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Audit Committee Effectiveness and Financial Information Quality: Evidence from Tunisia

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Abstract

This work investigates the impact of audit committee effectiveness on financial information quality (FIQ) among Tunisian listed companies. The sample consisted of 78 firms from financial and non-financial companies for the year 2015. The effectiveness of audit committee measured through its missions and characteristics. Whereas (FIQ) has been assessed using restatement of financial statement and earning management. In the present study employing Partial Component Analysis and regression models. The results illustrate that audit committee effectiveness is based particularly on risks control and information communication monitoring. While the relationship between audit committee effectiveness and discretionary accruals are significantly negative within non-financial firms. We signaled its inefficacity on detecting fraud and errors on either financial or non-financial firms. Tunisian companies are invited to more reinforce their audit committee's effectiveness by ameliorating independence, competences, vigilance of its members, the culture of control, and the external and internal control missions.

Key Words: *Audit committee effectiveness, restatement, earnings management*

1. Introduction

Following the multitude of accounting scandals over the world and the loss of confidence (WorldCom, Enron, Germany, BATAM), financial information quality caused a great deal regarding the quality of governance structures (Abbott et *al*. 2004; Al- Shaer et *al*. 2015). Audit committee is one of the board's sub-committees which represented the most efficient instrument of governance that is responsible to assure the credibility of financial reporting within organizations. The earlier studies have used characteristics of audit committee as determinant to its effectiveness. It must be independent, expert and vigilant in order to achieve its missions

(DeZoort et *al.*, 2002). Further, several regulations and code of governance over the world namely (Bouton report law, 1995 and 1997 in France; Sarbanes Oxley, 2002 in USA; Law of Financial Security in Tunisia, 2005) appeared in order to ameliorate the effectiveness of audit committees. Academic work has evolved over time from the study of the mere presence of these committees to the search for its effectiveness. Moreover, this effectiveness was based only on the amelioration of its characteristics. Moreover, research on the influence of audit committee effectiveness on reporting quality (Beasley 1996; Abbott et *al.* 2004; Klein 2002; Marra et *al.* 2011; Fodio et *al.* 2013), has provided a conflicting result. Several studies have found a better reporting quality when audit committee members are independent, experts and vigilant (Cohen et *al.* 2002; Fodio et *al.* 2013; Vlaminck and Sarens 2015; Lin et *al.* 2015). However, many papers suggested that characteristics of audit committee is not necessarily equivalent to its effectiveness (Bédard and Gendron 2010). Therefore, focusing only on factors affecting its effectiveness which are related to either financial information quality or to the committee itself (Chtourou et *al.* 2006) and ignored its functions fails to assess the audit committee's effectiveness.

This work extended the previous researches by conceptualizing an audit committee effectiveness index. This latter consists of both characteristics and missions. Specially, we examine the main factors that determine the effectiveness of this structure and whether has an impact on quality financial information in Tunisian context.

The motivations of this paper consist. First, is the lack of studies on the audit committee effectiveness and its relation with financial information quality specially on Tunisian context. The previous research proxies the effectiveness of this structure on the basis of its characteristics namely independence, expertise and vigilance (DeZoort et *al.*, 2002). At this time papers treated how an independent, expert audit committee reduce the likelihood of restatement and earning management (Abbott et *al.*, 2004; Lary and Taylor 2012; Vlaminck and Sarens, 2015).Papers on Tunisian context are not very well explored. Chtourou et *al.*, 2006treated the existence of audit committee within bank sector and its impact on internal and external supervision; Bouaziz et Triki (2012) discussed the effect of audit committee size, independence and competence on firm performance. Expect these researches, the paper of Ika and Ghazali (2012) which constructed an index of effectiveness based on a score composed of audit committee characteristics and they tested its effect on Indonesian firms' timeliness.

Second, Tunisian corporate governance enacted a set of laws in 1999 with the first standard n°22 that recommended the creation of an audit committee within bank sector and in 2001 with law that required the establishment of these committees within credit institutions. Subsequently in 2005 the Financial Security Act to enhance corporate governance, the legislation requires the establishment of audit committees for all listed Tunisian companies. The financial security Act introduced more information about audit committee, including the frequency of meeting, size and missions namely reviewing internal control, external auditor job and information communication. Therefore, it is very important to explore this structure within Tunisian firms.

Finally, is to improve audit committee composition and functions and to analyze how can an effective audit committee impact financial information quality. Our sample consists of financial and non-financial firms. It is expected, that effectiveness of audit committees would affect restatement of financial statement and earning management. This study is organized as follows. Second section present the literature review and development of hypothesis. Third section discusses our research method and finally we analyze our univariate and multivariate findings.

2. Literature review and development hypothesis

Researchers highlighted the important role of an effective audit committee on financial reporting quality. Consequently, to identify this effectiveness, efforts have been made by providing requirement to improve audit committee functions. At first, the establishment of these committees was voluntary, in order to reassure the financial market following the crisis of confidence. At this stage, the creation of these committees remains recommended and not yet mandatory until 1978 and it was around the 1980s that the private sector created commissions responsible for strengthening the functioning of these committees. Corporate governance underwent a significant evolution in terms of fight against fraud and financial scandals (Drori, 2006). The standards and recommendations to strengthen the functioning of these committees are essentially related only on the independence of its members, their skills and vigilance. Thus, studies documented how some characteristics of the audit committee can ameliorate financial information quality. We submit that an audit committee must be independent, vigilant and expert, it is important to examine the actual processes of monitoring carried out by these committees in order to measure its effectiveness.

2.1. Audit committee effectiveness: traditional criteria

Literature on audit committee effectiveness has demonstrated the big importance given to the characteristics of audit committee namely independence, expertise, size, meeting frequency as determinant of its effectiveness. Some characteristics have been shown to minimize discretionary accruals and restatement probability by providing efficient monitoring. Findings showed the need of sufficient members for audit committee to fulfill its functions (Visvanathan, et *al*., 2008) which offer more synergy, experiences and skills (Hossain et *al*., 2006). According to Stewart et *al.* (2007) audit committee regularity meeting provides more effectiveness in detecting fraud and resolving problems. Other researchers on competence and skills of audit committee's members showed their importance in understanding management practices and detecting errors and fraud (Abbott et *al*. 2004).

2.1.1. Effect of audit committee characteristics onearnings management

Opportunistic earnings management is the most used measure in the academic literature on financial reporting. This proxy consists of determining the abnormal component called discretionary accruals. It appeared with Healy in (1985) and was subsequently developed with Jones, (1991) and (1995) and by Kothari in (2005). An audit committee that is supposed to be effective must minimize abnormal accruals (Lary and Taylor 2012; Ika and Ghazali, 2012; Lin et *al.* 2015). Composition of audit committee members can help in guaranteeing a high quality of financial firms. Using a sample of 770 American companies during a post-SOX period (2004–2006), Dhaliwal et *al.* (2010) signaled a positive effect of audit committee accounting expertise on accruals quality. Nevertheless, a negative relationship was found between audit committee meeting and earning management (Baxter et *al.* 2009).

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More recent finding signaled a negative link between audit committee independence and earning management (Vlaminck et Sarens, 2015).

2.1.2. Effect of audit committee characteristics on restatement

In the accounting literature, restatement was defined by Financial Accounting Standards a Board (FASB) as a revision of previously published financial information to correct an error. Accordingly, this correction depending on the materiality of that error. Desai et *al*., (2006) defined accounting restatements as corrections made to the financial statements of previous years. It is an acknowledgment of errors in the financial statements already published. Accordingly, Doyle et *al*., 2007, defined restatements as an estimate of the financial information quality. They argued that the presence of restatements is linked to problems with internal control procedures. Indeed, it weakens investor confidence, and causes many financial problems. Many papers found that the board of directors and its sub-committees specially audit committees are responsible for monitoring the actions of managers and reporting financial process (Arthaud Day et *al*., 2004). Consequently, an effective audit committee based on independence, expertise and vigilance of its members minimize fraud and financial irregularities, lower frequency of errors in financial statements (McMullen,1996).As Abbott et *al*., (2000) point out, though audit committee members may be aware of independent directors, their American context reported a low possibility of being sanctioned by the SEC for erroneous financial statements. Indeed, a negative link between audit committee independence and restatement. Abbott et *al.*, (2004); restatement is lower when an audit committee has accounting or supervisory financial expertise members. Cohen et *al.*, (2010).

2.2. Audit committee effectiveness: indicial criteria

It should be notice that measuring the effectiveness of audit committees on the basis of its characteristics is not sufficient. These later are the determinants of effectiveness, a measure that is defined according to the degree of compliance with recommendations and regulations. For instance, size and frequency of meetings do not represent significant determinants of audit committee effectiveness (Piot et *al*; 2009; Bédard et *al*, 2010). Chtourou et *al.* (2006) based on interviews with Tunisian bank auditors, argued that frequency of errors discovered by the external audit in financial statements did not change significantly after the audit committee instauration.

Previous studies did not give any importance to audit committee missions (Abbott et *al*. 2004; Lary and Taylor 2012; Ika and Ghazali 2012). In the beginning, the normative texts did not specify the different missions disclosed to the audit committee. At this stage, the interest was to restore the confidence of users in the market for financial and accounting information produced and disseminated by these companies. These texts only indicated the main objectives to be achieved by these committees, in terms of reviewing financial information, the independence of internal audit and the work of external audit, without specifying what these tasks are. Faced with this normative silence, the Anglo-Saxon professional bodies in particular, the Tread way reports (1987) in the United States, and the Cadbury report in the United Kingdom (1992), the codes and guides to good practice and good governance and certain works academics, have tried to determine and detail the attributions of these audit committees. But with the 1990s, multitudes of normative texts appeared which specified the missions of the audit committee, in the United States (AICPA, NYSE, SEC), the SOX law, 2002 thereafter, in France on (report Viénot1 and 2 (1995,1999), 8th European directive, and in Tunisia the LSF (2005) and the circular of the central bank of Tunisia (2011). Accordingly, through an in-depth literature review, we can classify audit committee missions according to four levels. First of all, a first level of control this is interested in the supervision of the process of elaboration and communication of financial information. A second level of control which consists on the supervision of internal audit quality and the effectiveness of internal control system The third level concerns the supervision of external audit supervision and finally the fourth level of control focuses on risk management (Wolnizer, 1995; IFA, 2008). We anticipated that an effective audit committee will improve financial reporting quality by minimizing errors in financial statements and earning management within Tunisian companies.

Hypothesis1: An effective audit committee has a negative effect on earnings management.
Hypothesis 2: An effective audit committee has a negative effect on financial statement's restatement.

3. Research design

The research is done upon two steps: the first one is to construct an audit committee index of effectiveness. We beganby distributing questionnaires to the audit committee members within Tunisian companies. Because of the low probability to contact these members, given their unavailability, the questionnaires were sent to the internal audit directors, for their presence at meetings, as secretaries. This step was subjected to several pre-tests. This pre-test phase, from which the questionnaire was finalized, aimed to "check whether the items that make up the questionnaire are clear, well written and in a language that is closely related to the target population" (Valler and, 1989). We submitted the questionnaire to audit committee secretaries. Following this first review, corrections were made to the wording of the questions, the instructions and the terms used. We selected a 5-point Likert scale. This scale was chosen because of the large items number and in order to simplify respondents, this type is the most used in marketing (Igalens and Roussel, 1998). This is a scale for the level of audit committee performance missions ranging from strongly disagreeing to strongly agreeing. There is also an open-ended question to which respondents must answer in their own words and closed questions to which respondents must answer by yes or no.

The second step, consist on testing the impact of an effective audit committee on financial information quality proxies by restatement and earning management. For this, we use the simple regression estimation. The models are expressed as follows:

$DA = \alpha_0 + \alpha_1 ACEFF + \alpha_2\ SIZE + \alpha_3\ BIG4 + \alpha_4\ DEBT + \varepsilon_t$ (equation 1)

With DAF: discretionary accruals in financial firms; DANF: discretionary accruals in non-financial firms; ACEFF: audit committee efficiency; SIZE: total assets of the firm; BIG4: companies audited by large audit firms; DEBT: debts of companies; $\varepsilon_{t:}$ errors term

$Restatement = \alpha_0 + \alpha_1 ACEFF + \alpha_2\ SIZE + \alpha_3\ BIG4 + \alpha_4\ DEBT + \varepsilon_t$(equation2)

With; ACEFF: audit committee efficiency; SIZE: total assets of the firm; BIG4: companies audited by large audit firms; DEBT: debts of companies; $\varepsilon_{t:}$ errors term

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4. Sample and data

We select the initial sample of Tunisian firms from the web site of Tunisian securities exchange. We limited our sample to publicly traded firms which had established an audit committee flowing the financial security law of 2005. We examine audit committee functions and characteristics during the year 2015. We try to study the role of this structure after several year of its instauration. The data used in this study is related to78 Tunisian financial and non-financial listed companies. This sample is collected using two methods. First, through a questionnaire designated to build an audit committee efficiency index and to collect the restatement variable. Data on financial information was used to quantify discretionary accruals. Our final sample consists of 61 companies.

4.1. Dependent variables

We use two variables in order to detect financial information quality. Our first dependent variable restatement is a binary variable that takes the value 1 if the company is restated, 0 if not. The second dependent variable is the discretionary accruals retained for our work will thus be the difference between the error terms deduced from the Jones model modified by Dec how et al. (1995) and the peers adjusted by the ROA by Kothari et *al*. (2005). The second provides evidence that firms with high performance are the most exposed to accounting manipulations.

4.2. Independent variable

We inspire the idea to construct an index of effectiveness from the study developed by Ika and Ghazali (2012). Our index of effectiveness is based on three dimensions. First, the "missions" dimension includes themes related to monitoring producing financial information process, monitoring financial information communication, risk management control, internal audit and external audit verification. Second, the "operational" dimension includes charter topics, the availability of members and working tools, meetings, frequencies and participation in these meetings. Third, "characteristics" dimension includes themes related to the independence, competences and skills of members. For determination of this index and we use for this the Partial Component Analysis (PCA).

4.3. Control variables

Other factors may influence the earning management level and restatement of financial statement. This paper includes a set of control variables in its model. Two variables are more generally firm characteristics namely size and debt. One refers to the external auditor (Big 4).

4.3.1. Company size

Prior researches indicated the importance of company size in improving financial reporting quality. Omri et *al*. (2009); Habib and Bhuiyan et *al*. (2016) signaled a negative relationship between firm's size and discretionary increases. They provide evidence that large companies have sophisticated internal control systems and are audited by high-quality auditors. As Chen et *al*. (2015) noted that the company size was negatively associated with the financial statement's restatement.

4.3.2. Company's debt level

Regarding that, companies with high debt level are less likely to experience opportunistic earnings management due to the importance of supervision (Francis et *al*. 2008). However, Vlaminck and Sarens (2015); Habib and Bhuiyan (2016) reported a positive link between earning management and company with a high debt level.

4.3.3. External audit (Big4)

Several studies used Big N (Big4 today) as a quality of external audit measure. The latter represents the best guarantees of independent and competent control (Chan et *al*. 2011; Vlaminck and Sarens 2015). In the same vein, Ika and Ghazali (2012); Lin et *al*. (2011) found a positive correlation between Big4 auditors and financial reporting quality.

5. Empirical results

At the beginning, we analyze the index of effectiveness obtained. Second, we describe the summary analysis of our variables. Finally, we discuss the multivariate result.

5.1. *Construction of an effective audit committee index*

After verifying the measurement scale's reliability, we use the Principal Component Analysis to identify our index. This measure consists on the determination of the factors that explain, the most, audit committee effectiveness within Tunisian companies. We proceeded first to a factor analysis as a main component to three factors, and then to a single factor component. Only items related to financial reporting controls and risk management were retained (risk identification and monitoring procedure, the regular action plans, and significant risks verification). These findings provide evidence that Tunisian audit committee is explained specially by missions related to risk management and process of audit committee production. This signaled the inefficacity of its characteristics. The score resulted represents our index of effectiveness which will be used as an explanatory variable at the level of our model's estimations.

5.2. *Descriptive findings*

Table 1 and table 2 summarize descriptive statics of variables used in this study. The most important conclusion is the significant earning management value within Tunisian companies.

Table1 Summary statistics of discretionary accruals

	Financial firms				Non-financial firms			
Variables	**MOY**	MIN	MAX	SD	MOY	MIN	MAX	SD
AD	0,96	-0,18	9,188	2,24	-2,4	-0,15	0,53	0,13
CAEFE	8,24	-3,25	1,347	0,96	8,24	-3,25	1,34	0,962
DEBT	4517,49	0	1953695	259932,3	45217,9	0,69	1953695	-0,69
SIZE	18,066	12,21	12,218	1,898	18,066	12,21	22,67	1,89
Big4	0.08		1	0,387	0,180	0	1	0,38
Ob	30				31			

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The discretionary accruals on average of 90% with 9.18% maximum and (-0.18) minimum. These values indicate that financial firms present high discretionary accruals compared to non-financial firms. In addition, 18% of non-financial firms are audited by Big4 auditors compared to financial firms with 8.6%. Krishnan (2003) showed that high-quality auditor ameliorates time disclosure information by reducing discretionary accruals. The argued that auditors of Big audit firms had more knowledge and expertise to detect and prevent opportunistic manipulations (Baxter and Cotter's, 2009; Dhaliwal et *al*., 2010). We notice that financial and non-financial firms are highly levered. This result is in line with those of Vlaminck and Sarens (2015) and Habib and Bhuiyan (2016).

Table 2 Summary statistics of restatement

Variables	Discretionary accruals		Restatement	
	Financial firms	Non-financial firms	Financial firms	Non-financial firms
DEBT	-49,54	0,0246	0,701	-1.441069
	(0,078)*	-0,722	(-0,12)	**(0,066)***
BIG4	-0,0000168	1,62	6,27	0,0000604
	(0,83)	-0,228	(-0,632)	(-0,988)
SIZE	346,845	0,0069	-	3659515
	(0,001)***	-0,956		(-0,748)
ACEFF	12,281	0,21	0,10718	-0,0565776
	-0,281	**(0,000)*****	(-0,557)	(-0,853)
CST	-241,938	-3,842		
	-0,288	**(0,000)*****	-1,354038	2,685158
F	4,6	8,72	-0,682	-0,632
Prob F	0,0064	0,0001	3,21	5,55
R2	0,424	0,572	0,359	0,2351

Table 2 reported that 66.66 % of financial companies restated their financial statement versus non-financial peers with 70.9%. It should also be note that only 10% of financial companies are audited by Big4, compared to 25.8% for non-financial firms. In this vein, it is worded noting that firms audited by Big4 enhance financial information quality (Krishnan, 2005; Ika and Ghazali, 2012).

5.3. Multivariate analysis

We estimate (eq1) and (eq2), where DA (discretionary accruals) and restatement as financial information quality proxies are introduced in the models as dependent variable separately in financial firms then in non-financial firms. The output of both regressions is summarized in table 3.

Table3 Results of linear regression of discretionary accruals and restatement

	Financial firms				Non-financial firms			
	MOY	MIN	MAX	SD	MOY	MIN	MAX	SD
Rest	0,66	0	1	0,47	0,70	0	1	0.46
EFFCA	-0.13	-3.544	-3.045	1.15	0.11	-2,81	1,23	0.77
DEBT	84734.79	-0,695	0.848	1953695	6974,947	0	216214	38833,12
SIZE	18,00	13.72	22.67	2.44	18,12	12.21	20.63	1,43
BIG4	0,1	0	1	0,30	0,25	0	1	0.44
Ob	30				31			

We estimate (eq1) where financial information quality is measured by discretionary accruals. For the financial firms, (R2) reached (0.424), the model explains 42.4% of the dependent variable "discretionary accruals". Indeed, the model is significant at a level of (F Value - 0.0064).

we reported that an effective audit committee is significantly and negatively correlated with earnings management. Our finding is consistent with our first hypothesis only within non- financial firms, which is in line with those of Vlaminck and Sarens (2015).

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We note that the variable size within financial firms is related positively and significantly with discretionary accruals with 1% (0,000). This result suggests that large Tunisian companies are most exposed to opportunistic earnings manipulations (Rajgopal 2002).

We notice also that the variable leverage within financial firms is negatively and significantly at 10% significance level with earnings management. This means that firms with high level of debt provide more control and verification (Lin et *al.*2015).

With regard to the variable Big4, we signaled that there is no relationship with earnings management either on financial and non-financial firms. Our result confirms the work of Vlaminck and Sarens (2015). However, it's different with paper of Lin et *al.*, (2015) which showed the existence of a significant negative relationship between the companies audited by the Big4 and earnings management.

We estimate eq2 where financial information quality measured by restatement. The output notes the following results. With respect to the sub-sample containing, the variable audit committee effectiveness index has no effect on restatement within either financial and non-financial firms. This conclusion could reveal the lack of monitoring within Tunisian firms especially familial firm**s.** Concerning control variable, leverage appeared to affect negatively and significantly restatement of around 10% with (p - 0.066). This result contradicts those of Ika and Ghazali (2012). However, size and (Big4) variables have no relationship with restatement. Our result supported the finding of Ika and Ghazali (2012). Results signaled the inefficacity of audit committees within Tunisian firms (Chtourou et *al*. 2006) who pointed out the audit committee inefficacity in Tunisian banks and explained that by the lack of independence, competence and members vigilance (unavailability, low meetings frequency). They argued that Tunisian audit committees at this time are in an embryonic phase.

6. Conclusions

An effective audit committee is considered the most important mechanism of governance within firms. Many research studied the characteristics of this committee as determinant of its effectiveness (DeZoort et *al*., Lin et *al*., 2011; Ika and Ghazali, 2012). Therefore, it is interesting to investigate if missions achieved by the committee effect also its effectiveness. This paper contributes to the accounting literature. First, by providing an index of effectiveness based on three dimensions. Dimensions include themes related to missions carried out by audit committee, vigilance and characteristics of audit committee members. Secondly ,by testing the effect of an effective audit committee on financial information quality on Tunisian firms. We find that the main determinants of audit committee effectiveness are variables related to the missions carried out by the audit committee namely risks control and information communication control. As for the effect of this effectiveness on quality financial information, result show that an effective audit committee appears to decrease the earning management within non-financial firms. However, we signaled its inefficacity on detecting errors either on financial firms or non-financial peers. Tunisian companies have well required the audit committee establishment and the enforcement effort of its effectiveness. However, the findings of this study showed that firms did not fully benefit from this governance mechanism. The reason could be related to the lack of competence, expertise and independence of audit committee members. Therefore, we encourage firms to ameliorate these audit committees. Our study suffers from many limitations. First, sample size has been reduced due to the data availability. It's limited only to listed companies. Second, Studying the typology of restatement will be very interesting to assessing the financial information quality within Tunisian firms and the nature of errors, which expect to explore in our forthcoming paper.

Declaration of competing Interest
The authors declare that they have no known competing financial interests or personal relationship that could have appeared to influence the work reported in this paper.

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