AUDIT COMMITTEES AND CORPORATE GOVERNANCE IN A DEVELOPING COUNTRY[1].

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Audit Committees and Corporate Governance in a Developing Country

Abstract: *Market regulators, commissions and accountancy bodies have recommended the establishment of audit committees as an important step in improving corporate governance. In 2002 the Kenya Capital Markets Authority required all listed companies to establish audit committees. This study examined the role of audit committees in corporate governance in Kenyan listed companies. In particular, how audit committees operate in a developing country such as Kenya and how these practices compare with those of western economies and other emerging economies; how audit committees relate to management, internal audit, and external auditor; and the major achievements and challenges facing audit committees in Kenya. A questionnaire survey completed by 29 companies (60%) showed much similarity to studies in major economies. However, skills shortage and dominant shareholder or government may have affected the operations of audit committees. All the audit committees reported cordial relationships with the management, internal audit and the external auditors, and were perceived to have improved the quality of financial reporting.*

Key words: *Audit committees, Corporate governance, Kenya, Listed Companies, Internal audit, External audit*

1. Introduction and Motivation

Jensen and Meckling (1976) defined an agency relationship as a contract under which one or more persons (the principals) engage another (the agent) to perform a service on their behalf. Typically the shareholders, or the principals, delegate the day-to-day decision making to the managers or agents. Managers are charged with the responsibility of using and controlling the economic resources of the firm. However, they may not always act in the best interest of the shareholders partly due to adverse selection and moral hazard (Anthony and Govindarajan, 2007:531). Shareholders must therefore monitor the activities of the managers to ensure that they live up to the provisions of their contracts (Goddard and Masters, 2000).

To guard against management failures, Moldoveanu and Martin (2001) argued that shareholders should enact ratification, monitoring and sanctioning (reward and punishment) mechanisms. They defined ratification mechanisms as those used for validating the decisions of the agent, in giving final approval or veto for an initiative, directive or actionable plan of the agent. Monitoring mechanisms are designed for observing, recording and measuring the output of the efforts of the agent. Sanctioning mechanisms are designed for providing selective rewards and punishment to the agents for the purpose of aligning their efforts with the interests of the shareholders.

An important tool for monitoring is the annual report whose reliability is enhanced by the audit report Power (2002). However, the annual report may be inadequate for monitoring purposes due to information asymmetry. Moreover the nature of the audit is such that omissions or distortions may not be detected. Additional monitoring involves costs, which the shareholders may be unwilling to bear. To monitor management, shareholders have traditionally relied on the non-executive members of the board of directors and audit committees.

A number of corporate governance studies have been carried out in developed countries of Europe, United States of America (USA) and Japan (Joshi and Wakil 2004). However only a few studies have been completed in developing countries. Tsamenyi, Enninful-Adu and Onumah (2007) observes that corporate governance studies in developing countries are limited and available only on an individual country basis.

1.1 Corporate governance issues in developing countries

Wallace (1990) defines developing countries as those in the mid-stream of development and refers to an amorphous and heterogeneous group of countries mostly found in Africa, Asia, Latin America, the Middle East and Oceanea. Marked economic, political and cultural differences between developed and developing countries exist (Waweru and Uliana, 2005). For example, most developing countries suffer from a lack of skilled human resources, suggesting that companies in developing economies may experience difficulties attracting people with accounting or finance knowledge to their audit committees. Cultural differences between developed countries of North America (highly individualistic) and developing countries of Africa (highly collectivistic) may also require different corporate governance arrangements. Rabelo and Vasconcelos (2002) argue that factors such as economic trends towards globalization, structural characteristics of developing countries (undeveloped capital markets and government interventionism) will make the model of corporate governance different from that found in European or North American contexts. Mensah (2002) suggests that African countries are ill equipped to implement the type of corporate governance found in developed countries, due to the characteristics of the economic and political systems of these economies, such as state ownership of companies, weak legal and judicial systems and limited skilled human resource capacity. He notes a dominance of state enterprises (even with privatization) or closely held family-owned, while companies managed by other than owners and listed companies comprise a very small proportion of GDP. For example Kenya has only 48 listed companies with a market capitalization constituting 34% of GDP (World Bank 2007). This is small compared to South Africa which has 668 listed companies with a market capitalization constituting 132% of GDP.

Developing countries are often faced with a myriad of problems, such as underdeveloped and illiquid stock markets, economic uncertainties, weak legal controls and investor protection, and frequent government intervention (Tsamenyi *et al* 2007). Furthermore, there is a predominance of concentrated shareholding and controlling ownership in most developing countries (Rahman and Ali, 2006). Corporate structures in developing countries are characterized by the desire to maintain control over firms by the majority shareholder, the reliance on debt finance, weak financial markets and an ineffective legal system (Rabelo and Vasconcelos 2002).

Hussein (2003) examined the effect of audit committees on major disclosures and other non-financial characteristics of companies listed at the Nairobi Stock Exchange (NSE). However the study did not address the issue of how audit committees operate, their relationship with management or whether the committees were effective in the performance of their duties. Goddard and Masters (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) indicated that the issue of whether audit committees are actually discharging their important responsibility remains insufficiently understood. Therefore, there is need for a study to be carried out to examine the way audit committees operate in developing countries.

Kenya provides an appropriate setting as in Kenya many large companies are institutionally owned. Where such institutions are government owned (e.g. by state managed pension schemes or treasury), many board members serve by virtue of their position as management of the shareholder and not necessarily because of their qualification and experience (Mensah, 2002). The operations of audit committees in a developing country may differ when compared to practices in developed countries. This study attempts to understand, how audit committees operate in developing countries, the challenges they face and their relationship with management, the internal auditor and the external auditor. The Kenyan Capital Market Authority (CMA) issued guidelines on corporate governance practices for publicly listed companies in 2002. One of the guidelines requires the board to establish an audit committee with at least three independent and non-executive directors (Legal notice No 60 CMA, 2002).

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. We compare our findings with those of prior research in western countries and other emerging economies. The study addressed the following research questions:

i) *How do audit committees operate in a developing country such as Kenya and how do these practices compare with those of western economies and other emerging economies?*

ii) *How do the audit committees relate to management, internal audit, and external auditors?*

iii) *What are the major achievements and challenges facing audit committees in Kenya*?

The literature is reviewed in section 2, followed by the research approach (section 3) and the findings (section 4). The conclusions follow in section 5.

2. Literature Review

2.1 Introduction

Corporate failure and scandals have led to demand for reforms and for better regulations particularly in the field of 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 published in December 1992 (The Cadbury Code) which included recommendations for companies to establish audit committees comprising independent non-executive directors (Power 2002).

In the USA an increasing number of earnings restatements by publicly traded companies, coupled with allegations of financial statement fraud and lack of responsible corporate governance of high profile companies (e.g. Enron, Global Crossing, World com in the USA, Parmalat in Italy and MacMed, Masterbond and Leisurenet in South Africa) has sharpened the ever increasing attention on corporate governance in general and audit committees in particular. The fall of these companies raised concerns regarding the lack of vigilant oversight by their boards of directors and audit committees in the financial reporting process and auditing functions (Rezaee et al, 2003). The USA president, in a state of the union address, mentioned the seriousness of the problem by stating: '*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*' (Bush, 29th January 2002). A number of commissions and committees have been established to address corporate governance in the USA, which include the Treadway Commission (1987) and the Blue Ribbon Committee (1999). Further, the Sarbanes-Oxely act of 2002 was signed into law and one of its major provisions was that listed companies establish audit committees (Joshi and Wakil, 2004).

Rezaee, Olibe and Minmier (2003) stated that good corporate governance promotes relationships of accountability among the primary corporate participants and this may enhance corporate performance as it holds management accountable to the board and the board accountable to the shareholders. A key function of the board is to ensure that quality accounting policies, internal controls, and independent and objective outside auditors are in place. This may deter fraud, anticipate financial risks, and promote accurate, high quality and timely disclosure of financial and other material information to the stakeholders.

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 accountability with the ultimate objective of realizing shareholders long-term value while taking into account the interest of other stakeholders.

In Kenya the issue of corporate governance has been taken seriously; 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. One of the key recommendations in the PSCGT (2000:22) 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 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 (CMA, 2002). The appointment of properly constituted audit committees is therefore considered to be an important step in raising standards of corporate governance (PSCGT 2000).

In South Africa, Mangema and Chamisa (2008) found that the likelihood of a firm being suspended from the stock exchange is higher in firms without an audit committee. This suggests the importance of Audit committees in Africa.

The above refer to the operations and relationships of audit committees, being two of the objectives of this study. The third is to explore the challenges faced by audit committees in Kenya.

2.2 Operations of audit committees

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 other stakeholders, the systems of internal controls, which management and the board of directors have established, and all audit processes (Bean 1999). Bean (1999:6) 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.

iv. The committee will meet at least four times each year or more frequently if circumstances make it preferable.

Charter

Audit committees in developing countries may have difficulties in performing this role since they suffer from a shortage of accounting skills (Waweru, Hoque and Uliana, 2004). Several studies have been undertaken on the audit committees' oversight responsibilities. In general, the findings indicated wide variations in both perceived and stated responsibilities. Coopers and Lybrand (1995) and DeZoort, Hermanson, Archambeault and Reed (2002) 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.

Guy and Burke (2001) argued that every company that has an audit committee should develop a tailor made charter for the committee that describes the committee's composition, and specifies access to appropriate resources. The board should approve the charter, which serves as a guide to the audit committee in carrying out the responsibilities delegated to it by the full board.

A prerequisite for the effective performance of the audit committee requires its status to be formally established, such as by a resolution of the board or embodied in the by-laws of the company (Braiotta 1999). A comprehensive charter further enhances the effectiveness of the audit committee, serving as a roadmap for committee members by defining responsibilities and providing a systematic structure for discussions between the committee and management, the public accountant and others (Bean 1999). A 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 (KPMG 1999).

Changing conditions make a periodic review and update desirable, thus best audit committee charters are living, changing documents (Bean 1999). In Kenya the authority of audit committees is derived from the CMA Act, which requires the board to delegate some of its authority to the audit committees.

Composition

One of the most important variables in the composition of an audit committee is the question of independence (Joshi and Wakil, 2004). The effectiveness of the audit committee depends on the background of the members which should consist of both financial and non-financial people (Braiotta (999). The chairman has a critical role in coordinating the committee's tasks. The success or failure of the operation could depend on the chairman, therefore should be chosen with great care (Braiotta, 1999). 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).

There are differing views on whether all audit committee members should be independent as advocated by Bean (1999), The Blue Ribbon Committee (1999) and adopted in Kenya by the CMA in 2002 (Hussein, 2003), or depend on the circumstances of the particular company (Attwood 1986). What constitutes independence is also debatable. Bean (1999) described an independent director as one who is free of any relationship that could influence his or her judgment as a committee member. However, this is not always easy to determine (Pomeranz 1997), who further raised the issue of whether emphasis should be placed on independence in fact rather than on independence on appearance. In addition Herdman (2002) observed 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. 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 Kenya the independence of most directors may be affected by the fact that most of them serve as directors of more than one listed company. This is mainly attributed to the shortage of skilled human resources in Kenya. Moreover some of the listed companies are small, making it difficult for them to attract qualified people.

Financial skills

As with independence, there are differing views on the need for financial literacy. The Blue Ribbon Committee (1999) recommends that all members of the audit committee need to be financially literate. Rezaee et al (2003) defined financial literacy as the ability to read and understand fundamental financial statements. Herdman (2002) questioned whether the capital markets requirement about financial literacy of audit committee members went far enough. In contrast, Jonathan and Carey (2001) questioned 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.

Some studies have been carried out in the area of experience and expertise. For example, the US General Accounting Office (GAO) (1991) 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.

Meetings and reports

Guy and Burke (2001) stated that most audit committees have two to four scheduled meetings per year depending on the scope of their activities and the size of the company. However Graziano (2004) argue 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 the internal auditor (Graziano 2004). In addition to scheduled meetings, the audit committee must have authority to hold special meetings as needed (Burke and Guy, 2001).

Research studies involving meeting frequencies of audit committees and company variables have created some interest. Menon and Williams (1994) 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 their survey of audit committees, PriceWaterHouseCoopers (1999) found that audit committees among European companies met on average three to four times a year.

The audit committee's report should be addressed to the full board of directors and should 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 the member's participation in the audit planning process as well as their monitoring activities (Braiotta, 1999).

2.3 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. Rezaee et al (2003) stated that the more effective approach is for 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 to obtain complete understanding of their impact on fair presentation of financial performance conditions so as to reduce fraudulent earnings management. 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. However in developing countries many of the listed companies are institutionally owned (e.g. by government and or government managed pension schemes), consequently some members serve on the boards by virtue of their position in government. This may create some dominant senior managers capable of interfering with the work of the company's audit committee.

The audit committee must be totally independent from the CEO (Braiotta 1999). An appropriate relationship with the CEO is key as the CEO is the best source of information relating to the business and can ensure quick action on committee requests. The audit committee should expect the management to be integral in expanding its awareness of the company's financial reporting process, identifying risks and understanding the controls surrounding those risks as an effective audit committee is focused and informed (Terrell 2003).

Although the responsibility for reviewing the effectiveness of internal controls lies with the board of directors, in reality the board may delegate this task to its audit committee (Zaman, 2001). 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 have common objectives regarding the financial affairs. Prior to the Sarbanes-Oxley Act in the USA it was legal for auditors to report to management. The Sarbanes-Oxley Act required that the auditors report to and are overseen by an audit committee, which must approve all audit and non-audit services, receive all new accounting and auditing information from the auditors, and serve as the official line of communication between the auditor and the client company (Tackett 2004). 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 other services makes it difficult for management to purchase unneeded services from the auditor in the hope of getting 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.

Knapp (1987) surveyed 179 audit committee members and found that in audit disputes the audit committee tended to support the auditors rather than management. Dockweiler, Nikolai, and Holstein (1986) surveyed 731 accountants in the USA 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.

2.4 Achievements and challenges facing audit committees

Opinions on the usefulness of audit committees are mixed. Burke and Guy (2001) report that only 15% of executive directors of FTSE 100 companies believed that audit committees were vital 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. Menon and Williams (1994) investigated whether companies relied on their audit committee reports. They found 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. Furthermore, audit committees appear to be used more in larger firms and where there are a higher proportion of non-executive directors (Joshi and Wakil, 2004).

Increased emphasis on corporate governance has placed greater pressure on audit committees to oversee the integrity of their companies' financial reporting processes. 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).

Expectations for the non-executive directors who serve on audit committees are rising (Jonathan and Carey 2001). Matters concerned with management of risk, internal control, additional regulatory requirements, external auditor independence, as well as the move to international accounting standards, are increasing the responsibilities of audit committees. In addition, the many stakeholders interested in the company's activities, with varied agendas, increase the complexity and risk of serving on boards and audit committees. For example the Sarbanes-Oxley Act (2002) indicates that failure to perform may result in legal action. Furthermore the act requires that the responsibilities be specified in the audit committee charter and also be disclosed in the Annual reports. Likewise, audit committees in Kenya derive most of their power and responsibility from the CMA Act (2002), with their responsibilities disclosed in the annual audit report.

Rezaee et al (2003) noted that the inclusion of audit committee reports in the proxy statements presents challenges for audit committees. As audit committee members are not fully involved in the preparation of financial statements this requirement increases their risk.

Given the new corporate governance environment, it is essential for audit committees to focus on a process to support effective oversight that goes beyond mere compliance with the 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 the quality of oversight (KPMG, 2001).

2.5 Conclusion

Research in developed countries has revealed that good corporate governance may reduce fraudulent earnings management (Rezaee et al, 2003). Indeed the failure of most of the high profile companies has been attributed to the lack of vigilant oversight by their board of directors. Although Africa has not witnessed the level of corporate failure experienced elsewhere, it should be able to learn from some of the experiences (Okeahalem, 2004). Unfortunately, empirical research on the effectiveness of corporate governance in Africa is almost nonexistent. Mangema and Chamisa (2008) have observed that due to the country differences in Africa, it is desirable that various governance structures be examined separately in each country. This study attempts to bridge this apparent gap in prior research by contributing to our understanding of the operations and achievements of audit committees in Kenya.

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) investigated the motives, composition, selection, and frequency of audit committee meetings, audit committee's relationship with internal and external auditors and its broader role. In the USA, Abbot, Parker and Peters (2002) addressed the impact of certain audit committee characteristics identified by the Blue Ribbon Committee (Braiotta 1999) on improving the effectiveness of corporate audit committee and the likelihood of financial misstatement.

Previous studies in developing countries have not addressed the issue of how audit committees relate to management, internal auditor and the external auditor. We seek to fill this gap in the literature by investigating how audit committees in Kenya relate to management, the internal auditor and the external auditor

3. Research Method

This study used a questionnaire survey followed by personal interviews. A covering letter explaining the purpose of the study and a questionnaire were then sent to the 48 internal audit directors. The questionnaire, which was developed from the review of related literature and pre-tested with a group of academicians and practitioners, had 50 questions directly addressing the specific objectives of the study. The questionnaire focused on the operations, composition, independence, financial literacy and self-evaluation; relationships; and key achievements and challenges. Most of the questions were of the 'Yes' or 'No' type. Other questions requested the respondents to rate the achievements of the committees on a scale of 4 (To a very large extent) to 1 (Not at all).

Questions 1-6 covered the company's demographic information while questions 7-36 covered the operations/functions of the audit committee corresponding to the first research question. Questions 37-45 dealt with issues relating to the relationship between the audit committee, management, the internal auditor and the external auditor while questions 46-50 explored the achievements and challenges facing the audit committees corresponding to the second and third research questions respectively.

All the 48 internal audit directors of the companies listed at the Nairobi Stock Exchange (NSE) as at 30th June 2004 were initially contacted on telephone to explain the purpose of the study and to request their participation. The heads of internal audit were chosen as respondents since the CMA guidelines requires them to attend all the audit committee meetings and the internal audit function is also under the supervision of the audit committees.

As is shown in Table 1, 29 of the 48 companies (NSE, 2004) responded to the questionnaire, which represent a response rate of 60%. There were no significant differences between the characteristics of early and late respondents or responding and non responding departments. Seven respondents agreed to participate in a personal interview. The remaining 22 completed questionnaires which were later picked by the researchers directly from the respondents. This enabled the researchers to clarify any issues that were not clear to the respondents.

Table 1: Number of respondents

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%**

The data was analyzed using SPSS; frequencies were used to group or organize raw data for ease of interpretation. Percentages provided a general summary of collected data, while means were used to rank the scores. No statistical analysis was carried out as with 27 useable respondents, sub-groupings were too small for meaningful statistics. However the findings are still meaningful as the respondents represent 60% of the population.

4. Findings and Discussions

Twenty-seven of the 29 respondents had established audit committees, of which eight (30%) were established before 1998 when the CMA guidelines became effective, four (15%) were established in 1998, and 15 (55%) were established after 1998. Neither the type of industry nor the size of company was seen to be a determinant of whether a listed company established an audit committee or not. Joshi and Wakil (2004) reported that the size of the company and the audit firm (whether international or local) influenced the establishment of audit committees. This inconsistency may be due to the fact that audit committees in Kenya were established as a result of the CMA guidelines unlike in Bahrain (Joshi and Wakil, 2004) where this was done voluntarily. It is interesting to note that two companies had not established audit committees despite this being a legal requirement. One company cited the frequent changes in management while the other indicated that they had a strong internal control and did not therefore require an audit committee. These reasons support Okeahalam (2004) who reported a weak legal/judicial system in Kenya.

The findings are presented under the three main themes of the questionnaire; operations of the audit committee; relationships with stakeholders; and achievements and challenges. As the responses are straightforward the results of the questionnaire are incorporated in the discussion; tables are used only if needed for clarity.

4.1 Operations of Audit Committees

All the respondents had already developed audit committee charters, however, only 56% update their charters annually while the remaining 44% indicated that their charters were updated on a need basis only. While this is consistent with the literature that every company should develop a tailor made charter, it is in conflict with the recommendation that the charters should be updated annually (Hoi et al, 2007; Rezaee et al, 2003). This may be attributed to the limited human resource capacities in developing countries (Mensah, 2002).

The main responsibility of the audit committee is to oversee the financial reporting system. Audit committees should have the ultimate responsibility to select the external auditor. The results on Table 2 indicate that the formal relationship with the external auditors is widely recognized. This is unsurprising as a very important part of the audit committee's job it is to ensure the independence and qualifications of the external auditor. By contrast, only 41% of the audit committees are responsible appointing and dismissing the internal audit manager. Two respondents indicated that their audit managers are hired through recruitment firms and can be dismissed by the management in consultations with the audit committees. Other responsibilities of audit committees which were listed in their proxy statements included monitoring risks, ensuring compliance with internal controls, and ensuring management's compliance with relevant local regulations, enforcing the recommendations of the internal audit and defining the scope of internal audit.

Table 2: Responsibilities of audit committees

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

Audit committees should monitor internal and external audit coverage to ensure that all key risk areas are considered. This may involve meeting with the auditors to review and discuss the current year's audit plan, and the resolution of prior year issues. This was largely complied with among the respondents with 89% of the respondent companies indicating such meetings before the start of the audit. These planned meetings are important as they ensure that the external auditors focus their attention on risky and material areas of the business. All respondents indicated that the audit committees reviewed the management letter issued by the external auditor. This further strengthens the risk management role of the committee as it increases awareness of the weaknesses of the company's financial system and also ensures that the recommendations are implemented promptly.

The performance of the finance and accounting department is normally not the responsibility of audit committees. Nevertheless, 60% give this considerable attention, with a further 26% indicating some discussion. The audit committees of four of the respondent companies did not discuss it at all.

The independence of the external auditors is eroded if they also provide non-audit services. The audit committees should therefore monitor these non-audit services. Our findings indicate that, only 52% of audit committees monitor these services. Mensah (2002) observes that where government institutions own majority shares in companies, board members of the investee companies serve by virtue of their position as management of the shareholder and not necessarily because of their qualification and experience. This could be the case in Kenya, where the government still owns majority shares in listed companies.

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. 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. The average membership per committee is four. However, contrary to the CMA guidelines, 33% of the respondents had less than three independent non-executive directors in their Audit committees. Forty % had three non-executive directors, while 27% had more than three. Again, this may be attributed to the desire to maintain control over the firms by the majority shareholder (Rabelo and Vasconcelos, 2002), in view of the concentrated shareholding pattern in Kenya.

All the respondents indicated that the board of directors appoints the members of the audit committees. Three respondents indicated that the members of the committees appoint the chairmen while the rest (89%) indicated that the board appoints the chair. All the respondents indicated that their chairmen are independent non-executive directors.

All the committees included members from finance and accounting, with an average of 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. Seventy % of the respondents indicated that they engage experts, while 30% reported that although provided for in their charters they have never engaged experts.

In this study, all the respondents indicated that their committees had the knowledge and industrial experience to perform their job. In a way this reflects how corporate governance has progressed in a relatively short time. In a study in the USA in 1991, GAO (1991) reported 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 1998, Arthur Levitt, Chairman of the Securities Exchange Commission (SEC) remarked that an ideal audit committee is the one "*that meets 12 times a year before each board meeting*" (Joshi and Wakil, 2004). Only one respondent meets Levitt's ideal, while 71% meet at least quarterly. Most of the respondents (63%) held quarterly audit committee meetings, concurring with Bean (1999) that quarterly meetings are adequate unless circumstances require more. Similarly, PriceWaterHouseCoopers (1999) found that audit committees among European companies met on average three to four times in a year.

Most (85%) of the committees meet for two hours on average, the rest meeting for either three or four hours. None required additional time to complete their responsibilities.

To reduce the influence of other people especially management on the affairs of the committees, the chairperson should be in charge of setting the agenda and 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. All the respondents indicated that they were fully in charge of setting the agenda of committee meetings, and all bar one used the charter extensively in setting the agenda. The exception used the charter to some extent.

The audit committees report to the board mainly on a need basis and the board follows most of their recommendations. At the end of every year, they should assess their performance to see how well they have discharged their mandate. Informative reporting to the boards is a pre-requisite for the committees' effectiveness (CMA, 2002). 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. 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.

Audit committees in Kenya appear to be doing well in this area with 89% of the respondents reporting to the shareholders. However 37% indicated that they give their reports through the boards. Seventy % of the committees report to their boards after every meeting while the remaining 30% reports quarterly. However given that most committees meet four times in a year, it seems that even those that report quarterly may be reporting after every meeting. All the respondents were unanimous that the board of directors follows most of 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 report that does not give enough details as proposed by the CMA guidelines.

Fifteen (56%) respondents reported that they assess their performance annually while 12 (44%) respondents did not. The practice in Kenya falls short of the AIPCA (2004) recommendation that audit committees assess their performance annually.

Audit committees in Kenya seem to comply to a large extent with recommended best practice. Some areas of concern relate to the smallness of the economy and the interrelationships among organizations not least of which being the government.

4.2 Relationship with management, internal auditor and external auditor

The research examined the relationships of the audit committees with management, internal auditors and the external auditors, how they communicate, and how they resolve any disagreements.

All respondents perceived positive relationships with their main collaborators. 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 % indicated that they communicate on a need basis, 37% communicate quarterly, while 4% communicate semi-annually, apparently on the basis of scheduled meetings.

Audit committees must be able to hold meetings with both the internal and external auditors without the presence of the chief executive officer or other members of management. Such meetings would help to ensure a free and frank exchange where the expression of views might otherwise be restricted. This study found that 74% of the respondent companies' CEOs could attend audit committee meetings on invitations. All the respondents were unanimous that their audit committees were independent of management. They also indicated that there were procedures in place for reporting to the audit committee significant deficiencies and material weaknesses on a timely manner. They further reported that disagreements between management and outside auditors are reported timely to the audit committee. Fifty six % of the respondents indicated that the audit committee constructively challenges management. The appointment of directors on the basis of their relationship with the majority shareholder rather than their qualification and experience could be a major factor (Rabelo and Vasconcelos, 2002). All the respondents indicated that differences of opinion on accounting policies are always resolved to the satisfaction of the audit committees.

From this study the relationship with management, internal auditor and external auditor appears to be largely positive among Kenyan listed companies. There are open lines of communication while at the same time space for meetings without the presence of management.

4.3 Achievements and challenges of audit committees

The achievements of audit committees were captured using three questions. a) the influence of audit committees on the internal auditors; b) whether the committees increased the reliability of financial statements and c) the major achievements and challenges facing audit committees.

The performance and efficiency of the internal audit department is the responsibility of the audit committees. All respondents indicated that the audit committees improved the efficiency and effectiveness of the internal auditors to a large extent. Given that the internal audit is one of the key responsibilities of the audit committees, this can be seen as an indicator that audit committees are achieving their objectives in Kenya.

All respondents believe that the audit committees have significantly increased the reliability of the financial. The study findings are surprising since Kenya, like other developing countries experience a shortage of qualified accountants (Waweru and Uliana, 2005). However this weakness in Kenyan companies may have required audit committees to play a real role in improving the quality of reporting.

In this study, the major achievements of the audit committees was in providing the internal audit with a communication channel and ensuring that the audit issues raised by the internal audit were attended to promptly which then enhances the department's independence. Audit committees have also increased the reliability of the financial statements. Literature, however, is divided on the achievements of audit committees. A study by Burke and 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. However AICPA (2004) consider audit committees as vital in improving internal controls.

Other achievements noted included significant improvement in corporate governance practices, improved risk management and control processes, clarifying the role of internal audit Vis-à-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 auditing costs.

Some respondents indicated that there were no major challenges facing audit committees. However, a few respondents indicated that the challenges posed by the rapidly changing environment coupled with the increased local and international regulations were a major challenge. Further, the concept of audit committees, being new created a problem in setting boundaries within the company, and some dominant senior managers would interfere with the work of the audit committee if not closely watched. Others felt that audit committees were being asked to take major responsibilities over the financial reports although their involvement in the preparation of the accounts was minimal.

Two respondents had not established audit committees; one cited frequent management changes but they were set to establish one in 2005; the other claimed adequate internal control measures. This revealed ignorance of the CMA guidelines, an apparent weakness in the legal systems of developing countries (Mensah, 2002).

The literature gives the challenges facing audit committees as increased liability as a result of their reports being included in the proxy statements (Rezaee et al, 2003; Bean, 1999). Other challenges include many stakeholders interested in the 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 since their report has become part of the proxy statement and the problem of setting the boundary between the committee and the management.

5. Conclusions

This study investigated audit committees in terms of their operations, relationship with management, internal and external auditor and their achievements and challenges in Kenyan listed companies. Surprisingly, some of the findings are consistent with those of studies carried out in the major economies. Factors such as cultural differences, varying levels of governance, size of the markets may have been expected to influence the findings. However the results indicate that limited human capacity, dominant shareholder and government interventionism have influenced the operations of audit committees in Kenya. Almost half of the respondents did not update their audit charter annually as is required, suggesting a limited human resource capacity that is prevalent in most developing countries.

The relatively low incidence of monitoring other services provided by the external auditor, and challenges to management may be attributed to the fact that most directors in Kenya are appointed to the board based on their management position at the investee company (mostly the government) and not on their qualifications and experience. Contrary to the CMA requirements, 33% of the respondents had less than three non-executive directors in their audit committees, possibly suggesting a desire by the majority shareholders to maintain control of the firm. The results are consistent with observations of Tsamenyi et al (2007), Rabelo and Vasconcelos (2002) and Mensah (2002). Most of the listed companies meet the CMA requirements in terms of the composition, membership and independence of audit committee members.

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.

Audit committees have increased the independence of internal and external auditors. Overall, the findings indicate that audit committees in Kenya were perceived to have improved the reliability of financial accounting reports, which has the effect of boosting investor confidence. Furthermore audit committees were also perceived to have improved the efficiency and effectiveness of the internal audit function.

The results indicate that there is a cordial relationship between the audit committee and management. As observed by Rezaee et al (2003), good relationship may lead to improved corporate performance.

This study had a broad coverage but shallow depth. Furthermore some of the conclusions drawn were based on the perception of the respondents. An in-depth examination may therefore be required to confirm these findings. Out of the 48 companies, only 29 responded to the questionnaire. However this was not a major limitation as the respondents did not exhibit significant variations. However, it may be difficult to generalize the results of this study to other developing countries due to the Country differences (Mangena and Chamisa, 2008). Joshi and Wakil (2004) also caution that the prevalence, composition and role of audit committees are likely to be affected by country-level variables. This study raised two key issues outside of the scope but which are worthy of further research; the role of government, and other powerful shareholders, in the governance of listed companies; and the effect of the lack of skills on the functioning of audit committees. These are connected, but can be dealt with independently. Such research needs greater depth and would benefit from a case study approach so that the nuances and realities can be explored.

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