Effects of Audit Committee on the Financial Performance of Quoted Manufacturing Firms in Nigeria

ADELABU, Sunday Olushola

Department of Accounting
Bingham University
Karu, Nasarawa State
E – Mail: Sunregas2@yahoo.com, Phone No: +234 7062201906

Abstract

The obvious limitations in corporate governance of companies and the cases of accounting and audit failures have increased the concern of investors about corporate reports. For that reason, the need for the establishment of Audit Committees to ensure the credibility of financial statements cannot be over emphasized. This study seeks to evaluate the impact of Audit Committees (AC) on the performance of Quoted Manufacturing firms in Nigeria. The specific objectives of the study are to evaluate the impact of components of Audit Committees (independence and meetings) on return on assets. The study employs secondary data which was obtained from the examination of the annual report for five years of five Quoted Manufacturing companies in Nigeria. The analysis of the empirical data was done using ratio analysis, regression analysis, correlation, and other statistical instrument to determine the rate at which the independenceand frequency of meetings of audit committees have affected the performances of these companies. The study reveals that there is a negative and significant impact of the composition of the audit committee on financial performance. It also reveals that there is a positive and significant impact of audit committee tenure on financial performance thus, the chances of fraud because of this are also reduced as well as the cost of debt. The study concludes that there is a weak negative relationship between the meeting frequency of the audit committee and financial performance of Quoted manufacturing firms. The study, therefore, recommends that there should be strategy towards creating enabling environment for improve the sustainability of Audit Committee for enthronement of good corporate governance practices.

Keywords: Audit Committees, Quoted Manufacturing firms, Corporate governance, Audit failures.

INTRODUCTION

The financial performance of an organization is critical. It goes a long way and as a matter ofimportance its growth and the value it can give to the shareholders of the company. The efficiency and effectiveness of management is apparent in the financial performance thus, the Company and Allied Matters Act (2004, as amended) requires the preparation of some basic financial statements to help users make informed decisions. Also, the International Accounting Standards Board states the basic financial statements that should be presented by companies. Indeed, company's performance is very essential to management and other stakeholders such as shareholders, debt holders and the government (Iswatia and Anshoria, 2007). According to Wakaba (2014), the major goal behind forming the audit committee is to intensify auditing quality and questioning of the board of directors thus increasing performance. The concept of firm performance denotes measuring the results of firms' policies and operations in monetary terms. The results are reflected in the performance ratios such as, return on assets, return on equity, and return on capital employed. Consequently, this research will tryto establish the link between audit committee characteristics in developing economies such as Nigeria and how it influences firm's financial performance with industry as a case study. This study further attempts to investigate how audit committee operates in developing economies, the challenges faced by them and their effect on financial performance of Quoted Manufacturing firms listed in the Nigeria Stock Exchange. Thus, the hypotheses underlying this study includes:

HO1: Audit committee independence has no impact on firm performance of Nigerian Quoted Manufacturing Company.

HO2: There is no positive relationship between the audit committee frequency of meeting and the financial performance of Quoted Manufacturing Company.

LITERATURE REVIEW

Conceptual Framework

According to CAMA (2020, as amended), the audit committee is a committee of shareholders and non-executive directors charged with the responsibility of liaising between external auditors and the Board of Directors on one hand, and between management and external auditors on the other hand. Audit committees are empowered to provide over-sight over the integrity of financial reporting. The presence of this committee in the corporate governance mechanism raises the expectations of shareholders and the public for enhanced corporate governance and by extension, increased performance of companies. Literatures addressing the role of audit committees, the attributes of members of the audit committee and the functions that they perform highlight the need to provide audit committee that are recognized by legislation and charter. Ayinde (2002) view that the audit committee is a standing committee set up to enhance corporate accountability by working together with the internal auditors and management to improve and strengthen financial reporting practices of an entity and ensure proper behavior of corporate affairs in accordance with generally accepted ethical and legal standards. Knapp (1987) observed that an audit committee is more likely to support the auditor rather than the management in audit disputes and the level of support is consistent across members of the committee.

Empirical Clarification

Abbott and Parker (2000) show that firms with audit committees which are composed of independent directors and which meet at least twice per year are less likely to be sanctioned for fraudulent or misleading reporting. Audit committee independence affects companies' profit, management,and investors' perceptions. Empirical evidence shows that companies with greater audit committee size refer to suspicious auditor switches which has been claimed by Archambeault and Dezoort (2001). Klein (2002) specifies that reductions in audit committee independence are accompanied by large increases in abnormal accruals.

Theoretical Framework

Agency Theory

Agency theory is the theoretical framework of audit committees generally applied in an AngloSaxon setting, since audit committees are primarily an institution to align the interests of owners and management. The establishment of audit committees within the Unitary Board System is regarded as a reaction to information asymmetries between owners of a company and its management. Consequently, the analysis of audit committee formation on the level of the firm should focus on variables, for which we can assume a correlation with firm-specific agency costs. Companies with relatively high agency costs are especially inclined to create audit committees and/or enhance audit committee effectiveness. Audit committees (or high audit committee effectiveness) should be expected mainly in listed companies audited by large audit firms with high agency costs of equity and debt as well as high monitoring economies of scale. However, the audit committee formation focuses on monitoring efficiency, the agency perspective does not go far enough. The efficiency of decision making within an institution, given a certain aim, is at least partly due to its organizational setting.

METHODOLOGY

This study evaluates audit committee and its impact on the financial performance of Nigerian Quoted Manufacturing firms. The study will cover some Quoted Manufacturing firms in Nigeria. Data will be extracted from their annual report and sustainability/corporate governance report of the firms regarding the effect of audit committee on their financial performance. This design would allow the assessment of more than one independent variables (audit committee independence, and frequency of meeting) on a given dependent variable (financial performance using return on asset and profit after interest and tax) of listed firms over a period of five years (2011 – 2015). The study comprises of 5 leading Quoted Manufacturing companies in Nigeria over the period of five (5) years (2012-2016).

Purposive sampling was employed in selecting the companies out of the population. The sample size is based on the following criteria: The products of the companies are widely consumed in Nigeria due to their large capital base ii.The availability of existence of consistent financial reports and account. The sample elements are Guinness Nigeria Plc., National Salt Company of Nigeria (NASCON) Plc., Dangote Sugar Refinery Plc., Dangote Cement Plc., and Coca cola Plc.

Secondary Data was used for this study which will be obtained from the examination of the annual report of each company. The analysis of the empirical data will be done using ratio analysis, regression analysis and correlation to determine the rate at which the independence and frequency of meetings of audit committees have affected the performances of these companies. The model is now specified in accordance with the research objectives:

Objective One: Determine the impact of audit committee independence on financial performance of Quoted Manufacturing firms in Nigeria. This objective is achieved by using multiple regression analysis model.

Multiple Regression Analysis Model

$$\boldsymbol{FP}_{ɤ} = \boldsymbol{\alpha} + \boldsymbol{\beta}_1\boldsymbol{ACT}_{ɤ} + \boldsymbol{\beta}_2\boldsymbol{CAC}_{ɤ} + \boldsymbol{\beta FS} + \mu$$

Where =

FPr = Financial Performance in Time r (Response Variable)

ACTɤ = Audit Committee Tenure in *Time ɤ (Explanatory Variable)*

CACɤ = Composition of Audit Committee in *Time ɤ (Explanatory Variable)* FSɤ = Firm Size in Time ɤ *(Control Variable)*
μ = Error Term

β **=** Coefficient/slope of the explanatory variable
α = Intercept

The model was analyzed using Ordinary Least Square method of regression

Objective Two: Ascertain the relationship between audit committee frequency of meeting and financial performance of Quoted Manufacturing firms in Nigeria. The objectivewill be attained by looking into the relationship that exist between the dependent and independent variable. As such, a correlation analysis will be applied here to analyze the relationship of the variables.

Correlation Analysis Model

$$\frac{n\,\Sigma\,(FOMɤ \times FPɤ) - (\Sigma FOMɤ)(\Sigma FPɤ)}{\sqrt{[\{n\Sigma(FOMɤ)^2 - (\Sigma FOMɤ)^2\}\,\{n\Sigma(FPɤ)^2 - (\Sigma FPɤ)^2\}]}}$$

Where=

FOMɤ = Frequency of Meeting in Time ɤ

FPϒ = Financial Performance in Time ϒ

N = Number of meetings

RESULTS AND DISCUSSION

This result and discussion deals with presentation, analysis and interpretation of the data collected and analyzed for the purpose of achieving the specific objective of the study. It presents the result of the empirical study of Effect of Audit committee on financial performance of Quoted manufacturing firms in Nigeria (2011 – 2015). Results obtained from the estimation output of E-view 9.0 for the empirical model was presented below in accordance with the objectives of the study

Objective One: Impact of audit committee independence on financial performance of manufacturing firms in Nigeria

The Quoted Manufacturing companies' performance being the response variable was captured by ROA while the explanatory variables - composition of audit committee (CAC), Audit committee tenure (ACT) and Firm size (FRS) - are the regressors used in achieving the objective. The Table 4.1 reports the impact of audit committee independence on financial performance of 5 Quoted Manufacturing firms in Nigeria for the period of 2011 – 2015. Ordinary least square methods of three models namely fixed effect, random effect and ordinary were estimated. Post estimation diagnostic test of Hausman test and Redundant fixed effect test were adopted in selecting the most appropriate model to capture the effect of Audit committee independence on the performance of Quoted Manufacturing companies in Nigeria. The test indicated that random effect is not an appropriate model and non-normality of the variables will not encourage the use of ordinary least square. Therefore, in estimating the parsimonious model of the variable, fixed effectassumption will be appropriate, 62.85 % of the performance of Quoted Manufacturing companies was accounted for by the explanatory variables, while after adjusting the coefficient of determination due to degree of freedom, the percentage of the performance felt to 57.54%. This implies that about 57.54% of the Quoted Manufacturing companies' performance was accounted for by the explanatory variables. The F-statistics of 12.52685, with the p-value < 0.05 so that the explanatory variables are jointly different from zero and Durbin-Watson statistics of 1.995047 reported the likelihood of no autocorrelation.

Based on the result on Table 4. Two of the three explanatory variables composition of audit committee (CAC) (β = -9.49006, t= -10.7984 and p-value = 0.0000) and audit committee tenure (ACT) (β = 3.065707, t= 3.669561 and p-value = 0.0014) were significant at 95% level of confidence. From the results, composition of audit committee (CAC) was negatively and significantly related to Quoted Manufacturing companies' performance at 5% level, while audit committee tenure was positively and significantly related to performance at 5% level. The following statistics were estimated of CAC, and ACT using Fixed Effect Method, (β = -9.49006, t= -10.7984 and p-value = 0.0000) and (β = 3.065707, t= 3.669561 and p-value = 0.0014) respectively. This signified that performance would decrease by 9.49% given a 100% increase in CAC of Quoted Manufacturing companies and performance will also increase by 3.06% given a 100% increase in ACT of Quoted Manufacturing firms. Based on this results, it is advisable for firms to structure their audit committee composition in such a way that it will include at least 3 non-executive directors as member of audit committee, so that the decision and operation of the firms can be justified without biasness. Also, Quoted Manufacturing companies should lengthen the audit committee tenure as member who has served on the committee are more experienced than new members, the more time member serve on the audit committee, the more he/she is more expose to new ways of serving. This result is in conformity with the submission of Adesola (2016)and it contracted the work of Oyedare (2016)

Table 4.1: Multiple Regression Analysis Model

		Pooled Effect	Fixed Effect	Random Effect
CAC	Coff t-stat p-value	-9.627496 -5.886048 0.0000	-9.49006 -10.7984 0.0000	-9.94267 -9.832411 0.0000
ACT	Coff t-stat p-value	3.055228 1.987701 0.0426	3.065707 3.669561 0.0014	2.818464 2.328985 0.0299
FRS	Coff t-stat p-value	0.842666 0.784958 0.4412	0.795679 1.365656 0.1865	1.143726 1.362695 0.1874
C	Coff t-stat p-value	46.13669 3.133345 0.005	46.17081 5.773195 0.0000	43.37371 3.744998 0.0012
R-Squared		0.641519	0.628542	0.752762
Adj.R-sq		0.590308	0.575476	0.717442
F-Stat		12.52685	11.84464	21.31279
Prob (F-stat)		0.000065	0.000094	0.000001
Durbin-Watson Stat		2.007148	1.995047	1.854916
Redundant Fixed Effect Test			0.0160	
Hausman Test			0.0000	

Source: Author's computation (2020)

Objective Two: Ascertain the relationship between audit committee frequency of meeting and financial performance of Quoted Manufacturing firms in Nigeria.

Objective two of the research work focused on the relationship between audit committee frequency of meeting and financial performance. Table 4.2 presented the relationship that exist between the two variables. The table showed that there was a weak negative relationship of 0.15685 i.e 15.68% between audit committee frequency of meetings and financial performance.

The implication of this negative relationship was that both variable move in opposite direction. The result from this objective three implied that audit committee frequency of meeting and performance could explain little but in negative form.

Table 4.2: Relationship between Audit committee frequency of meeting and financial performance

VARIABLE	ROA	FOM
ROA	1.0000 (0.0000)	
FOM	-0.15685 (0.454)	1.0000 (0.0000)

Source: Author's computation (2020)

Discussion of findings

The manufacturing companies' performance being the response variable was captured by ROA while the explanatory variables - audit committee financial expertise (ACA) and Number of Years in the Committee(YIC) - are the regressors used in achieving the objective. The Table 4.2 reports the effect or impact of audit committee financial expertise of 5 manufacturing firms in Nigeria for the period of 2011 – 2015. Ordinary least square methods of three models namely fixed effect, random effect and ordinary were estimated. Post estimation diagnostic test of Hausman test and redundant fixed effect test were adopted in selecting the most appropriate model to capture the effect of Audit committee financial expertise of manufacturing companies in Nigeria.

CONCLUSION AND RECOMMENDATIONS

The result of the study concludes that there is a negative and significant impact of the composition of the audit committee on financial performance. It also concludes that there is a positive and significant impact of audit committee tenure on financial performance thus, the chances of fraud are also reduced as well as the cost of debt. The study concludes that there is a weak negative relationship between the meeting frequency of the audit committee and financial performance of Quoted Manufacturing firms. Based on the findings, the following recommendations are made:

i. Audit committee should be tolerated to serve more tenure in the committee as it strengthens financial performance of the firms.
ii. Audit committee should include at least three (3) non-executive directors in other to erase biasness in decision making.
iii. Audit committee members should have sufficient financial knowledge in other to give sound directions when decisions are to be taking.

References

Abbott, L.J., Parker, S. & Peters, G.F. (2004), Audit committee characteristics and restatements. *Auditing: A Journal of Practice & Theory*, 23, 69-87.

Ayinde, I. (2002). *Audit committee: History and Evolution*. Presented at a National Seminar on Enhancing audit committee effectiveness, organized by ICAN, Lagos

Companies and Allied Matters Act (1990): *Official Gazette*, No 2, Vol.77, Federal Government printer, Lagos State.

DeZoort, F.T., Hermanson, D.R., Archambeault, D.S & Reed, S.A., (2002). Audit committee effectiveness: a synthesis of the empirical audit committee literature. *Journal of Accounting Literature* 21, 38–75

Iswatia, S., &Anshoria, M. (2007). The Influence of Intellectual Capital to Financial Performance at Insurance Companies in Jakarta Stock Exchange (JSE), *Proceedings of the 13th Asia Pacific Management Conference*, Melbourne, Australia.

Klein, A. (2002). Audit committees, board of director characteristics and earning management. *Journal of Accounting and Economics, 33*(3), 375-400.

Knapp, M. C. (1987). An empirical study of audit committee support for auditors involved in technical disputes with client management, *The Accounting Review, 62*, 578-588

Wakaba R., (2014). Effect of Audit Committee Characteristics on Financial Performance of Companies Listed at the Nairobi Securities Exchange. *Department of Finance and Accounting, School of Business University of Nairobi*

Wild J. J., (1996). The audit committee and earnings quality, *Journal of Accounting, Auditing and Finance* 11, 247-276.

Williams, H. M. (1977, 9). Audit committees: The public sector's view. *Journal of Accountancy*, 156, 71-74

Xie, B., Davidson, W.N., &DaDalt, P.J. (2003). Earnings Management and Corporate Governance: The Role of Board and the Audit Committee, *Journal of Corporate* Finance, 9,295-316. Retrieved from http://www.ingentaconnect.com/content/els/09291199/2003/.../art00006