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AUDIT COMMITTEE EFFECTIVENESS TOWARDS QUALITY OF FINANCIAL REPORTING OF COOPERATIVES IN NORTHERN PHILIPPINES

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ABSTRACT

This study explores the factors influencing effectiveness of audit committee that improve quality of financial reporting and eventually enhance good cooperative governance. The target population was the duly registered cooperatives in Ifugao province in Northern Luzon, Philippines. The findings from both correlation and regression analysis revealed that audit committee independence, audit committee financial competence and audit committee meetings had statistically significant relationship with the quality of financial reporting. From the findings, the study concluded that members of audit committee of cooperatives must have high level of independence, financially competent and hold quality meetings to enhance the quality of their financial reporting. The current study may have provided some useful insights into the importance of audit committee effectiveness towards quality of financial reporting in the context of cooperatives in Ifugao, Philippines but there are some limitations. Firstly, the generalization of the results focused on cooperatives in Ifugao province. Hence, expanding the reach for cooperatives or other organizations will also enhance and provide a comprehensive data. Secondly, the data was confined to only a few variables. Thus, it would be interesting to incorporate audit committee honorarium, audit committee transparency and cultural influence as other variables for future studies on audit committee attributes and quality of financial reporting.

Keywords: Audit Committee Effectiveness, Cooperatives, Good Governance and Quality of Financial Reporting.

INTRODUCTION

The development of governance, from its emergence until today, has been characterized by the continued expansion of scope, processes and structures planned to help in the attainment of organizational objectives. As such, government and regulatory authorities exert efforts in setting up stringent governance systems to ensure the running of organizations smoothly. Among the integral parts of effective governance are external and internal audit. External auditing has long been a legal requirement for most organizations in assuring reliability of the information in the financial reports. Internal auditing, on the other hand, though traditionally not mandatory; is now being acknowledged as a significant aspect in enhancing governance, accountability, and transparency. Moreover, Yasin and Nelson (2012) claimed that aside from internal audit, audit committee also act as the internal control mechanism of the organization and is regarded as crucial and essential in ensuring accuracy and reliability in financial reporting. Hence, as a basic instrument of effective governance, several studies have suggested the establishment of audit committees whether for private and public organizations (Wiralestari and Tansil, 2015; Al-Baidhani, 2016) to safeguard all stakeholders' interests (Zeng and Jiang, 2009).

Drogalas et al (2016) posit that with a number of recent financial scandals which can be ascribed to weak organizational structures and financial manipulations, there is a necessity to examine and understand the various components of good governance and its connection to the different departments particularly those assigned to the monitoring processes like internal audit and the audit committee. Oniwinde's (2010) also recommended the need to investigate the audit committee's position as they directly or indirectly play an important function in overseeing financial reporting due to the different incidences of poor and fraudulent financial reporting including weak governance.

Just like any organization, cooperatives require an audit committee to ensure their efficiency and success. In the Philippines, cooperatives have long been a government policy tool for promoting fairness, social justice, and economic development, as stated in the 1987 Philippine Constitution and enabling legislation established by the Philippine legislature. (Castillo and Castillo, 2017). Like many developing countries, the population of the Philippines continuous to escalate placing intense demands for the government to implement sustainable development programs for the cooperative sector, perceived to have a socio-economic impact to the poor communities (Deriada, 2005). As such, the Philippine government passed and executed different laws, policies and regulations related to cooperatives in order to support their formation and organization and to create an environment conducive for its growth and development. In addition, with the creation of the Cooperative Development Authority tasked to support sustainability and development of cooperatives, the growing number of these organizations in the country shows that the public still considers cooperatives as good vehicle in seeking assistance for improving one's socio-economic situation.

Altman (2009) stated that even if cooperatives are not dominant; their quantitative positions in most developing countries particularly in the marginalized community, their sustainability and

their relatively high levels of production indicates that these types of organizations tried their best to have sustained a substantial stance in a globally increasing competitive arena. Furthermore, the International Co-operative Alliance (2008) states that as there are different types of cooperatives, there is no accurate weigh on the value of cooperatives in the modern era. Hence, cooperatives continuously to play a significant role globally with its importance that differ among countries such as retailing of consumer goods, micro-credit and other services that minimize or eradicate economic and social quandaries encountered by the economically and marginalized individuals. As cited by Shabri et al (2016), Azrah and Fatimy (2008) concluded that setting up of cooperatives in emerging continents of South America, Asia and Africa including the developed countries like Europe and North America indicate the key role played by these organizations in one's economy around the world. However, cooperatives face a lot of governance problems brought by mismanagement, partiality, theft of resources, conflict of interest among officials, hiring and dismissal of staffs and lack of accountability among leaders and members (Remato's report, 2011). Though, Shabri, et. Al (2016) stated that having good or strong internal control systems is not a guarantee for cooperative's profitability as it requires a lot of efforts and works, good governance is essential for the cooperative's sustainability and stability. Corporate governance in cooperative societies is a sensitive and difficult topic on a global scale, because cooperatives are based on the law of democracy in decision-making and have a larger share of ownership than traditional businesses. (Labie & Perilleux, 2009).

Significance of the Study

This study examined the impact of the characteristics of audit committee member such as audit committee independence, audit committee financial competence, audit committee diversity and conduct of audit committee meetings on the quality of financial reporting in cooperatives in the province of Ifugao, Philippines. The research is important for cooperatives and other authorities concerned about audit committee effectiveness in monitoring financial reporting processes and other relevant issues. Aside from that, the formation of audit committees is no longer a problem, as the question has been answered emphatically in the affirmative. Hence, audit committee were formed to helps the board to track the activities cooperatives, prevents the occurrence of irregularities or lapses, keeps the organization healthy and increase the likelihood of achieving its organizational goals. Additionally, audit committee promotes the overall governance as it serves as a basis for a sound and secure operation and ensure the quality of financial reporting and the reliability of financial reports, which are bases by the different stakeholders for a sound decisions-making.

However, academicians, regulatory organizations, and other stakeholders in the Philippines and around the world are debating the usefulness of audit committees in improving financial reporting quality. This is because, despite the fact that audit committees are required in some organizations, such as cooperatives, their usefulness as governance instruments is still being debated.

Although numerous researches conclude that effective functioning of the audit committee is indispensable in mitigating the risk of corporate failures and to enhance public confidence (Mohiuddin & Karbhari, 2010), in monitoring the financial reporting process (Mohiuddin & Karbhari, 2010) and in enhancing the quality of financial reporting (Jerubet, Chepng'eno and Tenai, 2017); still, there are gaps that need to be addressed. Firstly, previous studies may have focused on audit committee characteristics, only a few operationalized in terms of audit

committee independence, audit committee financial competence, audit committee diversity and conduct of audit committee meetings. Further, those few studies that operationalized on these variables have reported conflicting findings after evaluating its effects on the quality of financial reporting. Secondly, these fields have not been widely evaluated in the Philippines and especially in the cooperative sector. Additionally, most of the reviewed research focused on companies quoted in the stock exchanges, public sector, or banks of various countries.

Currently, to strengthen the governance regime in the Philippines, the “2016 Code of Corporate Governance” mandates that audit committee should be composed of at least three members, all non-executive with most independent directors and at least one independent director who have adequate skills and background in accounting, finance, and audit. Further, it is recommended that the members of the audit committee should meet at least four times during the year. Hence, there is a need to conduct research on cooperatives in the Philippines so as to evaluate the effectiveness of audit committees in cooperatives and its impact on the quality of financial reporting.

LITERATURE REVIEW

Independence of Audit Committee Members

In the many aspects of audit committee literature that tried to establish the impact of different proportions of audit committee independence on financial reporting quality, most studies showed mixed results (Wu et al., 2012). For example, Madawaki and Ahman (2013) and Jerubet, Chepng’eno and Tenai (2017) established a significant relationship between audit committee independence and quality of financial reporting. Jerubet, Chepng’eno and Tenai (2017) noted that independent audit committee helps ensure that management is open and honest, providing accurate information.

On the contrary, Plumlee and Yohn (2010) did not establish any association between reduced financial statement restatement and the existence of majority independent directors. They reported that only the presence of an audit committee is associated with lower financial statement restatements but not necessarily independent audit committee.

Financial Competence of Audit Committee

Because of the nature of the reports and ideas that management would want to present for consideration, the presence of competent members of the audit committee has garnered significant study attention (Fejembola et al., 2018).

Members of the audit committee with accounting experience can help the committee monitor the financial reporting process more effectively (Sun et al., 2014). This view is supported by Kusnadi et al. (2016) explaining that because the audit committee's primary responsibility is to oversee the company's financial processes, it is reasonable to believe that audit committee members with financial expertise, particularly accounting expertise, will be more effective in monitoring management's financial reporting practices, resulting in higher financial reporting quality. Jayanthi et al. (2011) postulated that directors are expected to serve as the overall monitor of management activities and the audit committee specially charged with the oversight on financial reporting. To carry out their responsibilities properly, all members of the audit committee should be financially knowledgeable, with at least one member having financial proficiency and professional qualification from recognized professional accounting bodies Kenneth (2012). This will allow the committee to carry out their tasks correctly, resulting in the

generation of credible financial statements, which is the foundation for good corporate governance (Oji and Ofoegbu, 2017).

The participation of audit committee members with accounting experience, according to most studies, improves the supervision of the financial reporting process, resulting in superior financial reporting quality (Dhaliwal et al., 2010 and Kusnadi et al., 2016). Moreover, McMullen and Reghunandan (2010) identified audit member's expertise in accounting, financial reporting, internal control and auditing as important inputs in the evaluation of audit committees' effectiveness. With the presence of accounting professionals in audit committee, quality of financial reports increases which is an indication on the important role expert plays in board monitoring and governance (Eyenubo et al., 2017). This view is similar to the study of Oji and Ofoegbu (2017) who noted that members of the audit committee should have a thorough understanding of the organization's key data and financial reporting and disclosure processes, as well as the entity's critical accounting principles and regulations.

Audit Committee Diversity

There have been numerous studies that recently introduced tenure of audit committee members as a brand-new variable into the audit committee literature such as Yang and Krishnan (2005) and Liu and Sun (2010). These studies found that the average duration of tenure of audit committee members was linked to higher financial reporting quality. Moreover, audit committee tenure was recommended by Oussii and Taktak (2018) aside from audit committee chair characteristics as other aspect of audit committee effectiveness.

Frances and Lublin (2016) have a contrasting perspective when they examined the effects of tenure on director effectiveness by focusing on corporate audit committees. They conclude that "long-tenured directors" can offer "entity's institutional memory" and deep acumen into the organization's operations across a variety of economic and competitive environments. However, Frances and Lublin's (2016) findings revealed that some investors are anxious for longtime board members who might grow too close to the firms and management teams and might cease to provide critical and fresh ideas that newer directors bring. Further, they provided "management friendliness" hypothesis and explained that long serving directors might lose their objectivity and become more likely to befriend corporation management than to represent shareholders.

Another important characteristic of audit committee is gender diversity because different genders entail diverse attitudes and ethical conduct in the performance of their duties. Women are more ethical than men when it comes to carrying out their responsibilities (Bilic and Sustic, 2011). Furthermore, according to Huang et al. (2011), women are more sensitive to establishing communications and assisting others, and thus are less likely to engage in unethical behavior such as manipulating earnings, late financial reporting, concealing vital information, or reporting over ambitious income. Presence of women boosts the ability of the organization to run smoothly, and a female presence is recognized as a complement to the male executives. Huang and Thiruvadi (2010) discovered that audit committees with at least one female director perform differently than audit committees with exclusively male members.

Meanwhile, Deloitte's (2014) study found evidence of generational diversity such that younger directors, being in their fifties, are more dynamic. According to Deloitte (2014), while senior directors bring a "depth of knowledge," younger directors have a fresh viewpoint that should not be overlooked.

Conduct of Audit Committee Meetings

The number of audit committee meetings is also observed as indicator of audit committee effectiveness. Frequent conduct of meeting is an indispensable attribute that could implicate audit committee's performance because the holding of meetings allows members of groups such as committees to come together and carry out their responsibilities. (Fejembola, 2018). For example, it establishes a mechanism for members of the audit committee to provide advisory services to the board and management (Brick & Chidambaran, 2010). Furthermore, audit committees that meet on a regular basis are better knowledgeable about the company's problems (Al-Matari, 2013) and provide a more effective oversight and monitoring system for financial activities, such as the preparation and reporting of financial data (Alqatamin, 2018). This evidence is consistent with the requirements set by Jordan's best practice code for corporate governance (ASE 2015), which stipulate that audit committees meet at least four times each year. On the other hand, Bryan, Liv and Tiras (2004) posit that audit committees conducting regular meeting improve the transparency and openness of reported earnings and therefore improve earnings quality. Aside from number of meetings, attendance of audit committee members in meetings is important to its effectiveness in the financial reporting of organizations (Rickling, 2014; Baxter and Cotter, 2009; Musa et al., 2017; Saleh et al., 2007; Yusof, 2010). Frequent meeting and attendance of members can make the audit committee be more efficient and functional in monitoring the management to suppress earnings management practice and reduce earnings manipulation (Musa et al., 2017) as well as lessen agency problem and thus, improve earnings quality (Jensen and Meckling, 1976).

In contrast, Madwaki and Amran (2013) found no positive relationship between frequency of audit committee meetings with quality of financial reporting. This finding is similar to those of Onyable, Okpanachi and Nyor (2018), Wiralestari and Tanzil (2015), Bedard, Chtourou and Courtteau (2004) and Lin et al. (2006).

Organizational Support and Staff Competence

Organizational support and professional qualifications of account staff of cooperatives must also be considered. Organizational support enhances financial reporting while having competent staff ensures that proper bookkeeping and recording is done and therefore may also enhance quality of financial reporting. Lack of them conversely affects financial reporting in a negative manner.

Figure 1. Conceptual Framework of the Study

The conceptualization shows the means to explore the interrelationships of variables in the study which serves as basis for testing hypothesis and coming up with generalizations in the findings of the study. The independent variables are the conceptualized audit committee characteristics which include independence, financial competence, diversity, and conduct of meetings. On the other hand, the dependent variable, quality of financial reporting, is operationalized by 6 measurement items for the qualitative characteristics of relevance (3 items) and reliability (3 items). The moderating variable in this study is organizational support and staff competence which is a non-audit characteristic but can affect the relationship between audit committee attributes and quality of financial reporting.

RESEARCH METHODOLOGY

The study was primarily based on qualitative approach. The target population comprised of all duly registered cooperatives in Ifugao province, Philippines. There were fifty-five duly registered cooperatives with the Cooperative Development Authority but only thirty-five cooperatives comprised the population of the study because the remaining cooperatives failed to meet the filtering requirements. The 361 respondents of the study comprised of the members of the board of directors, members of the audit committee and executives. Such individuals were considered due to their expected proximity with the confidentiality of the general operations of the audit committee as well as the qualifications and experience of the members. The pilot testing was made to the ten accounting and finance faculty of the lone university and ten senior auditors of the Commission on Audit in the province of Ifugao. After validating the questionnaire, the final questionnaires were distributed through actual administration. A response rate of 80.61% constituting a total of 291 was coded and tabulated.

Descriptive statistics which include frequency distribution, mean scores percentages and standard deviations were utilized. Aside from descriptive statistics, inferential statistics were also used in the analysis.

RESULTS AND DISCUSSION

Table 1 and 2 presents the results of the hypothesis testing. The examination of the hypothesis is based on the p-value, where a value lesser than .05, represents significant relationship.

Table 1

Inferential Results

Hypothesis	Relationship	Coefficient	P-value	Decision
H ₀₁	Independence and quality of financial reporting	0.739	0.000	Reject
H ₀₂	Competence and quality of financial reporting	0.584	0.000	Reject
H ₀₃	Audit Committee Diversity and Quality of Financial Reporting	0.023	0.698	Accept
H ₀₄	Audit Committee Meetings and Quality of Financial Reporting	0.753	0.000	Reject

Table 2

Regression Coefficient

	β	Std. Error	t	Sig.
(Constant)	0.9137	0.1338	6.8231	0.6498
Audit committee Independence	0.2700	0.0487	5.5429	0.1741
Audit committee Financial Competence	0.0770	0.0375	2.0490	0.0030
Audit Committee Diversity	0.0039	0.0225	0.1748	0.0404
Conduct of Audit committee Meetings	0.3470	0.0500	6.9302	0.2484
Organizational Support and Staff Competence	0.0875	0.0323	2.7088	0.0239

The result indicates that audit committee independence affects quality of financial reporting ($\beta = 0.739$, $p < 0.000$), hence not supporting H_{01} . The effect of audit committee financial competence is found to be positively significant ($\beta = 0.584$, $p < 0.05$). Therefore, H_{02} is supported. The findings of audit committee meetings are found to be positively significant ($\beta = 0.753$, $p < 0.05$). Hence, H_{04} is also supported. Surprisingly, in this study, audit committee diversity ($\beta = 0.137$, $p = 0.698$) is found to have no significant effect on quality of financial reporting. Therefore, H_{03} is supported. While results showed audit committee diversity ($\beta = 0.347$, $p = 0.2484$) and audit committee financial competence ($\beta = 0.347$, $p = 0.2484$) were found to have a positive and significant relationship with quality of financial reporting even after the introduction of the moderating variable (organizational support and staff competence). However, the effect of organizational support and staff over the relationship between relationship audit committee independence ($\beta = -0.270$, $p = 0.174$) and conduct of audit committee meetings ($\beta = 0.347$, $p = 0.2484$) over quality of financial reporting was found to be insignificant. Therefore, the finding leads to the conclusion that in the moderated multiple regression model, organizational support and staff competence did not significantly moderate the relationship between audit committee independence and quality of financial reports and between conduct of audit committee meetings and quality of financial reporting.

Audit committees have an essential part in the governance framework of cooperatives as these committees are acknowledged as a valuable provider of independent assurance and advice to the responsible authorities on key aspects of the organization's operations. Hence, this study sought to determine the effectiveness of audit committees and its influence on the quality of financial reporting of cooperatives in Ifugao, Philippines. Specifically, the study examined the effect of audit committee independence, audit committee financial competence, audit committee diversity and conduct of audit committee meetings on quality of financial reporting in cooperatives in Ifugao, Philippines. The study also sought to test the moderating effects of organizational support and staff competences on the relationship between audit committee and quality of financial reporting in in cooperatives in Ifugao, Philippines.

In line with previous studies, this study finds that the presence of independent and competent repress concluded that independent and financially competent representatives of audit committee are positively associated with the quality of financial reporting. Moreover, setting regular meetings with relevant and focused agendas are positively associated with the quality of financial reporting. However, having diversified individuals on the basis of age, gender and tenure in the audit committee has no significant impact on the cooperative's financial reporting.

CONCLUSION AND RECOMMENDATION

Findings gained from this study will be able to contribute to the body of knowledge on governance in a variety of ways. Firstly, this study extends knowledge on how audit committee characteristics are related to quality of financial reporting in the context of cooperatives in Ifugao, Philippines. Although there is a lot of literature on how audit committee can help improve quality of financial reporting, audit committee responsibilities vary a lot among countries, industries, and organizations. Studies have recognized that there is no "one-size-fits-all model" for audit committees and so improving their effectiveness will be more dependent on the implementation of good practices. The findings generated from the study show that with the broadening of audit committee's roles beyond their core financial reporting oversight responsibilities which place them under increasing pressure to oversee the major menaces on

their agendas in addition to fulfilling their core mandates, requires the right composition of the audit committee. Thus, policy makers should formulate policies to regulate audit committee member's qualifications particularly on financial competence which covers not only expertise, knowledge in accounting policies but also understanding on the industry and operations of the organizations. Similarly, regulatory authorities should also monitor cooperatives and similar organizations for an improved compliance with regulatory requirements.

Another important implication of the findings of the study is that appropriate frequency and efficiency of audit committee meetings with focused agendas and sufficient time and attention for in-depth discussion on critical areas helps in the enhancement of quality of financial reporting.

The outcome of this study indicates that members of the audit committee need continuing development to help them keep up to date on current issues. Hence, training providers should offer training programs, guidance, and other support tools in order to ensure that audit committee maintains knowledge of relevant developments in accounting, auditing and financial reporting, as well as new technologies for the improvement of the organization. In addition, the management of the cooperatives should try to strengthen the finance and accounting section as their function in producing reliable and auditable financial information is critical in supporting oversight role of audit committees. The finance and accounting section should be appropriately staffed and resourced which means that it has suitably qualified individuals in key positions and gives support for their continued development. Further, inculcating accounting and auditing programs to the members of cooperatives is imperative and will provide a long-term benefit for the members and the organization.

Overall, it was absolutely agreed that formation of audit committee is one of the critical factors in the enhancement of cooperative governance and quality of financial reporting entails effective audit committee. Hence, the potential gain for refining the efficacy of audit committees which eventually guarantee the quality of financial information will not only benefit the cooperative but also the whole community and the nation. Having quality financial information serves as basis in making sound decision by individuals which collectively help the cooperative sector and will ripple to the rest of the community.

Even though the current study has provided some useful insights into the importance of audit committee effectiveness towards quality of financial reporting in the context of cooperatives in Ifugao, Philippines, there are also some limitations that need to be addressed. Firstly, the generalization of the results focused on cooperatives in Ifugao province. Hence, expanding the reach for cooperatives or other organizations will also enhance and provide a comprehensive data. Secondly, the data is confined to only a few variables. Thus, it would be interesting to incorporate audit committee honorarium, audit committee transparency and cultural influence as other variables for future studies on audit committee attributes and quality of financial reporting.

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