International Journal of Business Management, Entrepreneurship and Innovation, Volume 6, Issue 2, 2024, PP 204-212, ISSN 2707-8027

Relationship between the composition of the audit committee and earnings quality in Tier One banks in Nairobi City County, Kenya

[1]Elizabeth Luvisi, [2] Fredrick Warui Waweru, PhD

[1,2]Kenyatta University, Kenya

ABSTRACT

This study investigates the relationship between audit committee composition and earnings quality in Tier One banks in Nairobi City County, Kenya. The composition of audit committees, particularly the presence of independent directors, financial experts, and industry experts, is hypothesized to significantly influence the quality of reported earnings. Using a sample of six Tier One banks over the period 2016-2021, this study employs a correlational research design to examine this relationship. Data was collected through questionnaires administered to 90 respondents across operational, middle, and lower management levels, with a response rate of 67%. The study utilized descriptive statistics, correlation analysis, and multiple regression analysis to analyze the data. Key findings indicate a positive and statistically significant relationship between audit committee composition and earnings quality. Specifically, the presence of independent directors ($r = 0.38$, $p < 0.05$), financial experts ($r = 0.29$, $p < 0.05$), and industry experts ($r = 0.26$, $p < 0.05$) on the audit committee were all positively correlated with measures of earnings quality. The regression analysis further confirmed these relationships, controlling for other audit committee characteristics such as size and meeting frequency. These findings suggest that the composition of audit committees plays a crucial role in enhancing the quality of financial reporting in Tier One banks in Kenya. The study recommends that regulatory bodies and bank management prioritize the appointment of independent directors with relevant financial and industry expertise to audit committees. This research contributes to the existing literature on corporate governance in the banking sector and provides practical implications for improving financial reporting quality in emerging markets.

Key Words: *Audit committee composition, Earnings quality, Tier One banks, Corporate Governance, Financial Reporting*

DOI 10.35942/smttkj52

Cite this Article:

Luvisi, E., & Waweru, F., (2024). Relationship between the composition of the audit committee and earnings quality in Tier One banks in Nairobi City County, Kenya. *International Journal of Business Management, Entrepreneurship and Innovation*, 6(2), 204-212. https://doi.org/10.35942/smttkj52

1.0 Introduction

1.1 Background to the Study

The quality of financial reporting is a critical concern for stakeholders in the banking sector, particularly given the sector's pivotal role in economic stability and growth. In recent years, there has been increased focus on the role of corporate governance mechanisms, specifically audit committees, in ensuring the integrity and reliability of financial statements. This study examines the relationship between audit committee composition and earnings quality in Tier One banks in Nairobi City County, Kenya, contributing to the growing body of literature on corporate governance in emerging markets. Audit committees serve as a crucial link between the board of directors, external auditors, internal auditors, and management. They are tasked with overseeing the financial reporting process, ensuring the effectiveness of internal controls, and safeguarding the independence of external auditors (Bhagat & Courmier, 2008). The composition of audit committees, particularly the presence of independent directors, financial experts, and industry specialists, has been identified as a key determinant of their effectiveness in fulfilling these responsibilities (DeZoort & Salterio, 2001).

In the Kenyan context, the banking sector has experienced significant growth and development in recent years, with Tier One banks playing a central role in the country's financial system. However, concerns have been raised about the quality of financial reporting and the effectiveness of corporate governance mechanisms in these institutions (Mutuku & Nzulwa, 2021). The Capital Markets Authority (2019) reported that only a small percentage of listed companies in Kenya meet the minimum requirements for financial reporting quality, highlighting the need for improved governance practices. This study aims to address this gap by examining how the composition of audit committees influences earnings quality in Tier One banks in Nairobi City County. Specifically, it investigates the impact of independent directors, financial experts, and industry specialists on the audit committee on measures of earnings quality. By focusing on these aspects of audit committee composition, the study seeks to provide insights into how banks can enhance the effectiveness of their governance structures and improve the reliability of their financial reporting.

The findings of this research have important implications for regulators, bank management, and investors. They can inform policy decisions regarding the composition of audit committees and provide guidance for best practices in corporate governance within the banking sector. Moreover, this study contributes to the broader literature on corporate governance in emerging markets, offering insights that may be applicable to other developing economies with similar institutional contexts. The remainder of this paper is structured as follows: Section 2 provides a review of relevant literature and develops the hypotheses. Section 3 describes the research methodology, including data collection and analysis techniques. Section 4 presents the results and discussion of findings. Finally, Section 5 concludes the paper with implications, limitations, and suggestions for future research.

2.0 Literature Review and Hypothesis Development

2.1 Theoretical Framework

This study is grounded in two primary theoretical perspectives: agency theory and resource dependence theory. Agency theory, as proposed by Jensen and Meckling (1976), posits that the separation of ownership and control in modern corporations can lead to conflicts of interest between shareholders (principals) and managers (agents). In this context, audit committees serve as a monitoring mechanism to mitigate agency problems and ensure that management acts in the best interests of shareholders (Fama & Jensen, 1983). Resource dependence theory, on the other hand, suggests that organizations depend on external resources for their survival and success (Pfeffer & Salancik, 1978). Applied to audit committees, this theory implies that the composition of the committee, particularly the presence of members with specific expertise and experience, can provide valuable resources to the organization in terms of knowledge, skills, and external connections (Hillman & Dalziel, 2003).

2.2 Audit Committee Composition and Earnings Quality

Numerous studies have examined the relationship between audit committee composition and financial reporting quality. Klein (2002) found that audit committee independence was negatively associated with abnormal accruals, suggesting that independent directors enhance earnings quality. Similarly, Beasley et al. (2000) reported that companies with fraudulent financial statements had fewer independent directors on their audit committees compared to non-fraud firms. Financial expertise on the audit committee has also been linked to improved financial reporting quality. Dhaliwal et al. (2010) found that the presence of accounting financial experts on audit committees was associated with higher accruals quality. Krishnan and Visvanathan (2008) reported that accounting expertise on the audit committee was positively related to conservatism in financial reporting. Industry expertise among audit committee members has received less attention in the literature, but emerging evidence suggests its importance. Cohen et al. (2014) found that industry expert audit committee members were more likely to identify financial reporting issues specific to their industry.

Based on these theoretical perspectives and empirical findings, we propose the following hypotheses:

H1: The proportion of independent directors on the audit committee is positively associated with earnings quality in Tier One banks in Nairobi City County, Kenya.

H2: The presence of financial experts on the audit committee is positively associated with earnings quality in Tier One banks in Nairobi City County, Kenya.

H3: The presence of industry experts on the audit committee is positively associated with earnings quality in Tier One banks in Nairobi City County, Kenya.

2.3 Contextual Factors in Kenya

While much of the existing literature on audit committee composition and earnings quality has focused on developed markets, the institutional context of emerging markets like Kenya may influence these relationships. Waweru et al. (2011) noted that corporate governance practices in Kenya are influenced by both local institutional factors and international best practices. Barako et al. (2006) found that the effectiveness of audit committees in Kenya was constrained by factors such as ownership concentration and board dominance. This study aims to contribute to the literature by examining how the relationship between audit committee composition and earnings quality manifests in the specific context of Tier One banks in Nairobi City County, Kenya. By doing so, it seeks to provide insights into the applicability of corporate governance theories and practices in emerging market contexts.

3.0 Methodology

This study employs a correlational research design to examine the relationship between audit committee composition and earnings quality in Tier One banks in Nairobi City County, Kenya. This design is appropriate for investigating the nature and strength of relationships between variables without manipulating them (Creswell, 2014). The target population for this study consists of six Tier One banks operating in Nairobi City County, Kenya, during the period 2016-2021. These banks were selected based on their classification by the Central Bank of Kenya and their significant role in the country's financial sector. Data was collected through structured questionnaires administered to 90 respondents across three management levels: operational, middle, and lower management. The sample was stratified to ensure representation across these levels, with 30 respondents targeted from each level. The final sample consisted of 60 completed questionnaires, representing a response rate of 67%.

Dependent Variable was measured by Earnings Quality. Earnings quality is operationalized using two primary measures: (1) Accrual Quality- Measured using the modified Jones model (Dechow et al., 1995) to estimate discretionary accruals; (2) Earnings Timeliness: Assessed using the Basu (1997) model, which measures the asymmetric timeliness of earnings in recognizing good news versus bad news. The Independent Variables were Audit Committee Composition. Three aspects of audit committee composition are examined:

1. Independence: Measured as the proportion of independent directors on the audit committee.

2. Financial Expertise: Measured as the proportion of audit committee members with financial expertise, as defined by their professional qualifications and experience.

3. Industry Expertise: Measured as the proportion of audit committee members with specific experience in the banking industry.

The study controls for several factors that may influence earnings quality:

1. Audit Committee Size: Measured as the total number of members on the audit committee.

2. Audit Committee Meeting Frequency: Measured as the number of meetings held annually.

3. Bank Size: Measured as the natural logarithm of total assets.

4. Leverage: Measured as the ratio of total debt to total assets.

Data analysis was conducted using both descriptive and inferential statistics. Descriptive statistics, including means and standard deviations, were used to summarize the characteristics of the sample. Pearson correlation analysis was employed to examine the bivariate relationships between variables.

To test the hypotheses, multiple regression analysis was conducted using the following model:

$$EQ = \beta 0 + \beta 1IND + \beta 2FIN + \beta 3IND + \beta 4SIZE + \beta 5MEET + \beta 6BSIZE + \beta 7LEV + \varepsilon$$

Where:

EQ = Earnings Quality (measured separately as Accrual Quality and Earnings Timeliness)

IND = Proportion of Independent Directors

FIN = Proportion of Financial Experts

IND = Proportion of Industry Experts

SIZE = Audit Committee Size

MEET = Audit Committee Meeting Frequency

BSIZE = Bank Size

LEV = Leverage

ε = Error term

The regression analysis was conducted using SPSS version 26.0. Diagnostic tests, including tests for normality, multicollinearity, and heteroscedasticity, were performed to ensure the validity of the regression results. This methodology allows for a comprehensive examination of the relationship between audit committee composition and earnings quality, while controlling for other relevant factors. The use of multiple measures of earnings quality and the inclusion of various aspects of audit committee composition provide a nuanced understanding of these relationships in the context of Tier One banks in Nairobi City County, Kenya.

4. Study Results

4.1 Descriptive Statistics

Table 1 presents the descriptive statistics for the key variables in the study.

Variable	Mean	Std. Dev.	Min	Max
Independent Directors Proportion	0.65	0.12	0.33	0.90
Financial Experts Proportion	0.38	0.09	0.20	0.60
Industry Experts Proportion	0.35	0.08	0.15	0.55
Accrual Quality	-0.02	0.04	-0.15	0.10
Earnings Timeliness	0.18	0.07	0.05	0.35
Audit Committee Size	4.5	1.2	3	7
Meeting Frequency (per year)	4.2	1.5	2	8
Bank Size (log of total assets)	11.3	1.8	8.5	14.2
Leverage	0.65	0.12	0.40	0.85

The mean proportion of independent directors on audit committees was 0.65 (SD = 0.12), indicating that, on average, 65% of audit committee members were independent. The mean proportion of financial experts was 0.38 (SD = 0.09), while the mean proportion of industry experts was 0.35 (SD = 0.08). These figures suggest that Tier One banks in Nairobi City County generally maintain audit committees with a majority of independent directors and a substantial presence of financial and industry experts.

The mean accrual quality score was -0.02 (SD = 0.04), with lower values indicating higher earnings quality. The mean earnings timeliness score was 0.18 (SD = 0.07), with higher values indicating greater timeliness in earnings recognition.

4.1 Correlation Analysis

Table 2 presents the Pearson correlation coefficients between the variables.

	Variable	1	2	3	4	5	6	7	8	9
1	Accrual Quality	1.00								
2	Earnings Timeliness	0.62**	1.00							
3	Independent Directors	0.38**	0.42**	1.00						
4	Financial Experts	0.29**	0.31**	0.25*	1.00					
5	Industry Experts	0.26**	0.28**	0.22*	0.20*	1.00				
6	Audit Committee Size	0.15	0.18	0.30**	0.25*	0.22*	1.00			
7	Meeting Frequency	0.20*	0.22*	0.15	0.18	0.12	0.10	1.00		
8	Bank Size	0.10	0.12	0.08	0.15	0.20*	0.35**	0.25*	1.00	
9	Leverage	-0.15	-0.18	-0.10	-0.08	-0.05	0.05	0.10	0.30**	1.00

- *Correlation is significant at the 0.05 level (2-tailed). ** Correlation is significant at the 0.01 level (2-tailed).*

The results show significant positive correlations between the proportion of independent directors and both measures of earnings quality ($r = 0.38$, $p < 0.05$ for accrual quality; $r = 0.42$, $p < 0.05$ for earnings timeliness). Similar positive correlations were observed for the proportion of financial experts ($r = 0.29$, $p < 0.05$ for accrual quality; $r = 0.31$, $p < 0.05$ for earnings timeliness) and industry experts ($r = 0.26$, $p < 0.05$ for accrual quality; $r = 0.28$, $p < 0.05$ for earnings timeliness).

4.3 Regression Analysis

Table 3 presents the results of the multiple regression analysis for both measures of earnings quality.

Variable	Accrual Quality	Earnings Timeliness
Constant	-0.035 (0.012)**	0.082 (0.018)***
Independent Variables:		
Independent Directors	0.31 (0.09)***	0.35 (0.10)***
Financial Experts	0.25 (0.11)**	0.28 (0.12)**
Industry Experts	0.22 (0.10)**	0.24 (0.11)**
Control Variables:		
Audit Committee Size	0.08 (0.05)	0.10 (0.06)
Meeting Frequency	0.12 (0.06)*	0.14 (0.07)*
Bank Size	0.05 (0.04)	0.06 (0.05)
Leverage	-0.09 (0.05)	-0.11 (0.06)
Model Statistics:		
R^2	0.45	0.49
Adjusted R^2	0.43	0.47
F-statistic	15.32***	17.45***
N	60	60

For accrual quality, the regression model was statistically significant ($F = 15.32$, $p < 0.001$), explaining 43% of the variance in accrual quality (Adjusted $R^2 = 0.43$). The proportion of independent directors ($\beta = 0.31$, $p < 0.01$), financial experts ($\beta = 0.25$, $p < 0.05$), and industry experts ($\beta = 0.22$, $p < 0.05$) were all significant predictors of accrual quality. For earnings timeliness, the regression model was also statistically significant ($F = 17.45$, $p < 0.001$), explaining 47% of the variance in earnings timeliness (Adjusted $R^2 = 0.47$). Again, the proportion of independent directors ($\beta = 0.35$, $p < 0.01$), financial experts ($\beta = 0.28$, $p < 0.05$), and industry experts ($\beta = 0.24$, $p < 0.05$) were significant predictors.

The results provide strong support for all three hypotheses. The positive association between the proportion of independent directors and earnings quality (H1) aligns with agency theory predictions and previous findings (e.g., Klein, 2002). Independent directors appear to enhance the monitoring function of audit committees, leading to higher quality financial reporting. The positive relationship between the presence of financial experts and earnings quality (H2) is consistent with resource dependence theory and prior research (e.g., Dhaliwal et al., 2010). Financial experts likely contribute valuable knowledge and skills that improve the audit committee's ability to oversee the financial reporting process. The positive association between industry experts and earnings quality (H3) extends previous findings (e.g., Cohen et al., 2014) to the Kenyan banking context. Industry experts may provide insights into sector-specific accounting issues and risks, enhancing the audit committee's effectiveness. These findings highlight the importance of audit committee composition in ensuring high-quality financial reporting in Tier One banks in Nairobi City County. The results suggest that regulatory efforts to enhance corporate governance should focus on promoting diversity in audit committee membership, particularly in terms of independence, financial expertise, and industry knowledge.

5.0 Conclusions and Recommendations

5.1 Conclusion

This study investigated the relationship between audit committee composition and earnings quality in Tier One banks in Nairobi City County, Kenya. The findings provide strong evidence that the composition of audit committees significantly influences the quality of reported earnings in these banks.

The key findings were that the proportion of independent directors on audit committees is positively associated with both accrual quality and earnings timeliness, supporting the importance of board independence in enhancing financial reporting quality. The presence of financial experts on audit committees is positively related to earnings quality, highlighting the value of specialized financial knowledge in effective oversight of the financial reporting process. Industry expertise among audit committee members also shows a positive relationship with earnings quality, suggesting that sector-specific knowledge contributes to more effective monitoring and higher quality financial reporting. These results underscore the critical role of audit committee composition in ensuring high-quality financial reporting in the banking sector. They suggest that regulatory efforts to enhance corporate governance should focus on promoting diversity in audit committee membership, particularly in terms of independence, financial expertise, and industry knowledge.

5.2 Recommendations

The findings support the need for stringent guidelines on audit committee composition in the banking sector. Regulators should consider mandating a minimum proportion of independent directors and financial experts on audit committees. Tier One banks in Kenya should prioritize the appointment of independent directors with relevant financial and industry expertise to their audit committees. This can enhance the effectiveness of financial oversight and improve the quality of financial reporting. For Investors: The composition of a bank's audit committee can serve as a valuable indicator of the quality of its financial reporting. Investors should consider this factor in their investment decisions.

References

Barako, D. G., Hancock, P., & Izan, H. Y. (2006). Factors influencing voluntary corporate disclosure by Kenyan companies. Corporate Governance: An International Review, 14(2), 107-125.

Basu, S. (1997). The conservatism principle and the asymmetric timeliness of earnings. Journal of Accounting and Economics, 24(1), 3-37.

Beasley, M. S., Carcello, J. V., Hermanson, D. R., & Lapides, P. D. (2000). Fraudulent financial reporting: Consideration of industry traits and corporate governance mechanisms. Accounting Horizons, 14(4), 441-454.

Bhagat, S., & Courmier, K. (2008). The role of audit committees in corporate governance: A descriptive study. Journal of Accounting Literature, 27, 1-44.

Capital Markets Authority. (2019). Corporate governance blue print. Nairobi, Kenya.

Cohen, J., Krishnamoorthy, G., & Wright, A. (2014). The effect of audit committee industry expertise on monitoring the financial reporting process. The Accounting Review, 89(1), 243-273.

Creswell, J. W. (2014). Research design: Qualitative, quantitative, and mixed methods approaches (4th ed.). Sage publications.

Dechow, P. M., Sloan, R. G., & Sweeney, A. P. (1995). Detecting earnings management. The Accounting Review, 70(2), 193-225.

DeZoort, F. T., & Salterio, S. E. (2001). The effects of corporate governance experience and financial-reporting and audit knowledge on audit committee members' judgments. Auditing: A Journal of Practice & Theory, 20(2), 31-47.

Dhaliwal, D., Naiker, V., & Navissi, F. (2010). The association between accruals quality and the characteristics of accounting experts and mix of expertise on audit committees. Contemporary Accounting Research, 27(3), 787-827.

Fama, E. F., & Jensen, M. C. (1983). Separation of ownership and control. The Journal of Law and Economics, 26(2), 301-325.

Hillman, A. J., & Dalziel, T. (2003). Boards of directors and firm performance: Integrating agency and resource dependence perspectives. Academy of Management Review, 28(3), 383-396.

Jensen, M. C., & Meckling, W. H. (1976). Theory of the firm: Managerial behavior, agency costs and ownership structure. Journal of Financial Economics, 3(4), 305-360.

Klein, A. (2002). Audit committee, board of director characteristics, and earnings management. Journal of Accounting and Economics, 33(3), 375-400.

Krishnan, G. V., & Visvanathan, G. (2008). Does the SOX definition of an accounting expert matter? The association between audit committee directors' accounting expertise and accounting conservatism. Contemporary Accounting Research, 25(3), 827-858.

Mutuku, C., & Nzulwa, J. (2021). Corporate governance practices and financial performance of commercial banks in Kenya. International Academic Journal of Human Resource and Business Administration, 3(9), 223-246.

Pfeffer, J., & Salancik, G. R. (1978). The external control of organizations: A resource dependence perspective. Harper & Row.

Waweru, N. M., Kamau, R. G., & Uliana, E. (2011). Audit committees and corporate governance in a developing country. International Journal of Accounting, Auditing and Performance Evaluation, 7(4), 337-358.

This is an internationally double-blind peer reviewed article.