



## Audit Committee Effectiveness on Firm's Financial Distress of Listed Industrial Goods Firms in Nigeria

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### ABSTRACT

*The study aims to examine the audit committee effectiveness on firm's financial distress of listed industrial goods firms in Nigeria. The sample size used is fourteen (14) firms listed in the Nigerian Stock Exchange (NSE) for the period 2011-2016. The collected data were analyzed using General Least Square regression method. The results empirically reveal that, audit committee independence (ACID), Audit committee meetings (ACMT) and Audit committee meeting attendance (ACMAT) are negatively and significantly related to the firm's financial distress of the firms under investigations. On the basis of the empirical result, the paper recommended that shareholders, stakeholders and other relevant policy makers of industrial goods firms should improve the activities of audit committee by adding more independence non-executive members which allow them to discharge their duties in accordance with the provision of the law, increase the number of meetings per annum and ensures the full attendance character of the committee members in the meeting, because it will help in making collective and effective decision on the factors that can undermine the firms' financial performance.*

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### INTRODUCTION

If there is one thing that has characterized in recent time, it is that many firms have become financially unhealthy because of the global credit crunch which led to the worldwide recession in 2009. Many large multinational firms such as Hypo Real Estate, Lehman Brothers, Sterling Airlines, Nortel Networks and Ssangyong Motor Company, suffered huge amount of losses and were acquired or went bankrupt during the financial crisis. Others also had to cut various expenses to survive or to avoid substantial deterioration of their operating performance (Ufo, 2015). This is

the worst economic performance since Second World War. Such problem does not left developing countries behind which Nigeria is included. As a result of this, many firms were experienced financial difficulties in Nigeria, some of which are; Cadbury Nig. Plc, Intercontinental Bank Plc, Oceanic Bank Plc, International African Bank Plc, Savannah Bank Plc, Oado Plc and many more. This led to some industrial reforms like Central Bank of Nigeria (CBN) reform for financial system by increasing the capital base of Banks to N25billion in 2005. The most recent economic condition of insecurity issue and economic recession,



have also caused problems to most of Nigerian firms, as a result, many firms are not able to meet their debt obligations. The financial difficulties caused many to be concerned about investors' loss of confidence in the sustainability of the companies' operation. Corporate governance is considered as watch dog to management activities not to do any act that will undermine the firms' value or goes in contrary to shareholders value maximization aims. Among the corporate governance attributes use to watch managers opportunistic tendencies is audit committee.

Audit committee generally consists of independent and non-independent members, where by combining their experience, judgment and expertise, hoping the company runs smoothly and is able to have good performance. In accordance with the provision of the Companies and Allied Matters Acts (CAMA) 2004 as amended, section 359 (6), the functions of audit committee are to review the audited and unaudited financial statements as well as other special investigation of the company in accordance with the legal requirement and agreed ethical practices and to ensure that the company maintains effective system of accounting and internal control as well as to review the scope and results of external auditors thereby reaffirming their objectivity. The critical role of Audit Committee is believed to be a means of improving economic efficiency and stakeholders' confidence in the corporations through financial standard compliance. To achieve this, audit committee should possess some certain attributes which include; the size of the committee, frequency of meetings, independence of the committee, and financial literacy (SEC, 2003). The weaknesses and shortcoming of internal control system as well as, the limitation of

external audit function are significantly addressed by the audit committee. This is because internal control and internal audit are less independent of the management, while external auditors' function is limited to the available information. Whereas, audit committees are independent to the management and have sufficient authority over the operations, documents and all other relevant records to perform their duties. It is believed that audit committee functions are expected to ascertain a true and fair view of the financial performance and position of the companies and also enhance the confidence of the investors, shareholders and other stakeholders. There are several studies conducted on audit committee effectiveness within and outside the country (Chtourou & Courteau, 2004; Yang & Krishnan, 2005; Piot & Janin, 2007; Kingsley, 2014; Soliman & Ragab, 2014; Chukwunedu & Ogochukwu, 2014; Ibrahim, Bello, & Kargi, 2015; Eyenubo, Mohammed, & Ali, 2017) and are proxied with audit committee size, audit committee meeting, audit committee independence and audit committee financial expertise. For the purpose of this study, the researcher intended to consider audit committee meeting attendance as an important variable to add up from the prior studies, therefore this study uses; audit committee independence, audit committee meeting and audit committee meeting attendance as variables of audit committee effectiveness.

The choice of industrial goods firms is as a result of the significant role play by the manufacturing sector in the development of every economy. The sector is expected to dominate, shape and define the core path of industrialization all over the world (Musa, Nura Dakata, Kamardin, 2017). The sector is reputed to be an important engine of growth, wealth creation, providing job opportunities and the threshold for sustainable development.



### **Objectives of the Study**

The study aims to examine the impact of audit committee attributes in monitoring the likelihood of financial distress of the listed industrial goods firms in Nigeria. The specific objectives are to:

- i. Investigate the impact of audit committee independence on financial distress of listed industrial goods firms in Nigeria.
- ii. Determine the effect of audit committee meeting on financial distress of listed industrial goods firms in Nigeria.
- iii. Ascertain the influence of audit committee meeting attendance on financial distress of listed industrial goods firms in Nigeria.

This study will benefit the Nigerian manufacturing sectors particularly the policy makers of industrial goods firms and aims to contribute to the existing literature for the potential researchers to build on. The remaining part of the paper will be as follows; section two literature reviews, section three methodology discussions while section four present and analyses the data and section five deals with conclusion and recommendations from the research findings.

### **LITERATURE REVIEW**

Corporate financial distress is an unclear term which can be grouped into four generic terms which are commonly used in business research; failure, insolvency, bankruptcy and default (Wang, 2006; Ross, Hillier, Westerfield, Jaffe, 2012). In addition, the default is usually described in two instances as either technical or legal. Default represent a signal of deteriorating firm performance and financial distress (Anjum, 2012). The likelihood of financial distress increases when risk shift to shareholder by agent. Moreover, Espenlaub & Garrett, (2008); Hertz, Li, Officer, & Rodgers, (2008) and Smith, Graves, &

Graves, (2007) see financial distress as it is a situation where a firm's operating cash flows is not sufficient to satisfy current obligations such as trade credit or interest expenses. In order to identify distresses, financial analyst and investors measure it using financial ratios to evaluate the companies. Most of the financial ratio can be calculated from financial statement to access the corporate financial performance or financial failure (R. B. R. Bukit & Iskandar, 2009; Gombola, Ho, & Huang, 2015; Kuo & Lin, 2014). Many questions come to the regulators' minds on how to monitor the likelihood of the financial difficulties of the corporations. As a result of this and some of the managers' opportunistic activities (Elloumi & Gueyie, 2001), the audit committee introduced to check the effectiveness of financial operations and performance of the firms. Without independent and effective control system, the management of a company is always tempted to deviate from protecting the shareholders' interests (Aldamen, Duncan, Kelly, Mcnamara, & Nagel, 2012; Brédart, 2014). Therefore, effective and efficient audit committees are needed to control the factors that lead to poor financial performance (Aanu, Odianonsen, & Foye, 2014; Chukwunedu & Ogochukwu, 2014; Ibrahim et al., 2015). Prior studies examine the relationships between good audit committee characteristics and audit quality, financial reporting quality, earnings management, company performance (Aanu et al., 2014; Chukwunedu & Ogochukwu, 2014; Eyenubo et al., 2017; Kingsley, 2014; Musa, Nura Dakata, Kamardin, 2017; Piot & Janin, 2007). Therefore, audit committee independence, audit committee meeting and audit committee meeting attendances are used to monitor financial distress in this study.

Audit committee comprises of executive and non-executive directors. The independency of the committee is based on



the high proportion of non-executive directors. The audit committee is considered independent when the domination of non-executive directors is considered. According to Ruiz-Barbadillo, Biedma-Lopez and Gomez-Aguilar (2007) executive members can impair the effectiveness of audit committee by influencing the decision making process of the board. High presence of executive directors limits the amount of information held by board members. More than one method was found to reduce this information's asymmetry. Thus, a large proportion of independent directors enhance management monitoring (Eyenubo et al., 2017), which evidently revealed that more independent audit committee has a high level of audit handling and seeking to preserve the independence of the external audit process (R. B. Bukit & Nasution, 2015; Soliman & Ragab, 2014). Therefore, the participation of non-executive members in large proportion improves the audit committee independence. According to Crişan & Fülöp, (2014) the enhancement of audit committee independence should facilitate decision and assure information objectivity. Because of this reason the audit committee should maintain the monitoring role delegated by the board with aim to provide better reliability of information. Independence non-executive directors are considered to be an important mechanism in ensuring corporate accountability of the firms (Miglani, 2014). Fully independent audit committee is associated to committee outcomes and expected to improve operational and financial activities of the companies. This clearly evidences that large proportion of independent members in audit committee ensures the effectiveness of strategic decision making of the management. In the same way, Uniamikogbo, Ayorinda & Babajida, (2014) observe that an audit committee should comprise a higher proportion of non-

executive directors and full-independent audit committee provides a better monitoring of management than the existence of executive members with objective decision. It is believed that presence of non-executive directors in audit committee reduces the likelihood of financial problem (Emeh & Appah, 2013). Hence, the presence of independent directors protects the best interests of shareholders. Independent audit committee protects companies' reputation by ensuring high quality of financial statement by reducing income increasing earnings practices (Bukit & Iskandar, 2009). Moreover, Miglani, (2014) finds that a negative association between the audit committee independence and the going concern of financially distressed companies. Soliman & Ragab, (2014) and Bukit & Nasution, (2015) suggest that audit committee independence address the likelihood of financial manipulation and enhance the financial reporting quality of the firms. In other words, the greater the proportion of affiliated directors on the audit committee, the lower the likelihood the auditor will issue a going concern reports. According to (Chtourou & Courteau, 2004), (Ibrahim et al., 2015) find positive association of audit committee with financial manipulation of the firms. This discussion leads to the development of (H01) is formulated as follows

**H01.** Audit committee independence has no significant influence on financial distress of listed industrial goods firms in Nigeria.

The establishment of an audit committee is meant to ensure continuous communication between external auditors, internal auditors and the board, where the committee meets regularly with the auditors to review the financial statements and audit processes as well as the internal accounting systems and controls (Emeh,



Yadirichukwu; Appah, 2013). The frequency of audit committee meeting is also one of the most extensively examined the activities of the management to ensure the reliability of financial reporting (E Uniamikogbo, B Ayorinda, 2014). The frequency of meetings indicates an active audit committee that devotes time to rectifying any immediate issues and offers a better review and oversight environment, which, in turn, may assist in detecting financial statements errors. Musa, Nura Dakata, Kamardin, (2017) agree that frequent meetings of audit committee check the likelihood of earnings manipulation and leads to the improvement of the financial accounting processes, which in turn discover the likelihood of financial distress. Extant literature in this aspect suggested that firms with the higher number of audit committee meetings experience less financial problems and have higher monitoring and control (Crişan & Fülöp, 2014; Ibrahim et al., 2015; Mohid Rahmat, Mohd Iskandar, & Mohd Saleh, 2009). According to this stream of literature, audit committees that meet regularly during the financial year are associated with effective monitoring system. The more frequent audit committees meet, the more efficient they discharge their oversight responsibilities (Kehinde & Osifo, 2017). The frequent meetings are likely to lead to higher performance, while Salloum, Azzi, & Gebrayel, (2014) and Aryan, (2015) highlight that, the quality of the meeting is significantly monitoring the likelihood of financial distress. A review of literature revealed no evident relationship between audit committee meeting and financial distress (Mohid Rahmat et al., 2009 & Aanu et al., 2014). While some studies revealed a positive relationship between the committee meeting and real activities manipulation (Yang & Krishnan, 2005 & Ibrahim et al., 2015), others found a

negative relationship such as; Uniamikogbo, Ayorinda, & Babajide, (2014); Musa, et al., (2017) and Soliman & Ragab, (2014). Due to this conflict, no conclusive evidence has been reached. Hence, the hypothesis two (H02) is formulated as follows.

**H02.** Audit committee meeting has no significant influence on financial distress of listed industrial goods firms in Nigeria.

There is believe that audit committee meetings show how serious the committee is and gives the committee chance to engage the external auditors, which can lead to lower default prediction (Emeh, Yadirichukwu; Appah, 2013). Many prior studies used absolute number of meetings to measure audit committee activity ( Wan Nordin & Noor Marini, 2009; Al-Matari, Al-Swidi, & Fadzil, 2014 & Kehinde,et al., 2017). However, sometimes the members do not attend the meetings regularly. When this happens, only few members are end up taking important decisions that can affect the whole company. Besides regular meetings, the level of attendance of audit committee members can also be used to measure the activeness of audit committee members of the firms. According to Wan Nordin, et al., (2009) even though the frequency of meeting is high but if the attendance levels are poor, it could impair the effectiveness of the audit committee. Musa, et al., (2017) note that audit committee that sits frequently but with different set of people due absenteeism could not be diligent. This posited that, the higher the level of attendance of audit committee members, the more active and participative the audit committee is, therefore the better is the quality of financial reporting. The argument is that whether absolute number of audit committee meeting guarantees its effectiveness in curbing financial distress of the firms. Most of the previous studies used number of meetings as a yardstick for



effective audit committee without considering the mode of the members attendance (Soliman & Ragab, 2014 & Sáenz González & García-Meca, 2014). In the real sense not all audit committee members attend meetings at all times, because of this, the Nigerian corporate governance Code 2011 mandates all public companies to disclose the number of meetings held during the year and the attendance of each director at the meetings, in order to encourage attendance during audit committee meeting. Therefore, this research aims to find out whether absenteeism by the audit committee members during meetings impedes the committee from mitigating financial default prediction of the firms under study. Thus, the following hypothesis is developed.

H03. Audit committee meeting attendance has no significant influence on financial distress of listed industrial goods firms in Nigeria.

## RESEARCH METHODOLOGY

This work is a correlational research that links proxies of audit committee effectiveness and financial distress. The study's population consists of all 24 industrial goods firms listed on the Nigerian Stock Exchange as at 31st December, 2017. To arrive at the sample size, attention was focused on firms that were listed on the NSE for the period of this study (2011 to 2016) and whose data for the study period is available. Therefore, 14 firms were selected to make 84 firm-year observations. A multiple regression model is structured using longitudinal panel data. The following regression model is use to captures the hypotheses of this study.

$$FID_{it} = \beta_0 + \beta_1ACID_{it} + \beta_2ACMT_{it} + \beta_3ACMAT_{it} + \beta_4ADQT_{it} + \mu_{it}$$

The variables used in the model are explained in the table 1.

**Table 1:** Variables Measurement

Acronyms	Variables	Measurement	sources
FID	Financial Distress	Atman's Z-score (1968); $Z = 0.012X1 + 0.014X2 + 0.033X3 + 0.006X4 + 0.999X5$ Where: Z = overall index; X1 = working capital/total assets; X2 = retained earnings/total assets; X3 = earnings before interest and taxes/total assets; X4 = market value of equity/total liabilities; X5 = sales/total assets	Farhana, Balkish, & Mohd, (2014); Khaliq, Hussein, Altarturi, Mohd, & Thaker, (2014); Waznah, Aima, & Mohd, (2015)
ACID	Audit Committee Independence	Total non-executive members of the audit committee to total members of audit committee	Ibrahim et al., (2015)
ACMT	Audit Committee Meetings	Measured in term of dummy variable coded 1 if meet at least four times in a year, 0 otherwise	(Choi, Jeon, & Park, (2004)



Acronyms	Variables	Measurement	sources
ACMAT	Audit Committee Meetings Attendance	Measured as proportion of attendance during audit committee meeting	Musa, et al., (2017)
ADQT	Audit Quality	Measured as natural log of audit fee	Bashir, & Mazadu, (2016)
$\beta_0$	Constant or Intercept		
$\beta_1 - \beta_4$	Coefficient of explanatory variables		
M	Error Term		
I	Firms		
T	Time		

Source: compiled by the author 2019.

## RESULT AND DISCUSSION

This section discusses the descriptive statistics, correlation matrix and summary of regression result.

**Table 2:** Summary of Descriptive Statistics

Variable	Observations	Min	Max	Mean	Std. deviation
FIDS	84	-.03	7.72	.685	1.106176
ACID	84	.26	6.47	1.31619	1.178711
ACMT	84	0	1	.5585238	.4994259
ACMAT	84	.32	1	.6638095	.144555
AFQT	84	9.66	19.07	15.0406	2.552252

Source: Output generated using stata13

Table 2 is the summary of descriptive statistics where the financial distress reveals that the average and standard deviation are 0.685 and 1.106176 respectively. The percentage of audit committee independence ranged from 0.26 to 6.47 with the average of 1.31619. The

audit committee meeting ranged from 0.00 to 1.00 with standard deviation of 0.4994259. Audit committee meeting attendance average is 0.6638095. The control variables of audit quality minimum and maximum ranged from 9.66 and 19.07 with averages of 15.0406.

**Tables 3:** Correlative Matrix

	FIDS	ACID	ACMT	ACMAT	AFQT
FIDS	1				
ACID	-0.21495	1			
ACMT	-0.1709	-0.1527	1		
ACMAT	-0.1449	-0.1359	-0.2185	1	
AFQT	0.0690	0.3062	0.2209	0.1241	1

Source: Output generated using stata13



Table 3 reveals that audit committee independence, audit committee meeting and audit committee meeting attendance, are negative and weak correlation with financial distress. This indicates that the higher of independence non-executive members in the audit committee, the less probability of financial distress. Also, frequent meeting of audit committee per annum and the rate of attendance of members in the meeting would help to check the likely financial irregularities which could cause financial difficulties. Meanwhile, the audit quality proxied with audit fee is positively

correlation with financial distress of listed industrial goods firms in Nigeria. The relationship among the independent variables of this study is weak.

Furthermore, the researcher uses the variance inflation factor (VIF) and tolerance values to avoid making wrong conclusions that could arise from multicollinearity. In table 4, the result indicates the absence of excessive correlation between pairs of independent variables as all factors and their respective tolerance values are below 1 and 10 respectively.

**Table 4:** Regression Result

Variable	Beta	z-value	p-value	Tolerance/VIF
Constant	1.223744	1.09	0.275	
ACID	-.3569266	-2.68	0.007	.797341/1.25
ACMT	-.722462	-2.85	0.004	.810335/1.23
ACMAT	-2.73414	-2.89	0.004	.858747/1.16
AFQT	.142708	2.03	0.042	.774927/1.29
<b>R<sup>2</sup> Overall</b>		<b>0.2195</b>		
<b>Wald Chi<sup>2</sup></b>		<b>16.74</b>		
<b>Wald-Significance</b>		<b>0.0022</b>		

Source: Output generated using stata13

Table 4 is the regression result of the study where the cumulative association of the audit committee effectiveness with financial distress of listed industrial goods firms were given by the value of Overall R<sup>2</sup> is 0.2195. This signifies that the overall relationship is up to 22%, indicating that the extent to which the explanatory variables (audit committee independence, audit committee meeting, and audit committee meeting attendance) and control variables (audit fee) influenced the dependent variable (financial distress) is 22%, this shows that audit committee effectiveness used in the study are able to predict financial distress of listed industrial goods firms in Nigeria; the remaining 78% is for

the other factors that do not capture in the model of this study. Thus, the Wald Chi<sup>2</sup> is 16.74 which is significant at 5% (P-value = 0.0022), this shows that the model is well fitted with the variables used in the study.

Considering the relationship between audit committee independence and financial distress of listed industrial goods firms in Nigeria, the result indicates negative relationship with the coefficient and z-value of -.3569266 and -2.68 respectively, which is significant at 1% level of significance. This indicates that audit committee independence is statistically, negatively, strongly and significantly influencing financial distress of listed industrial goods firms in Nigeria. Revealing





that, for every additional one independence member in the audit committee will reduce the probability of financial distress of listed industrial goods firms in Nigeria by 36%. The result indicates that, audit committee independence hinders the tendency of financial distress of the firms. This could be as a result of the rate of independence of the members of the committee to discharge their duties and responsibilities without intervention or influence of the management. Thus, the first hypothesis formulated; audit committee independence has no significant influence on financial distress of listed industrial goods firms in Nigeria is hereby rejected.

Moreover, audit committee meeting has beta value and z-value of  $-0.722462$  and  $-2.85$  respectively, which is statistically significant at 1% ( $p=0.004$ ) level of significance. This signifies that audit committee meeting is statistically, negatively, strongly and significantly impacting the financial distress of listed industrial goods firms in Nigeria. It indicates that for every increase in one committee meeting per annum, will lead to the 72% reduction of the probability of financial distress of the industrial goods firms. This is not surprising because it is expected that more audit committee meetings will help in tackling the financial issues that could lead to firms' difficulties. However, in reality when an audit committee holds a regular meeting, it addresses a number of financial issues that could lead to financial difficulties of the firms. Hence, based on the result the null hypothesis two (H2) is hereby rejected.

In an attempt to examine the relationship between audit committee meeting attendance and financial distress of listed industrial goods firms in Nigeria, the statistical result reveals a negative relation with the beta value of  $-2.73414$  and z-value of  $-2.89$  which is significant at 1% ( $p=0.004$ ). This indicates that audit committee meeting attendance is

statistically, negatively, strongly and significantly influencing financial distress of listed industrial goods firms in Nigeria. It implies that for every 1% additional effort of attending the meeting by all members of the audit committee, the probability of financial failure would be traced out. This is not surprising because it supports the prior expectation that, full attendance of the audit committee members would put collective efforts, ideas and experiences in place to bring out a lasting solution and blow the probability of financial distress. In order to test the hypothesis three (H3), the result provided the condition to reject null H3. Hence, the null H3 is rejected.

Furthermore, the relationship established between control variable (audit quality) and financial distress of listed industrial goods firms in Nigeria. The beta-value and z-value of audit fee are  $0.142708$  and  $2.03$  respectively, which is significant at 5%. Audit fee is positively and significantly correlated with financial distress. This implies that for every 5% increase of audit fee, will lead to 14% increase of the probability of financial difficulties of the industrial goods firms in Nigeria.

## CONCLUSION AND RECOMMENDATIONS

The study investigates the influence of audit committee effectiveness on financial distress of listed industrial goods firms in Nigeria. The result posited that audit committee effectiveness is explaining and predicting the financial distress of listed industrial goods firms in Nigeria. Hence, the committee members act in a manner that is consistent with the value maximization objectives of the firms. It has been statistically revealed that audit committee effectiveness has significant influence on financial distress of listed industrial goods firms in Nigeria. Based on the findings, it is therefore recommended that the shareholders, stakeholders and



other relevant policy makers of industrial goods firms should improve the activities of audit committee by adding more independence non-executive members this will give them power to discharge their duties in accordance with the provision of the law, increase the number of meetings per annum and ensures the full attendance character of the committee members in the meeting, because it will help in making collective and effective decision on the factors that can undermine the firms' financial performance.

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