



## **How Board Financial Expertise and Effectiveness of Audit Committee Influence Quality of Integrated Reporting: Firms Listed in Nairobi Securities Exchange**

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### **Abstract**

Integrated reporting in corporate reporting is recognized as a powerful tool for accurately portraying a company's ability to create value over time. Despite gaining attention from professionals and scholars, there is limited exploration into the quality of integrated reporting and its determinants. Financial expertise among board members is crucial for effective oversight of integrated reports, which contain both financial and non-financial information, highlighting the importance of board members possessing financial knowledge. Further, audit committee functionality promotes information disclosure among listed firms. It underscores the significance of enhancing audit committee effectiveness to improve the quality of integrated reporting, as evidenced by the strong correlation observed between audit committee effectiveness and integrated reporting quality. Companies should focus on strengthening the effectiveness of audit committees by ensuring that they comprise members with strong financial expertise and experience. This can be achieved by appointing individuals with relevant qualifications and experience in auditing, accounting, and financial management to the audit committee.

**Keywords:** Quality of integrated reporting, Audit committee, Board financial expertise

## **1. Introduction**

According Vitolla et al., (2020), integrated reporting in corporate reporting, serves as a potent tool for accurately depicting a company's ability to generate value over time. While garnering increasing attention from both professionals and scholars in recent years, there remains a dearth of exploration into the quality of integrated reporting and its determining factors. Another important board characteristic associated with integrated reporting concerns the financial expertise of board members. It is noteworthy that integrated reports contain financial and non-financial information, bringing to light the importance of board members having some financial expertise to provide oversight to the financial aspect of these reports effectively. The role and impact of board expertise on integrated reporting have been the subject of several studies, including Abernathy et al. (2015). Their study focused on firms listed in the S&P 500, particularly after the SEC mandated a reduced filing period to 60 days for firms with more than \$700 million in public float.

Abernathy et al. (2015) utilized descriptive and inferential statistics to examine the correlation between board financial expertise and disclosure practices. Their analysis revealed that board members' financial expertise, particularly those serving on audit committees, plays a crucial role in enhancing their understanding of the intricacies involved in financial reporting, including the audit process. This expertise provides them with insights and capabilities to delve deeper into financial matters, thereby potentially improving the quality and transparency of integrated reporting. Li et al. (2012) is another study that sought to establish the importance of board financial expertise on financial disclosures and, by extension, integrated reporting. The sample used in this study comprised UK IC-intensive sector companies that were fully listed on the London Stock Exchange (LSE) as of 30 December 2005. Descriptive and regression analysis was leveraged in this study to establish the relationship between board financial expertise and disclosure. The researchers in this study established that board financial expertise positively affects financial disclosures and works to reduce the acute information asymmetry.

Velte (2018) undertook a study to investigate how corporate governance factors, including board financial expertise, influence the quality of integrated reporting. This research analyzed a dataset consisting of 215 multinational firms over the period spanning from 2014 to 2016. The results of this study indicated a significant correlation between board financial expertise and the quality of integrated reports.

The literature review highlights the importance of financial expertise among board members in improving disclosure quality within corporate entities. However, it's important to note that while Velte (2018) focuses on the impact of financial expertise on integrated reporting quality, previous studies by Li et al. (2012) and Abernathy et al. (2015) primarily examine the relationship between board financial expertise and financial disclosure. Therefore, it can be suggested that the findings from these studies alone are insufficient to draw conclusive evidence regarding the influence of board financial expertise on the quality of integrated reports.

Audit committees represent pivotal operational bodies within a company's board of directors, tasked with the supervision of financial reporting and disclosure. Notably, these committees consist of members selected from the board of directors. As outlined by Carcello et al. (2011), akin to other board members, individuals serving on audit committees are appointed by shareholders but typically do not hold managerial positions within the corporation. The designation of non-executive board members to compose audit committees facilitates effective oversight of the corporation's financial reporting processes, internal controls, and independent auditors. Moreover, it is essential to underscore that audit committees, while appointed by shareholders, also render reports to shareholders through annual financial statements.

The existing literature underscores the significant role of corporate variables in shaping the quality of integrated reports. However, it is imperative to also acknowledge the influence of audit committee effectiveness on the production of integrated reports. Several studies, such as that conducted by Raimo et al. (2021), have delved into the moderating impact of audit committees on corporate governance variables and their implications for integrated reporting (IR) processes. In Raimo et al.'s (2021) study, a sample of 125 multinational firms that issued integrated reports in 2017, sourced from the International Integrated Reporting Council (IIRC) website, was examined. The findings revealed that various attributes of audit committees, including independence and level of activity, contribute to enhancing the quality of integrated reports produced by corporate entities.

Falatifah & Hermawan (2019) conducted another study aimed at exploring the moderating impact of audit committees on the quality of integrated reports. The objective of their research was to investigate the influence of integrated reporting (IR) disclosure on the cost of equity, as well as the influence of board of directors and audit committee effectiveness on the cost of equity through IR disclosure. Their study utilized

a sample consisting of international firms from over 20 countries listed on The International Integrated Reporting Council (IIRC) network database spanning the years 2015 to 2017. Employing both descriptive and inferential statistics, Falatifah & Hermawan (2019) concluded that there is no significant direct relationship between the board of directors and audit committee effectiveness on IR disclosure.

However, the findings presented by Raimo et al. (2021) regarding the moderating influence of audit committee effectiveness on integrated reporting were limited in scope, as the study did not account for the potential implications of other audit committee attributes, such as size, expertise, voluntary disclosure, and responsibility. Another examination of the moderating effect of audit committee effectiveness on integrated reporting quality was conducted by Chariri & Januarti (2017). In their study, the researchers collected data from companies listed on the Johannesburg Stock Exchange in 2014. Chariri & Januarti (2017) employed descriptive and inferential statistics to assess the moderating impact of audit committees on integrated reporting quality. Their analysis revealed that audit committees with expertise in accounting or finance positively influence the extent of integrated reporting. Furthermore, they found that both the frequency of audit committee meetings and the independence of audit committees have positive effects on the quality of integrated reports.

Islamic banking, grounded in Sharia principles, represents a dynamic financial institution requiring a tailored approach to integrated reporting, as highlighted by Bakar et al. (2020) and Hoque (2023). This reporting approach combines both crucial financial and non-financial details, with a focus on sustainability, to offer a comprehensive view of a firm's value creation process, as emphasized by Buallay et al. (2021). Despite its increasing importance, there exists a noticeable research gap regarding the impact of integrated and sustainable reporting elements on Sharia-compliant banks, as pointed out by Jan et al. (2023). Reviewing the existing literature reveals several researchers delving into the exploration of integrated reporting within the context of Islamic banking. Alketbi et al. (2022) shed light on the crucial role of value-centric strategies in enhancing sustainability and resilience in Islamic banking. Similarly, Muhamad et al. (2022) discovered that robust internal controls significantly improve the financial efficiency of Islamic banking entities, underscoring the importance of solid governance frameworks.

## **2. Problem Statement**

Integrated reporting is a relatively recent concept that offers numerous benefits to organizations in disclosing information. According to Hossain (2021), integrated reports serve as a means for corporate entities to effectively address information asymmetry between managers and shareholders. Despite its advantages, integrated reporting remains a voluntary practice in many jurisdictions, including Kenya. Additionally, the concept of integrated reporting is still in its early stages, with minimal research conducted on various aspects, particularly the impact of corporate variables on the quality of integrated reporting.

From the existing empirical literature and hypotheses building, there are notable gaps regarding the influence of corporate variables on the quality of integrated reporting. One such gap involves the impact of board gender diversity on integrated reporting quality. While studies by Songini et al. (2021), Tiron-Tudor et al. (2020), and Mawardani & Harymawan (2021) have explored this relationship, their findings have been inconclusive. These studies have produced mixed results, failing to decisively establish a connection between board financial expertise, effectiveness of audit committees and the quality of integrated reports.

## **3. Theoretical Foundation**

The study is anchored on Stakeholder-Agency theory. The theory provides a framework for understanding the relationships between stakeholders and the organization, and integrated reporting serves as a tool to operationalize these principles by promoting transparency, stakeholder engagement, accountability, and long-term value creation. The theory did not arise independently; its origins can be traced back to two fundamental theories in corporate governance: the Stakeholder Theory and the Agency Theory. The Stakeholder Theory, which emerged in the 1960s, emphasized the critical role of all entities that have an impact on or are impacted by an organization, advocating for businesses to recognize moral and practical obligations beyond mere shareholder profit maximization, as noted by Dmytriiev et al. (2021) and Jones et al. (2017). Conversely, the Agency Theory, developed in the 1970s, focused on the conflicts that arise between principals (such as shareholders) and agents.

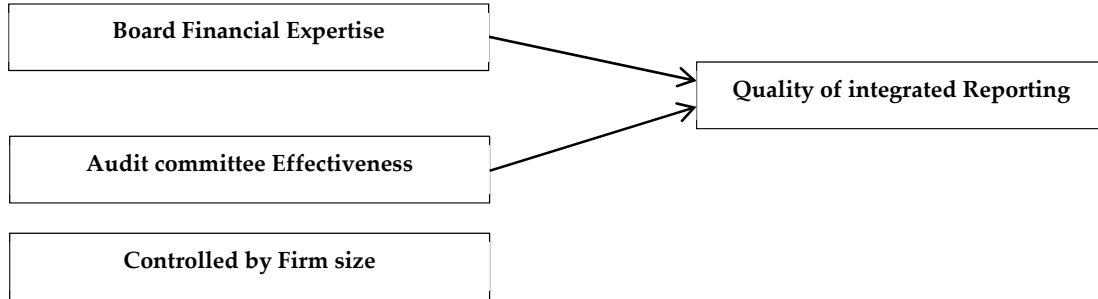
As per the Integrated Reporting Framework, the objective is to offer a succinct portrayal of how an organization generates value over time for "all stakeholders interested in an organization," as highlighted

by Jan et al. (2023). The foundational principle of corporate accountability that underlies integrated reporting ensures that these reports encompass all pertinent information pertaining to the company's governance structure, as indicated by Chouaibi et al. (2022). Stakeholder-agency theory assumes a central position in the research report, emphasizing that the information disclosed in integrated reports should reduce information asymmetry and alleviate conflicts of interest between managers and various stakeholder groups, as discussed by Ghafoor et al. (2019) and Juhandi et al. (2020). This notion suggests that companies need a suitable integrated reporting system to carry out effective integrated reporting processes, as outlined by Chouaibi et al. (2022).

Integrated reporting, as guided by the Stakeholder-Agency theory, aims to provide comprehensive and transparent information to all stakeholders. By disclosing relevant information about governance structures, performance, and sustainability efforts, integrated reporting helps reduce information asymmetry between managers (agents) and stakeholders (principals), thus aligning with the principles of agency theory. Integrated reporting emphasizes the importance of engaging with a wide range of stakeholders, consistent with the Stakeholder Theory. By incorporating stakeholders' perspectives and interests into the reporting process, companies can address potential conflicts and ensure that the report reflects the diverse needs and concerns of all stakeholders. Integrated reporting fosters accountability by providing a holistic view of the organization's activities and performance. By demonstrating accountability to various stakeholders, companies can build trust and confidence, mitigating agency conflicts and enhancing the effectiveness of corporate governance.

#### **4. Conceptual Framework**

The present study sought to address the forenamed problem in extant literature based on the conceptual framework provided below;



**Figure 1.** Conceptual Framework

## **5. Research Methodology**

### **5.1. Model**

Random effects model was used. This is because random effects captures unobserved factors that vary across both time and firms but is assumed to be random and unrelated to the dependent variable. In the context of firms listed on the Nairobi Securities Exchange, random effects refer to factors that affect all firms similarly, such as macroeconomic conditions or changes in the regulatory environment. The significance of random effects lies in their ability to enhance efficiency and generalization in statistical models. Random effects models assume that the unobserved effects are uncorrelated with other variables in the model, leading to more efficient estimates when this assumption holds. Moreover, these models are often more generalizable beyond the sample period and firms studied. By accounting for unobserved time-varying effects that impact all firms similarly, random effects provide a means to control for shared influences across firms.

### **5.2. Sample Size**

All the firms listed in Nairobi Securities Exchange (NSE) continuously for a minimum of 11 years, spanning from 2013 to 2023. Additionally, the firm must have voluntarily published integrated reports during the study period. Finally, the entity should have relevant financial data available from 2013 to 2023. The choice of starting the study period from 2013 was influenced by the publication of the first version of the 'International Integrated Framework' by the IIRC in that year. Considering the period allows for the

accumulation of sufficient data for statistical analysis. Based on this 44 firms for ten years were studied. This constitutes 484 observations.

## 6. Results and Discussions

Considering random effects that unobserved effects are uncorrelated with the other variables in the model, results indicate that the model is fit. As discussed earlier, random effects are more appropriate when you want to capture both within-firm and between-firm variation that is not explained by observable variables.

**Table 1.** Regression Results

QIR	Coef.	Std.E	t-value	p-value	[95% Conf	Interval]	Sig
Firm size	.008	.01	0.85	.397	-.011	.027	
Board F. Expertise	.235	.068	3.45	.001	.101	.368	***
Audit C. Effectiveness	.416	.145	2.88	.004	.132	.699	***
Constant	-.362	.245	-1.48	.14	-.842	.119	
Mean dependent var		0.216	SD dependent var			0.249	
Overall r-squared		0.018	Number of obs			484	
Chi-square		20.431	Prob > chi2			0.000	
R-squared within		0.052	R-squared between			0.003	

\*\*\*  $p < .01$ , \*\*  $p < .05$ , \*  $p < .1$

**Source:** Research Data Analysis

In summary, these results suggest that board characteristics such as board financial expertise and audit committee effectiveness positively influence the quality of integrated reporting. Board members with financial expertise possess a deeper understanding of financial processes, including accounting principles, financial analysis, and reporting standards. This expertise allows them to critically evaluate financial information presented in integrated reports, ensuring accuracy and reliability. Board members with financial expertise are better equipped to provide effective oversight of financial reporting processes within the organization. They can identify potential risks, errors, or inconsistencies in financial reporting and take appropriate measures to address them, thereby improving the quality and integrity of the integrated reports.

Board members with financial expertise can contribute valuable insights to strategic decision-making processes related to financial matters. Their ability to analyze financial data and trends enables them to



make informed decisions that support the organization's long-term sustainability and value creation, which can be reflected in the integrated reports. The presence of board members with financial expertise can instill confidence among stakeholders, including investors, regulators, and the public, in the accuracy and transparency of the integrated reports. This confidence contributes to the credibility of the organization and its reporting practices. Board members with financial expertise are more likely to ensure compliance with relevant financial reporting standards and regulations. Their knowledge of accounting principles and regulatory requirements helps ensure that the integrated reports meet the necessary standards for transparency, consistency, and disclosure.

Further, results of this study indicate a positive correlation between the quality of integrated reporting and the effectiveness of audit committees, suggesting that improved audit committee effectiveness can enhance the quality of reporting among listed firms in Kenya. Given that integrated reporting has implications for both management and stakeholders, listed firms should consider expanding the size of their audit committees by appointing individuals with a strong background in accounting and financial expertise (Al Farooque et al., 2020). By incorporating such expertise, audit committee members can enhance their abilities to oversee the financial reporting process, particularly concerning the dissemination of high-quality integrated reports. Hence, to improve audit committee effectiveness, it is advisable to hold audit committee meetings on a monthly or more frequent basis, as they provide a valuable platform for facilitating effective communication among committee members. These meetings enable members to exchange perspectives and knowledge related to the quality of integrated reporting (Bédard & Gendron, 2010). Therefore, audit committees should convene meetings regularly and according to a predetermined schedule.

In various countries like the United States and the United Kingdom, frequent audit committee meetings can enhance effectiveness by allowing committees to exchange ideas with other audit firms. This exchange can contribute to enhancing policy implications and operations aimed at bolstering board effectiveness within firms, ultimately leading to improvements in the quality of integrated reporting. Chariri and Januarti (2017) argued that to have an effective audit committee, they should have to be independent as the study also recommends the Board of the listed firm to be independent since an independent audit committee will offer an effective and transparent oversight, which helps firms to notice earlier their possible failures and address accordingly before it courses adverse damage on the firm's reputations.

## **7. Conclusion**

The study highlights the importance of board financial expertise and audit committee functionality in promoting information disclosure among listed firms. It underscores the significance of enhancing audit committee effectiveness to improve the quality of integrated reporting, as evidenced by the strong correlation observed between audit committee effectiveness and integrated reporting quality. Moreover, the study findings suggest that audit committees play a crucial role in mediating the relationship between board characteristics and integrated reporting quality. Integrated reporting, characterized by its holistic approach to corporate reporting, integrates both financial and non-financial information to offer a comprehensive perspective on an organization's performance, strategy, and governance. The study emphasizes that board characteristics significantly influence the quality of integrated reporting by shaping governance practices, oversight mechanisms, and strategic decision-making within the organization.

## **8. Policy Recommendations**

Based on the findings suggesting the importance of board financial expertise and the effectiveness of audit committees in enhancing the quality of reporting, the following policy recommendations can be considered:

Firms listed should prioritize the recruitment of board members with diverse financial expertise backgrounds. This can be achieved through targeted recruitment processes that aim to identify candidates with relevant experience in accounting, finance, and auditing.

Boards should implement programs to ensure that all members, particularly those without financial expertise, receive ongoing education and training on financial reporting standards, regulatory requirements, and emerging trends in the financial industry. This will help enhance their understanding and effectiveness in overseeing financial reporting processes.

Companies should focus on strengthening the effectiveness of audit committees by ensuring that they comprise members with strong financial expertise and experience. This can be achieved by appointing individuals with relevant qualifications and experience in auditing, accounting, and financial management to the audit committee.

Boards should regularly assess and evaluate the effectiveness of audit committees in fulfilling their oversight responsibilities related to financial reporting. This can be done through formal performance evaluations and assessments of the audit committee's composition, structure, and processes.

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