EFFECT OF AUDIT COMMITTEES CHARACTERISTICS ON QUALITY OF FINANCIAL REPORTING IN STATE CORPORATIONS IN KENYA

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DECLARATION

I declare that this dissertation is my original work and has not been previously published or submitted elsewhere for award of a degree. I also declare that this contains no material written or published by other people except where due reference is made and authors duly acknowledged.

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I do hereby confirm that I have examined the Master's dissertation of

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ABSTRACT

The role played by Audit committees in safeguarding public resources in State Corporations is of paramount importance. The study aimed at examining the effect of audit committee attributes on the quality of financial reporting in State corporations in Kenya. State Corporations in Kenya continue to experience problems related to poor management of resources. The audit committees are mandated to provide oversight in the management of public resources in State Corporations. This study was carried out to establish whether the attributes or characteristics of Audit Committees have significant influence on the quality of financial reporting in State Corporations. The study concentrated on AC independence, AC size and Financial expertise of AC members. These are the characteristics that could influence the quality of financial reporting in state corporations. The target population in the study was 187 State Corporations that are guided by the State Corporations Act cap 446.The study used agency theory, institutional theory, stewardship theory and stakeholders theory to investigate the relationship between the AC attributes and the quality of financial reporting. Secondary data was collected from the audited financial reports of the State Corporation. The logistic regression model was used to test the effect of Audit Committee characteristics on the quality of financial reports in State Corporation. The findings indicate that there is a fairly strong positive relationship between the independence of Audit committee members and the quality of financial reports. The findings also found that there is a strong negative relationship between the quality of financial reports and financial expertise of the Audit committee members. The study used correlation and regression analysis to analyze the data. Correlation analysis was applied on the relationship between the three AC attributes and inferential analysis was used to ascertain the relationship between AC attributes and quality of financial reports in State Corporations. A key recommendation of this study is that the Kenyan government should enact legislation to impose tough measures and penalties to deal with state corporations that do not comply with state corporations Act.

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DEDICATION

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LIST OF ACRONYMS

1. AC ………………………………………… Audit committee

2. OAG ………………………………………Office of audit general

3. SOX ACT: …………………………….. Sarbanes-Oxley Act

4. GOE…………………………………………Government Owned Enterprises

OPERATIONAL DEFINITION TERMS

Audit Committee – Operating Committee of the Board charged with oversight of financial reporting and disclosure

CHAPTER ONE

1.1 Introduction

This chapter seeks to introduce the Audit Committee and the attributes that are likely to influence the quality of financial reporting in state corporations in Kenya. The chapter also contains the objective of the study and the research questions that the study seeks to address.

1.2 Background of the Study

According to Beest F,Braan G and Boelens S.(2009), the quality of financial reports should be relevant and faithful in their presentations. The financial reports should be easy to understand, compare, verify and should be timely .These are the fundamental qualitative characteristics of financial reports as described in the International Accounting Standards Board, (2008). One of the key problems in prior literature was how to operationalize and measure the influence of AC characteristics on the quality of financial reports. The relationship between AC and their ability to produce quality financial reports is the focus of this study. The attributes of AC were studied and their influence on the quality of financial reporting in State Corporations in Kenya.

1.3 Audit Committees

Audit committee according to Al-Thunebat (2006) is the" committee that is composed of non-executive directors in institutions." Therefore it has a big role to play in ensuring clarity, decency and integrity in financial reporting.

Effectiveness of ACs is beneficial to various stakeholders including internal

and external auditors. Psarus and Seamer (2004) point out in their study that there are benefits that result from an effective AC. They indicate that when AC's carry out their functions effectively, the integrity of financial statements is maintained. They indicate that effective AC's ensure that the financial statements are accurate which is important in proper utilization of resources and accountability (Samuel G. 2012).

The audit committee of any Governance structure is very important in ensuring that resources are put in the best use through application of sound finance policies and ensuring that strong internal control systems are in place (BRC1999). One of the objectives of Audit committees in State Corporations is to ensure integrity of financial reporting in the institutions. The AC also is responsible of ensuring that the internal control systems are strong enough to safeguard the assets of the organizations.

Audit Committees in State corporations have various attributes which are; Independence of members, tenure of members, size of AC, financial expertise of members, frequency of meetings, multiple directorship in the board. This study focused on the attributes that are deemed to have influence on the quality of financial reports which are: (1) independence of the AC (2) size of the AC and (3) financial expertise of the AC (i.e. experience and education of the AC members). In Kenya, State corporations are required to have a number of characteristics for effective operation in their roles of vetting the quality and integrity of financial reports. (Ogora and Simiyu, 2015)

1.3.1 Audit committee independence

According to the Public Finance management Act, 2012 and the Public Finance Management Act, 2015, each public entity shall establish an audit committee in Kenya. According to Cohen, Krishnamoorthy and Wright (2000) an audit committee that is

effective should be independent from management's influence. An important issue to consider when evaluating the independence of any board or committee is the independence of committee composition. An independent audit committee member according to the Institute of Internal auditors (2014) is one who is not directly involved in the day to day running of the organizations operations and one who does not provide any services beyond her/his duties as an audit committee member. Independence of an AC member could be compromised if the AC member has a close relationship with suppliers in the organizations for example family members. The Canadian government for example require that majority of the AC members be from outside government. The auditor general of New Zealand and International Federation of Accountants, recommend most of the audit committee members should be by external appointments (Institute of Internal auditors, 2014). AC member independence will also be evaluated by looking at the proportion of independent non-executive directors in the board. The number of non-executive members to the total members in the AC.

1.3.2 Audit Committee Size

The size of the AC means the number of committee members that make up the AC. A large number of members are argued to provide more effective monitoring and thus improve firm performance. Jensen (1993) and Lipton and Lorsch (1992) on the other hand suggested in their study that large boards or ACs can be less effective than small boards. Their argument is that when AC become too big, agency problems (such as director free-riding) increase within the AC and the AC becomes more symbolic and less a part of the management process. Sharma et al. (2009) found evidence that there is a positive association between the

higher risk of financial misreporting and AC size.). Larger audit committees can lead to inefficient governance, thus yielding more regular AC meetings (Vafeas 1999).

1.3.2 Audit Committee members financial expertise

Another category of AC characteristics that might influence the performance relates to the financial expertise which consists of both experience and education. ACs that are characterized by strong governance contributes to greater monitoring by the AC and leads to enhanced oversight (Krishnan and Visvanathan, 2008). Most scholars argue that within each AC, the chair fulfills a key leadership role and therefore should be the most qualified person on the AC. Spira (1999) claims that where the AC chair has sufficient auditing background, it is very likely that the chair and the Chief Accountant will have a very good working relationship. This relationship could however work to strengthen oversight of the AC or could lead to compromise of the independence of the Chairman of the AC. According to Cohen, Krishnamurthy and Wright (2000) an audit committee that is effective should understand the financial reporting process. This study evaluated finance expertise by looking at the accounting and finance qualification or experience of AC members.

1.3.3 Role of Audit Committee in overseeing financial reporting.

Audit committee is an organ of corporate governance that ensures the quality, credibility and objectivity of financial reporting (Lindsell, 1992) in 1999, The Blue Ribbon Committee (BRC) was formed by the New York Stock Exchange and National Association of security dealers. In 1999, BRC issued a report and made 10 recommendations for improving the effectiveness of Audit Committees. The BRC (1999) describes the role of Audit Committee's oversight as ensuring quality Accounting Policies, internal controls, and independent and objective financial reporting, AC should be able to deter fraud, anticipate

financial risks and promote accurate, high quality and timely disclosure of financial and other material information to the board, to the public markets, and to shareholders.

The providers of resources to various entities be they shareholders in private companies or the government in public institutions which include state corporations, rely on financial reports to evaluate the financial positions of the entities. In today's world where fraud has become a huge detriment to the growth of the economy due to its practice in many organizations, the integrity of financial reports remain of great importance(Ogoro and Simiyu ,2015).

The Audit Committee being the body responsible for monitoring a company's activities on behalf of the shareholders and other providers of resources is expected to ensure that conflict of interest between shareholders (providers of resources), who are the owners, and managers, who are the agents managing the company's day-to-day operations are minimized by offering oversight on the operations of managers (Ogoro and Simiyu, 2015). Fama and Jensen (1983) argue in their study that the duty of Audit Committees is to oversee the effectiveness of management in order to maximize the shareholders' wealth and to avoid any activities that will damage the company's performance.

Audit committees are charged with the responsibility of ensuring that there are strong Internal Control Systems in order to minimize fraud and errors (BRC, 1999). The attributes of the AC play a great role in ensuring that this is done in the best way possible. The AC is vested with the responsibility of ensuring that financial reports prepared are accurate and are of integrity (IASB, 2008). In 2001, Enron Corporations scandal got many institutions thinking twice about the integrity of their financial statements. (Ogoro & Simiyu, 2015) The role of the ACs was questioned and issues of creative accounting and

window dressing were evident in this case. The US government introduced the Sarbanes-Oxley Act in 2000 to ensure that audit Committees are effective in their oversight role. (SOX Act, 2000)

DeZoort et al. (2002) defined as an effective Audit Committee as one that has qualified members with the power, authority and resources to protect stakeholder interests ensuring reliable financial reporting, internal controls, and risk management through its diligent oversight efforts. Therefore, the Audit Committee plays a monitoring role or oversight of activities. Kalbers and Fogarty (1993) defined audit committee effectiveness as the competency of the Audit Committee to specify oversight responsibilities in a firm. This study focuses on responsibilities of Audit Committee to provide oversight and ensure quality financial reporting.

1.3.4 Quality of Financial Reporting

According to the Public Finance management Act, 2015, the AC of a state corporation in Kenya should ensure there is a reliable financial reporting process and an effective internal audit. Kamaruzamet.et al (2009) stated that financial statements should be able to show important, dependable, comparable and comprehensive information. It is important that financial statements give a full disclosure of the financial position of the entity at a given reporting period. The AC plays a major role in ensuring that there is adequate accounting principles and internal control system that supports preparation of financial statements that are of integrity and that show a true and fair view of the entity's financial position (BRC, 1999). The AC if effective should ensure credible and accurate financial statements.

Quality financial reporting is an important factor in determining efficient and optimal utilization of an entity's resources. According to the IASB (2008), quality financial reports

should be easy to understand, compare, verify and should be timely. These are the qualitative characteristics of the financial reports that the State Corporations should ensure are produced.

Quality financial statements give the principal who are providers of resources a clear picture of the performance of the entity and hence guide the principals or providers of resources in optimal allocation of resources. According to Fel et. Al (2003) there is a positive correlation between audit committees and accuracy of financial reports produced.

There are various measures used to measure the quality of financial reports. The qualitative characteristics of financial reports are divided into two fundamental and enhancing qualities (IASB, 2008) Fundamental qualities according to IASB (2008) are relevance and faithful representation of the financial reports. The enhancing qualities generate useful information only if the financial report has the fundamental qualities (IASB, 2008). This study relied on the fundamental qualities to evaluate the quality of financial reports in the state corporations in Kenya. Maines and Wahlen (2006) argue that unqualified audit report is a necessary condition to perceive the financial report as reliable and faithful. The basis of testing if the quality of financial reports in State Corporation will be the report given either qualified or unqualified. Qualified opinion, adverse opinion, or disclaimer of opinion will indicate poor quality of the financial report while unqualified opinion will indicate high quality of financial report.

De Zoort *et al.* (2002) in their study describe effective audit committees as having qualified members with the authority and resources to protect stakeholder interests through reliable financial reporting and internal controls. This measure however of audit committee effectiveness has shortcomings since it regards the audit committee as an isolated

mechanism which fails to recognize the interdependence of audit committee components in a specific dynamic organizational/industrial context (Spira, 2006)

1.3.5 State corporations in Kenya

A State corporation according to the State corporations Act of Kenya is a body established by or under an Act of parliament or other written law. There are 187 state corporations in Kenya according to the presidential taskforce report on parastatals reforms of 2013 that was adopted in October 2013.These state corporations are guided by the State Corporations Act, Cap 446 of the Laws of Kenya According to section 15 (1) of the state corporations Act of Kenya, the Board of Directors in state corporations shall be responsible for the proper management of the affairs of the institutions.

1.4 Statement of the Problem.

Financial reporting relieves paramount asymmetry of information between managers/directors and providers of finances (Whittington, 1993). Limited access to managerial information causes providers of finance such as shareholders, bondholder and government to rely on financial reports to understand the financial position of the organization. According to Sloan (2001) among others, the financial reporting system provides a means by which providers of capital can monitor managers' actions.

There have been reported cases of failure of several state corporations despite the existence of legislation enacted to establish audit committees in these state corporations. Examples are National Social Security Funds (NSSF), Kenya Meat Commission (KMC), Kenya Cooperative Cremaries (KCC) among others due to fraudulent reporting. There is therefore need to study audit committee attributes and their effect on quality of financial reporting.(Ogoro and Simiyu ,2015)

Financial reports should provide accurate and truthful information that can be relied on by providers of finances and other potential investors to make the right decisions. The high value placed on accounting numbers create incentives for managers to manipulate figures to their own advantage (Rahman and Ali, 2006). The Board of Directors being the body that should safeguard the interests of providers of finances should be able to vet financial reports to find out if they are truthful, accurate free from manipulation by the managers.

According to BRC (1999) the AC should detect fraud, anticipated financial impropriety and risks. Klein (2002) argues that the effectiveness of Audit Committees in overseeing the financial reporting process depends on the independence of the AC. Independence is just one attribute of the AC. There other attributes for example size of the AC, financial expertise of the AC and Gender composition of the AC. According to Helland & Sykuta, 2005, the greater the number of independent directors there are on the Audit Committee, the greater the ability to monitor the management. This study seeks to establish the role played by AC's attributes on the quality of financial reporting in State Corporations in Kenya.

Various studies have been conducted on Audit committees but few studies have looked at the effectiveness of the ACs based on their characteristics especially in State Corporations in Kenya (Goddard and Masters, 2000). Very few studies have been conducted on audit committee attributes and their effect on the quality of financial reporting in Kenya State Corporations after the presidential taskforce report on State corporations was adopted in October 2013 that sought to make management of public resources in State Corporations more transparent. This study seeks to fill in the gap in literature by conducting a research on

the Audit committees attributes and their relationship with the quality of financial statement in State Corporations.

1.5 Objectives of the Study

The objective of the study is to examine the attributes of Audit Committees and their influence on the quality of financial reporting in State Corporations in Kenya.

1.5.1 Specific Objectives

To analyze the effect of independence of Audit Committee members on the quality of financial reporting in State Corporations in Kenya.

To investigate the effect of financial expertise of audit committee members on the quality of financial reporting in State corporations in Kenya

To establish the effects of audit committee size on quality of financial report in State corporations in Kenya.

1.6 Research Questions

What is the effect of Audit committee independence on the quality of financial reports in State corporations in Kenya?

What is the effect of Audit committee members' financial expertise on the quality of financial reports in state corporations in Kenya?

What influence does audit committee size have on the quality of financial reports in state corporations in Kenya?

1.7 Justification for the Study

The study of Audit Committee attributes and their effect on the quality of financial reporting is very important in our State Corporations in Kenya. This is because Kenya is a developing economy and all resources harnessed need to be safeguarded properly.

The Auditor General in Kenya in the last two audit cycles reported glaring discrepancies in the financial management systems of Government institutions. The findings alluded to weaknesses in the public sector accountability systems by highlighting corruption by way of payments that are not supported by invoices and receipts from service providers, absence or lack of updated asset registers, weak risk management policies as required by the Public Finance Management Act, weak debt recovery systems and flouting of procurement regulations among others. These ought to have been picked and dealt with if the Audit Committees were effective enough as per the finance and the agency theory.

This study will be beneficial to market participants who view audit committees as important in providing oversight on the financial reporting process .Investors will also benefit from the study in that they will be able to understand the effect of audit committee attributes on the management of their resources

.According to Verschoor, 1990a, 1990b; Lublin and MacDonald (1998)a lack of effective audit committee oversight can ultimately contribute to corporate failure and lack of public confidence in the integrity and quality of the financial reporting process. This will in turn have very negative effects on the economy of a country. This justifies this study further.

1.8 Scope of the Study

The study will be conducted on 187 state corporations in Kenya.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

The chapter discusses the theoretical review and framework and the studies that explain audit committee effectiveness and its relationship to quality of financial reports in State Corporations in Kenya. The conceptual framework depicts the variables of the study diagrammatically.

2.2 Theoretical Framework

This study has adopted a number of theories to study the relationship between Audit committee effectiveness and quality financial reporting. This section will review the theories related to this study. The theories are the agency theory , institutional theory, stewardship theory and stakeholders theory.

2.2.1 Agency theory

An agent makes decisions on behalf of the principal. Agency theory attempts to summarize and solve problems arising from the relationship between a principal and an agent in an institution

Under the agency relationship, there is always the disagreement that arises between the agents and principals as far as management of resources are concerned. While the principals may not be involved in the day to day running of the organizations, they appoint the AC to provide oversight and check the activities of the managements being the agents to ensure proper utilization of resources which is the ultimate goal of the principals. Preparation of quality financial statements is very important because it helps the principals evaluate the performance of the entity. The AC should therefore ensure that the Financial

statements prepared are accurate and are of integrity and presenting the true and fair position of the entity at any given time. The financial reports should be relevant and faithful.

Eisheher and Shield(1985) in their study argue that audit committees are a monitoring tool that should reduce information asymmetry between the management of an entity(agents) and the providers of resources (principals).Agency theory according to Jensen and Meckling (1976) identifies the agency relationship where one party, the principal, delegates work to another party, the agent. Jensen and Meckling (1976) further describes an agency relationship as a contract which one or 12 more persons, the principals engage another person. The agent appointed by the principal should act in the best interest of the principal. The agent undertaking the tasks assigned by the principal(s) should put in the interests of the institution before their own interests. The agency theory addresses the growing concern where the management builds empires for themselves at the expense of the entity's resources. This is what Jensen called the "systematic fleeting of shareholders and bondholders (1989)"

The agency theory can best explain the agency problem between the Audit Committees as the oversight authority to oversee the activities of the agent. They act as the eyes of the principals who are the providers of resources. For there to be success in management and financial reporting in state corporations, the AC should ensure that the financial statements are prepared accurately and that the statements give a true and fair view of the financial position of the organization or entity. This can only be possible if the AC is able to ensure that there are strong internal control measures in place and that the statements

are prepared in accordance with Accounting Principles that are well understood by management and the AC.

The extent to which the financial statements are understandable is an indicator of transparency. In some cases preparers of financial reports use accounting jargon that is hard for the Board members to understand. This is where the AC comes in to moderate between the preparers of the reports and the Board members. This is where the issue of the financial expertise of the AC members comes in because for the AC to be able to understand and appreciate the integrity of financial statements, they should be able to vet them and so should have knowledge on financial reporting. Since the AC should be composed of non – executive members, it should be able to play a big role in carrying out oversight duties in the entities.

Pincis et al (1989) argue that audit committees are used in situations where agency costs are high so as to improve the quality of information flow from the agents to the principals. In state corporations, the government or bondholders act as the principals and they have interest in deriving maximum utility from the actions of management serving as agents. ACs are therefore appointed to ensure quality financial reporting thus reducing the chances of principals discounting the value of the firm based on the likelihood of adverse selection and moral hazard, this reduces agency costs.

Agency theory explains how best one party will relate to the other in determining the work, which another party undertakes (Schneider, 1984). The theory argues that under conditions of incomplete information and uncertainty, which characterize most business settings, two agency problems arise: adverse selection and moral hazard, (Lin, Vargus and Bardhan, 2007). The agency theory is concerned with agency conflicts, or conflicts of

interest between agents and principals on financial reporting and management practices. This has implications for, among other things, corporate governance and business ethics. When agency occurs it also tends to give rise to agency costs, which are expenses incurred in order to sustain an effective agency relationship. The use of audit committees can be considered an important part of the decision control system for internal monitoring by boards of directors. Agency theory suggests some firms will have incentives to incur costs to differentiate themselves from others.

2.2.2 Institutional theory

Institutional theory developed by Meyer and Rowan (1977) suggests that social and environmental factors play an important role in creating an environment which influences the adoption of certain technology, practices, or management structures among organizations in seeking their legitimacy. According to DiMaggio and Powell (1988), the basic concepts and principle of the institutional theory approach provide useful guidelines for analyzing organization-environment relationships with an emphasis on the social rules, expectations, norms, and values as the sources of pressure on organizations. This theory is built on the concept of legitimacy rather than efficiency or effectiveness as the primary organizational goal (Doug & Scott, 2004). Researcher such as Meyer and Rowan (1991) asserts that innovative structures that improve technical efficiency in early-adopting organizations are legitimized.

According to William Richard Scott (1995) there is no single and universally agreed definition of an institution in the institutions school of thought. William argue that "institutions are social structures with a high degree of resilience. They are composed of

cultures, normative and regulative elements that together with activities and resources provide stability and meaning to social life”

Campbell and Pederson(2001),Campbell(2004),Schmist (2008) all argue that the common view that agent’s choices and actions are influenced by the institutional environment they are embedded and they have their own assumptions about the relationships between actors and their environment. From this study one can deduce that the actions of Audit committees will be influenced by the environment they are in. Scott(2008) emphasizes that Institutional theory is a widely accepted theoretical posture that emphasizes rational myths, isomorphism and legitimacy

According to institutional theory by Schneider, (1984), an organization is designed and functions to meet social expectations in so far as its operations are visible to the public. Therefore organizational internal operations, which are often complex and difficult to identify, may take second place to the issue of external legitimacy (Goodwin, 2004). It is suggested that the external image of the organization may be “loosely coupled” with its operating processes (Sterck, and Bouckaert, 2006). An audit committee in government institution is a cornerstone of good public sector governance. By providing unbiased, objective assessments of whether public resources are responsibly and effectively managed to achieve intended results, Audit committees help government organizations achieve accountability and integrity, improve operations, and instill confidence among citizens and stakeholders. Oversight addresses whether government entities are doing what they are supposed to do and serves to detect and deter public corruption.

2.2.3 Stewardship theory

Stewardship theory suggests that managers are concerned about the welfare of the owners and overall performance of the institution. This contradicts Agency theory which believes that agents are self-centered and individualistic (Donaldson and Dvis,1991) According to Davis et. Al (1997), control lowers a steward's motivation and undermines pro-organizational behavior. The theory further suggests that managers will do everything in order to achieve the goals of shareholders (Boyd et. Al ,2011) Ntim(2005) argued that the performance of an entity will be enhanced if the executives have more powers and are trusted to run the firm. The theory suggests that having majority executive directors on a committee will increase effectiveness and provide superior results than majority independent directors on a committee (Al Mamun et. Al ,2013) This study will be keen to evaluate the reality of this theory as far as independence of the AC members is concerned.

Executive directors could be viewed as being better to unify the different interest of stakeholders and that they will willingly act in a way that will protect the interests and welfare of others(Hernandez,2012) assuming that the actions of the steward are aimed at protecting the long term welfare of the principal. The theory assumes a strong relationship between organization success and principal satisfaction. It believes working for the organization, collective ends meet personal needs.

Stewardship theory is based on a model where a steward perceives greater utility in cooperative, pro-organizational behavior than in self-serving behavior. The theory assumes a strong relationship organizations success and principal's satisfaction.

In the context of state corporations governance, and based on the assumptions of stewardship theory, inside directors will be able to contribute more in decision of the board sub committees due to their technical expertise and knowledge about state corporations.

2.2.4 Stakeholders theory

The stakeholder theory is a theory of organization management that addresses moral and values in managing an organization. It was originally detailed by Ian Mitroff . Freeman also made a contribution to the theory in 1983.

Stakeholders theory is defined by Fort and Schipani (2000) as ensuring the conditions on the responsibilities of the institution to the various stakeholders to create value and coordinate the management levels among the various stakeholders including stockholders, employees, customers, creditors, suppliers, competitors even the whole society. The theory centers on issues concerning the stakeholders in an institution.

The theory proposes that good/proper management of resources benefit not only the owners or providers of finances but also the various relevant stakeholders. Jensen (2001) however realized that the proponents of the stakeholder theory have been unable to provide realistic solutions of the numerous conflicting interests of stakeholders that institutions need to protect. Stakeholder theory is very important in the context of the control mechanisms adopted by the companies and other institutions such as ACs that is examined in this study.

2.3 Empirical Review

2.3.1Audit Committee Independence relationship with Quality Financial Reporting

Management may exert pressure on auditors to alter financial reports to exhibit the best case scenario. This will lead to inaccurate or fraudulent reports. The Audit committee members should act in independence and avoid influence by management. Visvanathan(2008) used pre SOX data to examine the association between the quality accuracy and integrity of Financial Reports and AC independence. He found out that AC independence is not associated with quality of financial reports. According to the Institute of Internal auditors (2014) an independent audit committee member is one who is not involved in day to day running of an organization, or one who does not provide any services to the organization beyond his/her duties as an audit committee member AC independence according to BRC (1999) is the number of non- executive directors in the AC. Independence of Ac helps to ensure that the management is transparent and is held accountable by the stakeholders(BRC,1999)

Empirical evidence on different independent studies have documented the importance of the independence of audit committee members for maintaining the integrity and quality of the corporate financial reporting process (e.g., DeFond and Jiambalvo, 1991; Dechow et al., 1996; Carcello and Neal, 2000; Klein, 2002). According to McMullen and Raghunandan, (1996), Companies with financial reporting problems are less likely to have audit committees composed only of outside directors. In contrast, according to Abbott et al., (2000) companies with audit committees composed of independent directors are less likely to be sanctioned by the SEC for fraudulent or misleading financial reporting .These studies were conducted in private institutions where the body charged with the authority to appoint

Audit Committee members is different from that one in public institutions. Further studies therefore need to be conducted on the independence of ACs and their effect on quality of reporting in public entities.

Carcello and Neal (2000) examined the relationship between the percentage of audit committee members affiliated with companies experiencing financial distress, and the likelihood that the auditor will issue a going-concern report. Their finding was that audit firms are less likely to issue going-concern reports to financially distressed clients whose audit committee members lack independence. This study shows that there is some extent of relationship between AC independence and the integrity of financial reports generated in entities. In a recent study, Carcello and Neal (2003) find that auditors who issue a going-concern report are more likely to be dismissed if audit committees have a larger percentage of affiliated and gray area directors on the audit committee. These studies provide justification for calls that audit committees be composed solely of independent directors to provide effective oversight of the corporate financial reporting process, and thus, to reduce the risks of financial fraud and corporate failures. More research however need to be conducted on public institutions whose main objective is not profit making but service delivery to citizens

Hsu (2008) however in his study contradicted with the above study when he showed that audit committee independence is not associated with firm performance. In his study there was no evidence that audit committee activity is positively related to firm performance and by extension Quality of financial reporting. Abbott *et al.* (2004) examined cases of financial reporting restatement, and found that the independence and activity level of the

audit committee exhibit a significant and negative association with the occurrence of restatement.

The extant literature has long suggested that the higher the proportion of independent directors on the audit committee, the better the monitoring quality and the less likely firms would engage in earnings management (Be´dard et al. 2004; Klein 2002). However, upper echelons theory suggests that corporate executives view themselves as the upper class of the business community and are often identified with fellow executives (Useem 1984) As a result, when outside directors are CEOs of other companies, they tend to form a coalition with top management of the firm to support peer CEOs in board decision, and are less likely to carefully safeguard shareholder interests (Conyon and He ,2004; Weshphal and Zajac ,1997)

2.3.2: Financial expertise of the AC members and its effects on Quality of Financial reports

Accounting or financial expertise are attributes, qualification or experience acquired by a person before becoming a member of an AC of a company. The Sarbanes –Oxley Act(20020 provides high standards for the structure and responsibilities of AC with regard to Financial reporting. For example, the SOX section 407 requires disclosure of audit committee members that a company chooses to designate as financial experts. This is an indication that there is relationship between quality financial reporting and the financial experts of at least some members of the audit committee. In order to discharge its responsibility effectively in providing oversight and restrict managers from using the organization's resources to increase their own wealth, Audit committee members should possess clear and adequate understanding of financial reporting(SEC rule 33- 1877, 2003)

Prior research finds that higher financial reporting quality is associated with more accounting financial experts in the AC (Dhaliwal et.al,2007, Carcello et. Al 2008, Bedardet. Al 2001, Krishnan ,2005) Zhang *et al.*2007 also noted that ACs with less financial expertise are likely to be identified with poor quality financial reporting due to weaker internal control systems.

Porter and Gendall (1998) studied audit committees in the public sector and found that 70 percent of audit committees in the public sector have chief executive officers (CEOs) as a member of the audit committee. Respondents in this study reported that an understanding of the audit committee purpose and ability to exercise sound judgment were the most important attributes of audit committee membership, ahead of independence and financial expertise but the study did not conclusively find out what attributes will guide the members to exercise sound judgment. This study seeks to find out if financial expertise is important for AC members in order for them to carry out their duties effectively and its relationship with AC independence.

Carcello et,al(2008) in their research in 2003 used 350 firms to examine the effect of audit committee financial expertise on accurate financial reports. They found out that although AC financial expertise has no association with inaccurate or fraudulent financial reports, it positively related to abnormal discretionary expenditures for firms with a weak AC. This study will defer form Carcello et. al (2008) in that it will examine not just the financial expertise of the AC but also AC independence and size.

Abbott *et al.* (2004) and Bédard *et al.* (2004) find that the presence of financial experts on the audit committee is associated with less earnings restatements and earnings management. Farber (2006) found out in his study that fraudulent firms have fewer financial

experts on the audit committee. Collectively, these results suggest that audit committees with financial expertise are effective at limiting earnings management and reporting irregularities. Consistent with this view, audit committees with more expertise are more likely to understand complex accounting issues and the need for auditors to perform inquiries to increase their level of assurance that the financial statements do not contain material misstatements is minimal. Consequently, extant studies have found that a larger proportion of financial experts on an audit committee or a board of directors is associated with a smaller likelihood of financial restatements, fewer financial frauds, and less earnings management (DeFond et al. 2005; Dhaliwal et al. 2010; Krishnan and Visvanathan 2008).

The role of financial experts could be particularly crucial in a regulated industry due to more complex financial reporting and accounting rules in these industries. According to the American Institute of Certified Public Accountants' (AICPA 2006) report, banks' loan loss allowance ranks number one among various deficiencies found by Public Company Accounting Oversight Board (PCAOB) inspectors. This study intends to conduct further research on whether financial expertise of ACs have any effect on the State Corporations since most research has concentrated on profit making entities

2.3.3 Audit Committee size and its influence on Quality of Financial reports

AC size is considered the first factor of the AC characteristics. It is measured by the number of members serving on the AC of an organization (Beur et. Al 2009, Hsu & Petchsakulwong, 2010,Nuryanah & Islam, 2011, Obiyo & Lenee,2011) Beasley (1996) argues in his findings that the likelihood of inaccurate or fraudulent financial reporting increases with the size of the Audit Committee. Beasley(1996) results paints a picture that the smaller audit committees are more likely to be effective and be able to carry out

oversight better than larger ones. If the findings of Beasley(1996) is anything to go by, then we might conclude that Ac size might be associated with a higher incidence of financial misreporting for financially distressed companies. The limitation in Beasley study mentioned above is that it was conducted on profit making firms. Audit committees of state corporations in Kenya have a requirement to have 3 to 5 members.

The study of Mazlina et. al(2006) tried to test the relationship between size of the AC and its effect on financial reporting. Anderson et al (2004) found that smaller boards are associated with higher quality monitoring. The study showed that companies with smaller boards could shape the Chief Executive Officer to have a good reputation in terms of accuracy of their financial records and other forms of financial reporting.

This study seeks to find out if AC size has a similar effect on public institutions like parastatals whose major objective not profit is making but service delivery to citizens. The Blue Ribbon Committee on Improving the Effectiveness of Financial reporting (BRC, 1999) asserted that the audit committee's responsibilities and the complex nature of accounting and financial matters suggests that audit committees should consist of at least three directors. Larger audit committees tend to have more power (Kalbers and Fogarty, 1993), receive more resources (Pincus *et al.*, 1989), be associated with lower cost of capital (Anderson *et al.*, 2004) and experience a positive association with financial reporting quality (Felo *et al.*, 2003). A small committee may not possess sufficient resource and manpower to devote to such matters, which may impair its effectiveness in detecting and controlling earnings management (Beasley and Salterio 2001) . There appears to be conflicting evidence on the effect of AC size on Financial reporting with some researchers claiming that small ACs are

more effective while others argue that a large AC is better .This study will contribute by bridging the gap that the studies still have not been able to bridge.

Yermack (1996) shows that firms with smaller boards are able to better discipline CEOs in cases of poor performance. Similarly, Beasley (1996) finds that the likelihood of financial fraud increases as board size increases. These studies thus suggest that a smaller board is associated with higher monitoring quality. Consequently, we expect a positive relationship between audit committee size and earnings management.

The negative effect of a large audit committee may be particularly salient in a regulated industry. Several studies have suggested that executives in regulated firms are less actively monitored than those in unregulated industries because directors of regulated firms face less market pressure to do so (Helland and Sykuta 2004). Baysinger and Zardkoohi (1986), for example, find that boards of public utilities have more symbolic directors than those of less regulated firms. These directors often perform functions related to regulatory concerns such as helping the firm navigate political environments, and are thus different from board members in industrial firms who are mainly in charge of monitoring top management.

2.3.4 Summary of Literature review and Knowledge gap.

From the above literature review, it is evident that there is need for further research on the effect of audit committee characteristics on the quality of financial reporting in State Corporations. Various empirical studies conducted on AC attributes effects on the quality of financial reports were conducted on profit making institutions. Very few studies have been conducted on the effects of AC attributes on public institutions and specifically on state corporations.

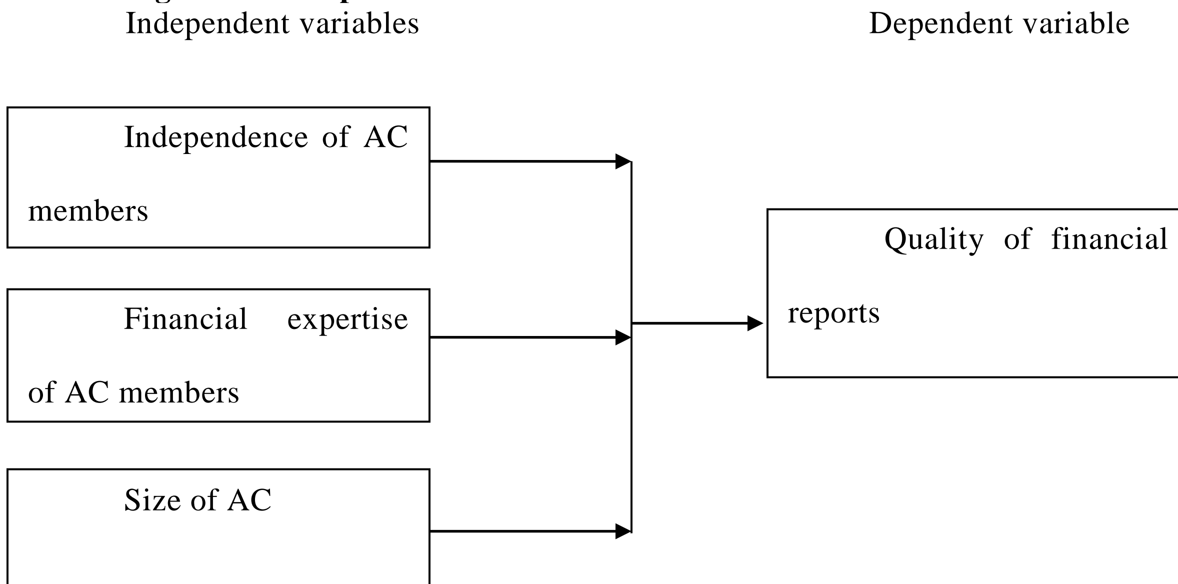
There have been contrasting findings on the various attributes of AC and their effect on the quality of financial reporting. For example According to McMullen and Raghunandan, (1996), companies with financial reporting problems are less likely to have audit committees composed only of outside directors. In contrast, according to Abbott et al., (2000) companies with audit committees composed of independent directors are less likely to be sanctioned by the SEC for fraudulent or misleading financial reporting. This shows that there is need for further research on the effect of Ac independence on the quality of financial reporting. The study will contribute to the body of research on AC attributes effects on quality of financial reporting in State corporations.

Various studies on AC size and its effect on quality of financial reporting have been conducted with contradicting findings. Larger audit committees tend to have more power (Kalbers and Fogarty, 1993) receive more resources (Pincus *et al.*, 1989), be associated with lower cost of capital (Anderson *et al.*, 2004) and experience a positive association with financial reporting quality (Felo *et al.*, 2003).In contrast Yermack (1996) shows that firms with smaller boards are able to better discipline CEOs in cases of poor performance. Similarly, Beasley (1996) finds that the likelihood of financial fraud increases as board size increases and There appears to be conflicting evidence on the effect of AC size on financial reporting with some researchers claiming that small ACs are more effective while others argue that a large AC is better .This study will contribute by bridging the gap that the studies still have not been able to bridge.

2.4 Conceptual Framework

Conceptual framework gives a depiction on how the variables in the study are related to one another. The variables defined here are the independent variables and the dependent variables. The independent variables are the explanatory variables whilst the dependent variable is the response variable. An independent variable influences and determines the effect on another variable called the dependent or response variable. The independent variables in this study are AC independence, AC member's financial expertise and Ac size. The dependent variable is quality of financial statements. The size of the state corporation is a control variable

Fig 2. 1: Conceptual Framework



2.5 Operationalization of the study variables

Operationalization is the process of strictly defining variables into measurable factors. The process defines fuzzy concepts of variables and allows them to be measured empirically and quantitatively (Nachmias and Nachmias, 2004) It means finding a measurable, quantifiable and valid index to study whether independent, moderating or dependent variables. It gives meaning to a concept by specifying the activities or operations necessary to measure it.

The table below shows how the variables in the study will be operationalized.

Table 2. 1: Operationalization of the variables

Category	Variable	Operationalization of the variable	Measurement
Independent variable	AC independence	This variable will be measured by the number of non-executive directors in the AC.0 will be assigned where there is no executive director in the AC and 1,2,3,4,5,6 will represent the number of executive directors in the AC	Ordinal
Independent variable	AC members financial expertise	This variable describes the financial expertise of AC members by the number of members with finance accounting education or experience. 1,2,3,4,5,6 will be assigned to number of members with finance or accounting education and experience while 0 where none of the members have any finance or accounting experience and education	Ordinal
Independent variable	AC size	This variable will be describe the number of members in the AC it will be assigned 3,4,5,6 each number representing the number of members in the AC	Ordinal
Dependent variable	Quality of financial reporting	This will be measured by the opinion given by the auditor General. Qualified opinion, Adverse opinion or disclaimer of opinion will be a dummy coded 1 and 0 for unqualified opinion.	Ordinal

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter is about the research design and methodology that were used to carry out the research. The chapter presents the research design, the target population, sample size and sampling procedure, data collection and data processing and analysis.

3.2 Research Design

Research design according to Chandran, (2004) represents the techniques that were used to gather data. The sampling strategies and tools that were used and how time and cost constraints were dealt with. In other words, it is guidance on data collection and analysis of the data in a way that combines their relationship for the purpose of the research (Chandran, 2004). In this study a combination of archival method were used where data was collected from the website of the Office of Auditor General. The data collected guided in analyzing AC independence, AC member's financial expertise and AC size. The data was also used to help establish the number of state corporations whose audit opinion was either qualified or unqualified.

3.3 Target Population

The unit of analysis for this study is the audit committees of State Corporations in Kenya. The study population is 187 state corporations as per the report of the presidential task force on Kenyan parastatals 2013.According to the report, state corporations are classified into 5 as follows: Commercial state corporations, Commercial state corporations with strategic function, Executive agencies, Independent regulatory agencies, Research institutions, public

universities, Tertiary and training institution. These are the State Corporations guided by the State Corporations Act cap 446. The year 2014/2015 was used as the base year for which data will be collected because this is the most recent year for which full financial statements are available from the Auditor Generals database of audit reports. All State Corporations in Kenya are required to follow the existing government regulations and others that are issued to guide the operations of these committees.

3.4 Sampling and Sampling Procedure

The sample of the study is the 187 state corporations. The focus is on state corporations that are guided by state corporations Act cap 446 .Data was collected from the state corporations that have already prepared financial reports for the year 2014/2015 and have been audited and the report s filed with the office of auditor general of Kenya.

.Simple random sampling method was used to select a representative sample from the population of 187 corporations. 60 state corporations were selected for the study to represent the 187 state corporations. This sample represents 32% of the whole population. According to Hair, Bush, Ortinas (2000) a sample of more than 10% is a true representation of the population.

The focus of the study was on the state corporations who have audited financial reports for the year 2014/2015.

3.5 Data Collection Procedure

Secondary data was obtained from the Office of Auditor General website in form of audited annual financial reports of the state corporations for the year 2015. The state corporation's annual financial reports were examined to collect data on AC independence, AC size and AC members finance or accounting experience and education.AC member's biographical

information was also examined to determine whether an AC member possesses finance and accounting experience or education. The audit reports were examined to obtain the opinion of the statutory auditor.

3.6 Data Processing Analysis

Data was organized mainly by use of descriptive and inferential statistics. Descriptive statistics include mean, standard deviation. Inferential statistical techniques included correlation and regression analysis which was used to draw a relationship between the independent variables and the quality of financial statements. Correlation was also used to measure the strength of relationship between the variables.

Logistic regression model was adopted in this study to test the effect of AC independence, size of AC and financial expertise of AC on the quality of financial reports by reduced number of financial restatements. Independence was coded as 1,2,3,4,5 representing the number of members of the AC who are executive members and 0 where no member is an Executive director. The size of the AC was coded as 3,4,5 ,6 depending on number of members in the AC. Financial and accounting experience and education was coded as 1,2,3,4,5,6 for number of AC members with finance or accounting experience or education or 0 is no member has any finance or accounting experience or education . Audit opinion is a dummy coded as 1 for qualified, adverse opinion or disclaimer of opinion and 0 for unqualified opinion. The data was analysed using stata software.

The model will be presented in a linear equation as below:

$Y = Bo + B1X1 + B2X2 + B3X3 + B4X4 + e$

Where:

Y – Quality of financial reports - Auditor's opinion either unqualified or qualified, adverse opinion or disclaimer of opinion

Bo is a constant

X1 is AC independence the proportion of independent directors

X2 is AC members with finance and accounting experience and expertise.

X3 is AC size - the actual number of directors in the committee

.

B1, B2, B3AND B4 are beta coefficients

e is the error term

CHAPTER FOUR

RESULTS AND DISCUSSION

4.1 Introduction

This chapter presents the analysis and findings of the study as set out in the research methodology. The results were presented on the effect of audit committee characteristics on the quality of financial reports. The study data was collected from the annual financial and audit reports of the 60 state corporations in Kenya in the financial year 2014/2015 based on the study variables.The statistical data management and analysis in this study was carried out on two fronts; descriptive statistics and inferential statistics.

4.2 Descriptive Statistics

In this section, frequency tabulations and sample statistics are presented in order to give a quick description of the individual variables.

Table 4. 1: Opinion given by the Auditor General

Opinion on quality of financial reports	Freq.	Percent	Cum.
0	25	41.67	41.67
1	35	58.33	100.00
Total	60	100.00	

As indicated in Table 2, 35 (58.33%) State Corporations received a qualified opinion from the Auditor General while 25 (41.67%) received unqualified opinion from the Auditor General.

Summary statistics of the Opinion given by the Auditor General are reported in Table 4.2.

Table 4. 2: Summary statistics for Opinion

Opinion on quality of financial reports

	Percentiles	Smallest		
1%	0	0		
5%	0	0		
10%	0	0	Obs	60
25%	0	0	Sum of Wgt.	60
50%	1		Mean	.5833333
		Largest	Std. Dev.	.4971671
75%	1	1		
90%	1	1	Variance	.2471751
95%	1	1	Skewness	-.3380617
99%	1	1	Kurtosis	1.114286

From Table 4.2, the mean response was 0.58 which corresponds to the response category 1, implying that on avaerage, the opinion on State Corporation’s financial quality from the Auditor General was qualified. The variability of the opinions on the different State Corporations was 0.2472.

Table 4. 3: Audit Committee independence

Audit Committe independence	Freq.	Percent	Cum.
0	24	40.00	40.00
1	24	40.00	80.00
2	7	11.67	91.67
3	4	6.67	98.33
4	1	1.67	100.00
Total	60	100.00	

As presented in Table 4.3, 24 (40%) of the State Corporations had no executive directors in the Audit Committee, an equal number 24 (40%) of the State Corporations had only a single executive director in the Audit Committee, 7 (11.67%) of the State Corporations had 2 executive directors in the Audit Committee, 4 (6.67%) of the State Corporations had 3 executive directors in the Audit Committee while 1 (1.67%) State Corporations had 4 executive directors in the Audit Committee.

Summary statistics of the Opinion given by the Auditor General are reported in Table 4.4.

Table 4. 4: Summary statistics for Independence

Audit Committe independence

	Percentiles	Smallest		
1%	0	0		
5%	0	0		
10%	0	0	Obs	60
25%	0	0	Sum of Wgt.	60
50%	1		Mean	.9
		Largest	Std. Dev.	.9690114
75%	1	3		
90%	2	3	Variance	.9389831
95%	3	3	Skewness	1.102303
99%	4	4	Kurtosis	3.834443

From Table 4.4, the mean response was 0.9 which corresponds to the response category 1, implying that on avaerage, State Corporations had a single executive director in the Audit Committee. The variability in the number of executive directors in State Corporations was 0.9390.

Table 4. 5: Financial expertise of the Audit Committee

Financial expertise of the Audit Committee	Freq.	Percent	Cum.
0	26	43.33	43.33
1	17	28.33	71.67
2	10	16.67	88.33
3	5	8.33	96.67
4	2	3.33	100.00
Total	60	100.00	

As presented in Table 4.5, 26 (43.33%) of the State Corporations had no members of the Audit Committee with any education in finance and accounting, 17 (28.33%) of the State Corporations had a single member of the Audit Committee with education in finance and accounting, 10 (16.67%) of the State Corporations had two members of the Audit Committee with education in finance and accounting, 5 (8.33%) of the State Corporations had 3 members of the Audit Committee with education in finance and accounting while 2 (3.33%) of the State Corporations had four members of the Audit Committee with education in finance or accounting.

Summary statistics of the Opinion given by the Auditor General are reported in Table 4.6.

Table 4. 6: Summary statistics for Expertise

Financial expertise of the Audit Committee

	Percentiles	Smallest		
1%	0	0		
5%	0	0		
10%	0	0	Obs	60
25%	0	0	Sum of Wgt.	60
50%	1		Mean	1
		Largest	Std. Dev.	1.119927
75%	2	3		
90%	3	3	Variance	1.254237
95%	3	4	Skewness	.9491233
99%	4	4	Kurtosis	3.046019

From Table 4.6, the mean response was 1 which corresponds to the response category 1, implying that on average, State Corporations had had a single member of the Audit Committee with education in finance or accounting. The variability in the number of members of the Audit Committee with education in finance or accounting in State Corporations was 1.2542.

Table 4. 7: Size of the Audit Committee

Size of the Audit Committee	Freq.	Percent	Cum.
2	1	1.67	1.67
3	19	31.67	33.33
4	22	36.67	70.00
5	15	25.00	95.00
6	3	5.00	100.00
Total	60	100.00	

As shown in Table 4.7, 1 (1.67%) State Corporation had two members making the Audit Committee, 19 (31.67%) of State Corporations had three members making the Audit Committee, 22(36.67%) of State Corporations had four members making the Audit Committee, 15 (25%) of State Corporations had five members making the Audit Committee while 3 (5%) of State Corporations had six members making the Audit Committee.

Summary statistics of the Opinion given by the Auditor General are reported in Table 4.8.

Table 4. 8: Summary statistics for Size

Size of the Audit Committee

	Percentiles	Smallest		
1%	2	2		
5%	3	3		
10%	3	3	Obs	60
25%	3	3	Sum of Wgt.	60
50%	4		Mean	4
		Largest	Std. Dev.	.9205746
75%	5	5		
90%	5	6	Variance	.8474576
95%	5.5	6	Skewness	.2629068
99%	6	6	Kurtosis	2.352

From Table 4.8, the mean response was 4 which corresponds to the response category 4, implying that on avaerage, State Corporations had four members making up the Audit Committee. The variability in the number of members making up the Audit Committees in State Corporations was 0.8475.

4.3 Inferential Statistics

In this section, regression and correlation analysis are carried out to determine the model that fits the data on the dependent variable Opinion on quality of financial reports of State Corporations given by the Auditor General and the set of independent variables; Audit Committee independence, Financial expertise of the Audit Committee and Size of the Audit Committee. Further a correlation analysis is carried out to establish the nature and degree of association between the dependent variable and each of the independent variables.

4.3.1 Regression Analysis

A multiple logistic regression analysis was carried out between the dependent variable Opinion on quality of financial reports of State Corporations given by the Auditor General and the set of independent variables; Audit Committee independence, Financial expertise of the Audit Committee and Size of the Audit Committee. The results of the estimated logistic model are reported in Table 4.9 and 4.10.

Table 4. 9: Logistic Regression

```
.  logit opinion independence expertise size

Iteration 0:   log likelihood = -40.751596
Iteration 1:   log likelihood = -9.9120344
Iteration 2:   log likelihood =  -9.010683
Iteration 3:   log likelihood = -7.6381297
Iteration 4:   log likelihood = -7.5819182
Iteration 5:   log likelihood = -7.5812154
Iteration 6:   log likelihood = -7.5812153

Logistic regression                               Number of obs   =         60
                                                  LR chi2(3)      =      66.34
                                                  Prob > chi2     =     0.0000
Log likelihood = -7.5812153                       Pseudo R2       =     0.8140
```

opinion	Coef.	Std. Err.	z	P>|z|	[95% Conf.	Interval]
independence	6.357753	2.884428	2.20	0.028	.7043773	12.01113
expertise	-4.610655	1.764021	-2.61	0.009	-8.068073	-1.153237
size	1.060556	.9934215	1.07	0.286	-.8865143	3.007626
_cons	-3.582387	4.398798	-0.81	0.415	-12.20387	5.039099

Table 4.9 presents the regression model in 1.

$$Y = -3.582387 + 6.357753X_1 - 4.610655X_2 + 1.060556X_3 \quad (1)$$

Where,

Y is the Quality of financial reports measured by the opinion given by the Auditor General on financial reports

X_1 is Audit Committee independence measured by the number of executive directors in the Audit Committee directors.

X_2 is the Financial expertise of Audit Committee members measured by the number of members in the Audit Committee with education in finance or accounting.

X_3 is the Size of the Audit Committee measured by the number of members making up the Audit Committee.

At $\alpha = 5\%$ level of significance a decision is made on the effect of each independent variable on the dependent variable.

As indicated by the p-value = 0.028 < $\alpha = 0.05$, the variable Audit Committee independence is statistically significant in influencing the Quality of financial reports. A p-value =0.009 < $\alpha = 0.05$ also indicated that the variable Financial expertise of Audit Committee significantly determines the Quality of financial reports. However, different results were obtained for the third variable as p-value =0.286 > $\alpha = 0.05$ indicates that the variable Size of the Audit Committee does not significantly influence the Quality of financial reports.

However, as indicated by the p-value =0.000 (Prob>chi2) < $\alpha = 0.05$, the set all independent variables significantly influence the dependent variable Quality of financial reports simultaneously.

A goodness of fit coefficient (Pseudo R2) = 0.8140 implies that 81.4% of the changes in the Quality of financial reports are accounted for by the set of independent variables; Audit Committee independence, Financial expertise of the Audit Committee and Size of the Audit Committee while the remaining 18.6% of the total changes in the Quality of financial reports is accounted for by other factors (variables) not included in the logistic regression model.

Further analysis was carried out to determine if the specific levels of the insignificant variable (Size of the Audit Committee) influence the Quality of financial reports independently. The results are presented in Table 4.10.

Table 4. 10: Logistic Regression (Levels of Size of the AC)

```
Logistic regression                               Number of obs   =         59
                                                  LR chi2(2)      =      71.05
                                                  Prob > chi2     =     0.0000
Log likelihood = -4.6821312                       Pseudo R2       =     0.8835
```

opinion	Coef.	Std. Err.	z	P>|z|	[95% Conf.	Interval]
independence	56.10567	.	.	.	.	.
expertise	-37.67628	.	.	.	.	.
size						
2	0	(empty)				
3	-37.09562	.	.	.	.	.
4	-36.98313	1.870829	-19.77	0.000	-40.64989	-33.31637
5	-37.67628	2	-18.84	0.000	-41.5962	-33.75635
6	0	(omitted)				
_cons	37.67628	1.414214	26.64	0.000	34.90447	40.44808

The results in Table 4.10 show that the variable is only significant at levels 4 and 5. This means that when the size of the Audit Committee is 4, it significantly determines the Quality of financial reports as indicated by a p-value =0.000 < $\alpha = 0.05$. Similarly, when the size of the Audit Committee is 5, it significantly determines the Quality of financial reports as indicated by a p-value =0.000 < $\alpha = 0.05$. When the size of the Audit Committee is 2, 3 or 6 members, it is not statistically significant in influencing the Quality of financial reports of the State Corporations.

4.3.2 Correlation Analysis

A correlation analysis between a given set of two variables was carried out and the results reported in Tables 4.11-4.16.

Table 4. 11: Correlation between Opinion and Independence

```
. corr opinion independence
(obs=60)

             |  opinion indepe~e
-------------+------------------
     opinion |   1.0000
independence |   0.6157   1.0000
```

As shown in Table 4.11, a fairly strong positive relationship exists between the Quality of financial reports and the Audit Committee independence. This is indicated by the sample autocorrelation coefficient of $r = 0.6157$.

Table 4. 12: Correlation between Opinion and Expertise

```
. corr opinion  expertise
(obs=60)

             |  opinion expert~e
-------------+------------------
     opinion |   1.0000
   expertise |  -0.7306   1.0000
```

As indicated in Table 4.12, a sample autocorrelation coefficient of $r = -0.7306$ implies that there exists a strong negative relationship between the Quality of financial reports and the Financial expertise of the Audit Committee.

Table 4. 13: Correlation between Opinion and Size of AC

```
. corr opinion   size
(obs=60)
```

	opinion	size
opinion	1.0000	
size	0.0000	1.0000

As indicated in Table 4.13, a sample autocorrelation coefficient of $r = 0.0000$ implies that there does not exists a linear association between the Quality of financial reports and the Size of the Audit Committee at all levels collectively.

Table 4. 14: Correlation between Independence and Expertise

```
. corr independence expertise
(obs=60)
```

	indepe~e	expert~e
independence	1.0000	
expertise	-0.4217	1.0000

As indicated in Table 4.14, a sample autocorrelation coefficient of $r = -0.4217$ implies that there exists a weak negative association between the independence of an AC and the expertise of the Audit Committee.

Table 4. 15: Correlation between Independence and Size of the AC

```
. corr independence  size
(obs=60)
```

	indepe~e	size
independence	1.0000	
size	-0.1710	1.0000

As indicated in Table 4.15, a sample autocorrelation coefficient of $r = -0.1710$ implies that there exists a very weak negative association between the independence of an AC and the size of the Audit Committee.

Table 4. 16: Correlation between Expertise and Size of the AC

```
. corr  expertise  size
(obs=60)
```

	expert~e	size
expertise	1.0000	
size	-0.0164	1.0000

As indicated in Table 4.16, a sample autocorrelation coefficient of $r = -0.0164$ implies that there exists an extremely weak negative association between the expertise in an AC and the size of the Audit Committee.

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter presents an overview of the research findings, conclusions and recommendations based on the study's objectives and research questions. The chapter also suggests areas for further research.

5.2 Summary

The public sector and specifically state corporations was the main focus of the study. The effect of Audit committee characteristics on the quality of financial reports was studied. Secondary data was collected from audited financial reports in the website of the office of the Auditor General of Kenya. 60 state corporations in Kenya were sampled for the study .The study focused on 3 research objectives Objective one was to analyze the effect of independence of Audit Committee members on the quality of financial reporting in State Corporations in Kenya. Objective two was to investigate the effect of financial expertise of audit committee members on the quality of financial reporting in State corporations in Kenya and objective three was to establish the effects of audit committee size on quality of financial report in State corporations in Kenya. Data was collected on the number of independent directors in the Audit committee for objective one, Number of audit committee members with finance or accounting experience or training for objective two and number of audit committee members for objective three.

5.2.1 The effect of Independence of Audit Committee members on the Quality of financial reporting in State Corporations in Kenya.

The logistic regression analysis presented a positive dependence between the Quality of financial reporting in State Corporations in Kenya and the Independence of Audit Committee members (with a regression coefficient of 6.357753) implying that the more independent an Audit Committee was the higher the quality of financial reporting in State Corporations in Kenya was. These results are consistent with the findings by Abbott et al., (2000) which found out that companies with audit committees composed of independent directors are less likely to be sanctioned by the SEC for fraudulent or misleading financial reporting A test of significance further revealed that the dependence between the two variables was statistically significant at 5% level of significance as indicated by the p-value = 0.028 < $\alpha = 0.05$.This result is further compounded by a correlation analysis that was carried out to establish the extent of the relationship as well. A sample autocorrelation coefficient of $r = 0.6157$ further showed that the positive relationship was fairly strong.

5.2.2 The effect of financial expertise of audit committee members on the quality of financial reporting in State corporations in Kenya

The logistic regression analysis presented a negative dependence between the Quality of financial reporting in State Corporations in Kenya and the financial expertise of Audit Committee members (with a regression coefficient of -4.610655) implying that a higher financial expertise of Audit Committee led to a lower quality of financial reporting in State Corporations in Kenya. This is consistent with the findings of the study by McMullen

(1986) who found out that quality of financial reports decreases with the increase in proportion of financial experts in the audit committee. A test of significance revealed that this dependence was statistically significant at 5% level of significance as indicated by the p-value =0.009 < $\alpha = 0.05$. This result is further supported by a correlation analysis that was carried out to establish the extent of the association between the two variables. A sample autocorrelation coefficient of $r =$ -0.7306 showed that there existed a strong negative relationship between the Quality of financial reports and the financial expertise of the Audit Committee.

5.2.3 The effect of Audit Committee size on Quality of financial report in State corporations in Kenya.

Results from the logistic regression analysis presented a positive association between the Quality of financial reporting in State Corporations in Kenya and the size of the Audit Committee (with a regression coefficient of 1.060556) implying that a bigger size of Audit Committee led to a higher quality of financial reporting in State Corporations in Kenya. A test of significance however revealed that this dependence was not statistically significant at 5% level of significance as indicated by the p-value =0.286 > $\alpha = 0.05$ implying that the size of the Audit Committee did not influence the Quality of financial reports. Previous studies conducted have their findings giving contradicting results on the effect of audit committee size on quality of financial reports (Kalbers and Fogarty, 1993, Anderson et al 2004.)This result is supported by a correlation analysis that was carried out and revealed no linear association between the two variables as indicated by sample autocorrelation coefficient of $r = 0.000$. However, when specific sizes of the audit committee were

considered, it was discovered that Audit Committees of sizes 4 and 5 significantly influenced the quality of financial reports as indicated by a p-value =0.000 < $\alpha = 0.05$ in each case.

Moreover, a goodness of fit coefficient (Pseudo R2) = 0.8140 showed that the data did fit the model relatively well as 81.4% of the total variations in the Quality of financial reports were explained by the set of independent variables; Audit Committee independence, Financial expertise of the Audit Committee and Size of the Audit Committee. The study also established that the three independent variables were all negatively correlated with each other.

5.3 Conclusions

Given the set of independent variables, the study concludes that, only the independence of the Audit Committee influences the quality of financial reports in State Corporations in Kenya positively and significantly. The size of the Audit Committee also influences the quality of financial reports in State Corporations positively but there was no sufficient evidence from the data to show that this contribution of the size of the Audit Committee to the quality of financial reports in State Corporations was statistically significant not unless an Audit Committee composed of 4 or 5 members. On the contrary, the study concludes that a higher financial expertise of the members of an Audit Committee does significantly affect the quality of financial reports in State Corporations in Kenya but negatively.

5.4 Recommendations

Following the findings from this study, the study offers the following key recommendations.

The government of Kenya should enact laws that will impose stiff penalties on state corporations that do not comply with state corporations Act cap 446.

A legal framework need to be put in place to govern the appointment of audit committee members to avoid executive directors from being members of the audit committee.

The government of Kenya should provide a legal framework that will require a mix of trained skills in the audit committee to include different skills in management as well as finance expertise.

5.5 Recommendations for future research

This study is not perfect and has various limitations. Firstly the findings from the study should not be wholly relied on to conclude the effect of audit committee characteristics on the quality of financial reports. This study covered state corporations and therefore the results cannot be replicated to the entire public sector. Secondly, the research used cross sectional data that examined the characteristics of audit committees in the financial year 2014/2015. Following the above limitations, as suggestions of further studies it will be important to study the effect of audit committee characteristics on the quality of financial reporting A study needs to conducted on the effect of audit committees on the quality of financial reports after the implementation of recommendations made by a presidential task force on governance of State corporations in 2013 whose recommendations took effect in October 2015.This is after the year covered by this study. These studies will help understand how various legislation affect audit committees and the quality of financial reporting and could be important to the body of knowledge on governance in state corporations and its effect in management of public resources.

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APPENDICES

Appendix I: LIST OF STATE CORPORATIONS IN KENYA BY 2015

Purely Commercial State Corporations

1. Agro-Chemical and Food Company
2. Kenya Meat Commission
3. Muhoroni Sugar Company Ltd
4. South Nyanza Sugar Company Limited
5. Chemilil Sugar Company Ltd
6. Nzoia Sugar Company Ltd
7. Simlaw Seeds Kenya
8. Simlaw Seeds Tanzania
9. Simlaw Seeds Uganda
10. Kenya National Trading Corporation (KNTC) Tourism
11. Kenya Safari Lodges and Hotels Ltd. (Mombasa Beach Hotel, Ngulia Lodge,
12. Voi Lodge)
13. Golf Hotel Kakamega
14. Kabarnet Hotel Limited
15. Mt Elgon Lodge
16. Sunset Hotel Kisumu
17. Jomo Kenyatta Foundation
18. Jomo Kenyatta University Enterprises Ltd.
19. Kenya Rivatex (East Africa) Ltd.

20. 19.Rivatex (East Africa) Ltd
21. School Equipment Production Unit
22. University of Nairobi Enterprises Ltd.
23. University of Nairobi Press (UONP)
24. Development Bank of Kenya Ltd
25. Kenya Wine Agencies Ltd (KWAL)
26. KWA Holdings
27. New Kenya Co-operative Creameries
28. Yatta Vineyards Ltd
29. National Housing Corporation
30. Research Development Authority
31. Consolidated Bank of Kenya
32. Kenya National Assurance Co.
33. Kenya Reinsurance Corporation Ltd
34. Kenya National Shipping Line

State Corporations with Strategic Functions

1. Kenya Animal Genetics Resource
2. Kenya Seed Company (KSC)
3. Kenya Veterinary Vaccine
4. National Cereals & Produce Board (NCPB
5. Kenyatta International Convention
6. Geothermal Development Company (GDC
7. Kenya Electricity Generating Company (KENGEN

8. Kenya Electricity Transmission Company (KETRACO
9. Kenya Pipeline Company (KPC)
10. Kenya Power and Lighting Company (KPLC
11. National Oil Corporation of Kenya
12. National Water Conservation and Pipeline
13. Numerical Machining Complex Ltd
14. Kenya Broadcasting Corporation
15. Postal Corporation of Kenya
16. Kenya Development Authority
17. Kenya EXIM Bank
18. Kenya Post Office Savings
19. Kenya Airports Authority (KAA)
20. Kenya Ports Authority (KPA
21. Kenya Railways Corporation (KRC)

State Agencies

1. Biashara Kenya
2. Internal Revenue
3. Kenya Intellectual Property
4. Kenya Investment Promotion
5. Konza Technopolis Authority
6. Bomas of Kenya
7. Water Services Trust
8. Leather Development Authority

9. Agricultural Development Corporation
10. Anti-Female Genital Mutilation
11. Constituency Development Fund
12. Crops Development and Promotion
13. Customs and Boarder Security Service
14. Drought Management Authority
15. Export Processing Zones Authority (EPZA
16. Financial Reporting Centre
17. Fisheries Development and Promotion Service
18. Higher Education Loans Board
19. Information and Communications Technology
20. Investor Compensation
21. Kenya Academy of Sports
22. Kenya Accountants & Secretaries National Examination Board (KASNEB)
23. Kenya Deposit Protection Authority
24. Kenya Ferry Services Ltd (KFS)
25. Kenya Film Development Service
26. Kenya Institute of Curriculum Development(KICD)
27. Kenya Law Reform Commission
28. Kenya Medical Supplies Authority
29. Kenya National Bureau of Statistics
30. 30.Kenya National Examination Council (KNEC)
31. Kenya National Highways Authority (KeNHA)

32. Kenya National Innovation
33. Kenya Ordnance Factories Corporation
34. Kenya Roads Board (KRB
35. Kenya Trade Network
36. Kenya Wildlife and Forestry Conservation
37. Kenyatta National Hospital
38. LAPSSET Corridor Development
39. Livestock Development and Promotion
40. Local Authorities Provident
41. Moi Teaching and Referral Hospital
42. Nairobi Centre for International Arbitration
43. National Aids Control Council
44. National Cancer Institute of
45. National Coordinating Agency for Population &
46. National Council for Law Reporting
47. National Council for Persons with Disabilities
48. National Hospital Insurance Fund
49. National Industrial Training
50. National Irrigation Board
51. National Museums of Kenya
52. National Social Security Fund
53. National Youth Council
54. Nuclear Electricity Board

55. Policy Holders Compensation

56. Sports Corporation

57. The Kenya Cultural Center

58. Tourism Fund

59. Unclaimed Financial Assets Authority

60. Water Resources Management Authority

61. National Campaign Against Drug Abuse

State Agencies - Independent Regulatory Agencies

1. Agricultural, Fisheries and Food Authority

2. Commission for University Education

3. Communications Commission of Kenya

4. Competition Authority

5. 5.Council for Legal

6. Energy Regulatory Commission

7. Health Services Regulatory

8. Kenya Bureau of Standard (KBS

9. Kenya Civil Aviation Authority (KCAA

10. Kenya Film Regulatory Service

11. Kenya Maritime Authority

12. Kenya National Accreditation Service

13. Kenya Plant and Animal Health Inspectorate

14. Livestock Regulatory Authority

15. National Commission for Science, Technology and

16. National Construction Authority

17. National Environmental Management Authority (NEMA)

18. National Land Transport & Safety

19. Public Benefits Organizations Regulatory Authority

20. Public Procurement Oversight Authority

21. Technical and Vocational Education and Training Authority

22. Tourism Regulatory Authority

23. Water Services Regulatory

24. Financial Supervisory

25. Mining and Oil Exploration Regulatory Service

State Agencies - Research Institutions, Public Universities, Tertiary Education and Training Institutions

1. Bukura university
2. Chuka University
3. Cooperative University College
4. Dedan Kimathi University
5. Egerton University
6. Embu University
7. Garissa University College
8. Jaramogi Oginga Odinga University of Science and Technology
9. Jomo Kenyatta University of Agriculture And Technology
10. 10.Karatina University
11. Kenya Agricultural and Livestock Research Organization

12. Kenya Forestry Research
13. Kenya Industrial Research & Development Institute
14. Kenya Institute of Mass Communication
15. Kenya Institute of Public Policy Research & Analysis (KIPPRA
16. Kenya Marine and Fisheries Research Institute
17. Kenya Medical Research Institute (KEMRI)
18. Kenya Medical Training College (KMTC)
19. Kenya Multi-Media University
20. Kenya School of Law
21. Kenya Utalii College (KUC)
22. Kenya Water Institute
23. Kenyatta University
24. Kibabii University
25. Kirinyaga University
26. Kisii University
27. Laikipia University
28. Maasai Mara University
29. Machakos University
30. Maseno University
31. Masinde Muliro University of Science and
32. Meru University of Science and
33. Moi University
34. 35.Murang'a University College

35. National Crime Research
36. Pwani University
37. Rongo University College
38. South Eastern Education, Science and Technology Kenya University
39. Taita Taveta University College
40. Technical University of Kenya
41. University of Eldoret
42. University of Kabianga
43. University of Nairobi