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Effect of Audit Committee Characteristics on Fraudulent Financial Reporting in Commercial Banks in Kenya

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Abstract

The purpose of this research was to investigate the effect of audit committee characteristics on fraudulent financial reporting in commercial banks in Kenya. The research specific objectives were to; determine the effect of audit committee size, audit committee independence, audit committee financial expertise and audit committee gender diversity on fraudulent financial reporting in Commercial banks in Kenya. The theories used in this study were the Agency theory and Fraud pentagon theory. The research design used was explanatory research design and the year of observation were 2018 to 2022. The target population of the study was all commercial banks in Kenya. Secondary data obtained from the audited financial reports of the banks were used in the study. The panel data was analyzed using both descriptive and inferential statistics. The study findings revealed that larger audit committee sizes, greater independence, and higher gender diversity are all associated with significant reductions in fraudulent activities. The study revealed that larger audit committee sizes, greater independence, and higher gender diversity are all associated with significant reductions in fraudulent activities. The study findings sought to inform the banking institutions, institutions that deal with the fight against fraud and management, investors and for policy formulation.

Keywords: Audit, committee, characteristics, fraudulent, finance, commercial banks, Kenya

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Introduction

Three common types of fraud are asset abuse, corruption and financial report fraud. Ten percent of occupational frauds worldwide are related to financial statement fraud (Li & McMurray, 2022). Although it is the least frequent of the three main categories of fraud, it is also the most expensive, with a median loss of US$954,000 in 2020 compared to the most frequent category, asset misappropriation, which occurs 86% of the time and has a median loss of US$100,000 (Li & McMurray, 2022). Financial statement fraud erodes the reliability of financial information used to inform economic judgments. Due to an inefficient use of resources, poor economic decisions cause financial loss for the stakeholders and can have detrimental effects on an economy (Pududu & De Villiers, 2016). Therefore, it causes businesses or organizations to suffer enormous financial losses. According to (Wells, 2014), there are multiple factors that contribute to financial reporting fraud. One of the most important ones is the pressure placed on management to produce better results. This pressure can lead executives to manipulate financial records in order to conceal the true performance of the company and preserve their position, control, and income from wages, bonuses, and equity.

Financial statement manipulation is a tactic used by fraudsters to inflate components such as assets, sales, and profits while underreporting liabilities and losses. The frequency of this type of fraud has increased (Mehta & Bhavani, 2017). Deutsche Bank AG was accused by the US Securities and Exchange Commission in 2015 of filing false financial reports at the height of the financial crisis, failing to disclose a material risk that could have resulted in losses estimated to be in the billions of dollars. It also accused three former executives of hiding the true state of the bank's loan portfolio during the height of the financial crisis and understating millions of dollars in losses at Bank of the Commonwealth, located in Norfolk, Virginia (Axelton & Chandna, 2023). According to Bank of Ghana (2018), Sovereign Bank Limited and Beige Bank Limited used suspicious and nonexistent capital to obtain their banking licenses under false pretenses. As a result, they are unable to access their reported capital for operations. In order to meet the capital adequacy limits, Royal Bank Limited allegedly overstated its capital and circumvented single obligor limits, according to a report published by the Bank of Ghana in 2018. In Kenya, Due to allegations of financial statement falsification and embezzlement at NBK, the Board of the Capital Markets Authority

(CMA) initiated administrative action against the NBK Board members and former Senior Managers who were employed by the Bank as of December 31, 2015. Premature recognition of the sale of assets totaling Ksh 800 million, inadequate provisioning of loan amounts, and incorrect recognition of interest income led to the misrepresentation of National Bank of Kenya's (NBK) financial statements, which in turn caused the overstatement of profit in the corresponding periods (NBK, 2021). Imperial Bank is another bank that failed due to widespread fraud. According to CBK, the bank lost Ksh34 billion as a result of unlawful transactions carried out by senior managers and administrators (Rutten and Muli, 2008). On October 13, 2015, it entered receivership. The CBK ordered a forensic audit report, in which the regulator pointed out that Imperial Bank had misrepresented its financial statements and given fraudulent loans (CBK, 2015).

It has been extremely concerning that a number of financial institutions in Kenya, including Chase Bank and Dubai Bank, have failed. Due to allegations of financial statement falsification and embezzlement at NBK, the Board of the Capital Markets Authority (CMA) initiated administrative action against the former Senior Managers and NBK Board members who were employed by the Bank as of December 31, 2015. A December 31, 2015 audit also found that Chase Bank Ltd. had overstated its loan book, which was against CBK regulations. Corporate governance flaws are the primary cause of fraudulent financial reporting (Ndofor, Sirmon & He, 2015). According to Munther (2019) the efficiency of the corporate governance structure lowers the possibility of fraudulent financial reporting and helps to boost the credibility of financial reporting. The audit committee is one of the corporate governance tools that is crucial for stopping false financial reporting. Studies have indicated that audit committees can lessen the likelihood of fraudulent activities by minimizing discrepancies between non-financial and financial metrics (Brazel, 2018), (Edogbanya & Kamardin, 2015), and (Bhuiyan, Salma, Roudaki, and Tavite, 2020) . Fraud risks will go down if audit quality rises, so the audit committee will raise audit quality by making sure proper financial reporting is done. Regarding the size of the audit committee, it is plausible that a smaller committee will pose greater challenges for the directors in terms of efficiently discharging their duties. Conversely, an excessively large committee may cause problems with coordination and raise procedural issues. On the topic of audit committee independence, there have also been conflicting findings. (Raghunandan, Rama, & Read, 2001) discovered that audit committees can only function more effectively if they are made up entirely of independent directors and have at least one member with a background in finance or accounting. However, (Abbott, Parker, & Peters, 2004) pointed out that unless the audit committee is also active, independence is unlikely to translate into effectiveness. There were conflicting outcomes regarding the impact of audit committee experience on the caliber of financial reporting. According to earlier research, audit committee experience can lower financial statement fraud and increase earnings conservatism (Krishnan & Visvanathan, 2007). However, Xie, Davidson III and Dalt (2003) discover that there is no connection between the present discretionary accruals and the proportion of external legal and financial members on an audit committee. Regarding gender diversity, prior research yields contradictory findings. Female board members enhance corporate governance but have a negative impact on business performance, according to (Adams & Ferreira, 2009). According to Terjesen, Sealy and Singh, (2009), having more women on the board promotes better stakeholder communication and increases accountability. Stated differently, it raises non-financial metrics like gender representation, customer satisfaction, and corporate social responsibility. This study therefore seeks to investigate the effect of Audit committee characteristics on fraudulent financial reporting in Commercial Banks in Kenya. There are mixed results and yet inconclusive findings to support this topic hence the need for this study. The positive impact of the Audit committee characteristics examined in this study comprises of audit committee size, audit committee independence, audit committee financial expertise and audit committee gender diversity.

Theoretical Review

Two theories were used to guide the study.

The Agency Theory

The economic theory outlined by Alchian and Demsetz (1972) and expanded upon by Jensen & Meckling (1976) is the foundation of agency theory. It is described as the dynamic between agents, like company executives and managers, and principals, like shareholders. This theory states that the agents are employed by the shareholders, who are the company's owners or principals, to carry out tasks on their behalf. To put it simply, a principal is a person who primarily depends on an agent to carry out particular financial decisions and transactions that may have unpredictable results. Conflicts and disagreements of all kinds may arise because the principal depends so much on the agent to choose wisely. Agency theory examines these kinds of relationships in order to resolve disputes between the parties. According to Clarke and Branson (2012), directors or managers, acting as the shareholders' agents, are given authority by principals to manage the company. In order to prevent the agency problem and promotes mutual trust and cooperation between the principals and the agents, the leaders must devise a workable leadership structure. According to agency theory, good governance is supposed to lower agency costs (Arslan and Alqatan, 2020). According to Ashiru (2017), agency theory describes the dynamic in which a principle assigns tasks to an agent. According to him, the fundamental issue with corporate governance is seen by the principal agent model as self-serving managerial behavior in a general principal-agent relationship. This theory is important because it informs the fraudulent financial reporting in the study.

The Fraud Pentagon theory

As an extension of pre-existing fraud theories, such as the Fraud triangle theory and the Fraud diamond theory, Crowe Horwath (2011) developed the Fraud Pentagon Theory. With the addition of an element of arrogance to the previously identified indicators of pressure, opportunity, rationalization, and capability, this development ultimately completes the fraud theory into five indicator elements, forming Crowe's Fraud Pentagon theory (Horwath, 2011). Regarding pressure, as long as management is subject to constructive internal pressure from the company, such as receiving bonuses and incentives for good performance or the leverage ratio has the potential to generate external pressure. Businesses with high leverage ratios are considered to be highly credit-risky and heavily indebted. Creditors are less willing to lend money to businesses that pose a higher credit risk. Thus, this is one of the issues that the business is now concerned about and that could contribute to the rise of false financial reporting (Puspitha & Yasa, 2018).

Additionally, some opportunities arise and turn into gaps that are not under the principal's supervision, which management can take advantage of in carrying out its plans in order to properly assess its performance and reap the greatest possible benefit for its own prosperity and welfare. The existence of rationalization can then be used as a justification by management, acting as an agent within the company, to support their actions on the grounds of their contributions to the operation of the business and their service, even though they involve fraud.

Methodology

The study adopted both explanatory and longitudinal research design. The target population comprised of all commercial banks in the Kenya. All the 42 licensed commercial banks were considered. A sample of 39 Commercial banks was selected after the inclusion exclusion criteria. Each bank was analyzed annually for 5 years from 2018 to 2022. The study was conducted using secondary data which was achieved by analyzing the content of financial reports of all commercial banks in Kenya for the period between 2018 and 2022. The panel data was analyzed using both descriptive and inferential statistics.

Results

The table 1 presents the descriptive statistics for the dependent and the independent variables. The descriptive results showed that the fraudulent financial reporting variable had an average value of approximately -2.187 with a standard deviation of about 0.52, indicating moderate variability around the mean. The negative mean value and range suggest that the scale measuring fraudulent financial reporting might include negative values to indicate certain characteristics or levels of fraud, though the exact nature of the scale isn't specified. A higher value could indicate less fraud, while lower values could suggest higher instances of fraud. The average size of audit committees is approximately 0.409, with a standard deviation of about 0.10. The data suggests minimal variability in audit committee sizes among the firms studied. Audit committee independence averages about 0.80 with a standard deviation of 0.20. The high average close to 1 suggests that firms have a largely independent audit committee, which is often a good sign of strong governance. The average shows that most of the firms had independent audit committees. The mean financial expertise in audit committees is approximately 0.71, with a variability of about 0.25. This suggests a majority of committees possess significant financial expertise, though there is still notable variation across different firms. Gender diversity in audit committees has an average of about 0.30 with a standard deviation of 0.21. This variable shows a considerable spread, indicating that some audit committees may be all-male or close to it, while others approach a more balanced gender ratio.

The table 1 also presents the correlation matrix that shows the strength and direction of relationship between the various study variables. The table results showed audit committee size had a moderate negative relationship with fraudulent financial reporting (r= -0.6266), meaning that an increase in audit committee size tends to reduce fraudulent financial reporting. Audit committee independence had a moderate negative association with fraudulent financial independence (r= -0.6062), implying that an increase in audit committee independence leads to decrease in fraudulent financial reporting. Audit committee financial expertise had a moderate negative association with fraudulent financial independence (r= -0.6458), meaning that an increase in audit committee financial expertise leads to decrease in fraudulent financial reporting. Audit committee gender diversity had a moderate negative association with fraudulent financial independence (r= -0.6410), implying that an increase in audit committee gender diversity leads to decrease in fraudulent financial reporting.

The table results in table 1 further revealed that audit committee size had a negative and significant relationship with fraudulent financial reporting (β= -0.246, p=0.000). The audit committee coefficient suggests that a unit change in audit committee size minimizes fraudulent financial reporting and the p-value was less than 0.05 illustrating that audit committee size significantly affects fraudulent financial reporting. The audit committee independence had a negative and significant relationship with fraudulent financial reporting (β= -0.202, p=0.000), meaning that a unit change in audit committee independence tends to reduce fraudulent financial reporting by 0.202. The p-value was less than 0.05 revealing that audit committee independence significantly affects fraudulent financial reporting. The audit committee financial expertise had a negative but insignificant relationship with fraudulent financial reporting (β= -0.034, p=0.138). The results indicates that a unit change in audit committee financial expertise minimizes fraudulent financial reporting.

The results moreover highlighted that the p-value was greater than 0.05, implying that audit committee financial expertise insignificantly affects fraudulent financial reporting. The audit committee gender diversity had a negative and significant relationship with fraudulent financial reporting (β= -0.439, p=0.000). The coefficient indicated that a unit change in audit committee gender diversity diminishes fraudulent financial reporting by 0.4389. The p-value was less than 0.05, demonstrating that audit committee gender diversity significantly affect fraudulent financial reporting.

Table 1: Descriptive statistics, correlation matrix and regression results

Variables	Mean	Std.Dev	FFR	ACS	ACI	ACFE	ACGD	Coef.	p-value
FFR	**-2.187**	**0.522**	**1**					FRR	
ACS	0.409	0.097	-0.627	1				-0.246	0.000
ACI	0.796	0.201	-0.606	0.338	1			-0.202	0.000
ACFE	0.708	0.247	-0.646	0.321	0.379	1		-0.034	0.138
ACGD	0.304	0.211	-0.641	0.357	0.557	0.025	1	-0.439	0.000

FFR: Fraudulent financial reporting, ACS: Audit committee size, ACI: Audit committee independence, ACFE: Audit committee financial expertise, and ACGD: Audit committee gender diversity.

Discussions

The results showed that audit committee size has a significant effect on fraudulent financial reporting. The results suggested that an increase in audit committee size was associated with a decrease in fraudulent financial reporting. In other words, larger audit committees tend to be linked with lower levels of fraudulent financial reporting. This was consistent with (Mardessi, 2022) empirical findings that corporate governance mechanism, mainly audit committee size has a statistically significant relationship with real earnings management and (Shankaraiah & Amiri, 2017) that audit committee size has relationship with the financial reporting practices. Thus, it may be inferred that the companies may improve the financial reporting quality, by managing the audit committee size, as this has significant relationship with financial reporting quality. The study concluded that audit committee independence had a significant effect on fraudulent financial reporting. This illustrates that an increase in audit committee independent members leads to diminished fraudulent financial reporting. This was in line with the findings of (Makhlouf, 2022) that the independence of the audit committee, negatively affect impression management, implying that this characteristic mitigate financial reporting manipulation and decrease the practices of impression management. (Kibiya, Che-Ahmad, & Amran, 2016) that the audit committee independence was significant, indicating that AC monitoring mechanisms influence the quality financial reporting of listed non-financial firms in Nigeria. Audit committee financial expertise has insignificant effect on fraudulent financial reporting in commercial banks in Kenya. This was contrary with the findings of (Kamarudin, Ismail, & Alwi, 2014) that the expertise of members of the audit committee is negatively associated with corporate fraud. This suggests that when audit committee members are financially literate, they are more competent to curb fraudulent financial reporting. Audit committee gender diversity has a significant effect on fraudulent financial reporting in commercial banks in Kenya. This indicates that an increase in audit committee gender diversity is linked with a reduction in fraudulent financial reporting in commercial banks in Kenya. This suggests that greater gender diversity within the audit committee may contribute to improved oversight and control mechanisms, leading to lower incidences of fraudulent financial activities within the banking sector. This was in agreement with (Luh, 2024) findings that under the leadership of women (woman CEO and board gender diversity), higher external audit quality is ensured as higher audit fee is paid. Interestingly, it was found that with the presence of women on the audit committee, the integrity of internal controls and internal audit procedures are enhanced, which leads to quality financial reporting, calls for lower audit effort, hence lower audit fee and (Alkebsee, Tian, Usman, Siddique, & Alhebry, 2021) the study's findings suggest that the presence of female directors on the audit committee improves internal monitoring and communication, which reduce the perceived audit risk and the need for assurances from external auditors. The results also suggest that female directors demand high-quality audits and further assurance from external auditors when the firm is more complex and riskier.

Conclusion and Recommendation

The study sought to investigate the effects of audit committee characteristics on fraudulent financial reporting. The findings from the analysis of audit committee characteristics and their impact on fraudulent financial reporting within commercial banks in Kenya provided valuable insights for enhancing governance practices in the banking sector. The study revealed that larger audit committee sizes, greater independence, and higher gender diversity are all associated with significant reductions in fraudulent activities. These findings emphasized the key role of robust governance mechanisms in promoting financial integrity and transparency within banking institutions. Larger, independent and diverse audit committees are essential for effective oversight and control, leading to enhanced detection and prevention of fraudulent activities. Moreover, the results highlight the importance of promoting gender diversity within governance structures to promote varied perspectives and decision-making approaches.

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