

# EFFECT OF AUDIT COMMITTEE TECHNICAL COMPETENCE ON FINANCIAL PERFORMANCE OF SUGAR MILLING COMPANIES IN WESTERN KENYA

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**Abstract:** The purpose of the study was to establish the effect of Audit Committee (AC) technical competence on the financial performance of sugar milling companies in Western Kenya. The legislative provision on the Public Finance Management Act 2012 and its regulations 2015 laws of Kenya has given force on full implementation of Audit Committee. The study adopted Ex-post Facto and descriptive as the research design. The target population was 37 members of Audit Committee in all the eleven sugar milling companies in Western Kenya. The study used questionnaire and document analysis guide to collect primary and secondary data respectively. The secondary data were derived from audited and published accounts of the sugar milling companies for the period 2014-2016 financial years. Data analysis was done inferentially and descriptively. The finding was that Audit Committee technical competence had an effect on the financial performance of the sugar milling companies as was explained with a variation of up to 67.8%. The study recommended that, Audit Committee members to continue undergoing induction on new financial developments in order to be more technically competent.

**Keywords:** Audit Committee, Audit Committee Technical competence, Financial performance.

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## 1. INTRODUCTION

### Background of the study:

Audit Committee is created at the highest level of the organization and is subordinate to the Board. According to Wong (2012), Audit Committee needs to be technically competent and factors that appear critical to enable it performs includes; having clear authority and definition, charter, having members with right attributes, qualifications and experience Committee performing the required oversight functions, procedures and compliance to the relevant standards. Previous studies conducted by J.V.Ruto (2016), revealed that firms with higher quality of earnings are more associated with Audit Committee members who have accounts training. In view of Tiemstra (2016), Audit Committee members needs same level of competency as the chief financial officer. However, the sugar companies under this study are state owned and public with Board of Directors who sits in the Audit Committee being political appointees. There requisite qualification as Audit Committee members may be compromised. According to Year Book of Statistics of Directorate of sugar, 2014/15, 2015/16 financial performance, the accumulative losses for the sugar sector in Kenya stood at kshs.7.9 billion. Government of Kenya, intends to sell its stake, in all state owned sugar firms because of the losses and of which has been approved by the privatization commission of Kenya (Andae, 2016).

**Statement of the Problem:**

Sugar companies under this study are state, and public owned corporations. They were established with an objective to accelerate social- economic development. Under best practices, businesses are expected to perform adequately financially. For sugar sector, they have been making great losses which can be attributed to old technologies, overstaffing, over reliance on Government financing, poor accountability and supervisory structures, poor financial management, financial irregularities and malpractices, capacity underutilization and weak corporate governance which requires the input of the technical competence. Government of Kenya has been giving out loans at a low interest rate to state owned sugar companies and is to privatize them because they are not viable. Government of Kenya held sugar factories have been operational only because of COMESA safeguards. The Audit Committees were introduced by the Government of Kenya to improve performance but only gaining full force after being made legislative requirement pursuant to section 73(5) and 155(5) of the Public Finance Management Act (2012), its regulations (2015) and sugar Act (2001), laws of Kenya. Despite sugar sector in Kenya having strong legal backing over Audit Committee formation and composition, state owned and public sugar companies continue to post dismal performance financially. This study seeks to fill the gap by determining the effect of Audit Committee technical competence on financial performance of sugar milling companies in Western Kenya.

**Research objective:** To establish the effect of Audit Committee technical competence on financial performance of Sugar milling Companies in Western Kenya.

**Research Hypothesis:**

From the study, the following hypothesis was formulated;

H<sub>1</sub>: There is significant relationship between Audit Committee technical competence and financial performance of sugar milling companies in Western Kenya.

## 2. LITERATURE REVIEW

The theory that will guide this study is the agency theory. The theory addresses the issue in which one party (principal) delegates the work to the other (agent) who carry out the work (Jensen &Meckling, 1976). There is agency relationship when the actions of one individual influence welfare of that another person. The Audit Committee members who are part of Board of Directors becomes the agent who have been delegated with responsibility to do the oversight role on behalf of the principal but the said Audit Committee members should possess technical competence.

According to the researcher, technical competence of the Audit Committee is measured using characteristics as; professional qualification involving financial expertise, number of years in the board, size of the board, existence of Audit Committee charter, rotation policy of the Board, number of times the committee holds meetings and undergoing continuous induction and training. Deloitte (2015), noted that Audit Committee members should have necessary skills, experience and courage, sufficient intelligence, integrity, personality, and knowledge to stand against over powerful CEO, undergoing induction and relevant training. The Audit Committee members should participate in continuing education programme to enhance the members understanding of relevant accounting, reporting, regulatory, audit and industry issues. New members should be inducted to educate them on the company, responsibilities and reporting and accounting practices. They need to be financially literate, have understanding on; Principles and development in financial reporting, aspects of company operations, matters which may influence the presentation of accounts, principles and developments in company laws (Copnel, 2010). Previous studies conducted by KolejRishda et al., (2013) on effectiveness of Audit Committee and financial reporting fraud indicated that when members are financially literate, they are more competent to curb fraudulent financial reporting. Capital Markets Authority Act cap. 485A article 3.5.2 laws of Kenya, states that the Audit Committee members should have financial and business knowledge relevant to the company and keen awareness of the interest of the investing public and familiarity with basic accounting principles.

The size of the Audit Committee should not be too big. The objective is to allow the company operate efficiently and effectively. Organizational theory indicated that larger groups took relatively longer time to make decisions and therefore, more input time. Empirical studies have also shown that limiting the size of a committee or board to a particular level is generally believed to improve performance. Large committees will always give excessive control to the Chief Executive

Officer and harming efficiency (Mbalwa et al., 2014). The company should have rotation policy for the directors which is important to Audit Committee to provide a practical way to refresh and introduce new perspectives in the process. This enhances the opportunity for board members to gain in-depth and first hand understanding of function of Audit Committee. Appointments should be for three years after which they are subject to annual review extendable by additional three years period so long as they continue to be independent (KPMG 2009).

Njagi, (2012), noted that the most important aspects of establishing and maintaining an effective Audit Committee is to make sure that the Committee members are suited to perform their duties and they meet regularly. The meetings of the Committee and the number of times for public and private organization are generally timed to match the regulatory reporting and audit cycle. However there is emerging issue that the number of meetings and their duration should vary depending on the range and the complexity of the committee responsibilities. Nuhu, (2017) suggests they should meet eight times a year. The Audit Committee chairman in consultation with the secretary of the company should decide on the frequency and the timing of the meetings (Ernest & Young, 2014). The Audit Committee should have its charter defining purpose, authority and responsibility. Charter is to avoid possible trespass on the work of the Committee and the document should be approved by the Board (IPPF, 2009).

Kenyan sugar industry is an important component on the economy and sustains about six million (12.5% of Kenyans) and contributing to the GDP. The sector has remained hostage to different factors revolving around cane shortages, underutilization of factory machines, lack of regular factory maintenance, poor transport infrastructure, high costs of production, insufficient funding, inadequate research and extension services, liberalization under COMESA and World Trade Organization (WTO) protocols, inefficiencies on the production process in the factory, in ability to compete with imported sugar, perennial losses and political interference. The financial statements of state owned and public sugar milling companies have been showing losses. They are unable to pay farmers and fund there operations and rely on Government of Kenya for bail out in order to settle debts to farmers and suppliers of inputs. As at July 2015, sugar companies had debt amounting to kshs.89 billion of which the National Assembly was to provide a legal frame work on how it was to be written off to save sugar them from collapse (Bett, 2015). Knowing financial performance involves analysis on financial statements in interpretation of the profitability. This involves ratio analysis (Njagi, 2012). This study has used profitability indicators, gross profit margin, net profit margin, return on equity and return on assets ratios to assess financial performance.

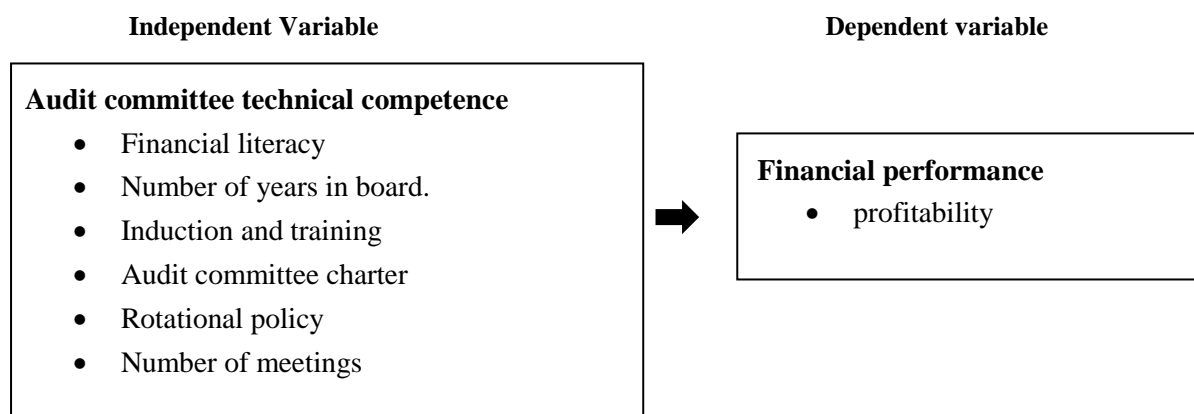


Figure 1.1: Conceptual Framework.

Source: Researcher’s own concept (2018).

The conceptual framework in this study considered Audit Committee technical competence as the independent variable, in influencing financial performance. In setting up an Audit Committee, it should be made up of independent nonexecutive directors who have adequate technical competence which among others requires financial literacy, several years as Board member, undergoing induction and training, and attending several Audit Committee meetings for it to duly serve its purpose. Having Audit Committee charter and rotational policy of the directors is equally important to create a positive effect on financial performance of sugar milling companies.

### 3. RESEARCH METHODOLOGY

The study adopted both Ex-post Facto and descriptive research design. In Ex-post Facto research design, secondary data of 2014-2016 was relied upon. In this design, data is collected after occurrence of an event and the aim is to find out the effect it had on a given variable (KIM, 2009). Descriptive research design employed both primary and secondary data. For primary data, questionnaire was administered followed with study of the recordings made and then doing data analysis and reporting descriptively. For secondary data, financial records which were relevant were analyzed under prevailing level of financial performance. It was followed by explanatory interpretive reporting descriptively. The target population of the study constituted all eleven sugar milling companies in Western Kenya of thirty seven Audit Committee respondents but twenty four returned their questionnaire. Due to small size of the population totaling to only thirty seven, no sample was identified. The study employed census on all members of the population.

Primary data underwent data cleaning and further tested for the eligibility of the data for the minimum threshold as recommended by Draugalis, Coons & Plaza (2008) for the response rate, Masconi et al., (2015) for missing values and Tabachnick & Fidel (2008) for outliers. The response rate was found to be ideal at 64.8%, missing values were found to be less than 5%, and for outliers the standard score of SPSS revealed none fell outside the recommended interval of between -3 to + 3. To enhance reliability of the instruments, Cronbach's Alpha coefficient was calculated and found to be 0.872. The coefficient was above 0.7 which was considered good (Rachel, 2016).

Primary data captured was analyzed inferentially and descriptively using the statistical package for social sciences. Secondary data were averaged because they were for a three year period of 2014-2016 financial years then profitability indicators were analyzed. The data processed underwent regression analysis as shown in the model specification. Hypothesis was tested in which financial performance was regressed on technical competence and there was a revelation of significant effect with an explanation of up to 67.8%. It was a conclusion, Audit Committee technical competence had significant effect on financial performance on sugar milling companies in Western Kenya.

### 4. STUDY FINDINGS

#### Descriptive Analysis of Study Variables:

Descriptive statistics were used to examine conformity of the Audit Committee technical competence with expected requirements, and effectiveness of the Audit Committee in the oversight functions. Frequencies and percentages were used to explore constitution of Audit Committee in compliance with minimum requirements, whereas means and standard deviations were used to examine effectiveness of Audit Committee in overseeing their oversight roles. Means captured typical response scores, and standard deviations indicated variations in scores.

#### Audit Committee Technical Competence:

Technical competence among Audit Committee members was examined for compliance and enabling conditions for further development. Constitution of the Audit Committee for sugar companies was found to have complied with technical competence requirements (Table 4.0). All the companies had the Audit Committee charter. Firms complied with the requirement of at least 2 members being financially literate (91.7% of the firms had 2 committee members literate, 4.2% each had 3 and 5 members financially literate). 14 respondents (58.3%) indicated that the Audit Committee holds 3 meetings per year, while 41.7% indicated more than three meetings in a year. Most firms exposed Audit Committee to either 2 workshops (45.8%) or 3 workshops (45.8%) per year. A majority of the firms had a rotational policy based either on personal negotiations (45.8%) or on statutory provisions (37.5%). Most Committee members last for 3 years (70.8%) although some members last more than three years in the committee (20.8%).

**Table 4.0: Compliance with Technical Competence Requirements.**

		N	%
Audit committee charter	Yes	24	100.0%
	No	0	0.0%
Members financially literate	2	22	91.7%
	3	1	4.2%
	5	1	4.2%

Number of meetings per year	3	14	58.3%
	More than three	10	41.7%
Financial and management workshops	1	1	4.2%
	2	11	45.8%
	3	11	45.8%
	4	1	4.2%
Rotational Policy	no rotational policy	4	16.7%
	personal negotiations	11	45.8%
	statutory provisions	9	37.5%
Length of stay in committee	more than three years	5	20.8%
	not specified	2	8.3%
	three years	17	70.8%

Source: Primary data 2018.

Examination of the prevailing environment for Audit Committees' development of technical competence revealed that Audit Committees in sugar milling companies in Western Kenya are not getting enough facilitation to develop technical competence (Table 4.1). Respondents consistently disagreed that; they are facilitated to be up to date with best practice and development in corporate governance (M=1.50, SD=0.511); that members recommendations in relation to training needs were promptly accepted (M=1.54, SD=0.509); that the committee gets exposure to ample specialist skills and advice (M=1.67, SD=0.482); that the induction given to new members is adequate for audit needs (M=1.67, SD=0.482); that the formal criteria for selection of committee chair is followed to the letter (M=2.04, SD=0.859); and that skills necessary for committee effectiveness are easily accessible (M=2.13, SD=0.680).

These findings may not auger well with the firms desire to perform well financially. Indeed, the findings contradict recommendations by Deloitte (2015) that, Audit Committee members ought to participate in continuing education programmes to enhance their understanding of relevant accounting, regulatory, reporting, audit and industry issues.

**Table 4.1: Facilitation for Competence Development.**

	M	SD
The committee is facilitated to always be up to date with best practice and development in corporate governance	1.50	.511
The audit Committees' recommendations to the board in relation to training needs are readily and promptly accepted	1.54	.509
The committee is often exposed to ample specialist skills and advice	1.67	.482
The induction given to new committee members is usually adequate for their audit needs.	1.67	.482
Audit committee members with financial experience help the rest to understand financial issues	1.79	.721
The formal criteria for selection of committee chair is usually followed to the letter	2.04	.859
Skills set required for the Audit Committee to remain effective are easily accessible to committee members	2.13	.680

Source: Primary data 2018.

#### Prevailing Levels of Financial Performance:

Financial Performance, was conceptualized as the dependent variable in the present study. Examination of the prevailing levels of financial performance among the sampled firms was conducted using statements of profit or loss, and statements of financial position for a period ranging from 2014 to 2016. Results calculated from (Table 4.2) indicate that all the sampled firms operated at a loss throughout the period of study. Gross profit margin (-52.4%); Net Profit margin (-41.3%); Return on Assets (-19.1%); and Return on Equity (-45.6%).

**Table 4.2: Summary /Averages of Key Financial values**

	<u>Three Year Totals</u> '000'	<u>Average</u> '000'
Sales	59317894	19772631
Cost of sales	59628848	19876283
Net profit before taxes	(24528897)	(8176299)
Net profit after taxes	(24528897)	(8176299)
Total assets	128402510	42800836
Total equity	(53685931)	(17895310)

**Source:** Secondary data 2018.

**Financial Performance on Profitability Based on the Above Averages.**

- i. Gross profit margin=(sales-cost of sales)/sales=-52.4%
- i. Net profit margin=net profits after taxes/sales=-41.3%
- i. Return on Assets=net profits after taxes/total assets=-19.1%
- v. Return on Equity=net profits after taxes/total equity=-45.6%

**Inferential Analysis Results:**

This focused on examining the effect of Audit Committee technical competence on financial performance of sugar milling companies in Western Kenya. A simple linear regression was used to test the conceptualized relationships. The hypothesis was formulated with respect to the relationships between Audit Committee technical competence variable and financial performance of sugar milling companies.

**Hypothesis H<sub>01</sub>** presupposed that the Audit Committees' technical competence had no significant effect on financial performance of sugar milling companies in Western Kenya. The presupposition was tested by regressing financial performance on technical competence. The model summary (Table 4.3) indicates that technical competence was indeed an important consideration for financial performance. Technical competence explained up to 67.8% (R square = 0.678) of the variations in financial performance. Therefore the null hypothesis was rejected.

**Table 4.3: Technical Competence Model Summary.**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.824 <sup>a</sup>	.678	.664	.04361

a. Predictors: (Constant), Technical competence.

b. Dependent Variable: Financial performance.

Source: SPSS Output 2018.

The regression coefficient (Table 4.4) affirms that technical competence among Audit Committee members positively and significantly predicts financial performance of sugar milling companies in Western Kenya ( $\beta = 0.824$ ,  $p < 0.05$ ). From the regression weight, it was apparent that an increase of 1 standard deviation in technical competence led to an increase of 0.824 standard deviations in financial performance.

**Table 4.4: Audit Committee Technical Competence And Financial Performance.**

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	T	Sig.
1	(Constant)	.185	.065		2.851	.009
	Technical competence	.233	.034	.824	6.812	.000

a. Dependent Variable: Financial performance.

Source: SPSS Output 2018.



Results confirm that technical competence remains a critical facet of Audit Committee oversight. It is important to note that results which tended to show that Audit Committees' are not facilitated in development of technical competencies are no doubt reflected in the poor performance manifested by losses made over the three year period of study. Importance of technical competence in financial performance is highlighted in a host of existing studies. Husam Alderman et al., (2012), examined Audit Committee features that best predict firm performance and established that expertise gained from technical competence correlated positively with performance. Njagi (2012) examined the relationship between financial literacy; a facet of technical competence and financial performance. He concluded that financial literacy of the Audit Committee members directly affects performance of sugar companies. The finding also corroborates views by Deloitte (2015) that Audit Committee members should have necessary skills, experience and courage to handle powerful Chief Executive Officers.

**Effect of Audit Committee technical competence on Financial Performance:**

The study conceptualized that financial performance of sugar milling companies was a function of Audit Committee technical competence and was modeled as follows:

$$Y = \beta_0 + \beta_1 X_1 + \epsilon$$

Where:

Y = Financial performance.

X<sub>1</sub> = Technical competence.

ε = Regression residual /error term.

β<sub>i</sub> = Regression coefficient to be determined.

To test this model, financial performance was regressed on the technical competence. The model summary (Table 4.5) revealed, coefficient of determination was 0.904, an indication that Audit Committee technical competence accounts for 90.4% of the variation in financial performance of sugar milling companies in Western Kenya.

**Table 4.5: Audit Committee Technical Competence Model Summary.**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.951 <sup>a</sup>	.904	.890	.02498

a. Predictors: (Constant), Technical competence.

Source: SPSS Output 2018.

The linear regression coefficient (Table 4.6) revealed, Audit Committee technical competence (β=0.298, p<0.05) was positive and significant predictor of financial performance of sugar milling companies in Western Kenya. The confirmed regression model can therefore be represented as;

$$Y = 0.298X_2 + \epsilon.$$

**Table 4.6: Audit Committee Technical Competence and Financial Performance.**

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error			
(Constant)	.111	.039		2.872	.009
Technical competence	.084	.039	.298	2.142	.045

a. Dependent Variable: Financial performance.

Source: SPSS Output 2018.

## 5. DISCUSSIONS OF FINDINGS

The study established that Audit Committees were constituted in considerations of Audit Committee requirements. All companies had an Audit Committee membership ranging from 3 to 5, and the members were all non-executive as recommended by Al-Matar et al., (2014). The finding that technical competence requirements have been complied with during composition of Audit Committee was a move in the right direction and reflects views by others (Colley, KolejRishda, 2013; KPMG, 2009). Such compliance may however amount to nothing if, as the study established, Audit Committees are not facilitated to grow and develop technically. Continued growth and education for Audit Committee members has been recommended if at all, Audit Committees are to perform their oversight functions effectively (Deloitte, 2015). Deloitte argue that Audit Committee members need to participate in continuing education programmes, in order to enhance their understanding of relevant accounting, reporting, regulatory, audit and industry issues. Besides, new members ought to be inducted through orientation to educate them on the company, responsibilities and reporting and accounting practices. The finding that Audit Committees have charters and rotational policies seemingly point to committees that are vibrant enough, which begs the question; why then is sugar milling companies in Western Kenya struggling financially? KPMG (2009) suggests that a company should have rotation policy for the directors which, in essence is an important step to the Audit Committee, as it provides a practical way to refresh and introduce new perspectives in the process. Besides, it also enhances opportunities for Board members to gain in-depth and first hand understanding of functions of the Audit Committee.

## 6. SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

The main finding of the study and which tends to answer the research objective was that Audit Committee technical competence impacts positively on financial performance of sugar milling companies in Western Kenya.

Descriptive exploration of key informants' response scores revealed that sugar milling companies in Western Kenya complied with the requirement of at least 2 members being financially literate; the Audit Committees hold at least 3 meetings per year, Audit committee members get exposure to some workshops, most of the companies have in place a rotational policy based either on personal negotiations or on statutory provisions; and Audit Committee members last for 3 years, although some members may last more than three years in the Committee.

On the negative, the study established that sugar milling companies in Western Kenya were not giving enough support to Audit Committees for continued development of technical competence. Lack of support in development of technical skills no doubt compromises the committees' effectiveness in oversight functions. Indeed, the regression results revealed that Audit Committee technical competence has a positive and significant effect on the financial performance of sugar milling companies in Western Kenya, and accounts for up to 67.8% of the variation in financial performance. It affirms, Audit Committee technical competence has direct effects on financial performance.

### Conclusions:

Technical competence among Audit Committee members is fundamental to the understanding of oversight roles and has direct impacts on financial performance of sugar milling companies in Western Kenya.

Audit Committee members are clear on their technical competence and have tried to go about them in a meticulous way. Audit Committees in the companies under study have been able to examine financial reporting, and appraise systems and controls in place. The collapse of the companies however, brings to question the ability of the committees to stem corruption being committee in charge of oversight functions.

### Recommendations:

The directors who sits in the Audit Committee of state owned sugar milling companies are the political appointees who have failed to clinch political seats and are rewarded for their loyalty meaning the industry is prone to state and political interference. The researcher is of the opinion that their technical competence may be impaired in attempt to do oversight role. This study suggests that government should divest her shareholding in state owned milling companies to less than 5%.

The Audit Committee members should undergo continuous training and induction without limit on new financial developments notwithstanding the fact that some are financially literate.



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A research be carried out on the effect of Audit Committee technical competence on general performance of sugar milling companies which involves, financial, management and production.

A recommendation is further made that a case study be done to each and every company to determine the technical competence of the Audit Committee on financial performance

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