

Effect Of Audit Committee Financial Competence On Quality Of Financial Reporting Among Non-Commercial State Corporations In Kenya

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ABSTRACT

The purpose of this research was to establish the effect of audit committee financial competence on quality of financial reporting in non-commercial state corporations in Kenya. The research was founded on agency theory, lending credibility theory and theory of inspired confidence. Empirical evidence on influence of audit committee financial competence on quality of financial reporting was reviewed analysed and research gaps identified. The research adopted descriptive research design and the target population was the seventy two non-commercial state corporations that existed subsequent to the introduction of The National Treasury guidelines in 2005 on formation and operationalization of audit committees in the public sector in Kenya. Descriptive statistics used in presentation of findings include frequencies, mean and standard deviation, while inferential statistics used are correlation and regression analysis. Regression analysis was employed to measure the relationship between dependent and independent variables. The findings from both correlation and regression analysis revealed that audit committee financial competence had a statistically significant relationship with the quality of financial reporting. The results revealed that audit committee financial competence reduced the ratio of queried transactions to annual budget of non-commercial state corporations in Kenya. From the findings, the research concluded that members of audit committees of non-commercial state corporations should have some level of financial competence in order to enhance the quality of their financial reporting and that audit committees should consist of members with knowledge in accounting and finance which provides a good basis for audit committee members to examine and analyse financial information.

Key words: Audit committee, financial competence, quality of financial reporting

INTRODUCTION

Background of the Research

According to Wong (2012) the main role of an audit committee in any organisation is to assist the board or a departmental head in fulfilling its oversight responsibilities for the financial reporting process, the system of internal control over financial reporting, the audit process, and the organization's process for monitoring compliance with laws and regulations. To perform its role an audit committee must be established and be empowered with the authority to perform its duties.

The aim of setting up an 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

Agency Theory

Proponents of agency theory argue that ownership and control separation lead to moral hazard problems, where agents act to obtain personal benefits at the expense of shareholders. To curtail such behaviour, effective control by the board would greatly help. The effectiveness of the board monitoring depends among others, on sub-committees of the Board (Kibiya, Che-Ahmad & Amran, 2016). Also Shi and Zhou (2012) argue that board audit as a sub-committee and their financial expertise are found to affect the level of the way managers manipulate earnings to achieve corporate or personal benefit.

Lending Credibility Theory

The lending credibility theory suggests that the primary function of the audit process is to add credibility to the financial statements. Audited financial statements are seen to have elements that increase the financial statement users' confidence in the figures presented by the management. The users' are perceived to gain benefits from the increased credibility and these benefits are typically considered to be that the quality of investment decisions improve when they are based on quality and reliable information (Hayes *et al.*, 1999).

Audited financial statements are used by management to enhance the stakeholders' faith in management's stewardship. If stakeholders such as stockholders, government, or creditors have to make their judgments based on the information they receive, they must have faith that this is a fair representation of the economic value and performances of the organization. The audit process reduces information asymmetry whereby management knows more than the stakeholders.

Theory of Inspired Confidence

This theory also known as the theory of rational expectations was developed in the late 1920s by Dutch professor Theodore Limperg (Hayes *et al.*, 1999). It was advanced to addresses both the demand and the supply for audit services. Stakeholders of an entity demand accountability from the management, in return for their investments. Accountability is realized through the issuance of periodic financial reports which are subjected to independent opinion of the external auditor.

However, since this information provided by the management may be biased and outside parties have no direct means of monitoring, audit committees should therefore be the first line of assurance towards inspiring confidence in the quality of financial statements. An audit is required to assure the reliability of this information. The audit committee and the external auditor should therefore act in such a way that they do not disappoint the expectations of a rational outsider, while, on the other hand, the auditor should not arouse greater expectations in his report than his examination justifies. So, given the possibilities of audit technology, the auditor should do enough to meet reasonable public expectations the least of which is giving an independent opinion on the reliability of the financial statements he so audits (Solomon, 2007).

Empirical Literature

Accounting or financial expertise are attributes, qualification or experience acquired by a person before becoming a board member of a company. Krishnan and Visvanathan (2007) focused on the audit committee financial competence and financial reporting quality. The

research employed multivariate regression analysis with a sample size of 125 and firms-year longitudinal panels of 725 observations of non-financial listed companies on Nigerian Stock Exchange for the period 2010 to 2014. The research adopted McNicholas (2002) model to examine the monitoring mechanisms on the quality of financial reporting. The results showed that control variables; company age and company size are statistically significant. Financial expertise was found to have a positive and statistically significant effect, indicating that audit committee monitoring mechanisms influences the financial reporting quality of listed nonfinancial firms in Nigeria.

Kabiru and Rufai (2014) focused on examination into the quality of audited financial statements of money deposit banks in Nigeria. The research employed the use of both primary and secondary sources of data where questionnaire was the primary source and the annual reports of selected banks were the secondary data. A judgmental sampling technique was used in selecting the sample size. Simple percentage was used for data analysis, while analysis of variance (ANOVA) was employed to test the hypotheses. The research concluded high proportion of financial experts not necessarily accounting experts was unlikely to report weaknesses in the internal control over financial reporting. The research recommended that audit committees of money deposit banks should be more strict in their investigations and should initiate moves for the suing of auditors where they are found wanting.

Bedard, Chtourou and Courteau (2004) conducted a research on the effect of audit committee expertise, independence, and activity on aggressive earnings management. The research investigated whether expertise, independence, and activities of a firm's audit committee have an effect on the quality of its publicly released financial information. In particular, the research examined the relationship between audit committee financial competence and the extent of corporate earnings management as measured by the level of income-increasing and income-decreasing abnormal accruals. Using two groups of U.S. firms, one with relatively high and one with relatively low levels of abnormal accruals in the year 1996, the research found a significant association between earnings management and audit committee governance practices. The research further 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.

Agung (2015) conducted a research on the impact of certain types of financial expert groups, including accountants and financial brokers performing financial oversight duties. Their research found that the professional accountants are effective in evaluating a firm's compliance with accounting standards and treatments. This implies that the member background in terms of education and experience influences their focus in the committee's activities. The research recommended that it is wise to include members in audit committee who have expertise and knowledge in accounting and auditing because most of the responsibilities of the committee are related to these areas.

RESEARCH METHODOLOGY

Research Design

Descriptive research design was applied in this research. Joseph and David (2006) stated that descriptive 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 research

A population is defined as the total collection of all the elements about which the researcher wishes to make some inference (Cooper & Schindler, 2011). The population for this research comprised of seventy two (72) non-commercial state corporations that existed in 2005 by which time the National Treasury guidelines on audit committees were effected. The respondents comprised head of 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.

Data Collection Instruments

For the purposes of achieving the research objectives, two instruments of data collection were employed. A questionnaire was used to obtain primary data of the independent variable while a secondary data template which included a summary of the queried transactions 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 which was the dependent variable. The two sources of data were fitted into a regression model so as to derive relationships among the research variables.

Data Processing and Analysis

Descriptive statistics and inferential statistics were employed in data analysis. Descriptive statistics involved the use of frequencies, tables and bar charts were also applied to further show relationships. Since regression analysis is used to quantify the effect of independent variables on a dependent variable, a univariate linear regression model was used to test the significance of the influence of the independent variable on the dependent variable. Inferential statistics such as correlation coefficients and regression analysis were used in the analysis. This was useful to prove the level of significance in testing the stated hypotheses.

Model Specification

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

$$QFR = \beta_0 + \beta_1 (ACFC) + e$$

Where:

QFR = Quality of Financial Reporting

ACFC = Audit Committee Financial Competence.

β_0 = Model intercept

β_1 = The beta coefficient of Audit Committee Financial Competence.

e = Error term of the model.

The model was tested on how well it fitted the data and at the same time the significance of the independent variable was tested using Fischer distribution test, F-test at 95% confidence level. F-test depicts the ratio between the mean square of the model divided by the error mean square. The p-value for the F-statistic was applied in determining the robustness of the model. The conclusion was based on the basis of p value where if the null hypothesis of the beta is rejected then the overall model was significant and if null hypothesis is not rejected the overall model was insignificant. In other words if the p-value was less than 0.05 then it was concluded that the model was significant and has good predictors of the dependent variable and that the

results are not based on chance. If the p-value was greater than 0.05 then the model was not significant and cannot be used to explain the variations in the dependent variable. Correlation between the variables was tested. The test of the goodness of fit of the model was obtained for model summary which determined the coefficient of determination, R- square which measured the proportion or percentage of the total variation in the dependent variable explained by the independent variables.

Test for Normality of data

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.

RESULTS AND DISCUSSIONS

Education Level of Respondents

The research sought to establish the level of education of the respondents. The findings are provided in the figure 4.1 below.

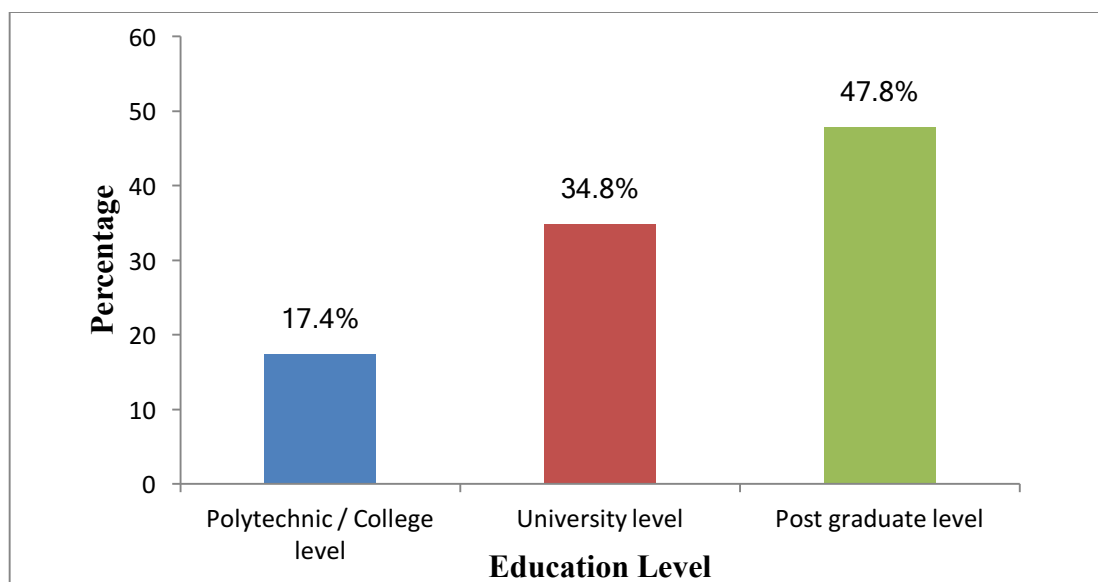


Figure 4.1: Education Level of Respondents

The results indicated that majority (47.8%) of the respondents had post graduate level of education while those who had university level were 34.8% and finally those with polytechnic/college level were 17.4%. This shows that they could interpret the questions in the questionnaires well and respond accordingly. This enhanced the reliability of the data collected.

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. 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). Cooper and Schindler (2008) have indicated 0.7 to be an acceptable loading. Other researchers suggest that 0.4 is the minimum level for item loading.

Table 4.1: Factor Analysis for Audit Committee Financial Competence Subcontracts

Component	Factor Loadings	Comment
Committee members' financial training.	0.801	Accepted
Committee members' knowledge in Accounting matters.	0.806	Accepted
Audit committee members experience in Financial reporting and audit related fields.	0.861	Accepted
Audit committee members' knowledge of governance and risk management.	0.565	Accepted

Extraction Method: Principal Component Analysis.

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

Normality Test

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.

H₀: The data is normally distributed

H₁: The data is not normally distributed

The rule is that if the p-value is greater than 0.05, H₀ is accepted and H₁ is rejected, if the p-value is less than 0.05, H₀ is rejected and H₁ is accepted.

Table 4.2: One-Sample Kolmogorov-Smirnov Test

		Ratio Queried Transactions to Annual Budget	AC Financial Competence
N		46	46
Normal Parameters a,b	Mean	1.232139	4.0163
	Std. Deviation	3.22507	0.84558
Most Extreme Differences	Absolute	0.351	0.253
	Positive	0.348	0.128
	Negative	-0.351	-0.253
Kolmogorov-Smirnov Z		0.382	0.717
Asymp. Sig. (2-tailed)		0.621	0.057

a Test distribution is Normal.

b Calculated from data.

The results obtained indicate that Kolmogorov-Smirnov Z statistic for 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.

Trends Analysis

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, it was constant

before increasing to 2012. The result implied that increases in the annual budget for state corporations corresponded to the increase in the ratio of queried transactions to annual budget.

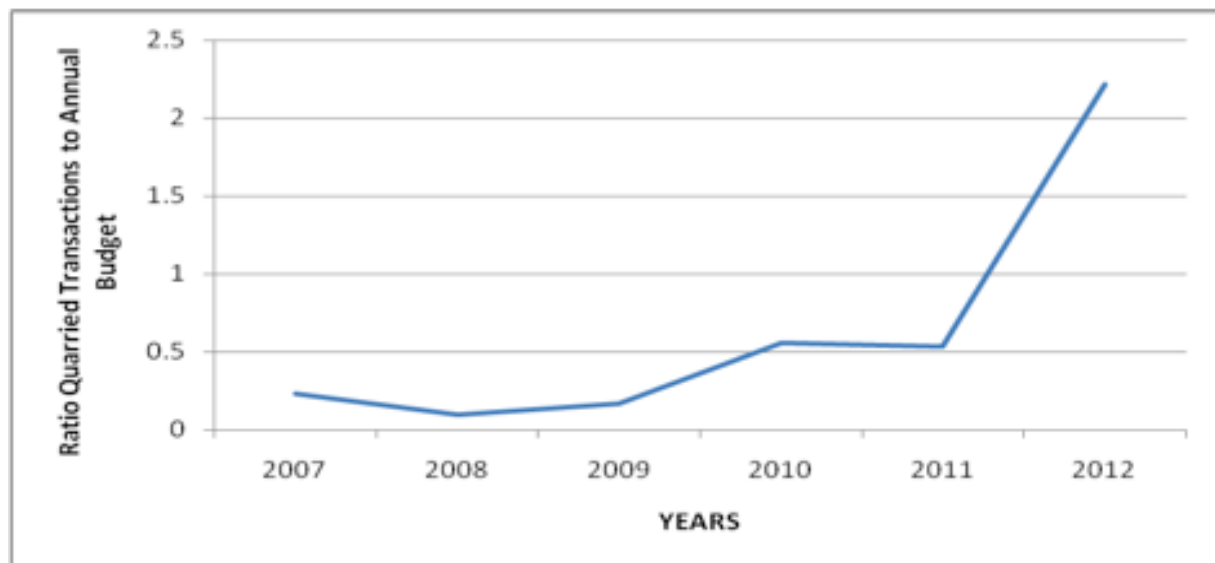


Figure 4.2 Trends in Ratio of Querried Transactions to Annual Budget

Descriptive Analysis Results

Table 4.3 Descriptive Results for Audit Committee Financial Competence

Statements	SD	D	N	A	SA	Mean	Std dev	CoV
Financial training of audit committee members.	8.7%	6.5%	2.2%	41.3%	41.3%	4	1.23	0.31
Knowledge in Accounting matters	6.5%	6.5%	4.3%	47.8%	34.8%	3.9	1.13	0.29
Experience in Financial reporting and audit and related fields.	2.2%	8.7%	6.5%	50.0%	32.6%	4	0.98	0.25
Knowledge in governance and risk management	6.5%	6.5%	0.0%	47.8%	39.1%	4	1.12	0.28

The research sought to know from the respondents whether the audit committee members in non-commercial state corporations in Kenya had undergone financial training. 41.3% strongly agreed, another 41.3% agreed while 8.7% and 6.5% of the respondents strongly disagreed and disagreed respectively.

The research was also interested in whether members of audit committees in non-commercial state corporations had demonstrated knowledge in financial matters, 47.8% agreed, 34.8% strongly agreed while 6.5% and 6.5% of the respondents strongly disagreed and disagreed respectively. The findings showed that all the statements had a mean of 3.9 which implied that majority of the respondents agreed with the statements in the questionnaire. The standard deviation and coefficient of variation of the statement was 1.13 and 0.29 respectively implying that the responses varied slightly from the mean.

The research was further interested in whether, audit committee members in non-commercial state corporations had some financial reporting experience in audit and related fields. The findings revealed that 50.0% of the respondents agreed, 32.6% strongly agreed while 2.2% and 8.7% of the respondents strongly disagreed and disagreed respectively. The statement was found to have a mean of 4.0, standard deviation of 0.98 and coefficient of variation of 0.25. These findings implied that majority of the audit committee members in non-commercial state corporations had experience in financial reporting and auditing.

Finally the research sought to establish whether the audit committee members in non-commercial state corporations had risk management skills. The findings showed that 47.8% agreed, 39.1% strongly agreed while 13% of the respondents disagreed. The statement on whether audit committees of non-commercial state corporations had governance and risk management skills had a mean of 4, standard deviation of 1.12 and coefficient of variation of 0.28.

Correlation Tests Results

Table 4.4: Correlation Results for Financial Competence and Ratio of Queried Transactions to Annual Budget

		Ratio of queried Transactions to Annual Budget	Audit committee Financial Competence
Ratio of queried Transactions to Annual Budget	Pearson Correlation	1	-0.425**
	Sig. (2-tailed)		.002
	N	46	46
Audit committee Finance Competence	Pearson Correlation	-0.425**	1
	Sig. (2-tailed)	.002	
	N	46	46

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

The findings showed that audit committee financial competence had a negative and significant ($r=-0.425$, $p=0.002$) association on ratio of queried transactions to annual budget. The results implied that increasing financial competence was found to have positive effects with quality of financial reporting since it reduced the ratio of queried transactions to annual budget.

Univariate Regression Results for Audit Committee Financial Competence and Quality of Financial Reporting

Table 4.6: Coefficients of Audit Committee Competence Sub constructs

	B	Std. Error	T	Sig.
(Constant)	8.833	2.133	4.141	0.000
Financial training of audit committee members	-0.238	0.08	-2.968	0.004
Knowledge in Accounting matters	-0.459	0.093	-4.949	0.000
Experience in financial reporting and audit and related fields	-0.427	0.609	-0.702	0.487
Knowledge of governance and risk management	-1.36	0.417	-3.262	0.002

The findings further revealed that audit committee members' financial training ($\beta=-0.238$, $p=0.004$), audit committee members knowledge in accounting matters ($\beta=-0.459$, $p=0.000$),

and audit committee knowledge of governance and risk management ($\beta=-1.36$, $p=0.002$), had a negative and significant relationship with the ratio of queried transactions. The findings implied that audit committee members' financial training, audit committee members knowledge in accounting matters and audit committee knowledge of governance and risk management increased the quality of financial reporting. However, financial reporting experience was found to have negative but insignificant relationship with ratio of queried transactions.

Overall Regression Results for Audit Committee Financial Competence and Quality of Financial Reporting

The model summary result of the regression analysis indicated that audit committee financial competence explained 18.1% of the variation in the ratio of queried transactions to annual budget ($R^2=0.181$) while the remaining percentage of 81.9% was explained by other variables not in this model.

Table 4.7: Model Summary for Audit Committee Financial Competence

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.425 ^a	.181	.162	2.9517008815

a. Predictors: (Constant), Audit committee Finance Competence

The results of ANOVA test show that the F value was 9.721 with a significance of p value = 0.003 which was less than 0.05, meaning that null hypothesis was rejected and concluded that there is a relationship between audit committee financial competence and quality of financial reporting (ratio of queried transactions to annual budget) of non-commercial state corporations in Kenya.

Table 4.8: ANOVA for Audit Committee Financial Competence

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	84.697	1	84.697	9.721	.003 ^b
	Residual	383.352	44	8.713		
	Total	468.048	45			

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

b. Predictors: (Constant), Audit committee Finance Competence

To further test the significance of regression relationship between audit committee financial competence 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 4.9: Regression Coefficients for Audit Committee Financial Competence

	B	Std. Error	Beta	t	Sig.
(Constant)	7.748	2.135		3.63	0.001
Audit committee Financial Competence	-1.622	0.52	-0.425	-3.118	0.003

a Dependent Variable: Ratio of queried Transactions to Annual Budget

The coefficient $\beta = -1.622$ was significantly different from 0 with a p-value=0.003 which was less than 0.05. The results imply that a unit change in audit committee financial competence will result in -1.622 units change in ratio of queried transactions to annual budget. This confirmed that there was a significant negative linear relationship between audit committee financial competence 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 financial competence was found to result to increase in quality of financial reporting.

Hypotheses Testing

H₀: Audit committee members' financial competence has no significant effect on quality of financial reporting in non-commercial state corporations in Kenya.

The results of ANOVA test show that the F value was 9.721 with a significance of p value = 0.003 which was less than 0.05, meaning that null hypothesis was rejected and concluded that there is a relationship between audit committee members financial competence and quality of financial reporting (ratio of queried transactions to annual budget) of non-commercial state corporations in Kenya. The coefficient $\beta = -1.622$ was significantly different from 0 with a p-value=0.003 which was less than 0.05. The results imply that a unit change in audit committee financial competence will result in -1.622 units change in ratio of queried transactions to annual budget. This confirmed that there was a significant negative linear relationship between audit committee members' financial competence 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 members' financial competence was found to result to increase in quality of financial reporting.

CONCLUSIONS AND RECOMMENDATIONS

Conclusion

The analysis of findings showed that audit committee financial competence had a negative and significant association with ratio of queried transaction to annual budget. The results implied that increasing financial competence was found to have positive effects on quality of financial reporting since it reduced the ratio of queried transactions to annual budget.

Recommendations

The research recommended that audit committees should consist of members with knowledge in accounting and finance which provides a good basis for audit committee members to examine and analyse financial information. The educational background becomes an important characteristic to ensure audit committees perform their roles effectively. The audit committee members who have accounting and auditing experience can play a leading role in the committee by providing valuable views, justification, and comments, which can increase a committee's productivity.

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