

## Effect Of Audit Committee Attributes On Corporate Risk Disclosure. Of Firms Listed In Nairobi Security Exchange, Kenya

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### Abstract

*the main purpose of the study paper was to determine the effect of audit committee characteristics on firm risk disclosure. Agency Theory informed the study. This study adopted a correlation research design. The target population for the study comprised of the 61 listed firms at Nairobi Securities Exchange(NSE) Census technique; was used in the study since it only captured all the 45 firms that had consistently been operating at the NSE for the past 8 years from 2005-2012 irrespective of their industry or market segment. This study utilized secondary data, and data were collected by use of content analysis. A document analysis guide was prepared to enable and guide the collection of data. Data collected was analyzed by use of descriptive statistics, for example, mean, and standard deviations were used, and inferential statistics which included Pearson correlation tested hypothesis and data were presented using tables. The results were likely to be of interest to investors because it provided a basis for evaluating a company's risk and risk management strategies contained in the annual reports*

**Keywords:** *Audit Committee Characteristics, Audit Committee. Quantity Of Risk Information Disclosed*

### Introduction

Companies have complex operations and face multiple risks, from within their own businesses, as well as from their external environment. Consequently, investors face various kinds of risks. They need information on risks so that they can perform their own risk assessments. This issue leads to the growing demand for better reporting of business risks that have emerged in recent decades. However, agency theory, signaling theory, and stakeholder's theory describe some of the firm characteristics that determine corporate risk disclosure level (Taylor 2011; Hassan, Saleh & Abd-Rahman, 2008) which have not been having been studied inconclusively.

In recent years, the concept of corporate risk disclosures has gained interest in financial reporting practice, regulation, and international research. Corporate financial reporting is a unique issue in ensuring mutually beneficial relations between a firm and its stakeholders, a situation which ultimately benefits stockholders. Firms provide disclosure through regulated financial reports, including the financial statements, footnotes, management discussion and analysis, and other regulatory filings. In addition, some firms engage in voluntary communication, such as management forecasts, analysts' presentations and conference calls, press releases, internet sites, and other corporate reports (Healy & Palepu, 2001).

A growing stream of research suggests that audit committee characteristics are critically important to the effectiveness of audit committees functions (Abbott *et al.*, 2003). Scholars emphasize the need for audit committees to be comprised of members who are independent, including some of who possess the financial expertise and for the audit committee to meet frequently (Carcello *et al.*, 2002; Abbott *et al.*, 2004). Thus, board and audit committee expertise has been shown to enhance firm value (Chan and Li, 2008; Bronson *et al.*, 2009). Research on audit committee diligence, which refers to the frequency in which audit committees meet, has been shown to have a potentially positive impact on firm performance (Raghunandan & Rama, 2007; Sharma *et al.*, 2009). According to Abbott *et al.* (2004), audit committees that meet at least twice a year will decrease the potentiality of misleading and fraudulent reporting.

The audit committee's role in the implementation of Audit committee characteristics principles and in enhancing firm value is significant. According to the principles of Audit committee characteristics, audit committees should be independent and carry out their responsibilities with due professional care. In instances of financial manipulation, the audit committee is held accountable for it, which is why the transparency of financial information minimizes information asymmetry and enhances firm value (Bhagat & Jefferis, 2002; Heenetigala & Armstrong, 2011). More independent audit committees are more likely to choose higher-quality successor auditors (Chen, Zhou 2007). Hermanson *et al.* (2009) find that shareholder votes for the auditor are positively related to audit committee financial expertise, suggesting that shareholders have more confidence in the elected auditor if the audit committee has more financial expert

Ideally, audit committee's works link communication network between internal and external Auditors and the Board of Directors, and their activities include analysis of nominated auditors attributes the ability of audit committee as the organizations agents to their characteristics leading to an overall range of the audit results and internal financial controls and financial disclosure.

Currently, developing economies such as Kenya doe experience disclosed a challenge that that many audit committee members do not possess the necessary skills, knowledge, and experience to act as audit committee members and perform their duties optimally (Cascarino & Van Esch, 2005); it also revealed the existence of management challenge to an apparent lack of available non-executive directors (NEDs) with the required business acumen and accounting background who are willing to serve on audit committees (Njunga, 2000).

Locally there are studies which have been conducted on the audit committee. Wakaba (2014) evaluated the effect of audit committee charterers on firm performance. Ogoro & stimulus (2015 carried out a study on the relationship between the characteristics of audit committees and its effectiveness in reducing the number of financial statement restatements for State Corporations in Kenya. a study on However, very few studies has shown how audit committee composition and corporate risk disclosure in developing countries such as Kenya. Therefore this research study sought to establish the relationship between audit committee characteristics and corporate risk disclosure, in the Nairobi securities exchange, Kenya? Thus, the study hypothesized that

H<sub>1</sub>: There is a relationship between audit committee size and quantity of risk information disclosed.

H<sub>2</sub>: There is a relationship between a number of independent auditors and quantity of risk information disclosed.

### **Theoretical Framework**

This study was anchored within the agency theory; the empirical studies increasingly recognized that the audit committee had a central role in reducing agency problems (Zahra, Pearce 1989). Agency theory, proposed by Jensen & Meckling (1976), may help to explain managers' incentives for voluntary disclosure. Agency theory conceives that the role of monitoring managers on behalf of the owners has been delegated to the board of directors. Agency theory conceives an inherent moral hazard between shareholders (principals) and managers (agents) that gives rise to agency cost (Rajab, 2009). Thus agency theory posits disclosure as a mechanism which decreases these conflict costs, for example by producing accounting reports and increasing the amount of information contained in these reports (Morris, 1987). Beasley (1996) and Felo & al (2003) based on the agency theory provide for the existence of a positive and significant relationship between the presence of an audit committee and the quality of financial statements. Similarly, Mc Mullen (1996), based on the agency theory, finds a positive relationship between the existence of an audit committee and the reliability of financial statements. The agency theory states that the presence of an audit committee within the board of directors is sufficient to ensure the reliability of financial statements. However, Beasley (1996) concluded that the mere

presence of an audit committee does not necessarily mean that this committee is effective in performing its oversight role.

Agency theory argues that the delegation of managerial responsibilities by principals (owners) and agents (managers) requires the presence of mechanisms that either align the interests of principals and agents or monitor the performance of managers to ensure that they use their delegated powers in the best interests of the principals. It has been argued that weak internal or external auditing, controlling and limited protection of minority shareholders intensify the traditional principal-agent problems in transitioning

Effective oversight of the financial reporting process depends largely on strong audit committees, and qualified, committed, independent, and tough-minded audit committees represent the most reliable guardians of the public interest (Bronson *et al.* 2009). An effective audit committee has to exercise professional care by working hard and frequently meeting in order to ensure good financial reporting quality. Herdman (2002), the chief accountant of Securities and Exchange Commission (SEC), indicated the importance of audit committee in the post-SOX period that the role of the audit committee is central to ensuring the integrity of published financial statements on which investors rely, and which are central to the efficiency of our capital market.

## **Empirical Review**

### **Audit Committee Size and Risk Disclosure**

Beretta and Bozzolan (2004) in the study on analysis of audit committee and an index to measure the quality of risk disclosure. The objectives of the study were to assess the effect of audit committee size and tenure on risk disclosure. The study applied a sample of apply cx85 Italian nonfinancial companies listed in the ordinary market on the Italian Stock Exchange. To verify that the framework and synthetic index are not influenced by the two factors recognized in the literature as the most powerful drivers of disclosure behavior for listed companies, the study used the OLS model. The regression shows that Audit committee size is an important determinant of the level of risk disclosure.

Linsley and Shrivs (2006) explored determinates of risk disclosures using a sample of 79 UK company annual reports using content analysis. The study objective was to determine the effect of audit committee size on risk disclosures and company size. The paper also discusses the nature of the risk disclosures made by the sample companies specifically examining their time orientation, whether they are monetarily quantified and if good or bad risk news is disclosed. The study used regression analysis and show particularly that there is a positive association between Audit committee size and the total number of risk disclosure. They also find the existence of a positive relationship between Audit committee size and a number of financial risk and non-financial risk disclosures.

Barako (2007) investigates the impact of audit committees' characteristics (audit committee size, independence, activity, financial expertise, and percentage of common stocks owned by audit committee) on improved accounting conservatism and earnings management practices for a sample of 50 Jordanian industrial corporations listed in Amman Stock Exchange (ASE) during the period of 2004-2009. The study measures accounting conservatism using book-to-market approach and ratio of total accruals to gross profit. By using Pooled Data Regression, the study found the audit committee characteristics is a significant predictor of disclosure of all categories of information.

Hussainey and Elzahar (2012) on their empirical analysis of 72 interim reports of UK firms found that Audit committee size is positively associated with the total corporate risk disclosure level. It is anticipated that large firms rely on external finance; hence, they have incentives to disclose more risk information to send a good

signal to investors and creditors about their ability to manage risk. In addition, large firms have sufficient resources to cover the cost of additional risk disclosure.

Hassan (2009) conducted a study in Malaysia, the purpose of this paper is to examine the association between audit committee characteristics and firm performance among public listed firms in Malaysia. This study employed EVA as a performance measurement tool. The sample is 75 firm year observations and covers fiscal years 2008-2010. The study found that audit committee independence is positively associated with firm performance while audit quality is negatively associated in Malaysia. Overall, audit committee characteristics have a positive effect on firm performance. This study contributes to the literature as well as in empirical evidence on audit committee characteristics and firm audit quality. The results suggest that Big 4 firms have a negative impact on the value-based measure in Malaysia.

Audit committee size considers a proxy for two main reasons, political sensitivity, and economies of scale. The first one, the larger of the Audit committee size, the larger political sensitive and the firms have a dominant ability in the market (positive relationship between the two variables) (Abraham & Cox, 2007; Hassan, 2009; Linsley & Shrides, 2006). So, larger firms have a motivation to disclose the higher level of risk information to clarify the higher level of return, increase investors' confidence and decrease political sensitivity. For the second reason, the largest of the Audit committee size, the less costly for additional disclosure incomparable to small Audit committee size.

Lowry (2005) claimed that a positive and significant association exists between disclosure and size; this is based on the possibility of economies of scale (Field, Lowry, & Shu, 2005). Research by Watson *et al.* (2002) proved that it is much cheaper for the larger audit committee to offer voluntary disclosures as opposed to smaller firms. Some of the direct costs that will be incurred through voluntary disclosure include the cost associated with getting the information together and later disseminating it and this exercise may also result in a competitive disadvantage as an indirect cost (Field *et al.*, 2005). They also add that since the risk of litigation for smaller firms is much less, this works as a deterrent for them to disclose a lot of their information in their annual reports as the benefits do not substantiate the cost incurred.

Linsley & Shrides (2006) found that there is a positive effect between Audit committee size as measured by TS and the level of risk disclosure for a sample of 79 companies from the UK (The turnover of companies and proxies were measured for size which is the market value, but they found no relation between size and the level of risk disclosure). Mohobbot (2005) found that there is a positive effect between Audit committee size as measured by TS and the level of risk disclosure among 90 non-financial Japanese companies.

Beretta and Bozzolan (2004) in a study carried out at the end of 2001, found that there was no effect between Audit committee size as measured by TS and the level of risk disclosure for a sample of non-financial companies from the Italian stock exchange. Abraham and Cox (2007) discovered a positive effect between Audit committee size as measured by TS and the level of risk disclosure for samples of non-financial companies which were ranked according to market value from 1–100.

Konishi and Ali (2007) found a positive relationship between the level of risk disclosure and Audit committee size as measured by TS among Japanese companies. Hassan (2009) found that there was no relation between Audit committee size as measured by TS and the level of risk disclosure for a sample of 41 companies from the UAE. Rajab & Handley-Schachler (2009) also found no relation between Audit committee size as measured by TS and the risk disclosure level for a sample of 52 non-financial companies from the FTSE-100 of England.

Oliveira *et al.* (2011) however, found a positive relation between Audit committee size and the level of risk disclosure for a sample of 81 non-financial Portuguese companies. There are some studies that investigated the

element of size and risk disclosure level of companies. Linsley and Shrivies (2006) found that there was no coefficient relation between Audit committee size as measured by TA and the level of risk disclosure for a sample of 79 companies from the UK. Kajüter (2006) found a positive effect between Audit committee size as measured by TA and the level of risk disclosure for samples from Germany.

Mohobbot (2005) discovered a positive effect between Audit committee size as measured by TA and the level of risk disclosure among 90 non-financial Japanese companies. Elzahar & Hussainey (2012) found the positive relation between Audit committee size and risk disclosure in the UK Interim reports a sample of 72 UK companies. There are several studies which measured the size of companies based on total revenue; Amran et al. (2009) conducted such a study and found that there was a positive effect between Audit committee size as measured by total revenue and the level of risk disclosure for a sample of 100 companies from Malaysia.

Kajüter (2006) found that there was no relation between Audit committee size as measured by total revenue and the level of risk disclosure for samples from Germany, while Kajüter (2006) found a positive relationship between the level of risk disclosure and Audit committee size as measured by TA and market capitalization. Konishi and Ali discovered a positive relationship between the level of risk disclosure and Audit committee size as measured by TR among Japanese companies. From an agency theory perspective, the hypo-proposal that large firms disclose more risk information in their annual reports that small firms are to be tested.

### **Number of Independent Auditors and Risk Disclosure**

Linsley, *et al.* (2003), argued that those companies that are better at risk management will have higher levels of relative Number of independent auditors, and they will then want to signal their superior risk management abilities to the marketplace via disclosures in the annual reports (as cited by Mohobbot (2005)). Companies which are more profitable may have more resources available to assess and manage their risks, as argued by Deumes and Knechel (2008)

Abraham and Cox (2007) also examined narrative risk disclosure from a broad perspective. They developed their study on risk reporting in three directions: first, analysis investigated ownership and governance determinants of risk reporting; second, analysis of risk reporting by examination of the association between UK companies that were dual listed in the US, third, analysis, focused on business, financial and internal control aspects of narrative risk reporting. They found a positive relationship between the quantity of narrative risk information in corporate annual reports, Number of independent auditors governance and US listing characteristics, and negatively related with share ownership by long term institutions.

Moreover, Amran *et al.* (2008) studied risk disclosure practices between Malaysian firms; they concentrated on the narrative section of the annual report and the chairman's statement. They found that firm Number of independent auditors was a significant relationship with the level of risk disclosure, and industry type also has a significant influence on the extent of risk disclosure. Hassan (2009) examined the association between the firm Number of independent auditors and the level of corporate risk disclosure applied to the United Arab Emirates (UAE) companies. The study found that there was no significant relationship between corporate Number of independent auditors and the level of corporate risk disclosure, but there was a significant associated between the level of corporate disclosure and industry type, and negatively associated with corporate reserve. Based on these the hypo-proposal that highly profitable companies disclose more risk information in their annual reports than low profitable companies will be tested.

Studies have examined the influence of firm characteristics on the risk disclosure level (Rajab and Schachler, 2009). Other studies examined the influence of corporate governance characteristics on risk disclosure (Abraham and Cox, 2007; Taylor, 2011). Besides, another stream of studies examines risk reporting related to



accounting standards, for example, IFRSs and derivatives (Lopes and Rodrigues, 2007; Hassan *et al.*, 2008). There are mixed results about the main characteristics of the audit committee and risk disclosure.

This dearth in this area motivated the researcher to carry out a study of the situation in Kenyan public-listed companies. Despite the growing interest in risk issues, only a few articles have studied the characteristics of risk disclosing firms. The question, which audit characteristics facilitate management risk reporting has largely been ignored in the literature. The aim of this study was to identify the audit characteristics that appeared to facilitate risk disclosure by management, using a sample of Kenyan listed firms.

### Methodologies

A cross-sectional design was employed in the study. Census technique was used in the study since it only captured all the 45 firms that had consistently been operating at the NSE for the past 8 years from 2005-2012 irrespective of its industry or market segment. This was to obtain a consistent population size. This study utilized secondary data, and data were collected by use of content analysis which was obtained from the annual financial statements reports of listed firms, annual investors' reports, magazine and articles related to the financial performance of listed. A document analysis guide had been prepared to enable and guide the collection of data on firm and Audit committee characteristics of the selected listed companies and the extent of their risk disclosures. The hypothesis was tested at 0.05 level of significance (95% confidence level) from the multiple regression

### Findings And Discussion

Study findings in table 1 illustrated the descriptive results in all the sectors. Results in table 1 revealed that the audit committee was composed of 13 members (mean = 13.407) with 44% of them being independent auditors (mean = 0.44). Risk disclosure among all listed firms in NSE was 9.2587.

**Table 1** Descriptive Results

	Min	Max	Mean	Std. Deviation	Skewness	Kurtosis
Audit Committee independence	0.4	0.47	0.44	0.03742	-0.374	-2.8
Audit committee size	8	14	13.4704	2.47717	0.908	1.039
Risk disclosure	3	16	9.2587	2.8598	-0.102	-0.582

### Correlation Results

Correlation analysis is a technique for assessing the relationship between variables: audit committee experience, audit committee independence and audit committee size board size with risk disclosure. Thus, the study analyzed the relationships that are inherent among the independent and dependent variables. The results regarding this were summarized and presented in Table 2. The number of independent auditors was positively correlated to risk disclosure as indicated by a correlation coefficient value of 0.258 indicating that independent auditors were a significant factor contributing 25.8% positive relationship with risk disclosure. Further, audit committee size was also positively correlated to risk disclosure as evidenced by a correlation coefficient value of -0.193 (significant at  $\alpha = 0.01$ ) an indication of 19.3% positive relationship with risk disclosure.

**Table 2**      **Correlation Results**

	Risk disclosure	Number of independent auditors	Audit committee size
risk disclosure	1		
Audit committee independences	0.258*	1	
Audit committee size	.193**	.381**	1

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

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

### Hypothesis Testing

Also, audit committee independence and audit committee size explained 45.3% variation of risk disclosure. This showed that considering the independent variables, there is a probability of risk disclosure (R squared = 0.453). The Durbin Watson value of 1.743 was within the thumb rule of 2 thus no autocorrelation. Study results in table 3 revealed that F value 57.86, with p-value = 0.000 significant at 0.05, this implies that the joint prediction of audit committee independence and audit committee size is significant. This shows that the model can be used in the future to predict risk disclosure. The regression results presented in Table 3 highlights both the direct effect.

Audit committee size showed a positive and significant effect on risk disclosure ( $\beta = -0.213$ ,  $p < 0.05$ ). Consequently, an increase in audit committee size by 0.213 units leads to an increase in risk disclosure by the same unit. Cognate to the results, Beretta and Bozzolan (2004) in their study on analysis of audit committee and an index to measure the quality of risk disclosure shows that audit committee size is an important determinant of the level of risk disclosure. Similarly, a study by Linsley and Shrive (2006) explored determinates of risk disclosures using a sample of 79 UK company annual reports using content analysis and revealed that there is a positive association between Audit committee size and the total number of risk disclosure. As well, Hussainey and Elzahar (2012) on their empirical analysis of 72 interim reports of UK firms found that Audit committee size is positively associated with the total corporate risk disclosure level. On the same note, Lowry (2005) claimed that a positive and significant association exists between disclosure and size. This was also the case with Linsley & Shrive (2006) who found that there is a positive effect between Audit committee size as measured by TS and the level of risk disclosure for a sample of 79 companies from the UK. In a similar vein, Mohobbot (2005) found that there is a positive effect between audit committee size as measured by TS and the level of risk disclosure among 90 non-financial Japanese companies. In light of the extant literature, larger firms have a motivation to disclose the higher level of risk information to clarify the higher level of return, increase investors' confidence and decrease political sensitivity. It is only Beretta and Bozzolan (2004) that found no effect between Audit committee size as measured by TS and the level of risk disclosure for a sample of non-financial companies from the Italian stock exchange.

Furthermore, Audit Committee independence showed a positive and significant effect on risk disclosure ( $\beta = 0.318$ ,  $p < 0.05$ ). This is a clear indication of 0.318 unit increase in risk disclosure once the audit committee independence is increased. corroboration with the results, for Linsley, *et al.* (2003), those companies that are better at risk management will have higher levels of relative Number of independent auditors, and they will then want to signal their superior risk management abilities to the marketplace via disclosures. Moreover, as opposed to studying findings, Amran *et al.* (2008) found that a firm number of independent auditors was a significant relationship with the level of risk disclosure. However, Hassan (2009) found that there was no significant relationship between corporate Number of independent auditors and the level of corporate risk disclosure. Finally, the VIF for all parameters were less than 4 signifying lack of multi-Collinearity.

**Table 3** Regression Analysis

	Unstandardized		Standardized Coefficients			Collinearity	
	B	Std. Error	Beta	T	Sig.	Tolerance	VIF
(Constant)	-9.894	2.048		-4.831	0		
Audit committee size	-0.419	0.096	-0.213	-4.366	0	0.824	1.214
Audit Committee independence	-1.165	0.185	-0.318	-6.287	0	0.765	1.307
R Square	0.453						
Adjusted R Square	0.446						
F	57.86						
Sig.	0						

a Dependent Variable: risk disclosure

### Conclusions And Recommendations

The study finds a significant positive effect between audit committee size and risk disclosure. Thus, risk disclosure provides more transparency and increases investors' confidence. Also, there is a need for a large audit committee size since it has the motivation to disclose the higher level of risk information to clarify the higher level of return and increasing investors' confidence. Furthermore, in addition to an audit committee, there is a need for a risk committee. This is because a risk committee enhances management ability to disclose risk so as to ensure investors are made aware of the ongoing activities in the firm.

The study has found a positive and significant effect between audit committee independence and risk disclosure. It is therefore utmost necessary to have a balanced board composition. As such, there is need to add outside directors to the board so as to keep the independence of the board. This is because outside directors are independent of management and more effective in protecting the interests of shareholders whenever there is an agency problem. Also, firms will be able to more risk information and signal ways in which the risks can be managed.

The study's main objective was to identify the firm and governance characteristics that determine risk disclosure in annual reports. Although the findings indicate that; audit committee size, independence, and experience have a significant effect on risk disclosure, more elaborate research on other firm and governance characteristics such as liquidity, return on assets, firm age, board composition and audit firm is necessary to accurately establish the effects of firm and governance characteristics on risk disclosures. Additionally, a comparative study across different industries might also be a more valuable contribution to this area of research.

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