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RELATIONSHIP BETWEEN AUDIT COMMITTEE CHARACTERISTICS AND THE AUDIT EXPECTATION GAP WITHIN STATE CORPORATIONS IN KENYA

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Abstract

Purpose: The current study sought to identify the relationship between audit committee characteristics and the audit expectation gap within the public sector in Kenya.

Methodology: The study adopted a positivism philosophy and a descriptive research design in solving the research problem. The target population for the research was pooled from audit committee members in all the 119 state parastatals. The study relied on primary data that was collected using semi-structured questionnaires and key informant interview schedules. This was further supplemented using secondary data that was sourced from government reports and published reports. The collected data was analyzed using descriptive and inferential statistics. Statistical tests such as ANOVA and t-test was conducted to help in accepting or rejecting the research hypothesis.

Results: The study findings indicated that audit committee composition $R^2 = .107$ and audit committee meetings $R^2 = .19$ had the highest association with audit expectation gap in state corporations.

Unique contribution to theory, practice and policy: The study recommends that gender inclusion should be upheld within the public sector and more so within audit committees. Further in constituting audit committees there is need for stakeholders to ensure individual competencies such as technical skills, leadership qualities and integrity are available to help mitigate expectation gap. More so there should be appropriate skill mix within the audit committee which should be regularly assessed to ensure conformity to best standards of practice.

Keywords: *Audit committee, Audit committee composition, Audit committee meetings, Audit expectation gap*

INTRODUCTION

Auditors are part of the force that drives organizations towards achieving their strategic goals. The paradigm shift of risks, evolving business practices, and ever-changing business environments are putting pressure on Internal Auditors not only to relay opinion on controls, but also to work in partnership with management to help them do things in a better way (Van-Gansberghe, 2005). Auditing continues to be most acceptable measure to control public financial stewardship, (Iyoha & Oyerinde, 2010). There is no good financial management without proper accountability of the same being mentioned (Adams & Evans, 2004).

According to the professional guidance of the Institute of Internal Auditors (IIA), public sector governance encompasses the policies and procedures used to direct an organization's activities to provide reasonable assurance that objectives are met and that operations are carried out in an ethical and accountable manner (Osborne, 2010). Governance in the public sector relates to the means by which goals are established and accomplished to address the needs and expectations of several stakeholders. At present, there is no generally accepted definition of the meaning of the audit expectations gap. Several accounting researchers and professional accounting bodies have offered their definitions. On the issue of its existence, the literature has explicitly accepted the existence of the problem of expectation gap (Odoyo, Omwono, & Okinyi, 2014). Pierce and Kilcommins (2006) observed that the audit expectation gap exists when the external auditor's understanding of their role and duties is compared against the expectations of user group and the general public.

Blue Ribbon Committee (BRC, 2009) reports that audit committees have become imperative for financial management in the public sector in recent years. Audit committee is a mechanism of good corporate governance. Organizations and firms need to continuously improve their global standards management leading to effectiveness and efficiency. The audit committee ensures the quality, credibility, and objectivity of financial reporting. The audit committee member has a role to oversight responsibility of the organization. The characteristics of audit committee are to enhance the effectiveness of responsibilities and include composition, qualification and method of communication with all parties as internal auditor, external auditor, management, and board of director to improve audit committee effectiveness (Cohen, Krishnamoorthy, & Wright, 2002).

In public sector, audit committees are required to have a number of characteristics for effective operation in their roles of vetting the integrity of financial statements. The characteristics that include: director independence which is represented by having the proportion of independent nonexecutive directors in the board, tenure of the directors, size of the audit committee, financial expertise for the audit committee, frequency of committee meetings and multiple directorships in the board; as proxy for evaluating the effectiveness of these committees in Kenya (Ogoro & Simiyu, 2014). In a study on the role of internal audit function on listed firms in Egypt, by El-Sayed (2011) the researchers discovered that it was very much entrenched in the corporate sector. That the role of the audit committees was not yet pronounced making their role difficulty thus negatively affecting their corporate governance. Sometimes the management affects internal audit independence by ensuring that it is not independent through manipulating the composition of the committee as well as the adoption of the audit department charter.

Ruhnke and Schmidt, (2014) considered the audit expectation gap in terms of its existence, causes and it's impact on the corporate governance of firms. The findings of the study indicated that increasing information content and mandatory rotation of the audit committee members helped in reducing the audit expectation gap. Mugo (2013) carried out a study to

establish the relationship between internal control systems and financial performance in Technical Training Institutions in Kenya. The study found that management of the institutions is committed to the control systems, actively participates in monitoring and supervision of the activities of the Technical Training Institutions in Kenya. The researcher further indicated that the composition the audit department affects the audit function within the institution.

According to Kamau, Nduati, and Mutiso, (2014) in their study on the internal auditor independence motivators the researchers indicated that promoting auditors independence and objectivity enhance the performance of the audit profession. However, the study did not consider the auditor expectation gap. In a recent review by KPMG (2017) on the audit committee challenges the report indicated that 4 out of 10 audit committees promoted effectiveness within their services. The study further indicated that audit committees are largely focussed on meeting their legal and regulatory compliances hence improving their effectiveness.

Statement of the Problem

Audit committees are a mechanism of ensuring the quality, credibility and objectivity of the financial reporting (Turley & Zaman, 2004). They have a role of oversight responsibility and assist a board to monitor responsibilities of an organization or institution hence their effectiveness is crucial in proper financial management (Baxter & Cotter, 2009). However, in the developing economies context, independence of the audit committees has often been compromised by both internal and external forces of the government institutions. There have also been instances where recruitment of technically unskilled members has been brought on board due to existing political systems which have been subject to corruption and embezzlement of funds. This has led to ineffectiveness of the audit committee in delegation of its oversight role (Turley & Zaman, 2007). However despite this there has been little empirical evidence examining how audit committee characteristics influence the audit expectation gap hence need for the current study. The current study will examine how audit committee characteristics influence the audit expectation within the state corporations which have been facing a myriad of financial management and service delivery challenges. This will enhance the body of literature and support future policy formulation.

Research Objective

- i. To assess the association between audit committee composition and the audit expectation in Kenyan state corporations.
- ii. To analyze the influence of audit committee meetings on the audit expectation in Kenyan state corporations.

Research Hypothesis

H₁ There is significant association between of audit committee's composition in mitigating audit expectation in public sector in Kenya.

H₂ There is significant association between audit committees meetings the audit expectation in Kenyan state corporations.

Significance of the Study

Policy Makers in State Parastatals

The study will be of great importance to the auditing practice in general as well as in policy formulation as well as enhancing the audit expectation gap in the public sector in wake of the ongoing embezzlement of public funds. Further the recommendations of this study will help policy makers to design a more progressive and effective policies aimed at ensuring good advancement of the audit practice in the public sector.

To the County governments

In the current dispensation the county governments have been obligated to enhance service delivery in the grassroots as well as support the national economic and social development. The findings of the research will empower the county governments to foster their audit departments as well as design audit charters that will enhance the auditing profession at the county level. This will be of importance in supporting better governance and accountability within the units.

To business organizations

The management of different business organizations also benefit from the study through the understanding of effectiveness of the audit committee in their organization in promoting corporate governance through adopting skilled and qualified manpower; properly delineated authority and responsibilities; and a reporting status that permits the maintenance of integrity, objectivity, and professional independence to enhance internal auditing and improve corporate governance.

THEORETICAL REVIEW

Institutional Theory

The institutional theory as proposed by Meyer and Rowan (1977); holds that the environment within which a firm operates plays an important role in influencing the adoption and implementation of various innovations, practices and structure within the organization which foster the technical aspects of the firm. DiMaggio (1988) further hold that the basic tenets of the institutional theory offer guidelines geared towards analyzing the environment within which an organization operates. The theory is built on the concepts of legitimacy rather than efficiency or effectiveness as the primary organizational goal (Scott, 2005).

According Meyer and Rowan (1991) the innovative structures that improve technical efficiency in early-adopting organizations are legitimized in the environment. Ultimately these innovations reach a level of legitimization where failure to adopt them is seen as "irrational and negligent" (or they become legal mandates). The institutional theory is relevant to this study in that it suggests that organizations incorporate technical practices, or management structures among departments in seeking to increase their overall performance. The audit committee being an oversight body helps to improve the audit expectation gap through application of the principles of the institutional theory. Such principles and practices can be incorporated to better explain the adoption structures and systems into practice and hence in improvement of overall performance of the public sector. Hence the theory anchored the audit committee composition and audit committee technical skills as best practices and structures respectively.

Stakeholder Theory

In line with Freeman (1994) the agency theory is a short-term perspective of an introduction and the purpose of the firm. Fort and Schipani (2000), as ensuring the conditions of the responsibilities to the various stakeholders to create value and co-ordinate the management levels among various stakeholders including stockholders, employees, customers, creditors, suppliers, competitors, even the whole society. This theory proposes that the essence of corporate governance activities is not only to benefit the shareholders but also the other relevant stakeholders. However, Jensen (2001) has realized that proponents of the Stakeholder Theory have been unable to provide realistic solutions of the numerous conflicting interests of stakeholders that businesses need to protect. In general he was in agreement that business cannot maximize their potential without investors or stakeholders being ignored. This indicates the importance of the theory in the context that mechanisms need to be adopted such as audit committees that do examine extensively the role of management and their actions.

EMPIRICAL REVIEW

The composition of the committee is critical to its effectiveness. Members with requisite skills, knowledge, independence and judgment are important. A range of diverse perspectives and thinking helps strengthen the quality of audit committee deliberations and delivers real value for companies and shareholders, especially for companies that operate globally. Focus on committee composition, including independence, financial expertise, broad business or leadership experience and succession planning is critical for company's accountability (Taboi, 2010; Di Napoli, 2007).

According to Ernst and Young, (2012) in support of the views of Taboi (2010); the audit committee needs to consider alternative viewpoints, evaluate whether the company's crisis preparedness is adequate. This helped in making periodical considerations on whether to; rotate audit committee members, stagger the terms of service to have the benefit of new skills and perspectives, engage independent advisers, as necessary, recognize the significant workload of board service, and especially of audit committee's members. Abedalqader, Tawfiq, and Ata Baker (2011) conducted a study on the effect of audit tenure and firm size on audit quality in Jordan, the findings revealed that audit tenure affects adversely audit quality while firm size had no impact on the correlation between audit tenure and quality. On pricing of audit fees Meshari, (2008) concluded that audit firm size had little significance influence on external audit fees. This affirms that auditor's independence could not be compromised much hence larger firms had provided for improved audit committee composition which enhances the committee's role in mitigating the expectation gap.

Audit committees need to meet regularly to facilitate the performance of their role and functions. This is important for the effective carrying out of their activities and roles. For instance an audit committee that convenes only twice a year before the regular board meeting for just fifteen minutes and whose duties are limited to a perfunctory presentation cannot be compared to one that meets twelve times a year before each board meeting; where every member has a financial background, where there are no personal ties to the chairman or the company, where they have their own advisers, where they ask tough questions of management and outside auditors and where ultimately the investor interest is being served (BCBS, 2010).

Bedard and Johnstone (2014) examined auditors' assessments of planning and pricing decisions related to earnings manipulation risk and corporate governance risk, and showed

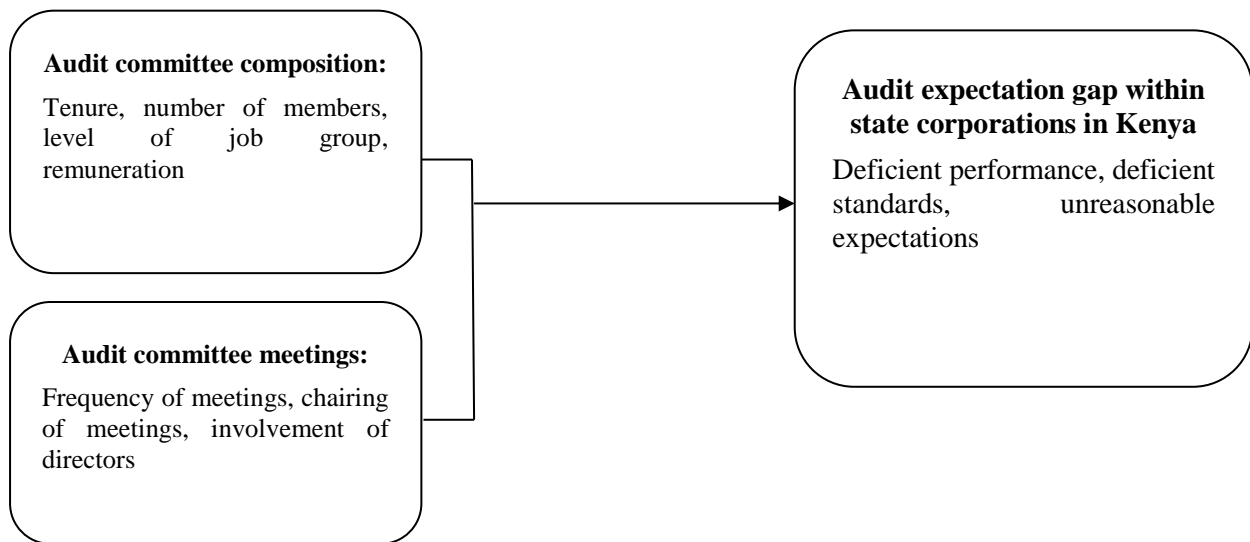
that auditors plans and meetings increased effort and billing rates for clients with earnings manipulation risk and that the positive relation between earnings manipulation risk and both effort and billing rates are greater for clients that have heightened corporate governance risk.

Muriungi (2010), researched on the relationship between auditing and the performance of Kenyan state corporations. The research sampled 10% of the 133 parastatals audited by KENAO. The primary data was assembled via structured questionnaires. The research revealed that without auditing committees, the companies were on the edge of falling into losses. On the other hand an increase in auditing practices which were meant to improve the audit committees, through increasing the frequency of meetings and control of the meeting agendas would improve the performance.

Conceptual Framework

Independent Variable

Dependent Variable



RESEARCH METHODOLOGY

Research Design

The current study will employ a descriptive research design; Cooper and Schindler (2008), state that in a descriptive research the problem is structured and well understood. The basic characteristics of a descriptive research is that it provides a descriptive analysis of a given population or sample in a qualitative, quantitative or a combination of both. In addition, both types of data can be presented and broad research questions used. This justifies the use of this design.

Target Population

The target population for the study was the audit committees for all the 119 state corporations (SCAC, 2017). Within every state corporation there is an average of 1-5 audit committee members; the study targeted 1 audit committee member.

Sample Population

The research will sample 97 audit committee members as well audit directors at KENAO (2) and members of the PAC (3) thus the total sample size was 102 respondents.

Data Collection

Primary data was collected using structured questionnaires. The questionnaires and research instruments were developed from literature review and organized on the basis of background information of the respondents and the research questions to ensure relevance to the research problem. Further the research adopted a key informant interview guide for the research. The study also utilized secondary data to collect public data on the audit committees and the expectation gap within state corporations. The secondary data was collected from government reports, state corporation publications as well as annual reports from state owned commercial corporations.

Data Analysis

Data was analyzed using descriptive and inferential techniques for the quantitative data while thematic analysis was used for the qualitative data. The analyzed data was presented using frequencies, percentages, means, standard deviations, regression models, t-tests and other infographics as deemed appropriate.

RESEARCH FINDINGS AND DISCUSSION

Response Rate

The main research population was 102 state corporations. The study was able to obtain a response rate of 84% (n=86) whereas only 16% (n=16) of the respondents did not take part in the study as shown in *figure 4.1* below;

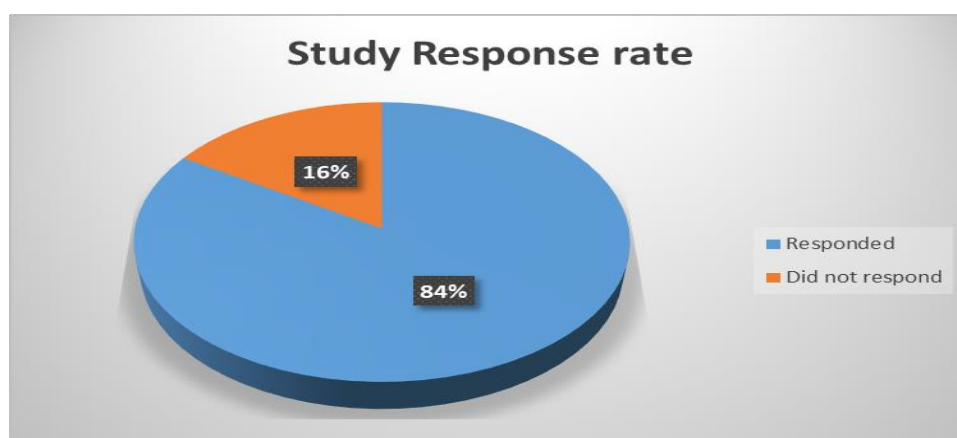


Figure 4.1 Response Rate

Role Played in Audit Committee

Table 4.1 Role Played

		Frequency	Percent
Valid	Chairman	18	20.9
	Secretary	9	10.5
	Member	59	68.6
	Total	86	100.0

The results of the study in Table 4.2 above indicated that the majority of the respondents 68% (n=59) of the respondents were members of the audit committee, 21% (n=18) of the respondents were Chairperson within the audit committee while only 11% (n=9) of the respondents were Secretary's' within the audit committees.

Age of Respondents

Table 4.2 Respondents Age

	Frequency	Percent
Valid 30-40 years	42	48.8
40-50 years	44	51.2
Total	86	100.0

The results of the study in *Table 4.3* above show that the majority of the respondents 51% (n=44) were between the ages 40-50 years while only 49% (n=42) of the respondents were between the ages 30-40 years.

Descriptive Statistics

Influence of Audit Committee Composition on Audit Expectation Gap

Table 4.3 Audit Committee Independence Descriptive Statistics

	N	Mean	Std. Deviation
Audit committee independence fosters objectivity and integrity in the committee functions	86	3.2442	.78119
Audit committee independence fosters impartiality in the committee functions	86	3.3256	.81806
Audit committee independence fosters the financial reports quality and accountability in the public sector	86	3.4419	.87588
Express audit committee independence ensures biasness in undertaking the responsibilities of the committee.	86	3.7791	1.05609
Independence of the audit committee fosters effective feedback and control of their functions	86	4.0814	.77026
Valid N (listwise)	86		

The results in the table above show that the majority of respondents were in agreement that audit committee independence fosters objectivity and integrity in the committee functions as indicated by the mean value of 3.2442 falling within agreement interval. The standard deviation of .78119 indicates that there were moderate variations in the study results. The findings are in line with the observations by Institute of Internal Auditors (2011) that audit independence enhances the freedoms of the auditors thus enhancing their ability to carry out their functions. Respondents were further in agreement that audit committee independence fosters impartiality in the committee functions as indicated by the mean value of 3.3256 and a standard deviation of .81806. The study results also indicated that in regard to audit committee independence fosters the financial reports quality and accountability in the public sector the respondents were in agreement as shown by the mean value of 3.4419. The results are in conformity with (Bédard & Gendron, 2010); who were of the view that independence of auditors enhances the financial statements quality. These findings are also supported by (Baxter & Cotter, 2009); who concluded that audit committees serve as an active control to the organization financial reporting.

In regard to express audit committee independence ensures biasness in undertaking the responsibilities of the committee, respondents were in agreement as shown by the mean value of 3.7791 and a standard deviation of 1.05609. Respondents were further in strong agreement that Independence of the audit committee fosters effective feedback and control of their functions as shown by the mean value of 4.0814 and a standard deviation of .77026. These findings reaffirm the notion held by Sarens and Debeelde (2006) that audit committees help the management in ensuring control of the financial reports and soundness of the firm. Further Warga, (2014) is of the view that audit independence ensures there are effective control policies within the organization which reaffirms the findings of the current research.

Influence of Audit Committee Meeting on Audit Expectation Gap

Table 4.4 Audit Committee Meeting Descriptive Statistics

	N	Mean	Std. Deviation
Audit committee meetings that are not subject to board influence enhance the effectiveness of the committee functions	86	3.3372	1.18431
Planning of audit committee meetings reduces manipulation and risks of board interference	86	3.6395	.88001
Availability of formal meeting calendar among audit committee members enhances the effectiveness of the committee	86	3.7791	.83174
Control of the audit committee agenda by the members fosters the attainment of the committee responsibilities	86	3.8023	.86527
Regular meetings of the audit committee enhances the performance of their role.	86	3.8256	.73871
Valid N (listwise)	86		

Findings on *Table 4.4* above show that with regard to audit committee meetings that are not subject to board influence enhance the effectiveness of the committee functions there was agreement among respondents as shown by the mean value of 3.3372. The above findings are in line with the BCBS (2010) study that recommended audit committees need to meet regularly in order to facilitate better performance of their roles. The results of the study also indicated that in regard to planning of audit committee meetings reduces manipulation and risks of board interference there was agreement among respondents as shown by the mean value of 3.6395 and a standard deviation of .88001. The study findings also showed that in regard to availability of formal meeting calendar among audit committee members enhances the effectiveness of the committee there was agreement as shown by the mean value of 3.7791 and a deviation of .83174. The results also showed that with regard to control of the audit committee agenda by the members fosters the attainment of the committee responsibilities there was agreement among respondents as shown by a mean of 3.8023 and a deviation of .86527. Muriungi (2010) findings are in agreement with the above study results as the researcher opined that regular audit committee meetings with independence in setting meeting agendas helped in enhancing the auditing practice.

Results from the study also showed there was agreement among respondents $M= 3.8256$, $SD= .73871$ in regard to regular meetings of the audit committee enhances the performance of their role. The above findings are in agreement with the assertions by Bedard and Johnstone (2014) that auditors need to continuously assess their plans to ensure there is effectiveness within the audit function. The study also indicated that planning for audit meetings was essential in enhancing deliberation and improving the quality of the audit report.

Correlation Analysis

The main objective of the study was to examine the relationship between audit committee characteristics and the audit expectation gap within state corporations in Kenya.

Table 4.5 Correlation of Variables

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
1 (Constant)	13.305	2.055		6.475	.000
Audit composition	.107	.053	.283	1.998	.052
Audit Meetings	.190	.076	.346	2.487	.017

a. Dependent Variable: Audit Expectation gap

The resultant regression model was of the form;

Audit expectation gap = .107 Audit committee composition + .190 Audit committee meetings + 13.305

The above model indicates that a unit change in audit committee composition will result in a .107 change in audit expectation gap. The findings further show that a unit change in audit committee meetings will lead to a .19 change in audit expectation gap within state corporations. The above statistics affirm that there is a statistically positive relationship between audit committee characteristics and the audit expectation gap ($sig < 0.05$).

CONCLUSION

The study results have indicated that the composition of the audit committee is a key determinant of the audit expectation gap. The study concludes that state agencies should ensure people being appointed to the audit committees have the right mix of competencies that will enhance the audit function. The study further concludes that the audit committees should be composed of outside members which will reduce board/management influence thus enhancing the quality of the audit reports. More so audit committees should have an elaborate succession plan which will guide the rotation of members across state corporations thus enhancing the audit function.

From the findings of the research it is evident that regular meetings can enhance the effectiveness of the audit function. Hence the study concludes that members of the audit committees should ensure they hold regular meetings with both internal and external auditors in order to enhance the quality of the audit reports. Further audit committee members should ensure that planning for meeting is not influenced nor dictated by the management in order to foster impartiality. The audit committee should also ensure routine meeting reports are generated to enhance the effectiveness of their responsibilities in the audit function.

RECOMMENDATIONS

In regard to the composition of the audit committee; the study recommends that gender inclusion should be upheld within the public sector and more so within audit committees. Further in constituting audit committees there is need for stakeholders to ensure individual competencies such as technical skills, leadership qualities and integrity are available to help mitigate expectation gap. More so there should be appropriate skill mix within the audit committee which should be regularly assessed to ensure conformity to best standards of practice. Further in constituting the audit committee there should be minimal inclusion of board members within the committee in order to enhance impartiality in audit reporting. The audit committees should also strive to have regular meetings over the laid down minimum of 3 meeting annually. The study recommends that audit committees should at least more than once a year hold separate meetings with internal and external auditors in order to promote the effectiveness of the audit report. The research further recommends that audit committees should at least make monthly reports on the state of the corporation and discuss with the management regularly in order to promote better attainment of committee roles.

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