AUDIT COMMITTEE CHARACTERISTICS AND CORPORATE FINANCIAL REPORTING QUALITY OF MANUFACTURING FIRMS IN RIVERS STATE: A CRITICAL REVIEW

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Abstract

This paper examined audit committee characteristics and corporate financial reporting quality of manufacturing firms in Rivers State. Extant related literatures were reviewed and indicated that the audit committee is an operating committee of the board of Directors charged with oversight responsibility of financial reporting disclosures. The purpose of establishing audit committee is to overhaul the financial system and uphold the integrity of financial statements. The audit committee establishes a buffer between the auditors and the executive directors in order to minimize the risk of the auditors coming under undue pressure from the executive members of the board. Our findings include the fact that audit committee characteristics include size, composition of members, financial expertise while the corporate financial reporting quality include understandability, relevance, and comparability. Furthermore the audit committee examines the auditors’ report and make recommendations thereon to the Annual General Meeting (AGM) as it deems fit. In conclusion, financial literacy is not enough, but a combination of financial and industrial expertise would further improve the quality of the financial report. This is because the financial reporting serves as the major medium of communication between companies and stakeholders by reducing the level of information asymmetry between the Directors, who have access to management information and providers of finance who are external to the company. The Audit Committee plays a significant role in strengthening the corporate financial reporting quality, hence this paper has analysed the link between audit committee and corporate financial reporting. Audit Committee that are active and independent, are less likely to experience fraud and other reported irregularities. It is, therefore, recommended that the managers and administrators of manufacturing companies in Rivers State, should subscribe to ethical code of good corporate accountability and governance.

Keywords: Audit Committee Characteristics, Financial Reporting, Manufacturing Companies, Rivers State.

A. Introduction

Every corporate organization especially the public limited companies allow for the separation of ownership and management. This means that owners do not need to be managers and managers do not need to be owners. While the owners invest and provide strategic advice, direction and clear guidelines for implementing plans with the objective of maximizing return on investment, the management has the function of planning, directing, controlling and organizing the corporate resources to achieve the shareholders and stakeholders expectations. The role of management as agent to the shareholders gives it obligation to be accountable to the owners. Management is responsible for the preparation of financial statements based on the accounting records of the organization which reflect the nature and operations of the entity and expected to be in conformity with the Generally Accepted Accounting Principles (GAAP). Accounting and auditing are essential factors in monitoring the agency relationship. The need for financial reporting and disclosure arises from information asymmetry and conflict of interest between managers and shareholders, Healy and Palepa (2006). In Nigeria, audit and audit reports are regulated by relevant sections of companies and Allied Matters Act (CAMA) 1990 as amended and 2004. Section 296 of CAMA 1990 as amended mandates all public limited companies to make public the financial status of the firm within a specific accounting period.

Auditing is a systematic process of objectively obtaining and evaluating evidence
regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users. American Accounting Association (1972). In order to give an assurance about the financial statements of an entity, the auditor receives assertions from the management about these reports.

According to International Accounting Standards Board (IASB), (2008), high quality financial reporting is critical to investors and other stakeholders in making investment, credit and similar decision.

Corporate financial reporting is a fundamental corporate responsibility and a core element of the corporate system. This is because, the financial reporting serves as the major channel of communication between companies and stakeholders by reducing the level of information asymmetry between the managers who have access to management information and business owners who are external to the company. Whittington (1993).

Corporate financial reporting is defined as the precision with which financial reporting conveys information about the firm’s operations, in particular its expected cash flows. Bartons (2005) assert that existing and potential shareholders use corporate financial reports to evaluate the investment potential of a company’s shares, creditors and lenders to assess the credit worthiness and liquidity, government to administer the company law.

However, the concerns on the quality of financial reporting have raised questions regarding the effectiveness of the monitoring mechanism of a company. Fama (1980) suggested that the credibility and transparency of financial reporting of a company depends upon the monitoring mechanism of the company itself and this has led researchers to examine corporate governance issues.

The premise for the trend is that there is the opportunistic tendency of managers to engage in unethical practice in the absence of good governance structure. Empirical researchers such as Fama (1980), Fama and Jensen (1983), have linked corporate governance mechanisms to high quality financial report. Given these developments, there has been emphasis on the need to improve corporate governance over the financial reporting process.

In view of this, therefore, the role of the Audit Committee has been identified as critical in ensuring the credibility of corporate financial reporting process. Abbott, Park and Parker (2000).

Audit Committee is a sub-committee of the Board of Directors that specializes in, and is responsible for, ensuring the accuracy and reliability of the financial statements provided by management. One high – level corporate governance device which has been identified as critical in ensuring the quality of financial reporting is the Audit Committee. As far back as 1967, the American Institute of Certified Public Accountants (AICPA) made recommendations that Audit Committee be established in companies. The Security and Exchange Commission (SEC) in 1972 also recommended that public companies are to establish Audit Committee to increase their oversight functions and responsibilities of its members, and to protect investors that rely upon financial statements.

In Nigeria, the formation of Audit Committee is traced to the promulgation of the companies and Allied Matters Act (CAMA) of 1990 as amended in 2004. CAMA repeated the companies Act of 1968. Section 359 (3) of CAMA requires public companies establish Audit Committee to examine and review reports of Directors and make adequate and or far reaching recommendations to the members of the company at the Annual General Meeting (AGM). DeZoort (2002) states that an effective Audit Committee has qualified members with the authority and resources to protect stakeholders’ interest by ensuring reliable financial reporting, internal controls, and risk management through its diligent oversight efforts.

Audit Committee make recommendations to the Board of Directors (BOD0 on the selection of an external auditors, liaise with senior financial managers and external auditors on issues such as the financial statements, audit process and internal controls as well as over see internal auditors, external auditors, and management to ensure that they act in the best interest of the shareholders. Lindsey (1992) asserts that one of the mechanisms that have been widely used by corporate organizations to monitor the effectiveness and efficiency of financial
statements is the Audit Committee. *Baxter and Cotter (2009)* indicated that the Audit Committees assist corporate governance in the improvement of financial reporting quality.

Further, *Ojo (2009)* pointed out that, the purpose of establishing audit committee is to overhaul the financial system and uphold the integrity of financial statements to reflect economic substance and present a true and fair financial statements. The existence of Audit Committee provides an oversight financial reporting and auditing process.

**B. Review of Literature**

The study was underpinned by the following structures; Conceptual framework, Empirical review, Theoretical framework and Summary of literature review.

**Operational Framework/Conceptual Framework**

*McGaghie et al., (2001)* put it; the conceptual framework “sets the stage” for the presentation of the particular research question that drives the investigation being reported based on the problem statement.

The conceptual framework lies within a much broader framework called theoretical framework. The latter draws support from time – tested theories that embody the findings of many researchers on why and how in particular phenomenon occurs.

![Figure 1 Source: Researcher's Operational Framework: 2017](image)

**Theoretical Framework**

Theoretical framework involves a well supported rationale and is organized in a manner that helps the reader understand and access the researcher’s perspective. Its purpose is to demonstrate that the relationships intended are not based on personal instinct or guess, but rather derived from facts obtained from authors of previous research.

The following theory is examined in the literature to build understanding on the concept and importance of auditing in corporate governance.
Agency Theory

Overview of the agency relationship leading to the demand for Auditing


Organizations are characterized by a separation between ownership and control, with the right to exercise control over the organization having moved from the absentee owners to the hired managers. The agency theory, the development of which is generally credited to Jensen and Meckling (1976), has been widely used in accounting and auditing literature in an attempt to set a set of well developed concepts to explain this inter – relationship in organizations between the owners and managers and to justify the need for auditing Messier et al., (2010) Droege and Spiller (2009); Gray and Manson (2008).

Jensen and Meckling (1976) defined an agency relationship in general terms as “a contract under which one party (the principal) engages another party (the agent) to perform some service on their behalf that involves delegating some decision – making authority to the agent.

In an agency relationship the principal entrusts his welfare and delegates his decision – making authority to the agent who makes decisions and takes actions on the principal’s behalf. Gradvrey et al., (2010); Tiessen and Waterhouse (1983), Jensen and Meckling (1976). The agency theory can, in general terms, be described as concentrating on the relationship in which the welfare of the interests of one person, the principal, is entrusted to and dependent on another, the agent. Godfrey et al., (2010); Droege and Spiller (2009).

Having identified the separation within the organization between ownership without appreciable control and control without appreciable ownership. Barley and Means (1932) questioned how the relationship between the ownership – group and the control – group can be expected to affect the conduct of the enterprise. They argued that the traditional owner, who controlled his own enterprise, operated the business in his own interest to strive to maximize the business profits, as such profits accrued directly to him as personal income, Larner
Consequently, there is a natural conflict of interest between the managers and the absentee owners that arises when decisions made by managers to minimize their own utility do not maximize ownership wealth. This means that because the agent – managers have self-seeking motives driven from a desire for personal monetary gain, they are likely to take the opportunity to act against the interest of the owners of the organization. Adam (1994); Barley and Means (1932).

The problem that arises out of the conflict between the desires and goals of the principal and those of the agent is that the principal cannot easily verify that the agent has behaved appropriately, which leads to the concept of agency costs.

**Functions of Audit Committee**

Section 350 (4) of CAMA 2004 stated that, the audit committee is an operating committee of the board of directors charged with oversight responsibility of financial reporting disclosures. The committee members are drawn from the board with chairperson selected from among the committee members. In United States of America, the role of the audit committee continues to evolve based on the Sarbanes Oxley Act of (2000). This act stipulates oversight regulatory compliance and risk management activities, overseeing the financial reporting and disclosure process, monitoring choice of accounting policies and principles, overseeing and hiring performance and independence of the external auditors, overseeing regulatory compliance, ethics and whistle i.e. blower hotlines, monitoring the internal control process and performance of internal audit functions and discussion risk management policies and practices with management.

In Nigeria, in response to dynamic environment, boards of directors are planning increased and reliance on audit committees to oversee and make adequate report.

**Corporate Financial Reporting Quality**

Corporate financial reporting quality has been generally recognized as a vital area in accounting. Numerous accounting professional institution world over have made attempts to define the objectives of financial statement and financial reporting which is vital to the development of financial accounting theory and practice. (Cyert, (2009) & Kirk, (2010). The term financial reporting refers to accounting information that is prepared by management to meet the needs of various users. Ball (2006) noted that corporate financial reporting is an important economic activity. Healy and Palepu (2001) state that the demand for corporate financial reporting results from the information asymmetry between the managers and owners of the company. Thus, the objectives set forth stem largely from the needs of those for whom the information is intended, which in turn depends significantly on the nature of the economic activities and decisions with which the users are involved.

According to the Financial Accounting Standards Board (FASB 2005), financial reporting should provide information that is useful to present and potential investors and Creditors and others users in making rational investment, credit and similar decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence. Financial reporting should provide information to help present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans. Since investor’s and creditor’s cash flow are related to enterprise cash flows, financial reporting should provide information to help investors, creditors, and other assess the amounts, timing and uncertainty of prospective net cash inflows to the related enterprise. The FASB added that financial reporting should provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owner’s equity), and the effects of transactions, events, and circumstances that change its resources and claim to those resources.

Financial statements are a central features of financial reporting. They are a principal means of communicating accounting information to those outside an enterprise. Although
financial statements may also contain information from sources other than accounting records, accounting systems are generally organized on the basis of the elements of financial statements (assets, liabilities, revenues, expenses etc) and provide the bulk of the information for financial statements. The financial statements frequently provided are (a) balance sheet or statement of financial position, (b) income or earnings statement, (c) statement of retained earnings, (d) statement of other changes in owner’s or stockholders’ equity, and (e) statement of changes in financial position (FASB 2005).

However, financial reporting includes not only financial statements but also other means of communicating information that relates, directly or indirectly, to the information provided by the accounting system that is, information about an enterprise’s resources, obligations, earnings, etc. management may communicate information to those outside the enterprise by means of financial reporting other than formal financial statements either because the information is required to be disclosed by authoritative pronouncement, regulatory rule, or custom or because management considers it useful to those outside the enterprise and discloses it voluntarily.

Information communicated by means of financial reporting other than financial statements may take various forms and relate to various matters. Financial statements are often audited by independent accountants for the purpose of enhancing confidence in their reliability. Some financial reporting by management outside the financial statements is audited or is reviewed but not audited, by independent accountants or other experts, and some is provided by management without audit or review by persons outside the enterprise.

**Audit Committee Size and Financial Reporting Quality**

Fama and Jensen (1983) view the board as the firm’s highest – level control mechanism, with ultimate responsibility of overseeing the activities of the firm. The literature on restatement, fraudulent financial statements, and financial reporting quality in general indicates that the composition and characteristics of the board influence its effectiveness in this regard. Board size is another determinant of financial reporting quality, the larger the board the more complex it will be as regard decision making. The size of the board of directors is often used by some scholars to measure the quality of corporate governance. Many scholars argued that the assertion that larger board size connotes viable governance is a misconception. On the contrary, other scholars debunked the assertion that larger size boards are better off. Extant literature shows that board size play a significant role in director’s viability to check on managers. Lipton and Lorsch (1992) and Jensen (1993) argue that large board gives room for rowdiness which in turn lowers the monitoring function of the board. Contrary to this Adams and Mehran (2002) and Yermack (1996) argue that some organizations need larger boards for effective monitoring. This is also supported by Changanti et al., (1985) who opines that large boards are useful for the breadth of their function. Klein (2002) finds that disintegration of board members into different committees largely depends on the size of the board. Monks and Minow (1995) and Lipton and Lorsch (1992) further suggest that larger boards are able to commit more time and effort to monitor management.

Beasley (1996) reports that board size has positive relationship with the likelihood of financial statement fraud while Uzun et al., (2004), Carcello and Nagy (2004) and Farber (2005) found negative relationship between financial quality and board size. Jensen (1993) and Lipton and Lorsch (1992) report that large boards of directors are less amenable to effective monitoring and easier to be controlled by the CEO. Xie, Davidson and Dalt (2003) documented an inverse relationship between the size of the board and the quality of financial reporting. Eisenberg, Sundgren and Wells (1998) and Yermack (1996) also found a negative relationship between the size of the board and the value of the company.

**Audit Committee Composition and Financial Reporting Quality**

Board comprises both executives and non – executives directors. Non – executive directors act as mechanism that enhances efficient monitoring. Non – executive directors help to curtail managerial excesses that are capable of reducing the quality of accounting information conveyed to the users of financial statements (Higgs, 2003). Many scholars are of the opinion that independent board has impact on financial reporting quality. Fama and

Audit Committee Meeting and Financial Reporting Quality

The effectiveness of audit committee depends on the extent to which the committee is able to resolve issues and problems faced by the company and to improve their monitoring functions of the company (Abbott, Park and Parker 2000). A more active audit committee is expected to provide an effective monitoring mechanism. Adeyemi, Okpala and Dabor (2012) observed that the more frequent the audit committee meets, the more opportunity it has to discuss current issues faced by the company. A more active audit committee is expected to provide an effective monitoring mechanism. Beasley et al., (2009) suggest that audit committee meetings are not mere rituals devoid of interest to managers and auditors instead meaningful and substantive meetings are consistent with an agency perspective. Chen and Zhou (2008) noted a number audit committee meeting as an important mechanism of corporate governance. Menon and Williams (1994) suggest a minimum of two meetings a year. This recommendation as to a minimum frequency to a guarantee effective audit committee control are supported by empirical evidence of a positive relationship between meeting frequency and the quality of a firm’s accounting information (Abbot et al., (2004); Xie et al., (2003). It is argued that effective control is unlikely to occur if an audit committee holds a single yearly meeting, or none at all (Deli & Gillan, (2000); Klein & Garcia, (2007); Abbott et al., (2007) noted that an effective Audit Committee should meet at least four times annually.

Audit Committee Financial Expertise and Financial Reporting Quality

Felo and Solieri (2009) regards audit committee members with financial experts to members that have past employment experience in finance or accounting, have professional certification in accounting, or any other financial oversight experience or backgrounds which result in financial sophistication. Song and Windram (2000) suggest that high level of financial literacy is needed for audit committee to effectively perform it oversight function of monitoring. The role of an audit committee in overseeing accountability of the management covers a wide scope, which include the overall process of corporate reporting. This demands the audit committee to possess accounting knowledge in order understand the financial report and make positive contribution that will lead to improved financial report. Financial literacy of audit committee member will go a long way to help in reducing fraud in corporate financial reporting. A formal recognition of this requirement was made in the US by including a clause in Sarbanes – Oxley Act (2002) which stipulates every public listed company to disclose whether or not it has a financial expert in its audit committee. Previous studies show that the fraudulent financial reporting companies have few members that have expertise in accounting (McMullen & Raghunandan, (1996), Beasley, Carcello & Hermanson (1999). DeZoort and Salterio (2001) document that audit committee members with account know – how are more likely to make better professional judgments than those without. Xie (2003), Abbott (2004) and Bedard (2004) document that audit committee financial expertise reduces financial restatements or constrains the tendencies of manager manipulating financial report.

Krishnan (2005) and Zhang, Zhou and Zhou (2007) find that firms are more likely to be identified with deficiencies in internal control over financial reporting if their audit committee have less financial expertise. All, these studies suggest that financially knowledgeable audit committee members are more likely to prevent and detect material
misstatements. Cohen et al., (2000) found that experienced external auditors believe that the lack of financial expertise of audit committee members negates the effectiveness of the committee. Baxter and Cotter (2009) and Bedard et al., (2001) investigated the relationship between audit committee expertise and financial reporting quality in Austral and US. They both found negative relationship between the audit accounting expertise and financial reporting. However, some authors reported that an audit committee flooded with accounting expertise member is less productive, given that the audit committee members do not have a sufficiently broad range to detect financial irregularities.

**Measures of Corporate Financial Reporting Quality**

A number of methods have been used in the research literature to empirically measure corporate financial reporting quality. Two empirical models have been used often to measure financial reporting quality. The first model is a modified version of the Jones (1991) model of discretionary accrual. This model has been widely used in the literature to capture earnings management, which is viewed as an inverse measure of earnings quality (Krishnan (2005); Chen, Lin & Zhou (2005)).

The second model used to measure corporate financial reporting quality was the (Dechow & Dichev, 2002) model. This model argues that estimation errors in accruals and subsequent corrections of these errors, decreases the quality of accruals and earnings. Therefore, while the Jones (1991) model assumes that accruals and earnings quality is only affected by management intent to manipulate earnings, the Dechow and Dichev (2002).

Hence, this study shall measure corporate financial reporting quality by the use of reliability, comparability and relevance.

**Reliability/Faithful Representation**

FASB states that in order to be useful, financial information not only must represent relevant phenomena, but it also must faithfully represent the phenomena that it purports to represent. To be a perfectly faithful representation, information has to be complete, neutral and free from error. A complete depiction includes all information necessary for a user to understand phenomenon being depicted, including all necessary descriptions, explanations and details. Moreover, in order to achieve faithful representation, a neutral depiction is mandatory. Neutral information does not mean information with no purpose or no influence upon behaviour. On the contrary, as it was already mentioned before, relevant information is capable of making a difference in users decisions. A neutral depiction is not manipulated in order to alter or change user's decisions, to influence them. Faithful representation is a term that is used also when trying to explain what reliability means. It is important to notice that in the past IASB used the term reliability to describe what is now called faithful representation. The framework (1989) said that information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent. It also discussed substance over form, neutrality, prudence and completeness as aspects of faithful representation. Anyway, due to the fact that IASB did succeed to define clearly reliability, this was a confusing term, not fully understood by the users of financial information. That is why, IASB sought a different term that would more clearly convey the intended meaning and the term faithful representation was the result of this search. This term incorporates the main characteristics that were previously seen as aspects of reliability. When trying to quantity faithful representation, we cannot only find relevance as a way of measuring faithful representation. Empirical accounting researchers have accumulated considerable evidence supporting relevant and faithfully represented financial information through correlation with changes in the market prices of entities' equity or debt instruments. Besides the fundamental qualitative characteristics of accounting information, FASB's framework states also the enhancing qualitative characteristics. These are comparability, verifiability, timeliness and understandability, which enrich the usefulness of information that is relevant and faithfully represented.

**Comparability**
A second enhancing qualitative characteristics is comparability, which “is the quality of information that enables users to identify similarities in and differences between two sets of economic phenomena” (IASB, 2008). In other words, similar situations should be presented the same, while different situations should be presented differently. Comparability is measure using six items that focus on consistency. Four items refer to the consistency in use of the same accounting policies and procedures from period to period within a company (Jonas & Blanchet, 2000; Vincent & Schipper, 2003; Beuselinck & Manigart, 2007; Cole et al., 2007). Two items are used to measure the comparability in a single period across companies (Cleary, 1999; Jonas & Blanchet, 2000; Cole et al., 2007) Beuselinck & Manigart, (2000&0; IASB, (2008).

Comparability includes consistency. “Consistency refers to the use of the same accounting policies and procedures, either from period to period within an entity or in a single period across entities”. (IASB, 2008). According to ED, companies should strive for comparability by means of consistency. Jonas and Blanchet (2000) operationalize consistency by referring to coping with change and uncertainty. New information, rules or regulation generally cause companies to change their estimates, judgments, and accounting policies. For instance, if new information is available which encourages a revision of the expected lifetime of a certain asset, this may result in a change of estimate. In addition, many EU-listed companies changed from local GAAP to IFRS in 2005, as a result of new rules and legislation. In terms of consistency it is important that these companies explain how these changes affect previous results. The comparability of earnings figures is important in the evaluation of the firm’s performance over time (IASB, 2006); Cole et al., 2007). If a company changes its estimates, judgments, or accounting policies it may adjust previous years’ earning figures in order to visualize the impact of the change on previous results. Additionally, since consistency refers to using the same accounting procedures every year, this year’s figures should be comparable to previous year’s figure (IASB, 2008). When a company provides an overview in which they compare the results of different years, even when no changes in estimates, judgments, or accounting policies occurred, this will improve the comparability of financial reporting information.

Comparability not only refers to the consistency of the use of accounting procedures by a single company, it also refers to comparability between different companies (IASB, 2008).

When assessing the comparability of annual reports of different companies, the accounting policies used, the structure of the annual report, and the explanation of transactions and other events are of special importance (Jonas & Blanchet, 2000). In addition, ratio and index numbers can be useful when comparing companies’ performance.

Relevance

Relevance is referred to as the capability "of making a difference in the decisions made by users in their capacity as capital providers” (IASB, 2008). Drawing on prior literature, relevance is operationalized using four items referring to predictive and confirmatory value. As discussed earlier, researchers tend to focus on earnings quality instead of on financial reporting quality. This definition is limited in scope because it neglects non – financial information and it excludes ‘future’ financial information already available to the users of the annual report, for example on future transactions (Jonas & Blanchet, 2000; Nicholas & Wahlen, 2004). In order to improve the comprehensiveness of the quality assessing measurement tool, this study will consider a broader perspective on predictive value including both financial and non – financial information. Many researchers have operationalized predictive value as the ability of past earnings to predict future earnings (e.g. Francis et al., 2004; Lipe, 1990; Schipper & Vincent, 2003). Predictive value explicitly refers to information on the firm’s ability to generate future cash flows. "information about an economic phenomenon has predictive value if it has value as an input to predictive processes used by capital providers to form their own expectations about the future” (IASB, 2008). We consider predictive value as most important indicator of relevance in terms of decision usefulness and measure predictive value using three items. The first item measure the extent to which annual reports provide forward – looking statements. The forward – looking statement usually
describes management’s expectations for future years of the company. For capital providers
and other users of the annual report this information is relevant since management has access
to private information to produce a forecast that is not available to other stakeholders (Bartov
& Mohanram, (2004). The second item measures to what extent the annual reports discloses
information in terms of business opportunities and risks. Jonas and Blanchet (2000) refer to
the complementation of financial information by non-financial information, when referring to
predictive value, and the knowledge that can be obtained of business opportunities and risks,
since it provides insight into possible future scenarios for the company. The third item
measures company’s use of fair value. Prior literature usually refers to the use of fair value
versus historical cost when discussing the predictive value of financial information. (e.g. Barth
et al., (2001); Hirst et al,(2004); McDaniel et al., (2002) Schipper & Vincent, (2003);
Schipper, (2003). It is often claimed that fair value accounting provides more relevant
information than historical cost because it represents the current value of assets, instead of
the purchase price (Inter alia Maines & Wahlen, (2006) Schipper & Vincent, (2003). In
addition, both the FASB and IASB are currently considering new standards to allow more fair
value accounting to increase the relevance of financial reporting information, since they
consider fair value as one of most important methods to increase relevance (Barth et al.,
(2001). In addition to predictive value, confirmatory value contributes to the relevance of
financial reporting information. Information has confirmatory value “if it confirms or changes
past (or present) expectations based on previous evaluations” (IASB, (2008);36). Jonas and
Blanchet (2000) argue that if the information in the annual report provides feedback to the
users of the annual report about previous transactions or events, this will help them to confirm
or change their expectations.

C. Empirical Review
Empirical Review of Audit Committee
McKee (1979) claimed that prior to the rise of the auditing profession in the United
States, committee such as the Audit Committee of the East Tennessee (ET) and Western North
Carolina Railroad WNCRR frequently handled the auditing task in 1870. On 28 February 1870,
shareholders of the Et and WNCRR appointed a special committee, which was required to
inspect the accounts of the offices of the Board of Directors of the company and report at the
next meeting McKee, 1979. The author remarked that this might be one of the earliest
documented instances in the United States of an audit committee reporting to the board of
directors of a corporation.

However, the concept of audit committees and their responsibilities have evolved
dramatically since they were first proposed in the late 1930s. Birkett (1986) stated that, audit
committees first attracted attention in the early 1930s when the Security and Exchange
Commission (SEC) and New York Stock Exchange (NYSE) encouraged their establishment after
the Mckesson and Robbins case.

Audit Committee were first proposed by the American Institute Certified of Public
Accountants (AICPA) as early as 1937 and have been endorsed by the SEC since 1940. One
interesting trend uncovered during a review of relevant literature suggests that, in all of the
countries where they have become established, audit committee have been stimulated by
unexpected company failure and/or corporate malpractice (Vanasco, 1994).

In addition, Green (1994) noted that corporate audit committees have developed and
evolved as a result of dissatisfaction with methods of corporate governance. Audit Committees
have been under pressure to accept increasingly high levels of responsibility over the past
decade because of the increasing public pressure for greater corporate accountability. The
volume of research on audit committee is more in the US than in other countries. Perhaps, this
is due to the fact that the history of audit committee in the United States is longer than
elsewhere (Spira, 1998).

During the 1970s, the role of audit committees received a great deal of attention
because of demands for greater corporate accountability and governance. In view of the
increasing size of corporations and the separation of ownership and management, shareholders
and other constituencies needed more assurance with respect to the integrity of the internal
and external auditing process and the financial reporting process (Spangler & Braiotta, 1990). Accordingly, Woolf (1997) mentioned that the appointment of an audit committee is an important development intended to enhance the communication between the board of directors and both the internal and external auditors. It is widely accepted that the idea of audit committees as discussed by Cadbury Committee (1992) derived from North American experience (Collier, 1996).

The SEC has supported the establishment of audit committees for many years and has strongly recommended that its registrants establish audit committees since the early 1940s (Birkett, 1986). Although the term “audit committee” had not been used yet, the SEC discussed the need to establish a specific group, composed of non–executive directors, to take on specific functions such as the selection of external auditors.

In 2001, the collapse of Enron Corporation, the biggest corporate failure in the history of the United States, has captured the attention of regulators, professional bodies and investors and has rekindled the debate on corporate accountability and raised fears that the corporate system in the US is rotting at its core (Sridhar, 2002). As a result, the US Congress passed legislation, the Sarbanes – Oxley Act (2002) that establishes many new requirements, including those governing the composition and responsibilities of audit committees. Most observers would agree that the Sarbanes-Oxley Act 2002 is the single most important piece of legislation affecting corporate governance, financial disclosure and the practice of public accounting since the US securities laws of the early 1930s (Price Waterhouse Coopers 2002).

In Canada, the pressure for audit committee arose from corporate collapses in the mid–1960s. the bankruptcy of Atlantic Acceptance Corporation Limited in 1965, which was a major event in the history of accounting in Canada, has been equated to the McKesson & Robbins Case in the United States (Green, 1994). This event had considerable repercussions for Canadian financial practices (Green, 1994; Collier, 1996) and let to the issuance of the Canadian Royal Commission Report in 1965, which recommended that all public companies should establish an audit committee. In 1967, the Lawrence Commission, an Ontario Select Committee on Company Law, recommended that the establishment of an audit committee should be mandatory for all public companies (Canadian Institute of Chartered Accountants 1981). The Lawrence Committee Report concluded that audit committee would make it easier for auditors to retain their independence with clients, and this report identified the audit committee as an important communication link between the auditor and the board of directors (Canadian Institute of Chartered Accountants 1981).

In 1971, the Canadian Central Governance adopted the legislation of the Ontario Business Committee Corporation Act 1970 (Solomon, 1978). This Act was amended in 1975 to require all public companies to have an audit committee whose duty is to approve the financial statements prior to the submission to the main board of directors for approval.

In Nigeria, The Companies and Allied Matters Act, 1990 (as amended 2004) states that a public limited liability company should have an audit committee (maximum of six members of equal representation of three members each representing the management directors and shareholders) in place. The members are expected to be conversant with basic financial statements. Nevertheless, the high profile fraud in both private and public companies in Nigeria raises doubts as to whether audit committees are in existence at all.

**Summary of Review of Literature**

The review of literature of this study is built on the following three structures. Conceptual framework, Theoretical framework, and Empirical review.

Traditionally, the role of the audit committee has included oversight of; the financial reporting process, international audit function, ethics and compliance and the independent audit relationship. Our business environment has become more dynamic and complex, the role of the audit committee, has expanded to include oversight of fraud prevention programme, enterprise risk management, cyber security and data privacy, conflict – of – interest and related party transaction.

However, the corporate financial reporting quality will depend on the following determinants; the size of the audit committee, its composition, the frequency and regularity of
meeting to resolve issues and problems faced by the entity and to improve their monitoring functions, including expertise of members.

Further, the measurement of corporate financial report quality aptly considers the following qualitative factors – faithful representation, comparability, understandability and of course relevance.

It is recommended that manufacturing companies in Rivers State should be encouraged to form audit committee. In view of its importance in corporate governance. Members of the committee, should be knowledgeable experts in financial matters and should be given training on corporate governance at regular interval. Above all, committee should be independent of management in order to perform its oversight functions for the benefit of stakeholders.

D. Conclusion

Audit committee plays significant parts in strengthening the corporate financial reporting quality. Hence, studies have analyzed the link between audit committee and corporate financial reporting. According to Abbott and Packer (2000) stated that audit committee particularly active and independent committees are less likely to experience fraud and other reporting irregularities. Audit Committee is effective in reducing misleading financial statement. Accordingly, Simnett (1993) pointed that; audit committee is expected to promote the effectiveness of both the internal and external auditors. Cardbury (1992) opines that, audit committee to be effective majority, if not all should independent and they should have adequate understanding of accounting, auditing and control issues. Carcello and Neal (2000) opines that, auditors are likely to issue going concern reports in the presence of more independent boards and are less to be fired by the company following the issuance of a going concern audit report. Accordingly, Dechow et al., (1996) investigated companies subject to accounting enforcement actions by the Securities and Exchange Commission (SEC) for alleged breaches of General Accepted Accounting Principles (GAAP). They found that companies that were manipulating their earnings were less likely to have an audit committee. McMullen (1996) examined five potential consequences of audit committee involving the occurrence of errors, irregularities and illegal acts relating to financial reporting. Her findings showed that companies with more reliable financial reporting were more likely to have audit committees. Beasley et al., (1996) found out that the presence of an audit committee did not significantly affect the likelihood of financial statement fraud.

Hence, Beasley et al., (2000) found that fraud companies in certain industries had less independent audit committee and fewer audit committee meetings. In a similar study, Abbott and Parker (2000) found out that firms with audit committees comprised of independent directors and that met at least twice a year were less likely to be sanctioned for fraudulent or misleading financial reporting. The findings of the study of IJK audit committees by Song and Windram (2004) suggested that the financial literacy of audit committees and their activity level contributed to the probability of companies complying with financial reporting standards. In a similar study, Lin, Li and Yang (2006) analyzed the association between the occurrence of earnings restatements and audit committee characteristics. Only the size of the audit committee was significantly negatively associated with earnings restatements.

A number of other studies have focused more on the characteristics of the board and auditor and their association with fraudulent financial reporting. Using data on cases of fraud in Australia, Sharma (2004) found out that the likelihood of fraud decreased as the percentage of independent directors on the board increased. Carcello and Nagy (2004) found a significant negative association between auditor industry specialization and client financial fraud, but the association was weaker for larger clients. In summary, there have been some mixed results in the literature on the association between the existence of audit committees and cases of financial statement fraud. While Dechow et al., (1996) and McMullen (1996) found evidence of an association between these variables, Beasley (1996) did not identify such an association.
Recommendations/Implementations

I. Companies should be encouraged to form audit committees.

II. The corporate instrument establishing audit committee should be regularly reviewed to ensure proper functioning of the audit committee. The instrument should include the purpose of the committee, to whom they report, the membership structure, frequency of meetings and outline of key responsibilities.

III. Clearly, the functions of the audit committee are quite wide-reaching. Therefore, it may be necessary to establish an internal audit department in order to help them fulfill their responsibilities.

IV. Be well rounded. Audit Committee members should collectively possess technical, accounting, auditing and financial management expertise.

V. For maximum independence. Most members should be appointed from outside the organization.

VI. Members of audit committee should be provided adequate education and training.

VII. The tenor of office of audit committee members should be longer than one year and staggered to provide continuity.

VIII. The committee should meet on regular and frequent (more than once a year) basis to resolve pressing issues confronting the company.

References


