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Audit committee attributes and real activities manipulation of listed manufacturing firms in Nigeria

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Abstract

This paper examined the effect of audit committee attributes in deterring real activities manipulation of listed manufacturing firms in Nigeria for a period of six years (2008-2013). The study used multiple regressions to analyze the data obtained from Annual Reports and Accounts of listed manufacturing concerns in Nigeria using the residuals of Roychowdhury (2006) to determine Real Activities Manipulation (RAM). Audit committees attributes were used as exogenous variables of the study. The finding reveals that audit committee attributes especially financial literacy is effective in restraining RAM, but other audit committee characteristics like independence, meeting, and size were found to be less effective in constraining RAM practice of listed manufacturing firms in Nigeria. Therefore, it is recommended that listed manufacturing firms should increase the proportion of members with financial acumen in the audit committee, because they are viable in constraining operational manipulative behaviour. Regulatory authorities like Securities and Exchange Commission, Nigerian Stock Exchange and Financial Reporting Council of Nigeria should embark on their surveillance and monitoring and ensure that, listed manufacturing firms are producing credible and reliable financial statements free from deception and window dressing in Nigeria for the consumption of various stakeholders.

Keywords: Real Activity Manipulation; Audit Committee Attributes; Manufacturing Firms; Nigeria

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1. Introduction

Investor's evaluation, compensation to managers and meeting contractual obligation depends on the earnings numbers being reported in the published annual reports of a firm. Various decisions of a firm ranging from investment, financing, dividends or liquidity decisions depend on their earnings metrics. However, earnings numbers may not reflect real activities or primary activities of the firm as a result of certain manipulations. Real activity manipulation which is a deviation from firm normal operational practice motivated by manager's desire to achieve certain financial reporting objective which is achieve through sales manipulation by offering more lenient and favorable term than usual, reduction in discretionary expenditure to increase income and over production to report lower cost of goods actually sold, and they all have cash flow consequences to the firm (Chapman, 2008; Liu, 2009). In order to curtail these dysfunctional behaviors by the management of listed Nigerian manufacturing firms, corporate governance attributes of audit committees were employed.

Rampant reported cases of accounting and financial scandals such as: Enron (2001), WorldCom (2004), Cadbury (1997), Parmalat (2003) and Xerox (2002), led investors to discredit financial statement information and central to these issues were corporate governance failure (Klein, 2002). These scandals were usually caused by the conflict of interest inherent in the relationship between the principals and the managers. These practices are threatening the credibility of financial reports. Financial statements are expected to provide users with factual not fictional, true and fair but not misleading information that will portray actual position and performance of the business. But where firm happens to manipulate its earnings through operational decision, information provided by their financial reports is no longer reliable and many stakeholders will be making decisions based on erroneous financial reports with manipulated earnings. This paper examines whether Audit committee attributes are associated with the propensity to engaging in earnings management through operational decisions (real activities) in Nigeria. Although there are some studies on earnings management by Nigerian companies, none have examined the presence of operational decisions in the practice of earnings management and none has addressed how to minimize it. This gap needs to be filled and find which attributes of audit committee can be used in deterring this dysfunctional behavior by the management of listed manufacturing firms in Nigeria.

It has been hypothesized that, audit committee characteristics have no significant effect in constraining real activities manipulation of listed manufacturing firms in Nigeria. The study will be significant to regulatory authorities like Securities and Exchange Commission (SEC), Nigerian Stock Exchange (NSE), and standard setters like Financial Reporting Council of Nigeria (FRC) to improve their transparency and improve quality of corporate reporting in emerging economy like Nigeria. Investor's confidence can be restored if financial information reveals true and fair view of firm's operations.

Listed Nigerian manufacturing firms use financial information to set security prices for capital market consumption, investors of listed manufacturing firms use financial information to decide when to buy, sell or hold securities. Market efficiency is based upon the information flow to capital market which is derived from financial statement of listed Nigerian manufacturing firms. Where the information obtained from financial statement is not correct, analysts and investors cannot value the securities correctly.

2. Literature review and theoretical framework

2.1. Real activity manipulation

Real activity manipulation is viewed as purposeful intervention in the external reporting process of an enterprise by delaying desirable investment, changing the timing and structure of an operating, investing or financing activity that can boost sales by offering more lenient and favourable conditions and terms than usual to achieve financial reporting objectives (Gunny, 2005; Yu, 2008).

2.2. Audit committee size

Companies and Allied Matters Act 1990, laws of Federation of Nigeria provides that in compliance with corporate governance standards, the audit committee shall consist entirely of three directors and three shareholders (Dabor and Adeyemi, 2009).

2.3. Audit committee meeting

The frequency of meeting is an important dimension of an effective board. A board that meets more often should be able to devote more time to issues such as real earnings management than a board that seldom meets which may not focus on these issues and may only rubber – stamp management plans (Nicola, 2006).

2.4. Audit committee independence

It is generally believed that members who are independent from management are assumed to be better monitors. Abdullah and Hussin (2009) defined the term independence in the Malaysian context in terms of two crucial aspects, independence from management and independence from significant shareholders in deliberating and raising concern over questionable manipulative behavior of the management.

2.5. Audit committee financial literacy

Blue Ribbon Committee (BRC) of U.S. (1999) defined Financial Expert as 'past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which resulted in the individuals sophistication, including being or having been a CEO or other senior officer with financial oversight responsibility in a particular organization.

Audit committee appears to be an effective tool in constraining Real Activity Manipulation. However, to date very little empirical evidence related to demonstrating an association between the audit committee attributes and the likelihood of Real Activity Manipulation exists. In Nigeria, audit committees are responsible for (1) reviewing earnings releases and financial reports (2) assessing the suitability of management's choice of accounting policies and disclosures in agreement with accepted accounting standards (3) ensuring judicious submission of financial statements by management (4) reviewing important or strange transactions and accounting estimates (5) reviewing and indulgent management's representation and (6) assessing whether the financial report presents a factual and just scrutiny of the company's financial situation and performance and complies with regulatory needs (Inaam et al., 2012).

Several studies were conducted to examine the impact of audit committee characteristics and real activity manipulation around the world. Visvanathan (2006) has shown that the objective in determining optimal audit committee size is to have a committee small enough to be manageable but large enough to effectively monitor. Thus, to effectively monitor Real Earnings Management, a committee larger than the required minimum may be needed. In addition, Visvanathan (2008) uses pre-Sarbanes Oxley Act data to examine the association between three types of REM (abnormal cash flow from operations, abnormal discretionary expenses, and abnormal production costs) and the size of the audit committee. He finds no relation between audit committee size and the three types of REM examined.

Graven (2015) examined the relationship between frequency of audit committee meetings and the occurrence of REM. They didn't find convincing evidence that companies involved in REM have fewer audit committee meetings; these results are inconsistent with those of Visvanathan (2008) who found a negative association between the number of audit committee meetings and the occurrence of REM through the reduction of discretionary expenses and not through sales manipulation or overproduction,

Dabor and Adeyemi (2008) conducted study on corporate governance and the credibility of financial reports in Nigeria using multiple regressions. The study among others, finds that companies having audit committee as stipulated by CAMA 1990 seem to produce credible financial statements. Bradbury et al. (2006) examined board characteristics, audit committee characteristics and abnormal accruals in New Zealand and examine the relation between accounting quality measured by abnormal accruals and audit committee characteristics, the study finds that audit committee independence are related to high quality financial reporting. In addition, find that companies with financial reporting problems are less likely to have Certified Public Accountant (CPAs) on their audit committee. Member financial expertise can increase financial reporting and auditing quality, decrease the probability of accounting manipulation, so it is probable that the financial expertise of audit committee members can increase their ability to detect and constrain real earnings management in listed New Zealand firms.

Wu and Hsu (2010), examine audit committee structure and the incidence of corporate failure in the U.K. The study finds that autonomous outside directors on audit committee is still critical to firm endurance and, unsuccessful firms are more likely to utilize key directors (CEO, Chairman and Finance executive) on the audit committee. Felo et al. (2003) examined the relation between audit committee characteristics and perceived quality of financial reporting: expertise; independence and size of the audit committee on the quality of financial reporting for the period 1995 – 1996. The study finds that financial reporting quality is predictably related to audit committee characteristics. Audit committee with financial expertise in accounting or financial management is positively related to financial reporting quality. The study also documents that audit committee independence is not related to financial reporting quality, while, the study finds a positive relation between audit committee size and financial reporting quality.

Abbot et al. (2002) examine audit committee characteristics and financial reporting misstatement. The study addresses the impact of certain audit committee characteristics identified by BRC on improving the effectiveness of corporate audit committee on the likelihood of financial misstatements. The study finds that an audit committee that lacks a member with financial expertise is significantly associated with financial misstatement. Also find that, an audit committee that comprised entirely of independent directors and meets at least 4 times per year exhibit significant negative association with the occurrence of financial reporting restatement. Xie et al. (2001) examine the role of board and audit committee characteristics in deterring earnings management practice of U.S non-financial firms for a period 1992 – 1996. The study finds that audit committee members with corporate financial backgrounds are negatively correlated with earnings management. Audit committee meeting frequency is associated with reduced levels of discretionary accruals. Audit committee action surrogate by meeting and member financial intellect may be important factors in restraining the susceptibility of managers to take on in earnings management.

Inaam et al. (2012) investigate the effects of audit committee characteristics (independence, size, meetings and financial literacy) on real activities manipulation in listed Tunisian firms. The study uses secondary data of 29 non – financial firms for the period 2000 - 2010 and reported that audit committee independence seems to be efficient in constraining real earnings management and manager's opportunistic behavior. Also there is no significance association between audit committee expertise and sales manipulation and no significance relation between audit committee expertise and over production; audit committee meeting is negatively correlated with sales manipulation; and lastly, finds that an audit committee size is positively associated with sales manipulation and over production.

2.6. Theoretical framework

The framework of this study is based on the positive accounting theory alongside with agency theory. Positive accounting theory is used to explain and predict accounting choices by managers. The opportunities of the contracting parties can influence accounting choices, because accounting numbers are control mechanism in the agency relationship, therefore, managements are responsible for reporting accurate financial statements free from deception and window dressing (Katherine et al., 2011).

The agency theory presents a basis for the governance of firms via different internal and external control mechanisms. These mechanisms are designed to ensure agent-principal interest alignment, protect shareholders' interests and thus reduce agency cost (Martinez, 2010). However, several factors may lead to manipulation, regardless of the kind of relationship between principals and their agents, such as pressure, opportunity and ethics (Nicola, 2006). Therefore, the kind of relationship between principals and their agents may reduce manipulation but cannot eradicate it (Osma, 2008).

Active monitoring hypothesis states that firms have incentive and ability to restrain manager's opportunistic earnings management through both accrual and real activity and whether internal audit has vested interest that could hinder active monitoring of firms reporting process. Also whether board has the opportunity, resources and ability to monitor, discipline and influences managers to focus more on corporate performance and less on self-serving behavior (Gilson and Gordon, 2003, in Liu, 2009). Majority of the empirical findings are in support of active monitoring hypothesis, therefore, this research is of the view that active monitoring hypothesis better explains the variables of the study and therefore, adopted as the theoretical base, with the better nexus underpinning variables of the study.

3. Research methodology

This study used Correlational research designs. Data were extracted from the financial statements of listed manufacturing firms in Nigeria. The population of this study comprises all the 39 listed manufacturing firms in Nigeria as at 31st December, 2013. For the purpose of this study, the whole population was intended to be considered as sample of the study, but some firms were dropped because of the criteria:

1) Firm must have all data needed for the variables of the study
2) Firm must not be suspended from trading *on the floor of the Nigerian Stock Exchange* within the period of the study (2008-2013).

As a result of the above criteria, 20 listed manufacturing firms made up the sample firms of the study. This comprises of six (6) from conglomerates, six (6) from food and beverages, four (4) from building materials and four (4) from chemicals and paints.

Only secondary data were used in the study and the information were extracted from financial reports of listed Nigerian manufacturing firms for a period of six years. The data for the study were analysed by means of multiple regression. Data for the study were transformed/ scaled by lagged total assets before running the regression. The analyses were conducted in two stages. The first stage, secondary model in which data were transformed and scaled by lagged total assets to estimates the relevant proxies, and then the primary model was applied in second stage to test the hypotheses raise in the study.

In the first stage of analysis, using secondary model, Real earnings management was estimated by a cross sectional regression model adopted by Roychowdhury (2006), which is a linear function of sales and change in sales, all scaled by lagged total assets (Gunny, 2005). It can be determined using the Dechow, Kothari and Watts (1998) as was used by Rowchowdhury (2006) model of abnormal cash flow. Cash flow from operation is portraying primary activity of the enterprise divided by the lagged total assets will be computed, an indicator variable equal to one, less than one or more than one. Assuming if the scaling cash flow from operation divided by lagged total asset is let's say the value is one, on the other hand, sales and change in sales all scaled by lagged total asset is also one, with no residual, then there is no evidence of real activity manipulation from that firm. However, where cash flow from operation scaled by lagged total assets is one and sales and change in sales is more than one the difference will be the earnings of the firm that cannot be explained by its sales and change in sales, which is real activity manipulation. Moreover, the residual from the first model is standing as RAM.

Regression was run and save the residuals and the residue representing abnormal cash flow, which portray whether the company manipulate their earnings or not by looking at its gravity. The higher the residuals, the higher the activity manipulation and the higher it affects the quality of earnings of listed manufacturing firms in Nigeria. Moreover, the lower the residuals, the lower the real activity manipulation, and lesser it effects on the quality of earnings of listed manufacturing firms in Nigeria (Roychowdhury, 2006; Gunny, 2009; Katherine et al., 2011). The yardstick is that cash flow scaled by lagged total assets as regressand will be run against sales and change in sales as regressors, if there is no residue means no any real activity manipulation from that firm, but where there is residuals, it means there is presence of real activity manipulation from that firms.

Abnormal cash flow model will be specified as follows:

$$CFO_t/TA_{t-1} = \underbrace{\alpha_o + \alpha_1 1/TA_{t-1} + \alpha_2 S_t/TA_{t-1} + \alpha_3 \Delta S_t/TA_{t-1}}_{\text{Normal cash flow}} + \underbrace{\mu_t}_{\text{abnormal cash flow}}$$

where:

- CFO_t = Cash flow from operation of the current year
- α $^{*1}/TA_{t-1}$ = Scaled intercept
- TA_{t-1} = Total assets at time t-1(of last year) scaling by lagged total assets is to take care of variation of the size of the firms in order to avoid spurious correlation among the variables, so that the result will not be misleading (Roychowdhury, 2006; Gunny, 2005; Yero, 2012)
- S_t = Sales at time t (of the current year)
- ΔS_t = Change in sales (this year sales minus last year sales) to captured overall expansion of a firm's business operation. Firms with growth prospects are more likely to have larger change in sales, and lower for declining firms
- μ_t = Residuals (which can alternatively be used to proxy for abnormal cash flow)
- α_o = The intercept
- α_1,- α_3, = Parameters to be used in estimating the normal cash flow

The scaled intercept ($1/TA_{t-1}$) in the estimation model allows the average CFO_t/TA_{t-1} for a particular industry year to be non-zero even when the main explanatory variables in the estimation model, sales and lagged sales, are zero, (Jones, 1991, Dechow et al., 2012; Kasznik, 1999).

In the second stage of analysis, corporate governance attributes of audit committee (audit committee independence, audit committee financial literacy, audit committee meeting and audit committee size) were run against real activity manipulation (residuals of first regression model) to see whether they can restrain this behavior. Using the residuals from the abnormal cash flow model which represent real activity manipulation (RAM), the model below is to test the hypothesis of the study.

$$RAM_{it} = \beta_o + \beta_1 ACIND_{it} + \beta_2 ACFL_{it} + \beta_3 ACMTG_{it} + \beta_4 ACSIZE_{it} + \varepsilon_{it.} \text{ ....ii}$$

where:

- RAM = Real activity manipulation (Abnormal cash flow)

- β_0 = Intercept
- $\beta_1 ACIND_{it}$ = Audit committee independence
- $\beta_2 ACFL_{it}$ = Audit committee financial literacy
- $\beta_3 ACMTG_{it}$ = Audit committee meetings
- $\beta_4 ACSIZE_{it}$ = Audit committee size
- β_1- β_4 = Regression coefficients
- $\varepsilon_{it.}$ = Error term

All variables in the empirical model are scaled by lagged total assets in order to take care of variation of the size of the firms to avoid spurious correlation among the variables, so that the result will not be misleading (Roychowdhury, 2006; Gunny, 2009; Yero, 2012).

Table 1. Variables measurements

Variable	Measurement
Real Activities Manipulation (RAM)	Residuals of Roychowdhury (2006) model of abnormal cash flow: (μ_t)
Audit Committee Independence (ACI)	Measured by the proportion of outside members in the committee. (Bradbury et al., 2006)
Audit Committee Financial Literacy (ACFL)	Measured by the proportion of members that are expert in finance in the committee (Inaam et al., 2012).
Audit Committee Meeting (ACMTG)	Measured by the number of meetings held in a year by the committee (Saidin, 2007; Klein, 2002)
Audit Committee Size (ACSIZ)	Measured by the total number of the committee members (Felo et al., 2003).

4. Findings of the study

Table 2. Regression results of real activity manipulation and audit committee attributes (independence, financial literacy, size and meetings)

Statistics	Model of the study	
ACI	(5.053) 0.000**	
ACFL	(-1.952) 0.053*	
ACS	(2.241) 0.027**	
ACM	(3.135) 0.002**	
R	0.723	
R^2	0.52	
Adj. R^2	0.50	
F- Statistic	31.573	
F-Sig	.000	
DW	2.029	
	Tolerance value	Vif
ACI	0.508	1.969
ACFL	0.972	1.029
ACS	0.947	1.055
ACM	0.527	1.899

Source: Authors computation using SPSS 20

*Note: '**', '*' denotes (1%) and (5%) level of significance respectively.*

From the regression result above, Real Activity Manipulation of listed manufacturing firms in Nigeria can be explained by the model below:

$$RAM = -5.30+ 5.053ACI - 1.952ACFL + 2.241ACS + 3.135ACM + e$$

From the above model it can be observed that, holding all other variables constant, a unit change in ACI will lead on the average, to an increase in real activity manipulation (RAM) by 5.05%, while a unit change in ACF reduces RAM by 1.952%. Further, a unit change in ACS leads to an increase in RAM by 2.241%. Similarly, if ACM changes by one unit, RAM will increase by 3.135%, given the fact that other variables are held constant.

The adjusted R^2 of 0.50 indicates that the regressors in the model (i.e. ACI, ACFL, ACS and ACM) accounted for 50% of the variations in real activity manipulation in the selected industries. However, the remaining percent is believed to be accounted for by the random error term.

The F –statistic value of 31.573 with a p – value of 0.0000 indicates that the regressors are jointly significant in explaining variation in the regressand (i.e RAM). The outcome demonstrate that the estimated model of the study is robust for the reason that all the explanatory variables audit committee independence, financial literacy, size and audit committee meetings are significant in determining the endogenous variable real activities manipulation. If audit committee attributes, has significant impact in limiting real activity manipulation of listed Nigerian manufacturing firms, the hypothesis raised was rejected based on p- values 0.000 and f- value of 31.573 respectively.

The Durbin – Watson Statistics of 2.029 indicates lack of serial correlation in the data both positive and negative. The tolerance value and the variance inflation factor (VIF) are two advanced measures of assessing multicollinearity amid the independent variables of the study. The variance inflation factors were always less than (10) signifying dearth of harmful multicollinearity (Casey et el., 1999). This shows the aptness of fitting the model of the study with the four independent variables. In addition, the tolerance values are constantly smaller than 1.00 thus, further provide evidence that there is nonexistence of detrimental multicollinearity among the independent variables (Tobachmel and Fidel, 1996).

The positive relation of audit committee independence with real activity manipulation of listed manufacturing Nigerian firms, is consistent with the empirical results reported in Wu and Hsu (2010) Britain study, but contradicts the findings of Inaam et al. (2012), Tunisian study and Bradbury et al. (2004), New Zealand study. The positive relation of audit committee size with real activity manipulation of listed manufacturing firms in Nigeria is consistent with the empirical results of Inaam et al. (2012), Tunisian study but contradict the finding of Kang and Kim (2012), Korean study.

The positive relation of audit committee meeting with real activity manipulation of listed manufacturing firms in Nigeria is inconsistent with the empirical results reported in Bita and Noravesh (2005), Iranian study, and Chtourou et al. (2001) Canadian study. The negative relation of audit committee financial expertise with real activity manipulation of listed manufacturing firm in Nigeria is consistent with empirical results reported in Xie et al. (2001) American study, Inaam et al. (2012) Tunisian study.

4.1. Implications of the research findings

Studies relating to earnings are of far reaching importance. This is owing to the tactically vital position which earnings as an end result of accounting processes holds, through the roles it plays in various decisions of organizations and individual investors; which has direct bearing on firms' present and potential employees' benefit, firms' expansion/contraction plans, individual investors' income, government's tax revenues, national output, and so on. For this, the findings from such studies that relates to reliability of earnings would certainly have some implications. Audit committee size is not the size that determine committee's mitigation of manipulative behaviour but rather nominating qualified and competent hand that can mitigate not collaborate at their own benefit. Audit committee meeting is not the number of meeting that determine the mitigation of manipulative attitude but it is the ability of the audit committee to deliberate on the sensitive issues like this, then are they nominated by the incumbent CEO, will they blow their whistle if the CEO deviate from firm's normal practice and lastly are they financially independent, or do they totally rely on committee's seating allowance that will affect their independence.

In light of the dwindling relevance of reported earnings, the findings has thus provided additional yardstick in assessing the relevance of the reported earnings and cash-flows. This is now possible using our independent variable as an indicator. Corporate boards, especially in the manufacturing sector, can use audit committee characteristics as control against incurring agency cost associated with abnormal cash-flows, which has value destroying consequences to the firm in the long run.

5. Conclusion and recommendations

From the findings of the study the following conclusions are drawn:

i. Audit committee characteristics were found to be important monitoring and control device for deterring manager's opportunistic behaviour.
ii. Audit committee characteristics especially financial literacy was found to be effective in restraining real activity manipulation of listed manufacturing firms in Nigeria, and improved the earnings quality but other audit committee attributes like: size; meeting and independence cannot be of any help in preventing abusive accounting practice by the management of listed manufacturing firms in Nigeria. They are just an adfidendum to the firm's administrative expenses not curtailing real activity manipulation.

Other recommendations include;

i. Securities and Exchange Commission and Nigerian Stock Exchange, being the surveillance body and avenue providers for stocks trading in the country, should make sure that listed manufacturing firms in Nigeria are strictly complying with corporate governance best practice to ensure that, shareholders and other stakeholders' interest are fully protected.

ii. Financial Reporting Council of Nigeria should make it mandatory that board of listed manufacturing firms should increase the proportion of members with financial know- how in their oversight functions and constraining management opportunistic behaviour.

iii. Size of the audit committee is not a factor in check – mating managers' opportunistic attitude. Increasing their number on the committee is just an addendum to the firm's administrative expenditure instead of curbing real activity manipulation which affects the firm's cash flow from operation.

iv. Meetings of the audit committee, is not the number of meeting that determine the monitoring, but acumen of the member who may be able to understand which directions management are going and its economic repercussion to the firm.

v. Real activities manipulation despite it has cash flow consequences in the long run, but the management of listed manufacturing firms in Nigeria, are having all the chances to do it, because there is no regulations specifying any normal level of activity to be carried out by firms, what volume of goods to produce, what price to charged, what minimum discount to offer and how much to expend on discretionary expenditures, all these are left for the market forces and management discretion to decide.

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