



The Moderating Effect of Audit Committee on the Relationship between Board Diversity and Earnings Management of Banks in Nigeria

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ABSTRACT

The increasing need for an improved quality of financial reporting is becoming a key challenge for stakeholders in the Nigerian corporate setting because the consistent failure being witnessed by many organizations. The presence of loan loss provision in the banking sector has paved the way for the managers to manipulate accounting earnings which have compelled the need for this research in order to examine factors that could help mitigate or curtail managers' tendencies to engage in earnings manipulation. Therefore, the study examines the effect of the board diversity and audit committee on the earnings management of listed Deposit Money Banks in Nigeria.

Board diversity variables include women director, board ownership, foreign director, board size, and board composition, while a composite index of audit committee size, composition and meeting were used to moderate two (women director and board ownership) of the board diversity variables. Earnings Management was represented by Chang, Shen, and Fang (2011) model. The population consists of fifteen banks and all were used for the analysis. Secondary data were collected from the annual reports and accounts of the banks during the period 2008-2015. Multiple regression techniques were adopted and Stata 13 was used as the tool of data analysis.

The findings revealed that all the variables before the moderation have a significant effect on earnings management of banks except for board size.

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Meanwhile, after the moderation, the findings revealed that explanatory variables explained the extent of earnings management better than before moderation. However, among all explanatory variables used during the moderation, only three variables (foreign director, board composition and audit committee) have a significant effect on the earnings management.

Based on the above findings, the study recommended amongst others that the percentage of women director, shares held by directors, and the number of foreign directors should be increased, while the number of non-executive directors and audit committee should also be improved in order to mitigate the tendencies for earnings management in banks.

Use of audit committee as a moderating variable and the test of applicability and the usefulness of Chang, Shen, and Fang (2011) model in Nigerian Banking Sector.

Keyword: Earnings management, Audit Committee, Board Diversity, Echelon theory

Introduction

The corporate environment in Nigeria has experienced cases of earnings management, such as the reported manipulative accounting scandal in African Petroleum Plc, Cadbury Nigeria Plc in 2006, the case of Oceanic Bank Plc, and Intercontinental Bank Plc. These brought doubt in the credibility of the financial reporting. Based on these series of reported accounting scandals, there is a need to identify factors that could be used to mitigate the management tendencies to engage in manipulative accounting practices. The diversity of the board members is believed to be one of the factors that could be used to curtail the extent of manipulative accounting.

According to Marimuthu (2008), board diversity is the variation in age, race, ethnicity, gender, and social/cultural identities among employees within a specific corporation. These diversities have attracted the researcher's attention due to their expected effect on earnings management. Gender diversity is expected to influence the extent of earnings management because of its effectiveness in meeting attendance and its adherence to ethical codes and standards which pose over the male counterparts on the board (Vafeas & Theodorou, 1998). Therefore, studies on ethics posit that women are less likely to engage in unethical behavior in the workplace to obtain financial rewards (Rose, 2007).

Likewise, the percentage of shares owned by the board of directors is expected to significantly affect the extent of earnings management. It is

either the percentage of shares enable them to align their interest with that of the owners, thereby the reduction of the agency conflict or the level of shares held by them might make them become entrenched since certain level of shares may put the managers in a dominant position which may permit the exploitation of external minority shareholders. In addition, the nationality of the board members and their stakes in the organization could also serve as an incentive to monitor the management just to safeguard their investment.

The size and the composition of the board members are posited by Yu (2013) to be effective and efficient for the board performance. Therefore, the size and the composition of the board are expected to serve as a driving force against the manipulative activities of management in the banks.

Consequently, audit committee has been identified as a core to financial reporting quality. Meanwhile, the basic function of audit committees is to oversee the financial reporting process, monitor managers' tendencies to manipulative earnings, increase the audit quality, and reduce the questioning of the board of directors. Hence, there is an increasing advocacy for the inclusion of women in audit committee because of their less likely nature to engage or encourage manipulation. The assumption is that if women serve on a board and in the audit committee, they may be able to mitigate the managers' tendencies towards earnings management. Moreover, since the audit committee may be composed of board members who have shares in the bank, it is expected that the multiplicative role of the board and the audit committee functions affect the level of earnings management significantly. This justifies the use of audit committee to moderate the relationship between women director, board ownership, and earnings management.

Studies such as Gulzar and Wang (2011), Guo, Huang, Zhang and Zhou (2015), Arun, Almahrog and Aribi (2015), Hussaini and Gugong (2015), Ibrahim (2015) and Ishaq, (2017) explored the influence of board diversity on earnings management in both developed and developing countries, but none of these studies considered the use of moderating effect variable on the relationship between board diversity and earnings management. As such, this study introduces the audit committee as moderating variable to examine its multiplicative role on the relationship between board diversity and earnings management in listed Deposit Money Banks in Nigeria.

Most of these studies in this area such as Gulzar & Wang, 2011; Qi & Tian, 2012; Saleh & Haat, 2014; Baccouche, Hadriche & Omri, 2014 were conducted in developed countries, while few studies such as Razek, 2012;

Shehu & Ibrahim, 2014; Kantudu & Samaila, 2015; and Ishaq, 2017 were carried out in Nigeria. Therefore, there is a need to add to the existing literature in another dimension using the moderating variable.

The study is also motivated by the fact that corporate governance culture in Nigeria has consistently failed to be responsible and accountable for the stakeholders and has no deep-rooted mechanism to maintain a balance among the major players which have resulted to an increase in the manipulation of reported accounting numbers as posited by Bello (2005). Hence, the study seeks to establish a relationship between the effect of board diversity and audit committee on earnings management of banks in Nigeria.

The main objective of the study is to examine the impact of board diversity and audit committee on earnings management of listed Deposit Money Banks in Nigeria. Therefore, the specific objective is: to determine the moderating effect of audit committee on the relationship between women director, board ownership and earnings management of listed Deposit Money Banks in Nigeria.

Based on the objectives above, the study hypothesized that:

Ho₁: Board diversity has no significant effect on the earnings management of listed Deposit Money Banks in Nigeria.

Ho₂: Audit committee has no significant moderating effect on the relationship between women director, board ownership and earnings management of listed Deposit Money Banks in Nigeria.

The result would have an important policy implication for the regulators who are striving to improve the transparency and quality of financial reporting in the financial sector, especially in assessing the effectiveness, the existing audit committee, and the board in ensuring quality financial reports devoid of misstatement.

Theoretical framework and literature review

This section relates each of the theories adopted with the variables used in the study. The theories are upper echelon theory and agency theory. Corporate monitoring by a diverse board in terms of women director and foreign director is expected to constrain managers' behavior because corporate monitoring by the diverse board may force managers to focus more on corporate performance and less on opportunistic or self-serving behavior. If corporate board diversity enhances monitoring, it is expected to be associated with lower use of discretionary loan loss provision in the

banks. Thus, organizations with more diverse senior managers are expected to reduce the level of earnings management.

The Agency theory views the board of directors as the agent of the shareholders and as such, there is a need for them (board of directors) to act in the best interest of the shareholders. In this situation, sometimes the agent may not act in the best interest of the shareholders which often result in an agency loss situation. The advocates of the agency approach view the manager (directors) as an economic institution that will mitigate the problems and serves as guardian to the shareholders (Hermalin & Weisbach 2003). This section reviews the concepts used in the work, this was followed by the empirical review of literature and the theories that underpins the variable of the study.

Conceptualization

Earnings Management: Barnea, Ronen, and Sandan (1976) regards earnings management as the deliberate dampening of fluctuations about “some level of earnings considered being normal for the firm”. Copeland (1968) defines the earnings management to involve a repetitive selection of accounting measurement or reporting rules in a particular pattern, which is aimed at reporting a stream of income with a smaller variation from trend than what have appeared. For the purpose of this study, the definition given by Copeland (1968) is adopted for the study.

Board Diversity: Burton and Ryall (1995) describes board diversity as the composition of the board by combining attributes, characteristics, and the expertise of individual board members that contribute to board processes and decision-making in a positive way. Mazur (2010) sees diversity as a subjective phenomenon, created by group members themselves who on the basis of their different social identities categorize others as similar or dissimilar.

Audit Committee: Audit committee is a sub-committee which is created by the board of directors with aim of making arrangements for the audit, carrying a regular check, and overseeing the financial statement. This committee enhances the ability of the board to fulfill its legal responsibilities and ensures that the credibility and objectivity of the financial reports are attained.

Women Director and Earnings Management

Shehu and Ibrahim (2014) revealed that women directors have a

significant positive impact on the real activity manipulation. Oba (2014) found that gender diversity has a significant negative impact on earnings management. A similar study conducted in Nigeria by Omoye and Eriki (2014) reported a significant negative effect of board gender on earnings management. Lakhali, Aguir, Lakhali, and Malek, (2015) found the negative influence of the proportion of women on board standing and on the earnings management of firms. Susanto (2016) result shows that gender has influenced the earnings management. Also, Hussaini and Gugong (2015) found that female director has a significant positive influence on earnings management. Ioualalen, Khemakhem, and Fontaine (2015) found that gender diversity has no significant influence on the earnings management of firms both in Iran and Canada firms investigated.

Board Ownership and Earnings Management

Kantudu and Samaila (2015) found that managerial shareholdings are significant in influencing the financial reporting quality of quoted oil marketing firms in Nigeria. Ramadan (2015) result shows that management ownership is associated inversely with the practices of earnings management. Ogbonnaya, Ekwe and Ihendinihu (2016) reported that Managerial ownership has a positive significant effect on earning management. Fei (2015) found that managerial ownership has a positive and significant impact on earnings reliability implying that managerial ownership reduces the level of earnings management. Kurawa and Saheed (2014) found that insider ownership and management equity holding have a significant positive influence on earnings management within the study period.

Foreign Director and Earnings Management

Abdul Rauf, Johari, Buniamin, and Abd Rahman (2012) reveals that board race does not influence the practice of earnings management. A study from Netherland by Hooghiemstra, Hermes, Oxelheim, and Randoy (2015) found that foreign director is positively, strongly, and significantly influencing the earnings management of firms. On the other hand Lei (2008) found that foreign board member, independent foreign institutional investors, and foreign director have a significant impact on the earnings management of firms.

Board Size and Earnings Management

Abdul Rauf, Johari, Buniamin, and Abd Rahman (2012) found that board

size does not influence the practice of earnings management. Mustafa, Mehmet, and Suleyman (2014) findings show that board size has a negative and significant effect on the earnings management. In a related study by Oba (2014), he documented a negative but insignificant effect of the board size on earnings management of firms in Nigeria. Fodio, Ibikunle, and Oba (2013) found that board size is negatively and significantly associated with the earnings management. Holtz and Neto (2013) reveal that earnings informativeness is negatively affected by larger board size (more than nine members). Salihi and Jibril (2015) results suggest that larger board is not efficient to minimize the tendency of managing earnings. Also, a study conducted by Patrick, Paulinus, and Nympha (2015) research findings show that board size has a significant influence on earnings management practices among Nigerian quoted companies.

Board Composition and Earnings Management

Zhang and Li (2007) findings show that the extent of earnings management is negatively related to the proportion of the independent directors. In a similar vein as documented earlier, Dimitropoulos (2011) specifically found that clubs with increased board independence are associated with a high-quality financial reporting through the deterioration of earnings management behavior. In another study by Fodio, Ibikunle, and Oba (2013), they found that board size is negatively and significantly associated with earnings management. Arabborzoo, Rashidpuran, Arabi (2015), in their study found that outside board members do not significantly affect earnings quality. Kankanamage (2015) findings revealed that there is a significant relationship between board composition and earnings management of the firms. Yohan (2016) found that outside director on the board positively affects firm value but not the earnings quality.

Committee and Earnings Management

Chandrasegaram et al., (2013) found that audit committee plays a significant role in mitigating earnings management of firms. In addition, Yasser and Al Mamun (2016) findings revealed that audit committee size is positively associated with the financial reporting quality. Their results indicate that the audit committee is a less significant factor in corporate governance than what suggested by many previous researchers and policymakers. Ayemere and Elijah (2015) findings confirm that audit committee characteristics have a constraining effect on earnings

management. Another study by Xi'an and Xi'an (2012) found that audit committee gender has a negative and significant influence on earnings management of firms. On the other hand, Ioualalen, Khemakhem, and Fontaine (2015) found that audit committee diversity does not have any significant impact on earnings management of selected Canadian firms.

Methodology

The study adopts the ex-post facto research design because the study is conducted based the positivism paradigm and quantitative approach. The data were sourced from their annual reports and accounts. Fifteen (15) Deposit Money Banks listed on the NSE at 31st December 2008 and remained listed up till 2015 are considered as the sample. Multiple regression techniques were adopted and the analysis carried out using Stata 13 as the tool of data analysis. The first regression's residual was used to determine the earnings Management (hereafter referred to as EM) of the samples banks and in the second regression, the effects of board diversity and audit committee on earnings management of the banks were measured.

The residual of the following model is used to estimate EM of the banks. The model adopted is Chang, Shen, and Fang (2011) which was specifically built for the financial sector and it is through this model that the residuals were arrived at for the second model.

$$DLLP_i / TA_{t-1} = LLP_{it} / TA_{t-1} - \{ \alpha_0 1 / TA_{t-1} + \alpha_1 LCO_i / TA_{t-1} + \alpha_2 BBAL_i / TA_{t-1} \} \quad (i)$$

DLLP represents Discretionary loan loss provision; LLP = Loan loss provision; LCO = Loan Charge-off; BBAL = Beginning Balance of loan loss; TA_{t-1} = Lagged Total Assets; α_0 = Constant. The second model is presented in the following equation which is used to estimate the measure the predictive ability of board diversity and audit committee on EM.

$$EM_{it} = \beta_{0it} + \beta_1 Wdir_{it} + \beta_2 Bown_{it} + \beta_3 Fdir_{it} + \beta_4 Bsize_{it} + \beta_5 Bodc_{it} + \beta_6 Acc_{it} + \mu_{it} \dots \dots \dots (ii)$$

$$EM_{it} = \beta_{0it} + \beta_1 Wdir_{it} + \beta_2 Bown_{it} + \beta_3 Fdir_{it} + \beta_4 Bsize_{it} + \beta_5 Bodc_{it} + \beta_6 Wdir_{it} * Acc_{it} + \beta_7 Bown_{it} * Acc_{it} + \mu_{it} \dots \dots \dots (iii)$$

$Wdir_{it}$ is Women directors measured as the number of women on board over the total number of board members. (Bathula, 2008); $Bown_{it}$ is Board Ownership measured as the percentage of share held by the board of directors (Farouk & Shehu, 2014); $Fdir_{it}$ is Foreign Director represented the number of foreign directors divided by total number of board members (Abdul Rauf, Johari, Buniamin, & Abd Rahman, 2012); $Bsize_{it}$ is Board Size

measured as the number of Board members in a particular year. (Daghsnii, Zouhayer & Mbarek, 2016); $Bodc_{it}$ is Board Composition measured as the ratio of Non-executive director to total number of directors. (Araborzoo, Rashidpuran & Arabi, 2015); and Acc_{it} is a composite index representing Audit Committee which is made of: (i) Audit committee size, the number of committee members, (ii) Audit committee composition, the number of shareholders on the total number of committee members, (iii) Audit committee meeting, the number of times the committee held meetings in a year. β_1 - β_7 = Coefficient of explanatory variables, β_0 = Constant or Intercept and μ = Error Term.

Results and Discussion

This section first establishes the usefulness and the strength of Chang, Shen, and Fang (2011) model in Nigerian Banking Sector. It further presents, interprets, analyzes, and discusses the result from the regression. Based on the F-ratio and the probability value, the hypothesis one of the study was tested, while the R of the two regression (Unmoderated and Moderated) were compared and used as the basis of testing hypothesis two of the study.

<i>Variables</i>	<i>Coeff</i>	<i>T-Stat</i>	<i>Prob</i>
<i>Constant</i>	<i>9.80e-11</i>	<i>1.37</i>	<i>0.173</i>
<i>LLPTA</i>	<i>1.167</i>	<i>16.2</i>	<i>0.000</i>
<i>TA</i>	<i>-0.98</i>	<i>-23.6</i>	<i>0.000</i>
<i>LCOTA</i>	<i>2.337</i>	<i>15.7</i>	<i>0.000</i>
<i>BBALTA</i>	<i>1.041</i>	<i>17.8</i>	<i>0.000</i>
<i>R²</i>			<i>0.9178</i>
<i>Adjusted R²</i>			<i>0.9150</i>
<i>F-Statistics</i>			<i>321.07</i>
<i>F-Significance</i>			<i>0.0000</i>

Source: Result output from Stata 13

From the cumulative result, the model records an R² of 0.9178 which shows the extent to which the discretionary loan loss provision is explained by loan loss provision scaled by total assets, inverse of total assets, loan charge-off scaled by total assets, and the beginning balance of loan loss provision scaled by total assets. This shows the strength of the model as developed by Chang et al. (2011), its applicability as well as the usefulness

of the model in ascertaining the extent of earnings management of listed Deposit Money Banks in Nigeria. Hence, this justified the adoption of the model in this study. Furthermore, the Fisher exact test (F-Statistics) value of 321.07 indicates that the model of the study is well-fitted and as such the variables in the model were properly selected, combined and used.

All independent variables (Loan loss provision scaled by total assets, Inverse of total assets, loan charge off to total assets, and Beginning balance of loan loss provision to total assets) in the model were found to have a significant effect on discretionary loan loss provision. The signs accompanying each of the individuals are in the model as specified which further substantiate the appropriateness of the model.

Table 2: Summary of Random Effect Model

<i>Unmoderated</i>			<i>Moderated</i>			
<i>Variables</i>	<i>Coeffi</i>	<i>Z-Stat</i>	<i>Prob</i>	<i>Coeffi</i>	<i>Z-Stat</i>	<i>Prob</i>
<i>Constant</i>	0.186	6.28	0.000	0.191	3.32	0.001
<i>Wdir</i>	-0.011	-1.17	0.086	-0.054	-1.43	0.154
<i>Fdir</i>	0.030	4.79	0.000	0.026	3.85	0.000
<i>Bsize</i>	-0.001	-1.63	0.104	-0.001	-1.43	0.154
<i>Bodc</i>	-0.044	-2.88	0.004	-0.037	-2.39	0.017
<i>Acc</i>	-0.015	-5.15	0.000	-0.016	-2.81	0.005
<i>Wdirac</i>			0.004	1.16	0.245	
<i>Bownac</i>			-0.001	-0.05	0.963	
<i>R2 Within</i>	0.4593			0.4588		
<i>R2 Between</i>	0.2882			0.3069		
<i>R2 Overall</i>	0.3521			0.3701		
<i>Wald Chi2</i>	88.57			83.66		
<i>Prob.</i>	0.0000			0.0000		

Source: Result output from STATA 13

The results of the robustness tests include: heteroscedasticity test (p-value = 0.01) indicates the unfitness of the OLS and we proceeded with the GLS; the Hausman specification tests for unmoderated and moderated model (p-value = 0.9385 and 0.9303) respectively, which indicates the appropriateness of the random effect for the panel regression; Langrange Multiplier tests for unmoderated and moderated model (P-value = 0.01 and 0.01) respectively, which indicates the presence of panel effect and hence the random effect used for this study. The regression results as follows:

The significant influence of the audit committee variable on earnings management of Banks in the first model (unmoderated) shows that the variable can be used as a moderator, however, compared with the overall R²

between the unmoderated (0.3521) and moderated (0.3701) models, it indicates that the interaction between women directors and audit committee, board ownership, and audit committee accounted for significantly more variance than when they are used as single variables. This implies the moderated model explains the behavior of earnings management better in relation to the independent variables of the study when compared with the unmoderated model. On the other hand, the test for the significant difference which recorded a chi-square value of 34.20 and p-value of 0.0000 (see Appendix) indicates that there was a significant difference recorded between the unmoderated and moderated models.

Under the unmoderated model, five of the variables (women directors, board ownership, foreign director, board composition, and audit committee) were significant in influencing the earnings management except for the board size. Women director, board composition, and audit committee were negatively related to earnings management under the unmoderated model, while board ownership and foreign director were positively related to earnings management of banks. As for the moderated, only three of the variables (foreign directors, board composition, and audit committee) have a significant effect on earnings management of banks except for women directors, board ownership, and board size. Among the significant variables, board composition, and audit committee were found to have a negative relationship with the level of earnings management of banks while the foreign director has a positive relationship with the level of earnings management.

The two moderated variables were found to have an insignificant effect on earnings management after the moderation implying that the variables only affect earnings management individually when they are moderated by the audit committee. Another interesting finding of this moderation is that the direction of the relationship changes. Women directors' changes from negative to positive after being moderated with audit committee, while board ownership changes from positive to negative after being moderated with audit committee which may have resulted in its insignificant could influence the earnings management.

Based on the foregoing analysis in respect of all the variables, the hypothesis one of the study which states that board diversity has no significant effect on earnings management of listed Deposit Money Banks in Nigeria is tested. With respect to the findings, Wald χ^2 of 88.57 is significant at the level of 1%. This implies that the independent variables

significantly predict the outcome of earnings management in listed deposit money banks in Nigeria. This, therefore, provides enough evidence to reject null hypothesis one of the study.

Based on the findings and analyses with respect to the moderated model of the study, the hypothesis which was formulated earlier in section one states that the audit committee has no significant moderating effect on the relationship between women directors, board ownership, and earnings management of listed Deposit Money Banks in Nigeria. This hypothesis is tested using the R^2 statistics. Based on the R^2 overall with respect to unmoderated and moderated models, they both record 0.3521 and 0.3701, respectively. This implies that the high R^2 recorded for the moderated model as against the unmoderated model could significantly moderate the relationship between women director, board ownership, and earnings management. Therefore, this provides sufficient evidence of rejecting the null hypothesis two of the study.

Conclusion and Recommendations

From the findings, the study concludes that board diversity and audit committee gender significantly affect the extent of earnings management in listed Deposit money Banks in Nigeria. While audit committee can be concluded to play a significant moderating role. Between the two moderated variables, moderated board ownership is better than moderated women director because of the changes in direction of the effect on earnings management.

It is recommended that management of the banks should increase the audit committee variables since they help checkmate the activities of the management and hence reduce the level of earnings management. Further, the management should consider the members of the board who have shares when constituting the audit committee. In addition, women directors who partake in audit committee should be carefully selected by the management to ensure their full participation

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