Audit Committee Multiple Directorships and Financial Reporting Quality in Nigeria: An Evaluation of the Interconnectedness using Empirical Evidence

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Abstract

The audit committee plays an oversight role in overseeing financial reporting. It is not uncommon to see directors sit on the audit committee of more than three public companies. In Nigeria, because of the small pool of directors available to the market, it is quite common for directors to serve on many boards. Against the backdrop that there are arguments for and against multiple directorships in the light of the quality of financial reports, opinion is split on the matter. The study seeks to examine the interconnectedness between audit committee multiple directorship and financial reporting quality in Nigeria. The study adopted a survey research, using questionnaire as the research instrument to harvest the views of stakeholders of publicly quoted companies on the subject. Data was analysed using percentage analysis, weighted mean, and the Z-test statistics at 5% significance level. It was observed that audit committee multiple directorship impacts the quality of corporate financial reporting. Also, financial literacy of audit committee members enhances the effective overseeing of corporation's financial controls and the quality of financial reporting. The study therefore supports the need for a high degree of financial literacy on the part of audit committee members to enhance effectiveness. It is recommended that regulatory agencies in Nigeria should also institute legislation similar to the Sarbanes Oxley act of the United States of America in order to curb the menace of earnings management and other unethical financial reporting practices

Keywords: *Audit Committee; earnings management; financial reporting; multiple directorships; Nigeria.*

1. Introduction

Boards of directors assume an oversight role to mitigate the agency problem resulting from the separation of corporate management and ownership (Alexander et al, 1994; Carroll et al, 1990). This oversight role involves appointing the CEO, approving business strategy, monitoring control systems, liaising with external auditors, etc. Given its diverse responsibilities, the board of directors typically delegates its oversight activities to different committees. The audit committee is one of these committees and its main responsibility is to oversee financial reporting. As audit committees are specifically charged with overseeing firms' financial reporting quality, multiple directorship among audit committee members is common among public companies in Nigeria. However, its effect on financial reporting quality is yet to be rigorously explored in literatures. Since regulatory changes have brought about certain uniformity in the characteristics of audit committees across firms in Nigeria, such as audit committee independence and financial expertise, it is important to examine other characteristics of audit committee such as audit committee multiple directorship. In addition, whether multiple directorships would significantly impair the monitoring ability of the audit committee is an unanswered empirical question.

Existing theories (agency theory and labour market theory) predict that audit committee multiple directorship can affect the financial reporting quality in two competing ways. Agency theory predicts that audit committees with high multiple directorships might be subject to time constraints, which could adversely affect their financial reporting quality. In

contrast, labour market theory implies that audit committees (or audit committee members) with high multiple directorships might work more diligently because of the reputation concern, and might transfer their knowledge and experience across firms. For a director to sit on the audit committee of more than three public companies, the New York Stock Exchange (2003) requires the related board of directors to consider whether the additional directorship would impair their monitoring effectiveness.

In Nigeria, because of the small pool of directors available to the market, it is quite common for directors to serve on many boards. The Nigeria CAMA (1990) provides that the audit committee shall consist of an equal number of directors and representatives of the shareholders of the company (subject to a maximum number of six members); however members of the audit committee shall not be entitled to remuneration and shall be subject to re-election annually.

In the light of the quality of financial reports, opinion is split on whether audit committee multiple directorships should stay or not. Given the divergent views as touching the arguments for and against audit committee multiple directorship, the study seeks to examine the effect(s) of audit committee multiple directorship on financial reporting quality as in Nigeria.

2. Review of Literature

The SEC Code of Corporate Governance (2011) in Nigeria refers to the Audit Committee as the 'Committee of Directors and the enterprises shareholders representatives whose specific responsibility is to review the annual financial statements before submission to the Board of Directors'. Usually, membership of the Committee is subject to the maximum number of 6 persons.

Audit Committees were established to enable the Directors and Shareholders be aware of important transactions taking place in the company, to enable the External Auditors alert Management where problems exists, to enable Directors to take their statutory responsibilities seriously, and to control the activities of dominant executives. One of the paramount tasks of the Audit Committee is to consider the appointment of the external auditor, set the audit fee, and handle any questions of resignation or dismissal. The audit committee is responsible for supervising the company's relationship with its outside auditor, including recommending to the full board, the firm to be engaged as the external auditor, evaluating the auditor's performance, and considering whether it would be appropriate for the auditor periodically to rotate senior audit personnel, or for the company periodically to change its external auditor.

Despite regulatory concerns on multiple directorships, there are contrasting views on the effect of multiple directorships on audit committee effectiveness. Multiple directorships can have both positive and negative impacts on monitoring effectiveness. Additional directorship provides directors with greater experience thus enhancing their monitoring effectiveness. However, because significant time commitment is required of a director to effectively monitor the financial reporting process, too many directorships can make a director too busy to effectively monitor management. When the number of additional directorship exceeds a certain threshold, the negative impact on monitoring effectiveness could be greater than its potential positive influence on effective monitoring. Core et al. (1999) contended that three additional directorships is an important threshold – directors that overextend themselves by sitting on three or more boards are too busy and overcommitted. These arguments suggest there is a need to limit the number of additional directorship to about three.

Dooley (1999), Mizruchi (1996), Davison et al (1984), and Koenig et al (1981) argued that multiple board appointments can signal directors' quality and reflect their reputation as monitoring specialists. Serving on a number of boards exposes them to different management policies, styles and practices. Such experience can strengthen their monitoring roles and enhance their reputation. These directors could experience relatively lower levels of litigation risk, and are better able to maintain their current board seats or obtain future board seats (Zajac, 2008).

Other studies suggest that multiple directorship could impair the effectiveness of the audit committee. As Jubb (2000) noted, time and effort are required for the effective monitoring of management. Thus, it is reasonable to expect that as additional directorship increases, the amount of time available for directors to fulfil their monitoring duties for each firm decreases. This can adversely affect the effectiveness of the audit committee to detect financial reporting irregularities. The likelihood of financial statement fraud increases as the number of additional directorship increases (Davison et al, 2004).

An interlocking directorate arises when a director sits on two or more company Boards. Many explanations have been offered for the existence of interlocking directorates covering a range of theoretical prescriptions. These perspectives have included transaction costs (Williamson, 1991), agency theory (Eisenhardt, 1989) and class theories (Koenig and Gogel, 1981). However, the most relevant explanation for their existence, in the context of our study, is that

they serve to reduce or control uncertainty in business environments (Allen, 1974; Schoorman et al. 1981; Mizruchi, 1996). Allen (1974) specified three main ways in which interlocking directorates attempt to reduce environmental uncertainty. These are by the exchange of information and expertise between companies; by providing a stable means of communication and liaison between companies; and by advising management concerning the relationship of the company to its external environment. However, when interlocking directors are systematically associated with a common auditor across their various board holdings, it is not clear that benefits exist for all stakeholders.

Unlike other products or services, the quality of an audit is not readily discernible. It cannot be judged from the outside and must be experienced to be evaluated (Pennings et al, 1998; Craswell and Francis, 1999). Interlocking directors holding multiple board positions are in one of the best positions to judge the relative quality of audits due to their experience with various service providers. Their experience gives them the ability to advise on and perhaps contribute to selection of the most appropriate auditor for companies on whose boards they sit. Sharing this knowledge with boards of other companies on which they sit reduces the costs of evaluating the strengths and weaknesses of potential auditors.

It is generally believed that an independent audit committee provides effective monitoring of the financial discretion of management and in ensuring the credibility of the financial statements. An audit committee is a sub-committee of the board that specializes in, and is responsible for, ensuring the accuracy and reliability of the financial statements provided by management. Indeed, much of the blame and criticism for accounting irregularities is aimed at audit committees for not fulfilling their financial reporting oversight duties due to independence issues (DeFond, 2000).

Zajac (2008) opined that multiple directorship allow directors to view a panorama of their companies' environments within which to monitor and control uncertainties. Sharing this outlook with auditors, who may be knowledgeable about their clients' business environments, creates synergies that potentially enable difficulties to be overcome more smoothly.

3. Methodology

3.1 Population and sample selection

The study adopted a quantitative survey research, using questionnaire as the research instrument for the collection of primary data. The study population were the stakeholders of publicly quoted companies. Samples were however drawn from a random selection of shareholders, lenders, and other stakeholders of 15 selected commercial banks in Nigeria. 200 copies of the instrument were distributed, 152 retrieved, but 147 copies found useful for analyses.

3.2 Hypotheses Formulation and Data Analysis Procedure

To achieve the research objectives, the following hypotheses stated in the null form, were formulated and tested:

H_0^1: There is no significant relationship between audit committee multiple directorships and the quality of corporate financial reporting.

H_0^2: There is no significant relationship between financial literacy of audit committee and the quality of corporate financial reporting.

H_0^3: There is no significant relationship between independence of audit committee and the quality of corporate financial reporting.

Data was analysed using percentage analysis, the weighted mean, and the Z-test statistics.

Weights were attached to responses in the research instrument based on a 5-pointed likert scale in the following order: 5 for *Strongly Agree (SA)*; 4 for *Agree (AA)*; 3 for *Indifference (ID)*; 2 for *Disagree (DA)*; and 1 for *strongly disagree (SD)*. The Weighted mean was computed for each statement by performing the following procedure:

$\mu = \sum (A^* B)/ n$ _____ (1)

Where:

μ is the weighted mean,

A is the assigned code 1 to 5

B is the number of observations under each standard response of *SA, AA, ID, DA,* and *SD*

n is the overall total number of respondents, which is 147

For the purpose of the research, a weighted mean score of 3.0 and above was considered high to uphold the statement for validity while a weighted mean score less than 3.0 was considered low and interpreted to be a weak consensus on the statement among respondents.

In testing the hypotheses of the study, the Z-test for population proportion adopted 5% level of significance under the two-tailed test. The formula for Z-test is shown below:

$$Z = \frac{\bar{P} - \pi}{\sqrt{\frac{\bar{p}.\bar{q}}{n}}} \quad (2)$$

Where $\bar{P}$ = Proportion of affirmative response

π = Hypothesized proportion

$\bar{q}$= 1 - $\bar{p}$

n = Sample size

It is hypothesized that 50% (0.50) of the respondents would have an affirmative response (x), while 50% will have no affirmative response. The null hypothesis would be accepted if the calculated Z-value is less than the table Z-value but if the calculated Z-value is greater than the table Z-value, the null hypothesis would be rejected while the alternative hypothesis would be accepted.

4. Results and Discussion

4.1 Descriptive statistical analysis

The results obtained from the survey and the descriptive analyses are presented in this section.

Table 1: Analysis of response: The presence of financial experts in the audit committee improves the performance of audit committee

	Frequency	Percentage	Valid Percentage	Cumulative Percentage
NO	53	36.1	36.1	36.1
YES	94	63.9	63.9	100.0
TOTAL	**147**	**100.0**	**100.0**	

Table 1 shows that 63.9% of the respondents agree that the presence of financial experts in the audit committee improves the performance of audit committee while 36.1% of the respondents do not agree. Since over 60% of respondents agree, we conclude that the presence of financial experts boosts the performance of the audit committee.

Table 2: Analysis of response: Extent to which financial literacy of audit committee members affects the effectiveness of overseeing corporation's financial controls and reporting practices

	Frequency	Percentage	Valid Percentage	Cumulative Percentage
No Extent	49	33.3	33.3	33.3
Some extent	4	2.7	2.7	36.1
Large extent	7	4.8	4.8	40.8
Very large extent	87	59.2	59.2	100.0
TOTAL	**147**	**100.0**	**100.0**	

Table 2 show that 33.3% of the respondents are of the opinion that there is no need for financial literacy on the audit committee to effectively oversee a corporation's financial controls and reporting, 2.7% of the respondents of the respondents are of the opinion that to some extent that there is a need for a high degree of financial literacy on the audit committee to effectively oversee a corporation's financial controls and reporting, 4.8% of the respondents are of the opinion that to a large extent there is a need for financial literacy on the audit committee to effectively oversee a corporation's financial controls and reporting, while 59.2% of the respondents are of the opinion that to a very large extent that there is a need for a high degree of financial literacy on the audit committee to effectively oversee a corporation's financial controls and reporting. Since an aggregate of 64% respondents submitted that to a large extent there is need for financial literacy on the audit committee members to effectively oversee a corporation's financial controls and reporting, we therefore conclude that financial literacy of audit committee members affects the effectiveness of overseeing corporation's financial controls and reporting practices .

The result of the analysis in table 1 reinforces that of table 2; to be financially literate enhances one's financial expertise which in turn positively affects ones delivery on financial matters. Being financially literate as a member of audit committee enhances the effective overseeing of corporation's financial controls and the quality of reporting which

translates to effective performance of the audit committee.

Table 3: Analysis of respondents' views on various Audit committee multiple directorships and financial reporting issues

S/N	Items	Response (in %)					Weighted Mean
		SA	AA	ID	DA	SD	
1	The presence of audit committee multiple directorship will have an adverse effect on the financial reporting quality	23.8	17.0	39.5	3.4	16.3	3.29
2	Boards of directors have an oversight role to mitigate the agency problem resulting from the separation of corporate management and ownership	19.0	13.6	38.1	3.4	25.9	2.97
3	Audit committees play a pivotal role in corporate governance	23.8	17.0	32.7	2.7	23.8	3.14
4	Audit committee members who hold director posts of too many companies may have limited time fulfilling their responsibilities	23.8	17.0	34.7	3.4	21.1	3.19
5	Multiple directorship may cause limitations of time and commitment for audit committee members from performing effectively	19.7	13.6	38.1	3.4	25.2	3.00
6	Audit committee multiple directorship is associated with financial reporting quality	23.8	23.8	32.7	2.7	17.0	3.35
7	High degree of financial literacy of audit committee members has impact on the quality of financial report	23.8	17.0	39.5	3.4	16.3	3.29
8	Audit committee members' independence impacts the financial reporting quality	26.5	39.5	17.0	0.7	16.3	3.59

Key: SA-Strongly agree, AA-Agree, ID- Indifference, DA-Disagree, SD-Strongly disagree

Table 3 shows the summary of analysis for statements in the research instrument. Results show that 19.7% of the respondents disagree that the presence of audit committee multiple directorships will have an adverse effect on the financial reporting quality: another 39.5% of the respondents are indifferent about the statement, 40.8% of the respondents agree. The mean score for the statement is 3.29, we therefore conclude that the presence of audit committee multiple directorship will have an adverse effect on the financial reporting quality.

29.3% of the respondents disagree that the boards of directors have an oversight role to mitigate the agency problem resulting from the separation of corporate management and ownership, 38.1% of the respondents are indifferent about the statement, 32.6% of the respondents agree. The mean score for the statement is 2.97, which represents a weak consensus to uphold the statement.

26.5% of the respondents disagree that audit committees play a pivotal role in corporate governance, 32.7% of the respondents are indifferent about the statement, while 40.8% of the respondents agree. The mean score for the statement is 3.14; we therefore conclude that Audit committees play a pivotal role in corporate governance.

24.5% of the respondents disagree that audit committee members who hold Director's posts of too many companies may have limited time fulfilling their responsibilities, 34.7% of the respondents are indifferent about the statement, and 40.8% of the respondents agree. The mean score for the statement is 3.19; we therefore conclude that Audit committee members who hold director posts of too many companies may have limited time fulfilling their responsibilities

19.7% of the respondents disagree that multiple directorship may cause limitations of time and commitment for audit committee members from performing effectively, 38.1% of the respondents are indifferent about the statement, 33.3% of the respondents agree that multiple directorship may cause limitations of time and commitment for audit committee members from performing effectively. The mean score for the statement is 3.00; we therefore conclude that multiple directorship may cause limitations of time and commitment for audit committee members from performing effectively.

19.7% of the respondents disagree that audit committee multiple directorship is associated with financial reporting quality, 32.7% of the respondents are indifferent about the statement, 47.6% of the respondents agree. The mean score for the statement is 3.35; we therefore conclude that Audit committee multiple directorship is associated with financial reporting quality.

19.7% of the respondents disagree that high degree of financial literacy of audit committee members have impact on the quality of financial report, 39.5% of the respondents are indifferent about the statement, 40.8% of the respondents agree. The mean score for the statement is 3.29; we therefore conclude that high degree of financial literacy of audit committee members has impact on the quality of financial report.

17% of the respondents disagree, 17% of the respondents are indifferent, and 66% of the respondents agree that

audit committee members' independence impacts the financial reporting quality. The mean score for the statement is 3.59; we therefore conclude that Audit committee members' independence impacts the financial reporting quality.

4.2 Test of Hypotheses

4.2.1 Hypothesis 1

H_0: There is no significant relationship between audit committee multiple directorships and the quality of corporate financial reporting.

Table 4: Analysis of Response: *Audit committee multiple directorship is associated with financial reporting quality*

	Frequency	Percentage	Valid Percentage	Cumulative Percentage
Strongly Disagree	25	17.0	17.0	17.0
Disagree	4	2.7	2.7	19.7
Indifferent	48	32.7	32.7	51.4
Agree	35	23.8	23.8	74.2
Strongly Agree	35	23.8	23.8	100.0
TOTAL	**147**	**100.0**	**100.0**	

$$\bar{X} = 47.6\ (23.8 + 23.8)$$

$$P = \frac{x}{n} = \frac{47.6}{147} = 0.32$$

$$\bar{q} = 1 - 0.32 = 0.68$$

$$Z = \frac{0.32 - 0.50}{\frac{\sqrt{0.32\ x\ 0.68}}{147}}$$

$$Z = \frac{0.18}{0.038} = 4.73$$

From the Z-table at 5% level of significance under the two-tailed test, the table Z-value is ± 1.96.

α = level of significance

$$\frac{\alpha}{2} = \frac{0.05}{2} = 0.025$$

The analysis shows that the computed Z-value of 4.73 is greater than table Z-value of 1.96. Figure 1 (in appendices) shows that the computed Z-value of 4.73 falls outside the acceptance region into the rejection region; we therefore reject the null hypothesis and accept the alternative hypothesis which states that there is a significant relationship between audit committee multiple directorships and the quality of corporate financial reporting.

4.2.2 Hypothesis 2

H_0: There is no significant relationship between financial literacy of audit committee and the quality of corporate financial reporting.

Table 5: Analysis of Response: High degree of financial literacy of audit committee members has impact on the quality of financial report.

	Frequency	Percentage	Valid Percentage	Cumulative Percentage
Strongly Disagree	24	16.3	16.3	16.3
Disagree	5	3.4	3.4	19.7
Indifferent	58	39.5	39.5	59.2
Agree	25	17.0	17.0	76.2
Strongly Agree	35	23.8	23.8	100.0
TOTAL	**147**	**100.0**	**100.0**	

$\bar{X} = 40.8\ (17 + 23.8)$

$P = \frac{x}{n} = \frac{40.8}{147} = 0.27$

$\bar{q} = 1 - 0.27 = 0.73$

$Z = \frac{0.27 - 0.50}{\frac{\sqrt{0.27\ x\ 0.73}}{147}}$

$Z = \frac{0.23}{0.036} = 6.38$

From the Z-table at 5% level of significance under the two-tailed test, the table Z-value is ± 1.96.

α = level of significance

$\frac{\alpha}{2} = \frac{0.05}{2} = 0.025$

The analysis shows that the computed Z-value of 6.38 is greater than table Z-value of 1.96. Figure 2 (in appendices) shows that the computed Z-value of 6.38 falls outside the acceptance region into the rejection region; we therefore reject the null hypothesis and accept the alternative hypothesis which states that there is a significant relationship between financial literacy of audit committee and the quality of corporate financial reporting.

4.2.3 Hypothesis 3

H_0: There is no significant relationship between independence of audit committee and the quality of corporate financial reporting.

Table 6: Analysis of Response: *Audit committee members' independence impacts the financial reporting quality*

	Frequency	Percentage	Valid Percentage	Cumulative Percentage
Strongly Disagree	14	9.5	9.5	9.5
Disagree	11	7.5	7.5	17.0
Indifferent	75	51.0	51.0	68.0
Agree	28	19.0	19.0	87.0
Strongly Agree	19	13.0	13.0	100.0
TOTAL	**147**	**100.0**	**100.0**	

$\bar{X} = 32\ (13 + 19)$

$P = \frac{x}{n} = \frac{32}{147} = 0.22$

$\bar{q} = 1 - 0.22 = 0.78$

$Z = \frac{0.22 - 0.50}{\frac{\sqrt{0.22\ x\ 0.78}}{147}}$

$Z = \frac{0.28}{0.034} = 8.235$

From the Z-table at 5% level of significance under the two-tailed test, the table Z-value is ± 1.96.

α = level of significance

$\frac{\alpha}{2} = \frac{0.05}{2} = 0.025$

The analysis shows that the computed Z-value of 8.23 is greater than table Z-value of 1.96. Figure 3 (in appendices) shows that the computed Z-value of 8.23 falls outside the acceptance region into the rejection region; we therefore reject the null hypothesis and accept the alternative hypothesis which states that there is a significant relationship between independence of audit committee and the quality of corporate financial reporting.

4.3 Discussion of findings

Considering the roles played by Audit committees, their effectiveness has become increasingly important following the financial scandals and has been the focus of regulatory changes in recent years. Result in table 3 shows findings from survey that the roles Audit committees play in corporate governance is so pivotal (mean score of 3.14), that Audit

committee multiple directorship may affect the quality of financial reporting (mean score of 3.35). This is supported by the rejection of null hypothesis (**H_0^1**) and acceptance of the alternative hypothesis that there is a significant relationship between audit committee multiple directorships and the quality of corporate financial reporting. Audit committee membership requires time as well; because members who hold director posts of too many companies may have limited time fulfilling their responsibilities (mean score of 3.19), this might affect the quality of financial reports. In other words, multiple directorships may cause limitations of time and commitment for audit committee members from performing effectively (mean score of 3.00). This is supported by survey findings that the presence of audit committee multiple directorship may have an adverse effect on the financial reporting quality (mean score of 3.29). To enhance the effectiveness of the Audit committees, financial literacy of audit committee members is considered a critical success factor as this impacts on the quality of financial report (mean score of 3.29). The rejection of hull hypothesis (**H_0^2**) and acceptance of the alternative hypothesis that there is a significant relationship between financial literacy of audit committee and the quality of corporate financial reporting supports this assertion.

The independence of the audit committee is also another key consideration that contributes to the effectiveness of the committee and the quality of financial reports. The statement that audit committee members' independence impacts financial reporting quality has weighted means score of 3.59. This conclusion is corroborated by the rejection of the null hypothesis (**H_0^3**) and acceptance of the alternative hypothesis that there is a significant relationship between independence of audit committee and the quality of corporate financial reporting.

A major concern raised post-Enron is that individuals hold too many directorships, as a result of which *they do not have the time to do their job* (Lindberg et al, 2004). Corporate reformers, likewise, have advocated reforms to prevent poor governance resulting from overcommitted directors. For instance, the Council of Institutional Investors suggests that individuals with full time jobs should not serve on more than two boards. An alternative view is that directors with more outside board seats may be more experienced and prove to be better monitors.

5. Conclusion and Recommendation

The study has attempted to empirically examine the interconnectedness between audit committee multiple directorship and financial reporting quality in Nigeria. Findings of the study were the following; there is a significant relationship between audit committee multiple directorship and the quality of corporate financial reporting because multiple directorship may cause limitations of time and commitment for audit committee members from performing effectively; there is a significant relationship between financial literacy of audit committee and the quality of corporate financial reporting, as being financially literate as a member of audit committee enhances the effective overseeing of corporation's financial controls and the quality of reporting; and there is a significant relationship between independence of audit committee and the quality of corporate financial reporting.

From empirical evidence, we conclude that audit committee multiple directorship has a significant impact on financial reporting quality in Nigeria. The study supports the need for a high degree of financial literacy on the part of audit committee member to effectively oversee a corporation's financial controls and reporting.

We recommend that publicly quoted companies should continue to ensure that only independent directors and shareholders' representatives should be on the audit committee; shareholders representatives' selection should however give consideration to financial literacy. The regulatory agencies in Nigeria should also institute legislation similar to the Sarbanes Oxley act of the United States of America in order to curb the menace of earnings management and other unethical financial reporting practices.

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Appendices

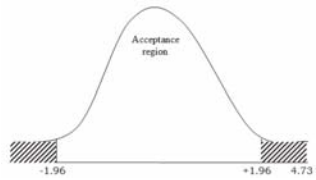

Fig 1. Z-test graph for test of hypothesis 1

Fig 2. Z-test graph for test of hypothesis 2

Fig 3. Z-test graph for test of hypothesis 3