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Abstract
The composition and character of the audit committee play a significant role in influencing an organization performance. This research aimed at establishing the effect of audit committee independence on financial performance of banking and insurance firms listed in Nairobi securities exchange, Kenya. The study was guided by the agency and stakeholder theories. This study adopted an explanatory design. The study target population was banking and insurance firms listed on the Nairobi Securities Exchange for the period ranging from 2011-2016. The study used a census sampling design. The sample size comprised of banking listed firms which have consistently traded in NSE and without missing data. A total of 20 banking and insurance firms were included in the study. The study used secondary data collected through extraction from financial reports. Data was coded and thereafter analyzed using Statistical Package for Social Sciences (SPSS) program and presented using tables. The study employed both descriptive and inferential statistics in data analysis. Descriptive statistics involved was the use of measures of central tendency such as mean standard deviation and percentages. Pearson correlation analysis and multiple regression analysis were used to determine if there is any correlation between the variables. Results further indicated a positive significant influence of audit committee independence. The findings indicated that there was no significant relationship between gender diversity of audit committee and the financial performance of banking and insurance companies in the NSE. There should be clarification by the Nairobi securities exchange showing the recommended number of independent auditors, gender and financial experts. This would ensure uniformity in all the audit committee across all firms listed under the NSE.

1.0 Background to the Study
Financial performance has connotations to organization’s health and in the end its survival. The Firms’ management effectiveness and efficiency in making use of company’s resources is highly reflected by high financial performance and this in turn contributes to the country’s economy at large (Naser & Mokhtar, 2004). Financial performance is very essential to management and other stakeholders such as shareholders, debt holders and the government as it is an outcome which has been achieved by an individual or a group of individuals in an organization related to its authority and responsibility in achieving the goal legally, not against the law and conforming to the morale and ethic (Iswatia & Anshoria, 2007).

The past few years have seen several well-known companies with significant international operations become mired in financial scandals. Aryan (2015) agrees that the world has witnessed a big financial turmoil during the last few years, which led many

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big firms to go bankrupt. Therewith, the investors became distrustful in the reliability of the global financial markets and the companies' financial information as well. As a result, interest in corporate governance has increased in both developed and developing countries in an attempt to regain the lost confidence.

In notable cases, investors have lost hundreds of millions or even billions of dollars. A number of the companies involved have been forced into bankruptcy as a direct or indirect result of the scandals, International Organization of Securities Commissions (IOSCO, 2005). Collectively, these financial scandals caused many to be concerned about investors’ confidence in the integrity of companies. As means of reducing the weaknesses in corporate governance, several mechanisms have been introduced among which is the adoption of Audit Committee (AC).

Audit Committee as a conception has now acquired mass blend as a mandatory element of corporate governance code (Krishnan, 2005). According to Spira (2003) Instances of accounting and audit failures and heightened concern of investors about the corporate reports of companies in the developed world led to the establishment of Treadway Commission in US, Cadbury Committee in United Kingdom and McDonald Commission in Canada (Braiotta et al., 2013). The aforementioned committees emphasized on the need for the establishment of audit committee as a board sub-committee comprising of independent directors to ensure the credibility of financial statements. Audit committee was promoted on voluntary basis as part of corporate governance reforms (Turley and Zaman, 2004), and gained significant acquaintance with the formation of specialized committees like Blue Ribbon committee.

Financial performance is affected by corporate scandals and failures which raise serious questions on the corporate governance practices of firms (Azim, 2012). These scandals have raised concern among researchers, governments, regulators and investors. Examples of corporate failures include those of Polly Peck, Maxwell, Bank recession in Europe. Other scandals and failure include Marconi, United Kingdom (UK), and Royal, Ahold in the Netherland, the Lehman Brothers, Barings Bank, All States Trust Bank, and the Afribank Nigeria Plc, Cadbury Plc and the Bank credit scam in Nigeria, leading to the sacking of five bank Chief Executives. Some of these scandals could be traced directly to poor corporate governance. In Kenya firms which have either collapsed or gone in receivership include, Kenya Corporative Creameries, CMC Motors, Uchumi Supermarkets and most recently, the Chase and imperial banks (Ombaba and Kosgei 2017). Mohd-Mohid et al., (2004) is of the opinion that the failure of big companies to continue their business is often associated with weak controlling and monitoring mechanism. La Porta et al., (2000) argues that weak corporate governance increases the probability of opportunistic behavior of management to act for their interest thus increasing poor financial performance. In Kenya, the scandals are attributed to a weak legal and regulatory framework (Gakeri, 2013).

Globally, corporate governance is believed to be a means of improving economic efficiency in a country and that its rules have economically significant impact on a firm’s value. Academic literature also suggest that audit committee effectiveness has significant positive impact in minimizing agency conflicts, protecting stakeholders’ interests and thus in maximizing firm’s overall value.

This precarious role of Audit Committee (AC) is believed to be a means of improving economic efficiency and stakeholders’ confidence in the banks through financial standard compliance (Abbott & Raghunandan, 2003b). However, to achieve this, audit committee should possess some certain attributes which include independence of the committee, frequency of meetings, the size of the committee and financial knowledge of the committee members (Mohiuddin & Karbhari, 2010).

These attributes of the audit committee are significant in addressing the short comings and weaknesses associated with the internal control system of the banks and the errors and limitations associated with external audit function. This is because internal control and internal audit are less independent of the management, while external auditors’ function is limited to the information available to them which is highly influenced by management. However, audit committees are independent of the management and have sufficient authority over the operations, transactions, documents and all the relevant records to perform their duties. Audit committee functions with these attributes are expected to ascertain a true and fair view of the financial performance and position of banks and also enhance the confidence of the
investors and other stakeholders (Aanu, Odianonsen & Foyeke, 2014). This study is anchored within the agency theory; the empirical studies increasingly recognize that audit committees have a central role in reducing agency problems. Agency theory argues that the delegation of managerial responsibilities by principals (owners) and agents (managers) requires the presence of mechanisms that either align the interests of principals and agents or monitor the performance of managers to ensure that they use their delegated powers in the best interests of the principals (Al-Thuneibat, 2006). It has been argued that weak internal or external auditing, controlling and limited protection of minority shareholders intensify the traditional principal agent problems in transitioning economies (Dharwadkar et al., 2000)

Statement of the Problem

Financial health of any organization is a critical element for its survival. Even though, in the recent past large corporations such as Enron, Parmalat, Tyco, WorldCom, Lehman brothers among others have been affected by financial markets and led to financial distress and bankruptcy (Zare et al., 2013). Developing economies have also experienced their bit of financial distress for instance in Tunisia where there was the collapse of Batam Ltd. (Matoussi and Gharbi, 2011) in Nigeria Bank credit scam SEC (2010). In Kenya financial poor financial performance has been witnessed in CMC motors, Uchumi supermarkets among others (Tarus, 2015; Ombaba and Kosgei 2017; Ngugi et al., 2009). In the recent decade, the Nairobi Securities Exchange has required all firms listed to have an audit committee. The committee is expected to scrutinize the respective company’s financial documents before they can be published. This act is expected to give confidence to the shareholders as well as other stakeholders associated or wish to be associated with the company. The banking and insurance sector in Kenya have been faced with various challenges among them rate capping and technological disruption. The composition of audit committee however is not affected by such external factors.

There are divergent views on the relationship between Audit Committees and financial performance. Some of the arguments support the link between Corporate Governance and performance while others see no link between Corporate Governance and performance. There is a skew in approach and method on study relating to Audit Committees and the studies are mostly concentrated on studies conducted in advanced countries with more matured financial systems compared to the developing countries like Kenya. Even though there are some studies related to developing countries, little or no evidence exist to the best of the researcher’s knowledge the topic. This study aims at establishing the relationships between audit committee characteristics and financial performance of banking and insurance firms in Nairobi Securities Exchange.

Research Objective

To establish the effect of audit committee independence on financial performance of banking and insurance firms in Nairobi securities exchange.

Research Hypothesis

H₀₀₁ - The independence of audit committee does not have significant effect on financial performance of banking and insurance firms in Nairobi securities exchange.

2.0 Literature Review

The Agency Theory

The main proponents of this theory are Jensen and Meckling in 1976 and Fama in 1983. The theory has dominated corporate governance arrangements in the economics and finance literature. It is founded on the assumption that owners of an organization (the principal) and those that are entrusted to manage it (the agent) are bound to have different interests. Needless to say, owners or organization’s shareholders worry that managers are likely to act in their own self-interests at the expense of benefiting shareholders.

It is argued that though the agency theory stipulates that directors or managers are delegated to run the affairs of an organization by its shareholders, such agents could advance their personal interests (Clark, 2004). This is in spite of the shareholders’ expectations that the managers or directors to act and make decisions to the interest of the organization. Padilla (2002) further reinforces this argument that the agent may fail to necessarily make decisions in the best interests of the principals. The agent may give in to self -interests, opportunistic behavior and failing short of
congruence between the aspirations of the principal and the agent’s pursuits. 

Agency theory perceives corporate governance arrangements as a way of ensuring that the management (agent) acts in the best interests of the shareholders principal (Keyse et al., 1997). It is averred that the board should monitor and control the management as part of corporate governance arrangements. In this light, therefore, the board members ought to be independent of the management in order for them to play an effective and unbiased oversight role. Agency theory with its emphasis on the conformance suggests that the monitoring role of the board, supported by such processes as external audit and reporting requirements, is likely to minimize problems of management pursuing their own interests or performing poorly. However, according to Cornforth and Chambers (2010), the application of agency theory could prove difficult in the public sector including the public universities due to the ambiguity over who the principals are. 

Agency theory assumes that the interest of the principal and agent varies and that the principal can control or reduce this by giving incentives to the agent and incurring expenses from activities designed to monitor and limit the self-interest activities of the agent (Delbufalo, 2018). According to Bonazzi and Islam (2006), the principal will ensure that the agent acts in the interest of the principal by giving him the incentives and by monitoring his activities. Among the measures established to reduce the self-serving nature of the agent is an independent Audit Committee. Therefore, in order to reduce information asymmetry, there is the need for governance mechanisms such as board subcommittees composed of directors with the appropriate attributes such as independence, expertise and experience to prevent or reduce the selfish interest of the agent (Wiseman et al., 2012). The separation of ownership and control in modern business creates conflicts of interest between managers and stakeholders. Following this conflict was between the principal and the agent, companies are obliged to use control mechanisms to reduce agency costs and information asymmetry like the audit committees (Hassan et al., 2018). Audit committees are used primarily in situations where agency costs are high to improve the quality of information flows from the agent to the principal. According to the agency theory, to ensure the effectiveness of an audit committee, managers are encouraged to prepare financial statements adequately to specify the return generated by the companies (Boatright, 2010). 

Felo (2003) study based on the agency theory provide for the existence of a positive and significant relationship between the presence of an audit committee and the quality of financial statements. There is a positive relationship between the existence of an audit committee and the reliability of financial statements. The agency theory states that the presence of an audit committee within the board of directors is sufficient to ensure the reliability of financial statements (Tosi, 2009). This study investigated the effect of audit committee characteristics on the financial performance of banking and insurance firms in NSE. The relationship between the members of audit committee and the personnel especially the directors of the company can be termed as a principal agent kind of relationship. Such a relationship is therefore deemed to influence the performance of the organization either positively or negatively.

**Independence of Audit Committee and Firm Performance**

According to DeZoort et al. (2002) an independent audit committee promotes the best interests of corporate stakeholders. Independence has been accepted as a good practice in corporate governance, but it still remains one of the most common variables in the audit committee research literature. However, in many aspects the audit committee independence literature produced mixed results which failed to prove the fulfilment of expectation on independent directors safeguarding the interests of investors. Miringú and Muoria, (2011) did a study on the effect of Corporate Governance on performance of commercial State Corporations in Kenya. The study found that most of the boards are deemed independent and it concurs with John and Senbet (1998) who argues, that boards of directors are more independent as the proportion of their outside directors increases. Beasley, Carcello, Hermanson & Neal (2000) found companies that committed fraud had less independent audit committees compared to their counterparts that did not commit fraud. Klein (2002) found that audit committee independence was negatively associated with abnormal accruals and that reductions in audit committee independence were associated with large increases in abnormal accruals. Bedard et al. (2004) investigated the
association between different audit committee characteristics and earnings management. They found that aggressive earnings management is negatively associated with the presence of an independent audit committee. Abbott et al. (2003) show that firms with audit committees which are composed of independent directors and which meet at least twice per year are less likely to be sanctioned for fraudulent or misleading reporting. Audit committee independence affects companies’ earnings, management and also investors’ perceptions.

Klein (2002) indicates that reductions in audit committee independence are accompanied by large increases in abnormal accruals. Raghunandan and Rama (2004) document that good audit committees can affect shareholder perceptions related to the auditor, particularly in those situations where shareholders might perceive an increased threat to auditor independence. However, the issue of audit committee independence is no longer popular today because the new stock exchange rules now require that all members of the audit committee be independent (SEC, 2002). Mustafa and Meier (2006) in their study show that the percentage of independent members in audit committees and the average tenure of audit committee members are significantly and negatively related to the incidence of misappropriation of assets in publicly held companies in both the random and the matched models while the number of audit committee meetings is not significant.

Hundal (2013) investigated independence, expertise and experience of audit committees. After studying a vast and diverse range of literature pertaining to the audit committees and governance issues, the study made an effort to demonstrate several aspects of independence of audit committee, for example, in formativeness, CEO’s power, and frequency of meetings, substitutability and complementarity with alternative corporate governance mechanisms, directors’ share ownership and earnings management.

Ahun, Odianonsen, and Foyeke (2014) investigated effect on a firm’s performance by using four audit committee characteristics including audit committee independence, financial expertise, size, and meetings. There were 25 manufacturing firms being selected from the year 2004-2011. The result of Pearson Moment Correlation revealed that independence of the audit committee is positively related to ROE as it claimed that company with independent audit committee will be relatively more reliable to invest in, and this will boost up the performance of a company.

Wang and Huynh (2013) have classified firm’s performance into financial and nonfinancial performance in their research. Sample size of 25 listed companies from year 2004 to 2011 were chosen whereby data was collected from financial reports. The study utilizes multiple regressions (F-test) to test the hypotheses. The results indicated that the independence of the audit committee can positively affect a firm’s performance due to diverse background and expertise.

**Conceptual Framework**

A conceptual framework is a diagrammatical representation showing the relationship between variables. Figure 2.1 shows the interconnection between the independent variables and the dependent variable.

![Conceptual Framework](image)

**Independence of the audit committee**
- Presence of non-executive members
- Transparency in chairman selection
- Transparency in appointment of members

**Independent Variable**

**Figure 2.1: Conceptual Framework**

As shown in figure 2.1 the indicators for the independent variables (audit committee independence) are: Presence of non-executive members, Transparency in chairman selection, Transparency in appointment of members.

**Dependent Variable**

- Return on assets (ROA)
Transparency in appointment of members. The dependent variable (financial performance) on the other hand has ROA as the main indicator.

3.0 Research Methodology

Research Design
This study adopted an explanatory (causal) design. Explanatory research can be defined as a method or style of research in which the principal objective is to know and understand the trait and mechanisms of the relationship and association between the independent and dependent variable. According to Cooper and Schindler (2003), an explanatory study uses theories or hypotheses to account for the forces that caused a certain phenomenon to occur. They further say that it goes beyond description and attempts to explain the reasons for the phenomenon. This study sought to establish whether audit committee characteristics can have an influence on financial performance. Quantitative data relating to audit committee size, gender diversity, number of independent directors and audit committee experience of banking and insurance firms in Nairobi Securities Exchange was collected over the past five (5) years from 2011 to 2016 annual reports.

Target Population
The study target population was banking and insurance firms listed on the Nairobi Securities Exchange for the period ranging from 2011-2016. Based on an analysis on the annual reports of listed companies, as at November 2016, there are 20 banking and insurance firms listed companies in the Nairobi Securities Exchange (NSE handbook, 2017).

Sample Design
The study used a census sampling design. Census sampling is a method of sampling where all objects or persons in the target population are included for study. Census sampling suit this study since the target population was considered small. The sample size comprised of banking listed firms which have consistently traded in NSE and without missing data. A total of 20 banking and insurance firms were included in the study.

4.0 Results and Discussion

Descriptive Statistics
The descriptive statistics for the variables under study were mean, standard deviation, minimum and maximum. The findings are indicated in Table 4.1.

Table 4.1: Descriptive statistics

<table>
<thead>
<tr>
<th>Variables</th>
<th>Min</th>
<th>Max</th>
<th>Mean</th>
<th>Std. Dev</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROA</td>
<td>-</td>
<td>0.37</td>
<td>0.06</td>
<td>0.141</td>
</tr>
<tr>
<td>IA (Independent auditors)</td>
<td>0</td>
<td>4</td>
<td>1.35</td>
<td>1.226</td>
</tr>
</tbody>
</table>

As shown in Table 4.1 it’s clear that the variables such as audit committee size and independent auditors have very high standard deviations. This implies that the size of audit committee and independent auditors varies significantly from one company to another that is some have high number while others have few or none.

All mean values were positive with return on assets (ROA) at 0.06, audit committee size (ACS) at 3.35, independent auditors (IA) at 1.35, ROA has a minimum of -0.37.

Correlation Analysis
A correlation coefficient, denoted by r, enables one to quantify the strength of the linear relationship between ranked or numerical variables. This coefficient takes the values between -1 and +1 (Lewis & Thornhill, 2009). The table below shows the Pearson correlation coefficient generated from the data.

Table 4.2: Correlation Analysis

<table>
<thead>
<tr>
<th>Variables</th>
<th>ROA</th>
<th>IA</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROA</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>IA</td>
<td>.151</td>
<td>.940*</td>
</tr>
<tr>
<td></td>
<td>.028</td>
<td></td>
</tr>
</tbody>
</table>

Ahmed and Ombaba, (2019)
The correlation matrix reveals that the correlation coefficients independent audit committee \((r=0.490, \ p=0.028)\) are significantly correlated to ROA. Auditors independence was also significantly correlated to size of the audit committee \((r=0.763, \ p=0.000)\). These findings are in line with Abbott et al. (2000) that firms with independent directors on the board are less likely to be involved in financial misreporting hence establish positive investor perception and improved firm performance.

**Hypothesis Testing**
A multiple regression analysis was conducted in order to test the effect of independent variables on the financial performance (ROA). Statistical package for social sciences (SPSS) was used to code, enter and compute the measurements of the multiple regressions for the study.

The main objective of this study was to assess the relationship between audit committee independence and financial performance of banking and insurance firms in Nairobi securities exchange. To achieve this, specific objectives were developed and hypothesis in relation to this were tested. The findings are presented in the sections that follow.

**Impact of audit committee independence and financial performance**
The following hypothesis stipulated that the independence of the audit committee does not have a significant effect on financial performance of banking and insurance firms in Nairobi securities exchange.

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>IA</td>
<td>(0.507) (\pm 0.024)</td>
<td>(0.490) (\pm 0.28)</td>
<td>2.385</td>
<td>0.028</td>
</tr>
</tbody>
</table>

According to the regression equation established, taking audit committee independence constant at zero, performance rating would be 0.125. The data findings analyzed also shows that a unit increase in audit committee independence will lead to a 0.507 increase in performance. The significance value is .028 less than p value of 0.05 thus statistically significant. We therefore reject the null hypothesis that independence of the audit committee does not have any impact on financial performance of banking and insurance firms in Nairobi securities exchange. We conclude that independence of the audit committee has an impact on financial performance of banking and insurance firms in Nairobi securities exchange.

The findings agree with previous study by Aanu, Odianonsen, and Foyeke (2014) that independence of the audit committee is positively related to financial performance. A company with independent audit committee will be relatively more reliable to invest in, and this will boost up the performance of a company. Mamun et al. (2014) study concluded that audit committee independence was significantly connected with financial reporting. Wang and Huynh (2013) further argued that independence of the audit committee can positively affect a firm’s performance due to diverse background and expertise.

**Discussion**
This study aimed at investigating the influence of audit committee independence on financial performance of banking and insurance companies in the NSE. The results showed a positive significant influence of audit committee independence and financial expertise of audit committee on financial performance of banking and insurance companies. This can be interpreted to mean that the number of independent audit committees and financial experts should be higher in order for a company to report a better performance.

**5.0 Summary of Findings, Conclusions and Recommendations**

**Impact of audit committee independence and financial performance**
On average there is about 1 independent auditor with a standard deviation of 1 auditor. The minimum number of independent auditors in the board is 0 and
the maximum is 4. Independence of the audit committee has a positive significant impact on financial performance of banking and insurance firms in NSE. This shows that a company with independent audit committee will be relatively more reliable to invest in, and this will boost up the performance of a company.

Recommendation of the Study
Based on the findings and conclusions on the findings, the study found it necessary to make the following recommendations.
The government together with the NSE needs to put measures indicating a fixed number of audit committee members in any given organization especially the banking and insurance sector. There should be clarification by the Nairobi securities exchange showing the recommended number of independent auditors.

Suggestion for Further studies
The researcher recommends the following;
For comparative purposes studies on effect of audit committee characteristics on financial performance should be conducted in other firms that are not listed in the NSE. Further studies should be carried out across other firms listed under the Nairobi securities exchange

References


