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Exploring How Audit Quality Bridges the Link between Board Audit Committee Financial Expertise and Financial Reporting Quality: Empirical Evidence from Kenyan Commercial Banks

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ABSTRACT

Financial reporting quality (FRQ) within the banking industry is of particular interest due to the importance of transparency, market confidence and financial stability. Banks are particularly prone to FRQ issues due to the high level of estimation within the accounting process such as loan loss provisions (LLP). In addition, low FRQ may mask risk and pose a threat to financial stability. This study sought to establish the mediating effect of audit quality on the relationship between board audit committee financial expertise and financial reporting quality (FRQ) among banks in Kenya. Anchored on Agency Theory, Stakeholder Theory and Resource Dependence Theory, the study adopted a positivist philosophy and an explanatory longitudinal panel research design. Secondary data were obtained from audited financial statements, annual reports, external audit reports and Central Bank of Kenya publications covering 2015–2024, and all analyses were based on this full balanced panel of 330 observations. Financial reporting quality was measured using absolute discretionary loan-loss provisions derived from a bank-specific loan-loss-provision model, with lower values indicating less reporting discretion and higher financial reporting quality. Audit quality was proxied by external audit fees. Mediation was tested using the Sobel test. The mediation results demonstrated that audit quality mediate the relationship between financial expertise (indirect $\beta = 0.008$, $p < 0.05$), meeting frequency (indirect $\beta = 0.007$, $p < 0.05$), independence (indirect $\beta = 0.005$, $p < 0.05$) and size (indirect $\beta = 0.005$, $p < .05$) and financial reporting quality. The study recommends that banks and regulators should strengthen substantive board audit committee financial expertise and engagement between Board Audit Committees and external auditors. The findings have the potential to provide policymakers and regulators with information highlighting the significance of strong audit board committee in the process of enhancing financial reporting quality.

Keywords: Quality Audit, Audit Fees, Dimensions of Board Audit Committee, Quality of Financial Reporting, Discretionary Loan-Loss Write-offs, Mediation, Kenyan Banks

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1.0 Introduction

Quality of Financial Reporting (FRQ) is about the degree to which financial reports are reliable, transparent and accurate and provide information to stakeholders in a manner that enables them to make an informed decision regarding the financial status and performance of the firm. Improvements to auditing and financial reporting have been at the forefront of global efforts to increase transparency and improved governance in both auditing and financial reporting since the reforms that have occurred in these areas (FRC, 2013a; Chronopoulos et al., 2024; Mardessi, 2022). Audit quality can also be thought of as the probability that an audit will (a) pick up on a material misstatement or irregularity within a client's accounting system and (b) identify the irregularity. Both the ability of the auditor in detection and the independence of the auditor in identifying violations are important in defining audit quality (DeAngelo, 1981; DeFond & Zhang, 2014). While, DeAngelo, (1981) asserts that the quality of an audit is fundamentally based on two primary pillars: the auditor's capacity to identify significant errors and misstatements, and the independence required to adopt an appropriate stance toward reporting these discrepancies. The recognition of these two pillars is additionally categorized into input-oriented and output-oriented methodologies.

Several well-publicised bank failures including Charterhouse (2006), Imperial (2015) and Chase (2016) have identified various problems in auditing, governance and financial reporting within banks. These bank failures were caused due to weak internal controls, insider lending, fraudulent reporting and have highlighted the importance of the role played by the Board's Audit Committee in providing reliable financial reporting. Various local and international best practice have resulted in an increased focus on improving the quality of audit in Kenya. Increased quality in the audit has also resulted due to the implementation of IFRS and the work carried out by the IAASB. IFRS 9 has required banks to start using expected credit loss (ECL) in loan loss provisioning, increasing the technical ability and judgement required in the loan loss provision. This has created greater importance on the role of external auditors and the Board's Audit Committee in the provision of faithful representation. (Central Bank of Kenya, 2018)

In Kenya, the audit committee in commercial banks is explicitly constituted as the Board. Audit Committee (BAC) under CBK's corporate governance prudential guideline (CBK/PG/02). The BAC's objective is to provide independent oversight of the institution's financial reporting and internal control system and recommend remedial action at least every three months. The current governance framework aims to define the connection between the level of audit quality and the role of the audit committee. BAC independence as well as skill and effort on the part of the committee enhances the level of auditor interaction and review and is expected to result in higher quality audits and in turn better quality financial reporting quality (FRQ) (Central Bank of Kenya, 2013; Mardessi, 2022). There is also a second externally provided but acquired level of assurance provided by the external auditor. The strength of this audit is also influenced by the audit committee choices regarding the auditor selection, audit fee, and scope of the audit.

Whether committee attributes improve reporting quality by their own force, or by strengthening the external audit, or both, is an empirical question with materially different implications for how banks and regulators should act and it is the question this study was designed to answer. Despite strengthened prudential supervision and corporate governance requirements, concerns about financial reporting quality (FRQ) in Kenya's banking sector persist. High-profile collapses of banks, including, Charterhouse (2006), Dubai bank (2015) Imperial bank (2015) Chase bank (2016) exposing profound weaknesses in quality of financial reporting, audit quality, and corporate governance within the sector. These failures were due to major issues insider trading, weak corporate governance, weakness in regulatory and supervisory system,

poor risk management, lack of internal controls, conflict of interest all linked to reliability of financial reporting, raising concern about audit quality, reporting integrity, Board audit committee failures on financial oversight.

There is a research gap because most research studies tend to look at direct links. The link between board audit committee and FRQ has not been thoroughly examined in the banking sector. This study therefore examines the link between board audit committee characteristics and Financial Reporting Quality (FRQ) and Audit Quality (AQ). Some research has indicated potential for mediation as the quality of the audit committee can influence the audit and the assurance provided (Islam et al., 2023). This link however has only been examined in a small number of large public listed firms and has not been examined to a significant extent in the banking sector in Kenya. This study will examine the mediating influence of audit quality on the link between board audit committee characteristics (financial expertise) and FRQ among banks in Kenya. The aim is to provide information that is relevant to regulators and the board in the Kenyan banking sector. Furthermore, some discrepancies in prior research can be explained with the results of this study.

2.1 Theoretical and Literature Review

2.1.1 Agency Theory

Agency theory can be traced back to the early 1970s with the research of Barry Mitnick (1973) and Stephen Ross (1973). Further refinement and application in the field of corporate governance came with the research of Jensen and Meckling in 1976. Agency theory suggests that if decision rights are transferred from a principal to an agent in a setting of imperfect information and self interest agency problems will exist. Principals (shareholders and other stakeholders) transfer decision making rights to agents (managers) who should act on behalf of the principals.

However, managers are likely to have more information about the company and the actions within the company than the principals. As such, managers are also likely to pursue their own interests and not the interest of the principals. Such problems can lead to risk and information concealment, earnings management and financial reporting that is not faithful to the underlying financial information. In banking, this is of particular significance as many stakeholders (investors, creditors, regulators, and depositors) rely on financial reports and audit reports in order to gain insight into the governance, risk, and solvency of the bank.

Agency theory can be related to the characteristics of this study. FRQ is the dependent variable in this study and refers to the accuracy, faithfulness and reliability of financial information in bank reports. Agency problems are likely to arise when managers exercise discretion over loan loss provisions and affect the financial position or performance of the bank. Board Audit Committee (BAC) financial expertise is an oversight mechanism that can reduce agency problems. A BAC with financial expertise will be better suited to review financial information, challenge management assertions and interpretations of audit results. Also, it will be better equipped to review disclosures and estimates within financial reports. This would result in less misstatements within the reports. Financial expertise within a BAC reduces manager discretion because it increases the power of the monitor. This is addressed in the first hypothesis (H01).

Audit quality (AQ) can be a mediating variable in this relationship based on Agency Theory. External audit can be an effective method of alleviating information asymmetry. The external audit provides an independent check on the accuracy of the reported financial information. However, the level of assurance can vary based on auditor independence, competence, incentives, audit effort, and area of specialization. Agency theory would posit that governance characteristics that affect auditor independence, auditor selection and the conduct of the audit

will have an impact on the level of assurance provided. A BAC with financial expertise can help reduce agency problems in the following ways: selecting qualified auditors, promoting sufficient audit effort, providing oversight over auditor independence issues such as tenure and non-audit services, and ensuring that audit results are properly acted upon. Higher levels of audit quality would aid in FRQ by providing more reporting and detection of misstatements and by reducing earnings management. This supports the mediating role of Audit Quality (AQ) in the relationship between financial expertise within BAC and FRQ as it relates to how financial expertise in BAC can be transferred to higher levels of FRQ via the impact that Audit Quality has on FRQ. This is also addressed in the second hypothesis (H02). However, Agency Theory focuses on the relationship between manager and shareholders and banks are also accountable to other stakeholders including depositors, regulators, and investors. For this reason, Stakeholder Theory is also relevant.

2.1.2 Stakeholder Theory

Stakeholder Theory was introduced by R. Edward Freeman in 1984. The theory advocates for consideration of the interests of all parties that can impact or are impacted by a firm including shareholders, customers, employees, creditors, regulators and the community in the mission and governance of a firm. In the context of banking, stakeholder interest is particularly relevant because the health of banks affects the economy and depositors and regulators need reliable information in order to perform prudential supervision. Under Stakeholder Theory FRQ is not only useful to shareholders but also a trust and accountability outcome to a variety of stakeholders.

The unique contribution of Stakeholder Theory to this research is its explanation for the relevance of reporting quality to banking. Bank stakeholders include not only shareholders, but also depositors (whose claim is informationally important and who have no ability to diversify away from bank-specific reporting issues), the bank's regulator (whose judgments are impacted by the quality of reported assets) and the financial system (which is impacted by the externalities of bank reporting quality). Because of these stakeholder interests, reporting discretion in loan loss provisioning (which is the basis for the measure of FRQ in this research) is not a purely internal issue between management and shareholders but a first order stakeholder issue.

Stakeholder Theory is relevant to this research because it frames BAC as a broad accountability mechanism. If the BAC possesses accounting knowledge then the BAC will be able to offer a higher level of confidence in the complex accounting within banking statements. This could assist in establishing confidence amongst stakeholders. AQ can also play a part in establishing confidence within stakeholders. External stakeholders require assurance from the quality of the audit in order to gain assurance over the quality of the information within the statements. Hence AQ can add to the benefits of BAC as well as offering more assurance to stakeholders with respect to FRQ. Both internal and external auditing can be seen as a form of stakeholder protection. Stakeholder Theory does offer some understanding of accountability however it offers little in relation to how the board can obtain and make use of knowledge that can aid the quality of audit and reporting. Resource Dependence Theory is therefore relevant.

2.1.3 Resource Dependence Theory

Resource Dependence Theory (RDT) was put forward by Pfeffer and Salancik (1978). RDT suggests that organisations depend on external resources (e.g. knowledge, information, legitimacy and capital) and establish mechanisms of governance in order to obtain these resources and deal with environmental uncertainty. In corporate governance boards and board committees can be seen as both monitors and conduits for accessing important resources. This

is relevant to banking because FRQ requires highly specialized knowledge and both strong governance and reliable assurance systems.

According to RDT the independent variable in this research is also a resource. BAC accounting knowledge is a human resource that can be used to perform technical scrutiny over financial reports. In this research, BAC accounting knowledge is measured as the percentage of committee members who possess accounting, auditing, finance or banking knowledge. RDT also is relevant to AQ as a mediating variable. Audit services (especially high quality audit services) can be seen as an external resource accessed by organizations. High quality auditors provide legitimacy, credibility and specialized knowledge. A strong BAC can gain access to this resource by selecting competent auditors, providing adequate resources to the external auditor and establishing effective governance over auditor independence. Once gained, AQ enhances FRQ by increasing the reliability of financial reporting and decreasing the likelihood of opportunism.

Resource Dependence Theory provides a prediction that is not provided by either Agency or Stakeholder Theory in a clean manner. According to RDT the value of some board committee characteristics can be realized in external relations rather than within the board. If board committee members are conduits for accessing important external resources then a more well-resourced board committee would be one with stronger ties to the most important external resource to a bank - the external auditor. Thus Resource Dependence Theory enhances the logic for the mediation in this research. BAC accounting knowledge can allow a bank to gain access to and utilize high quality external auditors which in turn can enhance FRQ. This prediction is tested in the mediation analysis (H02).

2.2 Empirical Review

Qawqzeh et al. (2020) explored the impact of the effectiveness of external auditors on the quality of financial reporting and the partial role of external audit quality as a mediator in this relationship amongst listed Jordanian firms. The study employed panel data from 180 Amman Stock Exchange (ASE) listed firms from the years 2009 to 2017. Causal Steps Method was employed in the analysis of the data. Among the findings; the size of the auditor was found to have no significant impact on financial reporting quality. On the other hand, industry specialization was found to positively influence financial reporting quality by lessening the use of earnings management. Auditor tenure was also found to have a significantly negative impact. The size of the auditor was found to have a negative impact on the quality of audit. Industry specialization and auditor tenure were found to have a positive and significant impact on the quality of audit. Further, the relationship between the effectiveness of an auditor and the quality of financial reporting was found to be partially mediated by the quality of audit in terms of fees.

This study is related to the present study in two ways. Firstly, the quality of an audit was used as audit fees similar to the proxy used in the current study. Secondly, the use of mediation through the causal-steps methodology employed by the current study was made by this study. However, in this study the characteristics of the external auditor were used and not characteristics of the audit committee. This study uses data from Jordan. This study can be extended by examining whether the quality of an audit transmits the impact of the financial expertise of the Board Audit Committee to the quality of financial reporting amongst banks in Kenya.

Qawqzeh, Endut and Rashid (2021) focused on the impact of board characteristics, director pay, audit fees (as an indication of the level of audit quality) and the quality of financial reporting in Jordan. Panel data from 180 listed firms on the Amman Stock Exchange from the

years 2009 to 2017 were used in the study. Multiple regression analysis and the Causal Steps Method were used in the analysis of the data. The findings indicated that an increased board size and the presence of independent directors negatively and significantly affect FRQ, while board expertise and directors' remuneration positively and significantly influence FRQ, in alignment with Agency Theory. I find that board size, board independence and director pay have a positive and significant impact on audit fees. Board expertise has a relatively strong negative relationship with audit fees and audit quality partially mediates the impact of board characteristics on financial reporting quality. This research demonstrates that a governance factor can impact financial reporting quality via audit fees. Additionally, this research has found that board expertise has a positive impact on FRQ while reducing audit fees; thereby creating an empirical issue regarding the relationship between board expertise and audit quality. This research investigated board expertise at the board level and in Jordan. This research investigates financial expertise on the Board Audit Committee which is the board responsible for the management of the external audit. The impact of this expertise on audit quality and FRQ is investigated in a panel of 10 years of data on banks in Kenya.

While not as large as the research investigating both direct effects, the mediation research is the primary driver for this study. There is some evidence that audit quality can transmit the impact of governance on financial reporting quality. However, this research mostly focuses on non-bank samples or studies done outside of Kenya. Furthermore, much of this research has focused on board characteristics and auditor characteristics rather than expertise on the audit committee. No prior study was found in this search that investigated within a longitudinal panel of banks, the transmission of the impact of financial expertise on the Board Audit Committee on financial reporting quality via audit quality and thereby separated the direct impact of financial expertise from the impact transmitted via external audit quality. This research seeks to fill this gap utilizing a balanced panel of 330 bank-year observations across 33 banks from the years 2015 to 2024. Audit quality is measured via statutory external audit fees and FRQ is measured via discretionary loan-loss write-downs.

2.2.1 Effect of Audit Committee Financial Expertise on Financial Reporting

Chaudhry, Roomi and Aftab (2020) examined the impact of the financial, monitoring, and experiential expertise of the audit committee chair (ACC) and the HR, monitoring, and experiential expertise of the nomination committee chair (NCC) on the financial performance (FP) of the firm. This study employed a quantitative approach to gather data from 50 non-financial firms in Pakistan, utilizing e-views for data analysis to test the hypotheses. The study found that financial and surveillance skills of ACC and experience skills of NCC are positively related to the net profit margin, return on equity and return on assets of the firm. But there was no significant influence of experience skills of ACC and surveillance and HR skills of NCC on FP.

Krishnamoorthy et al. (2023) presents a comprehensive analysis of how the AFE located in the AC chair influences the oversight of financial reporting quality and the auditing process. Through an analysis of more than 13,840 observations from U.S. public companies, we observe that the AFE of the AC chair correlates with reduced earnings management and improved oversight of the audit process. When enhanced by AC members with AFE, the AC chair AFE shows a negative correlation with the risk of misstatements. This finding indicates that appointing an AFE to the AC alone may not adequately improve oversight quality, unless the committee is also led by a chair who has AFE qualifications. Ultimately, chair AFE is observed to increase the probability of disclosing material control weaknesses and goodwill impairments.

Khudhair et al. (2019) analysed the impact of board characteristics such as board size, audit committee independence, audit committee expertise, and number of audit committee meetings on audit quality in a sample of Iraqi non-financial firms. Audit quality was measured as a binary variable, where a value of 1 was assigned to firms that engaged one of the big five audit firms and zero for all others. Using logit regression methodology, the research objectives were addressed. The study found a positive relationship between the percentage of non-executive directors on audit committees and audit quality.

Alareeni (2019) studied the relationship between characteristics of audit firms (e.g firm size, non-audit service, industry focus, and auditor-client relationship length) and measures of audit quality. Moreover, the research studied how certain characteristics may affect these relationships. Such characteristics include the type of jurisdiction and US vs. non-US firms. Using a method similar to that of Hunter et al. (1982), the study tested its research hypotheses and addressed its research objectives through a meta-analysis. 71 published studies were included between the years 1992 and 2017. The characteristics of audit firms all found to have a significant positive relationship to audit quality. Relationships between characteristics of audit firms and audit quality were affected by measures of audit quality. These relationships were also affected by other characteristics such as the difference between US and non-US studies, time before and after SOX, jurisdiction, strength of reporting and auditing standards, and developed vs. developing nations.

Mardessi (2022) studied the effect of audit quality on the quality of financial reporting as measured through real earnings management. Moreover, the study studied how audit quality may moderate the relationships between the characteristics mentioned. The sample used in the study included 90 non-financial firms listed on the Amsterdam stock exchange within the AEX all share index from the years 2010 to 2017. The study used a quantitative research method and mainly used secondary data to conduct the study. Ordinary least squares regression was used to study the moderating role of audit quality on the relationship between financial reporting quality. The results found that corporate governance characteristics such as the presence of independent directors, financial expertise and the size of the audit committee all have a statistically significant relationship with real earnings management. The presence of audit committee meetings and real earnings management appears to have no significant relationship. There is some evidence that audit quality has an effect on the relationship between the audit committee and real earnings management. We therefore hypothesized that:

H₀₁: To examine the effect of Board Audit Committee financial expertise on financial reporting quality (FRQ) among banks in Kenya.

2.2.2 Mediating Role of Audit Quality

Qawqzeh, Endut, Rashid and Dakhlallh (2020) studied the effect of effectiveness of the external auditor on the quality of financial reporting and also the mediating role of external audit quality on the relationship between the effectiveness of the external auditor and the quality of financial reporting for Jordanian firms. Panel data was used for 180 listed companies on the ASE from the years 2009 to 2017. Multiple regression analysis and Causal Steps Method were used to test data. Results found that auditor size has no significant impact on financial reporting quality. On the other hand, industry specialization has a significant positive impact on financial reporting quality by reducing the extent of earnings management. Auditor-client relationship length has a significantly negative impact on financial reporting quality. Results also found that auditor size has a negative impact on audit quality. Moreover, auditor-client relationship length and industry specialization have a positively significant impact on audit quality. The relationship between effectiveness of external auditors and quality of financial reporting was partially affected by the quality of the external audit in terms of fees. These

findings have important implications for regulators, auditors, decision-makers and shareholders who are trying to implement new policies related to the audit profession, increase the level of specialization in industry and strengthen policies regarding auditor rotation in Jordanian firms. This study is unique in that it studied the relationship between effectiveness of external auditors and quality of audit and quality of financial reporting as well as the mediating role of audit fees in the context of Jordan.

Qawqzeh, Endut and Rashid (2021) studied the role of audit fees as a measure of audit quality in relation to characteristics of the board, directors' compensation and quality of financial reporting for Jordanian firms. Panel data was used for 180 public listed companies on the Amman Stock Exchange for the years 2009 to 2017. Multiple regression analysis and Causal Steps Method were used to test the data. Results found that larger board size and presence of independent directors have a significant and negative impact on FRQ. Board expertise and directors' compensation had a positively and significantly impact on FRQ in line with Agency Theory. Board size, board independence and directors' compensation had a positively and significantly impact on audit fees as a measure of audit quality. Board expertise had a significantly negative impact on audit fees. Audit quality also played a partial mediating role in the relationship between characteristics of the board and quality of financial reporting. These findings have important implications for decision-makers and regulators as they attempt to implement new policies related to the characteristics of the board and the audit profession. The findings also highlight the increasing monitoring role of independent directors and larger boards over management in the preparation of financial reports. Moreover, these findings also show the relationship between the effectiveness of the board and quality of audit in reducing the extent of earnings management and also quality of financial reporting in a developing country like Jordan. There also appeared to be a relationship between factors affecting FRQ and the interaction with external factors that can improve these factors. This would address the role of the board of directors in reducing financial fraud.

Agus and Ghozali (2019) studied the relationship between auditor ethics and litigation of audit results and also studied the mediating role of auditor quality. A sample of 220 public auditors employed by public accounting firms was used. Random sampling methods were used. Structural Equation Modelling was used as the main analysis tool. The results found that auditor ethics have a positively and significantly relationship with audit quality while auditor quality has a significantly negative relationship with litigation of the auditor. The study has importance as it highlights the ethical issues that auditors must consider during their work. Audit quality in this study has importance as it strengthens the relationship between auditor ethics and litigation of an auditor.

Cheng, Chen and Chen (2013) studied the relationship between auditor size and auditor performance. There are two different types of audit firms; the first targets public companies and the second targets non-public companies. Using path analysis, it was observed that the size of the auditor had a direct effect on performance and an indirect effect on performance through auditor quality. Auditor quality has a direct relationship with both the size of the auditor and performance of the auditor. The size of the auditor has a greater impact on the performance of PCAMFs than NCAMFs. Auditor quality in PCAMFs (Public Company Audit Market Firms) explains a greater amount of variation in performance than it does in NCAMFs (Non-Public Company Audit Market Firms). Results suggest that PCAMFs are able to achieve better financial performance due to better auditor quality. We therefore hypothesize that:

H₀₂: To examine the mediating effect of audit quality on the relationship between Board Audit Committee financial expertise and financial reporting quality (FRQ) among banks in Kenya.

2.3 Conceptual Framework

In this study, Board Audit Committee (BAC) dimensions namely financial expertise,are the independent variables, audit quality is the mediating variable, and financial reporting quality (FRQ) is the dependent variable. The study incorporates firm age and firm size as control variables. Figure 1 shows the conceptual framework.

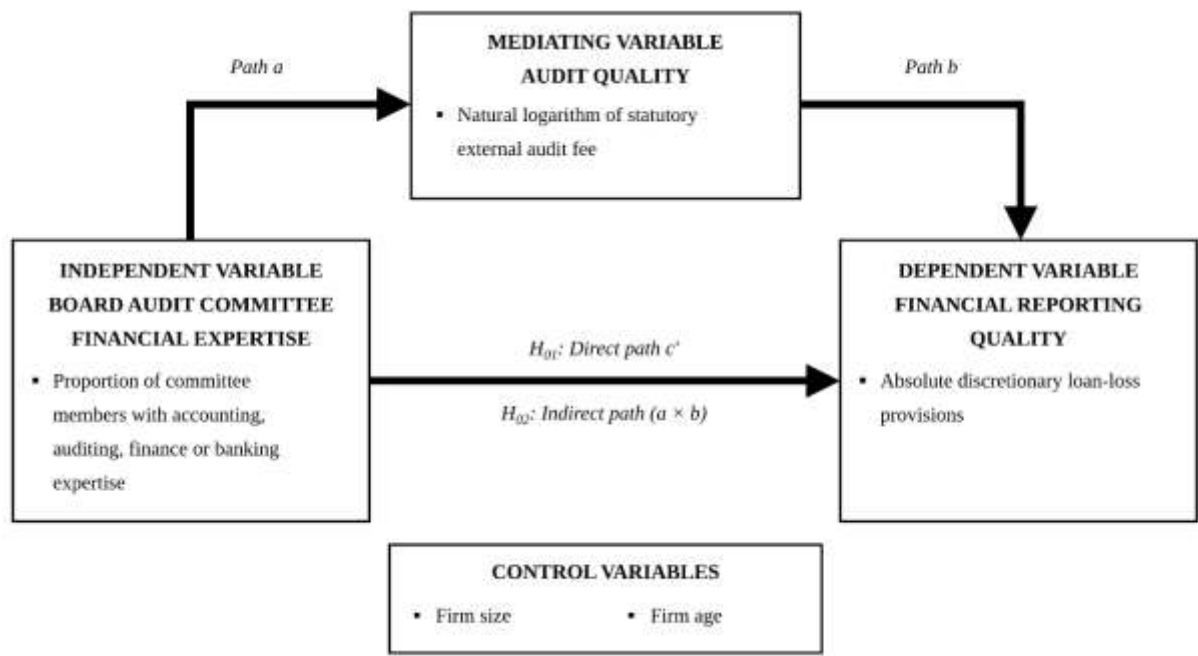


Figure 1: Conceptual Framework

Source: Adapted from Hayes (2018), Model 4

3.0 Methodology

A positivist research approach was used in the present research. The research design used in the present study is an explanatory longitudinal study. Thus a longitudinal research design is suitable for this study since data are available for all banks for a period of 10 years from 2015 to 2024. Panel data were used which incorporated cross sectional differences between banks and time series differences between years. The changes in Board Audit Committee (BAC) financial expertise, financial reporting quality (FRQ) and audit quality (AQ) over time were captured using this data. Furthermore, relationships and trends that could not be captured with a cross sectional study were also identified (Hsiao, 2022).

The data used in this study is a balanced panel consisting of data from 33 banks over 10 years from 2015 to 2024. The sample size consisted of 330 bank year observations. The data used are quantitative panel data collected from bank annual reports, external audited audit reports, governance information, Central Bank of Kenya reports and audited financial statements for the period 2015-2024.

Audit quality (AQ) is the ability of the external auditor to identify and highlight material misstatements and to give confidence in the financial statements of the bank. DeFond and Zhang (2014) have discussed several advantages of using audit fees as an indicator of audit quality. These advantages include that audit fees are continuous and hence differences in audit quality can be detected with high precision and there have been significant developments in the research on audit fees. Many studies have developed sophisticated fee models which result in very high R-squared values. Since audit quality is not directly measured in this study, the

statutory external audit fee was used as a continuous proxy for the effort and intensity of the audit. The statutory external audit fee was used in the following way:

$$AQ_{i,t} = \ln(\text{Statutory external audit fee}_{i,t})$$

The audit fee consisted of the statutory fee charged for the audit of the annual financial statements and did not include any separately reported fees for tax, consultancy, non-audit and other assurance services. If an annual report contained a combined total for all fees charged by the auditor but this fee could not be broken down then the observation was recorded in a uniform manner with clear note but an estimated audit fee was not provided. Transformation to natural log helped to overcome problems relating to the scale of the fees and the impact of outliers.

Financial reporting quality (FRQ) was measured using a modified discretionary loan loss provision model for banks proposed by Beatty and Liao (2014). The discretionary loan loss provision was multiplied by -1 so that the greater the value of this variable, the greater the quality of financial reporting and lesser the discretion exercised by the bank. The independent variable used was Board Audit Committee (BAC) financial expertise which is defined as the percentage of members of the Board Audit Committee who have accounting, auditing, finance or banking expertise. This variable was measured as:

$$BACF_{i,t} = \text{Financially expert BAC members}_{i,t} / \text{Total BAC members}_{i,t}$$

Audit quality (AQ) was the mediating variable, while bank size (FS) and bank age (FA) were included as control variables. Bank size was measured as the natural logarithm of total assets at the end of the financial year, and bank age as the natural logarithm of the number of years since incorporation:

$$FS_{i,t} = \ln(\text{Total assets}_{i,t})$$

$$FA_{i,t} = \ln(\text{Financial year}_t - \text{Year of incorporation}_i)$$

3.1 Model specification

The effects of bank size and bank age on FRQ were first estimated using the following control-variable panel regression model:

$$FRQ_{i,t} = \beta_0 + \beta_1 FS_{i,t} + \beta_2 FA_{i,t} + \mu_i + \varepsilon_{i,t} \dots\dots\dots 1$$

The first hypothesis (H0₁), on the effect of Board Audit Committee financial expertise on FRQ, was tested after controlling for bank size and bank age. The model was specified as follows:

$$FRQ_{i,t} = \beta_0 + \beta_1 BACF_{i,t} + \beta_2 FS_{i,t} + \beta_3 FA_{i,t} + \gamma Z_{i,t} + \mu_i + \varepsilon_{i,t} \dots\dots\dots 2$$

Where μ_i is the unobserved bank-specific effect, $\varepsilon_{i,t}$ is the error term, and $Z_{i,t}$ represents the remaining Board Audit Committee attributes (meeting frequency, independence and size), which were held constant so that the coefficient on BACF represented its own effect on FRQ. The Hausman specification test was used to select between the fixed-effects and random-effects estimators.

The second hypothesis (H0₂), on the mediating effect of audit quality on the relationship between Board Audit Committee financial expertise and financial reporting quality, was tested using the Baron and Kenny (1986) causal-steps procedure. Andrew F. Hayes Model 4 is the standard simple mediation model used to test whether a variable (M) transmits the effect of an independent variable (X) to a dependent variable (Y). In this study, X was BACF, M was AQ and Y was FRQ. The models were estimated within the structural equation modelling (SEM) framework in Stata, and the significance of the indirect effect was assessed using the medsem

post-estimation package, which reports the Delta, Sobel and Monte Carlo tests. Path a: The effect of Board Audit Committee financial expertise on the mediator, audit quality, was estimated.

$$AQ_{i,t} = \beta_0 + \beta_1BACF_{i,t} + \mu_i + \varepsilon_{i,t} \dots\dots\dots 3a$$

Paths b and c’: Audit quality and Board Audit Committee financial expertise were entered jointly to estimate the effect of audit quality on FRQ and the remaining direct effect of financial expertise.

$$FRQ_{i,t} = \beta_0 + \beta_1BACF_{i,t} + \beta_2AQ_{i,t} + \mu_i + \varepsilon_{i,t} \dots\dots\dots 3b$$

Under the causal-steps procedure, mediation required a statistically significant relationship between BACF and AQ (path a) and a statistically significant relationship between AQ and FRQ after controlling for BACF (path b). The total effect (path c) and the remaining direct effect (path c’) were then compared. The significance level for all tests was set at 5%. A partial mediation is established when paths a and b are significant while the path from BACF to the dependent variable is also significant but the coefficient is reduced when AQ is used in the analysis.

4.0 Findings and Discussion

This research used a balanced panel of data for 330 bank-year observations. The sample consisted of 33 banks over a 10 year period (2015-2024). The descriptive statistics for the variables used in the analysis are shown in table 1. FRQ had a mean of -0.0098 and a standard deviation of 0.0160. The range of FRQ values are between -0.096 and 0.000. Based on this information it appears that on average the loan-loss provisions for the banks in the sample are close to the loan-loss provisions that are expected given the observable levels of credit risk. BACF has a mean of 0.475 and a standard deviation of 0.094. The minimum value for BACF is 0.250 and the maximum value is 0.667. This indicates on average slightly less than half the Board Audit Committee members are financially expert. The Audit Quality variable (AQ) was measured by statutory cost of external audit and had a mean of 16.086 and a standard deviation of 0.785. The range of the Audit Quality variable is between 14.304 and 18.369. This indicates there is a wide variance in the audit costs across the banks in the sample. Given the relatively large standard deviation it can also be inferred that there are relatively large differences between the level of involvement in the audit process across the sample banks.

The control variables bank size (FS) had a mean of 10.796 and a standard deviation of 0.655. The range of values for bank size are between 9.001 and 12.260. This implies there are differences in the size of the banks in the sample. Bank age (FA) had a mean of 3.509 and a standard deviation of 0.9525. The minimum bank age is 0.000 and the maximum bank age is 5.357. This also indicates there are relatively large differences in the age of the banks in the sample. The skewness for the variables in the sample ranged between -0.185 and 0.007. The kurtosis for the variables in the sample ranged between 2.495 and 3.094. This implies that the data for the variables in the sample is relatively normally distributed.

Table 1: Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max	Skewness	Kurtosis
FRQ	330	-.0098	.0160	-.096	0.000	-0.141	3.082
BACF	330	.475	.094	.250	.667	0.007	2.495
AQ	330	16.086	.785	14.304	18.369	0.005	2.941
FS	330	10.796	.655	9.001	12.260	-0.152	3.094
FA	330	3.509	.9525	0.000	5.357	-0.185	2.925

Source: Research Data (2026)

Table 2 presents the Pearson pairwise correlations among financial reporting quality (FRQ), board audit committee financial expertise, audit quality and the control variables. Table 2 demonstrates that financial reporting quality is weakly and positively correlated with board audit committee financial expertise ($r = 0.216$, $p < 0.05$) and audit quality ($r = 0.272$, $p < 0.05$), and moderately and positively correlated with bank size ($r = 0.583$, $p < 0.05$). However, FRQ is negatively correlated with bank age ($r = -0.486$, $p < 0.05$). Audit quality is positively correlated with board audit committee financial expertise ($r = 0.207$, $p < 0.05$) and bank size ($r = 0.529$, $p < 0.05$), and negatively correlated with bank age ($r = -0.386$, $p < 0.05$). The pairwise correlation matrix further confirms the absence of multicollinearity as all the coefficients are less than 0.8.

Table 2: Pearson Pairwise Correlation Results

	FRQ	BACF	AQ	FS	FA
FRQ	1.0000				
BACF	0.2163*	1.0000			
AQ	0.2715*	0.2067*	1.0000		
FS	0.5832*	0.0603	0.5293*	1.0000	
FA	-0.4856*	-0.1703*	-0.3861*	-0.5472*	1.0000

* Correlation is significant at the 0.05 level.

Source: Research Data (2026)

Hausman Specification Test

The Hausman specification test was used to select between the fixed-effects and random-effects panel regression models (Hausman, 1978). The null hypothesis of the test supports the random-effects estimator as consistent and efficient, suggesting that the unobserved bank-specific effects are not correlated with the explanatory variables, while the alternative hypothesis states that the random-effects estimator is inconsistent, in which case the fixed-effects estimator is the preferred panel-data estimation model. A p-value below 0.05 supports the fixed-effects model. The results presented in Table 3 revealed $\chi^2(6) = 19.90$ and $\text{Prob} > \chi^2 = 0.0029$. As a result, the null hypothesis was rejected, and the conclusion was that the fixed-effects regression model was the ideal model for testing the hypotheses.

Table 3: Hausman Specification Test

Variable	(b) Fixed	(B) Random	(b–B) Difference	S.E.
FA	-.0234205	-.024178	.0007575	.0014847
FS	.0227455	.0277582	-.0050127	.0014956
BACF	.0226277	.0214362	.0011915	.0018249

S.E. = sqrt(diag(V_b–V_B)). b = consistent under Ho and Ha; B = inconsistent under Ha, efficient under Ho. Test: Ho: difference in coefficients not systematic. chi2(6) = (b–B)'[(V_b–V_B)^(–1)](b–B) = 19.90; Prob>chi2 = 0.0029 (V_b–V_B is not positive definite).

Source: Research Data (2026)

Effect of the Control Variables on Financial Reporting Quality

Initially the impact of the control variables (age of bank and size of bank) on FRQ was assessed prior to the inclusion of the primary independent variable. The results of this are shown in Table 3. There was a statistically significant fixed-effects regression model ($F(2, 295) = 29.54$, $p < 0.05$) which implies that the impact of the control variables did contribute significantly to the variation in FRQ. Around 35.20% of the variation in FRQ could be explained by the size and age of the bank ($R\text{-squared} = 0.3520$). The within and between $R\text{-squared}$ were 0.1668 and 0.4724 respectively. Bank age was found to have a statistically significant negative relationship with FRQ ($\beta = -0.053$, $t = -5.08$, $p < 0.05$) whilst bank size was found to have a statistically significant positive relationship with FRQ ($\beta = 0.023$, $t = 3.02$, $p < 0.05$). This evidence seems to indicate that larger banks, subject to more monitoring by external auditors, investors, regulators and other stakeholders, have less freedom when deciding the amount of loan-loss provisioning. Older banks appear to have more such freedom.

Table 4: Fixed-Effects Regression Results for the Control Variables

FRQ	Coef.	Std. Err.	t	P>t	[95% Conf. Interval]
FA	-.0529465	.0104181	-5.08	0.000	-.0734496 - .0324433
FS	.0225499	.0074651	3.02	0.003	.0078582 .0372416
_cons	-.0534172	.0210212	-2.54	0.012	-.0947878 -.0120467

Fixed-effects (within) regression; Number of obs = 330; Number of groups = 33; R-sq: within = 0.1668, between = 0.4724, overall = 0.3520; $F(2, 295) = 29.54$; Prob > F = 0.0000

Source: Research Data (2026)

Effect of Board Audit Committee Financial Expertise on Financial Reporting Quality

Hypothesis H_{01} stated that: Board Audit Committee financial expertise has no significant effect on financial reporting quality among commercial banks in Kenya. The hypothesis was tested using the fixed-effects regression model, as supported by the results of the Hausman specification test ($\chi^2(6) = 19.90$, $p = 0.0029$), with bank age and bank size as control variables. The results presented in Table 4 show that the model was statistically significant, $F(6, 291) = 37.09$, $p < 0.05$. The overall $R\text{-squared}$ value increased from 0.3520 in the control-variable model to 0.4870 when the Board Audit Committee attributes were introduced. Board Audit Committee financial expertise had a positive and statistically significant effect on financial reporting quality ($\beta = 0.023$, $t = 3.29$, $p < 0.05$, 95% CI [0.009, 0.036]). The control variables remained statistically significant, with bank age having a negative effect ($\beta = -0.023$, $t = -2.58$, $p < 0.05$) and bank size having a positive effect ($\beta = 0.023$, $t = 3.65$, $p < 0.05$) on FRQ. Based

on the findings, H_{01} was rejected, and the conclusion is that Board Audit Committee financial expertise is a positive driver of financial reporting quality.

Table 5: Fixed-Effects Regression Results for BAC Financial Expertise and FRQ

FRQ	Coef.	Std. Err.	t	P>t	[95% Conf.	Interval]
FA	-.0234205	.0090636	-2.58	0.010	-.0412591	-.005582
FS	.0227455	.0062346	3.65	0.000	.0104749	.0350161
BACF	.0226277	.0068694	3.29	0.001	.0091077	.0361476
_cons	-.157965	.0197941	-7.98	0.000	-.1969227	-.1190073

Fixed-effects (within) regression; Number of obs = 330; Number of groups = 33; R-sq: within = 0.4333, between = 0.5449, overall = 0.4870; F(6, 291) = 37.09; Prob > F = 0.0000

Source: Research Data (2026)

From the agency theory perspective, the audit committee serves as a crucial oversight an instrument for reducing agency problems and information asymmetries between managers and shareholders (Jensen & Meckling, 1976). Thus, financial expertise in audit committee can facilitate the evaluation of complex accounting policies, scrutiny of management forecasts, and cooperation with internal and external auditors. Furthermore, financial expertise in the audit committee may inhibit management from exploiting loan-loss provisions for the purposes of profit smoothing, performance targeting, or regulatory capital manipulation. According to the resource dependence view, financial expert audit committee members bring external resources, professional and functional knowledge that improve the audit committee’s monitoring function (Pfeffer & Salancik, 1978). This study also finds support from Krishnamoorthy et al. (2023) who found a negative relationship between accounting financial expertise on the audit committee and earnings management and increased monitoring of the audit function. Furthermore, this study also finds support from Mardessi (2022) who found a positive and statistically significant relationship between financial expertise on the audit committee and real earnings management.

Mediating Role of Audit Quality in the Relationship between Board Audit Committee Financial Expertise and Financial Reporting Quality

The research further investigated if audit quality served as a mediator in the connection between board audit committee financial expertise and the quality of financial reporting in Kenyan commercial banks. The hypothesis was evaluated utilising the SEM framework in Stata, augmented with the medsem package to perform the Sobel test.

Hypothesis H_{02} stated that: Audit quality does not mediate the relationship between board audit committee financial expertise and financial reporting quality among commercial banks in Kenya. The study used SEM to test for mediation and medsem as a post estimation test. Based on the SEM results as outlined in Table 5 below, board audit committee financial expertise had a significant effect on audit quality ($\beta = 1.727$, $p < 0.05$). Further, the findings revealed that AQ had a significant effect on FRQ ($\beta = 0.005$, $p < 0.05$). The results further revealed that the effect of Board Audit Committee Financial Expertise on FRQ was significant ($\beta = 0.029$, $p < 0.05$). Hence, the findings revealed that paths a ($X \rightarrow M$) and b ($M \rightarrow Y$) existed, while path c’ ($X \rightarrow Y$) was also significant.

Table 6: BAC Financial Expertise, Audit Quality and Financial Reporting Quality

	Coef.	OIM Std. Err.	z	P>z	[95% Conf.	Interval]
AQ <- BACF	1.726661	.4499996	3.84	0.000	.8446781	2.608644
AQ <- _cons	15.26555	.2178985	70.06	0.000	14.83848	15.69263
FRQ <- AQ	.0048555	.0010935	4.44	0.000	.0027124	.0069987
FRQ <- BACF	.0286501	.0091358	3.14	0.002	.0107442	.046556
FRQ <- _cons	-.1010324	.0172442	-5.86	0.000	-.1348305	-.0672343
var(e.AQ)	.5878797	.0457664			.5046874	.6847852
var(e.FRQ)	.000232	.0000181			.0001991	.0002702
Structural equation model; Number of obs = 330; Estimation method = ml; Log likelihood = 844.77938						

Source: Research Data (2026)

Table 6 above shows the results of the post estimation test. The z-scores for the Delta, Sobel and Monte Carlo tests are significant. The p-value associated with the path $X \rightarrow Y$ is also significant. This again indicates partial mediation. The RIT statistic indicates that 22.6% of the relationship between BACF and FRQ is mediated through AQ. The RID statistic indicates the indirect relationship is 0.3 times the direct relationship between BACF and FRQ. In sum, there is support for a model of partial mediation. BACF has both a direct and indirect relationship with FRQ and the indirect relationship passes through AQ. Thus, H02 is rejected and it can be said that AQ mediates the relationship between BACF and FRQ.

Table 7: Post Estimation of BAC Financial Expertise, Audit Quality and FRQ

Estimates	Delta	Sobel	Monte Carlo
Indirect effect	0.008	0.008	0.008
Std. Err.	0.003	0.003	0.003
z-value	2.903	2.903	2.822
p-value	0.004	0.004	0.005
Conf. Interval	0.003 , 0.014	0.003 , 0.014	0.004 , 0.014
RIT = (Indirect effect / Total effect) = (0.008 / 0.037) = 0.226			
RID = (Indirect effect / Direct effect) = (0.008 / 0.029) = 0.293			

Source: Research Data (2026)

Recent research has also found a connection between the financial knowledge of board audit committees and the level of audit quality as measured by audit fees. Audit committee members with financial knowledge are considered to be in the best position to make the decisions and apply the technical judgement required in some elements of the audit committee’s role (Rahman et al., 2024). Vafeas and Waagelein (2007) propose governance knowledge is important in maintaining the level of audit quality and find a significant and positive relationship between governance knowledge and audit fees. Ghafran and O’Sullivan (2017) looked at the effect of audit committee knowledge on an aspect of audit quality (audit fees for FTSE350 companies) and found that greater financial knowledge within the audit committee is associated with higher audit fees and hence greater levels of audit quality. A summary of the testing of the hypotheses can be found in Table 8.

Table 8: Summary of Hypotheses Testing

Hypotheses	Findings	Decision
H0 ₁ : Board Audit Committee financial expertise has no significant effect on financial reporting quality (FRQ) among banks in Kenya.	($\beta = 0.023, p < 0.05$)	Reject
H0 ₂ : Audit quality does not mediate the relationship between Board Audit Committee financial expertise and financial reporting quality (FRQ) among banks in Kenya.	(indirect $\beta = 0.008, p < 0.05$)	Reject

Source: Research Data (2026)

Other studies also found evidence for the mediating effect of audit quality in the relationship between the financial knowledge of the board’s audit committee and the quality of financial reporting. Qawqzeh, Endut, Rashid and Dakhlallh (2020) found the quality of external audits mediate the impact of corporate governance on financial reporting quality in Jordanian companies. Hasan, Kassim and Hamid (2020) found the frequency of meetings of the audit committee and the quality of the external audit affected the quality of financial reporting in Malaysia. Agyei-Mensah (2019) found both a high-quality external audit and an effective audit committee to be partial substitutes for achieving the quality of disclosure. Lastly, Krishnamoorthy et al. (2023) found support for the monitoring function of the audit committee’s knowledge.

5.0 Conclusion

The study investigated the effect of board audit committee characteristics on financial reporting quality, and also whether audit quality mediates this relationship. A sample of 33 commercial banks in Kenya for the years 2015-2024 was used (330 firm-year observations)

The study found that board audit committee financial expertise has an impact on financial reporting quality in Kenyan commercial banks. Banks that enhance the financial expertise within their audit committees have more disciplined provisioning practices resulting from the committee’s review rather than any resulting impact on the external audit. Financial expertise is thus best understood as an internal assurance that provides value through direct interaction with management’s estimates. More frequently meeting audit committees was also positively related to the amount of external audit performed. This assurance then had a positive effect on financial reporting quality. However even after the indirect effect via external assurance the relationship between increased meeting frequency and financial reporting quality still existed suggesting a direct effect. This finding indicates that internal and external assurance are complementary within the context of agency theory.

Financial reporting quality in Kenyan commercial banks is jointly influenced by internal audit committee ability and external audit assurance. The study finds that the external audit is the mechanism through which audit committee characteristics are transformed into credible financial reporting used by investors, regulators and depositors according to Stakeholder theory. External audit fees were used as a proxy of audit quality. However these fees are only a partial proxy of audit quality as they also capture elements of risk, bank complexity and potentially market power of the auditor. While this has been controlled for to an extent some of the variation remains. The findings on mediation are contingent on the validity of the fee proxy used. Alternative interpretations of assurance may result in different results for the transmission of effects.

6.0 Recommendations

Boards should value financial expertise when establishing audit committees. At least a majority of audit committee members should possess recognised accounting, auditing, or banking qualifications and should be up to date with the requirements for expected credit-loss. Expertise should be viewed as an ongoing responsibility rather than a characteristic set at time of appointment. Experience can be gained through an induction process, annual training related to impairment and provisioning practices and the periodic review of each committee member's contribution to the review of management estimates. Where there is a shortage of suitably qualified non-executives boards may wish to co-opt technical advisors to the committee and seek in qualified members. The Central Bank of Kenya should require banks to disclose, in a standardised format, the professional qualifications of audit committee members. The Capital Markets Authority and the Institute of Certified Public Accountants of Kenya should develop continuing-education programmes targeted specifically at bank audit committee members, focusing on expected credit-loss estimation, the interrogation of management's forward-looking assumptions and the oversight of external auditors. Given the finding that expertise acts directly on reporting quality, raising the technical floor of committee membership across the sector is among the most direct policy levers available for improving the reliability of published bank financial statements.

As independence and committee size were found to have their effects transmitted via the external audit board members should ensure that independent members are involved in the decision to appoint an external auditor, negotiating the fees to be paid and deciding the terms of the audit. Boards should also provide sufficient resources for the external audit rather than simply minimising the cost of the audit through the audit fee. If the audit fee appears notably low in relation to the bank's risk and size it should be viewed by the committee as a potential signal of low audit effort and not as a procurement success. Committee size should be set to provide adequate resources for the oversight of the external audit. This may include appointing members to be responsible for the relationship with the external auditor and committee size should not be set simply for this purpose.

Prudential reviews should also explicitly acknowledge that independence is not self-executing. Prudential reviews should look at whether independent members actually have control over the external audit including the appointment, the audit fee, the terms of the audit and private access. As the study found, this is the channel through which independence has an impact on financial reporting quality. Prudential reviews should also look at audit fees across the industry as a potential observable indicator of audit effort. Prudential reviews should also investigate audits where the audit fee appears inconsistent with the size and complexity of the audited bank. Alternative indicators of audit quality (e.g. auditor size, tenure, industry specialisation, engagement partner characteristics) would provide opportunities to test the mediation results across alternative interpretations of assurance as was done with the synthesis of auditor firm characteristics by Alareeni (2019).

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