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Effect of Audit Committee Independence on Quality of Financial Reporting in Non-Commercial State Corporations in Kenya

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Abstract: *The purpose of this study was to establish the effect of audit committee independence on quality of financial reporting in non-commercial state corporations in Kenya. All the non-commercial state corporations that existed in 2005 were studied. The study was founded on agency theory, and stewardship theory. The study adopted descriptive research design and the target population of the study was the seventy two non-commercial state corporations that existed subsequent to the introduction of Treasury guidelines in 2005 on formation and operationalization of audit committees in the public sector. The study used a census survey on all 72 state corporations. The study employed stratified purposive sampling to select the respondents from the target population. The study used primary and secondary data. Primary data was obtained from administration of questionnaires while secondary data was obtained from the Kenya National Audit Office annual reports, Audited Financial statements of state corporations and Finance Bills of the respective financial years. Descriptive statistics used were frequencies, mean and standard deviation, while inferential statistics used are correlation and regression analysis. Regression analysis was employed to measure relationships between dependent and independent variables. The findings from both correlation and regression analysis revealed that audit committee independence had statistically significant relationship with the quality of financial reporting. From the findings, the study concluded that audit committees of non-commercial state corporations must have high level of independence. The study recommended that audit committees in non-commercial State Corporations should be as independent as possible.*

Keywords: *Quality of Financial Reporting, Audit Committee Independence*

I. Introduction

Background of the Study

An audit committee in an organisation is appointed by the board of directors to assist the board in fulfilling their oversight responsibility to stockholders, potential stockholders, the investment community and others relating to the institution's financial statements and the financial reporting process, the systems of internal accounting and financial controls, the internal audit function, the annual independent audit of the institution's financial statements, the independent auditors' qualifications and independence and the legal compliance and ethics programs as established by management and the board. In so doing, it is the responsibility of the audit committee to maintain free and open communication between the audit committee, the independent auditors, the internal auditors and management of the Company (Salehi, Salehi, Shirazi & Shirazi, 2016).

Audit committees are identified as effective means for corporate governance that reduce the potential for fraudulent financial reporting. They can be very effective not only in providing objective oversight of the accounting of an organization, but also in helping to set an ethical "tone at the top" (Locatelli 2002; Stein 2003). Corporate governance includes relationships and accountability of the organization's stakeholders, as well as the laws, policies, procedures, practices, standards, and principles which may affect the organization's direction and control (Cadbury, 1992). It also includes reviewing the organization's practices and policies in regard to the ethical standards and principles, as well as the organization's compliance with its own code of conduct. As a corporate governance monitor, the audit committee should provide the public with correct, accurate, complete, and reliable information, and it should not leave a gap for predictions or uninformed expectations (BRC, 1999).

The primary objective of financial reporting is to provide high-quality financial reporting information concerning economic entities, primarily financial in nature, useful for economic decision making (IASB, 2008). Providing high quality financial reporting information is important because it will positively influence capital providers and other stakeholders in making investment, credit, and similar resource allocation decisions enhancing overall market efficiency (IASB, 2008). The accounting scandals of the early 2000s (Catanach and Rhoades 2003) clearly demonstrate the importance of quality of financial reporting. However, the interpretation of quality of financial reporting remains problematic due to different financial reporting environments, regulations, procedures, and understandings. One good definition on aspects of quality issues in financial accounting is from the corporate report of the Accounting Standards Steering Committee, Institute of Chartered

Accountants in England and Wales (ICAEW 1975), which identifies seven qualitative characteristics viewed as desirable for the fulfilment of their fundamental objective of communicating decision-useful measurements: relevance, understandability, reliability, completeness, objectivity, comparability, and timeliness. The focus of this study was to establish the influence of audit committee independence on the quality of financial reporting in in non-commercial state corporations in Kenya.

II. Literature Review

Theoretical Background

The origins of the agency theory can be traced back to Adam Smith in 1776 and his discussion of the problem of the separation of ownership and control. He suggested that managers of other people's money cannot be expected to watch over it with the same anxious vigilance one would expect from owners and that negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company. Dinu and Nedelcu (2015) employed agency theory in explaining transparency and quality of financial disclosures in the case of Romanian listed companies. Koładkiewicz (2014) also analysed the main agency problems and their consequences. Similarly, Nayeri and Salehi (2013) analysed the role of the agency theory in implementing management's control. This study will add to the existing literature by adopting the agency theory in explaining the relationship between audit committee independence and quality of financial reporting in non-commercial state corporations.

The emergence of stakeholder theory, according to Gay (2002) was prompted by the growing recognition by boards of the need to take account of the wider interest of the society. This theory maintains that the objectives and therefore results of the firm should be derived by balancing the conflicting aims of the various stakeholders in the firm: managers, workers, stockholders, suppliers, vendors. It implies that a board will be mainly interested in performance of the company in terms of meeting the expectations of stakeholders and ensuring that the reported results are beneficial to the shareholders. Such a board should be made up of directors with the right background, independence and experience for effectiveness of their service function.
According to this theory, a well-functioning audit committee ensures better corporate governance practices in a firm, which ultimately leads to the overall welfare of many stakeholders. Dey's (2008) conclusion is notable in this respect, he mentioned that an organization's performance and stakeholders 'value are positively affected by various governance mechanisms, including audit committee. DeZoort, Hermanson, Archambeault, and Reed (2002) emphasized stakeholder interests in the definition of effective audit committee by stating that the ultimate goal of the committee is to protect all stakeholders' interests and welfare.

Empirical Literature Review

Madawaki and Amran (2013) , indicated that formation of audit committees was positively associated with improved financial reporting quality. It was also found that audit committees having an independent chair and audit committee expertise were positively associated with financial reporting quality. Other audit committee characteristics examined were found to be insignificantly related to financial reporting quality.

Kantudu and Samaila (2015) established that power separation, independent directors, managerial shareholdings and independent audit committee are all significant implying monitoring characteristics is influencing financial reporting quality of quoted oil marketing firms in Nigeria. It was recommended that the appointment of independent directors on the companies' board should be based on the previous records of those directors in terms of performance rather than emphasizing on the proportion to total number of directors on the board. Similarly, Hundal (2013) study made an effort to demonstrate several aspects of independence of audit committee, for example, informativeness, CEO's power, and frequency of meetings, substitutability and complementarity with alternative corporate governance mechanisms, directors' share ownership, earnings management. Moses, Ofurum and Egbe (2014) study used financial records from the financial statements of fifteen twelve-monthly reports and accounts of the banks whose stocks are traded in the Nigerian Stock Exchange. The research design utilized in this dissertation is correlation research design. The test of hypotheses and other breakdown of data were empirically completed by SPSS statistic 22.0. The outcomes of the study depicted that audit committee "independence had no significant effect on earnings management in quoted Nigerian banks. The study endorsed that audit committee should be well-thought-out and operational so as to curtail earnings management. Ghafran (2013) further conducted a study on audit committees and financial reporting quality. The study examined the impact of audit committee characteristics on financial reporting quality in the context of a large sample of UK companies over the period 2007-2010. The notion of financial reporting quality was assessed by looking at the audit quality and earnings quality of the firms. This study utilised the audit fee and non-audit fee ratio as its proxies for audit quality and accruals based earnings management models as its proxies for earnings quality. The findings from the multivariate analysis showed that that audit committees meeting three or more times per year and fully independent audit committees exert a significant positive impact on the quality of reported earnings.

III. Research Methodology

The study adopted a positivism philosophy. Positivists believe that reality is stable and that it can be described from an objective viewpoint, without interfering with the phenomena being studied. The study further employed descriptive research design. This study comprised of seventy two (72) state corporations that existed in 2005 from which the target population was drawn. The respondents comprised of top and middle level employees in the audit department of the non-commercial state corporations. These categories were chosen because of their expected proximity to confidential information about audit committee members qualifications and experience as well as general operations of the audit committee. Stratified purposive sampling was used in selecting the sample respondents. A sample of one (1) employee from every non-commercial state corporation was selected to be the respondents. Stratified purposive sampling was applied to select the head of audit department to represent top level management in each state corporation who were issued with a questionnaire to respond to research statements. Questionnaires were used to obtain primary data of the study variables. Annual budgets and value of queried transactions were obtained from the Finance Bill and the annual report of the Auditor General respectively of the respective financial years. These two sets of secondary data were used to compute ratio of queried transactions to annual budget of the state corporations. The models were tested on how well they fit the data and at the same time the significance of each independent variable was tested using Fischer distribution test, F-test and beta coefficient at 95% confidence level.

IV. Analysis, Findings And Discussions

Respondents Background Information

The background information sought included education level, respondent work experience and professional qualification of the respondents. The information was intended to ascertain the credibility of the respondents to provide the information necessary for this study.

Table 1: Respondents Background Information

Demographic Characteristics		Percent (%)
Highest level of education	Polytechnic / College level	17.4
	University level	34.8
	Post graduate level	47.8
	Total	**100**
Work Experience of the respondents	Less than 2 years	4.3
	3 to 5 years	47.8
	Over 5 years	47.8
	Total	**100**

The results indicated that majority of the respondents had post graduate level of education while those who had university level were the second largest and finally those with polytechnic/college level were the least. The findings imply that all the respondents had post-secondary education which justifies why they hold top management positions in their respectively entities. The study findings show that majority of the respondents had worked for between 3 and 5 years and over 5 years with an equal percentage of 47.8%. Those who had worked for less than 2 years were the least with a percentage of 4.3%. The results imply that the respondents had stayed longer enough to provide the information required for the study. The respondents of this study included the heads of internal audit which were privy to the detailed and confidential information about audit committee members by the virtue of being the secretary to the committee (Aryan, 2015).

Data Normality Test

The assumption of linear regression requires that the data should be normally distributed. Therefore to test the normality of the dependent variable, Ratio of Queried Transactions to Annual Budget, a One-Sample Kolmogorov-Smirnov Test (KS) was conducted. The Kolmogorov-Smirnov test (also known as the K-S test or one sample Kolmogorov-Smirnov test) is a non-parametric procedure that determines whether a sample of data comes from a specific distribution, i.e., normal, uniform, Poisson, or exponential distribution. It is mostly used for evaluating the assumption of univariate normality by taking the observed cumulative distribution of scores and comparing them to the theoretical cumulative distribution for a normally distributed variable. The null and alternative hypotheses are stated below.

H_o: The data is normally distributed

H_1: The data is not normally distributed

The rule is that if the p-value is greater than 0.05, H_o is accepted and H_1 is rejected, if the p -value is less than 0.05, H_o is rejected and H_1 is accepted.

Table 2: One-Sample Kolmogorov-Smirnov Test

		Ratio Queried Transactions to Annual Budget	AC Independence
N		46	46
Normal Parameters a,b	Mean	1.232139	3.2043
	Std. Deviation	3.22507	0.5473
Most Extreme Differences	Absolute	0.351	0.2
	Positive	0.348	0.095
	Negative	-0.351	-0.2
Kolmogorov-Smirnov Z		0.382	0.356
Asymp. Sig. (2-tailed)		0.621	0.051
a Test distribution is Normal.			
b Calculated from data.			

The results obtained indicate that Kolmogorov-Smirnov Z statistic for all the variables was greater than 0.05, the null hypothesis was accepted and concluded that the data for all the variables was normally distributed and therefore fit for linear regression analysis.

Trend in numbers of non-executive members in Audit committees in state corporations
The study also analysed trend in numbers of non-executive members in Audit committees in non-commercial state corporations.

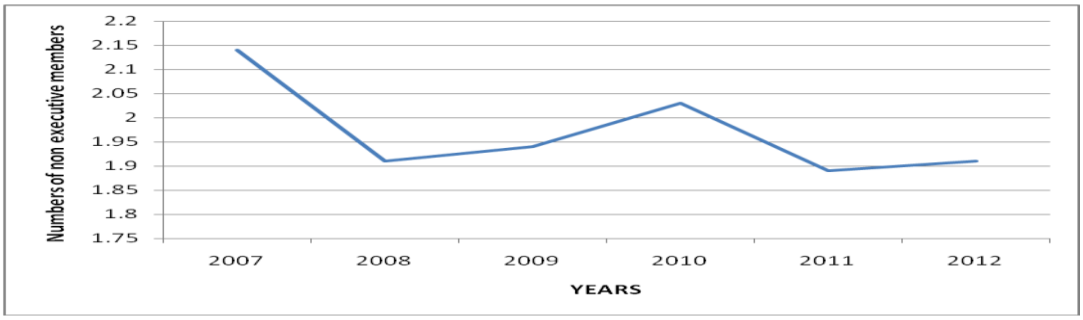

Figure 1: Trends in Numbers of Non-Executive Members

Trend analysis results showed that 2007 had the highest number of non-executive members of audit committee in non-commercial state corporations in Kenya. The numbers dropped in 2008 before increasing up to 2010. Between 2011 and 2012 the number slightly remained constant. An important contributor to this was the American Institute of Certified Public Accountants (AICPA), who issued a policy statement in 1967 encouraging public companies to establish AC's composed entirely of a membership outside the directors. Chatfield and Vangermeersch (2014) argued that the Audit Committee members should have a chairman among them who is an independent non-executive director and that the chairman should not be the chairperson of the board but could be invited to attend meetings as necessary by the chairperson of that committee.

Descriptive Analysis for Audit Committee Independence

The study sought to establish the effect of audit committee independence on quality of financial reporting in non-commercial state corporations in Kenya. The result on the statement used to measure the independence of audit committees in non-commercial state corporations is presented in Table 3. The findings are given on the scale of strongly disagree (SD) to strongly agree (SA). The results for mean, standard deviation and coefficient of variation (CoV) are also presented

Table 3: Descriptive Results for Audit Committee Independence

Statements	SD	D	N	A	SA	Mean	Std dev	CoV
Our audit committee has sufficient non-executive members	8.7%	4.3%	0.0%	34.8%	52.2%	4.2	1.22	0.29
Appointment of chairman in our audit committee is transparent	34.8%	17.4%	39.1%	2.2%	6.5%	2.3	1.17	0.51
Selection of members in our audit committee is transparent	2.2%	8.7%	17.4%	32.6%	39.1%	4.0	1.06	0.52
Audit committee members relate only professionally with managers	6.5%	0.0%	37.0%	19.6%	37.0%	3.8	1.15	0.30
Audit committee members have no form of relationship with top management	8.7%	4.3%	21.7%	34.8%	30.4%	3.7	1.2	0.32

The study sought to establish whether audit committees in non-commercial state corporations in Kenya had sufficient non-executive members. The results showed that 52.2% and 34.8% of the respondents strongly agreed and agreed respectively. The findings further showed that 8.7% and 4.3% strongly disagreed and disagreed respectively. The statement had a mean of 4.17 which further implied that majority of the respondents agreed with the statements. The standard deviation of 1.22 and coefficient of variation of 0.29 confirmed that the response slightly varied from the mean. This finding implied that there was independence in the audit committees of non-commercial state corporations in terms of having non-executive members in the ACs. The findings of this study conform to the guidelines on formation of audit committee in state corporations in Kenya. According to Institute of Certified Public Accountants of Kenya (ICPAK, 2015) report the boards of state corporations should establish an audit committee of at least three independent and nonexecutive directors who should report to the board, with written terms of reference, which deal clearly with its authority and duties.

The study further intended to find out whether the appointment of chairman in the audit committees in non-commercial state corporations was transparent; the results showed that the statement had a mean of 2.28 which indicated that majority of the respondents disagreed. Similarly the statement had a standard deviation and coefficient of variation of 1.17 and 0.51 respectively which indicated slightly high variation of the responses from the mean, an indication of varied responses on the subject. On the other hand a sizeable number agreed that the appointment of the chairman in the audit committees of non-commercial state corporations in Kenya was transparent. The finding of this study implied that the audit committee in non-commercial state corporations were independent in terms of transparency in chairman selection. According to the guideline in the ICPAK (2015) report; it states that the chairman of the audit committee should be an independent and non-executive director. Kantudu and Samaila (2015) recommended that the appointment of independent directors on the ACs should be based on the previous records of those directors in term of performance more than other factors.

The study further aimed to establish whether audit committee members relate only professionally with managers and whether audit committee members have no form of relationship with top management. All the two statement were found to have a mean of 3.8 and 3.7 respectively. The results also showed that the statements had standard deviation of slightly higher than 1 and a coefficient of variation of about 0.3 which indicated that the response had a slight variation from the mean. These findings implied that the respondents agreed and strongly agreed that members of the audit committees only related professionally and had no form of relationship with management. The findings of this study support the recommendations by Kantudu and Samaila (2015) that the appointment of members of the ACs should be very independent.

The study further sought to establish whether the selection of members in the audit committee in non-commercial state corporations was transparent. The result also revealed that the statement had a mean of 4.0, standard deviation of 1.06 and coefficient of variation of 0.52 which indicate that majority of the respondents agreed and slight variation in the response. The finding of this study implied that the audit committee in non-commercial state corporations were independent in terms of transparency in membership selection. Rezaee, Olibe & Minmier (2003) also pointed out that audit committees should comprise of members who are both independent and objective.

Correlation Results

The study also employed inferential statistics to further ascertain the relationship between independent and dependent variables.

Table 4 Correlation Results Audit Committee Independence and Ratio of Queried Transactions to Annual Budget

		Ratio of Queried Transactions to Annual Budget	Audit committee Independence
Ratio of Queried Transactions to Annual Budget	Pearson Correlation	1	-0.352*
	Sig. (2-tailed)		.016
	N	46	46
Audit committee Independence	Pearson Correlation	-0.352*	1
	Sig. (2-tailed)	.016	
	N	46	46

The correlation test results revealed a negative and significant association (r=-0.352, p=0.016) between audit committee independence and quality of financial reporting as measured by the ratio of queried transactions to annual budget in non-commercial state corporations in Kenya. The findings implied that increase in the audit committee independence reduces the ratio of queried transactions which further imply increase in the quality of financial reporting.

Similarly, Ghafran (2013) conducted a study on audit committees and financial reporting quality in the context of a large sample of UK companies over the period 2007-2010. The author found that independent audit committees exert a significant positive impact on the quality of reported earnings. Studies done in Nigeria by Madakawi (2012) and Madawaki and Amran (2013) on the audit committee characteristics and financial reporting quality in Nigerian listed companies reported that audit committees having an independent chair and audit committee expertise were positively associated with financial reporting quality. Madakawi (2012) recommended that regulatory bodies in Nigeria should mandate all the three board representatives on audit committee to be non-executive directors, while making a combination of financial and industrial expertise replace financial literacy to further improve quality of financial reporting. A study by Beasley, Carcello, Hermanson and Neal (2000) found companies that committed fraud had less independent audit committees compared to their counterparts that did not commit fraud.

Regression Analysis Results

To investigate the nature and strength of the relationship between audit committees of non-commercial state corporations and quality of financial reporting, the study adopted the use of ordinary least squares regression analysis. The study sought to determine the relationship between audit committee independence and quality of financial reporting which was measured by the ratio of queried transactions to annual budget. The study used regression to test the relationship between audit independence and quality of financial reporting. The regression analysis for audit committee independence and ratio of queried transactions to annual budget revealed that audit committee independence explained 12.4% of the variation in the ratio of queried transactions to annual budget (R^2=0.124) while the remaining percentage of 87.6% was explained by other variables.

Table 5: Model Summary for Audit Committee Independence

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	-.352[a]	.124	.104	3.0529583647
a. Predictors: (Constant), Audit committee Independence				

F-test was carried out to test the null hypothesis that there is no significant impact of audit committee independence on quality of financial reporting (ratio of queried transactions to annual budget) of non-commercial state corporations in Kenya. The results of ANOVA test show that the F value is 6.217 with a significance of p value = 0.016 which is less than 0.05, meaning that null hypothesis was rejected and concluded that there is a relationship between audit committee independence and quality of financial reporting (ratio of queried transactions to annual budget) of non-commercial state corporations in Kenya.

Table 5: ANOVA for Audit Committee Independence

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	57.944	1	57.944	6.217	.016[b]
	Residual	410.104	44	9.321		
	Total	468.048	45			
a. Dependent Variable: Ratio of queried Transactions to Annual Budget						
b. Predictors: (Constant), Audit committee Independence						

To further test the significance of regression relationship between audit committee independence and quality of financial reporting (ratio of queried transactions to annual budget), the regression coefficients (β), the intercept (α), and the significance of all coefficients in the model were subjected to the t-test to test the null hypothesis that the coefficients are zero. The null hypothesis state that, β (beta) = 0, meaning there is no significant relationship between audit committee independence and quality of financial reporting as the slope β (beta) = 0 (no relationship between the two variables).

Table 7: Regression Coefficients for Audit Committee Independence

	B	**Std. Error**	**Beta**	**T**	**Sig.**
(Constant)	7.876	2.702		2.914	0.006
Audit committee Independence	-2.073	0.832	-0.352	-2.493	0.016
a Dependent Variable: Ratio of queried Transactions to Annual Budget					

The results on the beta coefficient of the resulting model showed that the constant α = 7.876 was significantly different from 0, since the p- value = 0.006 was less than 0.05. The coefficient β = -2.073 was also significantly different from 0 with a p-value=0.016 which was less than 0.05. The results imply that a unit change in audit committee independence will result in -2.073 units change in ratio of queried transactions to annual budget. This confirms that there is a significant negative linear relationship between audit committee independence and ratio of queried transactions to annual budget of non-commercial state corporations in Kenya.

The reduction in the ratio of queried transactions to annual budget implies improved quality of financial reporting therefore these findings further indicate that increase in audit committee independence was found to result to increase in quality of financial reporting.

Similarly, Ghafran (2013) found that independent audit committees exert a significant positive impact on the quality of reported earnings. Studies done in Nigeria by Madakawi (2012) and Madawaki and Amran (2013) reported that audit committees having an independent chair and audit committee expertise were positively associated with financial reporting quality. A study by Beasley, Carcello, Hermanson and Neal (2000) found companies that committed fraud had less independent audit committees compared to their counterparts that did not commit fraud. Klein (2002) found that audit committee independence was negatively associated with abnormal accruals and that reductions in audit committee independence were associated with large increases in abnormal accruals. Bedard *et al*. (2004) investigated the association between different audit committee characteristics and earnings management. They found that aggressive earnings management is negatively associated with the presence of an independent audit committee.

V. Conclusion

This study supports the argument by various authors that an effective audit committee represents a good corporate governance mechanism that reduces potential agency conflicts arising due to the separation of corporate control and ownership between the management and the shareholders. Therefore the roles assigned to the audit committee requires it to have some characteristics that will enable it achieve its objectives. From the findings, the study concluded that audit committees must have high level of independence in order to execute their roles and mandate effectively. This will in turn enhance the quality of financial reporting. The primary objective of financial reporting is to provide high-quality financial reporting information concerning economic entities, primarily financial in nature, useful for economic decision making.

VI. Recommendations

Based on the findings of this study, the following recommendations were made; the study recommended that audit committees in non-commercial state corporations should be as independent as possible. Independence has been accepted as a good practice in corporate governance. In state corporations, audit committee members could be perceived as independent of the entity but this independence is usually eroded as they become affiliated with the management, and as a result they rely more and more on the financial rewards from the entity at the expense of committee effectiveness.

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