THE EFFECT OF AUDIT COMMITTEES ON MAJOR DISCLOSURES AND OTHER NON-FINANCIAL CHARACTERISTICS OF COMPANIES LISTED AT THE NAIROBI STOCK EXCHANGE

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BY

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DECLARATION

This project is my original work and has not been submitted for a degree in any other University

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This project has been submitted for examination with my approval as University Supervisor

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DEDICATION

To my Creator for his love, guidance and protection, always.

To Amir, Aliya, Firoz, Nasim, Hanif and Shafina for their love, understanding and encouragement, always.

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ABSTRACT

Disclosure and accountability are the corner stones of corporate governance. There has been a growing number of earnings manipulation which has only recently begun to receive the attention of regulators. A director's greatest virtue is his independence that allows him to challenge management decisions and evaluate corporate performance from a completely free and objective perspective. Audit committee comprising independent directors assist the board in fulfilling its responsibility to the shareholders and investing public by facilitating transparent and objective disclosures in company financial statements. There is however another school of thought that challenges the value added by independent directors which is that although such directors may perform some functions better than other directors they could perform other functions worse resulting in no net advantage for the company if its board has a high proportion of independent directors.

This study therefore sets out to determine whether audit committees and their composition of independent and non-executive directors have an effect on major disclosures and other non-financial characteristics of companies listed at the Nairobi Stock Exchange. The objectives of the study were to determine major disclosures and other non-financial characteristics of companies listed at the Nairobi Stock Exchange before and after the establishment of audit committees; to determine the perceived value of audit committees by management of such companies; and to assess the achievement of the objectives of audit committees in such companies.

In categorizing major non-financial disclosures, the annual reports were analyzed to determine the value added information and disclosures in these reports which included information on achievements, targets, corporate governance standards, social responsibility, risk management, compliance with regulatory standards, explanations and related party transactions. To determine the perceived value of audit committees by management of listed companies in Kenya a questionnaire was developed which included queries on the composition, mandate and reporting obligations of audit committees. It also sought to determine management perception to the various attributes of audit committees based on best international market practices and the recommendations of the Blue Ribbon Committee (1999).

From the analysis of the data it was observed that audit committees were mandated to ensure efficiency and effectiveness of operations, reliability of financial and other management information and to safeguard assets. These mandates however were not reviewed annually. It was noted that the audit committees reported to the Board and not the shareholders, contrary to best international market practices and the Blue Ribbon Committee (1999). It was also noted that, although management perceived audit committees to add value to the company, it had reservations on the attributes of audit committees, in particular the necessity of independence and the expertise of the members of the audit committees. It was also noted that only 23% of the companies responded that their audit committees had successfully achieved their objectives. The analysis determined that although audit committees have a significant effect on the major disclosures and other non-financial characteristics of companies listed at the Nairobi Stock Exchange, it was apparent that the essence of audit committees in listed companies in Kenya is yet to be appreciated and understood by both the Board and the management.

CHAPTER 1 - INTRODUCTION

1.1 Background on corporate governance

The Capital Markets Guidelines on Corporate Governance Practices by Public Listed Companies in Kenya (CMA 2002), defines corporate governance as –

"*the process and structure used to direct and manage business affairs of the company towards enhancing prosperity and corporate accounting with the ultimate objective of realizing shareholders long-term value while taking into account the interest of other stakeholders*".

Gopalsamy (1998) on the other hand based his research on a broader definition which has been generally supported by the international community and which states:

"*Corporate governance is not just corporate management, it is something much broader to include a fair, efficient and transparent administration to meet certain well-defined objectives. It is a system of structuring, operating and controlling a company with a view to achieve long-term strategic goals to satisfy shareholders, creditors, employees, customers and suppliers, and complying with the legal and regulatory requirements, apart from meeting environmental and local community needs. When it is practiced, under a well laid out system, it leads to the building of a legal, commercial and institutional framework and demarcates the boundaries within which these functions are performed.*"

The King Report (1994) explains the emergence of corporate governance noting that at the turn of last century, entrepreneurship and limited partnership were the general means of business ownership. As trade grew domestically and internationally, businesses grew and in turn demanded greater capital commitment. This led to partnerships and later on public corporations.

The public corporations as we have them today, comprise shareholders who are by and large owners of the organization with the objective of creating wealth but whose interests are diversified. Furthermore, the shareholders have no professional capability or capacity to operate the organization objectively. Shareholders appoint directors to run the company effectively. The directors are agents of the shareholders and are accountable to them.

Jensen and Meckling (1976) bring to light the conflict of interest between owners and managers. Narrowly defined, agency relationship is a contract in which one or more persons (the principals) engage another person (the agent) to perform some service on their behalf and delegate(s) some decision making authority to that agent. Spence and Zeckhauster (1971) provide early formal analysis of the problems associated with structuring the compensation of the agent to align his incentives with the interests of the principal.

Agency problems arise because corporations are legal entities that cannot perform functions on their own and require individuals including management, shareholders and other stakeholders to operate effectively. This brings about a set of contractual relationships among these individuals. Jensen and Meckling (1976) state that hired managers do not always have the same objectives as profit oriented private owners. This presents a situation of conflict of interest in managers who seek to use firm specific resources to satisfy their own objectives. The wealth maximization goals of the shareholders are not always achieved.

Ross (1973) observes that agency problems can create lack of transparency and accountability and cause asymmetric information, which in turn can influence the actions taken by stakeholders. Managers may not necessarily reflect with accuracy the true financial status of the company. Financial performance of a company is the means by which stakeholders monitor the performance of the managers and determine their monetary incentives. Asymmetric information and lack of accountability has led to global crisis over the last three decades as companies in financial distress and bankruptcy have grown in numbers.

Financial aspects of corporate governance were formally reported for the first time by the Cadbury Committee (1992) (The Cadbury Report). Davies and Lowry (1993) reported that the Cadbury Report had generated a high level of interest and brought issues of corporate governance to new levels of public attention. The Cadbury Report was based on the belief that the essence of any system of good corporate governance involves boards having the freedom to drive their companies forward, within the

framework of effective accountability. The Cadbury Report observed corporate governance as the "system by which companies are directed and controlled and accordingly a great significance is attached to the role of the board."

Several international organizations have developed guidelines or codes of best practice on corporate governance, some of which are, Centre for European Policy Studies (CEPS 1995), Organisation for Economic Cooperation and Development (OECD 1999), Commonwealth Association for Corporate Governance (CAGC 1999), European Association of Securities Dealers Automated Quotation (EASDAQ 1998). Corporate Governance has to date become the most focused on topic in the corporate world.

Gopalsamy (1998) states that corporate governance provides broad parameters of accountability, control and reporting system by the Board. It encompasses the interactive relationship among various constituents in determining directions and performances of business organizations. He further states that the issues and the challenges before the business community have never been as turbulent and unpredictable as they are today, following the globalisation of business. Intensive competition, emerging new multilateral trading order and the need for sustainable development, have generated extensive debate on the process and style of corporate governance.

Tirapat (2000) states that corporate governance may have different meaning to different people depending on their perspective. Tirapat is inclined to take a financial perspective along the line of Iskander et al. (1999) or Shleifer and Vishny (1997) who hold that corporate governance deals with ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.

1.2 Audit committees and corporate governance

The Private Sector Corporate Governance Trust (1999) sets out twenty-one principles of good corporate governance and a sample code of good governance expounding on these principles. It is upon the board of directors to adopt these principles of good

corporate governance, which include, evaluation of members, strategy and values, leadership, corporate performance, viability and financial sustainability, corporate compliance and corporate communication, among others.

Also included are principles on accountability to members, responsibility to stakeholders, balance of powers, internal control procedures, adoption of technology and skills, management of corporate risk, corporate culture, social and environmental responsibility, recognition and utilization of professional skills and competencies, recognition and protection of members rights and interests. Directors of a board are busy individuals and in adopting these principles it is important for the board to affectively oversee the successful implementation of each of these principles. Audit committees comprising of non-executive and independent directors can assist the board in accomplishing the successful implementation of these principles.

The Cadbury Report observed that the financial aspects of corporate governance are concerned with the way in which boards set financial policy and oversee its implementation. It also includes the use of financial controls and the process whereby they report on the activities and progress of the company to the shareholders. The Cadbury Report recommended that all listed companies should establish audit committees.

According to its recommendations, an audit committee should be formally constituted to ensure that it has a clear relationship with the board, membership being confined to non-executive and independent directors of the company. An audit committee should have explicit authority to investigate any matters within its terms of reference. The duties of the committee should be determined in light of the company's needs, including a review of the internal audit program. The chairman of the audit committee should be available to answer questions about its work at the annual general meeting of the company. The Report thus recommended the appointment of properly constituted audit committees as an important step in raising standards of corporate governance. The Cadbury Report also laid great emphasis on internal audit. In it's view, companies

should appoint an internal auditor to undertake regular monitoring of key controls and procedures.

1.3 The importance of audit committees

The PriceWaterhouseCoopers Report (1999) (PWC report) observed a growing recognition of the role of audit committees comprising non-executive and independent directors in providing a bridge between the board, management and shareholders, in areas of external financial reporting and internal controls. According to the PWC report an audit committee provides an important focus for discussions with the company's internal and external audit functions.

According to Tate (2001), latest developments indicate that audit committee's role and responsibilities are constantly evolving and expanding. When first established, audit committees tended to be responsible simply for reviewing the company's annual audited financial statements and recommending to the board of directors to approve them. The audit committees were also responsible for overseeing the relationship between management and the board, with the external and internal auditors.

New challenges, however, are contributing to an expansion of the role of audit committees according to the PWC report. These challenges include globalisation of markets, which has led to new business opportunities and increased competition. It has also led to the increase in the use of technology including networks, the internet, and electronic data interchange, all of which have changed the way organizations use and communicate information. Challenges also include increasing complexity of transactions, accounting standards and regulatory requirements, economic difficulties in many parts of the world, and some highly publicized business failures, which have led to questioning the credibility of the corporate reporting process.

There has also been some heightened interest in the quality of earnings and the resulting responsibility of management for full and fair disclosure of results and

financial condition, greater public interest in and concern about corporate ethics and new calls for the oversight of companies' risk management processes.

These new challenges have been most keenly felt globally, in particular since 1998. The Securities Exchange Commission (USA) (2000) in response to these challenges called for improved board oversight of the financial reporting process in public companies. Various bodies in the United States of America sponsored the formation of the Blue Ribbon Committee (1999).

The guiding principles for audit committees, according to the Blue Ribbon Committee (1999) are fundamentals that apply regardless of an individual company's size. These include committee members who are independent directors and 'add value' to company decision making, conduct candid discussions with management, internal auditors and external auditors regarding the quality of financial reporting, ensure effective communication and information flow with internal and external auditors and play a key role in monitoring the component parts of the audit process. These qualities have been reiterated in the PSCGT (1999) principles reflecting largely the attributes of audit committees.

Zulkarnain & Shamsher (2001) state that the independence of an audit committee is critical in ensuring that the board effectively fulfils its oversight role and holds management accountable to the shareholders. Regulators widely recognize that each member of the audit committee should be an independent director. Recent studies show a significant correlation between audit committee independence and desirable outcomes. They further state that audit committees members should come from adverse array of aptitude, area of specialization and experience, which come from different aspects of the company and industry activities. The members should have a wide knowledge in business finance and accounting. A well-qualified audit committee would be able to identify and report expediently any financial or non-financial irregularities and financial risks.

By playing a proactive role, audit committees, can enhance the credibility of financial reports and strengthen communication between auditors and management. This in turn improves the quality of information reported to the market and enables investors to make informed decisions.

In performing their oversight function the audit committee will rely on the advice and information it receives from management and its discussions with management, internal and external auditor. It is therefore upon the audit committee to ensure that the internal communication policy is effective.

Simnet, Green & Rosebush (1993) found that audit committees do improve or maintain the quality of financial reporting process and the actual and perceived independence of the internal and external auditors and improve the confidence of the financial statements by the user in the quality of financial reports. According to both Tate (2001) and the PWC report (1999), when properly structured and given a clear mandate, audit committees can be of great benefit to all companies and shareholders.

According to the PWC report (1999) the responsibilities of the audit committee include review of significant accounting and reporting issues, including recent professional and regulatory pronouncements and understanding their impact on the financial statements.

The responsibilities also include review of the annual financial statements and determine whether they are complete and consistent with the information known to the committee members, assessing whether the financial statements reflect appropriate accounting principles, reviewing other sections of the annual report, particularly management commentary and considering whether the information is adequate and consistent with members' knowledge about the company and its operations. The responsibilities further include ascertaining how management develops and summarizes interim and preliminary results information, and the extent of internal and external audit involvement in the review of such information. The responsibilities also include obtaining explanations from management and the auditors as to whether the generally accepted accounting principles have been consistently applied, and whether the

preliminary announcements and interim financial statements contain adequate and appropriate disclosures. It would therefore be appropriate for this study to determine whether audit committees have any impact on major disclosures and other non-financial characteristics of companies listed at the Nairobi Stock Exchange.

Tate (2000) states that experience has shown that audit committees have proved their worth and developed into essential committees of board of directors.

1.4 Statement of the research problem

Disclosures and accountability are the cornerstone of corporate governance, lack of which can create the like of the Asian Financial Crisis. The Commonwealth Association for Corporate Governance report (1999) (CACG) states that *Transparency and Accountability* are essential characteristics of good leadership because without these, leaders cannot and will not be trusted to the ultimate disadvantage and demise of a country's economy.

Gopalsamy (1998) states that the accounting standards set by the professional bodies provide room for "creative accounting" where an assortment of techniques are used to "fudge" the numbers. The growing phenomenon of earnings manipulation should therefore receive the attention of regulators, auditors and all concerned.

There is a general consensus among the reports and scholars that audit committees composed of independent directors assists the board in fulfilling their responsibility to the shareholders and to the investing public by facilitating transparency and objective disclosures in company financial statements. The PWC Report (1999) states that a director's greatest virtue is his independence, which allows him or her to challenge management decisions and evaluate corporate performance from a completely free and objective perspective. An audit committee is responsible for overseeing the financial reporting process both internally as well as externally and in doing so, it may need to challenge the judgment of management or take positions that may be contrary to those in management. Although the committee reports to the board, it must act in favour of the

shareholder body as a whole. Because of this oversight role, independence is an essential quality for audit committee members.

As corporate governance is a relatively new concept in the Kenyan capital market, it is important to determine the perception of management to the value and the various attributes of audit committees. Management should work closely with and appreciate the objectives of the audit committee to facilitate the committee to operate effectively. It is also important to determine through management perspective whether the audit committees have achieved their objectives.

There is another school of thought that challenges the value added by independent directors. Lawrence and Stapleton (2000) point out that each additional regulatory requirement imposed on companies add to their compliance costs. They suggest that independent directors may perform some functions better than other directors, but other functions worse – resulting in no net advantage for the company if its board has a relatively high proportion of independent directors. They question whether the costs involved by imposing governance regulations on all listed companies would be outweighed by benefits.

Given the non-unanimity in the literature, it is therefore an empirical matter whether audit committees and their composition of independent and non-executive directors have an effect on major disclosures and other non-financial characteristics of companies listed at the Nairobi Stock Exchange.

1.5 Objective of the study

The objectives of the study are:

(1) to determine major disclosures and other non financial characteristics of companies listed at the Nairobi Stock Exchange before and after the establishment of audit committees;

(2) to determine the perceived value of audit committees by management of such listed companies; and

(3) to assess the achievement of the objectives of audit committees in these listed companies;

1.6 Importance of the study

This study is important to the:

- **The investors and the general public**

Investor and general public sensitisation on the rights as shareholders and the required disclosures and accountability to them by the board of directors is pertinent. The investors should be made aware of the importance of corporate governance and the internal monitoring machinery through independent directors and the audit committees. This will facilitate the task for the regulator. The investor will demand international standards of good corporate governance upon which the company should adhere to meet. Audit committees are representatives of the shareholders and protect their interests and therefore their independence and effectiveness are of major importance to investors and the general public.

- **The Regulators and Government of Kenya**

The Regulators must ensure that the management systems within every organization are equipped with adequate internal controls to promote accountability and transparency and adherence to the statutory provisions governing the sector. This promotes investor confidence and attracts capital inflow. Additional disclosures about a company's audit committee and its interaction with the company's auditors and management will promote investor confidence in the integrity of the financial process. In addition, increasing the level of scrutiny by independent auditors of companies' quarterly financial statements should lead to fewer year-end adjustments

and therefore more reliable financial information about companies throughout the reporting year. Audit committees facilitate the regulator's task of surveillance and supervision.

- **Academicians and researchers**

These are the future managers, directors, regulators and shareholders. Sensitisation on the importance and effectiveness of corporate governance and audit committees is important to them. As significant changes occur in the international market impacting the economies such as technological developments and increasing pressure of companies to meet earnings expectations it makes it even more important for academicians, scholars and researchers to remain informed and observe the cause and effect momentum in their environment.

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CHAPTER 2 - LITERATURE REVIEW

2.1 The need for corporate governance

The CAGC (1999) states that, the globalisation of economies and the financial and international markets in the 1990s led to the convergence of initiatives of corporate governance. This, it states, was accelerated by the serious contagion effect on the global capital markets by the South East Asian markets in 1997/8 caused by weak political and corporate governance causing a great capital outflow from emerging markets. Emerging markets in particular, have had to refocus on their standards in corporate governance for the sustenance of their markets in the international network and the capital and investment flows.

The CAGC (1999) observes that institutional investors deploy internationally massive funds and demand high standards of corporate governance in companies in which they invest. In a number of cases, these institutions have set their own corporate governance standards as a measure determining their investment decisions.

Kamara and Traub (1997) state that public attention through high profile corporate scandals and collapses has forced regulators and boards of corporations to carefully reconsider fundamental issues of corporate governance as essential for public economic interest. In addition, the CACG (1999) notes that the volatility and instability experienced in emerging markets in recent times has drawn attention to the implications of corrupt practices and poor administration in public sector. There has also been a rise in investor sensitisation to the importance of corporate governance. Investors are demanding good corporate governance in the companies in which they have invested.

Pomerleano (1998) observes that managing and executive directors are required to devote whole or substantially whole of their time to the affairs of their companies yet, many of them serve as non-executive directors on several other boards. There is

international consensus in the various task forces like the Bosch Report (1995) and the King Report (1994) that the shareholders and stakeholders of the company appointing directors as their executives should have the benefit of their full attention. The CMA (2002) restricts multiple directorships in public listed companies to five at any one time.

Ng. (1998) emphasizes the need to bring about greater levels of informed attendance and meaningful participation by shareholders in matters relating to their companies, without however such freedom being abused to interfere with management decisions. The accounting and reporting formats used by the company should be more transparent and user friendly, improved annual reports concomitant with more detailed filing with regulatory authorities, and greater facilitation for informed participation using the advances in converging information and communications technologies.

Gopalsamy (1998) notes that incentives created by a sound business environment form a bedrock for strong corporate governance and contribute to global competitiveness. Without a strong legal, policy and institutional framework for business, countries risk the loss of investor confidence, financial and economic stability and competitive advantage. This has been demonstrated by the recent crisis in East Asia, for instance.

The economic and financial crisis of East Asian and other emerging markets have revealed several underlying weaknesses relating to the functioning of corporate and financial sectors, at the forefront of which is corporate governance. Poor corporate governance practices including inadequate disclosures, lack of independent oversight and weak minority shareholder rights, discourage investment and weaken incentives for efficient management. This has been endorsed in the findings of Tirapat (2000), Pomerleano (1998), Ng. (1998) and Kamara and Traub (1997). Ng. (1998) states that reshaping corporate governance practices means strengthening transparency, disclosure and independent oversight of management of public and private enterprises, and dismantling unhealthy alliances between government, corporations and the financial sector.

Ng. (1998) further observes that good corporate governance hinges upon the competence and integrity of directors and the board, who should observe the standard of probity and fiduciary responsibility in a wider business environment. In other words, an effective legal and regulatory regime, efficiency and probity in the state sector, reasonably competitive markets, active and responsible capital providers, an informed and critical media and appropriate considerations towards a broad range of stakeholder interests should all play a role to ensure good corporate governance.

Tirapat (2000) acknowledges the various academic studies that suggest that managers have enormous discretion about firms' decision and may not act in the best interests of the owners.

2.2 The significance of corporate governance

Kamara and Traub (1997) observe that the pre-occupation in many developing countries over the past decade or so, has been on monetary and fiscal stabilization. Pomerleano (1998) stresses the need to shift attention and the focus of policy makers to cope with policies and structures occurring on implementation of those structural adjustment and privatisation programs. Accordingly, there is a need for instruments that support the macro-economic policies arising from this transition. According to Ng. (1998) corporate governance can be considered a powerful micro-policy instrument and an effective lever for change at the business enterprise and sectoral level. CACG (1999) states that corporate governance is important and significant because it is concerned with the profitability and efficacy of business enterprises (and in particular listed companies) and their capacity to create wealth and employment, the stability and credibility within the financial sectors both nationally and internationally. It creates a transparent relationship between the business enterprises and their various stakeholders locally as well as globally.

Corporate governance is essentially about leadership, for efficiency and probity. It is also about leadership that is transparent, responsible and accountable. Each of these factors is of equal importance according to the CACG (1999). They affect the livelihood and

quality of life of all of the country's citizens. *Business efficiency* is necessary to compete in the global economy and thereby to create jobs. Without efficient business leadership, there will be no efficient companies and without efficient companies there will be no employment. *Business probity* is necessary because investors require confidence and assurance that the management of a corporation will behave honestly and with integrity in regard to their owners (shareholders). No person or institution will trust a corporation if its managers are known or suspected, of misusing funds from improper purposes and corrupting the economic system. In a broader sense, international investors require confidence that a country's financial system and structures are secure and have credibility. *Business Responsibility* is increasingly considered not to include profitability alone but to incorporate issues compatible with societal objectives and legitimate social concerns. *Transparency and Accountability* are essential characteristics of good leadership because without these, leaders cannot and will not be trusted to the ultimate disadvantage and demise of a country's economy.

Gopalsamy (1998) acknowledges that one of the most critical aspects of good corporate governance is disclosure to investors of timely and material information on corporate performance, in a form that can be compared to that of other firms. Boards cannot independently monitor performance when they lack proper information, including externally audited and accurate financial data. Inadequate disclosure and lack of fully consolidated financial statements allow some firms to hide debts on the books of their affiliates, preventing lenders and shareholders from discovering the firm's real exposure in high levels of dollar denominated debt. Such information as is available is questionable given auditing standards that do not meet international best practices.

The PWC Report (1999) observes that disclosure alone is not enough for better governance. Independent oversight of management is also necessary as a system of checks and balances against abuses of corporate power. Ideally, audit committees with independent directors, will fulfil this role by monitoring management performance and holding managers accountable to the board and also to shareholders. Making corporate boards more independent and effective is a challenge in the emerging markets, especially in corporations with conglomerate affiliations throughout the emerging markets, cross

shareholdings and interlocking directorships, and where firm's shares are closely held. There is a need of independent directors and audit committees.

2.3 Role and responsibilities of corporate board of directors

Reddy (2001) states that the role of the corporate board of directors as stewards of their shareholders and stakeholders has internationally gained significant ground in recent decades.

He further states that successive corporate failures and other disasters have strengthened the demand for more transparency and accountability on the part of corporations. In the discharge of these responsibilities, the corporate board has come to be regarded as the principal arbiter, ensuring on the one hand that, executive management competently and through legitimate means creates wealth, and on the other, that such created wealth is equitably distributed to all shareholders after meeting the due aspirations of and obligations to other stakeholders. This requirement applies equally to cases of extreme separation of operational control from share ownership and those with dominant shareholders in charge of executive management, as is the case in several developing countries.

Hence, the perceived need for the board to be independent of the executive, which position is sought to be achieved by infusion of a majority of competent non executive and independent directors with no material pecuniary relationships with the corporation or its opinion makers. It is imperative therefore for the board to encourage a greater role of the non executive and independent directors, and have a tighter delineation of independence criteria and minimization of interest conflict potential, with some stringent punitive punishments for executive directors of companies failing to comply with listing and other requirements.

2.4 The Blue Ribbon Committee

The US Blue Ribbon Committee (1999) was created by the New York Stock Exchange and the National Association of Securities Dealers, in response to the concerns expressed by the Securities and Exchange Commission (USA) (2000) Chairman who called for improved board oversight of the financial reporting process of public companies. The report and recommendations of the Blue Ribbon Committee on "Improving the Effectiveness of Corporate Audit Committees"(1999) focuses on the financial reporting and audit committee oversight processes. The report provides ten principal recommendations for changes in functions and expectations, not only for audit committees but also for external and internal auditors, management and the full board. The Committee emphasized that the recommendations are an integrated set of objectives that should be implemented in their entirety to achieve the intended results.

The recommendations include the independence of the non-executives. "Independence" has been defined to exclude any kind of association with the company or it's affiliates or associate companies in the recent past and the present. The definition is similar to the one adopted in the CMA (2002).

Directors are considered "independent" if they have no relationship that may interfere with the exercise of their independence from management and the corporation. For instance, a director being employed by the corporation or any of its affiliates for the period he serves as a director to the company or the five years prior to his appointment as director should not have accepted any compensation from (i) the corporation or any of its affiliates (other than compensation for board service) or benefits under a tax qualified retirement plan, or (ii) a director being a partner in, or (iii) a controlling shareholder, or (iv) an executive officer of, any not for-profit business organization to which the corporation made, or from which the corporation received, payments that are or have been significant to the corporation or business organization, in any of the five years prior to his appointment as a director of such company. Other recommendations include, small companies (having a market capitalization of above US$ 200 million or more should have an audit committee solely of independent directors. Smaller companies have audit

committees comprising a minimum of three independent directors. The Committee also recommended that each audit committee adopt a full written charter approved by the full board of directors specifying the mandate of the committee and such charter be reviewed on an annual basis, by the board. The charter should specify that that the audit committee is responsible for ensuring its receipt from the external auditors of a formal written statement delineating all relationships between such auditor and the company. The audit committee should also be responsible for actively engaging in a dialogue with the external auditor to ensure objectivity and independence of such auditor.

The Blue Ribbon Committee (1999) recommended that, the Securities Exchange Commission (USA) should promulgate rules that require the audit committee for each listed company to disclose in such company's proxy statement for its annual meeting of shareholders whether the audit committee satisfied its responsibilities during the prior year in compliance with its charter, which charter shall be disclosed at least triennially in the annual report to the shareholders or proxy statement.

The Committee also recommended that the listing rules to require audit committee charter for every listed company to specify that the external auditor would ultimately be accountable to the board of directors and the audit committee as representatives of shareholders and that these shareholders representatives have the ultimate authority and responsibility to select, evaluate and where appropriate, replace the external auditor to be proposed for shareholder approval.

Tate (2000) states that the audit committee is mandated to evaluate the scope of representations made by an accountant engaged to compile financial statements and compare the disclosures to the ones made in the prior years. Audit committees perform internal control and monitor related party transactions. Generally, internal control is the set of procedures implemented by the reporting entity to ensure that assets are safeguarded and transactions are accurately and timely valued, documented, recorded and reported in the accounting records. Audit committees should therefore provide effective leadership and ensure independence within the systems to ensure that accurate information is channelled to them in a timely and efficient manner.

The PWC report observes that the audit committee should meet with management and the external auditors to review the financial statements for the year and the results of the audit. The committee therefore has to ascertain how management develops and summarizes interim and preliminary financial information and the extent of internal and external audit involvement in the review of such information. The external auditors should also obtain explanations from management and the internal auditor as to whether the generally accepted accounting standards have been consistently applied and whether the reports contain adequate disclosures. The committee should also obtain regular updates from management's investigation and follow up of any fraudulent acts or accounting irregularities. The audit committee should also ensure that the board has established a written code of conduct and that there is adequate flow of information within the organization and review compliance with such code. The audit committee should also review the activities and organizational structure of the internal audit function, assess the qualifications of the manager of internal audit and other internal audit staff and review the effectiveness of the internal audit function.

The audit committee should also review the proposed audit scope and approach, consider the findings from the financial statement audit, review the performance of external auditors and consider the independence of the external auditors. The audit committee may utilize the knowledge and experience of the external auditors by meeting with them to receive regular updates on developments affecting financial reporting.

Shamsher, Mohamad & Zulkarnain (2001) state that members of the audit committee should ideally be individuals with integrity, a sense of accountability and good track record. They should posses certain core competencies such as financial literacy, experience with organizations, leadership and strategic thinking. Most importantly they must have a significant degree of commitment to the company and its board and be able to perform objectively.

Zulkarnain Mohamad Shamsher, Mohamad & Mohamad Ali Abdul Hamid (2001) state that the audit committee should consider a continuous training and education program to

ensure that its membership has the proper background and knowledge base, and are updated with the current developments in accounting and finance. Audit committee members should continuously assess their strengthens and weaknesses and identify gaps in knowledge and "know how". They observed that in developed countries audit committees are required to submit a letter with the company's annual report to shareholders disclosing the following issues:

- Whether or not management had reviewed the audited financial statements with the audit committee including a discussion on the quality of accounting principles applied and significant judgment affecting the company's financial statements;
- Whether or not the external auditors have discussed with the audit committee their judgment on the quality of those principles; and
- Whether or not the members of the audit committee have discussed among themselves without management or the external auditors present the information disclosed to the audit committees.
- The audit committee in reliance on the review and discussions conducted with management and external auditors believe that the financial statements are fairly presented and are in conformity with the requirements.

2.5 Developments in the capital markets in Kenya

The Private Sector Corporate Governance Trust (PSCGT) and the Capital Markets Authority both acknowledge that the development of effective competitive capital market requires that all investors are protected from the misuse of corporate assets and that investor rights under law are protected. Minority shareholders are encouraged to commit their capital when there are safeguards against majority owners or management expropriating their assets. The need for audit committee has been identified for listed companies and has become mandatory under the Capital Markets (Securities)(Public Offers, Listing and Disclosures) Regulations, 2002 (Capital Markets Regulations 2002). Every listed company shall as from the financial reports issued during the year 2002 disclose the extent of compliance with the CMA (2002) and where there has been no compliance, the reasons thereof.

The Capital Markets Regulations 2002 and the CMA (2002), also require every chief financial officer and auditor of a listed company in Kenya to be a registered member of the Institute of Certified Public Accountants of Kenya. This would ensure that expatriates would be required to sit exams in taxation and other pertinent laws of Kenya.

PSCGT and the Capital Markets Authority have entered into a joint public and investor education program arrangement to be implemented during the financial year 2003/2004 that is targeted to sensitise investors and stakeholders on the principles of corporate governance and their importance in the economy. The arrangement includes the promotion of a shareholders association, a directors association and a centre of excellence in corporate governance. The objective of having an association of directors is to promote corporate governance to directors and require all directors to register with the association. The association would offer various courses to existing directors and other persons who are expected to sit exams to qualify as directors. The PSCGT, the Capital Markets Authority, the Institute of Certified Public Secretaries Kenya and the Nairobi Stock Exchange are also promoting "an award for excellence in corporate governance" which will have set standards and recognize private and public companies who demonstrate good corporate governance standards and principles.

CHAPTER 3 - RESEARCH METHODOLOGY

This study is an empirical approach to survey the impact of audit committees on major disclosures and other non-financial characteristics of companies listed at the Nairobi Stock Exchange. The methodology of the research is detailed under the following categories:

- Population and sample
- Sources of data
- Period of study
- Method of data analysis

3.1 Population and sample

The population of interest for this study comprised listed companies at the Nairobi Stock Exchange as at December 31, 2001. The sample comprised the fifty companies that were continuously listed during the period January 1, 1997 to December 31, 2001. (Population and sample shown as Appendix II and III respectively).

3.2 Sources of data

A questionnaire entitled "Questionnaire on audit committees in listed companies in Kenya" was used to collect primary data. The questionnaire (shown as Appendix I) focused on the existence of audit committees, their composition, mandate or charter and sought to analyse the perception of management on the attributes of audit committees.

Secondary data from annual reports of the listed companies was collected on a standard template. The annual reports were available at the Nairobi Stock Exchange.

3.3 Method of data analysis

In categorizing major non-financial disclosures, the annual reports were analysed to determine the company's achievements, targets, corporate governance standards, social responsibility and risk management. These form the basis of non- financial information to assist an investor in making an informed decision.

Achievements: Refers to the company's achievements during the course of the financial year compared to its previous year's achievements. Achievements directly or indirectly are financial and reflect on how the directors have realized their objectives and at what cost. The efficiency in the use of the resources and accomplishment of targets are also reflected under this heading.

Targets: Refers to a company's objectives for the following financial year. These objectives reflect where the company is to focus its resources at what cost and whether it is promoting its core activities or its strength. It may reflect the reasons for pursuing certain targets. This may have an impact on the company's profit earnings. A user of the annual report could assess the extent of such impact.

Corporate governance standards: Refers to disclosure on the composition of the board, multiplicity of directorships, existence and composition of audit committees, nomination and remuneration committees, related party transactions between directors or management and the company. Also included under this heading is the number of times the directors have invited shareholders outside the annual general meetings to a forum to discuss pertinent issues, for instance, a rights issue or a conversion of a company from an investment company to a mutual fund. Value added statements that include comparisons of turnover, sale of fixed assets and profits earned from subsidiaries within the reported year compared with that of the preceding financial year and how this was shared between the staff, government, creditors and shareholders, in a graphical manner.

Social Responsibility: Refers to information on a company's commitment to society, the immediate environment and to those who depend on it. It includes

information on whether the company is undertaking any reforms in its chemical disposal processes or conservation of forest and at what cost. Social welfare for the less advantaged and staff also fall under this heading. It also includes information on how much resources are used on training and whether it is justified in so far as the investor is concerned.

Risk management: This refers to management of risk in various aspects of operation of a company. Risk management reflects on the strength of a company's mission and vision. It also reflects on the company's commitment to achieve its objectives and to deliver to its stakeholders. The expertise involved in managing risk is very important to the investor.

In categorizing other non-financial disclosures, the annual reports were analysed to determine the company's compliance with regulatory standards, explanations of the technical terms and disclosures on related party transactions. These assists an investor to read the financial statements with ease, ensures compliance with the regulatory requirements and standards and also reflects the level of insider loans and related party transactions within the company. These disclosures play a critical role in enabling investors evaluate the board and management.

Compliance with regulatory standards: This refers to disclosures relating to compliance with the regulatory standards pertaining to the Company. It should be noted here that although the Kenyan Accounting Standards adopted certain principles of the International Accounting Standards (IAS) effective January 1999, disclosures on deferred taxation, depreciation on leasehold land and leases were not mandatory prior to this time. IAS makes these disclosures mandatory and as a result, companies have had to restate their accounts to comply. Compliance with the regulatory requirements prior to January 1999 was therefore noted from the auditors report. After January 1999 disclosures on deferred taxation and the application of depreciation on leases and leaseholds were also observed from the financial statements.

Explanations: A significant number of users of a company's financial reports are retail investors who are not sophisticated or necessarily familiar to the financial and legal terms in the reports. Financial reports ought to therefore have a section in which explanatory notes are provided and a glossary to assist non-financial users to understand the terms used in the reports.

Related party transactions: Refers to disclosures that relate to conflict of interest transactions, loans to directors, management and employees. This heading includes disclosures of any material contracts.

Descriptive statistics were used to analyse the:

(i) Establishment and composition of audit committees;
(ii) Frequency of meetings and reporting obligations of audit committees;
(iii) Existence of major disclosures obtained from the secondary data before and after the establishment of audit committees.

To determine the perceived value of audit committees by management of listed companies in Kenya, the questionnaire included queries on the composition and the reporting obligations of audit committees. It also sought to determine management perception to various attributes of audit committees based on best international market practice and the recommendations of the Blue Ribbon Committee (1999).

Descriptive statistics were used to determine the perception of management on the attributes of audit committees based on the responses in the questionnaire. The attributes in this study have been based on the Blue Ribbon Committee (1999) recommendations and the CMA (2002).

Descriptive statistics were also used to analyse the:
i) Perception of value of audit committees by management of listed companies based on the responses in the questionnaire; and
(ii) Achievement of the objectives of such audit committees.

CHAPTER 4 - DATA ANALYSIS AND FINDINGS

Thirty companies in the sample responded to the questionnaire representing a response rate of 60%. Appendix IV shows the respondees and data on whether or not they have audit committees and the year of establishment of their committee. The responses from the thirty companies were analysed in order to achieve the objectives of this study.

4.1 Mandate of audit committees

The mandates of audit committees were similar in their objectives and focus on ensuring efficiency and effectiveness of operations, safeguarding of assets, ensuring reliability of financial and other management information. They also focus on ensuring compliance with group policies and procedures. The audit committees are also mandated to ensure that the financial reporting is accurate and comprise sufficient information to enable investors make informed decisions.

Peculiar to the non-financial characteristics of companies having established audit committees is having independent directors to ensure systems of internal control are objectively and soundly conceived, effectively administered and regularly monitored. It also includes reviewing annually the program for monitoring compliance with established code of business practice and regulatory requirement. The committees are also required to define the responsibility of internal audit to review financial statements. The committee is required to review the scope, fees and coordination of external auditors to ensure their independence, review their findings and provide recommendations to the board on the analysis, among other important characteristics.

4.2 Establishment and composition of audit committees

Table 4.2.1 below shows the establishment and composition of the audit committees. Apart from BAT, which established it's audit committee in 1980, 7% of the companies established their audit committees in 1996, 11% in 1997, 23% in 1998, 23% in 1999, 13% in 2000 and 7% in 2001. 46% of the audit committees were established in 1998 and 1999. 13% of the companies did not have audit committees. It was noted, that 21% of the companies had established audit committees prior to the Capital Markets Authority Guidelines on Audit Committees for listed companies in Kenya becoming effective in

June 1997. The guidelines were replaced by CMA (2002). The guidelines required listed companies to establish audit committees by financial year 1998. 43% of the companies complied.

The number of directors appointed to the committees range from 3 to 5 with an exception of 14 for Barclays Bank (K) Limited and 6 for NIC Bank.

Table 4.2.1 – Establishment and composition of audit committees

Company	Year audit committee established	Total members	Number of Executive Directors on committee	Number of Non Executive Directors on committee	Number of Independent Directors on committee
Bamburi Cement	1999	5	-	3	2
Barclays Bank	1996	14	3	4	7
BOC Gases	1996	2	-	2	-
BAT	1980	8	5	2	1
Car & General	2000	3	1	2	-
Carbacid	1998	3	-	1	2
CFC Bank	1997	3	1	2	-
CMC Holdings	2001	4	-	4	-
Diamond Trust	1998	3	-	3	-
EABL	1998	3	-	-	3
E A Cables	2000	4	-	2	2
Express Kenya	2001	3	-	3	-
Athi River Mining	1999	3	1	2	-
Housing Finance	1998	4	-	4	-
ICDC Investments	1999	5	-	2	3
Jubilee Insurance	1999	3	-	-	3
Kakuzi Ltd	2000	3	-	1	2
Kenya Airways	1998	5	-	-	5
Marshalls	1998	3	-	-	3
Nation Media Group	1998	3	-	-	3
NIC Bank	1997	6	2	-	4
Pan Africa Insurance	2000	5	2	3	-
Rea Vipingo	1999	3	-	2	1
Standard Chartered	1999	3	-	2	1
Tourist Promotion	1997	5	-	-	5
Williamson Tea	1999	3	1	2	-
Total Kenya	-	-	-	-	-
EA Packaging	-	-	-	-	-
A Baumann	-	-	-	-	-
Cititrust	-	-	-	-	-

Source: Questionnaire on audit committees in listed companies in Kenya

20% of the committees are composed fully of independent directors. The guidelines required that audit committees comprise at least one-third independent or non-executive directors. By 1998, 43% of the companies complied, having at least one-third

non-executive or independent directors. By 2001, 33% of the companies did not have any independent directors in their audit committees and 60% of the companies did not have any executive directors in their audit committees.

4.3 Frequency of meetings and reporting obligations

Table 4.3.1 shows the frequency of meetings and reporting obligations of audit committees. The committees meet at least half yearly and report to the board at least once a year. 50% of committees meet and report to the board quarterly.

Table 4.3.1 - Frequency of meetings and reporting obligations

Company	No. of times audit committees meet annually	No. of times committee reports to the Board Annually	No. of times committee reports to shareholders Annually
Bamburi Cement	Four	Four	Once
Barclays Bank	Six	Six	Six times *(only to major shareholders)*
BOC Gases	Two	Two	-
BAT	Three	Three	-
Car & General	Four	Four	-
Carbacid	Four	Four	-
CFC Bank	Four	Four	-
CMC Holdings	Four	Four	-
Diamond Trust Bank	Four	Four	-
EABL	Three	Three	-
E A Cables	Two	Once	-
Express Kenya	Three	Three	-
Athi River Mining	Four	Four	-
Housing Finance	Six	Six	-
ICDC Investments	Three	Three	Once *(at the AGM)*
Jubilee Investments	Four	Four	-
Kakuzi Ltd	Two	Two	-
Kenya Airways	Four	Four	-
Marshalls	Four	Four	-
Nation Media Group	Four	Four	-
NIC Bank	Six	Six	-
Pan African Insurance	Four	Four	-
Rea Vipingo	Two	Two	-
Standard Chartered	Four	Four	-
Tourist Promotion Svc	Four	Four	-
Williamson Tea	Four	Four	-
Total Kenya	-	-	-
EA Packaging	-	-	-
A Baumann	-	-	-
Cititrust	-	-	-

Source: Questionnaire on audit committees in listed companies in Kenya

10% of the committees meet and report to the board half yearly. 10% of the committees meet and report to the board six times yearly. 3% of the committees meet half yearly but reports to the board once a year. 13% of the committees meet and report to the board three times annually while 14% of the companies did not have audit committees.

It can be noted that only 10% of the audit committees report to the shareholders. The CMA (2002) requires the board to set out the frequency of the meetings for audit committees and reporting obligations to the board as a matter of best practice.

The analysis under paragraphs 4. 2 and 4.3 provides value to analysis in paragraphs 4.4, 4.5 and 4.6. The date of establishment reflects on the achievement of objectives under paragraph 4.6. Depending upon their mandate audit committees could have an impact on major disclosures and other non-financial characteristics of the companies and this would appear in the major disclosures and other non-financial characteristics of listed companies, as shown in paragraph 4.4. The composition and reporting obligations of the audit committees have an effect on the efficiency of audit committees. The independence of committee enhances the existence of the various attributes of audit committees under paragraph 4.5 and could be indicative of its ability to achieve its objectives and operate efficiently.

4.4 Major disclosures and other non-financial characteristics of listed companies before and after establishment of audit committees

Table 4.4.1 below show the existence of major non-financial disclosures of companies before the establishment of audit committee.

Table 4.4.1 - Major non-financial disclosures before establishment of audit committee

Nature of disclosure by companies	Existent %	Non existent %
Achievement	91%	9%
Targets	46%	54%
Corporate Governance	16%	84%
Social Responsibility	26%	74%
Risk Management	3%	97%

Source: Annual Reports 1997 - 2001

It can be noted from Table 4.4.1 that 91% of the companies informed their shareholders on achievements during the financial year in which the performances were being reported. Other major disclosures as can be noted, were largely non-existent. It was observed that all companies having international affiliations had major disclosures in their annual reports.

Table 4.4.2 below shows the existence of other non-financial characteristics of the companies before the establishment of audit committees.

Table 4.4.2 - Disclosure of other non-financial characteristics before establishment of audit committees

Nature of non financial characteristic disclosed by companies	Existent %	Non Existent %
Compliance with regulatory requirements	70%	30%
Explanation of technical terms	68%	32%
Related Party Transactions	9%	91%

Source: Annual Reports 1997 - 2001

Table 4.4.2 shows that related party transactions were virtually non-existent. However, explanations of technical terms and compliance with regulatory requirements were largely existent.

Table 4.4.3 below shows the existence of major non-financial disclosures after the establishment of audit committees.

Table 4.4.3 - Existence of major non-financial disclosures after establishment of audit committees

Nature of disclosure by companies	Existent %	Non existent %
Achievement	94%	6%
Targets	94%	6%
Corporate Governance	79%	21%
Social Responsibility	64%	36%
Risk Management	68%	32%

Source: Annual Reports 1997 – 2001

It can be noted from Table 4.4.3 that the level of existence of major disclosures rose considerably after the establishment of audit committees. Although some information was still non-existent the levels had dropped significantly. In particular, disclosures on company's targets rose from 46% before to 94% after the establishment of audit committees, corporate governance rose from 16% before to 79% after, social responsibility rose from 26% before to 64% after and risk management rose from 3% before to 68% after the establishment of audit committees.

Table 4.4.4 below shows the existence of other non-financial characteristics of the companies after the establishment of audit committees.

Table 4.4.4 - Disclosure of other non-financial characteristics after establishment of audit committees

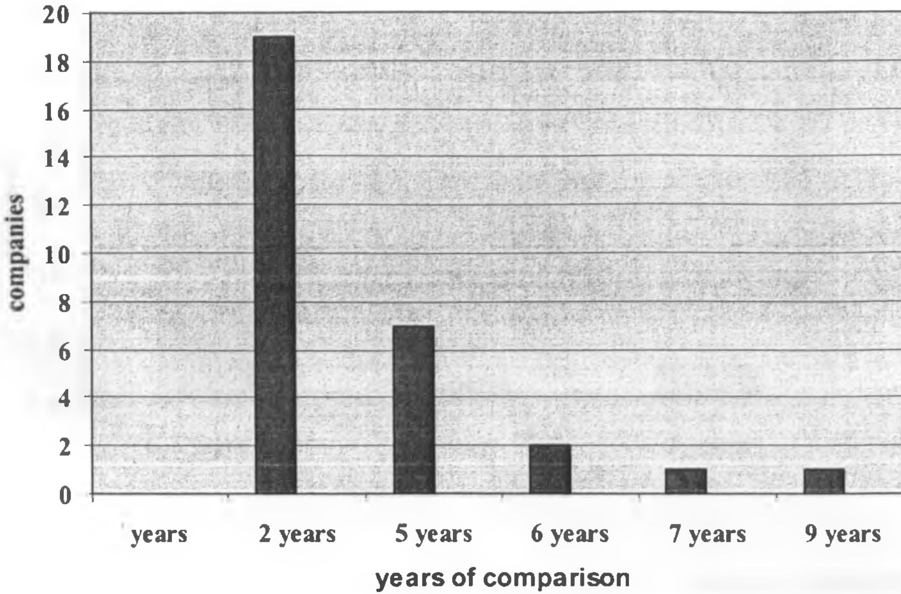
Nature of the non financial characteristic disclosures by companies	**Existent %**	**Non Existent %**
Compliance with regulatory requirements	90%	10%
Explanation of technical terms	85%	15%
Related Party Transactions	80%	20%

Source: Annual Reports 1997 - 2001

It was noted that there was a significant improvement on the disclosures of related party transactions after the establishment of audit committees, which rose from 9% before the establishment of audit committees to 80% after the establishment of audit committees. Compliance with the regulatory requirements rose from 84% before to 90% after the establishment of audit committees and explanation of technical terms increased in terms of existence from 68% before to 85% after the establishment of audit committees.

Figure 4.4.1 below shows the comparative disclosures in the financial statements before the establishment of audit committees.

Figure 4.4.1 - Comparative disclosures in the financial statements before the establishment of audit committees

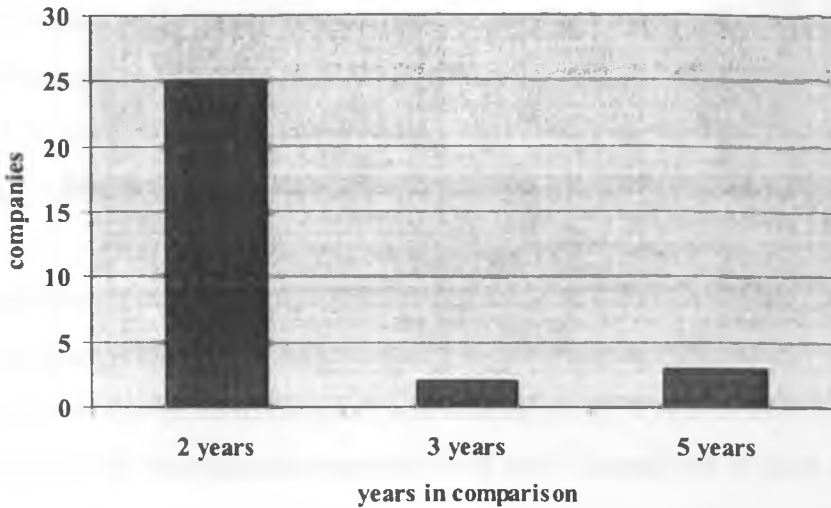


Source: Annual Reports 1997 - 2001

Before the establishment of audit committees 19 companies used 2-year comparative figures, 7 companies used 5-years, 2 companies used 6-years, 1 company used 7 years and 1 company used 9 years.

Figure 4.4.2 below shows comparative figures used by companies after the establishment of audit committees. It was observed that the number of companies using 2-year comparative figures rose from 19 to 25. No companies gave comparative figures more than 5 years.

Figure 4.4.2 - Comparative disclosures in the financial statements after the establishment of audit committees



Source: Annual Reports 1997 – 2001

Companies performed well across all sectors and trends in the performance levels were positive up to 1998. This may explain greater comparative figures in the annual reports prior to 1998. The downturn in the economy thereafter affected the performance trend that may have led the companies to use a shorter comparative span.

From the above analysis it was noted that major disclosures and other non-financial characteristics of companies listed at the Nairobi Stock Exchange improved significantly after the establishment of audit committees. The effect of disclosures and transparency are important to nurture the relationship between shareholders on one hand and directors and management on the other. It was observed, that among the companies having major disclosures and other non-financial characteristics reflective in their annual reports were companies having international affiliations such as Standard Chartered Bank Kenya Limited, East African Breweries Limited, Barclays Bank of Kenya Limited, Tourist Promotion Services Limited. It must however be noted here, that there were some companies with international affiliations like Total Kenya Limited and Crown Berger Limited who did not have audit committees and were among the companies not having any major disclosures or other non-financial characteristics in their annual reports. No reasons were given in their annual reports for their non-existence.

It was also noted that indigenous companies like the Nation Media Group, Jubilee Insurance Limited, NIC Bank Limited, Kenya Airways and ICDCI Limited had established audit committees and had major disclosures and other non-financial characteristics in their annual reports after the establishment of audit committee.

4.5. Management perception to various attributes of audit committees

Audit committees are only effective if they have the right attributes to enable them to operate objectively and independently to achieve their mandate. They require full support of the board of directors and management. It was therefore important to determine the management perception of audit committees in light of the fact that corporate governance and the importance of audit committees is relatively a new concept in the Kenyan capital markets.

The following analysis denotes management perception to various attributes of audit committees. All the attributes are equally important regardless of the number or position on the list. Table 4.5.1 below shows management perception to various attributes.

Table 4.5.1 Perception of management to various attributes of audit committees

Members -	Strongly agree	Agree with a reservation	Do not agree	Indifferent
1. Should all be independent and non-executive*	70%	4%	23%	-
2. Should have a strong understanding in financial reporting*	73%	17%	7%	-
3. Should have sufficient knowledge and experience**	67%	10%	3%	14%
4. Should be proactive*	83%	8%	3%	3%
5. Should be ready to challenge management*	94%	-	-	3%
6. Should promote an effective communication policy**	77%	10%	3%	4%
7. Independence should be a prerequisite in the membership*	77%	10%	10%	-

**one company (3%) did not answer this questions*

***two companies (6%) did not answer this question*

Source: Questionnaire on audit committees in listed companies in Kenya

Four companies did not have audit committees but gave management perception on the attributes of audit committees.

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It can be noted that 70% of the companies strongly agreed that all members of an audit committee be independent and non-executive directors. 23% of the companies did not agree to this attribute. 4% of the companies agreed with a reservation, some stating that there should be a balance of independent, non-executive and executive directors.

73% of the companies strongly agreed that all members of an audit committee should have a strong understanding in financial reporting, while 17% of the companies agreed with a reservation, some stating that this attribute was not absolutely essential. Some of the reservations were that some understanding was essential but it was not necessary that all members be financial experts although some members should have some expertise in finance. 7% of the companies did not agree, one stating that audit committee should be more than just mere accountants.

67% of the companies strongly agreed that all members of an audit committee have sufficient knowledge and experience in the industry in which the listed company operates. 10% of the companies agreed with a reservation, some stating that broad business knowledge on the part of the committee members would be sufficient. They further stated that sufficient knowledge and experience would be preferable but not absolutely essential. 14% of the companies were indifferent to this attribute.

83% of the companies strongly agreed that all members should be proactive. 8% of the companies agreed with a reservation, one stating that by members being proactive could easily impinge on management functions and should therefore be controlled to be effective. 3% of the companies did not agree, while 3% of the companies were indifferent to this attribute.

94% of the companies strongly agreed that audit committee members should be ready to challenge management. Only 3% of the companies were indifferent.

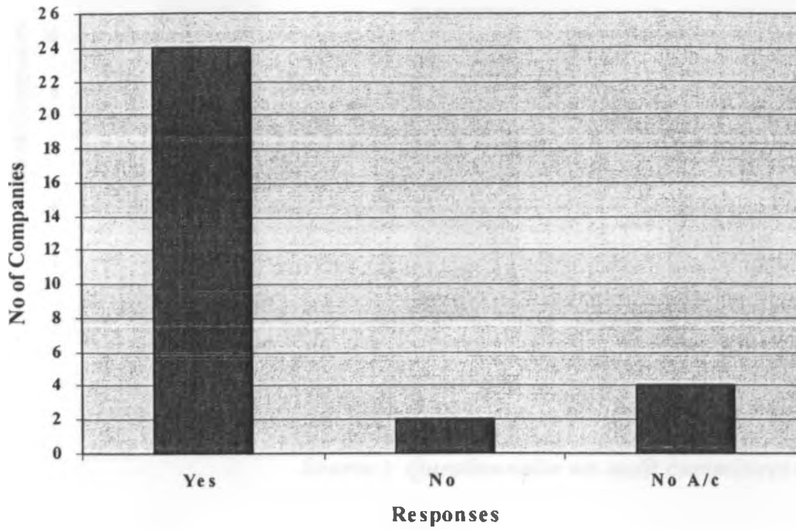
77% of the companies strongly agreed that audit committee should promote an effective internal and external communications policy of the company. 10% of the companies agreed with a reservation, one stating that the committee should only promote communication policy pertaining to controls. 3% of the companies did not agree and 4% of the companies were indifferent.

77% of the companies strongly agreed that independence should be a prerequisite in the membership of audit committees. 10% of the companies agreed with a reservation some stating that non-executive directors bring a balance to the composition of the committee. They further stated that cost may be a factor and that the importance ought to be placed on objectivity rather than independence.

It was observed that one of the companies that did not agree with the attribute of independence and having knowledge in financial reporting, has faced a court action initiated by a substantial shareholder to have all directors replaced for inefficient use of assets of the company. Some of the companies that do agree to the attributes that all members of the audit committees should be independent and non executive and have a strong understanding in financial reporting, do have at least one third executive directors as members of their audit committee. It is however important to note that these companies have international affiliations and the parent or sister companies are regulated by regulators such as the Financial Services Authority of United Kingdom that has stringent continuous reporting obligations as a condition to listing with a focus on corporate governance standards. The internal audit system of such companies are structured such that no one individual has complete control over any one transaction within the system without the oversight by internal or external officers who report to officers based in the parent or sister companies. There are sufficient checks and balances within their internal audit system that ensures an effective communication system, transparency and accountability at all levels.

Figure 4.5.1 below shows management perception on audit committees being cost effective.

Figure 4.5.1 Cost effectiveness of an audit committee

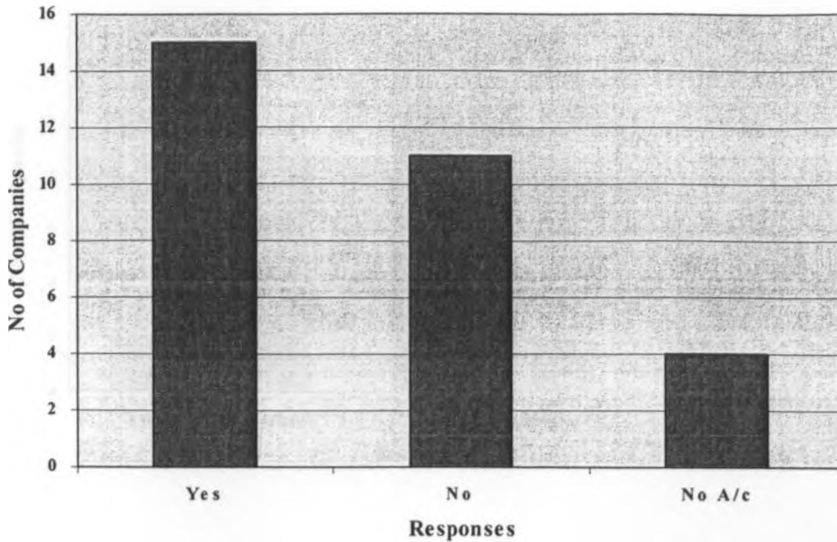


Source: Questionnaire on audit committees in listed companies in Kenya

It can be noted that four companies did not answer this question, as they did not have audit committees. 80% of the companies agreed that audit committees were cost effective. 7% of the companies did not agree although stating that their audit committee had successfully achieved all its objectives within the required time. These 7% of the companies were either indifferent or did not agree to all the attributes of audit committees in the questionnaire.

Figure 4.5.2 below shows management perception of whether the board has a documented process of regular assessment of audit committees.

Figure 4.5.2 - Availability of a well-documented process of regular assessment of an audit committee

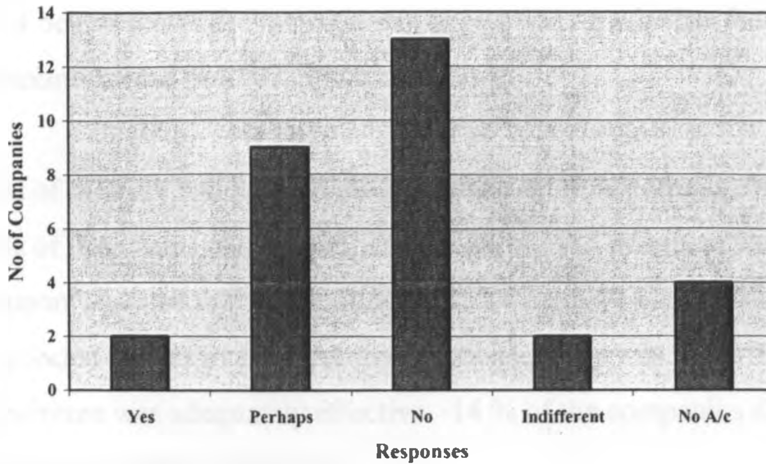


Source : Questionnaire on audit committees in listed companies in Kenya

It can be noted from Figure 4.5.2 that 50% of the companies agreed that their boards have a well-documented process of regular assessment of audit committees. 37% of the companies stated that their boards do not have such a process. 13% of the companies did not have audit committees. By having a well-documented process boards are able to discern whether audit committees could do more than their mandate to be more efficient.

Figure 4.5.3 below shows management perception on whether audit committees could do more than their mandate to be more efficient.

Figure 4.5.3 - Ability of audit committees to do more than their mandate to be more efficient



Source: Questionnaire on audit committees in listed companies in Kenya

It was noted that 7% of the companies agreed that audit committees could do more than their mandate to be more efficient, one of these companies further stated that its audit committee could be more efficient by 50% if its mandate was broadened and would therefore be able to achieve its objectives and add value to the company. 30% of the companies stated that their audit committees could perhaps be more efficient if their mandate was broadened, 13% of which stated that if audit committees had more time they could perform efficiently within their mandate. Of the 30% companies that answered 'perhaps' 44% established their audit committees more than 4 years ago and 56% established their audit committees in the year 2000.

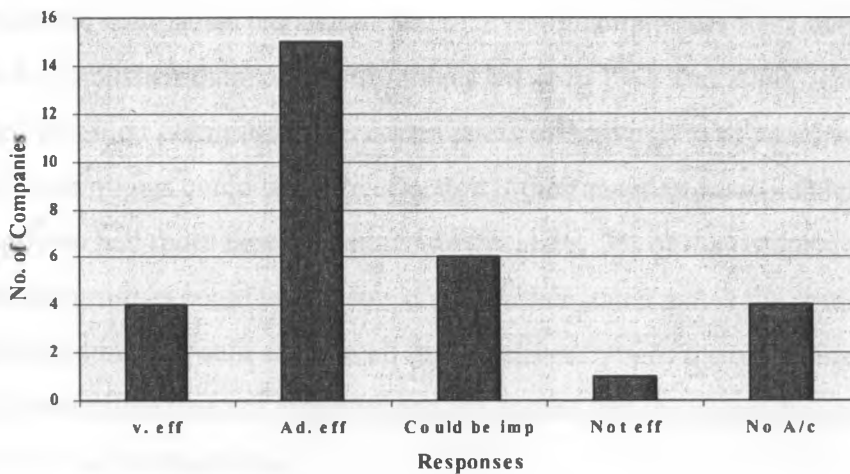
43% of the companies did not agree that their audit committees could do more than their mandate to increase its efficiency of which 77% of these companies established their audit committees during 1996 to 1999. 7% of the companies were indifferent, however they did agree that their audit committees were very effective.

13% of the companies did not answer this question, as they did not have audit committees.

Considering the general objectives of audit committees an effective communications policy in the company would facilitate the committee to achieve its objectives. Figure 4.5.4 below shows the management perception on whether there is an effective communications policy in the company.

13% of the companies responded that their internal communications were very effective. 50% of the companies stated that their policy was adequately effective. 20% of the companies stated that their policy could be improved and 3% of the companies responded that its internal communications policy was not effective but its audit committee was adequately effective. 14 % of the companies did not respond, as they did not have any audit committees.

Figure 4.5.4 - Effectiveness of the communications policy

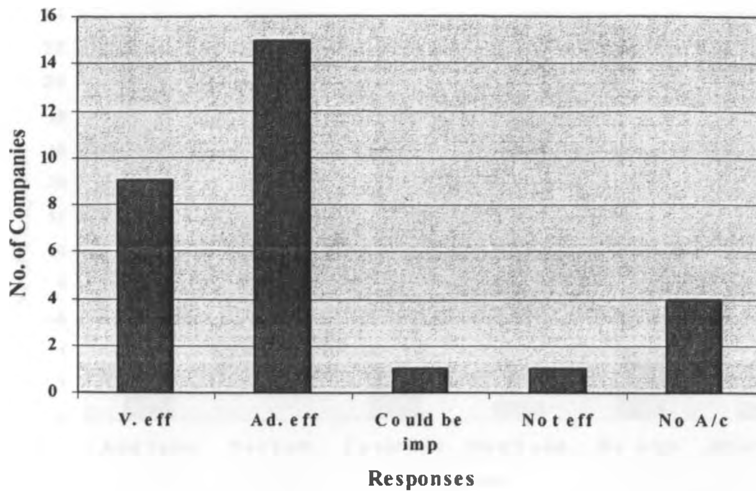


Source: Questionnaire on audit committees in listed companies in Kenya

It can be noted from above, that only 13% of the companies perceived their internal communications policy to be very effective while 50% of the companies perceived their policy to be adequately effective.

Figure 4.5.5 below shows management perception of the effectiveness of audit committees.

Figure 4.5.5 - Effectiveness of audit committees



Source: Questionnaire on audit committees in listed companies in Kenya

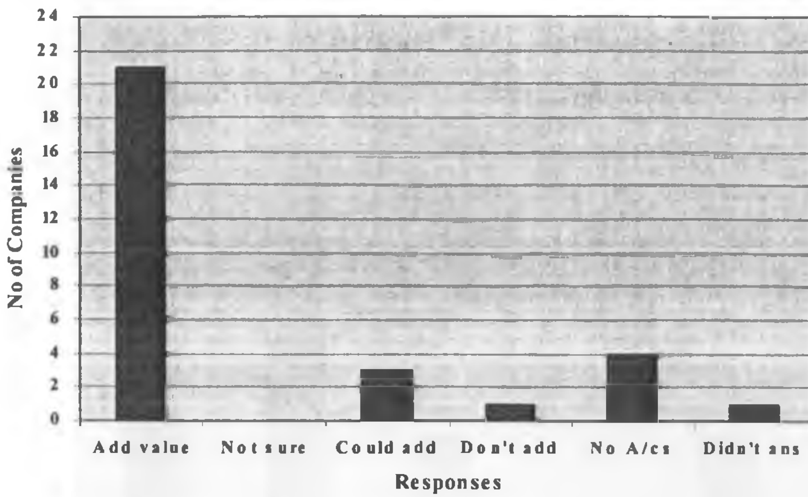
30% of the companies responded that their audit committees were very effective, 50% of which established their audit committees between 1998 and 2000. 50% of the companies stated that their committees were adequately effective 60% of which added that their audit committees could be more effective if their mandate was broadened and if the committee had more time to achieve its mandate. 3% of the companies stated that their audit committees could be improved and further stated that if the committee had sufficient time it would achieve all its objectives. 3% of the companies stated that their audit committee was not effective and yet agreed that the committee had successfully achieved all its objectives.

4.6 Achievement of objectives

To assess the achievement of the objectives of audit committees in listed companies in Kenya, the questionnaire also sought management perception of whether the objectives of audit committee in their organization had been achieved and whether audit committees add value to the company.

Figure 4.6.1 below shows management perception to whether audit committees add value to the company.

Figure 4.6.1 - Management perception on value added by an audit committee

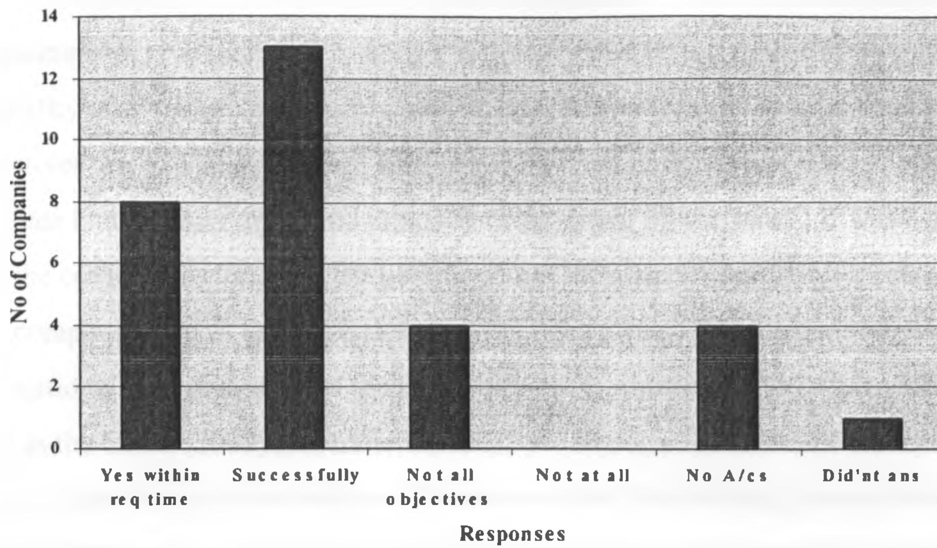


Source: Questionnaire on audit committees in listed companies in Kenya

70% of the companies stated that audit committees add value to the company. 10% of the companies responded that audit committees could add value had they been given a broader mandate and more time. 3% of the companies responded that their committee does not add value although the committee had successfully achieved its objectives. Further stating that they were either indifferent or did not agree to all the attributes of the audit committee given in the questionnaire. 3% of the companies did not answer this question and 14% of the companies did not have audit committees.

Figure 4.6.2 below shows management perception to whether the audit committee has achieved its objectives. It can be noted from this Figure that 23% of the companies responded that their audit committees had successfully achieved their objectives within the required time. 50% of the companies responded that their committees had achieved their objectives successfully and not necessarily within the required time, 3% of which stated that while the audit committee had achieved its objectives successfully, it did not add value to the company. 13% of the companies stated that their committees had not

Figure 4.6.2 - Management perception on achievement of objectives by audit committee



Source: Questionnaire on audit committees in listed companies in Kenya

achieved all the objectives 25% of which had established its audit committee in 1998 and stated that the audit committee could do more than it was mandated to be more effective and that members needed more time to achieve the objectives.

CHAPTER 5 – CONCLUSION, LIMITATIONS AND SUGGESTIONS FOR FURTHER STUDIES

5.1 Conclusion

From the analysis of the mandate of audit committees it was observed that the audit committees were established to ensure efficiency and effectiveness of operations, reliability of financial and other management information and to safeguard assets. The objectives were to a large extent similar for all audit committees. It was observed that the mandate had not been reviewed annually or modified by the board. It was also observed that the committees report to the board and not the shareholders. It was noted that only two companies report to all the shareholders once a year. This is contrary to the international best practice and the Blue Ribbon Committee (1999) recommendations as well as the CMA (2002) recommendations. Audit committees are in essence ambassadors for the shareholders. It was also noted that although management perceives audit committees to add value to the company, it still had reservations on the attributes of audit committees in particular the independence of directors and all members having sufficient knowledge in financial reporting and some business experience or expertise in the industry in which the company operates.

It was also observed that there were some companies whose management perceived audit committees as not adding value and not effective. Management also perceived audit committees in taking control of the operations of the company by having a relatively close relationship with the internal and external auditors, management and the board of directors. There appeared to be reservations on the time available to audit committees and the requirement of a broader mandate. Although from the observations, there is a significant effect of audit committees on the major disclosures and other non-financial characteristics of companies listed at the Nairobi Stock Exchange, it is apparent, that the essence of audit committees in listed companies in Kenya is yet to be appreciated and understood by the board and the management.

5.2 Limitations

The effectiveness of the observations and analysis in this study has its limitations due to various factors. Financial disclosures were also analysed and it was determined, that no financial ratio on operations or performance of the company or even the issuing of dividends were directly connected to the audit committees. Furthermore, market performance of such companies is largely affected by micro and macro elements. Internal elements like audit committees cannot significantly affect performance be it corporate or market. The fact that audit committees were established by these companies at different times, analysis even within sectors proved difficult if not impossible. Furthermore, only 30 companies responded to the questionnaire out of which 4 companies did not have audit committees.

5.3 Recommendations (to companies in relation to audit committees)

Directors today have to maintain a transparent relationship with the shareholders and other stakeholders since investor confidence in the capital markets is founded on disclosure and transparency. Audit committees having the attributes recommended by the Blue Ribbon Committee (1999) can ease the burden off the board by taking on the task of reviewing internal audit and communication policies, ensuring accurate information in the financial statements of the company, independence of external auditor and adherence to the regulator framework within which the company operates. Audit committees today globally are taking on more responsibility and are being recognized as being the ambassadors for the shareholders to uphold their interest in the company.

Companies with audit committees that have the recommended attributes and that report to the board and the shareholders have an edge in investor and shareholder confidence over companies that do not. Today in the wake of investor education and shareholders association, shareholders are being made aware of their rights and corporate governance and soon enough companies will have no choice but to incorporate the principles of corporate governance into their operations.

5.4 Suggestions for further research

This study focused on determining management perception on the attributes of audit committees, whether audit committees had achieved their objectives and the non-financial characteristics that distinguish companies before and after the establishment of audit committees.

The Capital Markets Regulations (2002) and CMA (2002) make it mandatory for companies to disclose adherence to the statutory requirements under these regulations and guidelines. The statutory requirements focus on corporate governance practices and periodic disclosures to the investors starting from financial reports issued during 2002. It is important to carry out a study to find out whether these regulations and guidelines are indeed making a difference in the disclosure standards of the listed companies in Kenya and whether the dialogue between the companies and shareholders improve as a result of this regulatory requirement.

Further research should be carried out on whether the independent directors as members of the audit committee are indeed independent in accordance to the definition provided by CMA (2002) and if the independence of directors in Kenya's capital markets is indeed making a difference to the performance of the audit committees. Further research also needs to be carried out on whether the members of the committee have adequate knowledge and expertise and if that aspect is making a difference to the performance of the audit committees.

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Appendix I

QUESTIONNAIRE ON AUDIT COMMITTEES IN LISTED COMPANIES IN KENYA

Name of Company: ______________________________

Year listed at the Nairobi Stock Exchange: ______________________________

Name of Company Secretary: ______________________________

E Mail address: ______________________________

1. Does the Company have an audit committee? Yes_____ No_____

   If the answer to question 1 is No, please go to questions 9 and 11

2. When was it established? ______________________________

3. Does the audit committee have a written terms of reference or charter of expectations or other document that describes the role and expected performance of the members of the audit committee?

   Yes____ No_____

   Will you avail a copy of the terms of reference to the person carrying out this research?

   Yes_____ No_____

4. What is the composition of the audit committee:

   Total number of members: _______

   Executive Directors ______%

   Non-Executive Directors ______%

   Independent Directors ______%

5. How often does the audit committee meet?

   Once a month ☐ Every two months ☐ Every quarter ☐ Half yearly ☐

   Once a year ☐ other ☐ *(please specify)*

6. Does the audit committee report its activities:

   to the board? Yes______ No_____

   to the shareholders? Yes______ No_____

   a. How often does it report to the board?

   Once a month ☐ Every two months ☐ Every quarter ☐ Half yearly ☐

   Once a year ☐ other ☐ *(please specify)*

b. How often does it report to the shareholders?

Once a month ☐ Every two months ☐ Every quarter ☐ Half yearly ☐

Once a year ☐ other ☐ *(please specify)*

7. Has there been a turnover of members in the audit committee since its establishment?

Yes_____ No______

8. How many members left in the first year ☐ second year ☐ third year ☐

If there were changes what were the nature of changes in the membership of the audit committees?____

Has there been any changes or modification to the mandate since the establishment of the audit committee?

Yes _______ No _______

9. In the perception of management are the following attributes of audit committee members necessary or add value in the performance of the company?

- The members should all be independent and non-executive

Strongly Agree	**Agree with a reservation** *(please specify)*	**Don't agree**	**Indifferent**

- Independence should be a pre requisite in the membership

Strongly Agree	**Agree with a reservation** *(please specify)*	**Don't agree**	**Indifferent**

- Members should have sufficient knowledge of and experience in the industry in the which the listed company operates

Strongly Agree	**Agree with a reservation** *(please specify)*	**Don't agree**	**Indifferent**

- Members should have a strong understanding in financial reporting and audit process

Strongly Agree	**Agree with a reservation** *(please specify)*	**Don't agree**	**Indifferent**

- Members should be proactive

Strongly Agree	**Agree with a reservation** *(please specify)*	**Don't agree**	**Indifferent**

- Members should be ready to challenge management on issues relating to the financial reporting process, risk management and auditor independence, replacement of external and internal auditor and other aspects of their mandate

Strongly Agree	**Agree with a reservation** *(please specify)*	**Don't agree**	**Indifferent**

- Members should promote an effective internal and external communications policy

Strongly Agree	**Agree with a reservation** *(please specify)*	**Don't agree**	**Indifferent**

10. Do the objectives of audit committee in your company include the following?
(please number in order of priority)
please answer this question if the terms of reference or charter of the audit committee is not available to the person carrying out this research.

a) to oversee and monitor the management and independent auditor's participation in the financial reporting process ☐

b) to monitor the activities and performance of internal and external auditors ☐

c) evaluate whether management is:

   a. setting appropriate corporate culture by communicating the importance of internal controls and management of risk ☐

   b. ensuring all employees have an understanding of their roles and responsibilities ☐

d) monitor whether internal control recommendations made by the internal and external auditors have been implemented by management ☐

e) consider with the internal and external auditors any fraud, illegal acts, deficiencies in internal controls or similar issues ☐

f) ask management and internal and external auditors about significant risks and exposures and plans to minimize such risks ☐

g) gain an understanding of the current areas of great financial risk and whether management is managing these effectively ☐

h) review all sections of the annual reports including the financial statements and determine whether they are complete and consistent with the information known to committee members ☐

i) assess whether the financial statements reflect appropriate accounting principles ☐

j) review the effectiveness of the internal audit function ☐

k) review the external auditor's proposed audit scope and independence from management ☐

l) ensure compliance with the laws, regulations and internal code of conduct ☐

11. In management's perceptions:

- are audit committees cost effective? Yes____ No____
- does the board have a well defined and documented process for regular assessment of the audit committees? Yes_____ No______

Could audit committees do more than it has been mandated to do to be more effective?

Yes by at least % more	**Perhaps if members had more time**	**No**	**Indifferent**

Does your company have an effective communications policy?

Very effective	**Adequately effective**	**Could be improved**	**Not effective**

Is the audit committee effective?

Very effective	**Adequately effective**	**Could be improved**	**Not effective**

Has the audit committee achieved its objectives?

Successfully within the required time	**Successfully**	**Not all objectives have been effectively achieved**	**Not at all**

Do audit committees add value to the Company

Add value	**Not sure**	**Could add value if given sufficient time and a broader mandate** *(delete where necessary)*	**Don't add value**

Appendix II

The listed companies as at December 31, 2001 which composed the population:

Table 1 POPULATION

MAIN INVESTMENT MARKET SEGMENT

No.	Company
1	African Lakes Corporation PLC
2	Athi River Mining Limited
3	B O C Kenya Limited
4	Bamburi Cement Limited
5	Barclays Bank of Kenya Limited
6	BAT Kenya Limited
7	Brooke Bond Limited
8	Carbacid Investments Limited
9	CFC Bank Limited
10	Car & General (K) Limited
11	CMC Holdings Limited
12	Crown Berger Limited
13	Diamond Trust Kenya Limited
14	Dunlop Kenya Limited
15	E A Cables Limited
16	E A Portland Cement Limited
17	East African Breweries Limited
18	Firestone (EA) Limited
19	Housing Finance Co. Limited
20	ICDC Investments Limited
21	Jubilee Insurance Limited
22	Kakuzi Limited
23	Kenya Airways Limited
24	Kenya Commercial Bank Limited
25	Kenya National Mills Limited
26	Kenya Oil Company Limited
27	Kenya Power & Lighting Co. Limited
28	Marshalls E A Ltd
29	Mumias Sugar Company Limited
30	Nation Media Group Limited
31	National Bank of Kenya Limited
32	NIC Bank Limited
33	Pan African Insurance Co. Ltd.
34	Rea Vipingo Plantations
35	Sasini Tea & Coffee Ltd.
36	Standard Chartered Bank
37	Total Kenya Limited
38	Uchumi Super Markets Limited

ALTERNATIVE INVESTMENT MARKET SEGMENT

No.	Company
40	A Baumann & Co. Limited
41	Cititrust
42	E A Packaging Industries Limited
43	Eagaads Limited
44	Express Kenya Limited
45	Kapchorua Tea Company Limited
46	Kenya Orchards Limited
47	Limuru Tea Co. Limited
48	Standard Newspapers Limited
49	George Willamson Kenya Limited

FIXED INCOME SECURITIES MARKET SEGMENT

No.	Company
50	Safaricom Limited
51	Kenya Hotels Limited
52	East African Development Bank
53	Shelter Afrique

Source: Nairobi Stock Exchange

Appendix III

Companies that were continuously listed at the Nairobi Stock Exchange from January 1, 1997 to December 31, 2001 that composed the sample:

MAIN INVESTMENT MARKET SEGMENT

Athi River Mining Limited
B O C Kenya Limited
Bamburi Cement Limited
Barclays Bank of Kenya Limited
BAT Kenya Limited
Brooke Bond Limited
Carbacid Investments Limited
CFC Bank Limited
Car & General (K) Limited
CMC Holdings Limited
Crown Berger Limited
Diamond Trust Kenya Limited
Dunlop Kenya Limited
E A Cables Limited
E A Portland Cement Limited
East African Breweries Limited
Firestone (EA) Limited
Housing Finance Co. Limited
ICDC Investments Limited
Jubilee Insurance Limited
Kakuzi Limited
Kenya Airways Limited
Kenya Commercial Bank Limited
Kenya National Mills Limited
Kenya Oil Company Limited
Kenya Power & Lighting Co. Limited
Marshalls E A Limited
Nation Media Group Limited
National Bank of Kenya limite
NIC Bank Limited
Pan African Insurance Co. Lim
Rea Vipingo Plantations
Sasini Tea & Coffee Limited
Standard Chartered Bank
Total Kenya Limited
Uchumi Super Markets Limite
Unga Group Limited

ALTERNATIVE INVESTMENT MARKET SEGMENT

A Baumann & Co. Limited
Cititrust Limited
E A Packaging Industries Limited
Eagaads Limited
Express Kenya Limited
Kapchorua Tea Company Limited
Kenya Orchards Limited
Limuru Tea Co. Limited
Standard Newspapers Limited
George Williamson Kenya Limited

FIXED INCOME SECURITIES MARKET SEGMENT

Safaricom Limited
Kenya Hotels Limited

Source: Nairobi Stock Exchange

Appendix IV

LISTED COMPANIES IN THE SAMPLE THAT RESPONDED TO THE QUESTIONAIRRE

Company	Sector	Audit Committee	Year Established
B A T Kenya Limited	I	Yes	1980
B O C Kenya Limited	I	Yes	1996
Barclays Bank of Kenya	F	Yes	1996
CFC Bank Limited	F	Yes	1997
Nation Media Group Ltd	C	Yes	1997
NIC Bank Ltd	F	Yes	1997
Tourist Promotion Services	C	Yes	1997
Carbacid Investments Ltd.	I	Yes	1998
Diamond Trust Kenya Ltd.	F	Yes	1998
East African Breweries Ltd.	I	Yes	1998
Housing Finance Co. Ltd	F	Yes	1998
Kenya Airways Ltd	C	Yes	1998
Marshalls E A Ltd	I	Yes	1998
Athi River Mining Ltd	I	Yes	1999
Bamburi Cement Limited	I	Yes	1999
ICDC Investments Ltd	F	Yes	1999
Jubilee Insurance Ltd	F	Yes	1999
Rea Vipingo Plantations	A	Yes	1999
Standard Chartered Bank	F	Yes	1999
George Williamson (K) Ltd	A	Yes	1999
Car & General (K) Ltd.	C	Yes	2000
E A Cables Ltd	I	Yes	2000
Kakuzi Limited	A	Yes	2000
Pan African Insurance Co.	F	Yes	2000
CMC Holdings Limited	C	Yes	2001
Express Kenya Ltd	C	Yes	2001
Total Kenya Limited	I	No	-
A. Baumann & Co. Ltd.	C	No	-
Cititrust Ltd	F	No	-
E A Packaging Industries	I	No	-

Sectors

A Agriculture

C Commercial & Services

F Financials

I Industrial & Allied

Source: ***Questionnaire on audit committees in listed companies in Kenya***