Effect of Audit Committee Characteristics and Earnings Management of Firms Listed in Nairobi Securities Exchange

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Abstract:

Purpose: *The primary objective of this study was to analyze the effect of Audit Committee Characteristics on earnings management and to investigate the moderating role of ownership structure in this context.*
Material/methods: *The study adopted an explanatory design, targeting the 60 firms listed on the Nairobi Securities Exchange. A census technique was utilized, capturing data from the 45 firms that have consistently operated on the Exchange from 2005 to 2012. The study relied on secondary data collected through content analysis and analyzed using descriptive and inferential statistics. Hypotheses were tested using a multiple regression model.*
Findings: *The findings indicated that audit committee independence and audit committee tenure had no significant effect on earnings management. However, the audit committee size was found to have a significant positive effect on earnings management.*
Conclusion*: The study concluded that specific characteristics of the audit committee, particularly its size, significantly influence earnings management among firms listed on the Nairobi Securities Exchange.*
Value: *The study underscores the need for improvements in corporate governance codes in Kenya, suggesting that such enhancements could help reduce earnings management and prevent potential collapses of listed companies. This adds value to ongoing discussions and policymaking in corporate governance and financial regulation.*

Keywords*: Audit Committee Independence, Audit Committee Tenure, Earning Management, Audit Committee Size, Listed Companies*

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1. Introduction

Earnings management reduces the quality of reported earnings and its usefulness for decisions making, thus reducing investor confidence. The accounting earnings are more reliable and of higher quality when managers' opportunistic behavior is reduced

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using monitoring systems by enhancing corporate governance and the independence of external auditors (Habbash, 2010). Earnings management is the deliberate altering of financial information to either mislead investors on the underlying economic status of a firm or to gain some contractual benefits that depend largely on accounting numbers (Ronen and Varda Yaari, 2008). Accruals are the most important earnings management instruments that are used by managers to either increases or decrease reported income. This is because they are components of earnings that are not reflected in current cash flows, and a great deal of managerial discretion goes into their construction (Bergstresser and Phillippon, 2003).
Jiraporn *et al*., (2008) argued that firms with inaccurate information may engage in earnings management because a higher degree of asymmetric information makes it more difficult for the board to monitor managers. Managers might abuse their discretion over earnings, such as engaging in earnings management, thereby increasing agency costs. Kang and Kim (2011) observed that management could influence reported earnings by making accounting choices or by making operating decisions discretionally. One of such discretionary decisions to manipulate reported earnings is imbedded in the accrual-based accounting. Earnings management affects firm performance and can even temper with shareholders' wealth. The motivation for misrepresentation of firm performance arises because of the conflict of interest between managers and shareholders.
In this regard, Gul and Tsui (2001) support the effectiveness of audit committee characteristics as a monitoring system. Xie *et al*. (2001) and Klein (2002b), among others, show that audit committee characteristics reduces management's ability to manage earnings. Audit committee characteristics and external audit therefore assist investors by aligning the objectives of management with the objectives of shareholders, thereby enhancing the reliability of financial information and the integrity of the financial reporting process (Habbash, 2010). Empirically, it is widely accepted that governance practices limit a manager's ability to manipulate earnings (Peasnell *et al*., 2005; Kim and Yi, 2006; Chen *et al*., 2007; Huang *et al*., 2007 and Jaggi *et al*., 2009). Accordingly, in order to constrain any divergence in interests and to ensure appropriate accountability of resources, an organization needs a comprehensive structure of controls that encourages efficient performance and responsible behavior. Epps and Ismail (2008) confirmed that board characteristics are important determinants of earnings management.

Cornett *et al*., (2008) found that adjusting for impact of earnings management substantially improves the relevance of governance variables and significantly declines the importance of incentive-based compensation for firm performance. Zhu and Tian (2009) findings reveal that board composition is more effective towards improving firm performance when actual performance is considered. In today's corporate environment, good governance structures include an adequately functioning audit committee, a thoughtfully composed board of audit committee, a balanced ownership structure, and an independent and vigilant external auditor (Habbash, 2010). Cohen *et al.,* (2002) recognizes that one of the most important functions of corporate governance is to ensure the quality of the financial reports. Thus, effective oversight of the financial reporting process by the aforementioned corporate mechanisms is thought to improve the accuracy of reports to shareholders and act as a deterrent against possible opportunistic behavior by managers.

Earnings management is increasing its popularity among firms particularly in developed economies (Wawero and Riro, 2013). Recent studies (Chen et al., 2007; Huang et al., 2007 and Jaggi et al., 2009; Zoysa and Rudkin 2010; Jiraporn et al., 2008) have shown that earnings management could also be undesirable to shareholders. When the interests of shareholders and managers diverge, managers can manipulate earnings for their own purposes at the expenses of shareholders' interest. According to Lei (2008) corporate governance mechanisms such as composition of board of audit committee and audit committee in particular, are responsible for monitoring managers on behalf of shareholders and overseeing financial reporting process by company law. Therefore the board of tenure, CEO duality, audit committee Independence and audit committee should play a role in retaining earnings management.

In Kenya, there are cases where managers and audit committee have been accused of poor corporate governance resulting to corporate scandals which include the collapse of Euro Bank in 2004, the placement of Uchumi Supermarkets under receivership in 2004 due to mismanagement, the near collapses of Unga Group, National Bank of Kenya and more recently board room wrangles and the discovery of secret overseas bank accounts for siphoning company money by some audit committee at CMC Motors (Madiavale, 2011). Hendrikse (2004) argue that the corporate failures witnessed recently confirmed that many audit committee put their own interests before those of the company and shareholders. In response the regulators have continuously spelt guidelines and regulations to ensure that there is prudential management in the organizations. This is in recognition that prior to 2002; poor management was one of the factors pointed out to be contributing to serious liquidity problems and collapse of public organizations in Kenya.

However, recent studies have shown that audit committee characteristics is key determinant of earnings management (Lei, 2008; Iqbal and Strong, 2010; Cormier *et al*, 2012). Most of these studies have been conducted in developed world and very few have been conducted in developing countries leaving a dearth on the existing literature. Thus, the study was important in Kenya since it highlighted how ownership structure affects earnings management. In addition, most scholars argues that studies conducted in developed countries may become impossible to employee the same methodologies in developing countries due to their ongoing structural changes. Therefore, the current study investigated the effect of audit committee characteristics on earnings management in listed firms in Nairobi stock exchange, and extended the study further and investigated the moderating effect of ownership structure.

H_{o1}: Audit committee independence has no significant effect on earnings management

H_{o2}: Audit committee tenure has no significant effect on earnings management

H_{o3}: Audit committee size has no significant effect on earnings management

2. Theoretical and Literature Review

Agency theory developed by Jensen and Meckling (1976) as a means to curb the agency cost that arises as a result of the conflict of interest between owners (shareholders) and controllers (managers). According to Hassan and Ahmed (2012) agency theory provides the natural backdrop upon which this study is based. The theory explains the relationship that exists between managers and shareholders as a result of the separation of ownership from control of the modern day business. Theoretically, the manager is supposed to act in such a manner that tallies with that of the shareholders. However, this is not always the case as the manager enjoys some privilege information that makes it possible to pursue his own interest at the expense of that of the shareholders. This may eventually temper with the value maximization objective of the firm. If corporate governance mechanisms are effective, the interest of both the owners and controllers of firms' resources are expected to converge. This means that governance variables should be positively related with financial performance and inversely related with opportunistic tendencies of managers (ibid, 2012).

Agency Theory is also based on hypothesis that principals and agents act rationally and that they will use the contracting route to maximize their wealth (Michael, 1994). This means that because agents have self-seeking motives, they are likely to take the opportunity to act against the interests of the owners of the firm for example partaking unwarranted high perquisite consumption. Scapens (1985) refers to this dilemma as the "moral hazard" problem. An inclusive theory about agency theory by Jensen and Meckling (1976) indicated that the principals who are the company owners can comfort themselves that the agent will make the most favorable decisions only if appropriate incentives and rewards are given and only if the agent is watched. Incentives involves things like stock options, bonuses and many other benefits which are related with how fine the results of management's decisions serve the interests of shareholder.

Jensen and Meckling (1976) argued that the separation of ownership and control results in agency costs due to the conflict of interests between managers and shareholders. When there is ownership diffusion, agency costs are high resulting in a high demand for informative disclosure to monitor managers (Fama and Jensen, 1983).As a result, the extent of disclosure is likely to be greater in widely held rather than in closely held corporations. Wang (2008) considers large stockholders to be the accounting information demanders and possess more power to govern and control quality of the accounting information.

The agency theory posits a negative relationship between Audit committee on earnings management and earnings management. Jensen and Meckling (1976) indicated that the principals who are the company owners can comfort themselves that the agent will make the most favorable decisions only if appropriate incentives and rewards are given and only if the agent is watched. This in effect supports monitoring of management by the director who according to the stewardship theory hold the fiduciary duty of safeguarding shareholder's interest

2.1. Empirical Review

2.1.1. Audit committee Independence and Earnings Management

Audit committee Independence refers to the proportion of independent audit committee on the board (Sweeney, 1996). Recently, Garcia Osma (2008) shows that a more independent board contributes towards restricting managers from using research and development expenditure as a tool to manipulate earnings.

Chen *et al.,* (2006) also found out that characteristic of the board to independency is related to the earnings management level in a company. Bushman (2009) stated that having lower audit committee Independence and higher earnings management can be part of the general equilibrium and does not necessarily indicate that audit committee Independence reduces earnings management.

Studies demonstrates that the effectiveness of outside audit committee as monitors is greater when the cost of information acquisition is lower (Raheja 2005; Adams and Ferrira 2007; Harris and Raviv 2008; Duchin *et al*. 2010). It thus follows that the more informative the information environment is, the lower the information acquisition costs are, and the more effective the outside audit committee will be. Adams and Ferreira (2007) and Harris and Raviv (2008) show that knowing independent audit committee are tougher monitors, the management is reluctant to share important information with them or a board dominated by independent audit committee.

Larcker *et al*. (2007) find that audit committee Independence is not correlated with signed abnormal accruals, the absolute value of abnormal accruals, or the likelihood of accounting restatements. Beasley (2006) finds that audit committee Independence is negatively correlated with the likelihood of accounting frauds. In contrast, Agrawal and Chadha (2005) find that board and audit committee independence are not correlated with the likelihood of accounting restatements. Adams and Ferreira (2007) argue that "unless boards are given better access to information, simply increasing audit committee Independence is not sufficient to improve governance."

A number of studies have linked audit committee Independence to financial performance and shareholder wealth (Brickley *et al*., 1994). Moreover, audit committee Independence is more effective in monitoring management. Klein (2002), Xie *et al*. (2003), Sonda *et al*. (2003) and Peasnell *et al*. (2005) provided evidence concerning audit committee Independence and earnings manipulation and found that companies with independent boards are less likely to report abnormal accruals. Conversely, Park and Shin (2003), Abdul Rahman and Ali (2006) and Osama and Noguer (2007) found no relationship between outsider audit committee and earnings management.

Klein (2002) finds that audit committee Independence is negatively correlated with earnings management, proxied by the absolute value of abnormal accruals. While this finding is confirmed by some later studies, such as Bedard *et al*. (2004), other studies find conflicting results. For example, Vafeas (2005) finds that audit committee Independence is significantly related to the likelihood of avoiding earnings surprises, a proxy for earnings management. Independent non-executive audit committee have both, strong incentives to monitor the board, and the capabilities to identify earnings management (Peasnell *et a*l.2000a). The need to maintain director's reputation in the competitive market for audit committee provides incentive for independent non-executive audit committee to monitor the board, failing which would increase the likelihood of dismissal (Fama 1980). In addition, there is no tangible benefit that accrues to the independent non-executive audit committee from earnings management. Peasnell *et al.*, (2000a) report that independent non-executive audit committee have the capabilities to detect earnings management since most of them are familiar with financial reporting issues by holding senior management positions in other firms

The mixed prior evidence makes it difficult to predict whether the extent of earnings management will change when audit committee Independence increases following the recent regulatory requirements. In addition, prior studies, by examining the cross-sectional correlation between audit committee Independence and earnings management, are likely subject to the endogeneity issue. As pointed out by Guay (2008), Bushman (2009) and others, having lower audit committee Independence and higher earnings management can be part of the general equilibrium and does not necessarily indicate that audit committee Independence reduces earnings management.

2.1.2. Audit Committee size and Earnings Management

It is generally believed that an audit committee provides effective monitoring of the financial discretion of management and in ensuring the credibility of the financial statements. An audit committee is a sub-committee of the board that specializes in, and is responsible for, ensuring the accuracy and reliability of the financial statements provided by management. Indeed, much of the blame and criticism for accounting irregularities is aimed at audit committees for not fulfilling their financial reporting oversight duties due to independence issues (Pergola, 2005).

Klein (2002) finds a negative association between earnings management and the proportion of the audit committee, or audit committees comprising majority independent audit committee and earnings management. However, she finds a positive association and therefore argues there is no meaningful relation (Klein, 2002) between audit committees and earnings manipulation. Audit committees are intended to monitor the financial reporting process and constrain opportunistic managerial reporting. This role reflects agency theory and the need to monitor managers (agents) to reduce their ability to extract rents from the firm (Beasley *et al.*, 2009)

Bedard *et al*. (2004) found significant negative relation between measures of earnings management and audit committees. However, they found no significant relation between earnings management and audit committee proxied by annual meetings. Cheng and Warfield (2005) investigated whether the propensity for earnings management is lower when managements' interest and owners' interests are aligned through higher managerial ownership. Their results confirmed that earnings management is lower for firms with higher managerial ownership.

In Indonesia, research done by Parulian (2004) in Siregar and Utama (2008) reveal that there are negative relation between discretionary accrual with the audit committee. Klein (2002) and Jaggi and Leung (2007) states that company that has an audit company can prevent earnings management practices done by the management. Dabo and Adeyemi (2009) found that audit committee is positively related with discretionary accruals in Nigerian manufacturing firms. Managerial investors are another important variable that is often examined by researchers in the corporate governance literature. It is argued that firms with large managerial shareholders are more likely to act in the interest of the investors, because large institutions have more resources and ability to monitor, discipline and influence managers (Hartzel and Stark, 2003).

Audit committee can reduce earnings management practice in a company with a concentrated owner. Lin (2006) did a research to test the effect of audit committee existence with earnings management showing a negative effect, meaning audit committee can reduce earnings management practice done by the management. There is evidence that the composition of the board of audit committee affects the reliability of financial statements. Abbott *et al*., (2004) and Bedard *et al*., (2004) found that the independence and activity level (their proxy for audit committee diligence) of the audit committee exhibit a significant and negative association with the occurrence of restatement. They also document a significant negative association between an audit committee that includes at least one member with financial expertise and restatement. They found that aggressive earnings management is negatively associated with the financial and governance expertise of audit committee members, with indicators of independence, and with the presence of a clear mandate defining the responsibilities of the committee.

Klein (2002) finds the magnitude of abnormal accruals to be more pronounced for firms with audit committees comprised of less than a majority of independent audit committee. While she finds a negative association between abnormal accruals and the percent of outside audit committee on the audit committee, she finds no difference in abnormal accruals between firms with and without wholly independent committees. Zhou and Chen (2004) found that banks with more active audit committees, audit committees with greater governance expertise, and boards that are more active are associated with less earnings management. When they further classify firms into high and low earnings management groups, they find that the number of audit committee meetings, audit committee members' governance expertise, and board meetings are negatively related to earnings management for low earnings management banks. For the high earnings management group and audit committee size play an important role in constraining earnings management.

DeZoort and Salterio (2001) report that audit committee members with greater audit-reporting knowledge will show more support for the auditor in a dispute with client management than will members with less audit-reporting knowledge. In terms of business-specific expertise. An Audit Committee is vital in monitoring the company's operation and internal control system with the aim of protecting the interest of the shareholders. An effective audit committee would focus on improving the company performance and competitiveness, particularly in a changing business environment which is beyond the control of the company (Craven at el., 2001).

2.1.3. Audit Committee Tenure and Earnings Management

Audit committee tenure is defined as the average tenure (in number of years) of all outside audit committee on the board and a director‘s tenure is calculated as the year of annual meeting minus the start year of audit committee minus any breaks in the service of audit committee (Jensen, 2006). The tenure will provide the board with the experience and abilities to control and supervise the company's activities. This in turn will support the board's effectiveness in doing its functions in the company, and this is an important part of corporate governance which ensures the implementation of company strategies, supervision of the management in their tasks, and accountability of the earnings management (James, 2001).

Board members with a longer tenure are responsible for supervision. They examine financial reports from the corporation and then give their assessment of the reports. They are expected to notice inconsistencies in the reports and report these inconsistencies. The board committee's presence alone may reduce earnings management practices (Klein, 2002). This is in accordance with Lin's (2006) reveals that a tenured committee may reduce the company earnings management practices.

Longer audit committee tenures may lead to board interlock which occurs when a board implements interlocking audit committee in the company. Interlocking audit committee refers to a board in one company that also functions as a board in another. The board may be the supervisory board in one company and the management board in another. Interlocking audit committeehip contributes positively to a company, in that the company will receive more information on its external environments. The research by Rommens, Cuyvers and Deloof (2007) discovers a significantly negative connection between board interlock and company leverage. The research also finds that a board from a company with a high leverage is a rather unattractive board candidate for other companies (Rommens, Cuyvers and Deloof, 2007).

Tenure of a audit committee may determine his or her effectiveness in managing the firm and in acquisition of effective earnings management. Some studies suggest that top officials with little experience have limited effectiveness because it takes time to gain an adequate understanding of the company (Alderfer, 2006). The tenure of a firm‘s audit committee at the aggregate level affects both the level of the board‘s firm-specific knowledge as well as the extent of its independence and in overall its earnings management. On the one hand, firm-specific knowledge can be accumulated as tenure increases over time and this on-job learning improves firm value (Celikyurt *et al.*, 2012). On the other hand, increased familiarity between the board and management can undermine independence (Fracassi and Tate, 2011; Hwang and Kim, 2009).

Anecdotal evidence suggests that long audit committee tenure is negatively associated with firm performance in the aspect of earnings management, and that shareholders are concerned about boards with long tenure. (Jones 2001). Audit committee tenure is negatively correlated with earnings management and is positively correlated with CEO ownership and board interlocking. Complexity of a firm's operation is associated with longer audit committee tenure. Coles, Daniel, and Naveen (2008) show that firms operating in a more complex environment have greater board advisory needs and thus longer audit committee tenure may help board to better understand the business. Bedard at el., (2004) argue that director audit committee tenure may reflect monitoring effectiveness. Audit committee with long audit committee tenure have greater knowledge and experience, thus resulting in higher monitoring effectiveness. On the other hand, long tenure audit committee may be less effective because they are more likely to befriend managers and are less likely to adequately monitor managers (Vafeas, 2003).

The value contribution of insider board members may also change with their tenure. A number of studies in the management literature examine how CEO tenure is related to firm value. Hambrick and Fukutomi (2001) provide a conceptual framework for the time-series pattern of the effect of CEO tenure on earnings management, identifying an initial period of adaptive learning, whereby new CEOs gain knowledge about the firm and address the structural and organizational challenges it faces. The firm's performance generally improves over this initial period. After some time, risk-aversion (McDonald and Westphal, 2003), information restriction (Katz, 2002; Miller, 2001), preference for the status quo (March and March, 2007; Steven, Beyer, and Trice, 2008; Hambrick, Geletkanycz, and Fredrickson, 2003), and entrenchment (Miller, 2001) take over, leading to a downturn in firm performance. Long tenure audit committee may have high reputation developed over time. Those audit committee are likely to pay more attention to the job performance as the poor performance will dramatically impair their reputational capitals. In addition, audit committee who survive long tenure must perform well if the job market of audit committee is efficient (Vafeas, 2003).

3. Material and methods

This study adopted an explanatory design because the research tries to establish causal relationships. The target population for the study comprised of the listed firms at Nairobi Securities Exchange, by 2014 there were 60 listed firms trading at the NSE and therefore the target population above was chosen since the data required was easily accessible. Census technique was used in the study since it only captured all the 45 firms that have consistently been operating at the NSE for the past 8 years from 2005-2012 irrespective of its industry or market segment. Document analysis was used because data being collected was secondary in nature.

3.1 Measurement of Variables

Dependent variable

Earnings management was measured as the difference between net income, which is the earnings before taxation and extraordinary item and cash flow from operating activities (Dechow et al. 1995).

Independent variable

Presence of Audit committee size was coded 1; otherwise 0 and the frequency of board meetings was taken for every company during the year (Henry, 2010; Khan, 2010; Zhou and Chan, 2004).

Audit committee tenure was measured as the number years audit committee have been in the board (Peasnell *et al*., 2005).

Audit committee Independence was measured as the percentage of non-executive audit committee members on the board (Beasley, 1996; Klein, 2002; Beekes *et al*., 2004).

Control Variables

Firm size was measured as the natural log of total revenue, industry was rated 1 for industrial and allied, 2 for commercial, 3 for financial, 4 was Agricultural sectors (Henry, 2010) . Firm age is measured in the number of years the firm has been in operation since the year of initiations.

3.2. Data Analysis and Presentation

Data collected was analyzed by use of quantitative technique; quantitative data was analyzed using descriptive statistical method, the statistical tools such as frequency distribution, tables. Measures of central tendency such as mean, mode and median were used. Regression analysis was used to analyze the data collected and data was presented using tables. Hypothesis was tested at 0.05 level of significance (95% confidence level) from the multiple regression model which showed the relationship between the independent variable and dependent variable. The data was analyzed using SPSS version 20 and was presented in a tabular form. The regression model used in this study was given as;

$$y_{it} = \beta_0 + \beta_1 x_{1it} + \beta_2 x_{2it} + \beta_3 x_{3it} + \text{å}$$

y = earnings management

β_0 = Constant of the equation

x_1 = Audit committee Independence

x_3 = Audit committee

x_4 = Audit committee tenure

β_1 - β_4 are the coefficient regression or change induced in y by each x

t = time

I = measure of firms observation at t^{th} time

ε = error term

4. Findings and Discussion

4.1. Descriptive Statistics

Findings from table 4.1 indicated that average board size was 9 members with 74% of board members being independent audit committee. Maximum board size was 17 members while minimum were 3 members. This means that on average the number of board members in firms listed in NSE was 9 board members. It shows that board members hold meeting in average of 5 times a year. More findings revealed that 41% of firms had audit committee and 24% of the firms had CEO serving as a chairperson and CEO at the same time. Firms were reported to have an average of 53 years since the year of incorporation and 74% shareholder concentration. Firm size ratio was 6.6906 and gender was at a mean ratio of 0.4286. This implies on average there board of audit committee is composed of 42 women audit committee.

Table 1: Descriptive Statistics

	Minimum	Maximum	Mean	Std. Deviation	Skewness
Audit committee independence	0.03	0.99	0.7464	0.16932	-1.625
Audit committee tenure	1	15.55	5.1366	2.49754	1.251

Audit Committee size	0	1	0.4173	0.49379	0.337
Firm size	4	8.46	6.6552	0.76845	-0.291
AGE	0	158	53.6043	27.96826	0.869

4.2. Correlation Results

Table 2 represents Pearson correlation results of the study. The findings indicate that audit committee tenure had negative and significantly association with earning management (r = 0.110, ρ<0.05). Further, audit committee size was positively and significantly correlated to earning management(r = 0.126, ρ<0.05). However, firm size was negatively correlated with earning management (r = 0.402, ρ<0.01). However, audit committee independence and age had no significant relationship with earning management. This implies that only four variables are expected to influence earning management.

Table 2: Correlations

	1	2	3	3	4	5
1	1					
2	0.049	1				
3	-.110*	0.048	1			
4	.126*	.116*	0.076	1		
5	-.402**	-0.03	.119*	0.029	1	
6	-0.05	.105*	0	0.068	0.074	1

** Correlation is significant at the 0.01 level (2-tailed)
.* Correlation is significant at the 0.05 level (2-tailed).

1 = Earning management
2 =audit committee independence
3 = Audit committee tenure
4 = Audit Committee size
5 = Firm size
6 = Age

4.3. Hypothesis testing

The study findings in Table 3 showed that all the study test variables explained 47.29% variation of earning management. This showed that considering the independent variables, there is a probability of predicting earning management (R squared = 0.4729). Further, coefficient of determination was significant as evidence of F ratio of 23.52 with p value 0.000<0.05 (level of significance).

Hypothesis 1 postulates that audit committee Independence has no significant effect on earnings management. Hypothesis 1 stated that audit committee Independence has no significant effect on earning management. Study findings revealed that indeed audit committee Independence has no significant effect on audit committee Independence as evidenced by (β_1= 0.03, ρ>0.05).Consistent with the results, Agrawal and Chadha (2005), and Siregar and Utama (2008) found no relationship between board's independence and earnings management. Also, Mak, and Tan (2006) in Singapore failed to find any association between earnings management and audit committee Independence.

As much as the study has found no relationship between audit committee Independence and earning management, audit committee Independence from management is one of the important factors determining the board effectiveness and monitoring ability. For instance, Ching *et al*., (2002) argues that a board comprising of non-executive and external audit committee increases board's independence and monitors top management effectively hence preventing earning management. Contrary to the results, Xie *et al*. (2003), Peasnell *et al*. (2005; 2006), and Liu and Lu (2007) indicate that external audit committee are negatively related to earnings management. In a similar vein, Mohd Saleh *et al*. (2005) in a study of sampled firms listed on Bursa Malaysia found a positive relationship between discretionary accruals and the ratio of non-executive and independent audit committee in firms with negative unmanaged earning as a result of big bath activities.

Hypothesis 2 stipulated that audit committee tenure has no significant effect on earning management. The study however insignificant effect between audit committee tenure and earning management. In contrary with the results, Chtourou *et al* (2001) found that average tenure of outside audit committee is negatively associated with the level of earnings management. Moreover, Beasley (1996) finds the likelihood of financial reporting fraud to be negatively related to the average tenure of non-executive audit committee. Moreover,

Hypothesis 3 postulated that audit committee has no significant effect on earning management. Even so, study findings showed that audit committee size has a positive and significant effect on earning management (β_3= 0.136, ρ<0.05). Contrary to the results, Klein (2002), reports that the existence of audit committee reduces the earning management practices through reviewing the corporation's financial statements, audit process and internal accounting. In the same way, Abbott *et al* (2002) shows that financial misstatements are less likely to occur in firms whose audit committees are independent and have at least one financial expert. Consequently, audit committee alleviates agency conflicts between top management and shareholders by improving the quality of financial reporting and information asymmetry between inside s and outside managers. Further, Xie *et al* (2003) finds that audit committees that are more independent, meet more often and have members with financial background hence they are less likely to engage in earning management. Furthermore, research done by Parulian (2004) in Siregar and Utama (2008) reveal that there are negative relation between discretionary accrual with the audit committee. Similarly, Klein (2002) states that a company that has an audit company can prevent earning management practices done by the management. Additionally, Jaggi and Leung (2007) are also of the same opinion and they argued that audit committee can reduce earning management practice in a company with a concentrated owner. In a similar vein, Lin (2006) indicated a negative effect between audit committee and earning management implying that the existence of an audit committee leads to a decline in earning management.

Table 3: Regression Results for Testing the Hypothesis

	Coef.	**Std. Err.**	t-value	P value
audit committee Independence	0.156809	4453186	0.35	0.725
Audit committee tenure	0.002501	0.029237	0.09	0.932
Audit Committee size	0.439173	0.150722	2.91	0.004
Firm size	-1.48738	0.103826	-14.33	0.000
Age	0.00134	0.002611	0.51	0.608
constant	13.85867	0.989437	14.01	0.0000
R-sq: overall	0.4729			
R-sq: between	0.1165			

F(14, 352)	23.52
Prob > F	0.0000

5. Conclusion and Recommendations

The study results have shown no significant effect between audit committee Independence and earning management. However, the more the firms have external audit committee, the more effective they monitor managers. This is due to the fact that they are able to stand pressures from the firm's management to manage earnings because they do not have self interest in the firm. Further, external audit committee is independent of management and are more effective in protecting the interests of shareholders when there is an agency problem. A balanced board is therefore important for balanced board composition, prevention of earning management and enabling the board to function effectively.

Also, the results of the study indicated a negative association between the tenure of non-executive members and earning management. Particularly, the results of the study show that the longer the experience of non-executive members, the more knowledgeable they become. As a result they are more capable of monitoring managers and the financial reporting process. However, basing on Corporate Audit committee (NACD) Board Guidelines 1999, outside audit committee with longer tenure are more likely to be entrenched with managers and thus enhance earning management.

The results of the study have shown a positive and significant effect between audit committee and earning management. The insight on the positive association between audit committee and earning management has shed new light onto the existing body of literature since a number of prior studies have indicated the negative link between audit committee and earning management. It is generally believed that audit committee independence negatively affects earning management. Previous studies have provided plenty of evidence that an independent audit committee is better at monitoring financial reporting and auditing process of the firm.(e.g., Abbott *et al*., (2002); Parulian (2004); Jaggi and Leung (2007) and Lin (2006)).

The results of the study also indicate that non-executive members' tenure has a negative effect on earning management. This is an indication that the longer the experience of outside audit committee on the board, the better knowledge of company and their executives they will get. Therefore, outside audit committee may be more capable of monitoring managers and financial reporting process if they have served the board for a longer time. As a result, there is need to re-elect non-executive members that have served for more than 9 years to the board because of their vast experience.

The results of the study indicate that audit committee has a positive and significant effect on earning management. It is therefore necessary for the audit committee to meet regularly with firm's outside auditors and internal financial managers to review the corporation's financial statements, audit process and internal accounting controls so as to prevent earning management from being practiced by management. The audit committee should be independent and have at least one financial so as to prevent financial misstatements.

This paper was limited to three important audit committee characteristics namely, audit committee, size and audit committee Independence. While this thesis only examined internal governance mechanisms, it is possible that external governance factors not explored in this thesis also determined the earning management. These points to the need of future researchers to explore the effect of external governance factors.

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