



## EFFECTS OF AUDIT COMMITTEE ACTIVITY ON EARNINGS QUALITY OF LISTED NIGERIAN FIRMS USING INFORMATION AND COMMUNICATIONS TECHNOLOGY (ICT)

<sup>1</sup>Abdulwahab, U. M., <sup>2</sup>Aliyu, B. and <sup>1</sup>Isah, S.

<sup>1</sup>Department of Accounting, Ahmadu Bello University, Zaria, Kaduna State, Nigeria

<sup>2</sup>Department of Accounting and Finance, Faculty of Management Sciences, Abubakar Tafawa Balewa University, PMB 0248, Bauchi, Nigeria

**Corresponding Authors' E-mail** bintaaliyu9@gmail.com **Tel.:** 07035103885

### ABSTRACT

The study was conducted to examine the effects of audit committee activity on earnings quality with particular focus on the listed ICT firms in Nigeria. The secondary sources of data were employed and the panel data collected was analysed using multiple regression model. The findings revealed that the some of the variables of the audit committee activity have significant and positive association with earnings quality for the selected listed firms. The study recommends that the regulatory authorities like Nigerian stock exchange (NSE) and security and exchange commission (SEC) should consider encouraging ICT firms to have in addition to the three non-executive directors in their audit committee at least one independent director. This will further improve the financial reporting quality of ICT firms in Nigeria as revealed by this study, among others.

**Keywords:** Audit Committee Activity, Audit Committee Diligence, Audit Committee Independence, Audit Committee Size, Earnings Quality.

### INTRODUCTION

The quality of earnings is intrinsically linked to the quality of audit committee effectiveness, which as a proxy for good corporate governance (Sloan, 2001). Earnings provide information, among other aspects, concerning executives' performance that is needed by most corporate governance mechanisms to effectively operate in addressing agency problems (Bushman & Smith, 2001; and Sloan, 2001). Previous studies have shown that the board of directors and its structure and composition, as well as that of its committees, affect the quality of earnings, indicating that effective audit committee practices benefit shareholders (Vafeas, 2000; Xie *et al.*, 2003; Trapp, 2009). In addition, the efforts to grasp the function of the audit committee, an advisory body of the board of directors directly responsible for the supervision of accounting processes have also increased.

Audit committee as a concept is based on the goals, functions and responsibilities given to committee members. According to Al-Thunebat (2006) audit committee is the committee that is composed of non-executive directors in the establishment. This vital committee has therefore, remained a very substantial institution that helps the managers to enrich the clarity and decency of quality of earnings. Specifically, resourceful committee ought to enrich the quality of economic disclosure by performing multitudinous duties such as making remarks, giving approval on accounting principles, evaluating the financial statement and ensuring that the internal control mechanisms are sustained (Klein, 2002). This resourcefulness of the audit committee serves as a motivation for this study.

The financial scandals over the years ranging from Enron scandal, WorldCom, amongst others despite the presence of audit committees have raised worrisome situation. Also, there



have been several cases of manipulation of financial statements which suggest that the mere presence of an audit committee is not sufficient enough to mitigate the tendencies for financial statement manipulation by management. Consequently, the concern and emphasis in recent times has not just been about the formation of audit committees but on the operations of the audit committees in improving stakeholder's confidence in financial statements especially in the light of the financial scandals (Ayamere & Elijah, 2015). In this regards, several studies including Klein (2002) have recommended that a number of characteristics are important for an audit committee to carry out its operations effectively. These characteristics include: the overall independence and expertise of the audit committee; the level of its activity and its size, amongst others. It is in the light of the above that this study seeks to examine the effects of audit committee activity on earnings quality of listed ICT firms in Nigeria.

The study examined the effects of audit committee activity on earnings quality of listed ICT firms in Nigeria with the specific objectives of to: examine the effect of audit committee size on earnings quality of listed ICT firms in Nigeria; determine the impact of audit committee independence on earnings quality of listed ICT firms in Nigeria; and ascertain the influence of audit committee diligence on earnings quality of listed ICT firms in Nigeria. The study provided answers to the following research questions. What is the influence of audit committee size on earnings quality of listed ICT firms in Nigeria? Does audit committee independence have impact on earnings quality of listed ICT firms in Nigeria; and what is the influence of audit committee diligence on earnings quality of listed ICT firms in Nigeria?

The study tested the validity or otherwise of the following hypotheses stated in null hypotheses viz; H<sub>01</sub>: Audit committee size has no significant effect on earnings quality of listed ICT firms in Nigeria. H<sub>02</sub>: Audit committee independence has no significant impact on earnings quality of listed ICT firms in Nigeria; and H<sub>03</sub>: Audit committee diligence has no significant influence on earnings quality of listed ICT firms in Nigeria.

The significance of the study rested on its expected practical implications. On the practical implication, the study produced reliable empirical evidence that would encourage Nigerian firms to be attuned with the global paradigm shift from tangible resources and with audit committee size. It was anticipated that this would enhance the competitive states of Nigerian firms in the global market where auditing has been made compulsory for corporate entities. The study could also be beneficial in providing corporate management useful insight as they would seek to take advantage of corporate reporting in increasing their productivity, profitability, investment and business growth.

The scope of the study was on the effects of audit committee activity on earnings quality of listed Information and Communication Technology (ICT) firms in Nigeria. The choice of this industry is based on the fact that despite the avalanche of studies in this area little or nothing has been said about the efficiency and effectiveness of audit committee activity in this industry. However, the study covers five (5) years period spanning from the year 2012 to 2016. The study relied on annual accounts and reports obtained from the websites of ICT firms in Nigeria for the data used in testing the research hypotheses. It was not possible to visit the ICT firms to obtain the hard copy version of the annual accounts and reports, to authenticate the internet versions. This could act as a hindrance to the generalization of the results of this study.

Audit committee refers to a working group chosen by a firm as a linkage between the managers and the outside assessors. The committee as a subcommittee of the governing body specializes in the provision of accurate and reliable financial statements. It may also be defined as an advisory body of the board of directors consisting, preferably, of independent board members. It assures to the board of directors the control over earnings quality and internal



controls, and it is regarded as an essential mechanism in corporate governance (Trapp, 2009). The independence of an audit committee is considered a vital characteristic influencing the committee's efficiency in managing the process of financial statements (Baxter & Cotter, 2009). The independence of an audit committee can serve as active to control the financial reporting. Therefore, audit committee independence has been found to be significantly associated with measures of earnings quality in prior studies (Baxter & Cotter, 2009). On the other hand, Nimer *et al.* (2012) documented that, the results of the multiple regressions indicated that there is no significant relationship between audit committees' effectiveness factors and dividend pay-out policies in listed Jordanian firms.

Financial expertise improves the effectiveness of audit committees. The expertise of the audit committee is generally considered an important characteristic for its effective operation (Baxter & Cotter, 2009). According to Lisic *et al.* (2011), they found negative association between audit committee financial expertise and incidence of restatements is moderated by CEO power. Thus, they suggest that having a financial expert on the audit committee does not automatically translate into more effective monitoring. Rather, the substantive monitoring effectiveness of audit committee financial expertise is contingent on the power of the top management. On the other hand, some inconsistencies exist between the results of these studies that failed to find an association between the magnitude of earnings management and the audit committee's financial expertise (Baxter & Cotter, 2009). Thus, the audit committee expertise should be taken into consideration to determine whether this variable impact the performance either positively or negatively.

The level of activity of an audit committee has been recommended as important to enhance its effectiveness in improving earnings quality (Baxter & Cotter, 2009). In addition, the size of an audit committee can have a positive impact on earnings quality. Larger audit committees can be more effective as they are likely to include members with varied expertise to perform more intense monitoring of financial reporting practices (Baxter & Cotter, 2009). While audit committee size, independence and expertise are the primary inputs to audit committee effectiveness, the audit committee is not effective if the committee lacks diligence in its oversight process (DeZoort *et al.* 2002). The most common proxy for audit committee diligence used in previous research is the frequency of audit committee meetings (DeZoort *et al.*, 2002; and Abbott *et al.* 2004).

Investors' concerns with earnings quality increased during the last decade after many international companies announced non-authentic and temporary earnings as part of their quarterly reports. Thus, investors became more cautious in considering net earnings. Ohlson & Feltham (1995) and Qaraqish (2009) define earnings quality as the investor's ability to predict future abnormal earnings depending on recent data. Many of the definitions of earnings quality revolve around the two previous ones. Earnings quality is the ability of the present earnings to provide a real picture about the company and its ability to survive in the future. The significance of earnings quality stems from the earnings on which many parties depend when they take their decision.

Balhaj (2006) believes that earnings quality is considered an important factor in the financial statement and is used as guidance to decision making. Depending on earnings of low quality leads to an inappropriate management of fortune (Schipper & Vincent, 2003). Understanding earnings quality plays an important role in the process of financial analysis; earnings of high quality help financial analysts in analysing three basic sides of information. These are the present functional performance of the company, future functional performance, and value of the company (Dechow & Schrand, 2004). In addition, earnings quality might be



used as an indicator of dividends. Farinha (2007) ascertains that there is a relationship between earnings quality and dividends: the possibility of dividends by companies increases as the quality itself improves, and the amount of such dividends also increases. There are different views regarding the concept of earnings quality: while some use earnings continuity as a standard of its quality as explained by Altamuro & Beatty (2006), the continuity of earnings refers to the relationship between the present earnings with the future ones. Different styles for measuring earnings quality led to different evaluations, where the same company might be given a higher or lower quality level according to the earnings quality form adopted (Abdelghany, 2005).

Beasley *et al.* (2000) investigated whether the number of AC meetings has an impact on the possibility of having fraud financial reports in the health-care and the technology businesses. The results of their study indicate that there was a negative relationship between the number of meetings and the likelihood of fraud. Abbot & Parker (2002) examines audit committee characteristics and financial reporting misstatement. The study addresses the impact of certain audit committee characteristics identified by BRC on improving the effectiveness of corporate audit committee on the likelihood of financial misstatements. The study finds that an audit committee that lacks a member with financial expertise is significantly associated with financial misstatement. Also find that, an audit committee that comprised entirely of independent directors and meets at least 4 times per year exhibit significant negative association with the occurrence of financial reporting restatement.

Xie *et al.* (2003) and Bedard *et al.* (2004) find no significant association between AC size, measured by the number of directors on the committee, and earnings management. Noland *et al.* (2004) analysed the value that audit committees added to small commercial banks. The authors were able to evaluate specific internal control questions that assessed the benefit of having an audit committee. The findings of this study indicates that institutions with audit committees report more internal controls in place on most questions than institutions without audit committees. The most important finding of this study is that institutions with audit committee members who had banking or financial experience reported significantly more effective internal controls than institutions without this expertise on their audit committee. Karamanou & Vafeas (2005) researched the relation between corporate board, the characteristics of the AC and the accuracy of management earnings forecasts. They found that board independence and committee expertise are positively related, whereas board and AC sizes are negatively related to the market reaction to a forecast. Also, Lin *et al.* (2006) found that AC size is negatively related to earnings quality, implying that a certain minimum number of AC members may be relevant to the quality of earnings.

Felo *et al.* (2003) examined the relation between audit committee characteristics and earnings quality: expertise; independence and size of the audit committee on the earnings quality. The study finds that earnings quality is predictably related to audit committee characteristics. Audit committee with financial expertise in accounting or financial management is positively related to financial reporting quality. The study also documents that audit committee independence is not related to financial reporting quality, while, the study finds a positive relation between audit committee size and financial reporting quality.

Bradbury *et al.* (2006) examined board characteristics, audit committee characteristics and abnormal accruals in New Zealand and examine the relation between accounting quality measured by abnormal accruals and audit committee characteristics, the study finds that audit committee independence are related to high quality financial reporting.



Baxter and Cotter (2009) studied the impact of the presence of audit committees on earnings management in the American context where they focused mainly on studying the characteristics of these committees. They found that the financial expertise of the members of the audit committee reduces earnings management significantly and reduce earnings quality. Ghosh *et al.* (2010) analysed the financial statements and characteristics of the companies mentioned in the S&P 1500 index before and after the Sarbanes-Oxley (SOX) law; they found that there is a positive relationship between the presence of audit committees and earnings management. This presence is materialized according to these authors by the characteristics of the audit committees, namely, the independence, the number of meetings and the expertise of its members.

Inaam *et al.* (2012) examined the effects of audit committee characteristics (independence, size, meetings and financial literacy) on real activities manipulation in listed Tunisian firms. They found that there is no significant association between audit committee expertise and sales manipulation and no significance relation between audit committee expertise and over production; audit committee meeting is negatively correlated with sales manipulation; and lastly, finds that an audit committee size is positively associated with sales manipulation and over production. Graven (2015) examined the relationship between frequency of audit committee meetings and the occurrence of REM. They didn't find convincing evidence that companies involved in REM have fewer audit committee meetings; these results are inconsistent with those of Wan *et al.* (2016) find that in the Malaysian context, the independence of the board of directors mainly via its audit committee and administrators, does not lead to reducing the earnings management.

The existence of divergent and sometimes conflicting objectives between managers and shareholders has given rise to the design of many concepts and mechanisms to ensure that the cost associated with such divergent interest are minimised. One of the proposed arrangements is corporate governance in which audit committee is a vital mechanism, and it is not surprising that agency theory has been the dominant postulate in the corporate governance literature. However, several other theories have evolved in an attempt to highlight the objective of the firm and how it should respond to its different obligations (Visvanathan, 2008). For the purpose of this study, Agency theory will serve as a foundation on which this study shall be built. This is justified by the fact that the leading theory since attainment of earnings quality is our base. Quality financial reporting also serve as a focal point in agency relationship as well, as it is the tool by which the agent can be seen to be accountable to the principal, that is, when he renders quality financial report.

## **MATERIALS AND METHODS**

### **Research Design**

The study employs ex-post facto research design. According to Kerlinger & Rint (1986) in Egbunike & Udeh (2015) explains that an ex-post facto design seeks to reveal possible relationships by observing an existing condition or state of affairs and searching back in time for plausible contributing factors.

### **Sampling Techniques**

The study population was made up of entirely seven (7) ICT firms whose shares are traded in the Nigerian Stock Exchange (NSE) as at December 31, 2016. The ICT firms are Chams Plc., Courtville Business Solutions (CBS) Plc., Computer Warehouse Group (CWG) Plc., E-Transact international Plc., NCR (Nigeria) Plc., Omatek Ventures Plc., and Tripple Gee and Company Plc. For the purpose of the study, due to unavailability of data for CBS Plc.,



Omatek Plc., and Tripple Gee Company Plc., the remaining four (4) firms were adopted as the sample size.

**Method of Data Collection**

Secondary sources of data will be employed. This secondary data were sourced from annual reports and accounts of the selected ICT firms in Nigeria.

**Analytical Techniques**

The multiple regression analysis using Ordinary Least square (OLS) was adapted to test the effects of audit committee activity on earnings quality of listed ICT firms in Nigeria. The model specified below follow the model specification of Moghri & Galogah (2013) as used by Ajide & Aderemi (2014) and modified as follows to examine the effects of audit committee activity on earnings quality of listed ICT firms in Nigeria:

$$E\_Q = \beta_0 + \beta_1AC\_Size + \beta_2AC\_IND + \beta_3AC\_DLG + \beta_4LnFS + Er \quad \dots(1)$$

where;

E\_Q = Earnings quality; AC\_Size = Audit committee size; AC\_IND = Audit committee independence; AC\_DLG = Audit committee diligence; and FS = Firm size

**Measurement of Variables**

The measurement of variables was defined in Table 1.

**Table 1: Variable Definition**

| Variables                    | Acronym | Definition  | Validity   |
|------------------------------|---------|---|--|
| <b>Dependent:</b>            |         |   |  |
| Earnings Quality             | E_Q     | Cash flow from operating activities/ earnings before interest and tax   | Klein (2002); Al-Najjar (2011)   |
| <b>Independent:</b>          |         |   |  |
| Audit Committee Independence | AC_IND  | ‘1’ if audit committees are composed of three non-executive members for the period of the study and ‘0’ if otherwise. | Klein (2002); Bédard <i>et al.</i> (2004); Davidson <i>et al.</i> (2005) |
| Audit Committee Size         | AC_Siz  | Number of members of audit committee elected by the BoD   | Al-Najjar (2011); Salawu (2017)  |
| Audit Committee Diligence    | AC_DGL  | Number of annual meetings the committee holds   | Menon & Williams (1994)  |
| <b>Control:</b>              |         |   |  |
| Firm Size                    | FS      | Natural log of total assets   | Sharma <i>et al.</i> , 2009; Bronsonet <i>et al.</i> , 2009              |

**RESULTS AND DISCUSSION**

**Analysis of the Descriptive Statistics of the Study**

The Table 2 presents the minimum, maximum and mean values in addition to the standard deviation of variables employed in our statistical models. From Table 2, the mean represents the normal state of variables; possess an average mean of -2.7273. The Audit Committee Independence which was denoted with the help of dummy variables (1 and 0) shows an average output of 0.6667 which is close to 1.



**Table 2:** Descriptive Statistics

|              | Number | Minimum | Maximum | Mean    | Std. Deviation |
|--------------|--------|---------|---------|---------|----------------|
| E_Q          | 20     | -13.47  | 5.43    | -2.7273 | 5.46661        |
| LAC_DLG      | 20     | .00     | .85     | .5444   | .25601         |
| AC_IND       | 20     | .00     | 1.00    | .6667   | .48795         |
| LAC_SIZ      | 20     | .48     | .90     | .7753   | .09066         |
| LFSIZ        | 20     | 10.65   | 11.98   | 11.2601 | .46468         |
| Valid Number | 20     |         |         |         |                |

Source: SPSS Output, version 20 (2018)

**Regression Results**

This segment analyzed and interpreted the outcomes from the tests conducted on the data collected for the study. This is followed by drawing relevant inferences from the analysis as well as the test of hypotheses formulated for the study. From Table 3, the R<sup>2</sup> which represents the correlation coefficient shows a strong explanation of 0.726, while the more crucial variable R<sup>2</sup> squared shows an output of 0.527, which signifies that changes associated with the response variable (Earnings Quality), is captured by the changes in the explanatory variable (Audit Committee Activity). In other words, 52.7% R<sup>2</sup> indicates that earnings qualities are accounted for by the explanatory variables captured in the study.

**Table 3:** Model Summary

| Model | R                 | R Square | Adjusted R Square | Std. Error of the Estimate | Durbin-Watson |
|-------|-------------------|----------|-------------------|----------------------------|---------------|
| 1     | .726 <sup>a</sup> | .527     | .337              | 4.45031                    | 1.304         |

a. Predictors: (Constant), LFSIZ, LAC\_SIZ, AC\_IND, LAC\_DLG

b. Dependent Variable: E\_Q

Source: SPSS Output (Version 20) (2018)

Consequently, Table 4 results of the Analysis of Variance (ANOVA) showed a significant regression at the 10% level of significance with F statistics of 2.781 showing the fitness of the model.

**Table 4:** ANOVA<sup>a</sup>

| Model |            | Sum of Squares | Df | Mean Square | F     | Sig.              |
|-------|------------|----------------|----|-------------|-------|-------------------|
| 1     | Regression | 220.320        | 4  | 55.080      | 2.781 | .086 <sup>b</sup> |
|       | Residual   | 198.053        | 10 | 19.805      |       |                   |
|       | Total      | 418.373        | 14 |             |       |                   |

a. Dependent Variable: E\_Q

b. Predictors: (Constant), LFSIZ, LAC\_SIZ, AC\_IND, LAC\_DLG

Source: SPSS Output (Version 20) (2018)

**Analysis of the Multi-collinearity between the Explanatory Variables**

From Table 5, the Tolerance value statistics are consistently greater than the common threshold of 0.10 and also the variance inflation factor in relation to all the variables considered are consistently less than 10. These confirm the absence of multi-collinearity in between the explanatory variables.



Table 5: Coefficients<sup>a</sup>

| Model      | Unstandardized Coefficients |            | Standardized Coefficients |        |      | Collinearity Statistics |       |
|------------|-----------------------------|------------|---------------------------|--------|------|-------------------------|-------|
|            | B                           | Std. Error | Beta                      | T      | Sig. | Tolerance               | VIF   |
| (Constant) | -4.277                      | 41.897     |                           | -.102  | .921 |                         |       |
| LAC_SIZ    | -48.830                     | 18.894     | -.810                     | -2.584 | .027 | .482                    | 2.074 |
| 1 AC_IND   | 7.056                       | 3.478      | .630                      | 2.029  | .070 | .491                    | 2.036 |
| LAC_DLG    | 9.216                       | 8.411      | .432                      | 1.096  | .299 | .305                    | 3.277 |
| LFSIZ      | 2.637                       | 3.474      | .224                      | .759   | .465 | .543                    | 1.842 |

a. Dependent Variable: E\_Q

Source: SPSS Output (Version 20) (2018)

Table 5 showed that the regression results on the effects of audit committee activity on earnings quality. The estimated regression relationship for the model is  $E_Q = -4.277 - 48.830(AC\_SIZ) + 7.056(AC\_IND) + 9.216(AC\_DLG) + 2.637(FSIZ)$ . The model indicates how the results show the coefficient of determination for the model, which is fitted at 10%. This coefficient measured the percentage of the total variation in the earnings quality, which is indicated to be 52.7% of the audit committee activity. In addition, the study also provides evidence that audit committee size is significantly and negatively associated with earnings quality, this provides grounds to reject the null hypothesis, which stated that audit committee size has no significant effect on earnings quality. This indicates that larger AC sizes are more effective in monitoring earnings quality; hence larger AC size would reduce the extent of earnings manipulation with managers. This result is consistent with prior findings of Felo *et al.* (2003), and Inaam *et al.* (2012). They provide evidence on the effectiveness of larger audit committee size in improving the extent of earnings quality. More so, a positive association between audit committee independence and earnings quality is found in this study. In other words, audit committee independence might not guarantee that managers would not manipulate earnings. A possible explanation could be that the independent members of the audit committee might not be financially literate enough and may not have the industry experience which allows for monitoring effectiveness, therefore on this basis, the null hypothesis is also rejected. The result is consistent with the findings of Ghosh *et al.* (2010). Finally, the study provides an insignificant but positive relationship between the AC diligence and earnings quality. Thus, the null hypothesis is accepted. This result is contrary to the findings of Baxter & Cotter (2009), and Ghosh *et al.* (2010); they documented that the frequency of audit meetings is assumed to increase the effectiveness of monitoring. This indicates that the more often an audit committee meets the more likely it is to have fewer financial problems.

### CONCLUSION AND RECOMMENDATIONS

The study concluded that audit committee size and audit committee independence have effects on earnings quality of listed ICT firms in Nigeria. While audit committee diligence has no impact on earnings quality of listed ICT firms in Nigeria. In line with the findings and conclusions of the study, the following recommendations are proffered:

- i. The regulatory authorities like NSE and SEC should consider encouraging ICT firms to have in addition to the three non-executive directors in their audit committee at least one independent director. This will further improve the financial reporting quality of ICT firms in Nigeria as revealed by this study.





- ii. The regulatory authorities should also give attention to the issue of financial literacy of audit committee members. Efforts should be made to ensure that elected shareholders into the audit committee are financially literate.
- iii. The audit committee members should be encouraged to attend meetings regularly. It is discovered from this study that in some instances meetings are sparsely attended by members. This has the tendency of affecting the quality of contributions that would have been made if most or all members were to be in attendance. Attendance at meetings and the number of meetings held in a year should be made public. Regulatory authorities should consider sending delegates to attend and bring feedback at companies' audit committee meetings at least once in a year.

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