

MODERATING EFFECT OF AUDIT COMMITTEE FINANCIAL LITERACY ON EARNINGS MANAGEMENT AND THE VALUE OF LISTED DEPOSIT MONEY BANKS IN NIGERIA

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Abstract

The study examined the moderating role of audit committee financial literacy on earnings management and the value of quoted Nigerian banks. Correlation research design was adopted to define the structure and strategy of the study, while the target population was quoted Nigerian deposit money banks as at 31st December, 2020. Out of the 19 banks 14 were purposively chosen based on their complete annual reports over the period of the study (2016-2020). Regression analysis was adopted in analyzing the collected data. Thus, the study found a positive and significant relationship between accrual earnings and returns on assets, and real earnings and returns on assets of the banks. However, audit committee financial literacy was found to negatively moderate earnings management and the value of the banks. This signifies that, the higher the audit committee members with financial literacy the lower the practice of earnings management among the banks. Therefore, the board of Nigerian quoted deposit money banks should increase the number of audit committee members with financial literacy skills. This can minimize the practice of earnings management by the managers, hence improve firm value.

Keyword: Audit committee financial literacy, Deposit money banks, Firm value, Nigeria

1. Introduction

The value of firm is very important to stakeholders given the current impact of COVID 19 pandemic on business operations globally. The pandemic has affected the strategies of many business, which increases business risk. However, for any business to remain competitive and sustainable, maximization of firm value is inevitable. Thus, financial reports gives an insight on how businesses value is generated (Olatunji & Juwan, 2020). Hence, the quality of this financial reports has been found by various scholars to be a major determinant of a quality of investment decisions making (Oudat et al., 2021). Therefore, financial report should be relevant and faithfully presented to enhance economic decision making of the investors.

However, since financial statement reflects the management competence, several managers do engage in accounting practices

such as earnings management, creative accounting, smoothing income, engineering accounting with the aim of portraying accounting information to users that are not necessarily the true and fair financial substance of the business. This results in business failures globally such as Enron, WorldCom, Pamalat, and Cadbury Plc. (Aguguom et al., 2019). In Nigerian context, the case is not different, as several studies such as Saidu et al. (2017) reported that; in 2013, the House of Representatives Committee on Finance confirmed sharp practices by banks including discrepancies in the data submitted and manipulation of financial information.

Looking at the corporate failures in Nigeria, corporate governance topped the highest discussion among many stakeholders, as its weaknesses was identified as the major caused of accounting and auditing scandals. In view of this, as other countries, in 2011

Nigeria established code of corporate governance to enhance monitoring and control of the activities of quoted business. Thus, the code provides that, each quoted business should establish a board of directors with the responsibility to ensure proper firm management and enhance shareholder value. Furthermore, the board is required to operate through committees, and one of those committees is audit committee.

The major responsibility of audit committee is to oversee management's process and to ensure proper and fair reporting system. However, this moderating role of audit committee has not being empirically investigated by previous studies in respect to earnings management and firm value. Furthermore, Oudat et al. (2021) argued that, the efficacy of the audit committee is determine by the qualities of the constituted members. This corroborated the provision of the Nigerian code of corporate governance that, members of the audit committee should at least have one member with basic financial literacy and should be able to read financial statements.

However, there is scarcity of empirical studies on earnings management and firm value, particularly in Nigeria. Moreover, the findings of previous studies on earnings management and firm value are contradictory and inconsistent. Studies such as Nasiri and Ramakrishnan (2020) and Gerio et al. (2021) reported a direct influence of earnings management on firm value, while Okafor and Ezeagba (2018) and Aguguom et al. (2019) reported an indirect influence of earnings management on financial performance. But, Cyril et al. (2020) found no significant influence of earnings management on firm value. Thus, the motivation of this study to adopt audit committee financial literacy and examined its interactive role on earnings management and firm value of quoted deposit money banks (DMBs) in Nigeria. As this study believes that, the extent of financial literacy of audit committee members would

significantly moderate the practice of earnings management, hence improve firm value of the banks. Thus, the formulation of research questions as follows:

- i. To what extent does earnings management affects financial value of quoted DMBs in Nigeria?
- ii. To what extent does audit committee financial literacy moderate the relationship between earnings management and the financial value of quoted DMBs in Nigeria?

To answer these research questions, the following research hypotheses were formulated to guide the study.

H₀₁: Earnings management has no significant influence on the financial value of quoted DMBs in Nigeria.

H₀₂: Audit committee members' financial literacy has no significant moderating effect on earnings management and financial value of quoted DMBs in Nigeria.

The novelty of this study lies in its contributions to knowledge as is the first study that adopted audit committee financial literacy and observed its interactive effect on earnings management and firm value. In respect to the beneficiaries, the study would benefit policy makers especially the Nigerian Stock Exchange, Central Bank of Nigeria, and the Securities and Exchange Commission on the level of compliance and the impact of the provisions of code of corporate governance on quoted deposit money banks in Nigeria. It would further enlighten the management of the banks on the influence of audit committee quality and its oversight function that would accordingly increase companies' value.

The remaining part of this study is structured into four sections. The review of relevant literatures were presented in Section 2, while Section 3 described the methodology adopted for the study. Then, Section 4 discusses the results of the

empirical analyses, while Section 5 presents conclusion and recommendations.

2. Literature Review

2.1 Firm Value

According to Afrizal et al. (2021), the concept of firm value is a presentation of certain circumstances that the business desires to attain as a form of public trust in the business for all activities carried out by the corporation. In this regards, Darmawan et al. (2019), were of the view that, firms' value is used by stockholders as a basis carrying out investment activities associated to stock prices because increasing enterprise value shows that the business has a good performance that improved the interest of stakeholders. Hence, Mohammed (2016) viewed firms' performance as the achievement of organizational objective. He further suggested that, the most commonly used measure of firms performance is financial performance.

Financial performance was defined by Hossan and Habib (2010), as the rate of success of the organizational mission measured in monetary terms. Most often, scholars used the word performance to denote the range of measurements of transactional efficiency. Hence, Thachappilly (2009) confirmed that profitability ratios indicates a business's general monetary efficiency. It measures the efficient utilization of firms' resources and control over its expenses to generate an acceptable rate of return.

2.2 Earnings Management

Schipper (1989) viewed the concept of earnings management as an intervention in financial reporting process by management, deliberately with an intension to achieve anticipated earnings. While, Healy and Wahlen (1999) stated that, earnings management arises when managers use judgment and choice of accounting policies in business reporting process. This means earnings management is achieve through exploiting accounting rules, principles, and

concepts that may result to favorable reporting of earnings. It is made possible as the result of management discretion over operational activities and accounting choices. Furthermore, researchers such as Umoren et al. (2018) and Utami et al. (2020), indicated that, management use techniques such as accrual management and real earning management to achieve their objectives. Therefore, this study used accrual earnings, and real earnings as an indicators of earnings management.

2.2.1 Accrual earnings management

Financial statements are prepared using accrual-based accounting system. The non-discretionary part of accrual are not subject to earnings management (Nwaobia et al., 2019), however, Omar et al. (2014) were of the view that, management adopts discretionary accrual to achieve their target of earnings management. This occurs as a result of management interest in the way companies account are prepared. Thus, in this study, discretionary accrual was considered and measured using modified Jones model.

2.2.2 Real Earnings Management

Ningsih (2017) viewed Real Earnings Management (REM) situation when management interest contradicts established accounting principles. Thus, Nwaobia et al. (2019) stated that, REM can be attained via three ways such as manipulation of cash flow, decrease of operational expenses and abnormal production cost. Real activities such as discretionary cost reduction is desired by managers rather than accrual manipulations as a way of managing earnings. Hence, management mostly use real earnings management because of its difficulties to be differentiated from optimal business decisions (Nhadab & Al-own, 2017).

2.3 Audit Committee Financial Literacy

CAMA (2004) defined audit committee (AUC) as a committee of stockholders and non-executive directors saddled with the obligation of liaising between the external

auditor and the board of directors on one hand, and between management and the external auditor on the other hand. All quoted business are obligatory under Section 359 (3) and (4) of the CAMA to form an audit committee. It is the duty of the board to make sure that the audit committee is established in the way specified and is able to effectively carry-out its legal responsibilities. Thus, Osarumwense and Aderemi (2016) were of the opinion that, the financial literacy of the committee is an important factor that might enhance audit committee function. This corroborated the provision of both Sarbanes-Oxley Act (2002) of UK and the Nigerian code of corporate governance in respect to audit committee qualities.

Furthermore, empirically, a number of studies have documented a positive and significant association between the extent of audit committee financial literacy and quality financial reporting. Dhahival et al. (2010) and Samuel (2012) reported a positive and significant relationship between audit committee financial literacy and financial reporting quality. Hence, Osarumwense and Aderemi (2016) concluded that, firms that have greater number of audit committee members with financial skills and expertise reports a high qualitative financial statement than its counterpart. Therefore, this study believes that, the extent of financial literacy of the audit committee members would significantly moderates the relationship between earnings management and firm value of quoted DMBs in Nigeria.

2.4 Empirical Review

Several empirical studies were conducted in respect to earnings management and business performance. However, the findings of these studies were contradictory and inconsistent, thus, inconclusive. Below are the review of some empirical studies.

Ibrahim et al. (2015) carried out an analyses of earnings management and sustainability reporting of sixteen (16) quoted companies

in Malaysia over a period of two (2) years (2011-2013). Analyzing the data collected using regression analysis, the study found a positive and significant relationship between discretionary accrual and returns on assets of the firms. This finding was confirmed by a study conducted by Mangala and Dhand (2019) on earnings management and financial performance of 152 IPO firms in India. The study also reported a direct relationship between accrual and ROA. Furthermore, Gerio et al. (2021) also reported a direct influence of earnings management on financial performance of quoted agricultural companies. The findings of these set of scholars implies that, the practice of earnings management would directly and significantly increases financial performance of firm.

However, Purbaningsih (2015) in a study on the analyses of earnings management and under performance of 14 quoted business in Indonesia over a period of two years (2012-2013) found a negative relationship between discretionary accrual and returns on assets of the business. This was corroborated by the finding of the study of Mostafa (2018) on the influence of firms' financial performance on earnings management of quoted firms in Egypt. The researcher reported an inverse relationship between discretionary accrual and cash flow from operational activities of the firms. Furthermore, Umoren et al. (2018) studied the effect of earnings management on financial performance of 10 deposit money banks in Nigeria for seven (7) years (2008-2015). Using linear regression analyses, the study found an inverse relationship between discretionary accrual and returns on assets of the banks. In the study of Huang et al. (2021) on the influence of earnings management on company's efficiency among 396 listed electronics firms in Taiwan, reported a negative effect of discretionary accrual on returns on assets of the firms.

Looking at the trend of the research findings on the effect of earnings management on

firms' value, the outcomes are contradictory and inconsistent, hence inconclusive. Therefore, there is a need to adopt a moderating or mediating variable to observe its interactive effect on earnings management and firms' value. Thus, the motivation of this study to adopt audit committee financial literacy to observe its interactive effect on the two variables.

Empirical studies have documented that, a qualitative and effective audit committee has a significant effect in enhancing financial reporting practices. In a study conducted by Osarumwense and Aderemi (2016) on the influence of audit committee financial literacy on financial reporting quality of 131 listed companies in Nigeria, reported a direct relationship of the variables. Thus, the study concluded that, firms with higher number of audit committee members with financial knowledge and expertise presents a higher financial reporting quality. This confirmed the result of the earlier study conducted by Ibrahim et al. (2015) which also reported an important role of audit committee accounting knowledge in minimizing earnings management practice in Nigeria. Therefore, this study believed that audit committee financial literacy would significantly reduce earnings management, hence improved value of quoted DMBs in Nigeria.

2.5 Theoretical Review

In the quest of understanding and explaining the concepts of earnings management and corporate governance, previous accounting and finance scholars have adopted several theories. However, this study adopts the postulates of agency theory which is under the positive accounting theory (PAT).

Positive accounting theory is an accounting theory that is used to explain accountants and managers behavior and its impact on the market. Hence, it is used in this study, to explain accountants and managers behavior in respect to the use of freedom of accounting estimates, judgment

and choice of principles and its effect on financial value. The freedom enjoyed by accountant might affects the preparation of financial statement, consequently present in-accurate firms' value that is not free from bias (Ibrahim et al., 2015).

Therefore, effective corporate governance mechanism such as audit committee, which is established to reduce agency cost is expected to control management behavior, hence improve corporate value. Several empirical studies are in support of active and effective monitoring mechanism such as audit committee, therefore, this study is of the view that the effectiveness of audit committee through financial literacy would significantly moderates the practice of earnings management, thus improve firm value.

3. Methodology

This study adopted correlation research design to define the structure and strategy of the study. The target population consist of all the registered DMBs in Nigerian as at 31st December, 2020, which were nineteen (19) in number. Out of the nineteen (19), fourteen (14) were chosen based on the complete and available required financial reports of the banks over the period of the study. The data collected for the period of five (5) years (2016-2020) were analyzed using both descriptive and inferential statistics.

Two models were developed to test the hypotheses of the study and were presented as follows.

Model 1 was developed to test hypothesis one, which positions that earnings management has no significant effect on firm value of registered deposit money banks in Nigeria. The variables used are earnings management (DEM & REM) as independent variable, firm value (ROA) as dependent variable, while firms characteristics (FMS, FLE) as control variable.

$$ROA_{it} = \beta_0 + \beta_1 DEM_{it} + \beta_2 REM_{it} + \beta_3 AFL_{it} + \beta_4 FMS_{it} + \beta_5 FLE_{it} + \mu_{it} \dots \dots \dots \text{Model 1}$$

Model 2 was developed to observe the moderating role of audit committee financial literacy (AFL) on the relationship between earnings management (DEM, REM) and firm value (ROA) of the banks.

$$ROA_{it} = \beta_0 + \beta_1 DEM_{it} + \beta_2 REM_{it} + \beta_3 AFL_{it} + \beta_4 DEM_{it} * AFL_{it} + \beta_5 DEM_{it} * AFL_{it} + \beta_6 FMS_{it} + \beta_7 FLE_{it} + \mu_{it} \dots \text{Model 2}$$

Accrual earnings management was measured by the Jones (1991) modified model. Thus, the expression of the model as follows:

$$\frac{T_{Ait}}{A_{it}} = \beta_0 (1/A_{it-1}) + \beta_1 \left[\frac{\Delta REV_t - \Delta REC_t}{A_{t-1}} \right] + \beta_2 \frac{PPE_t}{A_{t-1}} + \mu_{it} \dots \text{Model 3}$$

Where: TAC_{it} is total accruals; TA_{it} is lagged total assets; ΔREV_{it} is the change in revenues; ΔREC_{it} is the change in receivables; PPE_{it} is net property, plant, and equipment; μ_{it} is the residual.

While, real earnings management was measured using abnormal cash flow (Olatunji & Juwan, 2020). Therefore, the model is present as follows:

$$CFL_t/A_{t-1} = \beta_0 (1/A_{t-1}) + \beta_1 (CFL_t/A_{t-1}) + \beta_2 (\Delta CFL_t/A_{t-1}) + \mu_{it} \dots \text{Model 4}$$

Table 1 present study variables which gives information in respect to the measurement as used by the previous studies.

Table 1: Variables identification and measurement

SN	Label	Variable	Description	Expected outcome
1	ROA	Firms' value	Profit before tax (PBT) at the year-end divide by total assets	
2	DEM	Accrual earnings management	Discretionary earnings estimated by Modified Jones model	+
3	REM	Real earnings management	Residual value of abnormal operating cash flow	+
4	AFL	Audit committee financial literacy	Proportion of audit committee members with background in accounting and finance to total audit committee members	+
5	FMS	Firms size	Natural logarithms of total assets	+
6	FLE	Firms leverage	Debt to equity ratio	+

4. Results and Discussions

The results of all the statistical analyses conducted are presented under this section.

Both descriptive and inferential statistical tools were used, thus the results are presented as follows.

Table 2: Descriptive Statistics

Variables	Mean	Stand. Dev.	Minimum values	Maximum values
ROA	0.218	0.137	0.034	0.842
DEM	0.137	0.362	0.108	0.684
REM	0.237	0.048	0.082	0.804
AFL	0.318	0.182	0.001	0.531
FMS	0.128	0.201	0.043	0.613
FLE	0.031	0.015	0.004	0.712

Source: STATA 13 Descriptive Statistics Result (2021)

Table 2 contained descriptive statistics of accrual earnings (DEM), real earning management (REM), audit committee financial literacy (AFL) and return on assets (ROA) for the period 2016-2020, while firms size (FMS) and firm leverage (FLE) were used as control variable.

The descriptive statistics result revealed a mean value of 0.218 of ROA with a standard deviation of 0.137, while minimum and maximum values were 0.034 and 0.842 respectively. In respect to explanatory variables, the mean of DEM is 0.137, minimum value is 0.108, and standard deviation is 0.362, while maximum values was 0.684. REM mean is 0.237, standard deviation 0.048, minimum value 0.082 and maximum value 0.804.

0.318 was revealed as the mean value of AFL, standard deviation 0.182, minimum value 0.001 and maximum value 0.531. The descriptive statistics of the banks characteristics shows a mean value of 0.128 and 0.031 with standard deviations of 0.201 and 0.015 for FMS and FLE respectively. While the minimum values FMS and FLE were 0.043 and 0.004 respectively and maximum values of 0.613 and 0.712.

Given the results of the descriptive statistics which analyzed the properties and pattern of the data collected, Table 3 contained correlation analysis which was carried out using Pearson moment correlation to determine the correlation between the variables of the study.

Table 3: *Correlation matrix*

	ROA	DEM	REM	AFL	FMS	FLE
ROA	1					
DEM	0.532	1				
REM	0.614	-0.421	1			
AFL	0.492	-0.218	-0.491	1		
FMS	0.341	0.004	0.010	0.451	1	
FLE	0.218	0.100	0.218	0.302	0.007	1

Source: Correlation matrix-STATA 13 (Level of Significant @ 5%)

The result of the correlation analyses in Table 3 revealed a strong and positive correlation between accrual earnings management and returns on assets ($r=0.532$), and real earnings management and returns on assets ($r = 0.614$). However, a moderate correlation exist between audit committee financial literacy and returns on assets ($r = 0.492$), and audit committee financial literacy and firms size ($r = 0.451$). While the correlation between firm size and returns on assets ($r = 0.341$), and firm leverage and return on assets ($r = 0.218$) were found to be low.

However, in respect to the direction of correlation, the correlation between accrual earnings management and real earnings management, audit committee financial literacy and real earnings management, and

audit committee financial literacy and accrual earnings management were found to be negative, while others were found to be positively correlated.

Furthermore, there was no problem of multicollinearity among the variables of the study, since the highest correlation coefficient of 0.614 is the correlation between real earnings management and returns on assets is less than 0.800 critical level of multicollinearity problem (Hair et al., 2009).

In order to carry out regression analyses, a diagnostic tests in Table 4 were conducted using variance inflation factor, standard skewness, standard kurtoses, and Durbin Watson test statistics.

Table 4: *Result of VIF, Standard Skewness, Standard Kurtoses, and Durbin Watson test*

Variables	VIF	1/VIF	Std. Skewness	Std. Kurtoses
DEM	1.502	0.666	0.132	0.712
REM	3.721	0.269	0.292	0.505
AFL	2.319	0.431	0.309	0.612
FMS	4.101	0.244	0.421	0.813
FLE	2.141	0.467	0.264	0.752
Durbin Watson test = 1.791				
Chi ² - prob. = 0.000				

Source: STATA 13 Output (Level of Significant @ 5%)

The diagnostic result in Table 4 shows that, the data collected were normally distributed given all the values of standard Skewness and standard Kurtoses of the explanatory variables are less than ± 1.96 (Haniffa & Hudaib, 2006). Furthermore, the results of VIF and tolerance coefficient are not above the standards of 10 and 1 respectively, thus no multicollinearity case (Hair et al., 1995). In respect to the issue of auto correlation, the result of Durbin Watson test statistics of 1.791 is less than the standard value of 2,

thus no problem of autocorrelation among the variables of the study (Adefila, 2014). The value of Hausman model specification test of 0.000 is significant, thus, random effect was rejected for fixed effect.

Given that, the data collected were normally distributed, and there was no problem of autocorrelations and multicollinearity, the regression analyses were carried out and the result presented in Table 5.

Table 5: *Regression result*

Models Variables	Model 1		Model 2	
	Coefficient	p-value	Coefficient	p-value
Intercept	0.521	0.003	0.623	0.000
DEM	0.003	0.021	0.271	0.501
REM	0.108	0.030	0.231	0.732
AFL	0.223	0.019	0.431	0.000
FMS	0.010	0.017	0.212	0.015
FLE	0.213	0.015	0.211	0.000
DEM*AFL			-0.062	0.035
REM*AFL			-0.108	0.029
R ² = 0.542	Adj. R ² = 0.446		R ² = 0.650	Adj. R ² = 0.626

Source: STATA 13 Output (Level of Significant @ 5%)

The regression result in Table 5 model 1 revealed a coefficient of determination (R²) of 0.542 and adjusted R² of 0.446. This implies that, about 54.2% of the variation in return on assets of the banks could be explain by the explanatory variables included in model 1, while 45.8% could be explain by other factors. The p-value of intercept of 0.003 at 5% significant level, is

significant, thus model 1 is significant, hence has a good predictive power.

In respect to the direct consequence of earnings management indicators on returns on assets, the regression result in Table 5 model 1 indicates that, both discretionary earnings management and real earnings management have positive and significant influence on returns on assets of the banks.

Furthermore, audit committee financial literacy, firm size and firm leverage were also found to have positive direct effect on returns on assets of the banks.

However, introducing audit committee financial literacy as a moderator in model 2, provides a higher level of significance (0.000) than the direct relationship presented in model 1. It implies that, audit committee financial literacy has improve the explanatory power of model 2. The result of the regression analysis of model 2 further displays that, the interaction between audit committee financial literacy and discretionary accrual and audit committee financial literacy and real earnings management have negative coefficients with significant results ($r = -0.062$, $p = 0.035$; $r = -0.108$, $p = 0.029$ respectively). This implies that, banks with higher audit committee members with accounting and finance background have a negative practice of earnings management than its counterpart. Furthermore, the adjusted R^2 is 18.0% higher than the adjusted R^2 of model 1. This suggests that, the introduction of audit committee financial literacy as a moderator could better predict the performance of the banks. Therefore, audit committee financial literacy has significantly moderated the relationship between earnings management and firm value of DMBs.

5. Conclusion and Recommendations

This paper examined the moderating effect of audit committee financial literacy on earnings management and firm value of quoted DMBs in Nigeria. The result of the regression analysis shows a positive and significant influence of accrual earnings management, real earnings management on return on assets of the banks. Thus, earnings management has a positive and significant influence on firm value of the banks. However, observing the moderating role of audit committee financial literacy on earnings management and banks, the statistical result revealed an inverse relationship of earnings management and

firm value of the banks. Thus, this study concluded that, audit committee financial literacy minimizes the tendency of earnings management practices. Hence, audit committee financial literacy has significantly moderated the influence earnings management on firm value of the banks.

Therefore, the study recommended that: for the board of Nigerian deposit money banks to reduce the tendencies of earning management practices among managers; the board of directors should include higher number of members with accounting and finance knowledge when forming audit committee, since it was found to negatively reversed the effect of earnings management on firm value of the banks.

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