit banks using a panel data model covering a period between 2001 and 2010 while the analysis was dichotomized into short run and long run condition using Arellano and Bover dynamic and fixed effect models while Hausman's tet of significance was conducted to verify the significance of the independent variables. Our findings revealed that, the selection process and financial literacy have negative and positive significant impacts respectively on AC; effectiveness in ensuring corporate governance practices in Nigerian banks. Also, estimates obtained from the long-run situation indicated that board size, management ownership and legal environment exerts insignificant impact on AC while character and independence of AC members are unrelated to their effectiveness. It is the reform suggested that appropriate selection process that will ensure adequate financial literacy of AC members be put in place while an environment of rule of law with compliance monitoring are recommended as tools for improving audit committee; effectiveness in enhancing corporate governance practices among Nigerian banks.

Keywords: Audit committee, corporate governance, effectiveness

I. Introduction

The need for internal control in any organization is as old as management itself and effective internal control system can neither be neglected nor under-played in any modern and dynamic economy as it was born out of the complexity of modern business organizations. Thus, systems of internal controls are put in place by many organizations including banks to check the use of their resources, minimize wastage, and ensure transparency and accountability, thereby promoting good corporate governance. One mechanism that has been widely used all over the world in corporate organizations to monitor the financial reporting process and corporate governance practices is the establishment of an audit committee comprising majorly of independent directors (Abbot & Parker, 2000).

Traditionally, statutory auditors are required to express opinion on the true and fair view of the financial statements of companies they audit after examining the records and underlying transactions

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to ascertain whether or not the financial statements are in agreement with the records. Auditors make use of various methods and tools to assist them in ascertaining the accuracy, completeness and reliability of the documents and records from which various financial statements are produced and on which they express their opinion.

Evidence, however, emanating from, not too long ago, of high profile corporations collapsed worldwide (e.g., Lehman Brothers, Enron Corp. and WorldCom in U.S) and a number of corporate abuses among some Nigerian firms particularly among banks have really placed skepticism on the efficacy of this system of internal control and as such makes this area of research of special interest to investors, regulators and academics not only in countries that suffered from such corporate collapses, but also in countries that have never experienced such crises. As a result, more attention has been given to regulations and mechanisms to enhance corporate governance practices worldwide in order to prevent or at least reduce the probability of the occurrence of financial failures as well as to restore the confidence in companies after they were shocked by the collapse of giant corporations. However, the search for mechanisms to enhance corporate governance and increase the quality of financial reports has mostly focused on the structure of audit committees. It was in this spirit that Levitt (1998) pointed out that qualified, independent and tough minded audit committees represent the most reliable guardians of the public interest.

Furthermore, a number of studies have investigated the efficacy of the Blue Robin Committee recommendations in enhancing audit committee effectiveness. For instance, Abbott *et al,* (2002) investigated the relationship between audit committee effectiveness and financial reporting misstatements using the Blue Robin Committee recommendations as benchmarks. They found that companies with an audit committee, which was independent and active, were less likely to have financial reporting misstatements. Their resulted support the Blue Robin Committee recommendations and provide indicators for the efficacy of such recommendations in enhancing audit committee ability to discharge its duties effectively.

This study focuses on the roles of audit committees in engagement of external auditors and maintenance of strong and adequate internal control systems by banks. This is because a number of researchers, regulators and professional bodies (e.g., Birkett 1986, Braiotta 1994, and Blue Robin Committee 1999) have considered the nomination and selection of external auditors as well as

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protection of their independence to be the primary responsibilities of audit committees. Also, independent audit committee members have incentives to protect their reputation by assuming significant responsibility for the engagement of the audit firms/ external auditors and the protection of its independence (Fama and Jensen, 1983). The belief is that a truly independent auditor would not only enforce accurate and transparent financial reporting but also, ensure overall good corporate governance by the firm. As pointed out by International Institute of Auditors (IIA, 2009), effective risk management enhances an organization's ability to meet objectives; helps define the risk appetite while oversight of all of this is part of the sometimes daunting role played by the board, and more specifically, by its audit committees.

This study therefore will be the first study to use the term "independent directors" instead of the term "non-executive directors" to represent audit committee independence to examine the association between audit committee's effectiveness and the auditor's selection process. Previous studies ignored the area of grey directors who are not executive directors, but have a direct or indirect interest in the company when determining the independence of the audit committee. For example, Abbott & Parker (2000) and Chen *et al.*, (2005) considered an audit committee to be independent if all of its members were non-executive directors. This study investigates the factors that influence the effectiveness of audit committees in their fiduciary duties of ensuring accurate and transparent financial reporting system and overall good corporate governance by their organizations.

Apart from this introductory section, this work is further divided into five sections. Section two addresses conceptual issues, the theoretical framework and empirical studies, and Section three focuses on the methodology. While Section four handles the discussion of findings. Section five summarizes, concludes and offer policy recommendations.

2. Literature Review

2.1 Conceptual Issues

Audit committees are an essential element of corporate governance (Green, 1994). In defining an audit committee therefore, emphasis is usually placed on its composition and functions. For instance, Canadian Institute of Chartered Accountants (CICA, 1992) defined audit committee as a committee of directors of an organization whose specific responsibility is to review the annual financial

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statements before submission to the board of directors. The committee generally liase 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 above definition asserts that an audit committee is a sub-committee of the main board of directors of a company, usually formed from non-executive directors, and charged with matters relating to financial reporting, internal control systems and audit and to act as a link between the board of directors, internal and external auditors. Similarly, IIA (2009) argued that an effective audit committee is a vital component of an effective corporate governance system. Audit committees can thus exert a powerful influence on auditors through their role in conducting a specific inquiry into the scope, nature and quality of the audit work done.

In Nigeria, the audit committees were created by the Companies and Allied Matters Decree, CAMD '90 (now CAMA, 2004). Section 359(3) states, inter alia, that 'the audit shall in the case of a public company also make a report to an audit committee which shall be established by the public company'. According to sub-section (4) of the above section, the make-up of the committees shall consist of an equal number of directors and representatives of the shareholders of the company (subject to a maximum number of six members), and shall examine the auditor's report and make commendations thereon to the annual general meeting as it may think fit; provided however, that such member of the audit committees shall not be entitled to any remuneration and shall be subject to re-election annually.

From the above, the intent of the statute in establishing the audit committee could be summarized as to enable:

i. directors and shareholders be aware of important transactions;
ii. external auditors alert management where problem exists;
iii. directors take their statutory responsibilities seriously; and
iv. the control of the activities of dominant executives.

Nevertheless, Audit Committee is defined as a "committee of directors and the enterprise's shareholders" representatives whose specific responsibility is to review the annual financial statement

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before submission to the board of directors." Usually, membership of the committee is subject to the maximum number of six (6) persons (ICAN, 2010).

Corporate governance was defined by Jayashree, (2006) as a system of making directors accountable to shareholders for effective management of companies in the best interest of the company and the shareholders along with a concern for ethics and values. It is the management of companies through the board of directors that hinges on complete transparency, integrity and accountability. On the other perspectives, Ugoji (2009) view corporate governance as the process by which managers provide leadership and direction, create enabling climate and link systematic collaborative efforts to work groups.

Corporate governance practices / principles have been published by different countries as national codes for the practice of good corporate governance. These were derived from Organisation for Economic Co-operative and Development (OECD) but were restated in Wilson (2006) to include:

i. Separating the roles of the CEO from those of the board chairman,
ii. Prescription of non-executive and executive directors on the board,
iii. Improving the quality and performance of board membership,
iv. Introducing merits on criteria to hold top management positions,
v. Introducing transparency, due process and disclosure requirements,
vi. Protection of shareholders rights and privileges and;
vii. Defining the composition, role and duties of the audit committee

However, the relationship between the numbers of non- executive and executive directors on the board calls for attention and is properly considered in this study. The associated benefits of adhering to good corporate governance practices have been identified and summarized by Becht, Bolton & Rosell (2002) and Sullivan, (2000) to include intensified global competition and rapid technological changes, favourable access to capital market and efficiency of investment. In essence, ability to achieve these objectives is hinged upon the audit committees effectiveness which is determined by the board composition, their independence, financial literacy as well as selection process, character and management ownership; thus the relevance of board effectiveness in reaping the benefits of good corporate governance.

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2.2 Theoretical Framework

Most of the studies that have examined audit committee formation and effectiveness have used the agency theory framework to evaluate audit committee effectiveness. However, institutional theory has been found also to be relevant to audit committee effectiveness and corporate governance practices in Nigerian banks.

2.2 (a) Agency Theory

The separation of management from ownership in modern corporations provides an ideal context for the operation of agency theory. Shareholders act as the principal with interests in deriving maximum utility from the actions of the agent (management). Conflicts arise because of the separation of ownership and management and the inability of principals to observe the actions of the agent (Jensen & Meckling 1976). Principals and agents have economic incentives to invest in various information systems and control mechanisms to reduce agency costs associated with information asymmetry (Jensen & Meckling, 2007 and Fama & Jensen, 2003). These control mechanisms might offer maximum gains for all parties since the agent would otherwise bear agency costs that occur when principals discount the value of the firm, based on the likelihood of adverse selection, shirking and moral hazard (Alchian & Demsetz 1972 and Jensen & Meckling 2007). Agency theory therefore, stands on two concepts: asymmetric information and creation of incentives.

Management may use various means to indicate to others the quality of the information they are providing. Demands for monitoring may result in external audits (Anderson *et al.*, 1993), the use of outside directors (Fama 1980 and Anderson *et al.*, 1993) and audit committees (Pincus *et al.*, 1989 and Bradbury 1990). The use of audit committees can be considered an important part of the decision control system for internal monitoring by boards of directors (Fama 1980 and Fama and Jensen 1983). Using an agency theory framework, prior studies, which investigated the relationships between the formation of audit committees and different agency costs, have produced mixed results (Pincus *et al.*, 1989 and Bradbury 1990). Therefore, the formation of an audit committee does not necessarily translate into an effective monitoring body (Sommer, 1991 and Abbott *et al.* 2002).

(b) Institutional Theory

Institutional theory suggests that organizational structures in such an environment become symbolic displays of conformity and social accountability (Meyer & Rowan 1977). In other words, internal

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operating processes loosely coupled with the observable structures accomplish the real work of the organization. As a result, organizations with the appropriate structures in place avoid deep investigations of their operating core by external parties (Meyer & Rowan 1977). They further argued that often these "institutional myths" are merely accepted ceremoniously in order for the organizations to gain or maintain legitimacy in institutional environment.

Organizations are subject to rules and regulations to which they must conform to, ensure their legitimacy, have access to resources and ensure their survival (DiMaggio & Powell, 1983). However, these rules and regulations do not necessarily ensure that organizations will continue to operate efficiently (Meyer & Rowan, 1977). DiMaggio & Powell (1983) suggested that institutional pressures would drive organizations to adopt similar characteristics through the desire to organize them in a manner that is similar to other organizations in the same environment. They argued that the net effect of institutional pressure is to increase homogeneity of organizational structures in institutional environment. Firms will adopt similar structure as a result of three types of pressures; coercive pressure which come from legal mandate. Mimetic pressures to copy successful forms arise during high uncertainty while normative pressures to homogeneity come from similar attitude and approach of professional groups and association. Establishment of audit committees within organizations in Nigeria can therefore be explained within the context of coercive pressures exerted by regulator (Stock Exchange). As a consequence, an increasing number of organizations have established audit committees.

DiMaggio & Powell (1983) argued that mimetic isomorphism is a process of change initiated internally by the organization. Mimetic change will occur when organizations perceive that audit committees will contribute to the corporate governance structures within these organizations. Normative isomorphism emanates from the professionalism of involved individuals, for instance, accountants and auditors, through their professional bodies such as the American Institute of Certified Public Accountants (AICPA) and the Institute of Internal Auditors (IIA), Institute of Chartered Accountants of Nigeria (ICAN) have pushed for the creation of audit committees and guidelines for their activities.

Fogarty, (1996) concluded that the key attribute of institutional theory lies in its ability to highlight the distinction between what organizations actually accomplish and what their structures suggest to

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the external environment. This indicates that this theory is very useful for researchers who aim to compare the best practices for audit committees with the actual performance for such committees. The institutional theory suggests that audit committee effectiveness is more attributable to internal factors such as areas covered by the audit committee than to external factors such as agency variables (Kalbers & Fogarty, 1998). As a result, researchers (e.g., Kalbers & Fogarty, 1998) who have used institutional theory argued that information made available to the publicis of limited use in getting at the real essence of the audit committee as one of the most important corporate governance mechanisms and its effectiveness.

Kalbers & Fogarty (1998) used both agency theory and institutional theory to investigate audit committee effectiveness. They argued that the use of agency theory alone could not differentiate qualitative degrees of the audit committee as a corporate control mechanism. Moreover, they found that audit committee effectiveness is more attributable to internal factors than to external factors such as agency variables. However, they did not examine or name specific internal factors in their study. Instead, they considered the failure to establish relationships between audit committee effectiveness and agency variables as an indicator of the great impact that internal factors could play in audit committee effectiveness. Kalbers & Fogarty's study (1998) suggests that neither theory alone is as useful as their synthesis. As a result, they suggested the use of both theories in any attempt to evaluate audit committee effectiveness, but they did not specify a theoretical framework that could link the two theories together.

2.3 Review of Empirical Literature

A number of studies have investigated the impact of the internal control system on the audit committees' effectiveness of firms. For instance, Felo, *et al.,* (2003), in his study, found a positive association between audit committee size and financial reporting quality. These studies provided support for the use of audit committee size as a proxy for the available audit committee resources. Mikol & Standish (2008) argue that in the absence of restrictions, auditors have incentives to create a competitive advantage by developing concentrations of multiple-service expertise. The benefits, which could be obtained from the economies of scope and increased client awareness, can reduce the costs of the audit firm, and, in turn, the fees charged to the client for service provision (Mikol & Standish 2008).

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services purchases might be a result of management's desires to send a positive message to the external users of the financial reports that management acts in the best interest of the shareholders and other third parties and not because of the audit committee efforts to control such purchases.

3. Methodology

3.1 Model Specification and Definitions of Variables

Stemming from the above submission, the most appropriate model to capture audit committee's effectiveness and the internal control system of corporate firms which is in tandem with the peculiar nature of the Nigerian economy is as specified below:

$$\text{CORP. GOV}_{i,t} = \alpha + \beta 1\, AC_IND_{i,t} + \beta 2\, AC_COMP_{i,t} + \beta 3\, AC_FNL_{i,t} + \beta 4\, AC_CHAR_{i,t} + \beta 5\, AC_SEL_{i,t} + \beta 6\, AC_LEG_{i,t} + \beta 7 MGT_OWN + \varepsilon$$

Where:

$CORP.GOV_{it}$ = Corporate Governance observed by the banks. It is measured by the level of accountability, transparency and disclosure reflected in their financial reporting systems.

Independent variable (audit committee effectiveness) is represented by:

IND = Auditors Independence,

COMP = Board Composition,

FNL = Financial Literacy,

CHAR = Character of Audit Committee Members,

SEL = Selection Process of the Members,

LEG = Legislative Environment and;

MGT-OWN = Management Ownership.

ε = Random Element of Residuals

$_{i,t}$ = Cross-sectional time Series index

3.2 Measurement of Variables

The dependent variable (good corporate governance) is measured by the level of disclosure, accountability, transparency and the degree of reliability of the banks' financial reporting systems as a result of the influence of variables stated hereunder and thus reflecting how effective their audit committees are.

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Management Ownership: This equals the percentage share ownership that management has in the company. The higher the proportion of the total shares owned by the top management, the more likely the management would pursue policies that serve their interest more

Audit Committees Composition: this variable refers to the percentage of non-executive directors/shareholders in the committee to the total number of the committee's members. The higher the ratio of the non-executive directors on the committees, the higher the chance of taking decisions that would be of greater interest to the members of the companies rather than the management if the need to cast vote arises.

Audit Committees Independence This is measured by the significant level of decisions taken at the committees meetings at variance with management decisions as well as ability of the committee to influence appointment of external auditors and determining their remuneration.

Financial Literacy Level of Members: This refers to the ratio of the members who are financial literate/understand accounting language (such as accountants and bankers) to the total membership of the committees.

Character of Members: This refers to the level of integrity among majority of the members of the audit committees as perceived by top managers of the banks and key shareholders. Are the members rated high, average or low in integrity in terms of past records assessment.

Legislative Environment: This refers to the adequacy of, and level of compliance with the existing laws and regulations guiding the conduct of audit committees in Nigeria.

Observance of independence and character of board members were coded as dummy as follows:

Traits	Codes
Character of Audit Committee Members:	
High level integrity	2
Low level Integrity	1
Of doubted Integrity	0
Audit Committee Independence:	
Highly independent	2
Moderate Independence	1
Low independence	0

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Table 4: Hausman Tests of Significance.

Non_audit*	Coefficient (b)	(B)	Difference (b-B)	Standard Error
A/ Comm._compst	1.6227	-0.7228	2.3455	0.8770
Independence	0.1460	0.6265	-0.4806	0.8284
Financial literacy	1.7303	2.5879	-0.8576	0.7043
Selection Process	-2.7237	-0.4592	-2.2645	1.0227
Character	0.0005	0.0029	-0.0024	0.0020
Mgt owner.	-0.6507	-2.8327	2.1820	1.2274

Chi2 (6) = 9.94; Prob>chi2 = 0.1274.

4.3 Discussion of Findings

The differenced and dynamic model estimates in tables 1and 2 reveals that only the selection process; of all the indices of internal control system/corporate governance practices impacted negatively and significantly, at the 5% level of significance, on the effectiveness of audit committee of corporate firms in Nigeria. The selection process has -2.9513 coefficients with 0.031 p-values while audit committee composition , the independence of committees and the management owners are also negatively related to the effectiveness of audit committee in Nigeria Banks with -2.5715, -2.3338 and -0.7039 coefficients but with insignificant p- values of 0.226, 0.199, 0.835 respectively. Contrarily, financial literacy of committee members is positively related to the effectiveness of audit committees with 2.0615 coefficient and p- values of 0.371.

In the long-run, the selection process and management ownership are negatively and significantly related to the effectiveness of audit committee with -2.7237 and -0.6507 coefficients and 1.32, 0.15 T-statistics ratios respectively while the audit committee members composition, members' independence, financial literacy and character of members are positively related with 1.6227, 0.1460, 1.7303 and 0.0005 coefficients coupled with 0.76, 0.08, 1.10 and 0.18 T-statistics ratios respectively. All these variables are insignificant at the 5 percent level.

This study, by the virtue of the positive linkage between the financial literacy of members and audit committee's effectiveness in the short-run situation, agrees with the study of Song & Windram (2004) which found that UK firms with audit committee of a higher level of financial literacy are less

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likely to have financial reporting problems. In relation to the insignificance convergence, in the Nigerian case, of the short-run analyses and long-run situations, this study held that in addition to the position held by Vafeas (2001) whose studies opined that audit committee's independence, expertise and financial literacy were all important determinants of audit committee's effectiveness, the process of selecting members representing shareholders at Annual General Meetings is also very critical and crucial in determining the effectiveness of audit committees.

5. Conclusion and Recommendation

Dynamic panel model and static panel model were employed to ascertain the short-run analysis and long run situation of how corporate governance practices by Nigerian banks are affected by effectiveness of the audit committee. Under the dynamic panel model; the differenced, systemic and linear versions were employed while for the static, the fixed-effect model was used for the long-run analyses as it is more robust.

From these, it can be concluded that various indices of AC effectiveness exerts different effect on corporate governance performances. Majorly, financial literacy of the AC members and their independence have positive impact on banks performance (corporate governance practices) while the AC selection processes adopted in Nigeria by these banks exerts negative impacts on these banks' performances. Also, of importance are the negative effect of management ownership but board composition impact is unspecific while character of board members has nothing to do with banks performance/ corporate governance practices.

In order to engender more compliance with corporate governance practices /raise bank performance and ensure audit committee effectiveness the following policy recommendations are proffered:

i. Sound corporate governance practices should be encouraged while adequate sanctions should be leveled against any erring bank manager who fails to comply. This type of sanctions should be reinforced and applied religiously.

ii. The selection process of the audit committee should be handled with care in order to avoid negative spillover effect it will exert on the AC effectiveness as well as corporate governance practices if people of doubtful integrity are put in place.

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iii. Security and Exchange Commission together with the Corporate Affairs Commission should work out modalities for a selection process that would take the relevant attributes such as financial literacy, relevant experience and character as necessary qualifications for election into audit committee.

iv. Composition of the Audit Committee should be established in accordance with CAMA Section 3549 (3) (4), with not more than one executive director on each committee. Such non-executive members serving on the committee should be independent of the company (i.e independent of management and free from any business or other relationship, which could materially interfere with the exercise of their independent judgment as committee members). The Chairman of the Audit Committee should be a non-executive director, to be nominated by the members of the Audit Committee. Also, membership of the audit committee should be for a fixed tenure but may seek for re-election after their tenure while the Secretary of the Audit Committee should be the Company's Secretary or such other person nominated by the Committee.

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