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

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ABSTRACT

The purpose of this study was to establish the effect of audit committee meetings on quality of financial reporting in non-commercial state corporations in Kenya. All the non- commercial state corporations were studied. The study was founded on stewardship theory and the policeman theory. Empirical evidence on influence of audit committees on quality of financial reporting was reviewed analysed and research gaps identified. The study adopted descriptive research design and used census on all 72 state corporations. The study used primary and secondary data. Primary data was obtained from administration of questionnaires and the secondary data obtained from the Kenya National Audit Office annual reports, Audited Financial statements of state corporations and Finance Bills of the respective financial years. Regression analysis was employed to ascertain existence of relationships between dependent and independent variables. The findings from both correlation and regression analysis revealed that audit committee meetings had statistically significant relationship with the quality of financial reporting. The results revealed that audit committee meetings reduced the ratio of queried transactions to annual budget of non-commercial state corporations in Kenya.

Keywords: Audit committee, Audit committee meetings, quality of financial reporting.

INTRODUCTION

Background of the Study

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). Audit committees are 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).

Audit committees form part of the governance structure of an entity and is arguably the most important and challenging sub-committee of any board of directors. Cadbury's committee report on the financial aspects of corporate governance concluded that an audit committee "has the potential to improve the quality of financial reporting by reviewing the financial statements on behalf of the board" (Cadbury Committee Report, 1992).

The aim of setting up audit committees in the public sector is to improve public governance (Kamolsakulchai, 2015). As a sub-committee of the governing body, an audit committee aims to provide assurance on financial and compliance issues through increased scrutiny,

accountability, and the efficient use of resources. An audit committee may also serve an advisory function aimed at performance improvement within the organisation. In the Kenyan public sector and because of the recognition accorded to accurate and quality financial reporting by several interested parties, the establishment of effective audit committees has been included in audit committee legislation through the issue of Treasury Circular 16 of 2005 and the public finance management Act of 2012 requiring all the public sector entities, to establish audit committees. The main purpose of these committees is to ensure proper financial reporting and accountability in the usage of public resources.

LITERATURE REVIEW

Stewardship Theory

Stewardship theory has its roots from psychology and sociology and it stresses on the role of top management being as stewards, integrating their goals as part of the organization as opposed to the agency theory perspective (Argyris & Schon, 1974). The stewardship perspective suggests that stewards are satisfied and motivated when organizational success is attained. It is based on a model of man where a steward perceives greater utility in cooperative, pro-organisational behaviour than in self-serving behaviour; the theory assumes a strong relationship between organisational success and a principal's satisfaction. Hence, a steward overcomes the trade-off by believing that working towards organisational, collective ends meet personal needs as well (Penman, 2007).

The theory also holds that managers do have similar interests to the corporation, in that the careers of each are linked to the attainment of organisational objectives, and their reputations are interwoven with the firm 's performance and shareholder returns (Mattor & Cheng, 2015). Tricker (1984) described accountability in stewardship theory as the means by which those who manage and oversee the affairs of the company are held to account for their stewardship of corporate assets. In organizations, these managers play the roles of stewards, safeguarding the benefits of the corporation.

The Policeman Theory

The policeman theory claims that the audit and assurance process is responsible for searching, discovering and preventing fraud. This was the case in the early 20th century. However, more recently the main focus of this process has been to provide reasonable assurance and verify the truth and fairness of the financial statements. The detection of fraud is, however, still a hot topic in the debate on the auditor's responsibilities, and typically after events where financial statement frauds have been revealed, the pressure increases on increasing the responsibilities of auditors in detecting fraud and manipulation of financial information.

This was the most widely held theory on auditing until the 1940s (Hayes, Schilder, Dassen & Wallage, 1999). Up until the 1940s it was widely held that an auditor's job was to focus on arithmetical accuracy and on prevention and detection of fraud. However, from the 1940s until the turn of the century there was a shift of auditing to mean verification of truth and fairness of the financial statements. Recent financial statement frauds such as those at Societe Generale, Satyam, Ahold, Enron have resulted in careful reconsideration of this theory.

According to this theory, the audit committees should put in place mechanisms to detect fraud before it happens just like a policeman tries to prevent crime from happening. In terms of quality of financial reporting, audit committee is viewed to perform the duty synonymous to that performed by the policemen such as to check and detect any instances of frauds in the organisations.

Empirical Literature

The study of Stewart and Munro (2007) from Australia focused on the results of frequency of meetings of the audit committee. They determined that the presence of an audit committee, the number of its meetings and the auditor's attendance for such meetings reduces audit risks, and that the external auditor believes that the presence of an audit committee is an important factor in reducing substantial risks of auditing. They further determined that reducing such risks is also affected by frequent meetings of the audit committee and auditor's attendance of such meetings. The audit committee helps in solving disputes and conflicts with the administration and that leads to more improvement in audit quality.

A study by Zábojníková (2016) sought to establish the relationship between the audit committee characteristics and firm performance. This study analysed the impact of various audit committee characteristics on firm financial performance using the evidence from non-financial UK companies listed on the London Stock Exchange. The findings suggested that there was a significant positive relationship between the audit committee size, frequency of its meetings and its financial experience and firm financial performance.

Osarumwense and Aderemi (2016) study focused on the impact of financial literacy and frequency of meetings of members of audit committee on financial reporting quality in Nigerian quoted companies. The main objective of this study was to evaluate the impact of Financial Literacy (FL) and Frequency of Meetings (FM) of members of Audit Committee on financial reporting quality in Nigerian quoted companies. The findings showed that audit committee financial literacy and audit committee frequency of meetings had a positive significant influence on financial reporting quality.

RESEARCH METHODOLOGY

Research Design

Descriptive research design was applied in this study. This research design is useful when the research objectives include determining the degree to which one variable (independent) affect the other variable (dependent).

Population of the Study

A population is defined as the total collection of all the elements about which the study wishes to make some inference (Cooper & Schindler, 2011). The population for this study comprised of all seventy-two (72) non-commercial state corporations that existed in Kenya in the financial year 2006 to 2012. Target population consists of all members of a real or hypothetical set of people, events or objects from which a researcher wishes to generalize the results of their research while accessible population consists of all the individuals who realistically could be included in the sample (Orodho, 2003).

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This study comprised of seventy-two (72) state corporations that existed in 2005 by which time the guidelines on audit committees were affected. It is from this population that the target population was drawn. The respondents comprised head of audit department of the non- commercial state corporations. These categories were chosen because of their expected proximity to information about audit committee operations.

Sampling Frame

The sampling frame for the target population was the audit department employees' data base of seventy-two state corporations. The non-commercial state corporations are categorized into six (6) sectors.

Table 1: Target Population

Category	Population
Regulatory	25
Research Institutes	10
Educational	14
Developmental/Promotional agencies	11
Culture/Social service	10
Revenue collection	2
Total	72

Source: Government of Kenya, Sessional paper 2005, privatization of state corporations and investments.

Sample Size

A sample is a relatively small portion of individuals, which acts as a representative of the entire organization (Mugenda & Mugenda, 2012). The study employed census on all the seventy-two non-commercial state corporations.

Data Collection Instruments

For the purposes of achieving the study objectives, two instruments of data collection were employed. Questionnaires were used to obtain primary data of the study variables. The questionnaire was divided into two sections.

The second instrument was secondary data template which included a summary of the transactions that the external auditor queried within that financial year derived from the audited financial statements of the non-commercial state corporations and the annual report of the Auditor General. Annual budgets for the state corporations were obtained from the Finance Bills of the respective financial years. These two sets of secondary data were used to compute the ratio of queried transactions to annual budget of the state corporation. The two sources of data were fitted into a regression model so as to derive relationships among the study variables.

Model Specification

With ordinary least square (OLS) simple and multiple regression analysis, the study assessed the effects of independent variables on the dependent variable. The model was stated as follows:

Model – Effect of Conduct of Audit Committee Meetings on Quality of Financial Reportingin non-commercial state corporations in Kenya.

$$QFR = \beta 0 + \beta 1\ (ACM) + e$$

Where:
QFR = Quality of Financial Reporting
ACM = Audit Committee Meetings.β0 = Model intercept
β1 = The beta coefficient of Audit Committee Meetings.e = Error term of the model.

Table 2: Operationalization of Variables

Category of Variable	Variable	Operationalization	Scale of Measurement	Methods of Analysis
	Audit Committee meetings	✓ Meeting Frequency ✓ Number of Meetings ✓ Relevance of Agenda ✓ Attendance of meetings	Nominal scale	Descriptive and inferential analysis • Correlation • Regression analysis

RESULTS AND DISCUSSIONS

Response Rate

A total number of 72 questionnaires were administered to the heads of audit departments in non- commercial state corporations in Kenya. A response rate of 46 was recorded. This constituted 63.89% response rate.

Factor Analysis

Factor analysis was conducted for the independent and dependent variables to find the strength of observed variables in order to reduce the number of variables, if necessary. The importance of conducting factor analysis was to summarize the information contained in a number of original variables into a smaller number of factors without losing much information. This implies that the newly created variables should represent the fundamental constructs, which underlie the original variables (Gorsuch, 1990). Factor loadings represent how much a factor explains a variable in factor analysis. The general rule of the thumb for acceptable factor loading is 0.40 or above (David, Patrick, Phillip & Kent, 2010).

Table 3: Factor Analysis for Audit Committee Meetings Subcontracts

Component	Factor Loadings	Comment
Meetings frequency.	0.804	Accepted
Adequacy of meetings held by the audit committee	0.746	Accepted
Relevance of agenda of audit committee meetings.	0.774	Accepted
Attendance of meetings.	0.622	Accepted

Extraction Method: Principal Component Analysis.

All the subcontracts for audit committee meetings were accepted based on the same rule of thumb for acceptable factor loading of 0.40 and above.

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Trends Analysis

Trend in Ratio of Queried Transactions to Annual Budget:

The study further sought to analyse the trends in the ratio of queried transactions to annual budget in non-commercial state corporations in Kenya. The results of trend analysis showed that Ratio of Queried Transactions to Annual Budget decreased from 2007 to 2008 before increasing to 2010. From 2010 to 2011 the Ratio of Queried Transactions to Annual Budget was constant before increasing in 2012.

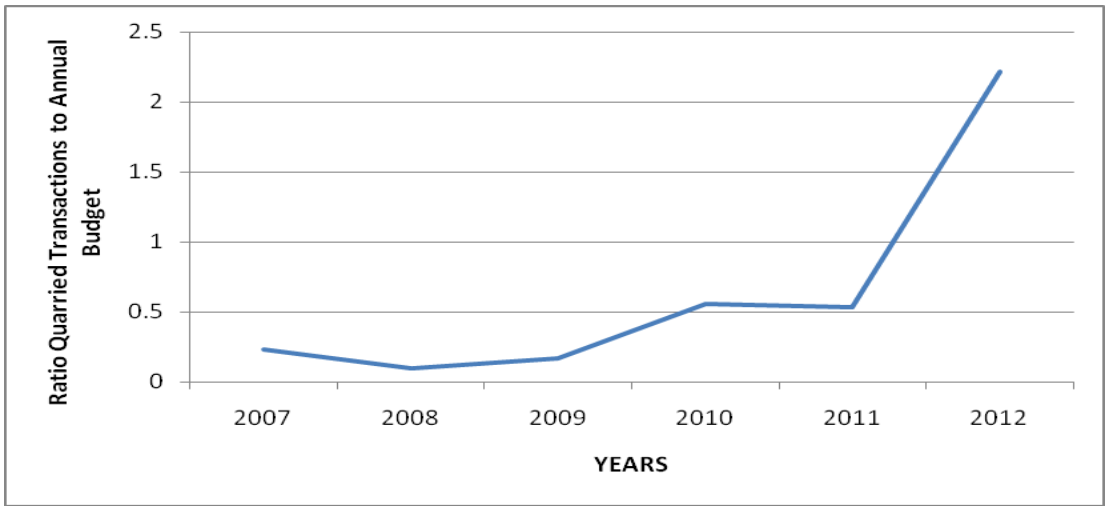

Figure 1: Trends in Ratio of Queried Transactions to Annual Budget

Trend in Number of Audit Committee Meetings:

Results showed that in the year 2007 the number of audit committee meetings in state corporations were low as compared to the year 2011 and 2012 that recorded the same number of meetings. From the year 2008 to 2011 the number of meetings of audit committee in state corporations increased. According to Stewart (2007) increasing the frequency of committee meetings lead to more effective audit committees, therefore committee members ought to be willing to devote more of their time for auditing (Lee & Mande, 2005).

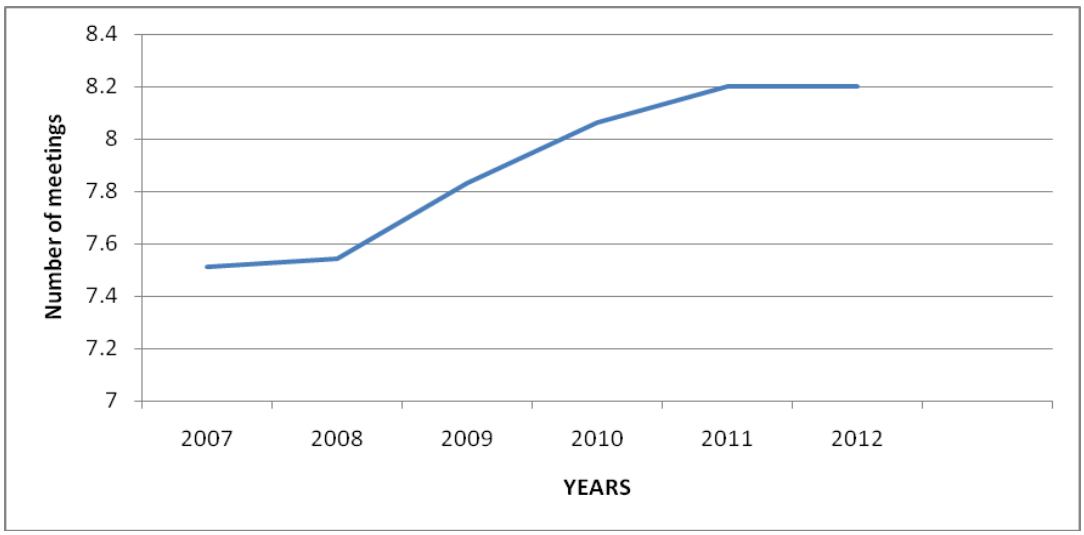

Figure 2: Trends in number of audit committee meetings

Descriptive Analysis Results

Conduct of Audit Committee Meetings:

Table 3 contains the descriptive result findings on audit committee meetings and quality offinancial reporting.

Table 4: Descriptive Results for Audit Committee Meetings

Statements	SD	D	N	A	SA	Mean	Std Dev	CoV
Frequency of audit committee meetings.	8.7%	4.3%	8.7%	37.0%	41.3%	3.98	1.22	0.31
Adequacy of audit committee meetings.	4.3%	8.7%	4.3%	45.7%	37.0%	4.02	1.09	0.27
Relevance of agenda of audit committee meetings.	8.7%	8.7%	2.2%	26.1%	54.3%	4.09	1.31	0.32
Attendance of meetings.	6.5%	6.5%	4.3%	54.3%	28.3%	3.91	1.09	0.28

The results indicated that 41.3% strongly agreed, 37% agreed while 8.7% strongly disagreed and 4.3% disagreed. The statement on whether audit committees of non-commercial state corporations held their meetings frequently had a mean of 3.98, standard deviation of 1.22 and coefficient of variation of 0.31. These findings further confirmed that majority of the audit committees in non-commercial state corporations held their meetings frequently. Having frequent meetings implied that audit committees in non-commercial state corporations had enough time to discuss issues conclusively. Stewart (2007) also shared similar views by stating that increasing the frequency of committee meetings leads to more effective audit committees, therefore committee members ought to be willing to devote their time for the meetings.

The study further sought to establish whether audit committee in non-commercial state corporations usually have relevant agenda during their meetings. The findings revealed that the statement had a mean of 3.91, a standard deviation of 1.09 and finally a coefficient of variation of 0.28. The results of the standard deviation and coefficient of variation showed that there was slight variation in the responses while the mean indicated that majority of respondents felt that the agenda in the meetings of audit committees in state corporations were relevant. Zábojníková (2016) also acknowledged the importance of relevant and frequent meetings by audit committees. The study also aimed to establish whether audit committee members attend meetings regularly. The results indicated that 54.3% strongly agreed while 26.1% agreed. The findings further revealed that the statement had a mean of 4.09, a standard deviation of 1.31 and finally a coefficient of variation of 0.32. The result of the standard deviation and coefficient of variation showed that there was slight variation in the responses while the mean indicated that majority of respondents felt that members of audit committees attended meetings regularly.

Finally, the study sought to establish whether audit committees in non-commercial state corporations held adequate number of meetings. The findings revealed that 45.7% agreed and 37.0% strongly agreed that the meetings held by the non-commercial state corporations were adequate. The statement had a mean of 4.02, standard deviation of 1.09 and coefficient of variation of 0.27 which further confirmed that the number of meeting held by audit

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committees were adequate according to the respondents. The findings conform to ICPAK (2015) guidelines that audit committees in state corporations should meet at least once in every three months. Morrissey (2000) also suggested at least four meetings in a year for audit committees. He further claims that the best quality of financial reports can be assured, if at least four sittings are held during the year. The number of audit committee meetings is a perceived indicator of audit committee effectiveness. Financial statement users perceive fewer meetings as an indicator of less commitment and insufficient time to oversee the financial reporting process.

Correlation Tests Results

The study employed correlation analysis to further ascertain the association between independentand dependent variables.

Table 5: Correlation Results for Audit Committee Meetings and Ratio of Queried Transactions to Annual Budget

		Ratio of queried Transactions to Annual Budget	Audit committee Meetings
Ratio of queried Transactions to Annual Budget	Pearson Correlation	1	-0.451**
	Sig. (2-tailed)		.001
	N	46	46
Audit committee Meetings	Pearson Correlation	-0.451**	1
	Sig. (1-tailed)	.001	
	N	46	46

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

The correlation results showed that audit committee meetings had a negative and significant (r= - 0.451, p=0.001) association with ratio of queried transaction to annual budget. The results implied that increasing audit committee meetings was found to have positive effects on quality of financial reporting since it reduced the ratio of queried transactions to annual budget.

Regression Analysis Results

To investigate the nature and strength of the relationship between audit committee meetings and quality of financial reporting, the study adopted the use of ordinary least squares regression analysis.

Regression Results for Audit Committee Meetings and Quality of Financial Reporting:

The model summary result of the regression analysis indicated that audit committee meetings explained 20.4% of the variation in the ratio of queried transactions to annual budget (R^2=0.204) while the remaining percentage of 79.6% was explained by other variables not in this model.

Table 8: Model Summary for Audit Committee Meetings

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.451a	.204	.186	2.9102117351

a. Predictors: (Constant), Audit committee Meetings

The results of ANOVA test show that the F value was 11.264 with a significance of p value = 0.002 which was less than 0.05, meaning that null hypothesis was rejected and concluded that there is a relationship between audit committee meetings and quality of financial reporting (ratio of queried transactions to annual budget) of non-commercial state corporations in Kenya.

Table 9: ANOVA for Audit Committee Meetings

Model		Sum of Squares	Df	Mean Square	F	Sig.
	Regression	95.398	1	95.398	11.264	.002[b]
1	Residual	372.651	44	8.469		
	Total	468.048	45			

a. Dependent Variable: Ratio of queried Transactions to Annual Budget

b. Predictors: (Constant), Audit committee Meetings

To further test the significance of regression relationship between audit committee meetings 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.

Table 10: Regression Coefficients for Audit Committee Meetings

	B	Std. Error	Beta	t	Sig.
(Constant)	7.908	2.035		3.886	0
Audit committee Meetings	-1.669	0.497	-0.451	-3.356	0.002

a Dependent Variable: Ratio of queried Transactions to Annual Budget

The coefficient β = -1.669 was significantly different from 0 with a p-value=0.002 which was less than 0.05. The results imply that a unit change in audit committee meetings will result in - 1.669 units change in ratio of queried transactions to annual budget. This confirmed that there was a significant negative linear relationship between audit committee meetings 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 implied improved quality of financial reporting therefore these findings further implied that increase in audit committee meetings was found to result to increase in quality of financial reporting.

Hypotheses Testing

- **H01**: Conduct of Audit committee meetings has no significant effect on quality of financialreporting in non-commercial state corporations in Kenya.

The results of ANOVA test show that the F value was 11.264 with a significance of p value = 0.002 which was less than 0.05, meaning that null hypothesis was rejected and concluded that there is a relationship between audit committee meetings and quality of financial reporting (ratio of queried transactions to annual budget) of non-commercial state corporations in Kenya. The coefficient β = -1.669 was significantly different from 0 with a p-value=0.002 which was less than 0.05. The results imply that a unit change in audit committee meetings will result in -1.669 units change in ratio of queried transactions to annual budget. This confirmed that there was a significant negative linear relationship between audit

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committee meetings and ratio of queried transactions to annual budget of non-commercial state corporations in Kenya. The null hypothesis that there was no significant relationship between audit committee meetings and quality of financial reporting in non-commercial state corporations in Kenya was rejected.

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

Summary

The objective of this study intended to establish the effects of conduct of audit committee meetings on the quality of financial reporting in non-commercial state corporations. The correlation results showed that audit committee meetings had a negative and significant association with ratio of queried transaction to annual budget. The results implied that increasing the number, frequency, relevance of agenda and attendance of audit committee meetings was found to have positive effects on quality of financial reporting since it reduced the ratio of queried transactions to annual budget.

Conclusion

The study concluded that having quality and optimal number of meetings by the audit committees improves quality of financial reporting. This is achieved when the attendance is good, agenda is relevant and the number of meetings is optimal. This will enhance the quality of financial reporting. The primary objective of financial reporting is to provide high-quality financial information concerning economic entities, primarily financial in nature but which is useful for economic decision making.

Recommendations of the Study

The study recommended that audit committees should have frequent meetings since meetings play a significant role in mitigating various issues including the agency problem ultimately influencing the quality of financial reporting. Attendance of meeting should be emphasised whilethe agenda of the meetings should be geared towards improving financial reporting.

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