INTERNATIONAL JOURNAL OF SOCIAL Sciences and Information Technology
ISSN 2412-0294 www.ijssit.com
http:// www.ijssit.com

EFFECT OF BOARD AUDIT COMMITTEE DILIGENCE ON MARKET RETURNS OF COMMERCIAL BANKS LISTED AT THE NAIROBI SECURITIES EXCHANGE, KENYA

[1*] **Ngechu Patrick Ng'ang'a**
ngechus@gmail.com

[2**] **Josephat Oluoch Oluoch**
oluochjoluoch@gmail.com

[1,2] School of Business and Economics, Kisii University, Kenya

Abstract: Equity security market company returns are essential in assessing the performance of shares of listed companies on stock markets. This reflects the financial condition, financial performance and the confidence of the investing public in that company. At the micro level, company market returns are indicative of the financial performance and attractiveness of ordinary equity investments in a corporation and consequently how well a company is being run. In a bid to improve financial performance, reduce agency problems and enhance corporate management and in line with corporate governance guidelines, the board of directors of companies usually constitute audit committees. These committees are there to oversee the financial management, internal control and financial reporting aspects of these companies. Despite the importance of these committees in corporate governance, it is still not clear if the attributes of these committees affect their effectiveness and if such idiosyncrasies have any effect on the market returns of commercial banks listed at the Nairobi Securities Exchange. This study sought to establish whether audit committee diligence is one of the idiosyncratic attributes of the board of directors' audit committee had any significant effect on the market returns of the commercial banks listed at the NSE. The diligence of the audit committee was represented by the number of meetings by the committee per the financial quarter of analysis. Following the analysis, it was revealed that audit committee diligence had a positive influence on the market returns of the commercial banks listed at the NSE. The implication is that commercial banks are encouraged to increase the number of meetings the audit committees carry per financial quarter. This is because this is likely to lead in the improvement in market returns on their shares as listed at the NSE.

Keywords: Audit Committee, Committee Diligence, Market Returns

INTRODUCTION

Audit Committee Idiosyncrasies

The board of directors is usually in charge of the oversight of the management of companies. This arrangement arises out of the need to enhance corporate governance of organizations and ensure that managers carry out their stewardship responsibility for the benefit of shareholders and other stakeholders. In essence, modern financial management is rooted in the need to maximize corporate wealth maximization and shareholder wealth maximization and this can only be done effectively if the board of directors institute an effective board audit committee. It is one of the most important committees in the contemporary corporate management set-up.

According to Abbot (2004), the audit committee has eight main roles to play. The committee is responsible for firstly overseeing the financial reporting in line with International financial reporting standards (IFRS) and the related internal controls and internal policy. This ensures integrity of the financial statements that are ultimately published for use by the various stakeholders. Such statements should be relevant and reliable and free from material errors, misstatements and frauds. Secondly, the audit committee of the board is responsible for oversight of business risk be it financial, operational, hazard or reputational risk. There is always need to balance the risk exposure and the expected returns of operating a business.

For the audit committee to effectively carry out their role, they must have some desirable idiosyncratic characteristics. International Federation of Accountants –IFAC (2021) identifies five key factors that help to enhance the effectiveness of the board audit committees. These are transparency, effective communication, appropriate committee composition with a good mix of skills, competencies and expertise, efficiency and effectiveness in working as well as a strong finance function within the organization.

Market Performance of Listed Companies

Corporate organizations often have an objective of maximizing corporate wealth as well as shareholder wealth and this is usually reflected in the changes in the stock market prices of those companies. The higher the capital gains arising from the changes in share prices, the greater the increase in value of the company and vice versa. Share returns also called company market returns taken as the holding period returns are used to evaluate the change in these values. The returns are taken as the ratio of the cum dividend change in prices over time to the share price at the beginning of the evaluation period (Orozco, Vargas & Galindo-Dorado, 2018).

Market returns also called firm security market return or holding period returns (HPR) reflect the change in equity security prices over time and is usually designated as value relevance. Value relevance is the ability of internal firm conditions like the attributes of the board committee to influence equity security prices and thereby the holding period or market returns of the concerned listed companies (Olugbenga & Atanda, 2014). Orozco, Vargas & Galindo-Dorado (2018). take it that value relevance should be seen from the perspective of the ability of internal conditions and financially reported financial information to precisely indicate firm value as shown by share prices on a security exchange for equity securities. According to Orozco, Vargas & Galindo-Dorado (2018), market returns measures are often derived from the share prices but reflect the changing fundamentals of the company both within and outside its environment. It is to be assumed that changes in company fundamentals are occasioned by deliberate actions of the board and management and that board attributes should be adequate to be reflected in the share prices.

Prices and market returns are therefore significant indicators of the dynamics within the firm that change company fundamentals. The returns that are used relate to the unrealized returns of the securities still trading at the stick market as opposed to the realized returns that relate to the shares that have been sold by the investors in the market (Olugbenga & Atanda, 2014). Whereas economic theory may expect the relationship between audit committee attributes and firm market returns to be a conventional causal inter-relationship, extant theoretical, empirical and contextual literature is confounding and hence the need for this study.

Audit Committee Idiosyncrasies and Market Performance of Listed Companies

The regional evidence relates to the findings from Africa with respect to how audit committee attributes affect the financial performance and market returns of companies listed at African stock Markets. In Egypt for instance, El-Hawary (2021) evaluated the effect of audit committee Effectiveness on financial performance of companies listed on the Egyptian Stock Exchange over a three-year period covering 2016 through 2018. The characteristics that were appraised included committee size, committee independence, committee experience, committee gender diversity as well as committee frequency of meetings. Based on panel data regression analysis, the findings show that audit committee size and audit committee members' experience have a positive effect on financial performance. They further reveal that committee independence, diligence and gender diversity have no influence on financial performance of companies listed at the Egyptian Stock Exchange.

In Nigeria, Ojeka, Iyoha and Obigbemi (2014) studied the effect of the effectiveness of audit committees on company financial performance. The study is based on 84 companies listed at the Nigeria Stock Exchange over the period a nine-year period of 2010 through 2018. Using panel regression, the findings reveal that audit committee attributes have no effect on financial performance of listed companies in Nigeria. This is in direct contradiction of the agency theory of Jensen and Meckling that expects a positive relationship between audit committees and performance of companies.

The contextual evidence relates to the findings from Kenya with respect to aspects of audit committees and financial performance. Ogoro and Simiyu for instance evaluated the association between the features of audit committees and its efficacy in decreasing the number of financial statement revisions for parastatals in Kenya. The study was based on six audit committee attributes. These were the independence of directors committee directors, committee size, diligence, financial expertise of the members, the membership tenure and multiplicity of directorships. The study was based on 177 parastatals that existed in the year 2012. Based on logistic regression the findings show that multiple directorships and audit committee tenure have a positive influence on financial reporting since they help to trim down the number of financial statement restatements.

Another contextual study is that by Okiro, Samuel, Chege, Cheku and Bulilo (2018) which evaluated the influence of county audit committees on the performance of devolved governments in Kenya. This census study relied on a census of all the 47 counties in Kenya. Based on regression analysis, the results show that their county audit committees positively affect the performance of the county in Kenya.

Commercial Banks Listed at the Nairobi Securities Exchange

There are 11 listed commercial banks at the Nairobi Securities Exchange (NSE) as at December 2020. Commercial banks are a significant segment of the NSE for two main reasons. Firstly, they comprise the most active counter at the bourse in terms of the daily volumes of shares traded. Secondly, their joint valuation provides a significant proportion of the entire stock market capitalization. Besides their importance to the overall stock market, the regulator pays a keen interest in their corporate governance to avoid risky managerial behavior that may lead to instability of the banking system and thereby occasion financial crises.

Commercial banks in Kenya are regulated by the Central Bank of Kenya (CBK). For those listed at the NSE, more regulatory requirements are provided by the Capital Markets Authority (CMA) and the Nairobi Securities Exchange. The NSE (2015) regulations provide that for a company to enjoy continued listing at the stock market, it must observe corporate governance guidelines including the constitution of board audit committees. This is to reduce agency problems between managers and other business stakeholders particularly the shareholders. With such committees, accounting policies should be consistent with International Financial Reporting Standards (IFRS).

Statement of the Problem

From a contextual perspective, commercial banks listed at the Nairobi Securities Exchange have exhibited fluctuating stock market performance over the five-year period of 2016 through 2020 ranging from very highly volatile like Equity Bank, very stable performance like that shown by the Co-operative Bank. It is not clear if these variations in market performance can be attributed to the variations in the idiosyncrasies of the audit committees constituted by these listed commercial banks. Further studies focusing on audit committee attributes and firm performance like Al-Matari, Al-Swidi and Fadzil (2012), Mohammed, Flayyih, Mohammed and Abbood (2019), Alqatamin (2018), Bansal and Sharma (2016), Habbash, Sindezingue and Salama (2013) and Oroud (2019) have all been done outside Kenya yet the country has unique corporate governance guidelines that requires a similar study be done in Kenya particularly with a focus on listed commercial banks.

The problem is further compounded by the conflicting findings from empirical literature. In Egypt for instance, El-Hawary (2021) show that outside of audit committee size and experience, all other attributes have no effect on performance of public companies in that country. In Jordan, Hamdan, Al-Hayale, and Aboagela (2012) find that audit committee size has no effect. Contrary to the findings of El-Hawary (2021, Kallamu and Saat (2015) show that audit committee independence has a positive effect on financial firm profitability. This contradicts the findings of Al-Matari, Al-Swidi, Fadzil and Al-Matari (2012) who showed that in Saudi Arabia audit committee independence and diligence have no effect on firm performance. There therefore exists and empirical literature gap because given all these contradictions, it is not clear how audit committee attributes affect the stock market returns of commercial banks listed at the Nairobi Securities Exchange.

Research Objectives

The overall objectives of this study is to evaluate the effect of corporate board audit committee idiosyncratic attributes on market returns of commercial banks with a specific objective to appraise the effect of board audit committee diligence on market returns of commercial banks listed at the Nairobi Securities Exchange.

Research Hypothesis

The hypotheses of the study is;

H_{01}: Board audit committee diligence has no significant effect on market returns of commercial banks listed at the Nairobi Securities Exchange

Scope of the Study

The study covers a 5-year period of January 2016 through December 2020 for all the commercial banks listed at the Nairobi Securities Exchange. The study is based on a panel causal design of all the eleven commercial banks listed at the NSE over a five-year period of 2016 through 2020. The analysis is based on quarterly market returns and audit committee attributes leading to 220 firm quarter observations for each of the variables used in the study. These attributes are audit committee independence, audit committee diligence, audit committee diversity, audit committee size and audit committee competence.

The 5 years are considered adequate enough for a panel data that not only covers each of the individual commercial banks in the population but also all the 20 quarters in the period. The period is long enough to experience all the phases of market changes in terms of bullish phases and the bearish phases of the market. The listed banks are considered because the dependent variable, which is market returns, can only be computed for listed firms. In addition, the banking segment of the NSE has been the most active over the last few years and therefore this provides room for very versatile results.

RESEARCH METHOLOGY

The study adopts the positivist philosophy. This approach is characterized by a detached approach to research that seeks out the facts or causes of any social phenomena in a systematic way. Positivistic approaches seek to identify, measure and evaluate any phenomena and to provide rational explanation for it (Crowther & Lancaster, 2012). Since the study establishes the causality between the idiosyncratic attributes of audit committees and market performance at the Nairobi Securities Exchange, the approach is largely quantitative and therefore positivist in nature. The study uses a causal exploratory research design using the panel data approach. The explanatory design is appropriate here because it helps not only explain how the market returns are affected by the attributes of the board audit committee but also helps test the significance of this effect. The population of the study is all the 11 commercial banks quoted at the Nairobi Securities Exchange over the study period January 2016 through December 2020. Accordingly, this is fashioned as a census survey since all the listed commercial banks are studied. Because the analysis of audit committee characteristics and market returns are done on a quarterly basis, the study ends up with 220 firm-quarter observations.

Model Specification

A panel data model considering both cross sectional and time series aspects of the data of the 10 commercial banks is specified as

$$MR_{i,t} = \beta_0 + \beta_1 ACD_{i,t} + e$$

Where

MR: market returns

ACD: is Audit Committee Diligence

RESEARCH FINDINGS AND DISCUSSION

Descriptive Statistical Findings

Descriptive statistics are used to establish the nature of the variables used in a study from both a dispersion point of view and the central tendency perspective (Crowther & Lancaster, 2012). The ensuing subsections relate to the descriptive statistic for both markets returns and audit committee attributes.

Market Returns Descriptive Statistics

The market average holding period for each of the 20 quarters of the study are reflected in table 1 and figure 1.

Figure 1: Market Return Trends over 20 Quarters in 2016-2020

The table 1 and figure 1 show that the highest average market returns for the 10 commercial banks that formed the study were attained in the second quarter of 2017 and the second and third quarter of 2018. Thereafter, the least average returns were obtained in 2020 probably due to the market slump-down following the onset of the COVID-19 pandemic.

Table 1: Mean Market Return Trends over 20 Quarters in 2016-2020

Year	Quarter	MR
2016	1	0.0306
	2	0.0254
	3	0.0240
	4	0.0382
2017	1	0.0675
	2	0.0851
	3	0.0242
	4	0.0261
2018	1	0.0217
	2	0.0675
	3	0.0691
	4	0.0179
2019	1	0.0241
	2	0.0239
	3	0.0307
	4	0.0294
2020	1	0.0269
	2	0.0242
	3	0.0241
	4	0.0248

The findings are still impressive since none of the quarters experienced an average negative return. This implies that the banking sector on overall maintained positive return and was a worth-while equity investment target for the investors at the Nairobi Securities Exchange. The related descriptive statistics of the market returns over the study period are indicated in Table 2.

Table 2: Market Returns Descriptive Statistics

Mean	0.0353
Median	0.0257

International Journal of Social Sciences and Information Technology
ISSN 2412-0294
Vol VII Issue IX, September 2021

Mode	0.0675
Standard Deviation	0.0197
Coefficient of Variation	0.5594
Minimum	0.0179
Maximum	0.0851
Count	200
Confidence Level (95.0%)	0.0092

From table 2, the mean holding period quarterly return for all the banks over all the 5 years was 0.0353 which translates to a quarterly return of 3.53% and an annual return of 14.12%. This provides one of the best performing segments of the NSE given that the Treasury Bill rate performance over the same period averaged 8.93% (KNBS, 2020).

The highest quarterly market return was identified as 8.51% while the lowest was 1.79%. This provides a range of 0.0673 or 6.73 percent between the lowest performing financial quarter and the highest performing financial quarter in terms of the market returns for the banks listed at the Nairobi securities Exchange. This reflect the coefficient of variation of 0.5594 which is established by comparing the mean of 0.0353 with the standard deviation of 0.0197. While the standard deviation of 1.97% is not relatively large, the figure becomes significant when compared with the mean return translating to a volatility in excess of 55% of the quarterly returns. This reflects a volatile sector as confirmed by the observed trends in figure 1.

Audit Committee Diligence Descriptive Statistics

Audit committee diligence is the degree to which the committee is careful and persistent in working or exerting effort in discharging the committee duties as represented by the frequency of meetings of the committee (Sultana, Singh & Van der Zahn, 2015). In this study, the meetings frequency was operationalized as the natural logarithm of the number of meetings per quarter. The descriptive statistics of this indicator is provided in table 3 and figure 2.

Table 3: Mean Logarithm of the Number of Meetings

Year	Quarter	Log M
2016	1	0.54407
	2	0.74036
	3	0.60206
	4	0.62325
2017	1	0.60206
	2	0.47712
	3	0.60206
	4	0.69897
2018	1	0.5563

	2	0.53148
	3	0.62325
	4	0.50515
2019	1	0.41497
	2	0.60206
	3	0.53148
	4	0.60206
2020	1	0.30103
	2	0.47712
	3	0.54407
	4	0.47712

The trends indicate that the frequency of the audit committee meetings has been conspicuous in the volatility although it dipped further down at the onset of the COVID-19 in 2020 indicating the disruptive nature of the pandemic and possibly the effect of lockdowns that reduced the frequency of meetings as indicated in figure 3.

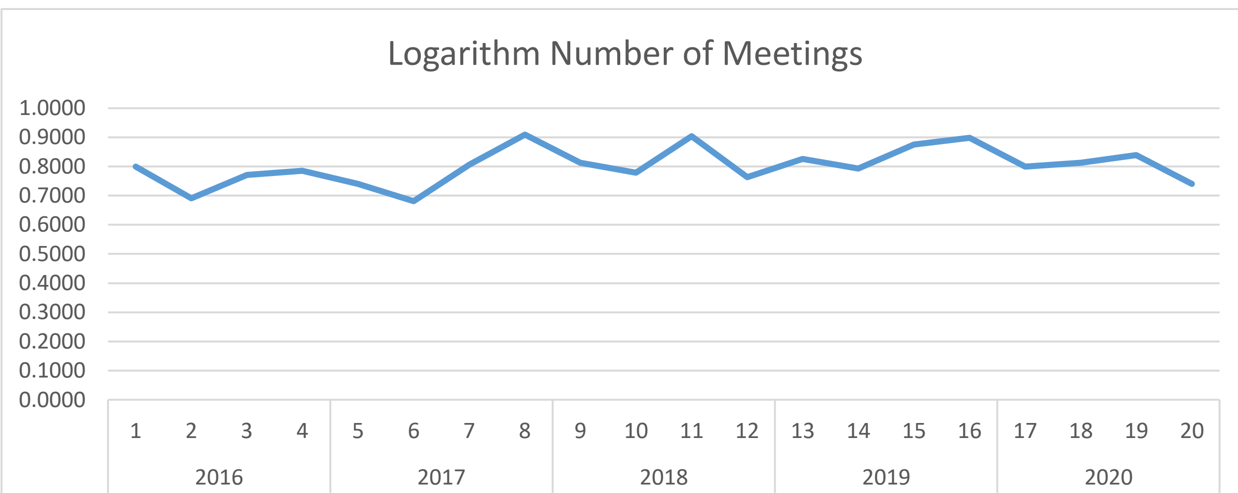

Figure 3: Trend in the Frequency of Audit Committee Meetings

The rest of the volatility could be attributed to changes in board compositions over time and the cyclical nature of audit committee activity and obligations which seem to increase towards the end of the financial year (Waweru, 2018). The higher frequency of this committee can be reflected in the descriptive statistics shown in table 4.

Table 4: Log Number of AC Meetings Descriptive Statistics

Mean	0.5528
Median	0.5502

Standard Deviation	0.0977
Coefficient of Variation	0.1768
Range	0.4393
Minimum	0.3010
Maximum	0.7404
Count	200
Confidence Level (95.0%)	0.0457

The average of the logarithm of the number of meetings is 0.5528 while the median is o.5502 which indicates some level of symmetry around the mean. With a standard deviation of 0.0977, the emergent coefficient of variation is 0.1768 which provides a below average range of volatility. This gain could be attributed to the regulatory requirements by CBK and CBA to ensure stability in the banking sector. It could be concluded that the audit committees are very active and are therefore displaying a high level of diligence.

Effect of Audit Committee Diligence on Market Returns

The second objective was to test if audit committee diligence has any effect on the market returns of commercial banks listed at the Nairobi Securities Exchange. The findings from table 4 indicate that the β_1 is a value of 0.17266 with a corresponding standard error term of 0.02379 and a t-value of 7.2577. The t-value is greater than the critical t at 95% confidence interval and 195 degrees of freedom of 1.9722. This indicates that β_1 is statically significant. This statistical significance is confirmed by a p-value of 0.00057 which again is lower than the significance value of 0.05. The conclusion from this is that audit committee diligence of commercial banks listed at the NSE has a positive effect on the market returns of those commercial banks and that the greater the diligence as indicated by the frequency of meetings, the higher the level of returns that will be expected and vice versa. Audit committees are encouraged to meet often in order to counteract the managerial agency problem and thereby boost financial and market performance.

The findings are consistent with those of Oroud (2019), who found that in Jordan, audit committee independence positively impact public industrial companies in that country. They are however contradictory to the findings of Alqatamin (2018) who in yet still in Jordan found out that audit committee diligence as reflected by the frequency of meetings had no effect on financial performance of non-financial firms. The difference could however be due to the fact that Alqatamin (2018) based his conclusion on non-financial firms, yet in this study, the focus is on commercial banks which are financial firms with high levels of regulations to comply with.

CONCLUSION

The objective sought to establish whether audit committee diligence as one of the idiosyncratic attributes of the board of directors' audit committee had any significant effect on the market returns of the commercial banks listed at the NSE. The diligence of the audit committee was represented by the number of meetings by the committee per the financial quarter of analysis. Following the analysis, it was revealed that audit committee diligence had a positive influence on the market returns of the commercial banks listed at the NSE. The implication is that commercial banks are encouraged to increase the number of meetings the audit committees carry per financial quarter. This is because this is likely to lead in the improvement in market returns on their shares as listed at the NSE.

This dynamic is possibly attributed to the fact that the frequency of audit committee meetings of the committee is likely to provide adequate room for exerting board control, over managerial stewardship role with respect to financial reporting, preventing and controlling errors and frauds as well as financial corporate communication Just like for independence, all these aspects are likely to reduce managerial opportunism as predicted by the Jensen and Meckling (1976) agency theory. It is from this perspective that financial and therefore market performances are enhanced. In summary, it is concluded that audit committee diligence as reflected by the frequency of committee meetings is good for the overall market performance of commercial banks listed at the NSE since it improves market returns.

REFERENCES

Al-Matari, Y. A., Al-Swidi, A. K., & Fadzil, F. H. B. (2012a). Audit committee effectiveness and performance of Saudi Arabia listed companies. *Wulfenia Journal*, *19*(8), 169-188.

Al-Matari, Y. A., Al-Swidi, A. K., Fadzil, F. H. B. H., & Al-Matari, E. M. (2012b). Board of directors, audit committee characteristics and the performance of Saudi Arabia listed companies. *International Review of Management and Marketing*, *2*(4), 241-251.

Al-Matari, E. M., Al-Swidi, A. K., & Fadzil, F. H. B. (2014). Audit committee characteristics and executive committee characteristics and firm performance in Oman: Empirical study. *Asian Social Science*, *10*(12), 98.

Alqatamin, R. M. (2018). Audit committee effectiveness and company performance: Evidence from Jordan. *Accounting and Finance Research*, *7*(2), 48.

Ashbaugh-Skaife, H., D. Collins, W., Kinney, W. and LaFond, R. (2008) The Effect of SOX Internal Control Deficiencies and their Remediation on Accrual Quality. *The Accounting Review*, 83 (1), 217-250.

Bansal, N., & Sharma, A. K. (2016). Audit committee, corporate governance and firm performance: Empirical evidence from India. *International Journal of Economics and Finance*, *8*(3), 103.

El-Hawary, E. (2021). 134 Audit Committee Effectiveness and Company Performance: Evidence from Egypt.

Habbash, M., Sindezingue, C., & Salama, A. (2013). The effect of audit committee characteristics on earnings management: Evidence from the United Kingdom. *International Journal of Disclosure and Governance*, *10*(1), 13-38.

Hamdan, A. M., Al-Hayale, T., & Aboagela, E. M. (2012). The Impact of Audit Committee Characteristics on Earnings Management: Additional Evidence from Jordan. In *European Business Research Conference Proceedings*.

Jensen, M. C., & Meckling, W. H. (1976). Theory of the firm: Managerial behaviour, agency costs and ownership structure. *Journal of Financial Economics*, *3*(6), 305-360.

Kallamu, B. S., & Saat, N. A. M. (2015). Audit committee attributes and firm performance: evidence from Malaysian finance companies. *Asian Review of Accounting*.

Mohammed, B. H., Flayyih, H. H., Mohammed, Y. N., & Abbood, H. Q. (2019). The effect of audit committee characteristics and firm financial performance: An empirical study of listed companies in Iraq stock exchange. *Journal of Engineering and Applied Science*, *14*(4), 4919-4926.

Ogoro, G. O., & Simiyu, C. N. (2015). Effectiveness of audit committees in the public sector: A case of parastatals in Kenya.

Ojeka, S., Iyoha, F. O., & Obigbemi, I. F. (2014). Effectiveness of audit committee and firm financial performance in Nigeria: an empirical analysis. *Journal of Accounting and Auditing: Research & Practice*.

Okiro, K., Samuel, A. J., Chege, E. N., Cheku, M. F., & Bulilo, M. J. (2018). The Effect of Audit Committees on the Performance of County Governments in Kenya. *African Development Finance Journal (ADFJ)*, *2*(1).

Olugbenga, A. A., & Atanda, O. A. (2014). Value relevance of financial accounting information of quoted companies in Nigeria: A trend analysis. *Research Journal of Finance and Accounting*, *5*(8), 86-93.

Oroud, Y. (2019). The effect of audit committee characteristics on the profitability: Panel data evidence. *International Journal of Economics and Finance*, *11*(4), 104-113.

Orozco, L.A., Vargas, J. and Galindo-Dorado, R. (2018). Trends on the relationship between board size and financial and reputational corporate performance: The Colombian case. *European Journal of Management and Business Economics, 27 (2), 183-197.*

Sultana, N., Singh, H., & Van der Zahn, J. L. M. (2015). Audit committee characteristics and audit report lag. *International Journal of Auditing*, *19*(2), 72-87.

Waweru, N. (2018). Audit committee characteristics, board ethnic diversity and earnings management: evidence from Kenya and Tanzania. *International Journal of Corporate Governance*, *9*(2), 149-174.

Wu, J., Zhang, L. and Zhang, X. (2010). The Q-Theory Approach to Understanding the Accruals Anomaly. *Journal of Accounting Research*, 48 (1), 177-223.