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The Effects of Audit Committee and Ownership Structure on Income Smoothening In Nigeria: A Study of Listed Banks

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Abstract

In recent times, financial statements which are known to show the economic state of an enterprise has lost its credibility and this has affected major companies especially banks in our economy today . In Nigeria, the economy faltered and the banking system experienced a crisis in 2009. The stock market collapsed by 70% in 2008-2009 and many Nigerian banks had to be rescued. This therefore brings about the question why income smoothening if there exists good corporate governance in the sector. This study examined if corporate governance proxies (Audit committee and ownership structure) influences the level of income smoothening among Nigerian Banks. To show this, the study employed the use of financial statements to gather relevant information needed for the analysis and was analyzed with the use of a regression analysis to test the hypotheses. The study therefore revealed that both independent variables influence the level of income smoothening, although not significant with audit committee. The study therefore recommends that there should be a fixed percentage of ownership for the directors. Also the Central Bank of Nigeria should de-emphasize the arbitrary application of codes and standards by banks and focus on introducing the use of penalties and/or enforcing existing ones more strictly. It is only when codes and standards have the capacity to serve as deterrents that they would become effective or increases their effectiveness.

Keywords: Corporate Governance, Income Smoothening, Banks and Nigeria

1 Introduction

In recent times the going concern of many nation's organisations has become uncertain, especially in the major sectors of the economy and as a result has become an issue that concern both the government and the entire citizens (Hope and Hope 1996). The big question is why is this happening when the financial statements are expected to inform the stakeholders on the present financial state of the organisation and also determine whether or not the organisation is a going concern? Financial statements are prepared to disclose the present state of a company and serves as a major way of determining if the firm is a going concern. However, income smoothening, which is a form of creative accounting that involves the manipulation of company's financial statements to show steady annual profits rather than large fluctuations, is sometimes used by the accountant whom by the will of authorities smoothen their earnings. Income smoothing relies not on falsehoods and distortions but on the wide leeway existing in alternatively accepted accounting principles and their interpretations. This implies that it is conducted within the structure of GAAP (Levit, 1999). In effect, it redistributes income statement credits and charges among periods. The prime objective is to moderate income variability over the years by shifting income from good years to bad years. Future income may be shifted to the present year or vice versa. In a similar vein, income variability can be modified by shifting expenses or losses from period to period. An example is the reduction in the current year to improve current period earnings. In the next year, the discretionary cost will be increased. Hence a need has been assessed in the result of which concept of appropriate corporate governance emerged.

The issue of income smoothening cannot be effectively discussed without putting into consideration the issue of corporate governance. This is because effective corporate governance enhances fairness in the disclosed financial statement. Therefore, corporate governance can be defined as a set of processes, policies, customs, laws and institutions affecting the way a corporation is directed, administered or controlled (Ashari, Koh, Tan, and Wong, 1994). It includes the relationships among the many stakeholders involved and the goals for which the corporation is governed. According to Arun and Turner (2002) a narrow view of corporate governance was explained as those oversight activities undertaken by the board of directors and audit committee to ensure the integrity of the financial reporting process which therefore, restricted it to only monitoring activities which may potentially undervalue the role that corporate governance can play. The principal stakeholders of an organization are the shareholders, management and the board of directors. Other stakeholders include employees, suppliers, customers, banks and other lenders, regulators, the environment and the community at large. Corporate governance is an internal system encompassing policies, processes and people, which serve the need of shareholders and other stakeholders, by directing and controlling management activities with good business savvy, objectivity and integrity (Unegbu, 2004).
One of the most important functions that corporate governance can play is in ensuring the quality of the financial reporting process. Levitt (1999) stated that the link between banks' directors and the financial reporting system has never been more crucial. Corporate governance has received increasing emphasis both in practice and in academic research (e.g. Beasley 1996; Rezaee, 2007, Oyebode, 2009; Olatunji, 2010; Uadiale, 2010) which was as a result of prevalence of highly publicized financial reporting frauds around the world. Furthermore, these academic researchers have found inconclusive association between weaknesses in governance and poor financial reporting quality; income smoothening and weaker internal controls. Due to all these factors, there has been an increasing need to improve corporate governance over the financial reporting process such as enacting reforms to improve the effectiveness of the audit committee and also to make the board of directors and management more accountable for ensuring the integrity of the financial reports as well as expanding research on corporate governance. It is against these backdrops that this study attempts to determine if there exist a significant relationship between corporate governance variables (audit structure and ownership structure) and income smoothening. Apart from the introduction part, which constitute section one of this paper, the paper is divided into three other sections. While section two covers the literature review, previous empirical studies; section three covers the methodology and the result of empirical analysis. Finally, section four includes the discussion of findings, conclusion and recommendations.

1.2 Scope of the Study

This study cuts across listed banks in the Nigerian stock exchange. These banks are studied to give a detailed knowledge on the level of corporate governance and its effect on income smoothening in the various banks in Nigeria. The period studied is between 2004 and2009.

1.3 Research Hypotheses

The hypotheses to be tested in this study are stated below in their null form:

Hypothesis 1:
H_0: There is no significant relationship between the proportion of non-executive directors in the audit committee and income smoothening

Hypothesis 2:
H_0: There is no significant relationship between the ownership structure of an organisation and the level of income smoothening

2 Literature Review

2.1 Corporate Governance Defined

The business world has described the term corporate governance in different ways and people have viewed it in different perspectives. Some authors define corporate governance from a regulatory perspective as "the system of laws, rules, and factors that control operations at a company". Others define it from the point of view of corporate governance participants and the related constraints. According to Rezaee (2007), corporate governance is a legal concept used to describe corporate oversight accountability and the balance of power that exists among shareholders, management and directors. Cadbury Committee (1992) also defined corporate governance as the system by which companies are directed and controlled. According to Shleifer and Vishny cited in Olatunji (2010: 2) Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment". This definition can be expanded to define corporate governance as being concerned with the resolution of collective action problems among dispersed investors and the reconciliation of conflicts of interest between various corporate claimholders. Corporate governance can also be defined in the context of the agency theory, as a process designed to align interests of management (agent) with those of shareholders (principals), and to hold management accountable to the company's equity owners (Rezaee, 2007).

According to Unegbu (2004), "Corporate governance refers to the processes and structures by which the business and affairs of an institution are directed and managed, in order to improve long-term shareholder value by enhancing corporate performance and accountability, while taking into account, interest of other stakeholders. Furthermore, Sanda, Mikailu and Garba (2005) pointed out that, "Corporate governance implies that a company would manage its affairs with diligence, transparency, responsibility and accountability and would maximise shareholders' wealth".

From the above definitions, we therefore define corporate governance as a way of ensuring transparency and accountability within an organisation as well as maintaining effective channel of information disclosure that will foster good corporate performance.

2.2 The Importance of Good Corporate Governance for Banks

The Banker's Committee under the leadership of the CBN set up two sub-committees; the Sub-Committee on Corporate Governance for Banks and Other Financial Institutions in Nigeria, and the Sub-Committee on Ethics and Professionalism. The Code of Corporate Governance for Banks and Other Financial Institutions in Nigeria is an addition to the Peterside Committee on Corporate Governance in Public Companies, which incorporates a code of Best Practices and it has now been codified. The Code emphasizes the need for best corporate governance practices in Nigeria as well as to help in restoring the confidence of the banking public in Nigerian banks. The report of the Sub-Committee on Ethics and Professionalism in addition to other functions addressed the issue of improving the image of banks and bankers in Nigeria. The report stated that the reputation of a banker has some direct correlation with the image of the bank. The image of banks and the reputation of bankers appeared to have suffered 'some' decline in Nigeria in the last fifteen years. As a result of this, banks have faced sharp criticisms from virtually every sector of the Nigerian economy. These criticisms have ranged from those accusing banks of making huge profits in an economy where other sectors were closing shops, to that which accuses them of milking the economy dry without growing it. Banks are also accused of making frivolous charges on the accounts of their customers (Unegbu, 2004).

A vibrant banking sector should ordinarily nurture an equally vibrant real sector. This will lead to enhanced capacity utilization which will boost employment and promote growth in the economy.

2.3 Income Smoothing: Motivations and Effects

Although creative accounting is not against the law, in the hands of less a scrupulous management, it can be a highly dangerous instrument of deception (Naser, 1993). The users of financial statements can be misled when making decisions based on manipulated accounting numbers. To a certain extent, the existence of creative accounting distorts the usefulness of financial statements. Income smoothing represents managers' attempts to use their reporting discretion to ''intentionally dampen the fluctuations of their firms' earnings realizations'' (Beidleman 1973). Although income smoothing has been widely documented for decades, its effect on earning information is largely unknown. On one hand, income smoothing improves earnings information if managers use their discretion to communicate their assessment of future earnings. On the other hand, income smoothing makes earnings noisier if managers intentionally distort the earnings number. Gordon (1964) predicts that as long as managers have discretion over accounting choices, they smooth reported income and the rate of growth in income. His prediction was tested in several studies. By the late 1970s, evidence for income smoothing was in abundance (Beidleman 1973; Ronen and

Sadan, 1981). In a recent study, Graham (2005) report an overwhelming 96.9% of the survey respondents indicate that they prefer a smooth earnings path. Recent research has enriched our understanding of managers' use of their reporting discretion, categorizing it as either (1) garbling or (2) efficient communication of private information (Arya, Glover and Sunder, 1998). The contracting theory argues that income garbling is an equilibrium solution because the principal would otherwise pay a high premium to compensate the agent, who has the information advantage, for taking additional risk (Demski and Frimor, 1999). In these circumstances, even if the contract is efficient, the communication has been garbled and thus the reported earnings are less informative about a firm's future earnings and cash flows.

In contrast, other studies view income smoothing as a vehicle for managers to reveal their private information about future earnings (Ronen and Sadan 1981; Sankar and Demski 1998). Such communication could be either active or passive. For example, Kirschenheiter and Melumad (2002) show that reported earnings have dual roles. The level of reported earnings allows investors to infer the level of permanent future cash flows. The fluctuations of reported earnings reduce investors' confidence in the inferred permanent component. The dual roles cause managers to smooth earnings. Using Spence's (1973) signaling framework, Ronen and Sadan (1981) argue that only firms with good future prospects smooth earnings because borrowing from the future could be disastrous to a poorly performing firm when the problem explodes in the near term.

3 Methodology

The population used is made up of all listed banks in the Nigerian stock exchange. The research utilized a sample size of 17 banks listed in the Nigerian stock exchange covering a time frame of six years (2004-2009). During this period, the financial statements of the banks were checked to determine whether or not income smoothening exist in the financial statement of each bank. In analyzing the data collected during the course of this research work, the Ordinary Least Square (OLS) regression technique was used to analyze the data through a computer econometric software package (E views). The Pearson's Moment Product correlation was also applied to test relationship between variables. These hypotheses were tested at 1%, 5% and 10% level of significance.

3.1 Model Specification

To enhance the examination of the relationship between corporate governance and income smoothening in the banking sector, a linear regression model equation was used. The two constructs involved in this study are corporate governance and income smoothening. The regression equation is as computed below:

Equation 1 can be defined as:

$$IS = f\,(CG) + c\mu \qquad (1)$$

Therefore representing equation with the variables of the construct, hence the equation is formulated with inclusion of a control variable (size of the firm). This is to enhance a better predictability and analysis of the level of relationship between the two constructs (corporate governance and income smoothening). Therefore the equation becomes;

$$IS = f\,(\text{Audit committee; Ownership structure}) + \text{Size} \qquad (2)$$

Therefore the Regression Equation is:

$$IS = (\beta_0 + \beta_1 AC_{i\text{-}t} + \beta_2 OS_{1\text{-}t} + \beta_3 SIZE \qquad (3)$$

Where:

IS=Income smoothing is an active manipulation of earnings toward a predetermined target, which is one form of earnings management. We measure income smoothing by the negative correlation between the change in discretionary-accruals proxy (ΔDAP) and the change in pre-discretionary income (ΔPDI) i.e. the total accruals in the Fiscal Year obtained by subtracting operating cash flows from net income before extraordinary items and discontinued operations (Myers and Skinner, 2002).

AC = The total number of non-executive directors on the audit committee divided by the total number of the audit committee members

OS = The number of shares held by the directors divided by the total number of shares

SIZE = Control variable measured as Natural log of total assets

B = Coefficient of parameter
$_{it}$ = Time coefficient this is the time frame been considered in the study
μ = Error term

A priori specification: The expectations for the co-efficient of the model: $\beta_1>0$, $\beta_2>0$.
Therefore, we expect a positive relationship between ownership structure and audit committee with income smoothening.

4 Presentation of Results and Analysis

Table 1: Descriptive Analysis

	IS	AC	OS	LNTA
Mean	3.20E-15	0.443039	0.105455	17.46978
Median	0.193191	0.5	0.065201	18.49882
Maximum	5.541833	0.57	0.736303	21.30427
Minimum	-7.04474	0	0.002904	11.17622
Std. Dev.	2.703436	0.111353	0.125563	2.747082
Observations	102	102	102	102

(Computed by researcher, 2011)

The results from the (IS) shows that the highest score achieved by the banks is 5.54% and the lowest score is -7.0% with a standard deviation of 2.70%. The statistics on the percentage of audit committee indicates a mean of 44.3% with a maximum and a minimum of 57% and 0% respectively. This indicates that the sampled banks, had 44.3% of the audit committee made up of directors while the remaining 55.7% was made up of the shareholders.
Ownership structure (OS) which is the percentage of board members who own shares in the company had a mean of 10.5% with a maximum and a minimum of 73.6% and 0.0029% respectively. The result also shows that firm size (the log of total asset) has a mean of about 17.5% with a maximum and a minimum of 21.3% and 11.1% respectively.

Table 2 Correlation Matrix

	IS	AC	LNTA	OS
IS	1	0.02414	0.287015**	0.260226**
AC		1	0.220559	-0.24045
LNTA			1	0.158081
OS				1

(Computed by researcher, 2011)

The analysis indicates that the correlation coefficient of number of non-executive directors on the audit committee (0.24045), ownership structure (0.260226) and total assets (0.287015) have positive effects on income smoothening. After this data has been tested, it was realised that there is no high correlation among variables used as independent variables.

Table 3: Ordinary Least Square Regression Analysis (OLS)

Variable	Coefficient	Prob.
AC	0.8213	(0.7415)
OS	4.7314	(0.0316)**
LNTA	0.2074	(0.0453)**
R-squared	0.158	
Adjusted R-squared	0.1117	
F-statistic	3.4147	
Prob (F-statistic)	0.0747	
Durbin-Watson stat	5.4147	

Note: *, ** and *** denotes significance at 1%, 5% and 10% respectively
(Computed by researcher, 2011)

Table 3 reports the result of the multiple regression analysis in the study based on ordinary least square. The table shows the association between the dependent variable (IS) and the experimental variables (AC and OS) as well as the control variable (LNTA). The co-efficient of coordination (R- squared), adjusted R- squared, and F- statistics for the regression model and summarized result of the dependent variables (IS) on the explanatory variables can be seen in the table.

The results indicate an R-squared of 0.158 and the adjusted R-square of 11.1%. Both of these suggests that a significant percentage of the variation in dependent variable (IS) can be explained by the variation in the whole set of independent variables. Also, an F value of 3.4147 (sig.0.0747), which is significant at 0.10% was recorded. This further confirms that the model is not bias.

The percentage of independent non-executive directors on audit committee has a positive coefficient of (0.821) and statistically insignificant at 0.7415 level. The result thus suggests that banks with a higher proportion of non-executive directors on the committee tend to have a positive influence on their bank. This is in agreement with Pearce and Zahra (1992). Since this relationship is not significant and is in line with the null hypothesis, we therefore accept our null hypothesis. However, ownership structure is a significant explanatory variable in the regression model for which the coefficient is positive (4.7314) and statistically significant at 0.0316 level. The result thus suggests that ownership structure of bank has a positive influence on the level of income smoothening. From this result, we therefore reject the null hypothesis. This is in line with Moses (1987). This implies that as directors' percentage of ownership increases, the ownership structure of a firm changes from one which is manager-controlled to one that is manager/owner-controlled. Thus, as managerial ownership increases, there is a corresponding increase in the manager's discretionary ability to modify the revenue generating process through the use of accounting policy choice and this is hazardous to firm performance (Chen and Kao, 2005). Furthermore, the control variable (LNTA) also recorded a significant positive relationship.

4.1 Conclusion and Recommendations

This study therefore conclude that a significant percentage of the variation in dependent variables (IS) can be explained by the variations in the independent variables (AC and OS) which suggests that corporate governance proxies under study positively affect the level of income smoothening. Also, that the total number of shares held by the directors of the banks goes a long way to influence manager's discretionary ability to modify the revenue generating process through the use of accounting policy choice and this is risky to bank financial performance.

The paper therefore recommend that since it is observed that as managerial ownership increases, there is a corresponding increase in the manager's discretionary ability to modify the revenue generating process through the use of accounting policy, it is therefore advisable that the percentage of ownership left for the directors should be reduced to a particular rate. Finally, the Central Bank of Nigeria as regards the regulation of banking ethics should de-emphasize the arbitrary application of codes and standards by banks, introducing the use of penalties and/or enforcing existing ones more strictly. It is only when codes and standards have the capacity to serve as deterrents, that they would become effective or increases their effectiveness.

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