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Audit Committee Effectiveness and Financial Information Quality: Evidence from Tunisia

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Abstract

The study investigates the impact of audit committee effectiveness on financial information quality among Tunisian listed companies. We suggest to construct an index for audit committee effectiveness. We assess financial information quality through discretionary accruals and accounting restatement. Findings put in evidence that audit committee effectiveness is based on two main dimensions, namely control of risks and monitoring information communication. Empirical results report that audit committee effectiveness contributes to less earnings management in financial companies and less accounting restatement in non-financial peers. Such a result might reveal that Tunisian audit committees at this time are in an embryonic phase and can explain the ineffectiveness of audit committees. On the other hand, the presence of a Big 4 audit company cannot provide any guarantee for good financial reporting quality as financial companies that are audited with a Big 4 have more discretionary accruals, and hence more opportunistic management behavior. The study also confirm that firm size incites Tunisian managers to pursue opportunistic accrual earnings management.

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

1. Introduction

The accounting scandals of the early 2000s (Lehman Brothers, Bernie Madoff, WorldCom, Enron, KPMG, among others) have resulted in huge losses for investors and creditors, but also panic and loss of confidence in financial statements; and raised big issues about information quality and effectiveness of corporate governance mechanisms (Abbott et *al*. 2004; Al- Shaer et *al.* 2015). The audit committee is one of the board's sub-committees that is responsible for ensuring the credibility of financial reporting within organizations. Most previous studies have focused on the characteristics of audit committees as determinants of their effectiveness. They must be independent, expert, and vigilant to achieve its missions (DeZoort et *al.* 2002). In this regard, several regulations and codes of governance have been enacted all over the world to enhance the effectiveness of audit committees, namely Bouton Report Law, 1995 and 1997 in France; Sarbanes Oxley, 2002 in the USA; Law of Financial Security in Tunisia, 2005.

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However, research on the influence of audit committee effectiveness on reporting quality has provided mixed results (Beasley 1996; Abbott et *al*. 2004; Klein 2002; Marra et *al.* 2011; Fodio et *al.* 2013). Several studies suggested that the presence of independent, experts and vigilant members among the audit committee would help to enhance the reporting quality (Cohen et *al.* 2002; DeZoort et *al*. 2002, Fodio et *al.* 2013; Lin et *al*. 2015; Vlaminck and Sarens 2015). The presence of such members would contribute to reducing the likelihood of restatement and earning management (Abbott et *al.*, 2004; Lary and Taylor 2012; Vlaminck and Sarens, 2015). Other studies argued that the characteristics of audit committees are not necessarily equivalent to their effectiveness (Bédard and Gendron 2010). Therefore, focusing on those factors that are related to financial information quality or to the committee itself (Chtourou et *al.* 2006) and ignoring its functions fails to assess the audit committee's effectiveness.

This paper would like to contribute to this topic and fill the research gap. It proposes a new novel construct for audit committee effectiveness. The new construct would include both the characteristics and missions of the audit committee. Afterwards, we analyze the impact of audit committee effectiveness on financial information quality, through two indicators namely earnings management and restatement, within the Tunisian context. Tunisian context is worth investigating for at least two main reasons. First, it is an emerging market that is endorsing several efforts to enhance corporate governance standards and promote financial information quality to attract foreign investment and boost economic development. The first trials dated back to 1999 with the first standard n°22 that recommended the creation of an audit committee in banks, and involved credit institutions in 2001. In 2005, the Financial Security Act obliged all listed Tunisian companies to have such an audit committee to enhance corporate governance. The Financial Security Act required more information about audit committees, including the frequency of meetings, size, and missions namely reviewing internal control, external auditor job, and information communication. Second, a few researchers have focused on such research field in the Tunisian context due to the lack of information and the difficulty to afford and collect it. Results are thus mixed and not conclusive. Chtourou et *al.* (2006) investigated the impact of audit committees on internal and external supervision in Tunisian banks. Bouaziz and Triki (2012) discussed the effect of audit committee size, independence, and competence on firm performance.

This study is organized as follows. The second section sums up the literature review. The third section presents the research design. The fourth section reports and discusses empirical results. Section 5 concludes with future research perspectives.

2. Literature review

Researchers highlighted the important role of an effective audit committee on financial reporting quality. Several efforts have been made to improve audit effectiveness through new requirements on the audit committee functions. At first, the establishment of these committees was voluntary, to reassure the financial market after the crisis of confidence. At this stage, the creation of these committees remains recommended and not yet mandatory until 1978. Around the 1980s, the private sector created commissions responsible for strengthening the functioning of these committees. The norms of corporate governance underwent evolutionary change to prevent fraud, corruption and eventually financial scandals (Drori 2006). The standards and recommendations to strengthen the functioning of these committees focus essentially on the independence of members, their skills, and vigilance. Thus, related studies documented how some characteristics of the audit committee can improve financial information quality.

2.1. *On the audit committee effectiveness*

Literature on audit committee effectiveness argued that some characteristics of audit committees, namely independence, expertise, size, and meeting frequency would provide efficient monitoring and contribute to minimizing discretionary accruals and restatement probability. Findings highlighted the need for a sufficient number of members within the audit committee to fulfill the required functions (Visvanathan et *al*. 2008). The presence of a sufficient number of auditors would offer more synergy, experiences, and skills (Hossain et *al*. 2006). The regularity of their meetings would also provide more effectiveness in detecting fraud and resolving problems (Stewart et *al.* 2007). Other researchers suggested that the competencies and skills of audit committee members would help them to understand management practices and detect errors and fraud (Abbott et *al*. 2004). Using a dataset of 222 Italian-listed firms, Marra et *al*. (2011) documented that an audit committee with expert members in finance and accounting had a negative effect on earnings management. Chan et al. (2013) reported that an independent audit committee is negatively associated with earnings management. According to these authors, audit committee members' long board tenure results in lower audit efforts. More recently, a study conducted on 60 Belgian companies between (2008) and (2009) showed that an audit committee with expert and sufficient members can decrease earnings management (Vlaminck and Sarens, 2015). On the other hand, some studies argued that the size and frequency of meetings do not influence the audit committee's effectiveness (Piot et *al*; 2009; Bédard et *al*, 2010). The frequency of errors discovered by external auditors in financial statements did not significantly change after the audit committee instauration (Chtourou et *al.* 2006).

Another bulk of studies suggested that the above characteristics of audit committees can influence the audit effectiveness but cannot assess the effectiveness itself. The audit effectiveness revealed the degree of compliance with recommendations and regulations. It sets for achieving the level of audit quality standards. Therefore, some researchers suggested focusing on the missions of the audit committee (Abbott et *al.* 2004; Ika and Ghazali 2012; Lary and Taylor 2012. In the beginning, the normative texts did not specify the different missions that should be entitled 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. Most laws only indicated the main objectives of the audit committee, 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 have tried to determine and detail the attributions of audit committees. For instance, the Treadway Reports (1987) in the United States, and the Cadbury Report in the United Kingdom (1992) have provided guidelines for good practices of corporate governance. Afterward, in the 1990s, several normative texts specified the missions of the audit committee, such as the AICPA, NYSE, SEC, and the SOX law of 2002 in the US, Viénot Reports (1995 and 1999) in France, the 8th European directive, the LSF (2005), and the circular of the Tunisian central bank (2011) in Tunisia. Accordingly, through an in-depth literature review, we can classify audit committee missions into four levels:

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first the supervision of the elaboration process and financial information communication, second quality and supervision of internal audit quality and effectiveness of internal control system, third external audit supervision, and fourth risk management (Wolnizer, 1995; IFA, 2008).

2.2. *On the financial information quality*

Two main variables are widely used in the academic literature on financial reporting to assess financial information quality, namely earnings management and restatement. The first strand of studies refers to opportunistic earnings management through the abnormal component of earnings that are called discretionary accruals (Healy 1985; Jones 1991; 1995; Kothari 2005). An effective audit committee is expected to help reduce abnormal accruals (Ika and Ghazali 2012; Lary and Taylor 2012; Lin et *al*. 2015). The audit committee characteristics are expected to influence the quality of accruals, and hence better financial information quality. For instance, the expertise of audit committee members would help to guarantee a high quality of financial information as it has a positive impact on accruals quality (Dhaliwal et *al*. 2010). Similarly, audit committee independence and the meetings frequency of the committee have a negative impact on earnings management (Baxter et *al.* 2009; Vlaminck and Sarens 2015).

The second strand of literature uses financial information restatement as another proxy for financial information quality. The Financial Accounting Standards Board (FASB) defines accounting restatement as a revision of previously published financial information to correct an error. The accounting correction depends on the error itself. It is also an acknowledgment of errors in previous financial statements already published (Desai et *al*. 2006). The occurrence of restatement is due to problems related to internal control procedures. Accounting restatement can serve hence as an estimate of the financial information quality (Doyle et *al*. 2007). The occurrence of restatement would lead to weaken investor confidence and hence several financial issues. A large bulk of studies put in evidence the role of audit committees to monitor managerial discretion and reporting financial processes (Arthaud Day et *al*. 2004). Consequently, an effective audit committee with experts, independent, and vigilant members is expected to reduce fraud, financial irregularities, and frequency of errors in financial statements (McMullen 1996). Previous studies reported a negative relationship between audit committee independence and restatement (Abbott et *al.* 2004). For instance, audit committee members are aware of the monitoring role of the advisors' board; of" which results in low restatement (Cohen et *al.* 2010). Similarly, American audit committee members are afraid to be sanctioned by the SEC for erroneous financial statements (Abbott et *al*. 2000).

3. Research design

3.1. *Sample and Data*

The sample included 78 Tunisian listed companies, which had established an audit committee following the financial security law of 2005. We examined audit committee functions and characteristics during the year 2015. The sample includes both financial and non-financial listed companies. Data was collected through a questionnaire designated to build an audit committee efficiency index and also to assess the restatement variable. Financial data was extracted from the financial statements of companies. Companies with missing data were eliminated. The final sample includes 61 companies.

3.2. *Construction of the Audit Efficiency Index*

Following Ika and Ghazali (2012), we constructed a three-dimensional index for audit efficiency. The first dimension sets for "missions" and includes themes related to monitoring and producing financial information process, monitoring financial information communication, risk management control, internal audit, and external audit verification. The second dimension refers to the "operational aspect" and focuses on charter topics, the availability of members and working tools, meetings, frequencies, and participation in these meetings. The third dimension "characteristics" deals with the independence, competencies, and skills of members. In the first step, we distributed a questionnaire to audit committee members of Tunisian-listed companies to collect data about the three dimensions of the audit efficiency index. The questionnaire was submitted to a pre-test before it was distributed. We submitted the questionnaire to audit committee secretaries. The pre-test aims 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" (Vallerand 1989). The questionnaire is made up of 25 questions related to the missions, operations, and characteristics the adult committee. Answers are based on a 5-point Likert scale, ranging from 'strongly disagree' to 'strongly agree'. There are also yes/no questions. The questionnaire ends with an open-ended question in which respondents are free to express their opinions.

After collecting data, we run principal component analysis (PCA) to construct the audit efficiency index. When performing PCA, the first principal component forms a set of original predictor variables that are jointly normally distributed and explain the most variance. The second principal component explains the most variance of what is left after removing the first component. We proceed through iterations until all the variance is explained. The principal components are independent. The objective of the study is to construct an index for audit effectiveness. Therefore, the PCA should lead to only one factor which would be a linear combination of predictors that captures the data set's maximum variance.

The Cronbach alpha allows assessing the reliability of the score by comparing the amount of shared variance, among the items making up the construct to the amount of overall variance. A Cronbach alpha that is higher than 0.60 reveals an adequate internal consistency and is excellent if it is higher than 0.80. Fit statistics that are between 0.05 and 1.5, a total explained variance of more than 80%, and a Root mean square error of approximation less than 0.08 approve of the construct validity.

3.3. *Estimation models for financial information quality*

In the second step, we investigated the impact of audit committee effectiveness on financial information quality. We used two proxies for financial information quality, namely accounting restatement and earnings management through discretionary accruals. The first dependent variable restatement is a binary variable that takes the value 1 if the company is restated, and 0 otherwise. The second dependent variable sets for the discretionary accruals. They represent the difference between the error terms, following the Jones model modified by Dechow et al. (1995) and adjusted by Kothari et *al*. (2005). The independent variable is the index of audit committee effectiveness constructed by running the PCA. As control variables that might influence earnings management level and accounting restatement, we consider the company size, debt, and also whether the company is audited by a Big4 or not. Prior research highlighted the negative impact of the company size on discretionary accruals (Omri et *al*. 2009; Habib

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and Bhuiyan et *al*. 2016). It has also a negative impact on accounting restatement (Chen et *al*. 2015). Large companies have sophisticated internal control systems and are audited by high-quality auditors, and hence better financial information reporting. Besides, highly leveraged companies are less likely to undergo opportunistic earnings management because of the monitoring role of debt (Francis et *al*. 2008). However, there is empirical evidence for a positive relationship between earnings management and leverage (Vlaminck and Sarens 2015; Habib and Bhuiyan 2016). Finally, companies audited by a Big4 would provide better guarantees for independent and competent control, and hence better financial reporting quality (Chan et *al*. 2011; Lin et *al*. 2011; Ika and Ghazali 2012; Vlaminck and Sarens 2015).

Accordingly, we have two models to estimate. We run the multivariate linear regressions. The models to estimate set as follows:

$$\mathbf{DA} = \alpha_0 + \alpha_1 \mathbf{AEF} + \alpha_2 \mathbf{SIZE} + \alpha_3 \mathbf{DEBT} + \alpha_4 \mathbf{BIG4} + \varepsilon_t \quad \textbf{(Eq. 1)}$$

$$\mathbf{RES} = \alpha_0 + \alpha_1 \mathbf{AEF} + \alpha_2 \mathbf{SIZE} + \alpha_3 \mathbf{DEBT} + \alpha_4 \mathbf{DEBT} + \varepsilon_t \quad \textbf{(Eq. 2)}$$

With DA: discretionary accruals that represent the difference between the error terms, following the Jones model modified by Dechow et al. (1995) and adjusted by Kothari et *al*. (2005);
RES: a binary variable that takes the value 1 if the company is restated, 0 otherwise;
AEF: the index of audit committee efficiency that is the output of the PCA;

SIZE: ln of total assets; DEBT: debt-to-total assets ratio; BIG4: a binary variable that takes one if the company is audited by a Big 4 audit company; ε_t: errors term.

4. Results and Discussions

4.1. *Descriptive statistics*

Table 1 summarizes the findings of the PCA that was to construct the index for audit effectiveness. First, it is recommended to verify the measurement scale's reliability and validity. Index reliability consists of determining the factors that most explain the audit committee's effectiveness within Tunisian companies. The audit effectiveness index is reliable with a Cronbach alpha that is higher than 0.80 and valid with a total explained variance of more than 80%, a significant Khi2, and an adjustment quality of 0.141.

Table 1. PCA Results for the Audit Effectiveness Index

Components	Proportion	Weight within the index	
Factor1	0.512	**0.716**	**Total explained variance :** 61.390 %
Factor2	0.878	**0.937**	**Khi - 2 :** 8.296
Factor3	0.725	**0.852**	**Quality of adjustment :** 0.141
Factor4	0.460	**0.678**	**Cronbach alpha :** 0.885
Factor5	0.495	**0.704**	

Results put in evidence that only items that are related to financial reporting controls and risk management were finally retained in the audit effectiveness construct. These findings provide evidence that the Tunisian audit committee gives more importance to those missions related to risk management and the process of audit committee production. Such a result is in line with the legal requirements imposed upon the Financial Security Act of 2005 for Tunisian-listed companies.
Table 2 reported the descriptive statistics for financial data, with a paired comparison between financial versus non-financial companies. Table 2 revealed that financial firms have higher discretionary accruals compared to non-financial peers with an average of 0.419 and 0.311 respectively. However, discretionary accruals are negative for both kinds of companies. Companies with higher discretionary accruals are likely to cope with opportunistic earnings manipulations (Rajgopal 2002). On the other hand, Table 2 shows that 66 % of financial companies restated their financial statements versus 70% of non-financial peers. Lesser accounting restatement showed better financial reporting and thus better financial information quality. The score of audit effectiveness is also higher for financial companies. Perhaps, legal requirements are mandatory for financial companies but still optional and more flexible for non-financial peers.

Table 2. Summary statistics of discretionary accruals

	Financial firms				**Non-financial firms**			
Variables	***MOY***	***MIN***	***MAX***	***SD***	***MOY***	***MIN***	***MAX***	***SD***
DA	-0.419	-0.652	0.92	0.378	-0.311	-1.4	1.53	0.474
RES	0.66	0	1	0.47	0.70	0	1	0.46
AEF	0.139	3.05	1.71	1.15	0.122	1.53	1.50	0.848
Big4	0.086	0	1	0.288	0.266	0	1	0.449
DEBT	0.148	0	0.842	0.264	0.301	0.658	0	3.243
SIZE	18.04	2.44	13.72	22.67	18.12	1.434	12.22	20.63
Ob	**30**				**31**			

DA: discretionary accruals that represent the difference between the error terms, following the Jones model modified by Dechow et al. (1995) and adjusted by Kothari et al. (2005); RES: a binary variable that takes the value 1 if the company is restated, 0 otherwise; AEF: the index of audit committee efficiency that is the output of the PCA; SIZE: ln of total assets; DEBT: debt-to-total assets ratio; BIG4: a binary variable that takes one if the company is audited by a Big 4 audit company; εt: errors term.

Surprisingly, non-financial companies look for a Big4 audit more than financial peers. Indeed, 26.6% of non-financial firms are audited by Big4 auditors compared to 8.6% of financial firms. Such a result would reflect the aspirations of investors who try to compensate the non-mandatory

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rules for non-financial companies to protect their rights and monitor the management. The presence of a high-quality auditor contributes to enhancing the time of information disclosure; and hence less discretionary accruals and less accounting restatement (Krishnan, 2005; Ika and Ghazali, 2012). Auditors of Big audit companies are renowned for having more knowledge and expertise to detect and prevent opportunistic manipulations (Baxter and Cotter's2009; Dhaliwal et *al*. 2010). The result related to the Big4 is consistent for discretionary accruals and not for accounting restatement. Indeed discretionary accruals are higher in financial companies while restatement is more frequent in non-financial peers.

4.2. *Multivariate analysis*

Table 3 compared the findings for the two variables of financial information reporting, namely discretionary accruals and accounting restatement. Financial and non-financial companies are not pooled together and regressions are run separately.

Table 3. Results of linear regression of discretionary accruals and restatement

Variables	Discretionary accruals		Restatement	
	Financial firms	*Non-financial firms*	*Financial firms*	*Non-financial firms*
AEF	-0.495 (0.078)*	0.0246 (0.722)	0.701 (0.122)	-1.441 (0.066)*
BIG4	0.346 (0.001)***	0.069 (0.956)	0.321 (0.251)	-0.365 (0.748)
DEBT	-0.001 (0.803)	1.621 (0.228)	6.272 0.632	0.006 (0.988)
SIZE	12.281 (0.281)	0.213 (0.000)***	0.107 (0.557)	-0.056 (0.853)
CST	-2.419 (0.288)	-3.423 (0.000)***	-1.354 (0.682)	2.685 (0.632)
F	4.6	8.72	3.21	5.55
Prob F	0.0064	0.001	0.359	0.235
R2	0.424	0.572	0.090	0.148

DA: discretionary accruals that represent the difference between the error terms, following the Jones model modified by Dechow et al. (1995) and adjusted by Kothari et al. (2005); RES: a binary variable that takes the value 1 if the company is restated, 0 otherwise; AEF: the index of audit committee efficiency that is the output of the PCA; SIZE: ln of total assets; DEBT: debt-to-total assets ratio; BIG4: a binary variable that takes one if the company is audited by a Big 4 audit company; εt: errors term.

Table 3 reported that audit committee effectiveness contributes to less earnings management in financial companies and less accounting restatement in non-financial peers. Such a result reveals the wide difference among financial and non-financial companies in terms of financial characteristics, mode of corporate governance, and legal requirements. Tunisian audit committees at this time are in an embryonic phase which can explain the ineffectiveness of audit committees. It can be due to the lack of independence, competence, and members' vigilance (unavailability, low meeting frequency), according to Chtourou et *al*. (2006). Furthermore, the index for audit effectiveness may fail to capture all deficiencies through Tunisian listed companies and do not take into consideration all features of both kinds of companies. Further research and investigations are needed to construct a more robust index for audit effectiveness.

On the other hand, financial companies that are audited with a Big 4 have more discretionary accruals, and hence more opportunistic management behavior. Big 4 audit firms do not act as a constraint on either earnings management or accounting restatement. The presence of a Big4 audit company cannot provide any guarantee of good financial reporting quality. Such a result does not converge with the findings of Chan et *al*. (2011), Lin et *al*. (2011), Ika and Ghazali (2012), and Vlaminck and Sarens (2015) among others.

Table 3 puts also in evidence the positive impact of firm size on discretionary accruals for non-financial companies. Discretionary accruals increase with the firm size, and hence more earnings management. Large firms tend to modify their earnings records to evade criticisms from financial analysts, and also to earn investors' confidence (Barton and Simko 2002)

However, debt has no significant influence on either discretionary accruals or accounting restatement even though debt is recognized to play an efficient monitoring mechanism. Debt fails to play such an expected role in Tunisian listed companies in improving the quality of information reporting as argued by Lin et *al*. (2015). Leverage does not discourage managers from income smoothing and managing earnings opportunistically to meet, for instance, the benchmark target of prior-year earnings.

5. Conclusion

The study examined the impact of audit committee effectiveness on financial information quality among Tunisian listed companies. The sample consisted of 78 financial and non-financial listed

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companies. We suggested constructing an index for audit committee effectiveness. We assessed financial information quality through discretionary accruals and accounting restatement. Findings put in evidence that audit committee effectiveness is based on two main dimensions, namely control of risks and monitoring information communication within the Tunisian context. Empirical findings reported that financial firms have higher discretionary accruals compared to non-financial peers while the latter restate more their financial statements than the former. Companies with higher discretionary accruals and more accounting restatement are expected to undergo more opportunistic earnings manipulations and provide worse financial information reporting. The study put in evidence that audit committee effectiveness contributes to less earnings management in financial companies and less accounting restatement in non-financial peers. Such a result might reveal that Tunisian audit committees at this time are in an embryonic phase and can explain the ineffectiveness of audit committees within Tunisian firms.

On the other hand, financial companies that are audited with a Big 4 have more discretionary accruals, and hence more opportunistic management behavior. Big 4 audit firms do not act as a constraint on either earnings management or accounting restatement. Furthermore, the study confirmed that firm size incites Tunisian managers to pursue opportunistic accrual earnings management.

The outputs of the study reveal that further efforts are needed to urge Tunisian-listed companies to follow the best practices of corporate governance. For instance, tougher legal requirements would help audit committees to fulfill their missions and achieve the expected objectives. The study offers at least three new avenues for future research. First, a large size of the sample would provide more credible results. Because of the reduced number of listed Tunisian companies, we can enlarge the sample by adding non-listed companies. Second, we can improve the reliability and the validity of audit effectiveness construct by adding more dimensions and taking into consideration the differences among financial and non-financial companies. Third, it is worth investigating the typology of restatement while assessing the financial information quality within Tunisian firms.

Declaration of Competing Interest

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

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