EFFECT OF AUDIT COMMITTEE CHARACTERISTICS ON THE QUALITY OF FINANCIAL REPORTS IN PUBLIC SECONDARY SCHOOLS IN KENYA: THE CASE OF PUBLIC SECONDARY SCHOOLS IN MURANG’A COUNTY

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Abstract

Both audit committees and the audit profession have continued to receive unending attention especially due to the cases of mismanagement and fraud cases in most public institutions in Kenya. In Kenya, the education system is loaded with financial management risks. A report by the Transparency International Kenya indicated that, 73% of the government’s social sector expenditure and 40% of the national recurrent expenditures is consumed by the education sector. This therefore calls for measures that promote accountability of such resources through internal control systems like the audit committees to promote quality assurance and improved financial reports relating to the financial standards. This paper used a descriptive study report where both the qualitative and quantitative data was used. The targeted population was of 307 public secondary institutions across the eight sub counties of the county which were random selected to constitute the study’s sample size. This paper entirely used secondary data gathered with a data collection sheet within 2014-2018, a period of 5 years. The obtained data was made analysis using correlation and regression analysis. This paper outcomes showed that a positive and statistically significant correlation linking the size of audit committees with quality of the public secondary institutions’ financial reports within Murang’a County. The study findings as well established that the diversity of audit committees encompasses a negative and also a statistically insignificant connection with the financial reports of public secondary schools within the Murang’a County. Additionally, the study results found that a negative and statistically insignificant connection to financial reports of the public secondary schools within Murang’a County. In conclusion, the results established that a negative and statistically insignificant connection existed between AC expertises with the quality financial reports of public secondary schools in Murang’a County.

Keywords: audit committees, audit profession, accountability, internal control, financial reports, financial standards

INTRODUCTION

1.1 Background of the study

The increase of public’s awareness on issues of corporate governance issues calls for due diligence in the midst of the audit committee members as they perform their duties. Globally, it has been a mandate to all public
institutions that they have structured ACs and thus members’ responsibilities have become greater than times before (Rezaee, 2009). The audit profession and audit committees as well have continued to receive unending attention especially due to the cases of financial collapses of large multinationals. One such case is the collapse of Enron which was a large Houston-based energy company (Solomon, 2007). The company which was formed in 1985 was reported to be making sales worth $4 billion. Nonetheless the company was appeared to have signs of distress in 2001 which resulted to serious financial crises. The company’s collapse was related to reluctance of the audit team in performing their role diligently and in good time (Solomon, 2007).

Audit committee is considered as a significant body in an organization as it is presumed to protect the shareholders interest (Mallin, 2007) as its key role relates to the administration of processes of the financial reporting (Klein, 2002). The success of the different obligations along with duties of audit committees is made achievable by proper communication with the internal audit department. An audit committee takes up a major task in making sure that accounting reports is done accurately in addition to strengthening its reliability so as to minimize fraud cases (Abbott et al., 2004). Independence of ACs is highly measured to be a vital quality affecting the success of the audit committees in overseeing of the processes relating to accounting records (Baxter & Cotter, 2008). It is argued that the independent board members are in the greatest position to execute their duties dynamically (Klein, 2002).

According to Menon and Williams (1994) simple AC structures do not necessarily imply that it can really be relied upon by the directors’ board to improve the control and oversight capabilities. Choi et al (2004) disputed that a dynamic and functional audit committee are more expected to contribute to quality financial audit reports than the dormant committees. Additionally, financial reporting processes are complex, and only the members having significant competencies or experience in finance, accounting or the industry are able to understand. Committee members having accountancy and financial skills are seen to have the capacity to be in a position of unveiling quality financial audit reports more successfully (Choi et al., 2004).

The key role of financial accountability is to give high quality financial reports about entities (IASB, 2008). The prerequisite of highly qualified accounting information is essential as it affects the fund providers and stakeholders positively in decisions relating to investments, business fund allocations that improve company’s market effectiveness (IASB, 2008). The quality of financial reports does not just refer to financial information but as well refers to the disclosures of nonfinancial information useful in the process of making decisions. According to DeAngelo, (1981) Audit quality is a combination of the prospect that outside auditors obtain irregularity in the accounts statements and it shows to all company stakeholders.

According to Kim et al, 2012, properly audited companies that are also publicly accountable are less probable managing its earnings by discretionary accruals, influence the real time profits and be subject to securities and exchanges commissions’ investigations. The task of audit committees is of ensuring quality corporate financial reporting.

1.2 Statement of the Problem

Despite the requirement by the Basic Education Act, 2015 to establish effective audit committees in Kenyan public schools as well as clear responsibilities for the financial reporting and accountability the financial reports in Murang’a County, are reported to be of poor quality in terms of relevance, comparability, understandability, and faithful representation. AC is an important aspect in any organization as it is able to ensure timely implementation of internal audit functions. Puri, Trehan and Kakkar, (2010) study looked at the internal audit
role along with the audit committees’ duties in assisting directors’ board to perform its financial and fiduciary duties.

In Kenya, the ministry of Education requires that all public schools be internally managed by an oversight audit committee and externally audited by the county schools Auditor annually. Despite the statutory requirement by the government of Kenya to have effective audit committees in place, Maronga et al, (2013) found out that less than half of the schools are properly audited on an annual basis. The study based in Gucha District also found out that more than half of the secondary schools fail to follow the laid down procedures of financial management and financial reporting standards.

Some local researches existing in this area of research are Gacheru (2013), Kimani (2017), Mwangi (2018) that relate that AC characteristics to the financial reporting qualities in state owned corporations. Maronga et al, 2013 looked at the effect of government policy on practices of financial management in public secondary schools. The researcher believes that no other papers exist in this the capacity of the public secondary schools in Kenya.

This paper as a result tries to fill in this knowledge and contextual gap through the analysis of AC traits with quality of financial reports in the secondary schools within Murang’a county since the findings of previous studies have not directly linked audit ACs’ traits with the quality of financial reports as gauged by the comparability, understandability, relevance, and faithful representation of financial reports. Similarly, other studies have used commercial and non commercial state corporations which may not necessarily be used to generalize all public entities. The study hypothesizes that the qualities of accounting reports will depend on the traits of AC members. Thus, the precise study goal is to find out the success of ACs by the character of their traits, such as diversity, independence, audit committee proficiency in addition to size encompass such positive influences on the financial reporting proficiency for the public secondary schools within Murang’a County.

1.3 Objectives of the Study

The study’s general intends was to find out on the influences of AC characteristics on financial reporting quality for the public secondary within Murang’a County. Specifically, the study sought;

1. To find out the effect of the size of audit committee over the quality of financial reports for the public secondary institutions in Murang’a County

2. To ascertain on the impacts of diversity for audit committees on financial reporting quality for public secondary institutions in Murang’a County

3. To estimate the effect of independence on the audit committee members on financial reporting quality for the public secondary institutions in Murang’a County

4. To find out the influence of AC proficiency on financial reporting quality for the public secondary institutions in Murang’a County
LITERATURE REVIEW

2.1 Theoretical Literature Review

The link connecting audit committees with financial reporting quality is reviewed by the theories below; the stewardship, stakeholder and agency theories.

2.2.1 Agency Theory

This theory is founded on regards to the links connecting a principal and an agent. The agency theory offers a presentation for the fundamental structures of principal and agent who are involved with joint behavior, although they have dissimilar goals and risk appetites. This postulation additionally takes the principal not to be effective in monitoring the agents’ activities, as they can tend to work for their own benefits. In relation to Stolowy and Breton (2003), supposing the creative accounting theory could be formed, it won’t relate to those methods employed in the manipulation, but to the opportunities, needs and the links amid the participants in the market. This theory offers a foundation relating to firms’ governance via different internal and external structures (Roberts et al., 2005).

This theory’s significant base is that the directors are highly driven through one’s own achievements thus work to take advantage of an individual’s interest instead of taking into consideration the shareholders wealth (Weir et al., 2002). Bedard (2010) based on the principal agent conflict supports the view that a large number directors who independent are expected to be devoted in their tasks with no influence from outside. This enables the auditors to competently observe the financial reporting process. This is recognized due to the verity that independent directors are not motivated by other aspects other than to perform the overseeing task assigned to them (Greco, 2011). Therefore, a committee having more independent audit members from the management enhances quality in the process of making financial reports (Akhtaruddin & Haron, 2010; Patelli & Prencipe, 2007).

2.2.2 Stewardship Theory

According to Alexander et al, 2009, this theory uses sociological and psychological perspectives of individual behaviors and does not support the principle that every decision is taken through economic perspectives (Psaros, 2009). The stewardship theory does not affirm on individualism perspectives (Donaldson & Davis, 1991), however majorly the executives’ role of being company stewards, thus incorporating their objectives as part of organizational goals. Stewardship theory recommends that organizational success is attained when stewards are satisfied and motivated. Their foundation is that people are highly influenced by the noneconomic ways such as personal growth, recognition, acceptance and the lack of gaining satisfactions with their performances (Psaros, 2009).

Stewardship theory argues that directors tend have same objectives with those of the organization. That is, the expertise of every manager is connected to the achievement of organizational goals. In addition, their characters are inter-linked with company’s performance as well as the shareholder returns (Young & Thyll, 2008). According to Van Berghe et al., (2000), Managers are perceived to be good stewards who are not likely to mismanage organizational funds for their own interests as they are wholly driven by the non financial benefits. This theory recommends self motivation value in that what is good. It assumes that directors, and board firms, are self driven to serve at best welfare of the company and also those of shareholders.
2.2.3 Stakeholder Theory

This theory appreciates that many company associations exist, and are not narrowed as to those involving the owners and directors (Psaros 2009). The basis is that ‘all stakeholders influence the corporation and are also influenced by the company’ (Psaros 2009). Stakeholders include both and silent and fiduciary stakeholders (Simmons 2004). Stakeholders can further be grouped as contractual (legal) stakeholders employees, shareholders, distributors, customers, lenders and suppliers and the community (social) stakeholders who are the regulators, consumers, government, pressure groups, local communities, media, the environment and the general public (Clarke, 2004).

Supporters of the stakeholder theory emphasize that with no the contribution by employees, customers, the environment and community at large, a corporation could not be in existence. Therefore, managers should be aware of how their decision processes affects these other business components (Stovall et al., 2004). McAlister et al. (2003) suggested that the presumption takes on relational and collaborative approaches to business along with its elements. In supporting this theory, it is argued that management governance problems turn around the company purposeful functions. Solomon (2007) affirmed on foundation of the stakeholder theory that organizations are too big and so their societal influence is pervasive, and that they have give accountability to many other societal divisions far from the shareholders. Therefore, they must include all the suppliers, employees, creditors, customers and the society in overseeing the organizational goals.

2.3 Conceptual Framework

The aim of a conceptual framework is to diagrammatically depict the relationship between the study variables. Figure 2.1 shows the conceptual framework

FIGURE 2.1: CONCEPTUAL FRAMEWORK

<table>
<thead>
<tr>
<th>Independent Variables</th>
<th>Dependent Variable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit committee size</td>
<td>Quality of financial reports</td>
</tr>
<tr>
<td>• Number of audit committee members</td>
<td>• Disclosure index</td>
</tr>
<tr>
<td>Audit committee diversity</td>
<td></td>
</tr>
<tr>
<td>• Ratio of women members to total audit committee members</td>
<td></td>
</tr>
<tr>
<td>Audit committee independence</td>
<td></td>
</tr>
<tr>
<td>• Ratio of non executive members to total audit committee members</td>
<td></td>
</tr>
<tr>
<td>Audit committee expertise</td>
<td></td>
</tr>
<tr>
<td>• Average score index for accounting, financial and other skills</td>
<td></td>
</tr>
</tbody>
</table>

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2.3.1 Audit Committee Size

This represents an important feature in towards improving financial statements and their quality since the large sized audit committees be expected to possess the benefit of understanding in broader skills as well as different proficiencies and thus perform their roles more efficiently. The exact numbers of audit committee members is a predominant key since it influences the obligation of memberships to take monitors on management in addition to the detection of fraudulent behaviors.

2.3.2 Audit Committee Diversity

The diversity in genders is regarded as the means of looking into the different skills and characteristics in persons that can add to the organizational benefits. Gender diversity is a significant aspect of the CG; that is explained in the relation of present female directors on the directors’ committee. Lady board members in audit committees can enhance company control using their ethical and traditionalist diversifiable qualities and the female managers are more ready for the board meetings than the male directors resulting to improved board behaviors along with success (Saleh et al., 2007).

2.3.3 Audit Committee Independence

The independence of audit committees shall relate to audit committees in taking an independent analysis relating the company financial reports also make sure that board of managers, leading to a better quality of audit reports, do not control the AC. Additionally, the audit committees ruled by an independent director is positively related to better quality in reporting the accounting reports with less occurrences of decisive behaviors.

2.3.4 Audit Committee Expertise

The AC members’ skills or knowledge is positively linked to committee’s success. Directors’ industry knowledge can be more advantageous to small companies during early development stages; this is because the directors may well serve as a resource to the company through providing a bond to the outside resources.

RESEARCH METHODOLOGY

This study adopted a descriptive survey research design. A descriptive research aims at providing an accurate and valid representation of the factors or variables that pertain or are relevant to the research question (Schindler, 2003). The target population was comprised of all public secondary institutions within Murang’a County. Data was collected for the financial year 2014-2018 since the Basic education act was enforced in the year 2013 making it mandatory for all secondary schools to have audit committees in place. Stratified random sampling method was employed in process of coming up with study sample where Ten schools from each sub-county were selected. This gave a sample size of 26% of the whole population which is more than 10% of the whole population and is considered a fair representation of the study as by (Hair et al., 2000). The collected data was analyzed using multiple linear regression which was used to draw inferences by establishing the relationship between the dependent and the independent variables. The regression equation took the following form

\[ Y = B_0 + B_1X_1 + B_2X_2 + B_3X_3 + B_4X_4 + e \]

Where \( B_0 \) is the intercept.
$B_n$ Measures change in Y with respect to Xn,

$X_1$ = Size of audit committee

$X_2$ = Independence of the audit committee

$X_3$ = Audit committee diversity

$X_4$ = Audit committee expertise

Y = Quality of financial audit reports

e is the error term

RESEARCH FINDINGS AND DISCUSSION

4.1 Regression Analysis

Regression analysis was used to establish the relationship between the dependent and the independent variables. The regression analysis results comprised of the model summary, Analysis of Variance (ANOVA) and the summary of regression coefficients.

4.2.1 Model Summary

<table>
<thead>
<tr>
<th>Model</th>
<th>R</th>
<th>R Square</th>
<th>Adjusted Square</th>
<th>Std. Error of the Estimate</th>
<th>Durbin-Watson</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>.351^a</td>
<td>.123</td>
<td>.113</td>
<td>1.35296</td>
<td>1.501</td>
</tr>
</tbody>
</table>

a. Predictors: (Constant), Audit committee expertise, Audit committee diversity, Audit committee independence, Size of audit committee

b. Dependent Variable: Quality of financial reports

The outcomes of the model summary reveal that the coefficient of determination (R square) was 0.123 which is shown to be 12.3% of the disparity in the dependent factor is explained by the independent factors (audit committee size, expertise, diversity, and independence.). Then, 87.7% of the disparity is explained by other aspects and the error term.

4.2.2 Analysis of Variance

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regression</td>
<td>91.327</td>
<td>4</td>
<td>22.832</td>
<td>12.473</td>
<td>.000^b</td>
</tr>
<tr>
<td>Residual</td>
<td>649.826</td>
<td>355</td>
<td>1.830</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>741.153</td>
<td>359</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

A. Dependent Variable: Quality Of Financial Reports

B. Predictors: (Constant), Expertise of audit Committee, Audit Committee Diversity, Audit Committee Independence, Size of audit Committee
The ANOVA on table 2 indicated that the F statistics value of 12.473 was statistically considerable as shown by the p value of 0.00<0.05. This shows that the regression model is statistically considerable and fit to found the connection of AC characteristics with the quality of audited accounting statements.

### 4.2.3 Regression Coefficients

#### Table 3: Regression Coefficients

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
<td></td>
</tr>
<tr>
<td>(Constant)</td>
<td>-1.452</td>
<td>.458</td>
<td>-</td>
<td>-3.168</td>
</tr>
<tr>
<td>Audit committee size</td>
<td>1.010</td>
<td>.163</td>
<td>.562</td>
<td>6.196</td>
</tr>
<tr>
<td>Audit committee diversity</td>
<td>-0.374</td>
<td>.314</td>
<td>-.060</td>
<td>-1.190</td>
</tr>
<tr>
<td>Audit committee independence</td>
<td>-0.203</td>
<td>.335</td>
<td>-.031</td>
<td>-0.607</td>
</tr>
<tr>
<td>Audit committee expertise</td>
<td>-2.773</td>
<td>.889</td>
<td>-.281</td>
<td>-3.120</td>
</tr>
</tbody>
</table>

a. Dependent Variable: Quality Of Financial Reports

The regression coefficients findings show that there exists a positive and statistically considerable connection linking the size of audit committees to quality of accounting statements of public secondary institutions within Murang’a County. In conclusion, the findings show that the connection linking audit committee proficiency with the quality financial statements of public secondary institutions within the Murang’a County was negative but statistically insignificant. From the results, the following equation was formulated

\[
Y = -1.452 + 1.010X_1 - 0.374X_2 - 0.203X_3 - 2.773X_4
\]

#### SUMMARY OF THE FINDINGS

The correlation outcomes showed that the size of audit committees had a positive impact on quality of financial statements of public secondary institutions. Thus, the hypothesis that AC size did not encompass considerable influence on quality of accounting audit reports of public secondary institutions in Murang’a County was null and the alternative hypothesis adopted. The findings are supported by Li et al (2008) and Persons (2009) as they disputed that size of audit committees is more probable of influencing the company disclosures. The findings also revealed a weak and positive correlation between the diversity of AC and quality of accounting reports produced by public secondary institutions. This finding however is contradictory to that of Mwangi et al (2017) he showed that diversity of audit committee had statistically considerable link with the quality of audited accounting standards. Moreover, research found out that the independence of audit committees has weak and positive connection with quality of financial statements in public secondary institutions. Thus, the hypothesis that diversity of ACs has no considerable influence on the quality of audited financial statements of public secondary institutions in was adopted and the alternative hypothesis rejected. Alexander et al. (2010) affirms that firms having the motivation and capacity of increasing the strengths of the audit committees shall do so through the inclusion of more external directors. Finally, audit committee expertise had weak and positive connections to the quality of financial statements in public secondary institutions. This finding is consistent with Krishnamoorthy et al. (2002), who posits that an audit committee lacking financial experts has reduced ability to arbitrate differences among the management with the outside audits.
CONCLUSION

The paper outcomes revealed that size of AC do have positive plus statistically considerable connection with quality of financial statements of the public secondary institutions in Murang’a County. This paper in relation to these findings makes conclusions that the size of AC considerably affected the quality of accounting reports for the public secondary institutions. The findings also revealed that there a negative connection existed among the diversity of AC with quality of audited financial statements of secondary institutions though the relationship was statistically insignificant. The study therefore concludes that AC’s diversity has no significant control on quality of audited financial statements for the public secondary institutions within Murang’a County.

This paper concludes that the independence ACs do not have a considerable influence on quality of financial statements for the public secondary institutions within Murang’a County. Lastly, the paper established that the expertise of audit committees had a negative but statistically considerable link with quality of the audited financial statements for the public secondary institutions. The study therefore makes conclusions that there exists considerable association involving audit committee expertise and quality accounting reports for the public institution’s schools in Murang’a County.

Recommendations

Based on these findings, this paper put forth that public secondary schools must ensure that the size of their AC is good to avoid the shortcomings associated with too large and too small boards so as to improve the financial report quality. Based on this finding, it is also recommended that public schools in area under study should ensure that they include women in their board as their existence provides an excellent expression of the society composition. Furthermore, public institutions within the study area should ensure that their audit committee is independent and should comprise of non-executive members as outside or independence members are more vigilant in monitoring behaviors and decision making of an institution and also ensures their presence and performance is not influenced by the insiders or the managers.

Finally, the study concluded that the expertise of AC considerably influences the quality of the financial statements for the public secondary institutions within the study area. Founded on the above conclusion, this paper makes recommendations that public secondary institutions in Murang’a county should ensure that AC members have the relevant skills and knowledge since the quality of accounting reports improves with the existence of skillful committee members.

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