Does Audit Committee Characteristics Drive Financial Performance? A Case of Nigerian Service Firms

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Abstract

This study was carried out to assess whether audit committee characteristics drive financial performance of publicly quoted service firms in Nigeria. Audit committee characteristic was measured using audit committee size and independence, financial performance by return on equity and earnings per share, while control variable is natural logarithm of total assets. Data were obtained from the annual reports and accounts of sixteen (16) publicly quoted service firms during the period 2012-2019. Multivariate estimation technique was employed in the analysis of data and findings indicated that audit committee characteristics significantly and positively affect financial performance. Moreover, while financial performance measure of return on equity negatively affects the size of firm, earnings per share do not. In view of the findings, it is recommended that the audit committee members should be empowered to be more independent in order to ensure significant audit that can propel financial performance; this would enhance financial performance of publicly quoted companies.

Keywords: Audit, committee, characteristics; financial performance; Earnings per share; Returns on equity

Introduction

The issue of audit committee characteristics and financial performance has attracted robust empirical discuss in accounting literature; this stems from the fact that there is contention that audit committee characteristics significantly improve financial performance of companies in Nigeria, the world over. In the views of Yahaya, Mohamad and Noor (2020); Chukwu and Nwabochi (2019), audit committee plays a vital role in financial reporting as they are saddled with the responsibility of monitoring management in order to avert tweaking of earnings and other accounting numbers.

Alluding to the above views, Dauda (2019); Ifeanyichukwu and Ohaka (2019), Umobong, and Ibanichuka (2017) posit that audit committees characteristics are to facilitate monitoring activities over management and to ensure improved financial reporting. Kibiya, Ahmad and Amran (2016) see audit committee as appointed members of companies who take active roles in overseeing accounting and financial disclosure practices. According to Temple, Ofurum and Egbe (2016), audit committees are setup by the board with the objective of contributing to effective corporate governance and in ensuring reliable financial disclosure. In accounting literature, several measures have been used to measure audit committee characteristics –audit committee independence, audit committee size, audit committee expertise, among others. However, this study employed two metrics of audit committee characteristics - audit committee independence and size.

Noteworthy is the fact that numerous studies (Yahaya, *et al*, 2020; Ifeanyichukwu & Ohaka, 2019; Dauda, 2019; Nwabochi, 2019; Umobong & Ibanichuka, 2017) have established that audit committee characteristics affects financial performance of companies. Interestingly, there is still a lacuna in accounting literature on whether audit committee characteristics (audit committee independence and audit committee size) affect financial performance with the moderating role of size of firm. More worrisome is the fact that studies in this area had focused on the banking, manufacturing and other sectors with dearth of studies among service firms. Thus, this paper assessed if audit committee characteristics drive financial performance of service firms with moderating effect of size of firm.

Literature Review

In this section, conceptual issues (like audit committee characteristics, financial performance and size of firm), theoretical framework and conceptual model of the study were presented.

Audit Committee Characteristics

The concept of audit committee has been widely defined in accounting literature; audit committee refers to appointed members who take active roles in supervising accounting and financial disclosure practices of companies (Kibiya, *et al* 2016). Recent studies have revealed that audit committee characteristics positively and significantly affects financial performance (Yahaya, *et al*, 2020; Ifeanyichukwu & Ohaka, 2019; Dauda, 2019; and Nwabochi, 2019). Notwithstanding the evidence on audit committee characteristics and financial performance nexus, there has been outcry that audit committee characteristics have not been able to drive financial performance effectively and efficiently (Musa, Oloruntoba & Oba, 2014; Ormin, Tuta & Shadrach, 2015; Nahla, Hasnah & Mazrah, 2019). Notably, the efficiency of audit committee is dependent on its characteristics (Ifeanyichukwu & Ohaka, 2019; Thoopsamut & Jaikengkit, 2009).

Extant literature has revealed that audit committee characteristics are largely determined by diverse characteristics like audit committee independence, size, diligence, financial expertise, (Yahaya, *et al*, , 2020; Nahla, *et al*, 2019; Chukwu & Nwabochi, 2019; Abdul Rauf, Johari, Sharifa & AbdRahman, 2012). In this paper, audit committee characteristics were gauged via audit committee independence and size, which have been used by extant studies (Yahaya, *et al*, 2020; Ifeanyichukwu & Ohaka, 2019; Dauda, 2019; Nwabochi, 2019; Umobong & Ibanichuka, 2017); more importantly, there is mixed results on the research subject.

Financial Performance

Financial performances are the benefits stemming from shares, functioning and operations, which are usually captured in financial statements of a firm. Financial performance can be measured with variables like profitability ratios (earnings per share, dividend per share, return on equity, return on asset, return on investment, return on capital employed etc.), or seemingly by market-based measures (Tobin's Q). According to Herly and Sisnuhadi (2011), a good performing firm is deemed to reinforce quality disclosure in its financial statements.

Generally, financial performance of a firm can be ascertained via the use of financial ratios which express link between variables disclosed in financial statements. Financial ratios are useful and can meaningfully be employed as financial performance measures when compared with other related meaningful information, either at present or a past similar measure(s) for the same entity or similar ones in the same industry (Kabayeh, Nu'aimat, & Dahmash, 2012). Al-Matari, Al-Swidi and Fadzil (2014) opine that financial performance forms the core of strategic management. Audit committee characteristics studies are highly dependent on accounting-based measures of performance; however, there are other studies that adopt market-based measurements.

Accounting-based measurement is generally considered as an effective dynamics of a firm's performance when compared to benchmark rate of return equal to the risk adjusted weighted average cost of capital. More importantly, shareholders are interested in performance metrics, particularly accounting-based measures (Al-Matarneh, 2009; Kapopoulos & Lazaretou, 2007; Wahla, Shah & Hussain, 2012). In this study, two (2) financial performance measures were employed – return on equity and earnings per share. Return on equity is the ratio of profit after tax to equity of a company in a particular accounting period while earnings per share, the profit after tax minus preference shares ranking for dividend for an accounting period.

Size of Firm

The size of firm is a characteristic that affects financial performance (Abdul Rauf, *et al*, 2012; Chalaki, Didar & Riahnezhad, 2012; Saheed, 2013; Beest, Braam & Boelens, 2009). The size of firm is determined by the natural logarithm of assets, natural logarithm of turnover among other measures (Saheed, 2013; Chalaki, *et al*, 2012), as it is acknowledged to have significant effect on financial performance since larger firms have more resources at their disposal and are able to employ the services of Big-4 audit firms. Chalaki, *et al* (2012) opined that larger firms are most probable to have an improved reporting system that enable them fast track all business and economic activities.

The reporting system of larger firms imparts improved internal control aimed at detecting and preventing earnings manipulation. Prior researches (see Saheed, 2013; Chalaki, *et al*, 2012; Thoopsamut & Jaikengkit, 2009) have established that size of firm moderates the relationship between audit committee characteristics and financial performance, hence the inclusion of size of firm as control variable in the study.

Theoretical Framework

This study is anchored on the agency paradigm by Berle and Means (1932). The agency paradigm provides that there are numerous parties connected to a firm with varied goals which are most likely to conflict with each other. The diverse parties to a contract or business are described as the principals (owners of wealth) and agents (management who runs the firm on behalf of the principals). According to Chowdhury (2004); and Jensen and Meckling (1976), since efficiency cannot be delineated from effectiveness, there is the tendency that information asymmetric must exist between the principals and agents.

In order to resolve the agency conflict, independent auditors are appointed by the principals to ascertain the true and fair view of the financial state of affairs of the firm; this is to assure them that the financial reporting process that produced the financial statement is true and fair and without manipulation or errors. The relevance of the agency paradigm to the current study is that audit committee is one of the agents of a firm; abetting them that the financial performance portrays a good image via an audit capable of influencing financial performance.

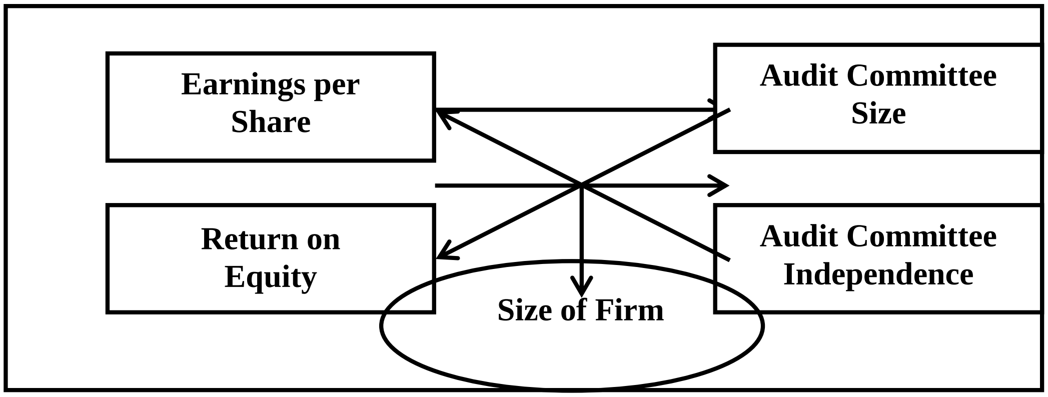

Fig. 1: Conceptual Model of Study

Methodology

This study assessed whether audit committee characteristics drive financial performance of service firms in Nigeria. *Ex-post facto* research design was employed. This design was adopted since the study sought to establish the variables that were connected with certain types of occurrence or behaviour by analysing past events of already existing conditions. The study population constitutes all service firms publicly quoted on the floor of Nigerian Stock Exchange (NSE). There are twenty (20) publicly quoted service firms on NSE as of 31st December, 2019; given the population of study, the purposive sampling technique was used by selecting sixteen (16) service firms. Secondary data were obtained and collated from the website of the sampled service firms annual reports and accounts during the period 2012-2019.

In this study, audit committee characteristics was measured using audit committee size and audit committee independence, while financial performance, earnings per share and returns on equity. In view of the dataset obtained in the study, multiple regression estimation technique was adopted and model given as:

$$finperf = f(auditcomsiz, auditcomind, size)\ldots\ldots\ldots\ldots \; eq.1$$

$$finperf_{it} = \beta_0 + \beta_1 auditcom_{it} + \beta_2 auditcomind_t + \mu_t \ldots eq.2$$

Equations1-2 are the implicit and explicit forms of the regression model; however, captures the dependent and independent variables of the study. Moreover, equation 3 was estimated to capture the control variable as follows:

$$finperf_{it} = \beta_0 + \beta_1 auditcomsiz_{it} + \beta_2 auditcomind_{it} + \beta_3 size_{it} + \mu_t \ldots\ldots\ldots \; eq.3$$

Where: *finperf*=financial performance (measured by earnings per share and returns on equity); *auditcomsiz*=audit committee size (number of audit committee in the board); *auditcomind*= audit committee independence (proportion of independent audit committee in the board); *size*=size of the firm (natural logarithm of total assets); β_0, $\beta_{1 \dots}$ β_2 =regressors; μ_t=error term.

The empirical models of the study was adopted from the studies of Yahaya, Mohamad and Noor (2020); Ifeanyichukwu and Ohaka (2019) and Dauda (2019), by introducing a control variable – size of the firm. Prior studies (Saheed, 2013; Chalaki, Didar, & Riahnezhad, 2012; Thoopsamut & Jaikengkit, 2009) have established that size of firm moderates the relationship between audit committee characteristics and financial performance, hence the inclusion of size of firm as control variable. The statistical analysis was carried out via STATA 16.0.

Results

Table 1: Summary Descriptive Statistics for Audit Committee Characteristics Measures, Financial Performance and Size of Firm

	reto	**eps**	**auditcomsiz**	**auditcomind**	**size**
Mean	13.466	.16800	5.4250	14.287	4.3300
Median	12.4300	.23000	6.0000	10.000	4.4000
Maximum	102.700	2.6000	7.0000	26.670	5.2100
Minimum	-1257.2	-3.5500	3.0000	0	2.2600
Std. Dev.	1.30800	.67194	.89364	1.1234	.58136
Skewness	-1.68000	-1.8733	-1.9937	-1.0444	-1.8434
Kurtosis	3.33500	2.8080	2.4001	3.8369	3.3032
Observations	150	153	153	148	150

Source: Author's Computation, 2020 via STATA 13.0

Presented in Table 1 is the summary of descriptive statistics of audit committee characteristics (audit committee size and audit committee independence), financial performance (return on equity and earnings per share) and control variable (size of firm). The result showed that all variables had positive mean values, perhaps due to improvement in disclosure requirements of companies as a result of transition to International Financial Reporting Standards (IFRS). The standard deviations values (reto = 1.31; eps = .672, auditcomsiz = .894; auditcomind = 1.12; size=.582) are clear indications that the companies audit committee and financial performance measures are similar.

Furthermore, the dependent, independent and control variables displayed non-zero skewness. Also, all the variables are negatively skewed, while all variables have a normal distribution as shown by the kurtosis values, which is closer to three (3). This means that the data satisfies the normality conditions, hence suitable for performing correlation and regression statistical analyses.

Table 2: Correlation Matrix

	reto	**eps**	**auditcomsiz**	**auditcomind**	**size**
reto	1.0000				
eps	-.4852	1.0000			
auditcomsiz	.04540	.08420	1.0000		
auditcomind	.04550	.09910	.16160	1.0000	
size	.07930	-.04430	.55210	.20910	1.0000

Source: Author's Computation, 2020 via STATA 13.0

Presented in Table 2 is the correlation result for the audit committee characteristics (audit committee size and audit committee independence), financial performance (return on equity and earnings per share) and control variable (size of firm). The result showed that financial performance measure (earnings per share) negatively correlates with size of firm, while all other variables were positively correlated with audit committee characteristics variables and size of firm.

Interestingly, none of the Pearson correlation coefficients exceeded 0.8 as recommended by Okoro & Egbunike (2016); Van, Shahnaz & Nurasyikin (2008) cited in Okoro & Egbunike (2017). This implies the absence of multicollinearity among pairs of independent variables of the study; hence the dataset are good enough in performing multivariate regression.

Table 3: Multivariate Regression Results of Audit Committee Characteristics and Financial Performance Measures, and Size of Firm

Equation	***Obs.***	***Parms.***	***RMSE***	***R-Sq.***	***F***	***P***
reto	139	4	8.8570	0.730	16.14	0.0000
eps	139	4	.65446	0.710	14.98	0.0000
	Coef.	***Std. Error***	***T***	***P>/t/***	***[95% Conf. Interval***	
reto						
auditcomsiz	.55345	.35060	7.80	0.000	.84230	.94920

auditcomind	.61646	.76247	4.32	0.000	.73531	.96824
size	.68147	.48790	4.43	0.000	.91500	.27800
_cons	1.1355	1.9513	14.0	0.000	1.1640	1.8928
eps						
auditcomsiz	.11279	.07696	8.47	0.000	.03941	.26500
auditcomind	.00707	.00578	7.22	0.000	.00436	.01849
size	.16341	.11281	-5.45	0.000	.38651	.05968
cons	.07595	.46315	12.8	0.000	.99192	.84001

Source: Author's Computation, 2020 via STATA 13.0

Presented in Table 3 is the multivariate regression result of audit committee characteristics (audit committee size and audit committee independence), financial performance (return on equity and earnings per share) and control variable (size of firm). The R^2 0.730 (*reto)* and 0.710 (*eps)* showed that the independent and control variables explained about 73% and 71% of the systematic variations in the dependent variable (return on assets – *reto* and earnings per share - *eps)*. Thus, the model of audit committee characteristics and financial performance provides a good fit to the data.

In addition, while *reto* positively affects audit committee size, audit committee independence, and size of firm, *eps* negatively affects size of firm, except audit committee size and audit committee independence. Besides, f-values 16.14 (*reto)* and 14.98 (*eps)* with corresponding p-values of 0.000 and 0.000 are less than 0.05; this shows that there is significant connection between audit committee characteristics and financial performance of publicly quoted service companies in Nigeria.

Discussions of Findings

This research developed an empirical model for assessing the relationship between audit committee characteristics and financial reporting and to study the moderating effect of size of firm. Results show that audit committee characteristics measures (audit committee size and audit committee independence) affect financial performance (return on equity and earnings per share) and the relationship is positive. This implies that audit committee characteristics drive financial performance of publicly quoted service companies in Nigeria. Consequently, our empirical models have been shown to be strongly linked to financial performance, due to the explained variance of 73% and 71% (see Table 3). The research established that while financial performance measure of return on equity positively affects size of firm, earnings per share negatively does.

In addition, we examined the signs of correlation between dependent (financial performance) and independent (audit committee characteristics) variables. The results demonstrate that audit committee characteristics contribute positively to financial performance. The results corroborate in part with the studies of Yahaya, *et al* (2020); Ifeanyichukwu and Ohaka (2019); Dauda (2019); Nwabochi (2019), who posited that audit committee characteristics are of fundamental import to improving financial performance.

Conclusion and Recommendations

This study was carried out with the view to assessing whether audit committee characteristics drive financial performance of publicly quoted service firms in Nigeria. Audit committee characteristic was measured using audit committee size and audit committee independence, while financial performance, return on equity and earnings per share and control variable (size of firm). The data were obtained from the annual reports and accounts of sixteen (16) service firms during the period 2012-2019. The study found audit committee characteristics to significantly and positively affect financial performance; the significant and positive effect of audit committee characteristics on financial performance may be connected with the fact that audit committee of service firms do not lack independence in audit.

In view of the findings, it is recommended that the audit committee members should be empowered to be more independent in order to ensure significant audit that can propel financial performance. In addition, audit committee size should be increased in order to accommodate more experienced and professionals in the audit committee. Again, the audit committee should be accorded 'genuine' independence in order to ensure that they carryout out their independent examination of the financial performance of publicly quoted companies in Nigeria; these would enhance financial performance of publicly quoted companies.

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