

AUDIT COMMITTEES AND CORPORATE GOVERNANCE IN KENYA.

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**A RESEARCH PROJECT SUBMITTED TO THE DEPARTMENT OF
ACCOUNTING, FACULTY OF COMMERCE, UNIVERSITY OF NAIROBI, IN
PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE DEGREE OF
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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 Lilian, Ann, Cynthia and Sam, for their understanding and encouragement.

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ABSTRACT

Market regulators, commissions and accountancy bodies have all recommended the establishment of audit committees as an important step in improving corporate governance. Audit committees comprising of independent non- executive directors assist the board, in fulfilling its responsibility to the shareholders and investing public by enhancing the quality of financial reports and disclosures. However, there is little empirical evidence as to whether audit committees really add any value to the organizations that establish them.

This study, therefore, set out to examine the role of audit committees in corporate governance in Kenya. The objectives of the study were to examine how audit committees in Kenya operate, how the committees relate to management, internal audit and the external auditors, their major achievements and challenges and why some listed companies had not established audit committees.

Primary data was collected via a questionnaire. The population comprised all the 48 companies listed at the NSE. Twenty-nine responses were received representing 60 percent of the population. Personal interview was used on 28 percent of the respondents while 72 percent were dropped and picked later. Secondary data was collected from the annual reports of the respondents for the year ended December 2004. The data was analyzed using frequencies, percentages and means.

From the analysis 93 percent of the companies have established audit committees with non-executive directors, they have written charters and have on average 4.3 directors. The committees meet on average 3.8 times in a year and each meeting lasts 2.2 hours on average. The audit committees generally have a cordial relationship with the management, internal audit and the external auditors with 100 percent of the respondents indicating that the relationship is positive to a large extent. The major achievement was given as enhancing the independence of the internal audit function and ensuring that its recommendations are implemented. Only two respondents indicated that they had not established audit committees. The major reason given was frequent changes management.

CHAPTER I: INTRODUCTION

1.1: Background of the study

The modern public corporation is a relatively new organizational form in the history of societies, dating back to the beginning of nineteenth century. Its distinguishing characteristic is the separation of ownership of the assets of the corporation from control of those assets. While ownership of the assets is vested in the shareholders of the corporation, control over these assets is vested in the hands of professional managers of the corporation. Hence managers take actions whose consequences are largely carried by the shareholders of the corporation (Moldoveanu 2001). Moldoveanu (2001) argued that there are two kinds of managerial failures that keep the managers from acting as perfect agents of the shareholders:

- i) Failures of managerial competence (genuine mistakes and miscalculations) relating to unwitting mistake in the discharge of managerial control;
- ii) Failures of managerial integrity (lies, fabrication, embezzlement and self-dealing) relating to willful behavior on the part of managers that negatively impact the value of the firm's assets.

This is what is called the agency problem and is discussed in the following section.

1.2: Agency problem

Jensen and Meckling (1976) defined an agency relationship as a contract under which one or more persons the (principals) engage another person (the agent) to perform some service on their behalf, which involves delegating some decision-making authority to the agent. The shareholders, or the principals, delegate the day-to-day decision making to the managers or agents. Managers are charged with using and controlling the economic resources of the firm. However, managers may not always act in the best interest of the shareholders due partly to adverse selection and moral hazard. Shareholders must therefore monitor managers to ensure they live up to the provisions of their contracts (Goddard et al 2000).

Power (2002) argued that agency theory is based on the notion that the delegation of material responsibilities by principal (owners) to professional managers requires the presence of mechanisms that either align the interests of principals and agents or monitor the performance of managers to ensure that they use their knowledge and the firms resources to generate the highest possible return for the principal. More specifically the agency theory suggests that the best option for owners is to design contracts that align manager /owner interest. Agency theory is concerned with aligning the interest of owners and managers and is based on the premise that there is an inherent conflict between a firm owner and its management.

To guard against management failures, Moldoveanu (2001) argued that shareholders should enact ratification, monitoring and sanctioning (reward and punishment) mechanism. He defined ratification mechanisms as mechanisms for validating the decisions of the agent, of giving final approval or veto for an initiative or directive or actionable plan of the agent. Monitoring mechanisms are designed for observing, recording and measuring the output of the efforts and strivings of the agent. Sanctioning mechanisms are designed for providing selective rewards and punishment to the agents for the purpose of motivating them to exert effort in directions that are aligned with the interests of the shareholders.

Power (2002) argued that the primary means of monitoring is via the annual accounts whose reliability is enhanced by the audit report. However, accounts may be inadequate for monitoring purpose due to information asymmetry. Managers who have more information than the shareholders or auditors produce the accounts and they may be unwilling to disclose private information for fear that it may be used against them. The nature of the audit is such that omissions or distortions may not be detected or reported to shareholders. In addition monitoring involves costs, which the shareholders may be unwilling to bear. To monitor management, shareholders have traditionally relied on the board of directors and audit committees.

1.3: Boards of directors and audit committees

The shareholders use the board of directors as one of the mechanisms of monitoring management. The management is accountable to the board and the board is in turn accountable to the

shareholders. A key element of board oversight working is to ensure that quality accounting policies, internal controls, and independent and objective outside auditors are in place to deter fraud, anticipate financial risks, and promote accurate high quality and timely disclosure of financial and other material information to the board, to the public market and to the shareholders.

Corporate failures and scandals have increased the visibility of the board of directors and led to the demand for reforms. One of the reform that has been endorsed by professional bodies e.g. American Institute of Certified Public Accountants (AICPA) and capital markets and major stock exchanges e.g. New York Stock Exchange is the requirement that boards of directors establish audit committees. In the U.K, the collapse of the Maxwell business empire in the 1990's stimulated discussions and debate about structures for controlling executive power (Power 2002). As a result, the Cadbury committee was constituted and one of its recommendations was that companies should establish audit committees. Power (2002) argued that as sub-committees independent from executive management, they would provide the natural reporting constituency for internal and external auditors. The Cadbury Code was later adopted by the UK stock exchange as a condition of registration and the public sector implication have been widely debated (Power 2002).

In the U.S.A an increasing number of earnings restatements by publicly traded companies coupled with allegations of financial statements fraud and lack of responsible corporate governance of high profile companies (e.g. Enron, Global crossing, World com) has sharpened the ever increasing attention on corporate governance in general and audit committees in particular. The collapse of the above companies has raised concerns regarding the lack of vigilant oversight functions of their boards of directors and audit committees in effectively overseeing financial reporting process and auditing functions (Zabihollah 2003). A number of commissions and committees have been established to address the corporate governance issue in the USA. These include the Treadaway Commission, Blue Ribbon Commission etc. The Sarbanes-Oxely act of 2002 was signed into law and one of its major provisions is that listed companies establish audit committees.

In Kenya, the Private Sector Corporate Governance Trust (PSCGT) first recommended the establishment of audit committees. The PSCGT (2000) code recommends that companies should establish audit committees composed of independent non-executive directors to keep under review

the scope and results of audit, its effectiveness and the independence and objectivity of the auditors. The code stated that a separate audit committee would enable the board to delegate to a sub-committee the responsibility for a thorough and detailed review of audit matters, thus enabling the non-executive directors to contribute independent judgment and play a positive role in an area for which they are particularly fitted and offer the auditors a direct link with the non-executive directors. The appointment of a properly constituted audit committee is therefore considered to be an important step in raising standards of corporate governance (PSCGT 2000).

The Capital Market Authority (CMA) also issued guidelines on corporate governance practices for publicly listed companies in Kenya in 2002. One of the guidelines requires the boards to establish audit committees of at least three independent and non-executive directors who shall report to the boards, with written terms of reference, which deal clearly with authority and duties. The chairmen of the audit committees should be independent and non-executive directors. The boards should disclose in their annual reports whether they have audit committees and the mandate of such committees (CMA 2002). Through legal notice No 60, of 2002, CMA directed that every listed company should establish an audit committee that complies with guidelines on corporate governance issued by the authority.

The establishment of an audit committee is, however, not a panacea for all corporate governance problems. As Pomeranz (1997) stated, it is a well-known fact that the mere labeling of a group of directors "audit committee" will not by itself create an effective monitoring committee. In this demanding environment, it is important for audit committee to focus on the process that supports effective oversight. This goes beyond mere compliance with the rules for compliance sake and requires careful consideration of an audit committee's framework that facilitates the coordination of the activities and information needed to support the committee's understanding, and monitoring of the company's financial reporting process (KPMG 1999).

There is growing research literature concerned with audit committees. Opinions on the usefulness of audit committees are mixed. Binder (1994) in a research cited by Guy (2001) found that only 15% of executive directors of FTSE 100 companies believed audit committees were vital in order to achieve sound corporate governance. A further 7% saw them as helpful, leaving the remaining

78% unconvinced about their value. However, 89% of non-executive directors employed by FTSE100 companies believed audit committees were vital or helpful. This accords with agency theory, as the principals appear to favor audit committees whereas the agents do not. Another study by Menon et al (1994) cited by Guy (2001) investigated whether the companies relied on their audit committees. They found out that although companies voluntarily formed audit committees, they did not appear to rely on them, implying that the audit committees were formed for other purposes. However, audit committees appear to be used more in larger firms and where there are a higher proportion of non-executive directors.

1.4: Statement of the problem

There is a role for an intermediary between managers, auditors, and shareholders. Goddard (2000) suggested that non-executive directors can act as arbiters in disagreements among internal managers and carry out tasks that involve serious agency problem between internal managers and residual claimants. The independent non-executive directors, without day-to-day responsibilities, are in a good position to perform a monitoring function. However, appointing non-executive directors without clearly defining their role and duties may be self-defeating. Formation of an audit committee can establish a framework for the non-executive director to work within.

A number of surveys and empirical tests have been carried out on the functioning and role of audit committees in various countries. For example, in Canada, Maingant and Zeghal (2000), quoted by Joshi (2004), investigated the motives, composition, selection, and frequency of audit committees meetings, audit committee's relationship with internal and external auditors and its broader role. In the USA, a study by Abbot et al (2002) addressed the impact of certain audit committee characteristics identified by the Blue Ribbon Committee on improving the effectiveness of corporate audit committee on the likelihood of financial misstatement (Braiotta 1999)

In Kenya, several studies have been carried out in the area of corporate governance. For example, Jebet (2001) examined governance practices of quoted companies; Mwangi (2002) examined governance practices in the insurance industry while Mucuvi (2002), examined governance in the motor vehicle industry. In 2003, Gakuo (2003) and Wang'ombe (2003) examined governance

practices among the NGOS in Nairobi and in co-operative societies respectively. Mwangi (2004) looked at factors influencing board composition. A study by Hussein (2003) examined the charter, composition, frequency of meetings, and effectiveness of audit committees. The study, however, only examined whether the audit committees complied with CMA guidelines. Goddard (2000) stated that audit committees have become more important and prevalent in recent years but there is a relative paucity of empirical research concerning their value. Kalbers and Fogarty (1993), in a research cited by Pomeranz (1997) indicated that the issue of whether audit committees are actually discharging their important responsibility remains insufficiently understood. There was need, therefore, for a study to be carried out to examine whether the way audit committees operated was conducive for them to discharge their responsibilities and improve corporate governance in Kenya.

1.5: Objective of the study

1.5.1: General objectives

This study examined the practices of audit committees in terms of their composition, membership, independence, meetings, charter and guidelines, achievements and challenges. It also examined the relationship of the audit committees and management, internal audit and external auditor. For companies that have not established their audit committees, the study examined why they had failed to do so.

1.5.2: Research questions

The study addressed the following questions:

- i) How do audit committees in Kenya operate?
- ii) How do the audit committees relate to management, internal audit, and external auditors?
- iii) What are the major achievements and challenges of audit committees in Kenya?
- iv) Why have some listed companies failed to establish audit committees?

1.6: Relevance of the study

This study is important to:

- The investors and general public

Investor and general public sensitization on the rights of 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 role of audit committees. The investors will demand international standards of good corporate governance and the company should strive to meet them. Audit committees are representatives of the shareholders and therefore their independence and effectiveness are of major importance to the investors and the general public.

- **The regulators (CMA)**

The regulator must ensure that the management systems within every organization are has adequate internal controls to promote accountability and transparency. This promotes investor confidence and attracts capital flow. 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 reporting process. Audit committees facilitate the regulator's task of surveillance and supervision.

- **Academicians and researchers**

Sensitization on the importance and effectiveness of corporate governance and audit committee is important to them. They are interested in establishing whether audit committees add value to the financial reporting system of an organization.

1.7 Chapter summary

Corporations have become very significant to the economies of the countries in which they operate. The health of these corporations is of concern not only to the shareholders but also to the governments and the general public. Over the past two decades there has been an evolutionary process in the development of the role and responsibilities of audit committees. Their role has evolved into independent oversight responsibility for the audit and financial reporting process. Zabihollah (2003) argues that to effectively fulfill its oversight function the audit committee should be independent, competent, and financially literate, with adequate resources and properly compensated

CHAPTER 2: LITERATURE REVIEW

2.1: Introduction

This chapter sets to give a detailed review of related literature. Attempts at improving corporate governance led to recommendations for the establishment of audit committees and therefore the chapter starts by examining the concept of corporate governance. It also goes on to detail the historical developments of audit committees, how they should operate, their major achievements and challenges.

2.2: Corporate Governance

Vinten (1998) stated that corporate governance is not a new issue. It dates back to when incorporation with limited liability became available in the nineteenth century, with the need for legislation and regulation. Recent debate has however, focused on more specific concerns. These revolve around the accountability of those in control of companies to those with residual financial interest in corporate success, normally the shareholders, but when the company is approaching insolvency, then its creditors as well, become interested stakeholders.

There has been extensive discussion of corporate governance during the 1990's but views differ on what it is and how it might be improved. The Private Sector Corporate Governance Trust (2000) defined corporate governance as the manner in which the power of a corporation is exercised in the stewardship of the corporations total portfolio of assets and resources with the objective of maintaining and increasing shareholders value and satisfaction of other stakeholders in the context of its corporate mission. Capital market Authority (CMA) 2002 defined 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. The CMA guidelines also defined corporate governance as the establishment of an appropriate legal economic and institutional environment that allows companies to thrive as institutions for advancing long-term shareholders value and maximum human- centered development, while remaining conscious of their other responsibilities to stakeholders, the environment and society in general.

Power (2002) argued that governance concerns the effectiveness of market-based controls, in the sense of the ability of an active takeover market to discipline managers into maximizing a firm's value. The most basic view of corporate governance is that the market will reward well-governed companies and penalize poorly governed ones. Equally it relates to the effectiveness of regulatory initiatives to penetrate the organization and ensure compliance with rules via specifically designed procedures, officers, audit committees, and other representatives. Power (2002) also stated that governance is an intra-organizational issue of control and motivation in which working practices must be made more sensitive to customers, more outward looking in orientation and in which systems of control require constant vigilance and improvement.

Zabihollah (2003) stated that good corporate governance promotes relationships of accountability among the primary corporate participants to enhance corporate performance. It holds management accountable to the board and the board accountable to shareholders. A key element of board oversight working is to ensure that quality accounting policies, internal controls, and independent and objective outside auditors are in place to deter fraud, anticipate financial risks, and promote accurate high quality and timely disclosure of financial and other material information to the board, to the public market and to the shareholders.

Corporate failure and scandals have led to demand for reforms and for better regulations particularly in the field corporate governance. In the UK a number of issues in the early 1990's most notably the collapse of the Maxwell business empire, stimulated discussions and debate about structures for controlling executive power (Power 2002). A code of best practice was developed by a committee chaired by Sir Adrian Cadbury, 'the Cadbury Code'. The original code was published in December 1992 and included recommendations for companies to establish formally audit committees with internally independent non- executive directors (Power 2002). Power (2002) argued that as sub-committees independent from executive management, they would provide the natural reporting constituency for internal and external auditors. The Cadbury Code was later adopted by the UK stock exchange as a condition of registration, and the public sector implications have been widely debated (Power 2002).

In the U.S.A an increasing number earnings restatements by publicly traded companies coupled with allegations of financial statements fraud and lack of responsible corporate governance of high profile companies (e.g. Enron, Global crossing, World com) has sharpened the ever increasing attention on corporate governance in general and audit committees in particular. The fall of the above companies has raised concerns regarding the lack of vigilant oversight functions of their boards of directors and audit committees in effectively overseeing financial reporting process and auditing functions (Zabihollah 2003). President George W. Bush, in a state of the union address, mentioned the seriousness of the corporate governance problem by saying that: *'Through stricter accounting standards and tougher disclosure requirements corporate America must be made accountable to employees and shareholders and held to the highest standards of conduct'* (Zabihollah 2003). A number of commissions and committees have been established to address the corporate governance issue in the USA, which includes the Treadaway Commission, Blue Ribbon Commission etc. The Sarbanes-Oxely act of 2002 was signed into law and one of its major provisions was that listed companies establish audit committees.

In Kenya, corporate governance has been addressed from two fronts. The Private Sector Corporate Governance Trust (PSCGT) in conjunction with the Commonwealth Association for Corporate Governance produced a sample code of best practice for corporate governance in June 2000 (PSCGT 2000). One of the key recommendations in the PSCGT (2000) code was that companies establish audit committees composed of independent non-executive directors to keep under review the scope and results of audit, its effectiveness and the independence and objectivity of the auditors. The code states that a separate audit committee enables the board to delegate to a sub-committee the responsibility for a thorough and detailed review of audit matters, enables the non-executive directors to contribute independent judgement and play a positive role in an area for which they are particularly fitted and offer the auditors a direct link with the non-executive directors. The appointment of properly constituted audit committees is therefore considered to be an important step in raising standards of corporate governance (PSCGT 2000).

The Capital Market Authority (CMA) also issued guidelines on corporate governance practices by public listed companies in Kenya in 2002. One of the guidelines stated that the board should establish an audit committee of at least three independent and non-executive directors who should

report to the board, with written terms of reference, which deal clearly with authority and duties. The chairman of the audit committee should be an independent and non-executive director. The board should disclose in its annual reports whether it has an audit committee and the mandate of such committee (CMA 2002). Through legal notice No 60, 2002, CMA directed that every listed company should establish an audit committee and comply with guidelines on corporate governance issued by the authority.

2.3: Historical development of audit committees

The Sarbanes-Oxley Act of 2002 defined an audit committee as a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer. Pomeranz (1997) stated that the audit committee represents a standing committee of the board of directors that is charged with dealing with audit related concerns. The Accountants International Study Group (1977) cited by Goddard (2000) defined an audit committee as a committee of directors of a corporation whose specific responsibility is to review the annual financial statements before submission to the board of directors. The committee generally acts as a liaison between the auditor and the board of directors.

Audit committees were first publicly endorsed in 1940 in the aftermath of the McKesson & Robbins (1939) scandal in the USA, when both the Securities and Exchange Commission (SEC) and the New York Stock Exchange (NYSE) advocated their creation (Attwood 1986). The NYSE issued recommendations, which stated, "where applicable, the selection of the auditor by a special committee of the board appears desirable" (Braiotta 1999). Although the term audit committee was not mentioned as such, several companies, for example, General Motors, established audit committees as a result of the McKesson and Robbins scandal. This scandal alerted the corporate community and the accounting profession that appointment of an audit committee by the board of directors should be recognized as an important action.

Until 1967 the concept of the audit committee received little support, and the functions of this committees remained undefined (Braiotta 1999). In July 1967 the executive committee of the

American Institute of Certified Public Accountants (AICPA) recommended that publicly held corporations establish audit committees of members outside the board of directors. External auditors started communicating with the audit committees whenever any significant question having material bearing on the company's financial statements had not been satisfactorily resolved at the management level (Braiotta 1999).

Braiotta (1999) goes on to state that during the 1970's the role and responsibilities of audit committees in the U.S received a great deal of attention because of the post-Watergate discoveries of illegal political contributions and overseas bribes. Thus the investing public demanded greater corporate accountability to increase the confidence in the quality of financial reporting. In view of the separation of ownership and management, shareholders and other constituencies needed more assurance with respect to both internal and external auditing processes and the financial reporting process.

In response to those demands, SEC in 1972, issued Accounting Series Release number 123 'Standing audit committees composed of outside directors', which stated in part: the SEC endorses the establishment by all publicly held companies of audit committees composed of outside directors. SEC urged the business and financial communities and all shareholders of such publicly held companies to lend their full and continuing support to the effective implementations of the recommendations in order to assist in affording the greatest possible protection to investors who rely upon such financial statements (Braiotta 1999).

In 1974 the SEC issued Accounting Series Release (ASR) number 165 which stated that disclosure is required of the existence and composition of the audit committee of the board of directors. The release also stated that the commission had already expressed its judgement that audit committees made up of outside directors have significant benefits for the company and its shareholders. The disclosure would make the shareholders aware of the existence and composition of the audit committee and if no audit or similar committee exists, the disclosure of that fact was expected to highlight its absence (Braiotta 1999).

While the SEC issued the directive in ASR No 165, the NYSE made the first official mandatory recognition of the need for an audit committee when it issued an audit committee policy statement. The policy statement stated that each domestic company with common stock listed on the exchange, as a condition of listing and continued listing of its securities on the exchange shall establish no later than June 30, 1978, and maintain thereafter an audit committee, composed solely of directors independent of management and free of any relationship that, in the opinion of the board of directors, would interfere with the exercise of independent judgement as a committee member. Directors who are affiliates of the company or its subsidiaries would not be qualified for audit committee membership (Braiotta 1999).

In addition to the aforementioned events, there were a series of court actions with respect to the establishment of audit committees. For example in Penn Central case cited in Braiotta (1999), the SEC emphasized the critical importance of the directors' responsibility as well as 'greater utilization of public and independent directors'. In the Mattel case, the SEC sought a consent injunction against the registrant for false financial reporting. As a result a court order was issued requiring Mattel to establish and maintain an audit committee.

Similarly, a US District court ordered Lum's Inc to establish a standing audit committee because the registrant was charged with proxy fraud in connection with future acquisition of business. Finally, in the Killearn Properties case, the court ordered the establishment of an audit committee because the registrant failed to provide a prospectus in accordance with the securities laws. In this particular case, the court outlined the specific functions for the committee, which included, a review of independent audit engagement, internal accounting controls, the internal audit function, the code of conduct, all public releases of financial information and the activities of the officers and directors. There is no doubt that the court actions provided a framework for the functions of audit committees and the question of what constitutes proper standards and practices for these committees was emerging through court settlement (Braiotta 1999).

The establishment of an audit committee is, however, not a panacea for all corporate governance problems. As Pomeranz (1997) stated, it is a well-known fact that the mere labeling of a group of

directors "audit committee" will not by itself create an effective monitoring committee. In this demanding environment, it is important for audit committees to focus on the process that supports effective oversight. This goes beyond mere compliance with the rules, requires careful consideration of an audit committee framework that facilitates the coordination of the activities and information needed to support the committee's understanding, and monitoring of the company's financial reporting process (KPMG 1999). Over the past few years, investors, regulators, corporate boards, and executives have debated on how corporations should be governed. Out of the controversy, a number of reports of corporate governance principles were issued with particular emphasis on the proper role of the audit committees.

The Treadway Report (Treadway Commission 1987) was the first such report issued in October 1987. It identified corporate governance principles that would significantly reduce the potential for fraudulent financial reporting. This report was the first formal document on audit committee responsibilities, and set standards of best practice rather than common practice. The major recommendations were that audit committees should have charters specifying members' responsibilities and only independent directors should serve on the committees. The Cadbury Committee of 1992 in the UK also made similar recommendations.

"The Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees" (1999) formed by SEC, urged all companies regardless of their size to make a good faith attempt to follow its recommendations in improving the audit committees' functions. The Blue Ribbon Committee (BRC) report included ten recommendations and five guiding principles for improving the performance of audit committees that should ultimately result in better corporate governance.

2.4: Functions of audit committees

Audit committees should have responsibilities tailor made for their organization. However, the primary function of the audit committees is to assist the board in fulfilling its oversight responsibilities by reviewing the financial information that will be provided to the shareholders and others, the systems of internal controls, which management and the board of directors have

established, and all audit processes (Bean 1999). Bean (1999) outlined the general responsibilities as:

- i. The audit committee provides open avenues of communication among internal auditors, the independent auditor and the board of directors.
- ii. The audit committee must report actions to the full board of directors and make appropriate recommendations.
- iii. The audit committee has the power to conduct or authorize investigations into matters within the committee's scope of responsibilities. The committee is authorized to retain independent counsel, accountants or others if needed to assist in an investigation.

Several studies have been undertaken on the audit committees' oversight responsibilities. In general, the findings indicated a lot of variations in both perceived and stated responsibilities. Cooper and Lybrand (1995), DeZoort (1997) found that audit committee responsibilities revolved mainly in the areas of financial reporting, auditing and overall corporate governance. Kalblers and Fogarty (1993) found that the responsibilities of audit committee included oversight of financial reporting, external auditor and internal controls.

2.5: Committee Charter

Pomeranz (1997) defined a charter as a formal statement of the charge, designed to acknowledge the existence of the audit committee in the corporate by laws. Guy (2001) argued that every company that has an audit committee should develop a tailor made charter for the committee. The board should approve the charter, and it serves as a guide to the audit committee in carrying out the responsibilities delegated to it by the full board.

As a prerequisite for the effective performance of the audit committee, Braiotta (1999) stated that the board of directors should either pass a formal resolution or amend the by-laws of the corporation in order to document the establishment of the committee. Bean (1999) argued that a comprehensive charter enhances the effectiveness of the audit committee, serving as a roadmap for committee members. A well thought out charter should be tailor made for the company, describe the committee's composition, and specify access to appropriate resources. Bean (1999)

also argued that a good audit committee charter organizes committee members' responsibilities, providing a systematic structure for discussions between the committee and management, the public accountant and others. Using the charter as a checklist focuses an audit committee's efforts and makes it much more effective than it otherwise might have been. KPMG (1999) stated that the audit committee charter has become an increasingly important document for helping members to focus on their specific responsibilities and also to help shareholders to evaluate the role and responsibilities of the audit committees.

The audit committee is responsible to the rest of the board and the shareholders, and its charter details what the shareholders reasonably can expect the committee members to do. Nonetheless, even though a good charter exists and the audit committee faithfully discharges the duties described by it, changing conditions can make a periodic review and update advisable. Thus, Bean (1999) stated that the best audit committee charters are living, changing documents.

2.6: Independence and financial literacy of audit committee members

One of the most important variables in the composition of an audit committee is the question of independence (Joshi 2004). Braiotta (1999) stated that the effectiveness of the audit committee depends on the background of the members and of the chairman. He argued that the membership of the audit committee should consist of both financial and non-financial people so that the committee can draw upon members from various professionals such as accounting, economics, education, psychology, and sociology. Equally important, Braiotta (1999) stated that the chairman has a critical role in coordinating the committee's tasks. The success or failure of the operation could depend on the chairman and therefore such a person should be chosen with great care. Although there is general consensus regarding the size of audit committees, obviously, the number of members will vary from corporation to corporation. The number of members depends not only on the committee's responsibilities and authority, but also on the size of the board of directors and the company (Braiotta 1999)

Bean (1999) argued that only independent directors should serve on the audit committees. The Blue Ribbon Committee also recommends that only independent directors should serve on the

audit committees, a recommendation that was adopted in Kenya by the Capital Markets Authority (CMA 2002). However, Attwood (1986) argued that the composition of the audit committee would depend on the circumstances of the particular company. Bean (1999) described an independent director as one who is free of any relationship that could influence his or her judgement as a committee member. An independent director may not be associated with a major vendor to, or a customer of, the company. When there is doubt about independence, Bean (1999) advised that the director should excuse himself from any discussions that might be influenced by that relationship. Pomeranz (1997) stated that there is concerns as to what constituted independence on the part of an audit committee member. He argued that a further decision needs to be made as to whether emphasis should be placed on independence in fact rather than on independence on appearance.

Herdman (2002) argued that because the road to becoming an audit committee member begins with the nomination process, independent parties, not the CEO/chairman, should be responsible for nominating members of the audit committee. Herdman (2002), quoting former SEC chairman Rodhills, argued that an ineffective audit committee should be considered a material weakness in internal controls, and that a prerequisite to effectiveness is the total independence of the members of the committee, including the nomination process.

Tackett (2004) stated that although the audit committee represents the interests of stockholders, current procedures make it difficult for an individual stockholder to become a candidate for the board of directors without the blessings of corporate management. He also stated that under normal circumstances, senior management or other directors nominate board candidates. Management fully recognizes the power implications of selecting board candidates who will be sympathetic to their needs. The result, Tackett (2004) argued, is often a board whose composition is biased towards the interests of management instead of the stockholders. If senior management can control the composition of the board of directors, then they also control the composition of the audit committees, which erodes their independence.

In addition to independence, audit committee members are required to be financially literate. The Blue Ribbon Committee recommends that all members of the audit committee need to be financially literate. Zabihollah (2003) defined financial literacy as the ability to read and understand

fundamental financial statements including balance sheet, income statements, and cash flow statements. To be an "audit committee financial expert," an audit committee member must have an understanding of economic and accounting principles, comprehend how financial reporting choices and accounting policies can affect a company's financial reports, and possess an understanding of internal controls and procedures. The issue is whether one 'financial expert' is sufficient on an audit committee to understand the nature and impact of complex business transactions such as derivative financial instruments, related party transaction etc. The requirement that only one audit committee member be a financial expert may not be adequate to fulfil effectively the financial oversight function of the audit committee.

Jonathan (2001) stated that it is yet to be seen the level at which this financial literacy will finally settle and whether there are enough people who, making the grade, are willing to be members of an audit committee. Jonathan (2001) also wondered whether in a world of ever more complicated accounting standards, which even fully trained accountants can struggle to understand, if this is a completely realistic and necessary requirement for audit committee members. However, Herdman (2002) questioned whether the capital markets requirement about financial literacy of audit committee members went far enough.

Some studies have been carried out in the area of experience and expertise. For example, a study by Gao (1991) cited by Joshi (2004) found that approximately half of the 40 surveyed audit committee chairs from large US banks perceived that their audit committees had no members with expertise in assigned accounting, auditing, banking and law oversight domains.

2.7: Meetings and Agenda

Attwood (1986) stated that in practice the timing of meetings of audit committee needs to be scheduled well in advance in order to fit in with what is normally a very tight timetable for the production of the company's interim and final accounts. Likewise the audit committee may want to plan meetings with different departments and subsidiaries, so that over a period of years it covers the whole of the areas included in the terms of reference. Guy (2001) stated that most audit committees today have two to four scheduled meetings per year depending on the scope of their

activities and the size of the company. Graziano (2004) differed with Guy and stated that audit committees are meeting more frequently -both formally and informally. Formal meetings are held at least four, and sometimes up to twelve times per year. Typically, four of the meetings are in person, last about three to four hours and include senior management, external audit and internal auditor (Graziano 2004). Adequate time should be allowed at each meeting so that the agenda can be covered in a professional and complete manner. In addition to scheduled meetings, the audit committee must have authority to hold special meetings as needed (Guy 2001).

Herdman (2002) stated that audit committee members must make the time, and take the time, to achieve an adequate understanding of the company's financial reports, to have time to consult with outside counsel and experts if necessary, to ask the tough and incisive questions, and to obtain answers that make sense. As such Herdman (2002) argued that an effective audit committee requires a commitment of quality and quantity time to allow thorough deliberations and discussions. This means that proper up-front planning, conduct of meetings and follow-up is essential.

Research studies involving meeting frequencies of audit committees and company variables have created some interest. Menon and Williams (1994) in a study cited by Joshi (2004) examined 200 companies and found that the number of audit committee meetings increased as the percentage of outside directors increased. Meeting frequency was positively associated with company's size, monitoring and need of audit committee meetings. In its survey of audit committees, PriceWaterHouseCoopers (1999) found that audit committees among European companies met on average three to four times a year.

The chairperson of the audit committee should prepare the meeting agenda. The chairperson, working with the chief finance officer, the audit manager, and the general counsel, along with input from external auditor, should prepare detailed agenda with topic and time allocations to help keep the committee focused. The chairperson should circulate proposed audit committee's agenda to all committee members to obtain their inputs about topics that should be added. Under no circumstances should management alone prepare the audit committee's agenda. Meeting agenda and related materials should be distributed to committee members in advance of scheduled meetings (Guy 2001)

Attwood (1986) stated that audit committees would find it most useful to keep minutes of its meetings. However, he argued that discussions between the audit committees and senior directors and managers might be inhibited if it takes place in the knowledge that the matters raised will be minuted and those minutes circulated. There is also the problem of finding an individual of sufficient seniority and confidentiality to do the minute-taking. Attwood (1986) stated that it is important for the audit committee to decide on the extent to which its minutes are circulated beyond its own membership. Above all, minutes are useful in order to ensure that there is a proper follow-up of the matters on which the audit committee decides that action is needed.

The audit committee's report is the basis for reporting on the board of directors' charge to the committee. The report should be addressed to the full board of directors and explain their findings and recommendations concerning primarily the overall effectiveness of both the internal and external auditing functions and other areas within the original jurisdiction as defined in the charter. In addition, the report should be based on their participation in the audit planning process as well as their monitoring activities (Braiotta 1999).

2.8: Self-evaluation

AICPA (2004) recommended that an audit committee should conduct a comprehensive self-evaluation on an annual basis. The self-evaluation can take different forms, involve a number of participants, and use diverse techniques. Most important, however, the self-evaluation should adopt a straightforward approach that will aid the audit committee in reassessing its strength and weaknesses and lay a foundation for future improvement. It is important that the audit committee evaluate its performance by asking specific questions about the impact it has had on the organization, most importantly, in its financial reporting process, the annual audit, the relationship with the independent auditor, and members of management. The audit committee should include the chair of the board in the evaluation session and ask for his/her input. The evaluation should be comprehensive and should involve all audit committee members and the committee chair. The chair should consider the result of the audit committee member's evaluation of each other in the context of the chair's evaluation of the members. The chair should consider whether any member

should be rotated off the committee, and this should be done in consultation with the chair of the board. The member's attendance records and level of participation should be considered during this process.

2.9: Relationship with management, internal auditor and external auditor

The Blue Ribbon Committee (1999) stated that quality financial reporting can only be achieved through open and candid communication and close working relationships among the company's board of directors, audit committee, management, internal auditors and the external auditors. The success of audit committees in fulfilling their oversight responsibilities depends on their working relationships with other participants of corporate governance.

Zabihollah (2003) stated that the more effective approach is the audit committee to work diligently with management and auditors to identify the most complex business activities, assess their relative risks, determine their accounting treatment, and obtain complete understanding of their impact on fair presentation of financial performance conditions. Audit committee members should be sufficiently knowledgeable to ask management as well as the internal and external auditors tough questions regarding quality, transparency, and reliability of financial reports.

Braiotta (1999) stated that it is essential that the audit committees be totally independent from the chief executive officers (CEO). In a study based on an examination of audit committees of 13 companies listed on the New York Stock Exchange (NYSE), M.L Lordal found that effective audit committees permit the CEO to attend committee meetings on invitation only (Braiotta 1999). The CEO is the best source of information relating to the business and he can ensure quick action on committee requests. In achieving appropriate relationship with the CEO, a key ingredient is the quality of the audit committee chairman. He must have both the sensitivity to know when to bring the CEO into the group's deliberations and the strength to stand up to him when the committee wants to pursue an inquiry or change policy. Terrell (2003) stated that a more effective audit committee is a more focused and informed committee. The audit committee should expect the management to be an integral element in helping it to expand its awareness of the company's financial reporting process, including identifying risks and understanding the controls surrounding

those risks. A study by Haka and Chalos (1990) cited by Reinstein (1996), found evidence of agency conflict between management and the audit committee chair.

The interface between the audit committee members and the internal auditing group provides a logical relationship because these groups have common goals. The board of a company is ultimately responsible for its system of internal controls. However, the board will normally delegate to management the task of establishing, operating and monitoring the system. The board should regularly assure itself that appropriate processes are functioning effectively to monitor the risks to which the company is exposed and that the system of internal controls are effective in reducing those risks to an acceptable level. Although the responsibility for reviewing the effectiveness of internal controls lies with the board of directors, in reality, the board is likely to delegate this task to its audit committee. The role of the audit committee in the review process is for the board to decide and will depend upon factors such as the size, composition of the board, and the nature of the company's principal risks (Zaman 2001). It is important that the audit committee and the internal auditor establish a working relationship that is not counterproductive (Braiotta 1999).

The work of the audit committee and the independent auditors is very closely related because both groups have common objectives regarding the financial affairs. Tackett (2004) stated that prior to the Sarbanes-Oxley Act in the USA, it was legal for auditors to report to their clients' management. The Sarbanes-Oxley Act required that auditors report to and are overseen by a company's audit committee. This committee must approve all audit and non-audit services, must receive all new accounting and auditing information from the auditors, and must serve as the official line of communication between the auditor and the client company. Tackett (2004) argued that requiring the audit committee to make all decisions about hiring or firing the auditors removes from management the ability to threaten or coerce the auditors with dismissal if the auditor fails to perform in a manner acceptable to management. Also requiring the audit committee to approve all payments made to the auditor for auditing and non-auditing services makes it difficult for management to purchase unneeded consulting services from the auditor with the intent of paying a 'legal bribe' in the hope of getting more favorable treatment from the auditor. Finally, requiring the audit committee to deal with disagreements between the auditor and management on accounting matters makes it difficult for management to prevail on questionable accounting practices.

A study by Knapp (1987), cited by Reinstein (1996), which surveyed 179 audit committee members, found that in audit disputes the audit committee tended to support the auditors rather than management. In another study by Dockweiler et al, also cited by Reinstein (1996) surveyed 731 accountants nationwide to ascertain if they perceived that audit committees enhanced their auditing independence or improved effectiveness of their audits - a primary audit committee objective. They found moderate support for both propositions, with respondents from larger firms agreeing more strongly with the statements than did those from smaller firms.

2.10: Challenges facing audit committees

Sweeping changes in and additional focus on corporate governance has placed greater pressure on corporate audit committees to oversee the integrity of their companies' financial reporting process. This uncertain and rapidly shifting regulatory climate has created higher visibility and expectations for audit committee members, who function as the ultimate guardians of investors (Terrell 2003).

Jonathan (2001) stated that for the non- executive directors who serve on audit committees, expectations are rising. Matters concerned with management of risk, internal control, additional regulatory requirements, external auditor independence, as well as the move to international accounting standards, are potentially creating extra headaches for the members of such committees. Combine all these issues with the many stakeholders who are interested in the company's activities, all with their own agenda to push, and it is hardly surprising that matters are getting trickier by the day for boards and their audit committees.

Zabihollah (2003) noted that the inclusion of audit committee reports in the proxy statements presents challenges for audit committees. It raises concerns that audit committee members are not thoroughly involved in the preparation of financial statements and, thus, this requirement increases their liability. This increased oversight function and associated liability may ultimately result in higher compensation for audit committee members or fewer qualified directors willing to serve on audit committees.

In order to take reasonable care, Jonathan (2001) suggested that audit committee members should check that the terms of reference and agenda items explicitly covers all matters. They should also ensure that they have enough meetings and significant sources of assurance to ensure that they can meaningfully discharge their duties.

Given the new corporate governance environment, it is essential for audit committee to focus on a process to supports effective oversight -one that goes beyond mere compliance with the new rules. This requires an oversight framework that facilitates the coordination of the activities and information needed to support the audit committee's understanding and monitoring of the company's financial reporting process. Audit committees should avoid becoming unduly focused on compliance for the sake of compliance- potentially at the expense of a quality oversight process (KPMG 2003).

2.11: Chapter summary

In summary, literature clearly shows the ever-growing importance and expansion of audit committees around the world. Companies in Kenya cannot afford to remain without audit committees in discharging their duties for effective corporate governance. However, companies should not establish audit committees for compliance's sake. As Pomeranz (1997) correctly stated, the mere labeling of a group of directors ' audit committee' will not by itself create an effective monitoring committee.

For audit committees to be effective, they must have tailor made charters that are updated annually, members should be independent and financially literate, and they should allow adequate time at each meeting so that the agenda can be covered in a professional manner. To facilitate the smooth operations of audit committees, the committee members should cultivate good working relationship with management, internal audit, and external auditor. Audit committees should also review their performance every year to assess their contribution to the financial reporting process.

CHAPTER 3: RESEARCH METHODOLOGY

3.1: Introduction

This chapter sets to explain the research design, population of interest, sources of data, and the techniques that were used in data analysis.

3.2: Research design

This was an empirical approach to survey the operations of audit committees of companies listed at the Nairobi Stock Exchange (NSE). An empirical study was adopted as it provides a wider access to geographically dispersed samples at low costs. However, the design has the disadvantage of not allowing an in-depth investigation. Communication approach was used as it enables abstract information e.g. opinions, attitudes, expectations and perceptions to be collected.

The major disadvantages of communication approach include

- i. The quality and quantity of information secured depends heavily on the ability and willingness of the respondent,
- ii. Respondents might misinterpret questions,
- iii. The questionnaire might not be completed by the intended respondent,
- iv. Respondents may intentionally mislead the researcher by giving false information.

Despite the above weaknesses, communicating with research subjects is a principal method of management research (Cooper 1998).

3.3: Population and sample

The population of interest for this study comprised all companies listed at the Nairobi Stock Exchange as at June 30, 2004 (Appendix I). As is shown in Table 3.3.1, twenty-nine of the forty-eight companies in the population responded to the audit committee questionnaire, which represent a response rate of 60%. The responses were analyzed in order to achieve the objectives of this study.

Table 3.3.1

Respondents to the audit committee questionnaire

Industry	No. of companies in the population	No. of respondents	Percentages
Agricultural	9	6	67%
Commercial and services	10	7	70%
Industrial and allied	17	8	47%
Finance and investment	12	8	67%
Total	48	29	60%

Source: audit committee questionnaire

3.4: Sources of data

Primary data was collected via a questionnaire. Interview method was used on the respondents who were willing to spare the time, while for others it was dropped and picked later. The questionnaire was addressed to the chairmen of audit committees/ heads of internal audit of all the 48 companies listed on the NSE. The heads of internal audit were chosen as respondents as the CMA guidelines states that they are supposed to attend all the audit committee meetings and the internal audit function is also under the supervision of the audit committees.

The questionnaire focused on the composition, independence and financial literacy, relationships, self-evaluation, key achievements and challenges (Appendix II). Most of the questions were 'Yes' or 'No' type. Other questions measured using the Likert scale ranging from 4 (to a very large extent) to 1 (Not at all) were used to gauge perceptions.

For companies whose head offices are in Nairobi, personal interview and dropped and picked later methods were used while for other companies the questionnaire was mailed. This distribution approach increased the response rate at minimal costs. To improve on the response rate, all possible methods were adopted, for example, a self addressed stamped envelope, reminders and an offer to avail the summary of findings, were sent to the respondent. Secondary data was collected from the annual accounts of the listed companies available at the NSE library.

3.5: Data analysis techniques

The data was analyzed using frequencies, percentages, and means. The computation of frequencies was used as a statistical method of grouping or organizing raw data for ease of interpretation. Percentages provide a general summary of collected data. Being the best measure of central tendency, the mean was used to provide a single measure or score, which represents the data obtained. Tables were used to represent the collected data and in organizing and summarizing the data while Statistical Packages for Social Sciences (SPSS) was used to facilitate analysis.

3.6: Chapter summary

In summary, an empirical approach was adopted in this study. The population of interest was all the companies listed at the NSE as at June 30, 2004. Primary data was collected using a questionnaire while secondary data was collected from the annual accounts of the listed companies. The data was analyzed using frequencies, percentages and means.

CHAPTER 4 DATA ANALYSIS AND FINDINGS

4.1: Introduction

This chapter sets to give a detailed analysis of data collected. Data was collected using the audit committee questionnaire and checked for consistency with audit committee reports included in the annual reports of 2004. Collected data was analyzed in order of the research questions to achieve the objectives of the study.

4.2: General information about the respondents

Table 4.2.1 present data on the number of companies having audit committees. It can be seen that 27 (93 percent) of the 29 respondents have already established audit committees. The questionnaire was addressed to the chairmen of audit committees/ the audit managers. Audit managers completed 24 (83 percent) of the questionnaires while chief accountants completed 5 (17 percent). The audit committee chairmen completed none.

Table 4.2.1 also shows that the respondents are evenly distributed across different industrial groups. Six (21 percent) of the total respondents were from the agriculture, 7 (23 percent) from commercial and services, 8 (28 percent) from industrial and allied, and 8 (28 percent) from financial and investment. Fourteen (48 percent) of the respondents had over 400 employees, 6 (21 percent) had between 200 –400 employees, 7 (24 percent) had between 100- 200 while 2 (7 percent) had less than 100 employees. Eight (30 percent) respondents indicated that their audit committees were established before 1998 when the CMA guidelines became effective, 4 (15 percent) were established in 1998, while 15 (55 percent) were established after 1998.

Table 4.2.1
Companies with audit committees

Industry	Number of companies in the sample	With A.C	Without A.C	Total respondents	Percentages
Agricultural	9	6	0	6	21%
Commercial and services	10	6	1	7	23%
Industrial and allied	17	7	1	8	28%
Finance and investment	12	8	0	8	28%
Total	48	27	2	29	100%

Source: audit committee questionnaire

4.3: Operations of audit committees

Most of the questions in the audit committee questionnaire focused on the operations of audit committees. A detailed analysis of the operations of audit committees follows below.

4.3.1: Audit committee charter and guidelines

Table 4.3.1.1 indicates a good trend that all the 27 respondents (100 percent) have already developed audit committee charters for effective functioning of their audit committees. However in the present study, as shown on Table 4.3.1.2, only 56 percent of the respondents update their charters annually while the remaining 44 percent indicated that their update only on a need basis, and therefore, not necessarily annually.

Table 4.3.1.1
Written charters

Responses	Number of respondents	Percentages
Yes	27	100%
No	0	0
Total	27	100%

Source: audit committee questionnaire

Table 4.3.1.2
Annual updating of the charter

Responses	Number of respondents	Percentages
Yes	15	56%
No	12	44%
Total	27	100%

Source: audit committee questionnaire

4.3.2 Responsibilities of the audit committees

The main responsibility of the audit committees is to oversee the financial reporting system. Audit committees should have the ultimate responsibility to select the external auditor. It is clear from Table 4.3.2.1 that 89 percent of the respondents indicated that their audit committees were responsible for appointing the external auditor and 81 percent said that they also specify their fees. This is a very important part of the audit committee's job because it ensures the independence and qualifications of the external auditor. However only 41 percent of the audit committees are responsible for the appointing and dismissing the internal audit manager. Eight percent of the respondents indicated that their audit managers are hired through professional recruitment firms and can be dismissed by the management in consultations with the audit committees. Fifteen percent responded that their audit committees' responsibilities were none of the above. Other

responsibilities of audit committees which are listed in their proxy statements included monitoring risks, ensuring compliance with internal controls, ensuring management's compliance with relevant local regulations, enforcing the recommendations of the internal audit and defining the scope of internal audit.

Table 4.3.2.1
Responsibilities of audit committees

Responses	Number of respondents	Percentages
Appointing the external auditor	24	89%
Appointing and dismissing the internal audit manager	11	41%
Specifying the external auditors fees	22	81%
None of the above	4	15%

Source: audit committee questionnaire

4.3.3: Conducting meetings prior to the start of the audit

The audit committees should monitor internal and external audit coverage to ensure all key risk areas are considered. This may involve reviewing and discussing with the auditors the current year's audit plan, together with the resolution of prior year issues. As indicated in Table 4.3.3.1, 89 percent of the respondents stated that their audit committees conducted meetings with the external auditors before the start of the audit. These planning meetings are important as they ensure that the external auditors focus their attention on risky and material sectors of the business. However, 11 percent indicated that the committees do not conduct any such meetings.

Table 4.3.3.1
External auditors conducting meetings with A.C prior to the start of the audit

Responses	Number of respondents	Percentages
Yes	24	89%
No	3	11%
Total	27	100%

Source: audit committee questionnaire

All the respondents indicated that the audit committees reviewed the management letter issued by the external auditor. This is important as it results in the audit committees becoming aware of the areas of weaknesses and also ensures that the recommendations are promptly implemented.

4.3.4: Discussion of the performance of the finance and accounting department.

The performance of the finance and accounting department is mainly not the responsibility of audit committees. As indicated in Table 4.3.4.1, only 19 percent of the audit committees discuss the performance of the accounting and finance department to a very great extent, 41 percent discuss it to a large extent, 26 percent to some extent, while 14 percent don't discuss it at all.

Table 4.3.4.1
Discussion of the performance of the A/F dept

Extent of discussion	Number of respondents	Percentages
To a very large extent	5	19%
To a large extent	11	41%
To some extent	7	26%
Not at all	4	14%

Source: audit committee questionnaire

4.3.5: Monitoring of the nature and extent of non-audit services performed by the external auditor by the audit committees

When the external auditors provide a lot of other non-audit services on top of normal audit services, it may erode their independence. The audit committees should therefore monitor these non-audit services. However, as indicated in Table 4.3.5.1, only 52 percent of audit committees monitor these services while 48 percent do not. However all the respondents indicated that the external auditor and the internal auditor have direct access to the audit committees, which greatly increase their independence.

Table 4.3.5.1
Monitoring non-audit services

Responses	Number of respondents	Percentages
Yes	14	52%
No	13	48
Total	27	100%

Source: audit committee questionnaire

4.3.6: Composition and membership of audit committees

To ensure the independence of the members of the audit committees and to avoid conflict of interest, all members should be appointed by the board of directors and not by the management. The CMA guidelines require that audit committees be composed of at least three independent and non-executive directors who shall report to the board. Having independent non-executive members in the audit committee is a primary and a fundamental requirement that was addressed in the

Treadway Report. As recommended by the CMA, all respondents have three or more members in their audit committees. In this study, the average membership per committee is 4.30. As shown in Table 4.3.6.1, 48 percent of the respondents had 3 members, 26 percent had 4 members, 7 percent had 5 members, and 11 percent had 6 members while the remaining 8 percent had 7 and 14 members.

Table 4.3.6.1
Number of directors

Number of members	Number of respondents	Percentages
3	13	48%
4	7	26%
5	2	7%
6	3	11%
7	1	4%
14	1	4%
Total	27	100%

Source: audit committee questionnaire

As is clear from Table 4.3.6.2, 33 percent of the respondents had less than the minimum number of independent non-executive directors. Forty percent had 3 non-executive directors, while 27 percent had more than 3 independent non-executive directors.

Table 4.3.6.2. Independent non-executive directors

Number of members	Number of respondents	Percentages
1	1	4%
2	8	29%
3	11	40%
4	5	19%
5	1	4%
11	1	4%
Total	27	100%

Source: audit committee questionnaire

All the respondents indicated that the board of directors appoints the members of the audit committees. Three respondents representing 11 percent indicated that the members of the committees appoint the chairmen of the committees while 89 percent indicated that the board appoints the chair. All the respondents indicated that their chairmen are independent non-executive directors. ✓

All the respondents indicated that they had a financial expert in their committees. To be an "audit committee financial expert," an audit committee member must have an understanding of economic

and accounting principles, comprehend how financial reporting choices and accounting policies can affect a company's financial reports, and possess an understanding of internal controls and procedures. Members of audit committees in the field of finance and accounting averaged 2.3 members per committee. All the respondents were also unanimous that their audit committee members have the knowledge, industry experience and the financial expertise to effectively serve in their role.

4.3.7: Audit committees engaging outside experts

The committees should be able to obtain external professional advice and to invite outsiders with relevant experience to attend meetings if necessary. From Table 4.3.7.1, 70 percent of the respondents indicated that they engage experts while 30 percent said that they have never had to engage experts though they have the provision in their charters

Table 4.3.7.1
Engaging experts

Responses	Number of respondents	Percentages
Yes	19	70%
No	8	30%
Total	27	100%

Source: audit committee questionnaire

4.3.8: Meetings of audit committees

In 1998, Arthur Levitt, Chairman of the SEC remarked that an ideal audit committee is the one "*that meets 12 times a year before each board meeting.*" In this study, only one of the respondents (4 percent) complies with that. The greater number of respondents has quarterly audit committee meetings (63 percent). Of the remaining, 11 percent meet twice per year, another 11 percent meet thrice, 7 percent meet six times while the remaining 4 percent meet eight times. It seems that quarterly meetings are enough unless there is an urgent issue to be discussed immediately by the committee. The average number of meetings in a year was 3.8 times.

Table 4.3.8.1

Number of meetings of audit committees

Responses	Number of respondents	Percentages
2	3	11%
3	3	11%
4	17	63%
5	0	0
6	2	7%
7	0	0
8	1	4%
9	0	0
10	0	0
11	0	0
12	1	4%
Total	27	100%

Source: audit committee questionnaire

As shown in Table 4.3.8.2, most of the committees meet on average for two hours (85 percent). Eleven percent meets for three hours while only 4 percent meet for four hours. The average audit committee meeting was found out to be 2.2 hours. No respondent indicated that they require any additional time to complete their responsibilities. All the respondents indicated that they were fully in charge of setting the agenda of committee meetings. This is important as it ensures that other people especially management will not influence the committees. Forty eight percent indicated that they use the charter to a very large extent in setting their agenda. Another 48 percent said that they use the charter to a large extent while 4 percent said that they use it to some extent.

Table 4.3.8.2

Time spent at meetings

Responses	Number of respondents	Percentages
2	23	85%
3	3	11%
4	1	4%
Total	27	100%

Source: audit committee questionnaire

4.3.9: Audit committee reports

Since audit committees serve as a guard on the assets of the shareholders, it is vital to have that the guardians convey all necessary information about the safety of assets to the shareholders. Informative reporting to the boards is a pre-requisite for the committees' effectiveness. No matter how good the work of the committees is the companies will not be able to benefit from their efforts if the boards are not informed of their findings. Lines of reporting between the committees and the

boards should be formalized, normally within the terms of reference of the committees. Regardless of the mode of communication, it is important that the relationships and communication channels between the committees and the boards are clearly defined and that the committee reports to the main boards on a regular basis. Through effective reporting, the board members will be aware of any issues or disagreements that may have been settled before the accounts are presented for approval.

Table 4.3.9.1 shows that 89 percent of the respondents report to the shareholders. However 37 percent indicated that they give their reports through the boards. Eleven percent does not report audit committees' findings to shareholders. Seventy percent of the committees report to their boards after every meeting while the remaining 30 percent reports quarterly. However given that most committees meet four times in a year, it seems that even those that reports quarterly may be reporting after every meeting. All the respondents were unanimous that the board of directors follows all the recommendations of the audit committees. All the respondents indicated that their current annual reports had a reference to the effect that they had an audit committee. However, the reference is mainly a two to three paragraph reports that do not give enough details as proposed by the CMA guidelines.

Table 4.3.9.1
A.C reporting to the shareholders on its activities and findings

Responses	Number of respondents	Percentages
Yes	24	89%
No	3	11%
Total	27	100%

Source: audit committee questionnaire

4.3.10 Audit committees assessing their performance annually

Table 4.3.10.1 shows that only 56 percent of the respondents indicated that they assess their performance annually. Forty four percent said that they do not conduct the assessment annually. Of those who assess annually, the audit committee members themselves carry out 64 percent of the assessments while the board carries out 36 percent of the assessment.

Table 4.3.10.1
Audit committee assessing its performance annually

Responses	Number of respondents	Percentages
Yes	15	56%
No	12	44%

Source: audit committee questionnaire

4.4: Relationship with management, internal auditor and external auditor ✓

The audit committee questionnaire included questions to capture the relationships of the audit committees with management, internal auditors and the external auditors. Other questions captured how they correspond, and how they resolve any disagreements.

4.4.1: Extent to which their relationships are positive

Table 4.4.1.1 indicate the extent to which the respondents perceived the relationships between the audit committees and the management, internal and external auditors as being positive. As can be seen from the table, 41 percent perceived the relationships to be positive to a very large extent while 59 percent indicated that it was positive to a large extent. This is commendable as audit committees can only be effective when the working relationship is positive. All the respondents indicated that they could communicate by mail, telephone and e-mail. Fifty nine percent indicated that they communicate on a need basis, 37 percent communicate quarterly, while 4 percent communicate semi-annually

Table 4.4.1.1
Nature of relationship with mgt, internal and external auditor

Extent of relationship being positive	Number of respondents	Percentages
To a very large extent	11	41%
To a large extent	16	59%
To some extent	0	0
Not at all	0	0

Source: audit committee questionnaire

4.4.2: Independence of audit committees ✓

For the audit committees to be effective, it must be independent and especially resist influence from the chief executive officer. The committees may find it useful or necessary to hold separate private meetings with both the internal and external auditors with no executive directors present. Private meeting(s) would help to ensure a free and frank exchange where the expression of views might otherwise be restricted. A private meeting with the executive directors in the absence of the auditors can also be helpful. As shown in Table 4.4.2.1, 74 percent of the respondents indicated that the CEO attends audit committee meetings on invitations only while 26 percent indicated that the CEO could attend at will. All the respondents were unanimous that their audit committees were independent of management. They also all indicated that there were procedures in place for

reporting to the audit committee significant deficiencies and material weaknesses in a timely manner. They also all indicated that disagreements between management and outside auditors are reported timely to the audit committee. Fifty six percent of the respondents indicated that the audit committee constructively challenges management while 44 percent said that there has been no challenge to date. All the respondents indicated that differences of opinion on accounting policies are always resolved to the satisfaction of the audit committees.

Table 4.4.2.1

CEO attending committee meetings on invitation only

Responses	Number of respondents	Percentages
Yes	20	74%
No	7	26%
Total	27	100%

Source: audit committee questionnaire

4.5: Achievements and challenges of audit committees

The achievements of audit committees were captured using three questions. There was a question on the influence of audit committees on the internal auditors and whether the committees increased reliability of financial statements. There were also open questions on the major achievements and challenges facing audit committees.

4.5.1: Extent to which audit committees have improved the effectiveness of internal auditors

The performance and efficiency of the internal audit department is the responsibility of the audit committees. As indicated on Table 4.5.1.1, seventy four percent of the respondents indicated that the audit committees improved the efficiency and effectiveness of the internal auditors to a very large extent while 26 percent indicated that the improvement was to a large extent. Given that the internal audit is one of the key responsibilities of the audit committees, this can be an indicator that audit committees are achieving their objectives

Table 4.5.1.1

Extent to which having an A.C has improved the efficiency and effectiveness of the internal auditors

Extent of believe	Number of respondents	Percentages
To a very large extent	20	74%
To a large extent	7	26%
To some extent	0	0
Not at all	0	0

Source: audit committee questionnaire

4.5.2: Extent to which audit committees increase the reliability of financial reports

As is clear from Table 4.5.2.1 most of the respondents (67 percent) believe that the audit committees increase the reliability of the financial reports to a very great extent. The remaining (33 percent) indicated that the committees increased the reliability to a large extent.

Table 4.5.2.1
Extent to which an A.C increases the reliability of financial reports

Extent of believe	Number of respondents	Percentages
To a very large extent	18	67%
To a large extent	9	33%
To some extent	0	0
Not at all	0	0

Source: audit committee questionnaire

4.5.3: Major audit committee achievements

The major achievement cited by most respondents was to do with the internal audit. Most respondents indicated that audit committees ensure that audit issues taken to management are promptly resolved. This has had the effect of enhancing the independence of the internal audit function. Other achievements noted included significant improvement in corporate governance practices, improved risk management and control processes, clarifying the role of internal audit vis a vis policy setting, forcing management to pay greater attention to internal controls, improving the tendering system and reducing time spent by the external audit hence cutting down on costs.

4.5.4: Major challenges facing the audit committees

Most respondents indicated that there were no major challenges facing audit committees. Others indicated the challenges as a rapidly changing environment, increased local and international regulations, that it is a new concept and setting its boundaries was an issue, dominant senior management interfering with the work of audit committee if not closely watched and that they are being asked to take responsibilities over the financial reports while their involvement was minimal.

4.6: Reasons why some companies have not established audit committees

There was one question on why some listed companies had failed to establish audit committees. Only two respondents (7 percent) indicated the absence of audit committees. One indicated that

the audit committee had not been established owing to frequent management changes but they are now set to establish it in 2005. The other respondent indicated that they had not established an audit committee as they had adequate internal control measures. This revealed ignorance of the CMA guidelines.

4.7: Chapter summary

This chapter has given an analysis of the data collected. Tables, frequencies, percentages and means have been used to summarize the data collected. The analysis is in order of the research questions as indicated in chapter one.

CHAPTER 5: SUMMARY, DISCUSSIONS, RECOMMENDATIONS, LIMITATIONS AND DIRECTION FOR FURTHER RESEARCH

5.1: Introduction

This study set out to answer the following research questions:

- i. How do audit committees in Kenya operate?
- ii. How do the audit committees relate to management, internal audit, and external auditors?
- iii. What are the major achievements and challenges of audit committees in Kenya?
- iv. Why have some listed companies failed to establish audit committees?

This chapter gives a summary of the findings, discussions, recommendations, limitations and direction for further research.

5.2: Summary of findings

5.2.1: Operations of audit committees

From the analysis, it was observed that most listed companies (93 percent) have established audit committees. The type of the industry and the size of the company are not determinants of whether a listed company has established an audit committee or not. All companies that responded to the questionnaire have audit committee charters where 56 percent update them annually which is commendable. Eighty nine percent of audit committees conduct meetings with the external auditors prior to the start of the annual audit and review the management letter issued. External and internal auditors have direct access to the audit committees and 56 percent of audit committees monitor the extent of non-audit services performed by the external auditors which is commendable. All the respondents indicated that their audit committees meet the minimum number of committee members required by the CMA guidelines with all of them having on average 4.3 members per committee. Members and the audit committee chairmen are appointed by the board of directors, which increases their independence from the management. All committees have a financial expert and the audit committee members have the knowledge, industry experience and financial expertise to be effective in their role. The average number of meetings is 3.8 per year where each meeting takes on average 2.2 hours.

The audit committee members are in charge of setting the agenda and they use the charter as a guide to a very large extent. The audit committees report to the boards mainly on a need basis and the boards follow all their recommendations. Fifty six percent of audit committee assesses their performance annually and the board mainly carries out the assessment.

5.2.2: Relationship with management, internal auditor and external auditor

The relationship with management, internal auditor and external auditor is positive to a large extent. Management and auditors correspond with the audit committees using mail, telephone and e-mail on a need basis. The audit committees are independent of management and 74 percent of CEO's attends audit committee meetings on invitation only.

5.2.3: Achievements and challenges of audit committees

The major achievements of the audit committees is providing the internal audit with a communication channel, ensuring that the audit issues raised by the internal audit are attended to promptly which enhances its independence. Audit committees have also increased the reliability of the financial statements to a very large extent. The major challenges cited were the changes in legal and operating environment and the problem of setting the boundary between the committee and the management.

5.2.4: Reasons for listed companies not establishing audit committees

There were only two companies that gave reasons why they had not established audit committees. One indicated frequent changes in management as a reason for not establishing audit committees while the other said that they had strong internal controls and therefore did not require audit committees.

5.3: Discussions

5.3.1: Operations of audit committees

From the analysis, it was observed that most listed companies (93 percent) have established audit committees. Neither the type of the industry nor the size of the company was seen to be determinants of whether a listed company established an audit committee or not. In a similar study conducted in Brahmin, Joshi (2004) had concluded that the size of the company and the audit firm (whether international or local) influenced the establishment of audit committees. These factors were not found to influence, as audit committees in Kenya were established as a result of the CMA guidelines i.e. not voluntarily.

All companies that responded to the questionnaire have audit committee charters where 56 percent update them annually which is commendable. There is a lot of literature on the need for audit committee charters. The key is that every company that has an audit committee should develop a tailor made charter for the committee and that the charters should be updated annually. All the respondents in this study have charters but only 56 percent update them annually. The fact that only 56 percent update annually can be attributed to the stable operating environment as charters are to be updated to fit changing situations.

Eighty nine percent of audit committees conduct meetings with the external auditors prior to the start of the annual audit and review the management letter issued. External and internal auditors have direct access to the audit committees and 56 percent of the committees monitor the extent of non-audit services performed by the external auditors which is commendable. Studies that have been undertaken on the oversight responsibilities of audit committees found that the responsibilities revolved mainly in the areas of financial reporting, auditing and overall corporate governance. This was found to be the case in this study.

All the respondents indicated that their audit committees meet the three minimum number of committee members required by the CMA guidelines with the average number of members being 4.3 per committee. Members and the audit committee chairmen are appointed by the board of directors, which increases their independence from the management. All committees have a

financial expert and the audit committee members have the knowledge, industry experience and financial expertise to be effective in their role. Literature has a lot on the membership of audit committees. The composition of audit committees should depend on the circumstances of a particular company. However, there is agreement that the members should be independent of management to be able to be effective. A study by Gao (1991) had found that half of the 40 surveyed audit committee chairs from large US banks perceived that their audit committees had no members with expertise in assigned accounting, auditing, banking and law oversight domains. In this study, all the respondents indicated that their committees had the knowledge and industrial experience to perform their job.

In this study the average number of meetings is 3.8 per year where each meeting takes on average 2.2 hours. Literature has it that formal meetings are held at least four and sometimes up to twelve times per year. Typically, four of the meetings are in person and last about three to four hours. PriceWaterHouseCoopers (1999) found that audit committees among European companies met on average three to four times in a year. It is apparent that audit committees in Kenya are doing well when it comes to the number of meetings.

The audit committee members are in charge of setting the agenda and they use the charter as a guide to a very large extent. The audit committees report to the board mainly on a need basis and the board follows all their recommendations. Fifty six percent of audit committee assesses their performance annually and the board mainly carries out the assessment. In the literature review, it was found out that the chairperson of the committee should be in charge of setting the agenda and that at no time should the management alone prepare the audit committee agenda. To ensure that the audit committees' cover all the areas included in their charters, they should use it as a guide when setting the agenda. At the end of every year, they should assess their performance to see how well they have discharged their mandate. Audit committees in Kenya appear to be doing well in this area.

5.3.2: Relationship with management, internal auditor and external auditor

In this study, the relationship with management, internal auditor and external auditor is positive to a large extent. Management and auditors correspond with the audit committee using mail, telephone and e-mail on a need basis. The audit committees are independent of management and 74 percent of CEO's attends audit committee meetings on invitation only. Literature has it that the success of audit committees in fulfilling their oversight responsibility depends on their working relationships with other participants in corporate governance. The CEO is the best source of information relating to the business and he/she can ensure quick action on committee requests. The chairperson of the committee should have the sensitivity to know when to bring the CEO in to the committees' deliberations and the strength to stand up to him when the committee wants to pursue an inquiry or change policy. A study in the USA found that effective audit committees permit the CEO to attend its meetings on invitations only which seems to be the case in this study. In another study Haka and Chalos had found evidence of agency conflict between management and the audit committee chair. Audit committees in Kenya appear to be doing well in this respect as 74 percent indicated that CEOs attend meetings on invitation only. The respondents also indicated that the relationship of audit committees with other players in corporate governance is positive. This will ensure that they will be able to achieve their objectives.

5.3.3: Achievements and challenges of audit committees

In this study, the major achievements of the audit committees is providing the internal audit with a communication channel, ensuring that the audit issues raised by the internal audit are attended to promptly which enhances its independence. Audit committees have also increased the reliability of the financial statements to a very large extent. Literature, however, is divided on the achievements of audit committees. A study by Guy (2004) found that only 15 percent of executive directors of FTSE 100 companies believed audit committees were vital in order to achieve sound corporate governance. However AICPA considers audit committees as vital in improving internal controls.

Literature gives the challenges facing audit committees as increased liability as a result of their reports being included in the proxy statements. Other challenges include many stakeholders

interested in companies' activities, additional regulatory requirements and greater visibility and expectations of audit committees. Audit committees in Kenya seem to be facing similar challenges as they indicated that the major challenges were the changes in legal and operating environment, increased liability and the problem of setting the boundary between the committee and the management.

5.4: Conclusions

All the listed meet the CMA requirements in terms of the composition, membership and independence of audit committee members. Committees have charters that in most cases are updated annually. Audit committees have increased the independence of internal and external auditors. The major challenge is the increased liability the committee members are exposed to as a result of the inclusion of their report in the proxy statements. The relationship of the audit committees with management, internal audit and external auditor is cordial to a large extent. For the company that has not established an audit committee, the reason given was frequent management changes.

5.5: Recommendations

Audit committees in Kenya appear to be on the right path. However, this can be enhanced if audit committees can have meetings with management and honestly iron out the issues of boundaries so that suspicion can be eliminated. This would greatly improve the relationships among the major players in corporate governance. Audit committees seem to be relying mainly on work and assurances given by others, which would explain the limited time they spend on audit committees' work in a year. Audit committees should endeavor to do more on their own rather than rely on the work of others.

The independence of the external auditor can be impaired by the amount of non-audit services they perform as was clear from the Arthur Anderson case. However, most audit committees are not monitoring these services. It would be important for audit committees to monitor these services as they have been proven to be having a bearing on external auditor's independence.

The CMA guidelines require companies to indicate in the annual reports whether they have an audit committee and the mandate of the committee. All the companies that have audit committees have one or two paragraphs on audit committees in their annual reports. These reports do not give the minimum information as required by the guidelines and therefore the companies should strive to give more.

5.6: Limitations

This was an empirical study, which means that it had a broad coverage but shallow depth. An in-depth examination would be required. Out of the forty-eight companies, only twenty-nine responded to the questionnaire. However this was not a major limitation as the respondents did not exhibit significant variations. Committee chairmen completed none of the questionnaires. This means that their side of the story was not captured in the analysis.

5.7: Direction for further research

Future research may be directed to the role of audit committees in companies that are not listed at the NSE. Further studies could be carried out to examine the effect of audit committees on audit fees. Additionally, there are some encouraging findings regarding the reduced likelihood of financial reporting problems when audit committees are more active and more independent, but much more need to be discovered about how the audit committees influence the financial reporting quality. Lastly, the mere presence of non-executive directors in audit committees is not enough for corporate governance standards to improve. A case study based research would be more appropriate to examine the actual functioning of the audit committees in terms of their power, effects and effectiveness and the role of independent non-executive directors.

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Audit committee questionnaire

1. Name of the company (optional) _____
2. Type of industry (Tick)
 - Agricultural
 - Commercial and Services
 - Industrial and allied
 - Finance and Investment
- 3 Total number of employees in the company
 - Less than 100
 - 100- 200
 - 200- 400
 - More than 400
- 4 Position of the respondent _____
- 5 Is there an audit committee in the organization?
 - Yes
 - No
- 6 If yes, when was it established? _____ (Year)
- 7 If no, are the functions of the audit committee performed by another body?
 - Yes
 - No
 - Please, specify the other body _____
- 8 If your company does not have an audit committee or equivalent, please give reasons. (The rest of the questionnaire assumes the existence of an audit committee)
 - _____
 - _____
 - _____
- 9 Are the audit committee's responsibilities defined in a charter?
 - Yes
 - No
- 10 If yes, is the charter updated annually and approved by the board of directors?
 - Yes
 - No
- 11 The audit committee members are responsible for:
 - Appointing the external auditor;
 - Appointing and dismissing the head of internal audit department;
 - Specifying the external auditors fees;
 - None of the above.

- 12 Do the external auditors conduct any meetings with the audit committee prior to the start of the audit?
- Yes
 - No
- 13 Does the audit committee review the external auditor's management letter issued at the end of each audit?
- Yes
 - No
- 14 The staffing and performance of the finance and accounting departments are discussed by the audit committee:
- To a very large extent;
 - To a large extent;
 - To some extent;
 - Not at all.
- 15 Does the audit committee monitor the nature and extent of non-audit services performed by the external auditors?
- Yes
 - No
- 16 Do the external and internal auditors have direct access to the audit committee?
- Yes
 - No
- 17 How many members does the audit committee consist of? _____ (Write number)
- 18 How many of the members are independent non-executive directors? _____ (write Number)
- 19 Who appoints the members of the audit committee?
- Board of directors
 - Chief executive officer
 - Other, please specify _____
- 20 Who appoints the chair of the audit committee?
- Board of directors
 - Audit committee member
 - Others, please specify _____
- 21 Is the chair of the audit committee an independent non-executive director?
- Yes
 - No
- 22 How many audit committee members are in the field of accounting and finance? _____
(Write Number)
- 23 Does the committee have a member who is a financial expert?
- Yes
 - No

- 24 Do the audit committee members have the knowledge, industry experience, and financial expertise to serve effectively in their role?
- Yes
 - No
- 25 Does the committee engage outside expert as appropriate?
- Yes
 - No
- 26 How many times did the committee meet in 2004? _____ (Write number)
- 27 How long was the average audit committee meeting in hours _____ (hrs)
- 28 How much additional time, if any, will be required to fulfill your audit committee responsibilities?
- More than 50% increase
 - 25% - 50% increase
 - 1% - 24% increase
 - No increase
- 29 a) Is the audit committee fully in charge of setting the agenda of its meetings?
- Yes
 - No
- b) If no please specify who is responsible for setting the committee's agenda
- _____
- 30 To what extent is the audit committee charter used as a guide in setting the audit committee's agenda?
- To a very large extent
 - To a large extent
 - To some extent
 - Not at all
- 31 Does the audit committee, report to the shareholders on its activities and findings?
- Yes
 - No
- 32 How often does the audit committee report to the board?
- Annually
 - Semiannually
 - Quarterly
 - After every committee meeting
 - Others, please specify _____
- 33 The recommendations of the audit committee are:
- All followed by the board of directors;
 - Not necessarily followed by the board of directors;
 - Followed by the board of directors with departures being communicated to the shareholders along with reason thereof.
- 34 Does the company's most recent report include a reference to the audit committee?
- Yes
 - No

- 35 Does the audit committee assess its performance annually?
- Yes
 - No
- 36 If yes, who performs the performance assessment?
- Audit committee members
 - Board of directors
 - Management
 - Other, please specify _____
- 37 Does the audit committee have a positive relationship with management the internal auditors and the independent auditors?
- To a very large extent
 - To a large extent
 - To some extent
 - Not at all
- 38 Does the audit committee correspond with management, internal auditors and external auditors by:
- Mail
 - Telephone
 - E-mail
 - Others, please specify _____
- 39 How often does the audit committee correspond with management, internal auditors and external auditors?
- Annually
 - Semi-annually
 - Quarterly
 - Others, please specify _____
- 40 Does the chief executive officer attend audit committee meetings on invitation only?
- Yes
 - No
- 41 Are there procedures in place for reporting to the audit committee significant deficiencies and material weaknesses in a timely manner?
- Yes
 - No
- 42 Are disagreements between management and outside auditors reported timely to the audit committee?
- Yes
 - No
- 43 Are audit committee members independent of management?
- Yes
 - No
- 44 Does the audit committee constructively challenge management's planned decisions, particularly in the area of financial reporting?
- Yes
 - No

- 45 Are differences of opinion on accounting policies always resolved to the satisfaction of the audit committee?
- Yes
 - No
- 46 To what extent do you believe that having an audit committee in your company has improved the efficiency and effectiveness of the internal auditors?
- To a very large extent
 - To a large extent
 - To some extent
 - Not at all
- 47 To what extent do you believe that the existence of the audit committee increase the reliability of financial reports.
- To a very large extent
 - To a large extent
 - To some extent
 - Not at all
- 48 What are the major achievements of the audit committee in your company?
-
-
-
-
- 49 What are the major challenges facing the audit committee in your company?
-
-
-
-
- 50 Any other comments on the functioning of audit committees and its role in improving corporate governance?
-
-
-
-

END

Appendix 1

Main Investment market

Agricultural

Uniliver Tea Kenya Ltd.

Kakuzi

Rea Vipingo Plantation Ltd.

Sasini Tea & Coffee Ltd.

Commercial and Services

Car & General (K) Ltd

CMC Holdings Ltd.

Hutchings Biemer Ltd.

Kenya Airways Ltd.

Marshalls (E.A.) Ltd.

Nation Media Group

TPS Ltd.

Uchumi Supermarket Ltd.

Finance and Investment

Barclays Bank Ltd.

C.F.C Bank Kenya Ltd.

Diamond Trust Bank Kenya Ltd.

Housing Finance Company Ltd.

I.C.D.C Investments Co Ltd.

Jubilee Insurance Co. Ltd.

Kenya Commercial Bank Ltd.

National Bank of Kenya Ltd.

NIC Bank Ltd.

Pan Africa Insurance Holdings Ltd.

Standard Chartered Bank Ltd.

Industrial And Allied

Athi River Mining.

B.O.C. Kenya Ltd.

Bamburi Cement Ltd.

British American Tobacco Kenya Ltd.

Carbacid Investment Ltd.

Crown Berger Ltd.

Olympia Capital Holdings Ltd.

E.A Cables Ltd.

E.A. Portland Cement Ltd.

East African Breweries Ltd.

Firestone East Africa Ltd.

Kenya Oil Co. Ltd.

Mumias Sugar Co. Ltd.

Kenya Power & Lighting Ltd.

Total Kenya Ltd.

Unga Group Ltd.

Alternative Investment Market Segment

A. Baumann & Co. Ltd.

City Trust Ltd.

Eaagads Ltd.

Express Ltd.

Williamson Tea Kenya Ltd.

Kapchorua Tea Co. Ltd.

Kenya Orchards Ltd.

Limuru Tea Co. Ltd.

Standards Group Ltd.

Source NSE