Effect of Quality of Financial Reporting on Performance of Manufacturing Firms Listed in the Nairobi Securities Exchange in Kenya

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ABSTRACT

Even though manufacturing firms in Kenya are of great value, there are inadequacies in financial performance. Kenyan Manufacturing firms are reporting losses, as evidenced by audit committee shortcomings and low earnings. The objective of the study was to determine the effect of audit committee effectiveness on the financial performance of manufacturing firms in Kenya. This study adopted a mixed research design with a target population of eight manufacturing firms listed at the Nairobi Securities Exchange (NSE), all of which were involved through the census. Secondary data was collected from financial statements between the 2015 and 2021 financial years. Data analysis involved descriptive and inferential statistics. Descriptive based on frequencies, percentages, and the mean. Pearson correlation results showed a weak but significant correlation between financial performance and audit committee effectiveness (ACE) ($r=0.0355$, $p<0.05$ and $r=0.0858$, $p<0.05$ for LN ACE 1& LN ACE2 respectively). This shows that the quality of financial reporting had significant effects on the performance of manufacturing firms listed in the Nairobi Securities Exchange in Kenya. Based on these findings, the study recommended that the number of auditors, as well as the stock owned by manufacturing firms, be enhanced for better income.

Keywords: Audit Committee Effectiveness, Financial Performance, Manufacturing Firms, Nairobi Securities Exchange, Kenya

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I. INTRODUCTION

Financial reporting quality through comprehensive disclosure generates transparency in an organization. Users of financial information have often relied on quality of financial reports with diverse reasons such as financial performance concerns. For instance, Delloite and Touche were the auditors of Mumias Sugar Company. In 2006, they reported a sterling performance of the company. Two years later, the company collapsed despite having good financial reports which should depict good financial health. An internal audit report at the sugar miller shows that in 2007, Mumias Sugar allegedly took Sh2.6 billion from Mumias Out Growers Company accounts and declared it as part of its profits (Business Daily Africa, 2015).

Manufacturing sector makes an economy more vibrant and realistic. Economists have high regards on the value of manufacturing firms (Kungu, 2015). There has been an upward growth trend among manufacturing firms in Kenya which has led to improved GDP, accelerated growth in employment trends and magnified earnings of foreign exchange (Okpala, 2015). In Kenya manufacturing sector has propelled foreign exchange earning to 34% (Kenya Association Manufacturers (Kenya Association of Manufacturers, 2021). Though manufacturing sector growth is declining in UK, it is the third largest, in Ireland it's the major contributor to GDP at 46% and employment at 29%. This has at the end improved development standards and living standards in the county. With global manufacturing growth being at least 2.7% on annual basis this is a remarkable trajectory (Kenya Association of Manufacturers, 2021). Manufacturing sector is the largest provider of employment at 20% in Kenya (Government of Kenya, 2021).

According to Khalifa and Shafii, (2013) manufacturing sector is an engine in the current economy as it generates development. Despite the tremendous upward trajectories, the manufacturing sector earning figures are declining in the recent past. The earning figures were as follows; in 2020 at 9.3%, 2021 at 8.7% and 2022 at 8.4% (CMA, 2020). Furthermore, ARM and E.A Cables losses increased by 134% and 14%, (Nairobi Stock Exchange, 2020).

Manufacturing sector makes an economy more vibrant and realistic. In Kenya manufacturing sector has propelled foreign exchange earning to 34% (Kenya Association Manufacturers, 2014) and it is the largest provider of employment at 20% in Kenya (GOK, 2021) yet its earnings figures are declining in the recent past. The earnings figures were as follows; in 2020 at 9.3%, 2021 at 8.7% and 2022 at 8.4% (CMA, 2020). Furthermore, ARM and E.A Cables losses increased by 134% and 14%, (Nairobi Stock Exchange, 2020).

Studies on financial reporting quality on financial performance are inconsistent. Mugwe (2018) found that accounting conservatism and audit committee had a significant influence on performance of agricultural firms whereas Klai and Omiri (2011) found financial reporting quality as insignificant while examining audit committee as well as earnings quality.

Based on recommendation by Okpala (2015) to examine quality of financial reporting in a manufacturing sector the current study employed an examination of audit committee effectiveness on manufacturing sector for a period of 2015 to 2021, cross-examining the listed firms.

1.1 Objectives of the Study

To examine the influence of audit committee effectiveness on listed NSE manufacturing firms' financial performance.

1.2 Research Hypothesis

H₀₁: Audit committee does not significantly influence financial performance of manufacturing firms listed in the Nairobi Securities Exchange in Kenya.

II. THEORETICAL LITERATURE REVIEW

2.1 Inspired confidence Theory

Developed by the Limperg in (1932), this theory bestowed trust and confidence levels to an auditor, it gives the auditor the benefits of trust that he/she will execute duties to the best of his/her knowledge. An auditor is expected to provide earnings as they arise without any alteration of earnings. Earnings should be shown as they get in. This calls for an effective approach when audit committee is making decisions regarding choice of audit committee, the committee should capitalize on experience and expertise in choosing members. This contributes in confidence making among auditors and those mandated with financial responsibilities. Therefore, audit committee must be in place to help manage confidence role.

According to Limperg (1932), confidence will make investors to gain trust and do business with the firm. It is an inspiration to ensure performance is continuous and on record. This theory was also brought on board by Okpala (2015) in Nigeria while studying audit quality practices. In his study audit committee should be well structured to inspire confidence among users of financial information and more so woe investors. Similarly, Carmichael (2014) crowns confidence levels to audit committee equally making earnings a reality. Therefore, this theory is of help on audit committee variable.

2.2 Conceptual Review

2.2.1 Audit Committee Effectiveness

Auditors have a solemn role of checking financial records of an organization to ensure accuracy hence reliability. They exist as both internal auditors and external auditors. Audit committee therefore provides the best check and they should be keenly selected based on expertise and experience (Hamdan, 2020). Audit committee effectiveness was measured by several members on audit committees. Furthermore, audit meetings, audit composition and audit independence will ascertain audit committee effectiveness.

2.2.2 Financial Performance

Financial performance is interested on the monetary gains an organization gets as a result of proper investment. Quality of financial reports helps in telling the financial performance based on earnings report provided, audit committee records and accounting conservatism records. Director's size helps in financial decision making process where there number matters a lot especially attached on their experience and qualifications. The shareholder capacity has a role on financial performance (Kariithi & Kihara, 2017). The study used return on assets as a measure for effective financial performance of the firm.

2.3 Empirical Review

Hamdan (2020) established at the influence of diligent audit committee and its meetings on firm performance of 23 entities at Gulf Cooperation Council for the period of 2014–2018. The study used panel data and longitudinal study design. The study found no correlation between audit meetings provided and financial performance of firms at Gulf Cooperation Council. The study is criticized for focusing on public firms without considering earnings quality as a study variable

A study by Elghuweel et al. (2017) checked on audit committee efficiency for 116 firms in Oman. This was with aim of ascertaining its financial influence. Audit committee efficiency based on the qualification of audit committee members, the working experience of committee members and composition of audit team. The study found that audit committee efficiency had not only a positive effect but also significant effect on firms' financial performance.

Albedal et al. (2020) studied quality of financial reports verses financial performance of Bahrain Stock Exchange listed firms. The study dwelt on quality of earnings and audit committee as independent variables finding them to be positive and significant in relation to ROA measure of financial performance. Though the study took place for 2013–2017 for more recent studies.

Nasiri and Ramakrishnan (2020) studied influence of audit committee on performance of firms in Ethiopia. The study used primary data based on likert scale questionnaire among the employees. The found expertise of audit committee to be of major significance value on financial performance of firms. Madawaki and Amran (2013) conducted a study at Nigeria stock exchange whereby quality of financial reports was provided based on audit committee. The companies under investigation were 70 and both primary and secondary data was collected. Findings showed significant effect of audit committee on performance.

Tuuisandi and Puspitasari (2015) established international financial reporting standard and financial performance of firms. IFRS used audit committee and earnings quality as its key variables that had positive significant effect on performance of firms. The study failed to highlight the element of financial reporting quality but dwelt on standards. Locally studies on financial reporting record mixed findings. Ojeka et al. (2015) examined financial reporting quality in a manufacturing sector and found financial reporting quality lacked influence on performance. Performance was measured using return on assets.

Mugwe (2018) examined audit characteristic and performance and opined that that experience mattered a lot when it comes to enabling financial performance. Mugwe (2018) concludes that the independence, composition, technical skills and prudential requirements of the committee are key in the ensuring that there is an effective and probably efficient audit to monitor and check performance and practices of an organization.

Wasan and Mulchandani (2019) studied the effect of audit committee meetings frequency on financial performance. The study used secondary data where number of meetings done was recorded and then the frequency or how often they were done. Later data converted to natural logs. The results provided that number and frequency of meetings had a significant effect on performance.

III. METHODOLOGY

The study used a mixed research design that explained both causal and longitudinal research designs. Kariuki et al. (2015) affirm need for a mixed research design approach based on advantages of harmonizing a number of designs.

Target population refers to entire units under study (Mugenda & Mugenda, 2018). The target population of the study comprises the 8 manufacturing companies listed in the NSE as at December 2021 (NSE, 2021).

The study used census study methodology which has zero cases of biasness (Kothari, 2014). The population comprises of 8 manufacturing firms listed at the NSE of which all the firms were done.

A data collection instrument refers to mechanisms used to obtain data (Creswell, 2003). A secondary data collection tool commonly referred as document analysis assembled a 5 financial year data between 2017 and2021. Ratios provided the basis upon which data was collected.

The econometric equation without the moderating variable was: $Y= \alpha + \beta_1 X_1 t+\varepsilon$

Where:

Y = Financial Performance; α = Constant; $\beta 1$ = the slope; X_1= Audit Committee Effectiveness; ε = error term

IV. FINDINGS

4.1 Normality Test

This study employed Jacque Bera descriptive approach to ascertain normality.

Table 1
Normality Test

Variable	Jarque Bera adj chi2(2)	Prob>chi2
LN Audit Committee Effectiveness 1 (ACE1)	5.03	0.54
LN Audit Committee Effectiveness 2 (ACE2)	1.406	0.4951
LN Financial Performance	1.620	0.418

LN: Natural log

For this case the data is normally distributed since the P value of Jarque Bera is greater than 0.05.

4.2 Correlation Matrix

Pearson correlation analysis was computed, this assisted in testing Multicollinearity.

Table 2
Pearson Correlation Analysis

LN ACE1	LN ACE2	LN ACE1
LN ACE1	1.0000	
LN ACE2 **p value**	-0.3082 0.0331	1.0000
LN FP **p value**	0.0355 0.0009	0.0858 0.0021

LN natural log, ACE 1&2 audit committee effectiveness, LN Natural log, FP Financial performance;

The results show weak but significant correlation between financial performance and audit committee effectiveness ($r=0.0355$, $p<0.05$ and $r=0.0858$, $p<0.05$ for LN ACE 1& LN ACE2 respectively). The relationship between audit committee effectiveness and performance was positive and significant; 0.0021 for ACE log 1 was positive and significant. This study agrees with Elghuweel et al. (2017) who studied on audit committee efficiency for 116 firms in Oman. The study found that audit committee efficiency had not only a positive effect but also significant effect on firms' financial performance. It further agrees with Nasiri and Ramakrishnan (2020) studied influence of audit committee on performance of firms in Ethiopia, the study found expertise of audit committee to be of major significance value on financial performance of firms. This study disagrees with Hamdan (2020) who established the influence of diligent audit committee and its meetings on firm performance of 23 entities at Gulf Cooperation Council for the period of 2014–2018. The study found no correlation between audit meetings provided and financial performance of firms at Gulf Cooperation Council.

Table 3
Regression Random Effect of ROA on Audit Committee Effectiveness

R-sq:	Observation per group:					
wtn = 0.272	minimum = 6					
btn = 0.0000	average = 6.0					
Ovl = 0.0091	maximum = 6					
	Wald chi2 (2) = 0.58					
	Prob > chi2 = 0.0046					
FPLog	**Coef.**	**Std. Err.**	**z**	**P>z**	**[5% sign]**	
LN ACE1_SB	.0942714	.5138273	0.18	0.004	-.9128117	1.101354
LN ACE2_SB	.306913	.4189843	0.73	0.004	-.514281	1.128107
_cons	-1.057318	.2546742	-4.15	0.000	-1.55647	-.5581661
sigma_u	.11749455					
sigma_e	.37221596					
rho	.09061371					

Audit Committee Effectiveness accounted for 27.2% of the variation in performance of Manufacturing Firms Listed NSE. The p-value is=0.0046 thus below 0.05. The partial regression coefficient for Audit Committee Effectiveness was 0.0942714 (ACE1) and 0.306913 (ACE2) respectively in Audit Committee Effectiveness across time and performance to increase by 0.0942714 and 0.306913 respectively.

The fitted models were:

LN ROA=0.0942714-1.057318ACE1

LN ROA=0.306913-1.057318 ACE2

The study therefore rejected the null hypothesis that Audit Committee Effectiveness has no significant effect on performance of Manufacturing Firms Listed NSE. This study agrees with Elghuweel et al. (2017) who studied on audit committee efficiency for 116 firms in Oman. The study found that audit committee efficiency had not only a positive effect but also significant effect on firms' financial performance. It further agrees with Nasiri and Ramakrishnan (2020) studied influence of audit committee on performance of firms in Ethiopia, the study found expertise of audit committee to be of major significance value on financial performance of firms. This study disagrees with Hamdan (2020) who established the influence of diligent audit committee and its meetings on firm performance of 23 entities at Gulf Cooperation Council for the period of 2014–2018. The study found no correlation between audit meetings provided and financial performance of firms at Gulf Cooperation Council.

V. CONCLUSIONS & RECOMMENDATIONS

5.1 Conclusions

On determining the influence of audit committee effectiveness on listed manufacturing firm's performance, audit committee effectiveness was found significant since the p-value is=0.0046 thus below 0.05. The partial regression coefficient for Audit Committee Effectiveness was 0.0942714 (ACE1) and 0.306913 (ACE2) respectively. Effectiveness of audit committee leads to maximum performance of a firm. It is therefore important to ensure that audit committee composition, age, qualifications and experience is given priority at all times.

5.2 Recommendations

Audit committee effectiveness must be evaluated by number of auditors as well as stock owned by auditors should be improved for better income. Organizations should ensure that the number of auditors is within the legal threshold and auditors should work in harmony to ensure performance is realized.

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