

**STRENGTHENING AND REDEFINING THE ROLE OF THE AUDIT AND  
SUPERVISORY COMMITTEES TO ENHANCE CORPORATE  
GOVERNANCE IN DEPOSIT TAKING SACCOS IN KENYA**

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**G62/69360/2011**

**THIS RESEARCH PROJECT IS SUBMITTED IN PARTIAL FULFILMENT OF  
THE REQUIREMENTS FOR THE AWARD OF THE DEGREE OF MASTER OF  
LAWS OF THE UNIVERSITY OF NAIROBI**

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## DECLARATION

I hereby declare that this is my original work and has not been submitted, nor is it pending for submission in this or any other University. All the sources of information have been duly acknowledge.

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## ABSTRACT

The study sought to find out how the Audit Committee and Supervisory Committee of deposit taking SACCOs carry out their mandate to achieve the set objectives and the role they play in enhancing corporate governance. Using desktop research, internet and library, the research made a comparison on the workings of the two Committees to determine how their roles can be strengthened and redefined to enhance corporate governance in deposit taking SACCOs (DTS). Further comparison was made on the workings of the two Committees in United States of America, Brazil and South Africa. The research reveals that the main responsibilities for the Audit Committee is to act as a bridge between the Board and Management and include providing oversight over Management and advisor to the Board; review of financial reporting; risk management and internal controls; audit work and compliance activities. These activities were found to have some similarities in jurisdictions examined. Materially different is the reporting structure. While in some jurisdiction the Audit Committee is accountable to the board in others like Brazil, they are accountable to general members. South Africa also amended their Act to have Audit Committee elected by members in the General Assembly making them accountable to members like the Supervisory Committee of the Kenyan Cooperatives. The King III Report of South Africa also proposes that Audit Committee be elected direct by the general membership. The Supervisory Committee on the other hand is the oversight body elected by general members to oversee the actions of the Board, Management and other officers to prevent abuse of corporate power. The DTS in Kenya have both Supervisory Committee and Audit Committee. However there is duplication of roles between the two Committees.

The study makes recommendation that the role of both Audit and Supervisory Committee can be strengthened and redefined with the former concentrating on internal audits while the later handles oversight over the Board/Management and external audits to enhance effective monitoring and corporate governance in DTS. Their structures and operations be strengthened to adopt best corporate governance practices.

## ACKNOWLEDGEMENT

I wish to recognize and acknowledge the individuals who have given me enormous support throughout this study. It may not be possible to mention each and every person by name but I feel greatly indebted and would like to thank all those who were instrumental in giving vital information that has made it possible to complete the project.

My first gratitude to God almighty for enabling me to achieve all that I have and being there for me in my despair, through my trials and tribulations, through my joy and sadness, in my sorrow and pain, in the promise of another tomorrow, granting me strength even when it seemed impossible to go on.

My special thanks to my supervisor Mr. Njaramba Gichuki who was very patient and understanding. He understood my tight work schedules thereby accepting to review my work even at short notice. He never on any day that I called to submit my work for review turned me down but received the work and within a short time reviewed and resubmitted back for correction. He tirelessly went through the report correcting and guiding me to the end. His cooperation, guidance and support throughout the study made it possible to complete the project. My appreciation to my reader, Ms. Naomi Njuguna who gave input to the study at the final stage.

I am also indebted to my loving husband Steve, my two sons, Martin and Paul Derrick, for their support, patience, understanding and encouragement as I tried to carve out precious hours to complete this work. They have stood by me all through my years of study. Being a mother, wife, an employee and student is a challenging combination that requires full support of your family members.

I acknowledge the support and materials I received from colleagues at the Sacco Societies Regulatory Authority, the department of Cooperative Department and Marketing particularly Mr. Peter Njuguna, Mr. Peter Owira, Mr. Phillips Koremo, Mr. Peter Kimotho and my colleagues from the profession Mr. Josiah Nyangweso, Diana Sawe and Metrine for their support during the research.

Thanks to Mr. Joshua Ojal the CEO Mwalimu National Sacco, Mr. Paul Wambua the CEO Stima Sacco for sharing insights on operations of the two committees in their institutions not to forget Ruby and Masila who together with all the others supported me during this project.

## ABBREVIATIONS

|         |   |
|---------|---|
| AC      | Audit Committee                                   |
| CAK     | Cooperative Alliance of Kenya                     |
| CCD     | Commissioner for Cooperative Development          |
| CEO     | Chief Executive Officer                           |
| CG      | Corporate Governance                              |
| CPA     | Certified Public Accountants                      |
| CIC     | Cooperative Insurance Company                     |
| CMA     | Capital Markets Authority                         |
| DTS     | Deposit Taking Saccos                             |
| FOSA    | Front Office Savings Activity                     |
| FSC     | Financial Service Cooperatives                    |
| FSD     | Financial Sector Deepening                        |
| GDP     | Gross Domestic Product                            |
| ICA     | International Cooperative Alliance                |
| ILO     | International Labour Organisation                 |
| KCC     | Kenya Cooperative Creameries                      |
| KERUSSU | Kenya Rural Savings and Credit Societies Union    |
| KNCPD   | Kenya Nordic Cooperative Development Programme    |
| KNFC    | Kenya National Federation of Cooperatives         |
| KUSSCO  | Kenya Union of Savings and Cooperative Societies  |
| MOCD&M  | Ministry of Cooperative Development and Marketing |
| NASD    | National Association of Securities Services       |
| NCUA    | National Credit Union Association                 |
| NYSE    | New York Stock Exchange                           |
| SACCO   | Savings and Credit Cooperative                    |
| SASA    | Sacco Savings Account                             |
| SASRA   | Sacco Societies Regulatory Authority              |
| SC      | Supervisory Committee                             |
| SOX     | Sarbanes Oxley Act                                |
| SSA     | Sacco Societies Act                               |
| WSF     | Front Office Savings Activity                     |
| WOCCU   | World Council of Credit Union                     |

# CHAPTER ONE

## INTRODUCTION

### 1.1 Background of the Study

Corporate Governance is defined as the system by which a corporation is directed, controlled and held to account for the manner in which power is exercised in the stewardship of its assets and resources to increase and sustain shareholder value and satisfy the needs and interests of all stakeholders<sup>1</sup>. Millstein defined corporate governance as the blend of laws, regulations and appropriate voluntary private sector practices which enable the corporation to attract financial and human capital efficiently and thereby perpetuate it by generating long term economic value for its shareholders, while respecting the interests of shareholders and society<sup>2</sup>.

The International Cooperative Alliance defines a cooperative as an autonomous association of persons united voluntarily to meet their common economic, social and cultural needs and aspirations through jointly owned and democratically controlled enterprises<sup>3</sup>. The cooperative principles were raised from five to seven by the XXXI International Cooperative Alliance (ICA) Manchester, United Kingdom 1995<sup>4</sup>. The congress adopted the set of principles which include: voluntary and open membership, democratic control, economic participation by members, autonomy and independence, education and training and information, cooperation among cooperatives and finally concern for the community<sup>5</sup>. The members run their own affairs and are equal regardless of shares held.

SACCO is an acronym for Savings and Credit Co-operative. There is no difference between a credit union and a SACCO. The term “credit union” is generally not used in Africa. A

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<sup>1</sup> Mudibo, K. E ((2005) “Report on Corporate Governance of Cooperatives; An East African Experience.” *Consultative Forum on Corporate Governance*, Dakar Senegal; Presented during the 3<sup>rd</sup> Pan –African, 18<sup>th</sup> – 20<sup>th</sup> November 2005, p. 3.

<sup>2</sup> Gregory, H. J (2001) “International Comparison of Corporate Governance Guidelines and Codes of Best Practice in Developed Markets” p, i.

<sup>3</sup> Kobia, S. K. (2011): *The Cooperative Movement in Kenya, Challenges and Opportunities*, Lukiko Trust, p. 8.

<sup>4</sup> Manyara, M. K. (2004) *Cooperative Law in Kenya*, Rock Graphics, p. 62.

<sup>5</sup> Kobia, S. K (2011) *Supra*, p. 8- 9.

SACCO is a democratic, unique member driven, self-help co-operative. It is owned, governed and managed by its members who have the same common bond: working for the same employer, belonging to the same church, labour union, social fraternity or living/working in the same community. A Savings and Credit Co-operative's membership is open to all who belong to the group, regardless of race, religion, colour, creed, and gender or job status<sup>6</sup>. The members agree to save their money together in the SACCO and grant loans to each other at reasonable rates of interest. The members are the owners who make decision on how their money will be used for the benefit of each other. The SACCOs are democratic organisations and decisions are made in a structured democratic way<sup>7</sup>.

It is important to note that not all cooperatives are SACCOs; there are different types of cooperatives registered with different objectives. They include marketing cooperatives, dairy, housing, investments, cotton and consumer among others. A SACCO is just one of the many types. The deposit taking Sacco Societies which are the focus of this study are a type of cooperatives whose main objective is to afford its members opportunity to save and borrow from their savings and in addition offer quasi banking services to their members.

The Sacco governance structure comprises of the Annual General Meeting, Board members, Supervisory Committee, Audit Committee, Managers and other staff members<sup>8</sup>. Among the ways in which SACCOs can embrace good corporate governance is through the establishment of strong and effective committees to undertake its activities in a detailed manner to enhance internal controls. The committees that are established in SACCOs include Audit, Supervisory, Credit and Nomination among others.

The Audit Committee which in some jurisdictions is referred to as Supervisory Committee has been recognised in many jurisdictions in its role to enhance corporate governance. For example in Malaysia, special attention has been given to the Audit Committee as the principal player in the effort to enhance the standard of corporate governance and strengthen public trust. Paragraph 15.13 of the Bursa Malaysia Securities Berhad Listing Requirements

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<sup>6</sup> [http://www.sacol.org.za/what\\_is\\_sacco.php](http://www.sacol.org.za/what_is_sacco.php) (Accessed on 14th September, 2013, at 11.20 pm).

7. *Ibid.*

<sup>8</sup> Mudibo, K.E (2005) *Supra*, p. 3.

(LRs) and Best Practices BB I - VI of the Malaysian Code on Corporate Governance (the Code) for instance, set out the functions and best practices for the Audit Committee<sup>9</sup>.

This research seeks to determine how strengthening and redefining the role of the Audit and the Supervisory Committee can enhance corporate governance of deposit taking SACCOs in Kenya. The research makes a comparison on the workings of the two committees to establish how strengthening and redefining the roles of the Audit and Supervisory Committees can enhance Corporate Governance in DTS. The Supervisory Committee is commonly referred to as members' watchdog and acts as the bridge between the members and the Board. It is responsible for examining and reviewing the affairs of the SACCO to ensure credibility and integrity in its affairs. It performs oversight function over the Board, Management and other officers<sup>10</sup>. The Audit Committee on the other hand acts as the bridge between the Board and Management to help the Board in their oversight role over the operations of the Sacco.

Committees are essential for good governance as they assist the board in in-depth analysis of important information before it is discussed by the board. They ensure that there is compliance with the laws governing the SACCOs and that the controls put in place operate effectively. They also oversee the development of plans that will impact the development of the credit union's strategy<sup>11</sup>. Board committees create a forum of independence where board members can make use of their specialized expertise while at the same time providing checks and balance within the board structure. These are among the many other key roles that the committees play to ensure that the members reap maximum benefits from their savings.

Corporate Governance has become a controversial and essential factor in many businesses. In recent years, the failure or success of many businesses has hinged solely on good corporate practices that enhance good governance. As business people make daily decisions, they must also consider the impact of those decisions on the society. New standards for corporate governance have emerged and companies and cooperatives alike are changing their corporate

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<sup>9</sup> KPMG (2006) "The Changing Role of Audit Committee" *Across the Board a Newsletter for Board of Directors Issue No. 1/June 2006*, Malaysia.

<sup>10</sup> Manyara, M.K (2004): *Supra*, p. 52.

<sup>11</sup> British Columbia (2012) *Advancing Governance, Report of the British Columbia Credit Union Governance Task Force*, p. 19.

behaviour and values in accordance with these standards. It is for this reason that good corporate governance practices must be nurtured and encouraged to evolve best management practices in institutions including SACCOs.

An improvement in governance practices of a cooperative brings not only individual benefits but also favours the whole financial cooperatives segment by improving security, reducing supervision and controlling costs, furthering the image and strengthening the cooperative spirit of participation, collective action and belonging<sup>12</sup>. Good practices in corporate governance have proved fundamental in the success of organisations to ensure safety of funds and returns to members.

The Kenyan vision 2030 blue print recognises SACCOs as institutions that will improve investor's access to term finance<sup>13</sup>. In addition, the Ethics Commission for Cooperatives established under the Ministry of Cooperative Development and Marketing considering the importance attached to governance of SACCOs developed a policy on Governance and Anti-Corruption for Cooperatives<sup>14</sup> to guide cooperatives in their governance practices. The government of Kenya recognised the importance of SACCOs and in order to ensure that their activities are effectively governed, enacted the Sacco Societies Act, 2008 which introduced prudential regulations in SACCOS and enhanced provisions on corporate governance<sup>15</sup>.

The Act established the Sacco Societies Regulatory Authority (SASRA) with the mandate to license, regulate and supervise Sacco Societies in Kenya<sup>16</sup>. The Authority in exercising its mandate to develop the Sacco sub sector through improved governance has initiated training programmes for the Sacco board of directors on corporate governance<sup>17</sup>. The above initiatives

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<sup>12</sup> Brazil (2008) Cooperative Governance" *Guidelines for Good Practices of Financial Cooperative Governance*, Brazilian October, 2008 Baonco Central Do Brazil at p. 14.

<sup>13</sup> Kenya, Government (2007) Vision 2030, p. 73.

<sup>14</sup> Ethics Commission for Cooperative Societies (2012): *Governance and Ant- Corruption Policy for Cooperative Societies*.

<sup>15</sup> Part IV The Sacco Societies Act, 2008 Laws of Kenya.

<sup>16</sup> *Ibid*, Section 4.

<sup>17</sup> SASRA (2012), *Sacco Supervision Department at the Sacco Societies Regulatory Authority (Deposit Taking Sacco's)*, Accessed from [www.sasra.go.ke](http://www.sasra.go.ke) on 20<sup>th</sup> July 2013, p. 37.

among others not mentioned demonstrate the importance that is attached to enhancing corporate governance in the Sacco sub sector and cooperative sector in general.

For cooperative members, governance issues aim at promoting conditions that facilitate collective decision making, reducing costs and potential conflicts. There are a growing number of financial cooperatives and this has led to the introduction of free admission of new members and the emergence of a varied set of interests among members of same cooperative that will be increasingly frequent. The decision of majority may thus be the origin of conflicts among groups<sup>18</sup>. This kind of trend offers strong support for need to have well governed and effective systems in Sacco Societies.

## 1.2. Statement of the Problem

The SACCO sub-sector contributes significantly towards economic growth and development in Kenya. There were about 3996 Sacco Societies in Kenya which by December 2011 had mobilized Kenya shillings two hundred and ninety one (291) billion representing about thirty one (31) percent of the country's savings or a third (1/3) of the country's Gross Domestic Product (GDP)<sup>19</sup>. This tremendous growth in the sub-sector has called for reform in the governance structure in SACCOs. It is noted that prior to enactment of the Sacco Societies Act, the SACCOs operated with Supervisory Committee as oversight body over the Board and Management in their governance structure under the Cooperative Societies Act.

However, with the enactment of the Sacco Societies Act, 2008, the law enhanced provisions on corporate governance and provides for establishment of Audit Committee by every deposit taking Sacco<sup>20</sup> while the Cooperative Societies Act cap 490 retains the requirements of a Supervisory Committee<sup>21</sup>. This therefore means deposit taking SACCOs regulated under the Sacco societies Act, 2008 have both Committees in place. This scenario requires review of the legislation to strengthen and redefine the roles of the Audit and Supervisory Committee to

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<sup>18</sup> Ethics Commission for Cooperatives Societies (2012): *Supra*, p.15.

<sup>19</sup> Ademba, C (2012) "Challenges Facing Sacco Regulations in Africa" *11<sup>th</sup> SACCA Congress held in Swaziland*, Accessed from [www.sasra.go.ke](http://www.sasra.go.ke) on 20<sup>th</sup> July 2013, p. 7.

<sup>20</sup> Regulation 57(1): Sacco Societies (Deposit Taking Sacco Business) Regulations 2010.

<sup>21</sup> Rule 28, Cooperative Societies Rules 2004.

avoid any unnecessary overlap that would complicate internal governance mechanisms in DTS.

The duties of the Supervisory Committee under the Cooperative Societies Act<sup>22</sup> are verification of all transactions of the society; writing period reports of its findings to be tabled at the Management Committee meetings; submission of its reports to the Commissioner and presenting its report to the general meeting. The duties of the Audit Committee on the other hand are provided under the Sacco Societies (Deposit Taking Business) Regulations 2010<sup>23</sup> which include: ensuring that internal controls are established; reviewing internal controls and audit reports; ensuring that accounting records and reports are accurate; coordinating between internal audit function and external audit; monitoring ethical standards; ensuring that relevant plans and policies are established; investigating members complaints ;consider any matter of significance raised at the general meeting.

The roles provided for Supervisory Committee are very broad and not specific as those of the Audit Committee. The duties of the Supervisory Committee to verify all transactions in the Sacco were provided when the Audit Committee was not in existence in DTS. It is therefore important that with the establishment of the Audit Committee, the role of the Supervisory Committee need to be redefined to avoid overlapping its function with those of Audit Committee in practice and to enhance checks and balance in the operations of the DTS. In this way, the Supervisory Committee will focus its attention on its oversight role.

The broad nature of the duties of Supervisory Committee as outlined above has led to similar work being taken by the two Committees in some instances. The Supervisory Committee reports examined during a survey conducted by Microsave Consultants<sup>24</sup> articulated the following audit role: reviewing internal controls to ascertain the adequacy in preventing frauds are errors; examining monthly statements and operating information to confirm accuracy and reliability; examination of loans and other related accounting transactions for

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<sup>22</sup> Rule 28, Cooperative Societies Rules.

<sup>23</sup> Regulations 57(3): Sacco Societies (Deposit Taking Business) Regulations 2010.

<sup>24</sup> Cracknell, D, Mugwang'a, T. O'Keeffe, T & Ngaine, M (2013) *SACCO Core Skills Gaps Survey and Capacity Building Report*, MicroSave Market led Solutions for Financial Services January 2013, p 16.

completeness and reliability; review of efficiency and effectiveness of operations among others.

The above scenario presents a situation where Supervisory Committee carries out internal audit work when the internal audit function under the Sacco Act is to be carried by the Audit Committee. The net effect of this will be lack of objectivity, less time/attention in oversight role of Supervisory Committee, conflict of interest in the course of duty and Management denied sufficient time to concentrate on its work if they have to schedule work for both Committee on same subject matters. It is therefore important to have the roles of both the Supervisory and the Audit Committee clearly demarcated in the legislation to redefine the extent to which each Committee should carry out their role. This study will therefore seek to make proposals on how to redefine and strengthen the role of both Committees to provide clarity.

The Board and the Committees constitute the greater part of governance structures in SACCOs and the extent to which the committee structure is effective depends on the clarity of the Committees responsibilities. Sabana states that it is the committee member's dedication plus the existence of well-defined and clear procedures which empower the members to effectively discharge their roles.<sup>25</sup> These structures and processes cannot work independently without considering the caliber of the individual directors. The nature of the boards in Sacco societies in this regard poses many challenges, specifically because of their institutional structure.

The Board of directors in SACCOs is democratically elected by the members based on popularity and influence rather than on merit, professional competence and knowledge making governance a challenge due to quality of leadership within the Sub sector. A strand of literature identifies that governance remains the prime weakness of SACCOs<sup>26</sup>. The study on skills gap in deposit taking Sacco's carried out by Microsave through the support of Financial

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<sup>25</sup> Sabana, B. (2006) *Governance: Organizing, Developing and Empowering Boards to Oversee MFI Operations*, Equity Bank, Kenya, p. 1.

<sup>26</sup> Cuevas & Fischer, (2006) "Cooperative Financial Institutions" *Issues in Governance, Regulation, and Supervision*, World Bank Working Paper No. 82, p. 7.

Sector Deepening (FSD) Kenya in 2013 also identified governance as number one major challenge facing SACCOs<sup>27</sup>.

The workshop participants numbering twenty seven (27) prioritized governance challenge as number one giving a score of one hundred and twenty five (125). The governance was considered as more than twice as important as any other issue<sup>28</sup>. In addition, a cooperative governance study by VAS Consultants Ltd. (2008) identified key areas that needed improvement in governance in cooperatives to include: insufficient clarity of the roles of various stakeholder; leadership manipulation in the liberalized environment by taking advantage of ambiguity in roles; opportunity for mismanagement due to lack of clearly defined roles; insufficient commitment by key stakeholders; deficiency in professionalism; weak internal management and operational systems; elections open to manipulation; inadequate training of Board and Management; and capacity of leadership<sup>29</sup>.

Further the growth in deposit taking SACCOs and governance challenges being experienced in the SACCOs poses a problem worth carrying out a study to seek solutions. A study by Linda Shaw<sup>30</sup> found that studies on Cooperative Financial Institutions indicate a correlation linking an increase in size with an increase in the severity of the owner-manager conflict. A research into corporate governance practices in the co-operative sector in Kenya undertaken by the Centre for Corporate Governance and the findings based on a national survey which involved two national co-operative societies, four secondary co-operative unions, 12 district unions and 24 primary societies further provided evidence of agency conflict between members and boards as a feature of the co-operative sector in Kenya<sup>31</sup>.

Good governance stems from clearly defined roles and responsibilities of the board of

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<sup>27</sup>Cracknell, D, Mugwang'a, T. O'Keeffe, T & Ngaine, M (2013) *SACCO Core Skills Gaps Survey and Capacity Building Report*, MicroSave Market led solutions for financial services January 2013, p , 6.

<sup>28</sup> *Ibid*, p , 6-7.

<sup>29</sup> Kobia, S. K. (2011) *The Cooperative Movement in Kenya: Challenges and Opportunities*: Lukiko Consulting Trust, p, 148-149.

<sup>30</sup> Shaw. L. (2006): "Overview of Corporate Governance Issues for Co-operatives" The Cooperative College Manchester, UK, p, 16.

<sup>31</sup> *Ibid*, p. 23.

directors, committees and senior managers. It also stems from codes of conduct which directors and staff at every level of the institute sign on to and respect in the completion of their tasks. Sound bylaws and policies seek to avoid conflicts of interest and provide mechanisms for dispute resolution where they do arise<sup>32</sup>.

### **1.3 Research Questions**

- a) What is the role of Audit Committee in enhancing SACCO governance in deposit taking SACCOs in Kenya?
- b) What is the role of Supervisory Committee in enhancing SACCO governance in deposit taking SACCOs in Kenya?
- c) What gaps exist in their mandate of enhancing corporate governance in SACCOs?

### **1.4 Study Objectives**

#### **1.4.1. General Objective**

- a) To strengthen and redefine the roles of both the Supervisory and Audit Committees in deposit taking SACCOs in Kenya.
- b) To determine the gaps that exist in the mandate of Audit and Supervisory Committee that may hinder effective execution of their mandate in enhancing good corporate governance in deposit taking SACCOs.

#### **1.4.2 Specific Objectives**

To strengthen and redefine the role of Audit and Supervisory Committee to enhance corporate governance in deposit taking SACCOs.

### **1.5. Significance/Justification of the Study**

The unique position occupied by SACCOs in the financial sector and Kenya as a whole makes them very critical focal point for steering social and economic growth in Kenya. The services provided by SACCOs play a big role in enhancing financial inclusion and access in Kenya. They serve the unbanked which constitute the majority of rural Kenyans by offering them credit at affordable rates than other players in the financial market hence the need for

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<sup>32</sup> *Ibid*, p. 30.

effective and efficient internal control systems backed by strong governance structures to safeguard members funds. The deposit taking SACCOs have grown in size and complexity and by the end of 2012 had increased their asset base to Ksh. 223,535,150,617 while all SACCOs together had assets amounting to Ksh 293,360,482,888 as indicated in the table below<sup>33</sup>. The membership within the subsector stood at 2,201,144<sup>34</sup>.

#### Performance of Deposit Taking SACCOs (DTS) in 2012

| YEAR              | ASSETS  | MEMBERS<br>DEPOSIT | LOANS<br>&ADVANCES | TURNOVER |
|-------------------|---------|--------------------|--------------------|----------|
| 2012              | 223,535 | 160,482            | 167,598            | 30,009   |
| 2011              | 196,470 | 140,646            | 147,727            | 24,463   |
| Change(%)         | 13.8    | 14.1               | 13.4               | 20       |
| Share of Industry | 76.8    | 76.3               | 76.4               | 80.8     |

Figures in Kshs. million

The above figures are indicative of the impact that deposit taking SACCOs have in the lives of Kenyans and the number that benefit from their services. The tremendous growth realized by the SACCOs overtime demonstrates the strategic position they occupy in the economy making this study very key.

The study is further significant to the Government of Kenya and especially the Sacco Societies Regulatory Authority (SASRA) as it will recommend ways of enhancing and strengthening financial regulation of SACCOs through the Audit and Supervisory committee and help determine whether deposit- taking SACCOs should maintain both Audit and Supervisory Committee. The study is further significant to the researcher in career development as it will increase her knowledge in the area of study. Finally the study is important as it will make the necessary policy recommendations to improve Sacco governance by all stakeholders.

Finally the study is significant as it will address structural and legal issues on operations of Audit and Supervisory Committees. Failure to address these issues may lead to conflict and

<sup>33</sup> SASRA (2012) Sacco Supervision Annual Report ( Deposit Taking Saccos), Accessed from [www.sasra.go.ke](http://www.sasra.go.ke) on 20<sup>th</sup> August 2013, p. 10

<sup>34</sup> *Ibid*, p, 18.

in fighting in some instances compromising the very intention of securing member's funds and service to members at reasonable cost.

## **1.6 Scope of the Study**

The study is limited to Audit and Supervisory Committees of deposit taking SACCOs in Kenya and comparative study in United States of America (USA), Brazil and South Africa. The three countries have been chosen first because Audit Committee first started in USA in the 1970s hence the comparison will offer history related to its genesis, Brazil has been chosen because cooperatives in Brazil have embraced internal best practices in corporate governance and is celebrated among cooperative fraternity. Finally South Africa has been chosen for comparison because of the King Reports one to three that have influenced governance practice in Africa and King III in particular applies to Financial Cooperatives in South Africa also.

## **1.7. Hypothesis**

Strengthening and redefining the role of both the Audit and Supervisory Committee will enhance good corporate governance in deposit taking SACCOs.

### **1.8.0. Theoretical Framework**

There are various theories that explain the auditing function of corporate organization and the necessity of audit and supervision. The first theory is the stakeholder theory. Friedman states that the organization itself should be thought of as grouping of stakeholders and the purpose of the organization should be to manage their interests, needs and viewpoints<sup>35</sup>. The second theory is the agency theory which is the commonly adopted theory in most corporate organisations and SACCOs are included in this context. The theory states that the relationship between the auditor and the investors creates an agency contract<sup>36</sup>. Effective Audit Committee and Supervisory Committee minimizes agency problem by reducing information asymmetry between owners and management and also acts as a safeguard of stakeholders' interests. The role of the auditor is to supervise the relationship between the manager and the owners. In the case of SACCOs, the role of the Audit and Supervisory Committee should be

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<sup>35</sup> Friedman, A. L. and Miles, S. (2006) "Stakeholders: Theory and Practice", *Oxford University Press*, p, 1.

<sup>36</sup> Ittonen, K. (2010) A Theoretical Examination of the Role of Auditing and the Relevance of Audit Reports p. 5.

clearly defined in their charter for effective execution of their mandate. The members expect the auditors and supervisors to ensure that their interests are secured and that all transactions are correctly accounted for.

Russell states that according to the practices of corporate governance which involves the wish to reduce the information asymmetry between principals and agents, the responsibility of the company's financial statements certification fully rests with the financial auditor,<sup>37</sup> the acknowledged, independent specialist, whose objective opinion assesses the compliance of the reported financial standings with a reference accounting framework<sup>38</sup>.

### 1.8.1 The Stakeholder Theory

The stakeholder concept was in use before the stakeholder theory was proposed by Edward Freeman. Freeman in 1984 defined a stakeholder as any group or individual who can affect or is affected by the achievement of the organization's objectives<sup>39</sup>. He was the father of the stakeholder theory though with time he changed the meaning of the stakeholder. In 2004 he redefined stakeholders as those groups that are vital for the survival and success of the corporation<sup>40</sup>. This stakeholder management is thought to be fulfilled by the managers of a firm. The managers should on the one hand manage the corporation for the benefit of its stakeholders in order to ensure their rights are protected and the participation in decision making and on the other hand the Management must also act as the stockholder's agent to ensure the survival of the firm to safeguard the long term stakes of each group.

The theory was used in the management discipline in 1970 and gradually developed by Freeman incorporating corporate accountability to a broad range of stakeholders<sup>41</sup>. The

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37 Russell, G. (2009). "Corporate Governance and Its Relevance to Audit Quality" Institute of Directors,' *The Handbook of International Corporate Governance, a Definitive Guide* 2nd edition, Kogan Page, London and Philadelphia, p. 2.

38 International Federation of Accountants (IFAC) (2010) *Handbook on International Quality Control, Auditing, Review, other Assurances and Related Services Pronouncements*, p. 38.

39 Freeman, R. E. (1984) *Strategic Management: A Stakeholder Approach*. Pitman, London, p. 4.

40 Freeman, R. E. (2004) *A Stakeholder Theory of Modern Corporations*, Ethical Theory and Business, 7<sup>th</sup> Ed. p. 1.

41 Freeman, R. E. (1984) *Supra*, p. 5.

proponents argue that managers in organizations have a network of relationships to serve which include the suppliers, employees and business partners. And it was argued that this group of network is important other than owner-manager-employee relationship as in agency theory<sup>42</sup>. The stakeholders in SACCO context include, the members, board of directors, staff, regulators, government, national cooperatives, and suppliers among others. All these players need reliable and credible information on the soundness and sustainability of the Sacco.

The demand of audit and supervision services results from participation of outside stakeholders in the Sacco who demands accountability from the Management, in return for their contribution to the organisation. The audit services are part of the monitoring activities within the company and significantly contribute to the decrease of information bias<sup>43</sup>. Since the information provided by the Management might be biased, a possible divergence between the interest of Management and outside stakeholders, an audit of this information is required to offer assurance on accuracy and fair presentation of facts hence increasing the supply of the audit reports.

Sundaram & Inkpen state that the theory attempts to address the group of stakeholder deserving and requiring management's attention<sup>44</sup>. Whilst, Donaldson & Preston claimed that all groups participate in a business to obtain benefits<sup>45</sup>. Nevertheless, Clarkson suggested that the firm is a system, where there are stakeholders and the purpose of the organization is to create wealth for its stakeholders<sup>46</sup>.

Freeman contends that the network of relationships with many groups can affect decision making processes as stakeholder theory is concerned with the nature of these relationships in

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<sup>42</sup> Freeman, R.E. (1999) "Response: Divergent Stakeholder Theory". *Academy of Management Review*, Vol. 24, No. 2, pp. 233-236.

<sup>43</sup> Watts, R.L. & Zimmerman, J. L. (1978) "Towards a Positive Theory of the Determination of Accounting Standards", *Accounting Review Vol LIII, No. 1*, p. 114.

<sup>44</sup> Sundaram, A.K & Inkpen, A.C.(2004)"The Stakeholder Theory and the Corporate Objective Revisited" *A Reply, Organization Science, Vol. 15, No. 3, May-June 2004*, pp. 370-371 p. 370.

<sup>45</sup> Donaldson, T & Preston, L, (1995): "The Stakeholder Theory of the Corporation. Concepts, Evidence, and Implications in": *Academy of Management Review*, Vol. 20, No. 1, p. 65.

<sup>46</sup> Clarkson, M. B. E, (1995) "A Stakeholder Framework for Analyzing and Evaluating Corporate Social Performance" *Academy of Management Journal*, 20/1, p. 92.

terms of both processes and outcomes for the firm and its stakeholders<sup>47</sup>. Donaldson & Preston argued that this theory focuses on managerial decision making and interests of all stakeholders have intrinsic value, and no set of interests is assumed to dominate the others<sup>48</sup>.

The political philosopher Blattberg has criticized stakeholder theory for assuming that the interests of the various stakeholders can be, at best, compromised or balanced against each other. Blattberg argues that this is a product of its emphasis on negotiation as the chief mode of dialogue for dealing with conflicts between stakeholder interests. He recommends conversation instead and this leads him to defend what he calls a 'patriotic' conception of the corporation as an alternative to that associated with stakeholder theory<sup>49</sup>. According to Mansell by applying the political concept of a 'social contract' to the corporation, stakeholder theory undermines the principles on which a market economy is based<sup>50</sup>.

In the authors view, the stakeholders play a critical role and cannot be ignored, their different contributions to the organization dictates success or failure of the organization. It explains the need for auditing and supervision and reduction of information asymmetric through monitoring and disclosures to all stakeholders. An effective audit process and supervision can be enhanced in SACCOs through strengthening and redefining their roles of the Audit and Supervisory Committee to ensure they effectively execute their mandate without impediments to enhance corporate governance.

### 1.8.2 Agency Theory

The theory was put forth by Jensen and Meckling in 1976<sup>51</sup>. It states that a reputable auditor is appointed not only in the interest of third parties, but also in the interest of Management. Agency theory emerged due to separation of ownership and control. This created the need for monitoring of management hence paramount to have good corporate governance which

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<sup>47</sup> Freeman, R.E. (1984) *Supra*, p. 5.

<sup>48</sup> Donaldson, T & Preston, L. (1995) *Supra*, p. 67.

<sup>49</sup> Blattberg, C. (2004) "Welfare: Towards the Patriotic Corporation". *From Pluralist to Patriotic Politics: Putting Practice First*. New York: Oxford University Press, p. 172.

<sup>50</sup> Mansell, S. (2013) *Capitalism, Corporations and the Social Contract: A Critique of Stakeholder Theory*. Cambridge: Cambridge University Press, p. 1.

<sup>51</sup> Jensen, M.C & Meckling, W.H. (1976) "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure" *Journal of Finance Economics*, Vol.3, No.4, pp. 305-360.

advocates for effective oversight bodies. Committees should not be symbolic or only provide elective positions for members but should seek to enhance internal control systems to ensure safety of member's funds.

A corporate organization is viewed as the result of more or less formal 'contracts', in which several groups make some kind of contribution to the corporation, given a certain 'price'. In the context of SACCOs, the agency relationship between the Board of directors, the Supervisory Committees, Audit Committee and the Sacco members is established the moment they appoint the board and Supervisory Committee and further when the board appoints the managers to monitor their savings. The Sacco members are the principals while the Board, Committee members and Management are the agents at different levels.

It has been argued by Alchian that agency theory posits an inherent moral hazard in principal-agent relations that gives rise to agency costs. They state that agents can adopt accounting procedures and methods that give favorable accounting results and which may maximize their own wealth under compensation and reward incentive schemes. An Audit Committee and Supervisory Committee is one way to reduce this incentive problem as effective Audit and Supervision Committees enhance the quality and credibility of annual audited financial statements; assists the work of the board of directors, which is charged with safeguarding and advancing the interests of shareholders<sup>52</sup>.

Heinrich states that the agency problems between shareholders and management usually arise from a combination of asymmetric information and differences in sensitivity to firm-specific risk. Here the term "sensitivity to firm-specific risk" is used to refer to how a decision maker ranks alternative choices differing in their riskiness<sup>53</sup>. He further states that the sources of these conflicts are externalities arising from asymmetries of information, differences in attitude towards risk and differences in decision-making rights.

Agency theory analyses the relationship between two parties: investors and managers. The agent (i.e. manager) undertakes to perform certain duties for the principal (i.e. investors) and

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<sup>52</sup> Alchian, A. & H. Demsetz. (1972) "Production, Information Costs and Economic Organization". *American Economic Review* Vol 62, No.5, p. 778. See also Fama, E. F., & Jensen, M. C. (1983) "Separation of Ownership and Control". *Journal of Law and Economics*, Vol.26, p. 301.

<sup>53</sup> Heinrich, P. R. (2002): *Complementarities in Corporate Governance*. Springer, Berlin, p. 4.

the principal undertakes to reward the agent<sup>54</sup>. According to this theory, the role of the auditor is to supervise the relationship between the manager and the owners. A gap expectation occurs when the distribution of the responsibility is not well defined. The responsibility of every organ is supposed to be well defined in the regulation to avert the conflict. The manager and the owners have to realize that the auditor and supervisor does not have responsibility of the accounting, but only see that the auditing is done properly<sup>55</sup>.

It is argued that in a corporation, in which share ownership is widely spread, managerial behavior does not always maximize the returns of the shareholders<sup>56</sup>. The degree of uncertainty about whether the agent will pursue self-interest rather than comply with the requirements of the contract represents an agent risk for an investor<sup>57</sup>.

Amongst the theories discussed above, the agency theory stands out as the best in offering an explanation on the relationship between the members of SACCOs, the Boards, Supervisory Committee, the Audit Committee and Management in a case where SACCOs have both of them. The Board, Supervisory and the Audit Committee members are the agents of the Sacco members and they should ensure that they give reliable information to their principals and guarantee safety of members' deposits and good return on investment. The Audit and Supervisory Committee provide good monitoring and supervision mechanism within the Sacco governance that resonates with the tenets of the agency theory.

## 1.9. Conceptual Framework

The agency theory is the most suited to support this study, as argued by Odhiambo as Saccos grow in size and complexity they require specific knowledge and skills to run the institutions hence hiring professionals. To protect the owners from opportunistic actions of decision makers a mechanism for management or supervision is needed; hence members vote part of

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<sup>54</sup> Jensen, M.C. and W.H. Meckling (1976) "Theory of the firm: Managerial Behaviour, Agency Costs and Ownership Structure", *Journal of Financial Economics*, Vol. 3, No. 4, p. 305.

<sup>55</sup> Andresson C. & Cecilia E (2005) *The New Auditing Standards in Sweden*, Unpublished Bachelor thesis, Goteborg University, p.1.

<sup>56</sup> Donaldson, L., & Davis, J. H. (1991) "Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns" *Australian Journal of Management*, Vol. 16(1), p. 50.

<sup>57</sup> Fiet, J. O. (1995): "Risk Avoidance Strategies in Venture Capital Markets" *Journal of Management Studies* Vol. 32 (4), p.551.

members to serve in the Board who in turn hire Management to run the organisation<sup>58</sup>. The Board however retains the ultimate control to approve and monitor major policy initiatives and general direction of the institution. The SACCO's Supervisory Committee serves as a further element of decision monitoring and member control. In theory the principal –agent problem is controlled by checks and balances within the process of decision making and decision monitoring<sup>59</sup> which strengthening and redefining the role of Audit and Supervisory will immensely help to achieve.

Audit by independent Audit Committees contributes to good corporate governance. The committee should operate free of conflict of interest, have the confidence of members and have laws in place redefining the roles of the committee and work procedure. The effect of this is to create a highly effective Sacco with good returns to members and assures on the safety of members funds. It also averts poor governance and inspires confidence in the members thereby reducing risks associated with agency. It is imperative that SACCOs identify the gaps that exist within their corporate governance structure and take steps to fill them.

The Supervisory Committee on the other hand serves as oversight body who through their report to annual general meeting assures the members that their organisation is well run within applicable laws and procedures. It helps to assure members of the safety of their deposits and that the SACCO is operating in sound business manner as a going concern. Its functions are independent from those of the Board and are aimed at ensuring that the affairs of the SACCO are run in a credible manner and with integrity.

It can therefore be concluded that strengthening and redefining the roles of both Audit and Supervisory will lead to effective execution of their mandate thereby enhancing corporate governance in SACCOs when the auditing and supervision role is undertaken by different organs without overlaps and conflict. The role of Audit and Supervisory Committee in enhancing corporate governance is therefore dependent on the gaps that may hinder effective execution of their mandate being identified and the roles strengthened and redefined.

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<sup>58</sup> Odhiambo, O. (2012) "Corporate Governance Problems of Savings and Credit Cooperative Societies" International Journal of Academic Research in Business and Social Sciences, Vol.2, No 11 ISSN: 2222- 6990, p, 93.

<sup>59</sup> *Ibid.*

## 1.10. Research Methodology

The Author used desktop research from both secondary and primary information. A critical evaluation of the available information has been done. Further the researcher has used information from the library, internet research, formal and informal discussion with Audit Committees, Supervisory Committee members and Chief Executive Officers of deposit taking SACCOs.

### 1.11.0. Literature Review

#### Introduction

Literature that has been written in this area has been reviewed to help understand what various authors have written in the core area of study and to determine the areas that require further research. Auditing is the tracking of operations. It can be defined as an examination and verification of a company's financial and accounting records and supporting documents by a professional<sup>60</sup>. The role would therefore require comparison of actual conditions with expected conditions and determination is made as to whether one is conformance or not in conformance. The same philosophy is used to perform financial, quality and regulatory compliance.

The concept of auditing revolves around, the true and fair view, the audit evidence and independence of the auditor<sup>61</sup>. Auditing operates on two hypothesis: the monitoring hypothesis which assumes that when delegating decision-making power to one party, as suggested in agency theory, the agent is motivated to agree to be monitored if the benefits from such activities exceed the related costs. This hypothesis is applicable to all co-operative relationships in any organization<sup>62</sup>. The second is information hypothesis, which focuses on the need to provide information to enable users to take economic decisions. One argument

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<sup>60</sup> [www.investorwords.com/324/auditors.html](http://www.investorwords.com/324/auditors.html)... Accessed on , 2<sup>nd</sup> November, 2013 at 10.55am.

<sup>61</sup> [www.alhea.com/eg027/search/web?Fcoid=417&fcop---and](http://www.alhea.com/eg027/search/web?Fcoid=417&fcop---and) [www.alison.com/Basic](http://www.alison.com/Basic) Accounting. Accessed on 2<sup>nd</sup> November 2013.

<sup>62</sup> Kimittonen, (2010): A Theoretical Examination of the Role of Auditing and the Relevance of Audit Reports, Business Administration 28, Accounting and Finance, VAASAN, p, 6.

regarding the demand for audited financial statements is that they provide information that is useful in investors' decision-making<sup>63</sup>.

The American Accounting Association's (AAA) Committee on Basic Auditing Concepts (1973) summarized the criteria that create the demand for auditing as the potential or actual conflict of interest; Consequences of errors; Complexity and Remoteness which prevents users from directly "auditing" the financial statements themselves<sup>64</sup>.

### **1. 11. 1 Role of Audit Committees**

The essential and original role of Audit Committee is to act as a bridge between the independent external auditors and the board avoiding the possibility of powerful executive directors, becoming too close to their auditors and resolving issues before they reach the Board<sup>65</sup>. This situation can apply in relation to Board members in SACCOs where some Boards in SACCOs are too close to the external auditors and may have financial reports manipulated to reflect favourable position for their own political mileage.

The role and responsibility of Audit Committee has expanded over the years. In many cases they include, advising the board on the company's systems of internal management, control oversight of internal audit, liaising with the external auditors and reporting to the board on audit process; reviewing financial information to be provided to shareholders and others; advising the board on board accountability; the oversight of risk management; corporate governance compliance and recommending external auditor for appointment<sup>66</sup>. The Audit Committee is an integral part of the Board with the same responsibilities as any other directors. It is therefore in their best interest to undertake their work effectively.

The Audit Committee in deposit taking SACCOs in Kenya was introduced in response to concerns on quality of financial reporting and monitoring within the Sacco sub-sector more particularly SACCOs that had expanded in their financial activities to offer quasi banking services and further taking cognizance that governance remains a challenge in SACCOs as

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<sup>63</sup> *Ibid*, p. 7.

<sup>64</sup> *Ibid*, p., 31-32.

<sup>65</sup> Tricker, B. (2008) *Corporate Governance, Principles, Policies and Practices*, Oxford, pp. 283.

<sup>66</sup> *Ibid*, 284.

indicated in the earlier parts of this chapter. The SACCOs are required under the Sacco Societies (Deposit Taking Sacco Business) Regulations, 2010 to establish Audit Committees

*“...duly constituted by the board of directors to review the financial conditions of the Sacco Society, its internal controls, performance and findings of the internal auditor and to recommend remedial actions at least once in every three months”*<sup>67</sup>.

The duties and responsibilities of the Audit Committee under the regulations includes among others: ensuring policies are in place to enhance internal controls ; ensure that financial reports reflect true position of the society’s affairs; liaising with external auditors and ensuring compliance with laws and policies among other duties<sup>68</sup>. The Audit Committee shall report to the board of directors on measures taken to implement recommendations and corrections of findings reported<sup>69</sup>.The Audit Committee plays a significant role in the SACCO reporting process. Its primary responsibility is to oversee on behalf of the board the integrity of the financial reporting controls and procedures implemented by management, to protect the interests of shareholders and other stakeholders. It is therefore instructive that the Board Audit Committee is well constituted with members who possess the requisite qualities and skills and their role redefined to enable them effectively carry out their mandate.

A study conducted by Microsave in deposit taking SACCOs revealed that SACCO Board Audit Committees being a relatively new feature in the governance of SACCOs faced challenges. Firstly, they are not headed by practicing audit professionals, members rarely have the relevant qualifications or experience required to oversee internal audit. Secondly, in many cases the Board Audit Committee is not as independent as it ought to be - its conduct is unduly influenced by Board members’ personal financial interests<sup>70</sup>. This demonstrates the potential risk posed by having inbred board members without the opportunity to coopt experts from outside to advise on technical issues broad before the Board. The Committee may in such cases become ineffective due to capacity challenges.

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<sup>67</sup> Regulation 57(1) : Sacco Societies (Deposit Taking Sacco Business) Regulations 2010, Nairobi Kenya.

<sup>68</sup> *Ibid*, Regulations, 57 (2).

<sup>69</sup> United Kingdom Financial Institutions Act, *Supra*, para 3.

<sup>70</sup> Cracknell, D, Mugwang’a, T. O’Keeffe, T & Ngaine, M (2013) *Supra*, p. 16.

Wolnizer states that the Audit Committee is commonly viewed as a monitoring mechanism that can make a significant contribution within a good corporate governance framework. He however further states that investors may be expecting too much from Audit Committees if the underlying accounting and auditing standards are inadequate<sup>71</sup>.

Without transparency, new laws and governance codes can do little to boost investor and member confidence. Various steps like use of standardized accounting practices, free flow of information and clear policies are needed. It is for this reason that SACCOs need to form an effective Audit Committee with proper policies and procedures put in place to enhance internal controls. The committees are to have clear terms of reference and work procedure to ensure they achieve optimum performance. Transparency has its costs and benefits. The benefits include increased shareholder confidence, safety of deposits and reduced cost of capital. The board's ability to effectively monitor the company's financial integrity and internal control is being increasingly focused through the Audit Committee. Special attention has been given to the Audit Committee as the principle player in the effort to enhance the standards of corporate governance and strengthen public trust<sup>72</sup>.

The negative costs are mainly associated with operational costs incurred in putting up measures to enhance internal controls. Sacco societies that have lean staff and of medium size have argued that employment of a qualified internal auditor to work with the Audit Committee as provided under the Sacco Act, 2008 is a costly affair for SACCOs to support. However, it will be noted that the benefits of well-established measures to enhance internal controls far outweighs any associated costs. Investors in most cases look for organizations with good corporate governance structures to invest their capital while moving away from bad governed institution and SACCO members are no exception to this phenomenon; they always transfer their shares to cooperatives that are well managed.

In Brazil, the Statutory Audit Committee is a body independent from the cooperative administration, with the purpose of supervising such administration as a representative of cooperative members. The body is the most important since it is not subordinate to the cooperative administrative body. It reports solely to the General Assembly and therefore not

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<sup>71</sup> Wolnizer, P.W. (1995) "Are Audit Committees Red Herrings?" *Abacus Vol. 31(1)*, p. 45.

<sup>72</sup> KPMG (2006) *Issue 1 June*, "The Changing Role of Audit Committees", p. 1.

subject to conflict of interest<sup>73</sup>. The Committee supervises the act of both strategic and executive administrators and verifies the performance of their duties, either legal or established in the cooperative by laws, in which administrative duties and managerial acts are performed<sup>74</sup>. This body can be equated to the Supervisory Committee in deposit taking SACCOs who are elected by members in the general meeting and present their report to the same organ. The Supervisory Committee as will be discussed in the subsequent sections of this chapter is an oversight body over the Board and Management.

In China, the Audit Committee comprises of four Independent Non-executive Directors. In addition, the Charter of the Audit Committee clearly defines the status, qualifications, work procedures, duties and responsibilities, funding and remuneration, etc. of the Audit Committee. The Audit Committee's principal duties include the supervision of the truthfulness and completeness of the Company's financial statements, the effectiveness and completeness of the Company's internal control and risk management system as well as the work of the Company's Internal Audit Department.

The Chinese Audit Committee is also responsible for the supervision and review of the qualifications, selection and appointment, independence and services of external independent auditors<sup>75</sup>. It ensures that the Management has discharged its duty to establish and maintain an effective internal control system including the adequacy of resources, qualifications and experience of staff fulfilling the accounting and financial reporting function of the Company together with the adequacy of the staff's training programmes and the related budget. The Audit Committee further has the authority to set up a reporting system to receive and handle cases of complaints or complaints made on an anonymous basis regarding the Company's accounting, internal control and audit matters.

The Audit Committees are also well established in the United States, where there has been a listing requirement of the New York Stock Exchange since 1978. A 1989 study revealed that

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<sup>73</sup> Baonco Central Do Brazil (2008) *Cooperative Governance, Guidelines for Good practices of Financial Cooperative Governance*, p. 45.

<sup>74</sup> *Ibid.*

<sup>75</sup> An example is the China Telecom Incorporation Ltd.

97% of major corporations had them. In Canada, the establishment of the Committee is also a legal requirement<sup>76</sup>.

The United States Congress enacted the Sarbanes-Oxley Act of 2002 in order to deal with fraud as witnessed in the case of Enron Incorporation<sup>77</sup>. It is reported that Enron's Audit Committee had six independent directors, two of whom had formal accounting training and experience, and only one who was less than expert<sup>78</sup>. Its Audit Committee was responsible for determining whether Enron's internal financial controls were working but nonetheless, the directors consistently ignored red flags and failed to inquire into questionable practices leading to collapse of Enron.

The Enrons case demonstrates that the establishment of Audit Committee alone is not a panacea to having good corporate governance; the holders of office also have a role to play by maintaining high independence, professionalism, diligence and high integrity to ensure efficiency and effectiveness. The independence of the Audit Committee is paramount for them to be able to exercise their own judgement, the members need to be independent in character and judgement and should not be hampered by relations or circumstances which could affect or appear to affect the members' judgement<sup>79</sup>. The success on operations of any Audit Committee determines the degree to which it enhances corporate governance.

### **1.11.2 Role of Supervisory Committee**

Supervision can be defined as keeping in check or control while oversight is the power to exercise watchfulness over an agency or organisation. The Merriams Webster's Collegiate Dictionary defines supervision as a critical watching or directing of activities<sup>80</sup>. The Supervisory Committee in some Jurisdiction is the equivalent of the Audit Committee in

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<sup>76</sup> Sir Adrian Cadbury Committee (1992). *Report on The Financial Aspects of Corporate Governance*, Published by the Committee on the Financial Aspects of Corporate Governance and Gee and Co. Ltd. Printed in Great Britain by Burgess Science Press, p. 60.

<sup>77</sup> Enron Fallout Report (2002) *Public Policy Consequences of Enron's Collapse*, 34 Sec. Reg. & L. Rep. 9, a S-5 (Mar. 4, 2002).

<sup>78</sup> American Bar Association (2003) "Corporate Governance in the Wake of Enron" *An Examination of The Audit Committee Solution to Corporate Fraud*, p. 2.

<sup>79</sup> KPMG (2006) *Supra*, p. 2.

<sup>80</sup> Webster's, M. (2003): *Collegiate Dictionary Eleventh Edition*, Springfield Massachusetts, U.S.A.P, 1255.

Kenya. However, Supervisory Committees in the DTS SACCOs is a separate organ independent from the Board and is directly accountable to the general members.

The Supervisory Committee members in SACCOs in Kenya are elected by the general members and their main duty is to cause to be made regular examination of accounts, records and affairs of the cooperative society. It shall review the activities of the Board, Committees and Management to ensure conformity with the laws, rules, society by laws and policies<sup>81</sup>. The Committee prepares annual committee reports, submits the reports to the Commissioner for Cooperative and present them to the annual general meeting of members for discussion and consideration<sup>82</sup>.

The Regulator in the U.S when addressing the National Supervisors Forum in November 2011 stated the following:

*“We have over the years identified significant deficiencies in how the supervisory committee function operates in credit unions. However despite this we have not seen substantial improvement in the performance of supervisory committees on a sector wide basis. Too often when we uncover major governance issues in credit unions the annual supervisory report to the members in no way reflects the performance of the board”<sup>83</sup>.*

The above statement demonstrates that there is room for improvement in the performance of Supervisory Committee to make them more effective and efficient in their performance covering all the critical components of the Cooperative operations.

A study carried on skills gap in SACCOs revealed that there is role conflict between Supervisory Committee and internal audit. The study revealed that there is a duplication of roles between the Supervisory Committee as established under the Cooperative Societies Act, Chapter 490 on one hand and the Board Audit Committee and Internal Audit as provided under the Sacco Act on the other hand.

The Supervisory Committee reports examined through the study articulated the following key internal audit roles that are undertaken by the Supervisory Committee:

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<sup>81</sup> Manyara, M. K. (2004) *Supra*, 52.

<sup>82</sup> Rule 28 Cooperative Societies Act, (2009) Chapter 490 Laws of Kenya.

<sup>83</sup> <http://www.lscu.coop/Education/Events-Calendar/LSCU-Conferences-Workshops/2012-Supervisory-Committee-Conference-on-2/11/2013>. Accessed on 2<sup>nd</sup> November 2013 at 8pm.

- a) Reviewing the internal controls to ascertain their adequacy in preventing the occurrence of errors and frauds.
- b) Examining monthly financial statements and operating information to confirm their accuracy and reliability.
- c) Examination of loans and other related accounting transactions for completeness and reliability.
- d) Review of efficiency and effectiveness of operational and non-financial controls
- e) Review of by-laws compliance, implementation of policies and procedures and statutory compliance<sup>84</sup>.

The duplication of roles has the effect of compromising the significance and contribution of internal audit and the Board Audit Committee and further that of Supervisory Committee if the committees pull in different direction hence requiring urgent attention to strengthen and redefine the roles of the two Committees.

The efficacy of actions by the Supervisory or Audit Committee depends on its independence and rectitude in performing its duties. The principle advantage of independence lies in the fact that the society is able to get an informed, objective and forthright opinion on the financial statements of enterprises which are used in making significant economic decisions by interested segments of society. Independence is the basis of impartiality and objectivity of the audit and supervision conclusions. Any person carrying out audit or supervision must therefore be independent and free from bias and conflict. The reports are to be reliable and correct and if there are links between the auditors and the things being audited, they may not trust the opinions given. The aspect of independence of the auditors or supervisors is very paramount.

Further, clarity in their role is significant in achieving expected level of effective performance. Therefore the cooperative law or regulations should provide appropriate rules. In Brazil for example, the legislation established rules to ensure independence of Committee' Article 1,066, paragraph 1, of Law no.10, 406/2002<sup>85</sup>.

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<sup>84</sup> Cracknell, D, Mugwang'a, T. O'Keeffe, T & Ngaine, M. (2013) *Supra*, p.18.

<sup>85</sup> Baonco Central Do Brazil (2008) *Supra*, p. 47.

The World Council of Credit Unions (WOCCU) advises that the principal role of the Supervisory Committee is to perform the annual audit or to select a qualified person to perform an annual audit, verification of member's accounts and periodic internal audit of operational areas throughout the year. Further, WOCCU states that because of the technical nature of the auditing procedures, it is imperative that the elected committee members have hand on experience in accounting and audit<sup>86</sup>. This recommendation by WOCCU presupposed a situation where only Supervisory Committee exists but not both the Audit Committee and the Supervisory Committee as it is in Kenya.

In addition to the Audit Committee, the Chinese Corporations have Supervisory Committees. For example in China Telecom Corporation Ltd, the Company's Supervisory Committee comprises six Supervisors, of which there is an External Independent Supervisor and an Employee Representative Supervisor. The principal duties of the Supervisory Committee in China include supervising, in accordance with the law the Company's financials and performance of its Directors, managers and other senior management of the Company so as to prevent them from abusing their powers.

The Supervisory Committee is a standing supervisory organization within the Company, which is accountable to and reports to all shareholders. The Supervisory Committee holds meetings at least once or twice a year for China Telecom Corporation Ltd. This demonstrates the level of independence that can be achieved through the Supervisory Committee which is accountable to the general membership just like it happens in cooperatives in Kenya. The only difference is that the members are all drawn from the membership of the Sacco and not outsiders.

### **1.11. 3. The Role of both the Audit and Supervisory Committees in Enhancing Corporate Governance of SACCOs**

There are many models and codes of governance practices of different forms of organisation in existence in Kenya and other jurisdictions such as Brazil, United States of America and South Africa. The codes have been examined to identify trends in different contexts that can

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<sup>86</sup> WOCCU (2002) *Development of Best Practices in Credit Union Supervision, Supervisory Committee Duties and Responsibilities*, 5<sup>th</sup> December 2002, p. 1.

be applied or modified to suit Kenyan own local circumstances. Audit Committees are usually set up to give the auditors and the shareholders a better guarantee that their interests are safeguarded.

*A principle of cohesion of a cooperative model is participation of members in monitoring and voicing their interests. However as noticed by survey and experiences of officials, participation is in several cases too shy in strengthening the importance of participation ...*<sup>87</sup>.

The failure by members to voice their interests weakens the monitoring process in cooperatives. The principle of transparency; defines in governance practices the interest of managers in assuming that owners, members in this case have full knowledge of information and results in a way to further their opinions. This requires establishment of efficient channels that are able to transmit information and receive criticisms and suggestions thereby enhancing stakeholder's engagement with cooperatives.

Xiaochuan states that the oversight role the boards of directors play involves appointing the Chief Executive Officer, approving business strategy, monitoring control systems, liaising with external auditors, etc. He further states that because of its diverse responsibilities, the board of directors typically delegates its oversight activities to different committees. The Audit Committee is one of these committees and its main responsibility is to oversee financial reporting<sup>88</sup>. The role of Audit Committee in corporate governance has been a subject of increasing regulatory interest and this cuts across the world.

DeFond and Jiambalvo state that overstatement of errors in annual earnings is less likely among firms that have an Audit Committee<sup>89</sup>. Wild finds that the earnings response coefficients for companies that formed Audit Committees are higher following the

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<sup>87</sup> Baonco Central Do Brazil (2008). *Cooperative Governance, Guidelines for Good Practices of Financial Cooperative Governance*, p, 13.

<sup>88</sup> Xiaochuan, Z (2008) *An Empirical Analysis of the Relationship between Audit Committee Multiple Directorships and Financial Reporting Quality*, A thesis submitted to Drexel University, p. 10.

<sup>89</sup> DeFond, M. L. & Jiambalvo, J. (1991) "Incidence and Circumstances of Accounting Errors". *Accounting Review Vol.66, No. 3 July 1991*, p, 644.

appointment of an Audit Committee<sup>90</sup>. He further states that a well-functioning Audit Committee system leads to the improvement of corporate financial reporting and a decrease in earnings for management or financial frauds thus enhances corporate governance.

The idea of Audit Committee monitoring in the USA as a solution to financial reporting failures has been around since at least 1999, when the New York Stock Exchange (NYSE) required listed firms to have Audit Committees composed mostly or exclusively of independent directors. The Securities and Exchange Commission (SEC) has required proxy statement disclosure about the Audit Committee's independence and discussions between the Audit Committee and Management about audited financial statements, also since 1999.

The King Report of Governance for South Africa (King III) emphasizes the vital role of an Audit Committee in ensuring the integrity of financial controls and integrated financial and sustainability reporting, and identifying and managing financial risk. In South Africa, the appointment of an Audit Committee is regulated as part of the enhanced accountability and transparency requirements. Although the Companies Act of South Africa only requires public companies and state owned companies to appoint an Audit Committee, King III proposed that all companies including SACCOs should have an Audit Committee<sup>91</sup>.

While some countries like the United States have their Credit Unions establishing Supervisory Committees others have an Audit Committees that performs the role similar to that of the Supervisory Audit Committee like Malawi<sup>92</sup>. Countries like Brazil and China have a dual system with both the Audit and Supervisory Committees. This is the same scenario obtaining in the deposit taking Sacco societies in Kenya.

The Capital Markets (Conduct of Business) (Market Intermediaries (Regulations 2011 under Regulation 13 provides for establishment of Audit Committee and such other committee<sup>93</sup>.

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<sup>90</sup> Wild, J. J. (1996): "The Audit Committee and Earnings Quality", *Journal of Accounting, Auditing and Finance Vol. 11*, P, 247.

<sup>91</sup> Erasmus, J (2010) *Audit Committee as an Independent Watchdog*", Deloitte and Touche, South Africa, p. 1.

<sup>92</sup> Mlelemba, E (2010) *Regulation and Supervision of Saccos: A case of Malawi*, A paper presented to the 3<sup>rd</sup> Annual SACCO Regulators' Roundtable, Lilongwe, Malawi, December 1, 2010, p. 18.

<sup>93</sup> Regulation 13, The Capital Markets (Conduct of Business) (Market Intermediaries) Regulations, 2011.

The Authority has in addition issued guidelines on corporate governance practices for listed companies in Kenya which provides for establishment of Audit Committee under paragraph 2.1.1. The guidelines further provide for its attributes and duties. The companies in Kenya only have the Audit Committee which has been given prominence due to its role in enhancing corporate governance.

The Sacco Societies (Deposit Taking Business) Regulations, 2010 under regulation 57 requires the SACCOs to establish Audit Committee, while retaining the Supervisory Committee as provided under the Cooperatives Societies Act. The roles of these committees as defined above are meant to contribute in enhancing corporate governance with more checks and balances.

The Audit Committee in Malaysia serve as a bridge in the communication network between internal and external auditors and the board of directors, and their activities include review of nominated auditors, overall scope of the audit, results of the audit, internal financial controls and financial information for publication<sup>94</sup>. In this way, they are able to take control of the company's audit function and ensure transparency. Walker states that the existence of an Audit Committee in a company would provide a critical oversight of the company's financial reporting and auditing processes<sup>95</sup>.

The effectiveness of the Audit and Supervisory Committee depends on their legal framework, composition and the resources given to the committee to execute their mandate. The Audit Committee was introduced in SACCOs on realization of the governance challenges that faced SACCOs hence their establishment is aimed at enhancing corporate governance in SACCOs. The Supervisory on the other hand enhances governance by offering members a bridge between them and the Board reducing information asymmetry.

## **1.12 Research Gaps and Departure of Opinions of Different Authors**

The Kenyan Sacco sub-sector faces several challenges being an infant market comparable to established and developed financial and credit markets in the west. Whereas there exists a

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<sup>94</sup> FCCG. (1999) *Report of the Federal Committee on Corporate Governance*, p. 1.

<sup>95</sup> Walker, R. G. (2004) "Gaps in Guidelines on Audit Committees". *Abacus*, Vol.40, No. 2, p. 159.

dual system where both the Audit and the Supervisory Committee of SACCOs perform almost similar roles, there is still room to examine their roles in enhancing corporate governance of SACCOs in Kenya and beyond in their current structure and further determine how they can be strengthened and their roles redefined to enable them effectively and efficiently enhance corporate governance in DTS.

There still remains a lot to be done in relation to legal and regulatory reforms for SACCOs in Kenya, improving transparency of transactions, reduction of transaction costs, improving public participation and education. In this regard, there are several research gaps existing within the sector calling for further scrutiny to make the sector efficient and robust for growth. In addition the Sacco Societies Act is just in its fourth year of implementation and the challenges faced so far in its enforcement calls for review of some provisions including that of Audit Committee and related areas.

Beecher –Monas argues that the corporate governance provisions of the Sarbanes-Oxley Act<sup>96</sup>, the implementation of internal financial control systems, monitored by an Audit Committee of independent directors are misconceived<sup>97</sup>. He further states that although the legislation has addressed some important aspects of corporate misconduct, it fails to go far enough in some important respects, and will be ineffective in the absence of the political will to enforce it. This in the researchers view holds true of the situation obtaining in some SACCOs, if elected leaders do not have the will to improve governance in institutions they manage, then any provision in the law to enhance governance remains just that without much achievement.

The manner in which directors get to office in SACCOs further compounds the problem especially where there is no clear election policy developed by the individual SACCOs or the pool of members is limited to certain profession leading to poor quality of elected leaders who may not be equal to the task. This may sometimes be due to democratic principle where the most popular gets elected not -withstanding their qualification. This calls for strengthening of the Committees to deal with this aspect.

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<sup>96</sup> Sarbanes-Oxley Act of (2002) US Congress, Pub. L. No. 107-204116 Stat. 745, 775-76 (2002), (S-O Act).

<sup>97</sup> Beecher-Monas E. (2003) 55 *ADMIN L. REV.* 357, *American Bar Association Administrative Law Review*, p. 2.

The emphasis of most authors in the United States of America is on auditor independence and financial literacy as some of the key criteria to be used in the appointment of members of Audit Committees of corporations and Supervisory Committee of credit union board members. The argument is that these two criteria assist the corporations in achieving its objectives without bias and external interference. Sori posits that Audit Committee in the United States of America (USA) enhances auditor independence<sup>98</sup>. Whereas auditor independence and financial literacy may be important criteria's to determine the members of the committees as is the case in the United States, they are by themselves not enough to ensure that good corporate governance practices are practiced. They need other additional criteria's to ensure that the high standards are met. Integrity test becomes very critical in this context.

The independence of Audit Committee members improves corporate governance and administration. Knapp discovered that an Audit Committee is more likely to support the auditor rather than Management in audit disputes and the level of support is consistent across members of the committee, regardless of whether the member is in a full-time or part-time position, such as corporate managers, academicians and retired partners of CPA firms<sup>99</sup>.

Mohiuddin argues that large investors usually dominate the board and exercise undue influence on management decisions<sup>100</sup>. To ensure that these corporate management dilemmas do not disadvantage the small investors who are the majority, the laws need to be legislated to ensure that the undue influence does not occur, that the board is more independent and with the requisite skills for effective audit and supervisory functions. Most corporate failures have arisen due to governance challenges.

Mohiuddin further states that an Audit Committee's effectiveness is very crucial for sound corporate governance practices in the organization. It was reported that lack of effective

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<sup>98</sup> Sori, Z. M. (2007) "Audit Committee Authority and Effectiveness" *The Perceptions of Malaysian Senior Managers International Research Journal of Finance and Economics - Issue 8 (2007)*, © Euro Journals Publishing, Inc. 2007, p. 2.

<sup>99</sup> Knapp, M. C. (1987) "An Empirical Study of Audit Committee Support for Auditors Involved in Technical Disputes with Client Management", *The Accounting Review*, vol. 62, No. 3, p. 580.

<sup>100</sup> Mohiuddin, M & Karbhari, Y. (2010) "Audit Committee Effectiveness, A critical Literature Review", *AIUB Journal of Business and Economics*, Vol. 9 No. 1, p. 100.

Audit Committee practice is a factor behind rigorous financial problems of companies<sup>101</sup>. However, effectiveness is an elusive concept that can be approached through several models. Cameron argues that none of the models of effectiveness is appropriate in all circumstances<sup>102</sup>. Spira also argued that "there is no discussion of the meaning of effectiveness, resources, or independence within the literature and this assertion is unsupported"<sup>103</sup>. Lee and Stone in explaining their purpose of study noted 'actual effectiveness is impossible to observe'<sup>104</sup>. In the researchers view, effectiveness depends upon the yardstick against which it is measured.

Whereas research has been conducted on the role of audit committee in companies, no research has been carried out on the workings of Audit and Supervisory Committee in deposit taking SACCOs to determine their suitability in meeting the needs of SACCOs and enhancing corporate governance.

## 1.13 Chapter Breakdown

### Chapter One- Background

Chapter one is the introductory part of the study that provides the background of the study. It sets out the scope of the study and statement problem. It further states the research questions and sets out the objectives intended to be achieved by the research. The chapter reviews literature on the topic of study and make comparative studies of the subject from different jurisdictions like Brazil, United States and South Africa. It identifies the points of departure in opinions and views on the subject and state why the current research is necessary. It is this part of research that provides justification for the study and states the hypothesis taken by the author before carrying out this study. The Chapter provides for research method adopted by the author in carrying the study.

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<sup>101</sup> Champbell, N. (1990) "Holding Audit Committees Accountable", *Canadian Business Law Journal*, 16(2), 134-159. See also Vicknair, D., Hickman, K. & Carnes, K. C. (1993) "A Note on Audit Committee Independence", *Accounting Horizon*, 7(1), 53-57.

<sup>102</sup> Cameron, K. S. (1986) "Effectiveness as Paradox: Consensus and Conflict in Conceptions of Organizational Effectiveness", *Management Science*, Vol. 32 No. 5, p. 539.

<sup>103</sup> Spira, L. F. (1998) "An Evolutionary Perspective on Audit Committee Effectiveness", *Corporate Governance: An International Review*, Vol. 6, p. 30.

<sup>104</sup> Lee, T. and Stone, M. (1997) "Economic Agency and Audit Committee: Responsibilities and Membership Composition", *International Journal of Auditing*, 1, p. 100.

## **Chapter Two- Historical Development of Cooperatives and SACCOs in Kenya**

The chapter looks at the historical development of cooperatives, SACCOs and deposit taking SACCOs in Kenya; consideration has been given to the various legal regimes of cooperatives in Kenya and concludes with emergence of deposit taking SACCOs in Kenya.

## **Chapter Three- Development of Audit Committee and Supervisory Committee**

The Chapter covers the development of Audit Committee and Supervisory Committee in deposit taking SACCOs in Kenya. It further looks at the emergence of the Audit Committees and Supervisory Committee in other organisations in Kenya and outside jurisdictions. Views obtained from informal discussion with some board committee members, and management will be included. In regard to other organisation, reference has been made to companies operating in Kenya. The author deems this comparison to be ideal since the idea of Audit Committee has been borrowed from practices obtaining in companies. It is therefore important to understand why they were introduced and challenges they have faced if any as we try to model the SACCO governance structure.

## **Chapter Four – Comparative Study on the Role of Audit Committee and Supervisory Committee**

The chapter makes comparative studies of the subject from three jurisdictions namely Brazil, United States of America and South Africa. The chapter considers the various legal frameworks under which they operate, to compare their mandate, composition, work procedure, challenges and achievements from various jurisdictions. The three countries were chosen for comparative studies for various reasons. From the literature review, the idea of Audit Committees started in the United States in 1978 after the fall of major corporations making the comparison key to help understand the genesis of Audit Committees.

South Africa has been chosen due to the application of the King Reports on Corporate Governance across all financial institutions regardless of the mode of formation, The King reports have also widely been used across Africa and has informed the pattern of corporate governance operating in Africa and beyond. Brazil on the other hand has made great strides

in embracing good corporate governance among the credit unions. It has adopted most of the current best practice that SACCOs in Kenya can learn from.

## **Chapter Five -Conclusions and Recommendation**

This chapter provides conclusion taken by the author on the study and provide recommendation for possible implementation by the government and other stakeholders in the Sacco sub-sector. It gives recommendations on suitable committees and how the Sacco governance can be strengthened through the committees.

### **1.14 Conclusion**

The Chapter has provided a broad background to the study and offered insights as to why the study is necessary. It has also considered the concepts of auditing and the theories that are relevant to the study. It has provided a brief role of Audit and Supervisory Committee in enhancing corporate governance. The development of the Sacco sub sector has been demonstrated to be very critical in the socio economic development of people of Kenya. The subsequent chapter gives the historical developments in cooperatives and the challenges they have faced that supports this study.

## CHAPTER TWO

### 2.0 HISTORICAL DEVELOPMENT OF COOPERATIVE SOCIETIES AND SACCOS IN KENYA

#### 2.1 Introduction

The Cooperative movement in Kenya has a rich history dating back to pre-colonial times. This chapter provides a snapshot of the history with emphasis on the critical developments and challenges that have been faced by cooperatives narrowing it down to SACCOS at the end of the chapter. It is important to appreciate the history which provided the journey that SACCOS have walked and where they stand now. The chapter looks at the history from the legislative instrument that has existed in the sector and how they influenced growth of cooperatives.

It looks at Cooperatives at Pre Independence era, during independence, post- independence and the liberalisation period. The chapter further looks at the emergence of SACCOS and DTS in Kenya to bring out why they are important for this study.

#### 2.2. The origins of Cooperative Societies in Kenya

##### 2.2.1. Cooperatives in the Pre-Independence Era

The history of the cooperative movement in Kenya can be traced back to the pre-independence colonial period. The cooperatives were formed through the initiatives of members who were exclusively white settlers<sup>105</sup>. The colonial settlers did not want to encourage the indigenous Kenyans to form cooperatives as that would have enhanced their political consciousness<sup>106</sup>.

The first co-operative society in Kenya was Lumbwa cooperative society which was established in 1908 in the present day Kipkelion<sup>107</sup> with the main objective of marketing and

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<sup>105</sup> Kobia, S. K. (2011) *Supra*, p. 30.

<sup>106</sup> *Ibid*, p. 29.

<sup>107</sup> Bottelberge, P. & Agevi, E. (2010) *Leading Change in Cooperatives and Member Based Organizations in East Africa: Findings of a Study on Leadership and Leadership Development*. Swedish Cooperative Centre, p. 3.

purchasing of farm inputs. The Sessional Paper No 8 on Cooperative Development released in 1910 paved the way for creation of the Ministry of Cooperative Development in 1914.

The Kenya Farmers Association (KFA) was registered in 1923 as a successor of the Lumbwa Cooperative Society. Its registration was however not under any law<sup>108</sup>. Its objects were to supply agricultural requirements like fertilizers, chemicals, seeds among others to European settler farmers only and to arrange for sale of their produce to take advantage of economies of scale. Kobia further states that the indigenous Kenyans were not allowed to join KFA until after independence when large scale farmers became eligible for membership<sup>109</sup>.

The colonial government passed the Cooperative Societies Registration Ordinance No 24 of 1931 which allowed the use of its provisions by associations registered in other forms for example companies as long as they engaged in cooperative marketing. The Kenya Cooperative Creameries (KCC) was the first cooperative society to be registered under the Cooperative Societies Registration Ordinance on February 8, 1931. It was registered to deal with the production and sale of dairy products. KCC was later registered under the Companies Act<sup>110</sup>. However, KCC retained the dual registration for both cooperative and company after independence this remains the position to date.

There was also Kiambu Native producer cooperative (SACCO) registered in 1934 which was largely producer cooperative but had savings and credit component<sup>111</sup>. The colonial government repealed the 1931 Ordinance in 1994 and replaced it with another Cooperative Societies Ordinance that opened the doors for the indigenous Kenyans to form cooperatives. The post for the Registrar of Cooperatives was proposed and created through this legislation. The first known SACCO called Government African Sacco was registered in 1944.

The Department of Cooperatives was established in 1946 and the Registrar appointed. It was also during this period that the registrar of cooperatives was appointed to have supervisory

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<sup>108</sup> Kobia, S. K. (2011) *Supra*, p. 30.

<sup>109</sup> *Ibid*.

<sup>110</sup> The Companies Act, Chapter 486 Laws of Kenya.

<sup>111</sup> Kenya, Government, The Department of Cooperative Development and Marketing-Registry Section.

control over indigenous cooperatives<sup>112</sup>. The Ordinance also created offences for deliberate neglect of the directives and orders of the Registrar<sup>113</sup>. During this period, the cooperative law exempted the settler community cooperatives from the control and supervision of the Registrar of cooperatives. The change of heart by the colonial masters was in order to achieve its goals and had wide powers in directing and regulating economic activities in both settler and African areas.

The period between 1950 and 1952, saw great support of the cooperative idea by the colonial civil servants leading to the formation of 160 cooperatives<sup>114</sup>. Kobia further observes that the passion and zeal for cooperative ideals by the government officers were instrumental in introducing and entrenching the cooperative system in Kenya<sup>115</sup>.

The Mau Mau rebellion during independence caused members of cooperatives to join the pro-independence forces in 1952. This was the time that Kenya had declared a state of emergency. The declaration hurt the economic growth including the growth and activities of the cooperative societies. King George VI Hospital (Now Kenyatta National Hospital) Staff Consumer Society was registered in 1954<sup>116</sup>. The period between 1954 and 1958 was the most successful for consumer cooperatives. In 1958, more than 400 cooperatives were registered<sup>117</sup>. In 1960, the Government saw the cooperatives as vehicles to introduce African Socialism and strengthen ties between the people from different regions of Kenya.

Like in most African countries, cooperatives in Kenya have developed through two main eras, that is, the era of state control and the era of liberalization<sup>118</sup>. In the era of liberalization, the natives through their own efforts formed cooperatives to trade amongst themselves and to

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<sup>112</sup> *Ibid*, p. 32.

<sup>113</sup> *Ibid*.

<sup>114</sup> *Ibid*.

<sup>115</sup> *Ibid*,

<sup>116</sup> *Ibid*, p. 33.

<sup>117</sup> *Ibid*.

<sup>118</sup> Wanyama, O. F. (2009) *Surviving Liberalization: The Cooperative Movement in Kenya*. Geneva: International Labour Organization, p. 1.

defend their interests against those of the foreigners. The formation of cooperatives among the emerging African middle class as a way of defending their interest against those of foreigners was an important factor in the development of genuine cooperatives later because of a sense of pride and self-confidence that characterized these early African organizations.

By the late 1950's the greater number of cooperatives were engaged in the marketing of agricultural produce. The traditional function of cooperatives had continued to be agricultural marketing cooperatives. By comparison other types of cooperative societies such as consumer and credit societies were of minor significance.

### **2.2.2. Cooperative Development during the Independence Period**

Kenya achieved independence from the colonial government on 12<sup>th</sup> December 1963. During the year of independence about 1,000 cooperatives were formed. The new government gave emphasis to the promotion of cooperatives as a key strategy for national development<sup>119</sup>. It was during this period that a government department was established to promote and supervise cooperative societies followed by the creation of a full-fledged Ministry of Cooperative Development<sup>120</sup>. The then Parliament during its debate stated that cooperative movement will take in all aspects and help the people develop their cultivation and farming to be able to save more money. If the peasant people are to save money then the government will be the richest<sup>121</sup>. These statements demonstrated the critical role that cooperatives were expected to play in the socio economic development of this country.

The desire of the government to form cooperatives to achieve rapid social and economic development was stated clearly by Hon. Ronald Ngala, the then Minister for Cooperative Development when he averred that:

*“ since the present government wants to use the cooperative movement more effectively and use it as an instrument which will give us prosperity and economic*

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<sup>119</sup> Kenya , Government (1965) Kenya Sessional Paper No. 10 of 1965.

<sup>120</sup> Kobia, S. K. (2011) *Supra*, p. 29.

<sup>121</sup>Kenya, Government (1963) *Report on Parliamentary Debates* Hansard 12th November 1963, See also Ouma, J.S. *History of Cooperative Development in Kenya*, p. 38.

*growth in the country....the government has this policy of increasing the guidance and supervision in the cooperative movement”<sup>122</sup>.*

The term cooperative movement which was often used to describe cooperatives in Kenya became justifiable around 1963 the year of attainment of independence. Unfortunately the often haphazard creation of cooperatives brought about many problems to the movement. Many of them were not economically viable and the Department of Cooperatives was handicapped in dealing with the rapid increase. The Department of Cooperatives had limited capacity and could not effectively carry out the oversight role over cooperatives.

### **2.2.3. Cooperative Development under the Post-Independence and Liberalization Period**

The Kenya-Nordic Cooperative Development Programme (KNCDP) was initiated in 1967 with help from the World Bank, the US and Germany to build human capital and boost capitalisation in cooperatives. The Government instituted subsidies and free access to government credit and free extension services. By the end of 1967 there were 1783 cooperatives on the register as compared to 847 in 1960<sup>123</sup>. Lack of management capabilities in these societies became a major drawback and by mid-1960's the situation in the movement had deteriorated due to inadequate administrative capability both in the Department of Cooperatives and within the cooperatives themselves, steps had to be undertaken to remedy the situation and ensure efficiency.

The government of Kenya therefore entrenched its control over cooperative operations in 1969 and made the Cooperative Societies Rules which stipulated the operational oversight procedures of all cooperatives by the Commissioner of Cooperatives<sup>124</sup>. These included, registration, amalgamation, deregistration, approval of budgets, borrowing powers and monitoring of financial performance. In essence, the Commissioner performed the oversight role over all cooperatives to ensure their desired objective was achieved.

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<sup>122</sup> Manyara, M.K.(2003) *The Development of Cooperative Law and Policy*, Oscan Print Publisher, Nairobi 2003 p .2. See also Ngala Minister for Cooperative Development, *Kenya House of Representatives Report (Hansard) Volume 10 Part II Column 2182-2184*.

<sup>123</sup> Department of Cooperative Development and Marketing, Registry Section.

<sup>124</sup> The Cooperative Societies Rules of 1969.

The other oversight roles included the auditing of accounts, countersigning of cheques and financial orders, replacing elected leaders, appointing management commissions, employment and dismissal of graded staff and dealing with related labour issues<sup>125</sup>. The 1966 Cooperative Societies Act and the 1969 Rules provided the Commissioner of Cooperative Development with overwhelming powers for the control of cooperatives. Kobia states that the legal and administrative regulations that were imposed by the cooperative Societies Act and Rules weakened the flexibility required to lead and manage cooperatives as independent business enterprises<sup>126</sup>.

The controls also diluted the fundamental and universal cooperative principles, values, ideals for member-based, member-controlled and self-reliant cooperative movement<sup>127</sup>. However, in the authors view, the controls were necessary at the time since cooperatives had not built the requisite capacity to handle their own affairs and needed to be nurtured to maturity to be able to realise the full benefits of cooperatives. Further, since the government wanted to use cooperatives as vehicle to attain socio economic development after attaining independence it had to take control and not leave anything to chance.

The state-controlled promotion of cooperative development was formalized by the introduction of a single legal framework for all types of cooperatives in 1966 via The Cooperative Societies Act<sup>128</sup>. This statute replaced the 1945 Ordinance. It embodied stern measures of control vested in the Minister and Commissioner of Cooperative Development to curb malpractices, which had become rampant in cooperatives.

The government was given wider supervisory powers than those conferred under the 1945 Ordinance. Extensive administrative machinery under the Commissioner of Cooperative Development was created, comprising a Deputy Commissioner, Assistant Commissioner, Senior Cooperative Officers and other junior cooperative officers<sup>129</sup>. Extensive powers were

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<sup>125</sup> Kobia, S.K. (2011) *Supra*, p. 94.

<sup>126</sup> *Ibid*

<sup>127</sup> *Ibid*.

<sup>128</sup> The Cooperative Societies Act, 1966, chapter 490 of the laws of Kenya.

<sup>129</sup> *Ibid*, Section 3.

vested in the Commissioner and a list of offences was created to permit the Commissioner in consolidation of the powers. Failure to comply with the provisions of the Act and willful performance of any act, which required the assent, or approval of the Commissioner without having first obtained such approval became offences carrying a punishment of either a fine or imprisonment<sup>130</sup>.

The Act also conferred on the Commissioner the power to surcharge in order to ensure the recovery of funds or property of a society misapplied or retained by any person participating in the management and organization of a society. Provision was made to allow for simultaneous criminal proceedings in the event of such misapplication or retainer and for breach of trust in respect of society property. Important controls were also introduced regarding financial management, particularly as part of the rule-making power of the Minister, which had formerly been exercised by the Governor-in-Council under the 1945 Ordinance.

In addition to the matters outlined in the 1945 legislation, the Minister's rule-making power was extended to cover provisions relating to the management of society's finances, of particular importance in this connection was the power to make rules on the form of the final accounts and balance sheet to be prepared annually and any other statements and schedules relating thereto.

The Act established an audit and supervision fund and a Cooperative Societies Liquidation account. Furthermore provision was made that any negotiable instrument and any order for goods or services in excess of a specified amount by the registered society shall be ineffective unless countersigned by the Commissioner or a person nominated by him for that purpose. These powers were geared towards enhancing the oversight role played by the Commissioner's office.

Besides giving the Commissioner power to register, amalgamate and deregister cooperatives, he/she had to approve annual budgets of cooperatives; authorize borrowing and expenditure; audit their accounts; monitor financial performance; and could even replace elected

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<sup>130</sup> Kobia, S.K. (2011) *Supra*, p. 94.

cooperative societies' officials by management commissions at his/her pleasure<sup>131</sup>. This kind of supervision made the cooperatives become over dependent on the support from the government and many did not work on building their own capacity to be able to take over management of their own institutions.

All employment issues in cooperatives fell within the mandate of the Commissioner as he/she had to approve remuneration, salary or other payments to staff or members as well as approve the hiring and dismissal of graded staff. The labour issues fell within the mandate of the Commissioner as the trade union Act was expressly excluded from applying to cooperatives<sup>132</sup>.

Administrative regulations imposed by the Cooperative Societies Rules impaired the flexibility required for running cooperatives as business enterprises<sup>133</sup>. Hussi, posits that other governments in Africa, for a variety of reasons, still continue to exert state control over cooperatives and continue to subsidize their operations<sup>134</sup>.

The government introduced Sessional Paper No. 10 of 1965 on African Socialism and its Application to Planning in Kenya which paved the way for the enactment of the Cooperative Societies Act in 1966 by the parliament of the independent government<sup>135</sup>. The law allowed direct intervention by the government in the management of cooperatives that compromised the principles of member owned and run organizations<sup>136</sup>. The government involvement hindered the emergence of member-controlled cooperatives since members relied on the government to safeguard their interests. As a result equality, equity, solidarity, democratic principles, self-responsibility and self-help that are important pillars of successful producer

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<sup>131</sup> Manyara, M. K.. (2003) *The Development of Cooperative Law and Policy in Kenya*, Nairobi, Oscan Print, p. 17.

<sup>132</sup> *Ibid*, p, 37.

<sup>133</sup> Hussi, P. Murphy, J, Lindberg O. & Brenneman, L. (1993) *The Development of Cooperatives and Other Rural Organizations: The Role of the World Bank*, Washington, D.C., World Bank, p. 3.

<sup>134</sup> Hussi, P. Murphy J., Lindberg O. & Brenneman, L. (1993) *Supra*, p. 3.

<sup>135</sup> Kenya, Government (1997) *Kenya Sessional Paper No. 10 of 1965 On African Socialism and its Application in Planning* Nairobi, Government Printer, p. 10.

<sup>136</sup> Gamba, P. & Komo, I. (2008) *Evolution, Growth and Decline of the Cooperative Sector*, p. 2.

organizations were thus hindered. These caused cooperatives to be run as if they were government owned instead of privately owned member organizations and cushioned the members against agency problem

The period of strict government control was followed by regulation and relaxation of tight controls on cooperative societies. The relaxation of controls was to allow the cooperative society members autonomy and prepared them for free competition with other businesses. The Structural adjustment programmes (SAPs) introduced in the 1990s accelerated reforms through liberalisation and structural reforms. The result of SAPs was wide-ranging policy changes in trade and macro-economic policies, impacting on production costs, incentive structures and sector competitiveness<sup>137</sup>.

The Sessional Paper on Renewed Growth through Cooperative Movement released in 1987<sup>138</sup> opened up rapid growth for cooperatives in Kenya. According to Wanyama, the first era made cooperatives platforms for implementing socio-economic policies to the extent that failure of state policies expressed themselves in the cooperative movement. The failures saw the need for the liberalization of the cooperative movement in early 1990s<sup>139</sup>.

This realisation led to the preparation of Sessional Paper No. 6 of 1997 which provided for a member-based, autonomous and member-controlled movement. The new liberalized cooperative environment led to the repeal of the 1966 Cooperative Societies Act and the 1969 Cooperative Societies Rules. These were replaced with a new Cooperative Societies Act<sup>140</sup> and Cooperative Societies Rules<sup>141</sup>. The management role previously performed by the Commissioner for Cooperative Development was transferred to the elected management committees of cooperative societies<sup>142</sup>. Liberalisation in the 1990s saw many mergers, disputes and splits in various cooperative societies, with some devolving into small and

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<sup>137</sup> Kobia, S.K (2011) *Supra*, p. 95.

<sup>138</sup> Kenya, Government. (1987) *Sessional Paper, No. 4 on Renewed Growth through Cooperative Movement*.

<sup>139</sup> Porvali, H. (ed) (1993) "The Development of Cooperatives and other Rural Organization", *Agriculture and Rural Development Series, No. 8*, The World Bank, Washington, D.C., p.1.

<sup>140</sup> The Cooperative Societies Act, No. 12 of 1997.

<sup>141</sup> The Cooperative Societies Rules, 1997.

<sup>142</sup> Kobia, S.K. (2011) *Supra*, p. 95.

uneconomic units on one hand, and on the other, suffering high level of mismanagement, fraudulent cases reported, nepotism and conflict of interest.

The 1997 Act empowered the members to be responsible for the running of their own cooperatives, through elected management committees. Nevertheless, cooperatives were not prepared for this freedom. Consequently, the immediate impact of liberalization on cooperatives was primarily negative<sup>143</sup>. To the detriment of primary cooperatives the newly acquired freedom was dangerously abused by elected leaders. This saw many cooperatives report cases of corruption and mismanagement such as gross mismanagement by officials, theft of cooperative resources, split of viable cooperatives into smaller ineffectual units, and failure of employers to surrender members deposits to cooperatives particularly SACCOs which situation precipitated regulation as regulatory requirements and compliance would serve as a mitigation to depositor losses<sup>144</sup>.

The problems that faced most cooperative societies after the government's abrupt shift from control to regulation only were mainly because the cooperative societies were ill prepared for the taking over of the roles previously performed by the Commissioner of Cooperative Development. However, this did not slow down the growth in the numbers and financial strength of cooperative societies. A National Poverty Eradication Plan launched in 1999 provided broad-based approach to economic growth, especially in the rural areas, with cooperatives being a key vehicle.

The registered cooperatives reached 10,297 in 2003, with a membership of 5.9 million and an income of about Kshs7.4 billion (\$87.1 million), contributing to about 30 per cent of national saving.<sup>145</sup> The government noted the spiral growth of cooperatives and it found it necessary to amend the law on cooperatives. In 2004, the Cooperative Societies Amendment Bill of 2004 was introduced in parliament. The Bill sought to re-introduce some degree of government control. This was mainly because of the abuse of liberalisation and autonomy by

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<sup>143</sup> *Ibid.*

<sup>144</sup> Makori, J, Munene, C & Muturi, W. (2013) "The Challenges Facing Deposit-Taking Savings And Credit Cooperative Societies' Regulatory Compliance In Kenya. A Case of The Gusii Region", *Interdisciplinary Journal of Contemporary Research in Business, Institute Of Interdisciplinary Business Research*, Vol 4, No 12, p. 1033.

<sup>145</sup> See more at: <http://softkenya.com/history-of-cooperatives-saccos-in-kenya> (Accessed on 8<sup>th</sup> August 2013).

a large number of cooperative societies as outlined above. The 2004 amendment to the Cooperative Societies Act 1997 provided that the Commissioner of Cooperative Development (CCD) can dissolve the Management Committee which in his opinion was not performing its duties properly and direct members to appoint an interim committee for a period not exceeding 90 days<sup>146</sup>.

The CCD under the new 2004 amendment was allowed to call for elections in any cooperative society, attend committee and general meetings of cooperatives and require notices, agenda and minutes each<sup>147</sup>, suspend from duty any Management Committee members charged in court with fraud or dishonesty, has to approve a list of auditors from which cooperatives can appoint their auditors and fix their remuneration<sup>148</sup>, can convene an annual general meeting of a cooperative society where he may chair and direct the matters to be discussed and may require any cooperative to update its by-laws<sup>149</sup>. These were the additional supervisory roles that the government re-introduced in the 2004 amendment to cooperative law of 1997 to enhance its oversight role over SACCOs.

The Sacco Societies Act was enacted in 2008 by the Kenyan parliament introducing prudential regulation in SACCOs. The Act established the Sacco Societies Regulatory Authority (SASRA)<sup>150</sup> to provide oversight over DTS. The Authority under the Act has powers to license, regulate and supervise SACCOs, inspect, advise and direct, intervene in management and take supervisory enforcement action as provided under Part V of the Act<sup>151</sup>.

The introduction of prudential regulations in DTS was a response to the growth and developments in the SACCO sub sector to provide quasi banking services while at the same time recognizing the governance challenges of mismanagement, nepotism, fraud among others that existed in the subsector which it sought to address. The prudential regulations were

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<sup>146</sup> Section 58(2) Cooperative Societies Act (1997) Chapter 490 Laws of Kenya.

<sup>147</sup> *Ibid*, Section 93A.

<sup>148</sup> *Ibid*, Section 25(4) & (5).

<sup>149</sup> *Ibid*, Section 27(8).

<sup>150</sup> Section 4 Sacco Societies Act, 2008 Laws of Kenya.

<sup>151</sup> *Ibid*, Sections 23-28, & 48-54.

introduced to ensure Sacco business is conducted in a manner that mitigate against systemic risks. The Act enhanced governance provisions in Part IV of the Act<sup>152</sup> which among others require SACCOs to appoint Internal Auditors, appoint external auditors from a list approved by the Authority and external auditors to rotate after three years. Further, the Ethics Commission for Cooperative societies was established in 2011 to handle ethical and integrity issues in cooperatives. The commission works closely with the national anti-corruption agency to minimise losses occasioned by graft, and recover assets, including land and buildings of cooperatives that have been acquired or disposed illegally.

According to Kenya Unions of SACCOs, cooperatives in Kenya have led to the development in agriculture, storage, housing, fishing and credit<sup>153</sup>. The Ministry of Cooperative Development and Marketing (MoCDM) conference report indicated that there were over 5200 registered SACCOs with over 5.6 million registered members in Kenya as at 2010<sup>154</sup>.

### **2.3. The Emergence of the SACCOs in Kenya**

The first SACCO called the Government Africa Sacco was registered in 1944. However, more SACCOs emerged in Kenya in the years between 1965- 1970<sup>155</sup>. Some of the SACCOs registered around that time include Shirika SACCO in 1969 for employees of the Ministry of Cooperatives and Harambee Sacco for employees in the office of the president<sup>156</sup>. The SACCOs grew out of the credit systems of the old farming cooperatives which were common in cash crop areas, particularly where coffee was produced. Union Banking sections were formed in most cooperative unions, and these banking sections were progressively converted into SACCOs in order to formalise the separation between economic and financial functions. The SACCOs assisted members to pool resources together for their social and economic advancement.

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<sup>152</sup> *Ibid*, Sections, 29- 47.

<sup>153</sup> Kenya Union of Saccos (KUSCCO) Annual Report 2011, p. 1.

<sup>154</sup> Kenya Government (2011) Ministry of Cooperative Development and Marketing, *Cooperative Conference Report*, Nairobi, p. 2.

<sup>155</sup> Chao-Béroff, R., Cao, T. H., Vandenbroucke, J. P. Musinga, M, Tiaro, E. & Mutesasira, L. (2000) *A Comparative Analysis of Member-Based Microfinance Institutions in East and West Africa*, Microsave, p. 16.

<sup>156</sup> Kenya Government, Department of Cooperative Development and Marketing -Registry Section.

The farmers would access financial services in the cooperatives through the union's banking sections. In the cooperatives' banking sections farmers saved and obtained advances that were serviced from income earned from the harvest. The SACCOs' banking services have grown in form of their operations and currently operate in Kenya under what is largely known as FOSA business undertaken by SACCOs. The registered Sacco Societies in Kenya as at the end of 2012 December stood at 3,996<sup>157</sup>.

Kenya has two national structures of SACCOs at the secondary level. These are the Kenya Savings and Credit Cooperative Organisation (KUSCCO) which brings together the urban SACCOs and the Kenya Rural Savings and Credit Union (KERUSSU) which brings together the rural SACCOs. The secondary structures are designed to offer services to their members such as advocacy, training, supervision, insurance products and refinancing options at concessional rates.

The Cooperative Bank of Kenya which is also a secondary cooperative offer services to SACCOs which include banking services, training for SACCO employees, and advice on management information systems. The bank has created a special unit at the Head Office to cater for the needs of the SACCOs. The SACCOs have grown in size and complexity as stated in the early parts of this research and their contributions in enhancing the livelihood of many Kenyans make them great focal point for any study on governance to ensure their operations are carried out in a safe and sound manner.

#### **2.4. The Emergence of Deposit-Taking SACCOs in Kenya**

The SACCO societies whose main objective is to afford members opportunity to save and borrow at affordable rates suffered in the early 1990s when due structural adjustments programmes many banks closed their branches outside Nairobi leaving the ordinary Kenyan who mostly were members of cooperative societies with no place to bank their meager resources. This vacuum created by banks forced SACCOs to think on ways of assisting their members keep savings that they could access at short notice and get affordable advances from the same. This led to the introduction of Deposit taking business in SACCOs which were initially called with-drawable Savings Fund (WSF), or Sacco Savings Accounts (SASA) and

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<sup>157</sup> Ademba, C. (2012) *Supra*, p. 7.

which later acquired the name Front Offices Savings Activity (FOSA) which has been retained to date<sup>158</sup>.

However, the Sacco Act, 2008 classifies these SACCOs as Deposit Taking SACCOs (DTS) within the meaning of the Act. The first SACCO to offer these services through the assistance of Cooperative College of Kenya and Cooperative Bank of Kenya was Muhigia SACCO. The Sacco started FOSA operations in 1995 when it diversified its activities from the traditional back office operations to offer quasi banking activities<sup>159</sup>. The success of this SACCOs saw many SACCO diversify their activities and started FOSA operations to be able to offer their members product different from the traditional ones that are offered under the traditional Sacco business.

The growth of these SACCOs brought with it human, capital and technological challenges in their operations key among them governance challenges which saw reported cases of mismanagement, fraud cases through mobile banking operated by SACCOs among others. The problem was further compounded by the fact that there was no legal and regulatory framework to take care of the business the SACCOs were undertaking in offering quasi banking services. The SACCOs continued to grow in size and complexity without clear guideline for almost a decade.

The SACCOs operated the front office operations without any form of legislative guidance until 2004 when through the Cooperative Rules a provision was made to guide SACCOs on establishment of front office<sup>160</sup>. However, the rules did not provide for prudential regulations yet the SACCOs continued to receive deposits from their members on day today basis with great systemic risks to the Sacco operations thereby putting the funds obtained from members under great risk and open to fraudulent activities. It is also this time that the establishment of Supervisory Committee was anchored in the law to provide oversight role on operations and activities of the SACCO on behalf of general members.

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<sup>158</sup> Kenya, Government, The Sacco Societies Regulatory Authority Supervision Department.

<sup>159</sup> *Ibid.*

<sup>160</sup> Rule 52, the Cooperative Societies Rules, 2004.

The deposit taking SACCOs in Kenya remained without prudential regulation and clear legal framework until the year 2008 when the then Kenyan Parliament enacted the Sacco Societies Act, 2008 to cover various aspects relating to regulation of SACCOs key among them being their licensing, supervision and regulation<sup>161</sup>. The Sacco Act brought on board provisions that are geared towards enhancing corporate governance and mitigate against inherent risks in the Sacco business<sup>162</sup>. SACCOs are different from other financial institutions a majority of whom are banks in that, the members who hold accounts in the SACCOs are at the same time the owners, and they conduct their voting mandate on the one member one vote basis irrespective of the members' shareholding. This means that only the members of these institutions can deposit and borrow from them<sup>163</sup>. SACCOs can only grant loans to their members<sup>164</sup>. It is also members of the SACCO who can be elected into the Board or any Committee of the SACCO.

Cooperatives operate on principles which are only unique to them; the principles as espoused by the International Cooperative Alliance include autonomy, independence, self-help and reliance, member controlled among others<sup>165</sup>. This uniqueness of the SACCOs informed the enactment of a Sacco specific Act to address their unique challenges and customize the legislation to suit their circumstances. Whether this is reflected in the Sacco Act as passed by the Kenyan Parliament can be a subject of further research.

The deposit taking SACCOs are observed to be controlling more than 78% of the total deposits and assets of the SACCO industry<sup>166</sup>. The SSA and the Regulations made thereunder required SACCOs that were already operating Front Office Services Activity (FOSA) as at the date of publication of the regulations which was June 2010 to apply for license with SASRA. Out of the two hundred and nineteen (219) Sacco societies that were authorized to operate FOSA, one hundred and ninety nine (199) applied for license, thirteen (13)

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<sup>161</sup> Section 5, Sacco Societies Act, *Supra*.

<sup>162</sup> *Ibid*, Sections 29-47.

<sup>163</sup> Makori, J. (2013) *Supra*, p. 1016.

<sup>164</sup> Section 33(5), The Sacco Societies Act, 2008.

<sup>165</sup> Manyara, M. K. (2004) *Supra*, p. 62-63.

<sup>166</sup> IMF (2011) *Financial Stability Issues in Emerging Markets and Developing Economies*, p. 1.

communicated their decision to discontinue FOSA while seven (7) did not submit license application by the deadline of 17<sup>th</sup> June 2011<sup>167</sup>.

The policy objective of establishing prudential regulation of deposit taking SACCO societies was to enhance transparency and accountability in the SACCO sub-sector, which is consistent with the ongoing reforms in the financial sector whose ultimate aim is to expand financial access, encourage efficiency and enhance financial stability of financial service providers in Kenya. The challenges of the successful implementation of the new regulatory framework differ significantly both because of the size and diversity of the SACCO Societies, with inadequate technical skills, both at Board and Management levels being identified as the key challenge<sup>168</sup>.

This rapid development in SACCOs that currently engage in big volumes of business bring to fore the critical need to strengthen the governance structure in these institutions to ensure member's funds are protected and members fully provide with credible information through open disclosures. This objective can effectively be achieved if the role of Audit and Supervisory Committee in DTS is strengthened and redefined to achieve high level of good governance through effective audits and oversight role.

## **2.5 Conclusion**

As it has been argued in the early parts of the document, the growth in membership and business organisations increases agency problem since members are not able to closely monitor their operations hence the need for effective monitoring and supervision mechanism that both the Audit and Supervisory Committee can enhance corporate governance when their structures are strengthened and their roles redefined. The development of cooperatives and SACCOs in Kenya has been considered in this part of the research to provide a platform for understanding the pace of their growth, the challenges they have faced and the critical role they play which are helpful in making any meaningful proposals for consideration. The next chapter looks at the development of Audit and Supervisory Committee from global perspective and in Kenya.

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<sup>167</sup> SASRA (2011) SASRA, Press Release. (Accessed from [www.sasra.go.ke](http://www.sasra.go.ke) on 16<sup>th</sup> August, 2013).

<sup>168</sup> *Ibid.*

## CHAPTER THREE

### 3.0 DEVELOPMENT AND EMERGENCE OF AUDIT AND SUPERVISORY COMMITTEE

#### 3.1 Introduction.

Auditing generally checks on compliance. It verifies information to check on compliance with set legal and regulatory standards that institutions which they apply to are expected to comply with. The work of the auditor therefore is to check the performance of an organization against these set standards. The concept of auditing revolves around, the true and fair view, the audit evidence and independence of the auditor<sup>169</sup>. Auditing operates on two hypothesis: the monitoring hypothesis which assumes that when delegating decision-making power to one party, as suggested in agency theory, the agent is motivated to agree to be monitored if the benefits from such activities exceed the related costs. This hypothesis is applicable to all co-operative relationships in any organization<sup>170</sup>. The second is information hypothesis, which focuses on the need to provide information to enable users to take economic decisions.

Supervision on the other hand is to critically watch over activities of an organisation. This chapter looks at how Audit and Supervisory Committee have evolved overtime and the role they play in enhancing corporate governance.

#### 3.2 Emergence of Audit Committees from Global Perspective

The Audit Committee was introduced in the United States in the 1970s and the significance of independent directors recognized<sup>171</sup>. The first report on Corporate Governance on financial aspects of corporate governance in the UK was produced by Sir Adrian Cadbury (1992) which was set up in response to various company collapses. The report advocated for independent directors and Audit Committees. This report influenced the thinking around the

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<sup>169</sup> [www.alhea.com/eg027/search/web?Fcoid=417&fcop---and www.alison.com/Basic](http://www.alhea.com/eg027/search/web?Fcoid=417&fcop---and www.alison.com/Basic) Accounting. Accessed on 2<sup>nd</sup> November 2013.

<sup>170</sup> Kimittonen, (2010): A Theoretical Examination of the Role of Auditing and the Relevance of Audit Reports, Business Administration 28, Accounting and Finance, VAASAN, p, 6.

<sup>171</sup> Tricker, B. (2008) *Corporate Governance Principles, Policies and Practice*, Oxford. p 10.

world and other countries which followed with their own reports; these included the Vienot Report (1995) from France, the King Report (1995) from South Africa, Toronto Exchange recommendations on Canadian Board practices (1995), the Netherlands Report (1997) and a report on corporate governance from Hong Kong Society of Accountants (1996)<sup>172</sup>.

As with the Cadbury Report, these reports were particularly concerned about the potential abuse of corporate power and similarly they called for greater conformance and compliance at board level, and recommended the use of Audit Committee as a bridge between board and external auditor and the wider use of independent outside directors<sup>173</sup>. This was meant to avoid the domination of audit process by senior management where the Chief Executive Officer tend to be closely involved with auditors during audit and any issues could be resolved before the auditor writes his reports consequently keeping the board ignorant. The same can be said of the Board of directors who may get close to auditors and have issues material for inclusion in the financial statements deliberated omitted keeping the general members ignorant of the true financial position of their affairs.

Serious considerations on corporate governance in Africa picked up from these reports especially the King report of South African that has greatly influenced governance practice in Africa. In Commonwealth countries where Kenya belongs, the push for good corporate governance gained momentum in 1995 when at a meeting of the Heads of State and Government it was resolved that each member state was going to promote good governance in its country. This effort culminated in the establishment of a forum to steer the process<sup>174</sup>. This processed was carried out and objective achieved as discussed in the next chapter.

Many countries have embraced good corporate governance practices and developed guidelines that organisations use to enhance governance practices. Hong Kong for example has proposed the following guiding principles to apply to ensure existence of effective Audit Committees<sup>175</sup>.

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<sup>172</sup> *Ibid*, p, 13.

<sup>173</sup> *Ibid*.

<sup>174</sup> Private Sector Initiative for Corporate Governance (1999) *Principles of Corporate Governance in Kenya and a Sample Code of Best Practice for Corporate Governance*, Foreword.

<sup>175</sup> Hong Kong Society of Accountants (2002) *The Guidelines for Effective Audit Committee*, p. 4.

- a) *Oversight role* – The Audit Committee should understand the respective roles and responsibilities of each party involved in the financial reporting and audit processes, including the management, the internal auditors and external auditors, and the interaction between these parties. It should satisfy itself that there are effective processes and safeguards employed by each party, that each carries out its functions effectively, and there are mechanisms to ensure accountability amongst the different parties.
- b) *Independent communication with internal audit* – In view of the unique position of the internal auditor as both an employee and a reviewer of management, and the tensions that this can create, the Audit Committee, with the support of the management, should develop a culture that promotes open disclosure on the part of the internal auditor to the Audit Committee, so that all identified problems are disclosed and dealt with. Copies of internal audit reports should be forwarded to the Audit Committee and formal mechanisms should be in place for meetings independent of management between the Audit Committee and the internal auditors.
- c) *Independent communication with external audit* – To ensure that the external auditors can perform their work independently and objectively, there should be formal mechanisms put in place, such as private meetings independent of management and/or regular reports made to the Audit Committee. In addition, the Audit Committee should promote a culture that values objective and critical analysis of the management and the internal audit process.
- d) *Discussions with key parties on issues relating to judgement and quality* – The Audit Committee is largely dependent upon the information supplied to it by the management and the internal and external auditors. It therefore needs to have candid discussions with all parties to provide the Committee with a greater insight into the considerations and processes behind the numbers entered in the financial statements, including matters that require the exercise of judgement and that impact upon the quality of the financial statements, financial reporting process and internal control and risk management systems.

- e) *Quality of membership* – The Audit Committee should carefully consider the qualifications required of its members. The Board should have in place mechanisms that encourage the selection and retention of diligent and knowledgeable Audit Committee members who are dedicated and willing to devote the requisite time and energy to these responsibilities, in addition to their other board duties<sup>176</sup>.

The guidelines have some critical components that if applied in Kenya will enhance the effectiveness of the Audit Committee. The Audit Committee should be established as a Committee of the Board with written terms of reference which deal clearly with its authority and duties. Formally constituting a Committee ensures that there is a clear relationship with the Board to which it reports. In particular, the authority to act on behalf of the Board and the Committee's areas of responsibility should be clearly defined.

The qualities of members that were considered in China to contribute to the effective operation of Audit Committees include: Soundness of judgment; independence of mind; objectivity; Inquiring attitude with a healthy degree of skepticism; sufficient understanding to deal adequately with the financial, accounting and auditing matters that the Committee will have to Consider; a clear understanding of the Society's business, its internal environment including its management structure, policies, business processes, management control and reporting systems; willingness and ability to commit sufficient time and effort to the committee's duties and responsibilities, including preparing and participating in committee deliberations and attending meetings. Factors such as the size and complexity of the Society, its financial reporting process, internal control and risk management systems and the quality of briefing papers provided by the management will directly affect the amount of time spent by the committee members in achieving their objectives<sup>177</sup>.

Audit Committee effectiveness is expected to increase as the proportion of experts in the Audit Committee increase. It is expected that Audit Committee member's expertise in finance enables a better understanding of financial statement and process<sup>178</sup>.

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<sup>176</sup> *Ibid*, pp. 4-5.

<sup>177</sup> *Ibid*, p. 7.

<sup>178</sup> Miettiner, J. (2008) "The Effect of Audit Quality on the Relationship Between Audit Committee Effectiveness and Financial Reporting Quality" *Business Administration and Accounting and Finance University of Wasaensia No. 197* p. 30.

### 3.3 Introduction of Audit Committees in Kenya

The idea of improving corporate governance in Kenya picked up in 1999 when at seminar held in Mombasa organized by M/S Dominion with participants drawn from the leading corporate organisations in Kenya. At the end of the seminar, an interim Committee was appointed with the mandate of doing all that was necessary to formulate code of best practice for corporate governance in Kenya and to coordinate, where applicable with other leading organisations in the region and beyond for purpose of improving corporate governance. The move was made on realization that the quality of governance at all levels was important for the success of both the politico-economy and its institutions. The shareholders in listed companies were also increasingly demanding better transparency and disclosure.

The Committee registered a Private Sector Corporate Governance Trust the same year<sup>179</sup>. The trust released the principles of corporate governance to be applied in Kenya and it is through these principles that the concept of Audit Committee was introduced in Kenya. It was recognized that a separate Audit Committee enables a Board to delegate to a sub-committee the responsibility for a thorough and detailed review of audit matters<sup>180</sup>. The Audit Committee was expected to have written terms of reference to deal with the membership, authority and duties.

The Capital Markets Authority (CMA) together with other organisations has been on the lead to ensure good governance especially for companies listed at the Nairobi Stock Exchange. The CMA developed guidelines on corporate governance for companies quoted at the Nairobi Stock Exchange in the year 2002<sup>181</sup>. The guidelines required the board to establish a formal and transparent arrangement for the shareholders to effect the appointment of independent auditors at each annual general meeting<sup>182</sup>. The CMA guidelines, provides that every listed company should establish an Audit Committee that complies with the guidelines on corporate

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<sup>179</sup> Private Sector Initiative for Corporate Governance (1999): *Principles of Corporate Governance in Kenya and Sample Code of Best Practice for Corporate Governance*, Foreword.

<sup>180</sup> *Ibid*, p, 20.

<sup>181</sup> Kenya Government, The Capital Markets Authority. (2002): *Guidelines on Good Corporate Governance*, Gazette Notice No. 3362.

<sup>182</sup> *Ibid*, Guideline No. 2.4 3.

governance issued by the authority<sup>183</sup>. This marked the entry of Audit Committee in 2002 in all the companies listed in the Nairobi Stock Exchange (now Nairobi Securities Exchange).

Most corporate organisations in Kenya have several gatekeepers of corporate governance such as a board of directors including a board Audit Committee, executive management, internal and external auditors. The Audit Committee is expected to play a vital role in providing independent oversight and has unique relationships with the other gatekeepers such as auditors, lawyers and government agencies. The chairman of the Audit Committee is required to be an independent and a nonexecutive director. The boards are required to disclose in their annual reports whether they have an Audit Committee and the mandate of such committees. In the case of DTS, they would be required to also disclose the existence of Supervisory Committee and its mandate. The Supervisory of DTS is independent of the Board hence no conflict of interest.

Onyango argues that gatekeepers of corporate governance are facing more and more scrutiny<sup>184</sup>. Heightened investor awareness of high-profile corporate failures, an increased risk of fraud, tightened regulatory and legal requirements and a fast-changing business environment are all contributing factors. Information technology and globalisation are also impacting on corporate governance. Concerns about Audit Committee effectiveness include whether they have the right skills or if they ask the right questions.

Housing Finance Company of Kenya Ltd is one of the companies listed in the Nairobi Securities Exchange. All the members of the Audit Committee are independent non-executive directors as it was publicly disclosed in 2012<sup>185</sup>. The Board considers that each member has appropriate professional qualifications and brings broad experience and knowledge of financial reporting to the Audit Committee's deliberations.

The Committee of Housing Finance Company of Kenya Limited reviews and monitors the integrity of the Group's annual and interim financial statements, circulars to shareholders and

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<sup>183</sup> Regulation F.01 Capital Markets Authority (2002) *Capital Markets (Securities) (Public Offers, Securities, Listing and Disclosure) Regulations*, Legal Notice No. 60 of 2002 3<sup>rd</sup> May 2002.

<sup>184</sup> Onyango, N. (2012) "Audit Committees can earn Public Trust", *Financial Focus Magazine on Risk and Regulation*, PWC Kenya, November 2012, p. 3.

<sup>185</sup> Housing Finance Company of Kenya (2012) *Information Memorandum Supplement*, 10th September 2012.

any formal announcements relating to the Group's financial performance, including significant financial reporting judgments contained within them. The Committee also reviews the appropriateness of the Group's accounting policies, recommendations for provisions against bad or doubtful loans and other credit exposures. Ultimate responsibility for the approval of the annual and interim financial statements rests with the Board. At least once a year, the Audit Committee of Housing Finance Company of Kenya Ltd meets separately with the external auditor and the Head of Internal Audit without Management being present to discuss any issues arising from the audit.

It is worthwhile to note that the oversight roles are also changing, over and above the traditional areas of financial statements and internal controls, Audit Committees increasingly oversee risk management programme design, its efficiency and effectiveness, responsibility and risk response. In addition, others oversee compliance with codes of conduct and ethics, compliance with laws and regulations and Management's action to resolve systemic issues. In some organisations, they monitor whistleblower and complaints hotlines, especially those relating to auditing and accounting issues.

Participating on an Audit Committee requires time and dedication to understand the issues well. The committee members need to have a good grasp of business issues and dedicate sufficient time. They need to have a high level of integrity as well as an inquisitive and open mind. In addition they ought to be prepared to challenge and maintain a healthy level of skepticism while maintaining objectivity. It should be noted that the positions in the Audit Committee should not be used for witch hunt to frustrate the working of the CEO and Management in general, but should be objective to help improve internal controls. There should be a culture of open disclosure where any identified weaknesses are discussed in the Board and solutions found.

The Chairperson needs strong leadership qualities and must encourage teamwork. He/she should also remain objective and be willing to dedicate additional time as well as possess adequate financial acumen and an awareness of international, regional and local financial and accounting best practices. He/she must be available in times of crisis outside of committee meetings in case urgent issues are raised by Management, internal or external auditors. The Chairperson must also drive high-quality reporting to the main Board on the work of the Audit Committee. Finally, the Committee should evaluate itself annually to ensure that it

adds value to the organisation and fulfills its mandate. If these principles were followed by more Audit Committees in Kenya, we would see a lot more confidence in corporate governance and growth among our companies, cooperatives and improved market conduct in general.

Onyango posits that Audit Committees must balance between advising and counseling Management with the fiduciary duty to monitor and oversee Management without interfering. To build trust, Audit Committees must cultivate effective communication channels<sup>186</sup>.

### **3.4. Emergence of Audit Committees in Savings and Credit Cooperative Societies (SACCOs) in Kenya**

The Savings and Credit Cooperative Societies (SACCOs) are a type of cooperatives whose main objective is to assist the members to save and borrow funds for various socio economic activities. They fall under the legal framework of the Sacco Societies Act<sup>187</sup> and the Cooperative Societies Act<sup>188</sup> in as far as the legal requirements for their formation and management is concerned. The Sacco societies Act, deals with the licensing, regulation and supervision of Deposit Taking SACCOs (DTS). The Sacco Act requires the appointment of auditors every year at an annual general meeting of the shareholders<sup>189</sup>.

The Centre for Corporate Governance in Kenya published guidelines on corporate governance for cooperatives in Kenya in 2005 which guided operations of SACCOs that chose to follow the guidelines since they were not binding in nature. However, the guidelines did not mention the types of committees to be established in cooperatives but only emphasized on the need to have committees to enable the board tackle keys areas more effectively. The guidelines further stated that the number and mandate of the committees should depend on the needs of specific cooperative societies, but should be appropriate to enable the board to deliver its mandate<sup>190</sup>.

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<sup>186</sup> Onyango, N. (2012) *Supra*, p. 3.

<sup>187</sup> Section 44 the Sacco Societies Act, Act No. 14 of 2008 Laws of Kenya.

<sup>188</sup> The Cooperative Societies (Amendment) Act, 2004 Laws of Kenya.

<sup>189</sup> The Sacco Societies Act (2008) *Supra*.

<sup>190</sup> Centre for Corporate Governance in Kenya (2005) *Guidelines on Corporate Governance in Cooperatives in Kenya*, p. 24.

The SACCOs having grown in size and complexity overtime and coupled with governance challenges that bedeviled the SACCO sub sector which include mismanagement, reported fraud cases, and conflict of interest, there was realization that governance challenges needed to be addressed through an Act of Parliament. The Sacco Societies Act enacted in 2008 by the Kenyan Parliament made provisions for the appointment of internal auditor who reports to the board of directors on the internal control system and financial matters of the society<sup>191</sup>. Though the Act does not directly provide for the establishment of Audit Committee, it is a commonly accepted practices that internal auditor reports to Audit Committee of the board, hence through the Deposit Taking Sacco (DTS) Regulations, 2010 it has been provided that Deposit Taking SACCOs are to constitute Audit Committees. These committees are to be duly constituted by the board of directors of the Sacco to review the financial conditions of the Sacco Society, its internal controls, performance and findings of the internal auditor and to recommend remedial actions at least once in every three months<sup>192</sup>. The Act further has other provisions on governance which SACCOs are expected to comply with<sup>193</sup>.

In addition, SASRA jointly with the MoCD&M and KUSSCO developed model by laws that incorporated establishment of Audit Committee by SACCOs. The model by laws for SACCOs provides that SACCOs should establish Audit Committees<sup>194</sup>.

### **3.5 The Composition, Functions and Role of Audit Committees in Kenya**

The regulations require that the Audit Committee in Kenya's deposit taking SACCOs be composed of not more than three members appointed from the Board of Directors, one of whom is required to be conversant with financial and accounting matters<sup>195</sup>. The regulations further provide that the chairman of the Board of Directors is not eligible to be appointed as a member of the Audit Committee.

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<sup>191</sup> *Ibid*, Section 43.

<sup>192</sup> Regulation 57, The Sacco Societies (Deposit –Taking Business) Regulations of Kenya, 2010.

<sup>193</sup> Sections 29- 47, The Sacco Societies Act, 2008.

<sup>194</sup> SASRA (2012) Model By-Laws for Saccos in Kenya, p. 24.

<sup>195</sup> Reg. 57(2) The Sacco Societies (Deposit Taking Business) Regulations, 2010.

The function of the Audit Committee of cooperative societies in Kenya is defined under the Sacco Societies (Deposit Taking Business) Regulations, 2010 as well as the provisions of the respective Sacco By-laws. While the roles of these committees are provided in the various laws, the committee members need the requisite skills and capacities in order to perform their work effectively. The primary duties of the Audit Committee under the regulations include: ensuring internal controls are established and effectively maintained; review of internal control including internal audit program and findings and recommendation to be taken; review internal audit reports; ensure that accounting and financial reports are promptly and accurately prepared; review coordination between internal and external audit functions as well as monitor external auditor independence; recommend three names of external auditor to the Board; review of external audit scope of audit plan; review of management reports and those from internal and external auditors on deviations and weaknesses in accounting and operational controls; investigate members complaints and consider matters of significance raised at general meetings<sup>196</sup>.

The Model Sacco by-laws in Kenya provide that the function of an Audit Committee is to assist the Board of the Sacco in providing an independent review of the effectiveness of the financial reporting process, internal control and risk management system of the Sacco, overseeing the audit process and performing other duties and responsibilities as assigned by the Board<sup>197</sup>. Though the model by-laws provide that the Audit Committee will conduct independent review of the financial process, the independence of the committee in Sacco governance structure is not largely tenable in most cases as the concept of independence has not been fully embraced. The members of the Audit Committee in SACCOs are both members and clients of the SACCO and benefit fully from the services offered by the Sacco, thus their absolute independence may be compromised being beneficiary of systems that sometimes may not be operating well and further that they are collectively responsible for actions taken by the Board as a whole.

The Audit Committee from global perspective is typically responsible for the financial reporting process; providing oversight of the SACCOs internal and external auditors; approving or recommending to the board for their approval, the appointment, compensation

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<sup>196</sup> *Ibid*, Regulations 57 (3).

<sup>197</sup> Article 53 Model By-Laws for Saccos in Kenya, *Supra*.

and dismissal of external auditors, reviewing and approving the audit scope and frequency; receiving key audit reports; and ensuring senior management is taking necessary corrective actions in a timely manner to address control weaknesses, non-compliance with policies, laws and regulations and other problems identified by auditors. In addition, the Audit Committee should oversee the establishment of accounting policies and practices.

In order to operate effectively, an Audit Committee requires the cooperation and support of the executive management in providing information and resources, and in implementing and carrying out the Committee's requests and recommendations. Members of the Committee are an integral part of the Board with specified legal responsibilities which they have to perform to ensure good governance and success in attainment of the objectives of the SACCO. Under the Sacco Regulations <sup>198</sup> the boards of directors are required to exercise prudence and diligence in conduct of their work and shall be held jointly and severally liable for any loss occasioned by their actions which are contrary to the Act. It is, therefore, in their best interests as Committee members to ensure adequate information is being supplied to them by the internal and external auditors. The failure of cooperation of the executive management can undermine the effectiveness of the Audit Committee in any organization hence critical to the success of executing their mandate.

Given the new SACCO legal framework and environment, it is essential for Audit Committees to focus on a process to support effective oversight that goes beyond mere compliance with the rules and by-laws. This requires an oversight framework that facilitates the coordination of the activities and information needed to support the Audit Committee's understanding and monitoring of the SACCO Societies' financial reporting process. The introduction of the Audit Committee therefore was meant to act as bridge between the Management and the Board to provide opportunity where the board can get information on regular basis on the soundness of internal controls and get an assurance that the business of the Sacco is being carried out in a safe manner.

The Committees can improve public confidence in the quality of financial reporting by adopting practices that are considered by the market as best practices an example is the governance disclosures in financial statements that SACCO's should embrace as this

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<sup>198</sup> Regulations 60(1), DTS Regulations, 2010, *Supra*.

enhances the attainment of transparency and accountability in reporting which is a key principle of corporate governance.

According to Sabia and Goodfellow, an Audit Committee cannot be effective if it does not have the right people as members. The Audit Committee members should be independent and competent<sup>199</sup>. Members' independence is generally defined as the absence of any relationship with the executive management or any other relation that may interfere with the exercise of their independence from management and the company<sup>200</sup>. The Audit Committee can therefore be strengthened by having members who are independent and what constitutes independence in the context of DTS can be defined.

The members of an Audit Committee should be selected preferably from all walks of life such as accountants, lawyers, educators, bankers and analysts<sup>201</sup>. The desired effect or goal of the Audit Committee is to strengthen the quality of financial information and to maintain/strengthen investor confidence in the quality of financial reporting. In the end, improved information quality as well as strengthened controls will result in cooperators being more confident about the quality of financial reporting and the functioning of the SACCOs.

The cooperative society members' perceptions may be affected by the adoption of practices that are considered as best practices for Audit Committees<sup>202</sup>. Several studies have examined how "financial expertise" relates to the identification of financial accounting reporting issues and the assessment of financial reporting quality<sup>203</sup>.

The top three most important roles of the Audit Committee are to review the internal audit programme, processes and the results of the internal audit reports; to review and monitor the

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<sup>199</sup> Sabia, M.J. & Goodfellow, J. L. (2005) "Integrity in the Spotlight", 2<sup>nd</sup> Edition. Toronto: *The Canadian Institute of Chartered Accountants, Smith Committee 2003*. p. 512.

<sup>200</sup> Blue Ribbon Committee (BRC)(1999) *Audit Committee Characteristics and Statements: A Study of the Efficacy of Certain Blue Ribbon Committee Recommendations*. New York: New York Stock Exchange and National Association of Securities Dealer.

<sup>201</sup> Mohamad, S. & Sori, Z. M. (2001) "The Role of Audit Committees in Supporting A Disclosure Based Corporate Environment" Some Comments: Akauntan Nasional. *Journal of Malaysian Institute of Accountants*, Vol. 14, No. 5, p. 8.

<sup>202</sup> Bedard, J. & Gendron, Y. (2009) *Strengthening the Financial Reporting System: Can Audit Committees Deliver?* Available at [www.camagazine.com](http://www.camagazine.com) (Accessed on 21st August 2013).

<sup>203</sup> McDaniel, L., Martin, R.D. & Maines, L.A. (2002) "Evaluating Financial Reporting Quality: The Effects of Financial expertise vs. Financial Literacy". *Accounting Review*, Vol. 77, p. 139.

effectiveness of the SACCOs; risk assessment procedures; and to review and analyze the adequacy and effectiveness of the internal accounting and financial controls. However, in the deposit taking Sacco context, the supervisory offers a great opportunity where the appointment of external auditor can be spearheaded by a Committee which is independent of the board and the names recommended to the general meeting for approval and appointment.

The Boards of SACCOs have full responsibility and authority for the management and supervision of the SACCO business. The Audit Committee does not take over these functions but is to report and make recommendations to the full Board on matters pertaining to its work and findings. The model by-laws provide that the Audit Committee should consist of not more than three members appointed from the board, one of whom should be conversant with financial and accounting matters<sup>204</sup>.

The primary responsibility of the Audit Committee is provided under the Sacco Regulations<sup>205</sup>. The responsibilities of the Audit Committee as stipulated in the regulations require a high degree of independence and therefore this degree of independence and impartiality should be maintained by ensuring that as the Audit Committee presents its findings to the board, the deliberations thereof should be unbiased and neutral to the Audit Committees findings. However, since the Committee members are drawn from the Board of Directors, it is difficult to perceive how such a Committee can be completely independent in its work without interference by members of the board who are not Audit Committee members but harbor same financial interests.

The Audit Committee was introduced into deposit taking SACCOs when Supervisory Committee was already in existence. However, a lot of thought may not have been put in redefining the role of Supervisory Committee as provided in the Cooperative Societies Rules to avoid duplication of roles with Audit Committee.

In order to ensure efficient management of cooperative affairs, the Cooperative Societies (Amendment) Act 2004 further provides that in the conduct of affairs of a co-operative society the members of the Committee are to exercise the prudence and diligence of ordinary

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<sup>204</sup> *Ibid*, Article 53(1).

<sup>205</sup> Regulation 57(3) The Sacco Societies (Deposit- Taking Business) Regulations 2010.

men of business<sup>206</sup>. The members are to be held, jointly and severally liable for any losses sustained through any of their acts which are contrary to the Act, rules, by-laws or the directions of any general meeting of the co-operative society. The joint and several liability of the board puts the Audit Committee in a situation where they can either perform well for fear of being liable or may shy away from exposing weaknesses that may affect them as board members. Their first duty is presumed to be to the board to who they are accountable to directly and secondly to members who elected them.

### 3.6. Emergence of Supervisory Committees of SACCOs in Kenya

The Supervisory Committee was first introduced in cooperatives in 1982 through a circular issued by the Commissioner for cooperative development; the circular was further reviewed in 1985 to enhance the role of Supervisory Committee<sup>207</sup>. However, it was not until 2004 that the Supervisory Committee was anchored in the Cooperative Rules made under the Cooperative Societies Act, Chapter 490 through amendments done to the Cooperative Societies Act, No 12 of 1997<sup>208</sup>.

The recognition of the Supervisory Committee in the 2004 amendments was due to the consequences of liberalization that SACCOs faced which included: corruption by Management officials; embezzlement of members' funds; endless litigation due to conflicts; illegal and unauthorized investments; nepotism; illegal payments to Committee members and conflict of interest among others<sup>209</sup>. These led to the amendments in 2004 to reintroduce state control and strengthen internal governance through introduction of Supervisory Committee to act as a bridge between the members and the Board of directors that is member's watchdog who would monitor the board and management and report any found malpractices to the members. The Cooperative Societies Rules<sup>210</sup> provides that the duties of the Committee shall include; verification of all transactions of the Society; writing reports of its findings and table

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<sup>206</sup> *Ibid*, Section 28 (6).

<sup>207</sup> Kenya, Government, Records from Department of Cooperative Development and Marketing Registry.

<sup>208</sup> Manyara, K. M. (2004) Cooperative Law in Kenya, Rock Graphics, p. 52.

<sup>209</sup> *Ibid*, p, 42.

<sup>210</sup> Rule 28 (3) Cooperative Societies Rules, *Supra*.

to Management Committee meeting read board of directors; submission to the Commissioner of Cooperatives ; and presenting its reports to the general meeting.

The Cooperative Societies Act 1997 provided that the Management Committee of the cooperative society was to be the governing authority and was only subject to any direction from the general meeting and the by-laws of the society with powers to enter into contract, to institute and defend suits and other legal proceedings brought in the name of or against the society and to do all other things necessary to achieve the objects of the society in accordance with its by-laws<sup>211</sup>. These provisions were retained in the amendments done in 2004 and specified that every co-operative society was to have a committee consisting of not less than five and not more than nine members<sup>212</sup>.

The Cooperative Societies Act<sup>213</sup> provides for disqualification of Management Committee members of a cooperative. The Management Committee members under the Sacco Act are the equivalent of Board of Directors under the Sacco Act. These factors as provided in the Act among others disqualify any person from being a member of any Committee of a Sacco including the Supervisory and Audit Committee. The Act further provides that the committee may delegate any of its duties to an officer or officers of the Society but the Committee would still be responsible for any actions of the delegates. The Committee is therefore not absolved from its responsibility to run the affairs of the co-operative society in proper and businesslike manner.

In the normal working of the Supervisory Committees in Cooperative Societies, they check on internal controls and all the areas provided for Audit Committee under the Sacco regulations except on issues related to external auditors. This may point to a clash of roles at some point if clear distinction is not made. In addition, the practices from other jurisdictions which will be discussed in later part of this research indicate that the role of the Audit Committee should include appointment of external auditor and not mere recommendation to the board. The committee should be reporting the same to the general meeting; hence this role

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<sup>211</sup> Section 27 The Cooperative Societies Act 1997, Laws of Kenya.

<sup>212</sup> Section 28, The Cooperative Societies (Amendment) Act 2004, Laws of Kenya.

<sup>213</sup> Section 28(4) the Cooperative Societies (Amendment) Act 2004.

is best suited to be performed by the Supervisory Committee which is not part of the Board and is accountable to the general membership who they report to in the general meeting.

### 3.7. The Legal Framework of the Supervisory Committee

The establishment and roles of the Supervisory Committees of SACCOs was formally provided for in the cooperative Societies Act in 2004 and the related cooperative Societies Rules<sup>214</sup>. Though SACCOs established Supervisory Committees through provisions in their by-laws much earlier guided by the circulars from the commissioner's office, it was not until 2004 that the Supervisory Committee was anchored in the law. The Cooperative Societies (Amendment) Act 2004 defines a Supervisory Committee as an oversight committee elected at the general meeting of cooperative society members<sup>215</sup>.

The legal framework for the Supervisory Committee of Cooperative Societies was deeply entrenched in the Co-operative Society Rules 2004<sup>216</sup>. The rules require that every cooperative society should establish a Supervisory Committee consisting of three members each elected at a general meeting for a period of three years and one member of the Supervisory Committee who is to retire annually<sup>217</sup>. The election of the Supervisory Committee is conducted in accordance with Rule 28 and relevant by-laws of the society.

The Cooperative Societies Rules 2004 further provide that any member of the Supervisory Committee can be removed by a resolution of the general meeting<sup>218</sup>. In addition at least one member of the committee is to have basic bookkeeping, accounting, and auditing or financial management knowledge. It is further provided that, where no such person is elected; those elected may be taken for basic accounting training. Though this provision exists, it needs to go further and set timelines within which such trainings should be undertaken.

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<sup>214</sup> *Ibid*, Section 2, See also the Kenya Cooperative Societies Rules 2004.

<sup>215</sup> Section 2, Cooperative Societies (Amended) Act 2004, *Supra*.

<sup>216</sup> The Cooperative Societies Rules, 2004.

<sup>217</sup> *Ibid*, Rule 28 (1).

<sup>218</sup> *Ibid*, Rule 28 (2).

### 3.8. The Election of the Supervisory Committee

The Supervisory Committee is elected directly by the Sacco members at a General Meeting<sup>219</sup>. The committee occupies the same position as the board of directors in the organization structure of the society, it is to be independent and not be a sub-committee of the board. They play supervisory role on behalf of the members of the Sacco and report to the annual general meeting. The members are to ensure that only reliable persons with the required competence are elected as directors. However, this is where the challenge comes where through democratic principles a candidate with the majority is elected notwithstanding that he/she may not have the required skills.

The operations of Supervisory Committees in cooperatives have been dogged with a lot of political undertones and being elected by members as distinct from the board it offers additional leadership position that many SACCOs would not want to let go. The political aspect and the aspiration of the Supervisory Committee members to move and serve in the board sometimes compromise their objectivity and in some cases reports may be given to discredit the serving board members to have them removed. This aspect more often than not undermines the very intention of the committee when it is used as a witch hunt tool with the objective of creating a vacancy in the board and not offer objective oversight role. Having provision in the law to prohibit those that have served in the Supervisory from being Board members for a certain period after expiry of their term as Supervisory Committee members may offer solution to this.

However, in cooperatives where good corporate practices have been embraced the committees' try to work well albeit with challenges on independence of Audit Committee members and duplication of roles between the Audit and Supervisory Committee. The committees in such SACCOs have helped improve internal control systems, and offered additional assurance to the general membership on the safety and soundness of the society's operations. Therefore strengthening and redefining the roles of the two Committees will address these challenges and enhance corporate governance in DTS.

To avoid the politics surrounding the aspiration of Supervisory Committee to ascend to the board, some SACCOs such as United Nations have incorporated provisions in the by-laws

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<sup>219</sup> *Ibid*, Rule 28( 1).

that a Supervisory Committee member cannot be elected to the board of the Sacco two years succeeding his/her term as Supervisory Committee member<sup>220</sup>. These are steps that will help build on the objectivity of the Committee while executing their mandate and avoid raising issues only meant to discredit the board for their self-interest of ascending to the board. The period can be increased to even three years to reflect the full term of a board member.

Unlike in corporate world where they have had Audit Committees to offer oversight, Supervisory Committee in cooperatives has been the oversight body reporting direct to the annual general meeting though its reports and recommendations are discussed with the board prior to presentation to the annual general meeting but without compromising the findings. It is a practice that has been embraced by all cooperatives and in the researchers view it only requires strengthening of their role to offer members additional assurance independent from the board.

The Audit Committee as constituted in SACCOs now does not meet the threshold of independence required of Audit Committee hence the Supervisory Committee whose membership is drawn from the general members should continue to be elected and serve provided their duties and roles are clearly redefined and approved. However, cooperatives should in the long run consider having independent directors who would be brought on board to fill in skills gap to ensure mix of skills in the board committee. This would help more particularly where membership is drawn from one profession. The additional skill would further help in reports presented to the Committee being critically interrogated for the benefit of members.

### **3.9. The Functions and Roles of Supervisory Committees in Kenya**

The term Supervisory Committee and Audit Committee are used interchangeably in some jurisdictions, however, in Kenya the Supervisory Committee and the Audit Committee are provided under different legal regimes that apply to deposit taking SACCOs. The Supervisory Committee in Kenya is established under rule 28 of the Co-operative Society Rules<sup>221</sup>. In order to effectively undertake their duties, the Supervisory Committee members

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<sup>220</sup> By law No.75 (a) United Nations Sacco Societies Ltd (2012) By laws. Accessed from [www.unsacco.unon.org/downloads/By\\_laws.pdf](http://www.unsacco.unon.org/downloads/By_laws.pdf) – on 2<sup>nd</sup> November, 2013.

<sup>221</sup> Cooperative Societies Rules 2004, Legal Notice No. 123 of 2004, *Supra*.

are required to have the same qualifications as those of the members of the Management Committee in cooperative. Leadership is a major factor in cooperative organizational and management development. Cooperatives deserve visionary, competent, dynamic and professional leadership given their elaborate business model of ownership, purpose, structure, principles and values<sup>222</sup>.

The Supervisory Committee serves as the internal Audit Committee of Sacco Societies who have not established Audit Committees. Its role is complimentary to that of the Board of directors which is mainly to ensure that there is an effective control system in the society. The main objective is that of assisting the board of directors in ensuring that adequate checks and balances are put in place and that the principles of transparency and accountability are observed for the good of the Society and its members. The Committee is elected by the members in the general assembly hence is accountable to the general membership and not the board of directors.

The duties of the Supervisory Committee as provided under the cooperative Societies Rules includes the verification of all transactions of the society; writing periodic reports of its findings to be tabled at Management Committee meetings; submission of its reports to the Commissioner of Cooperatives and presenting its reports to the general meeting<sup>223</sup>. The Supervisory Committee is however required not to perform any of the duties that are performed by another committee of the Society or to exercise any of the powers of the Committee of the society<sup>224</sup>.

Highlands SACCO society has the following tasks listed for the Supervisory Committee among others: scrutiny of minutes of all committees and General Meeting; scrutiny of members' cheques /loan registers; verify receipts and disbursement of society funds; verify the assets of the society against the assets register from time to time. The Committee further scrutinizes the acquisition and disposal of goods and services and adherence to the procurement and disposal regulations; verify deductions through the check off system, cash

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<sup>222</sup> Kobia, S.K. (2011) *Supra*, p. 15.

<sup>223</sup> Rule 28(3) Cooperative Societies Rules 2004.

<sup>224</sup> *Ibid*, Rule 28 (4).

and bank standing order remittances; confirm cash regularly and reconcile it with the records; check out bank accounts monthly and their reconciliation; check delinquent loans among the Committee, staff and members and ensure appropriate action is taken.

In addition, the committee checks loan applications and note anomalies; check balance sheets and income and expenditure statements to ensure their accuracy; ensure the books of the society are kept in accordance with the internationally accepted standards; make regular review of budgets against actual performance; attend to members' complaints; assist the Management Committee in seeking to problems facing the society; generally ensure that the society is operating according to the law and working towards the achievement of the stated goals and objectives<sup>225</sup>.

The tasks as outlined in these by laws demonstrate that there is need to redefine the role of Audit and Supervisory Committee to avoid duplicity of roles. The functions undertaken by Supervisory Committees are similar to those prescribed for the Audit Committee under the Sacco societies Act for SACCOs operating FOSA. This situation is compounded due to the fact that Cooperatives Societies Rules only provide for broad outline of what the Supervisory Committee should do whereas the Sacco regulations provides details on the role and responsibilities of Audit Committee. There is therefore need to reconsider the roles of both to clearly define what each should do and set boundaries.

### **3.10. Conclusion**

The Supervisory role has changed from reviewing loan files, members statements, performing cash counts and confirming closed accounts to currently understanding the risks their institutions are facing and governance challenges to ensure compliance and that policies are put in place to counter negative effects. The roles of Audit and those of Supervisory Committee in practice have been found to have similarities which need to be addressed. The next chapter will therefore have comparison on the practice obtaining in selected countries to be able to make recommendations that can be adopted on the roles of Audit and Supervisory Committee of DTS in Kenyan to avoid duplication.

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<sup>225</sup> Article 65 Highlands Sacco Societies Ltd, By laws. Accessed from [Kenyahighlandssacco.co.ke](http://Kenyahighlandssacco.co.ke).

## CHAPTER FOUR

# COMPARATIVE STUDIES ON THE COMPOSITION, FUNCTIONS AND ROLES OF AUDIT AND SUPERVISORY COMMITTEES IN BRAZIL, U.S.A AND SOUTH AFRICA

### 4.1. Introduction

This chapter makes a comparative study of the functions and roles of the Audit and Supervisory Committees in Brazil, United States of America (US) and South Africa. Whereas the administrative structure of the SACCOs in Kenya & South Africa and Credit Unions in the United States of America & Brazil may be different and unique, the roles and functions of both the Audit and Supervisory Committees in these countries and institutions are meant to achieve the same objectives.

The United States of America has been chosen due to long history of Audit Committee in the country, on the other hand the Supervisory Committee that operate in the Credit Unions in the US are the equivalent of Audit Committee in Kenyan DTS since they are appointed by the Board. Secondly, Brazil was chosen due to the gains they have achieved in embracing international best practices in governance that have seen the financial cooperatives prosper, they have Statutory Audit Committee which is the equivalent of Supervisory Committee in Kenya and Audits which handles internal audit. South Africa has been considered due to the King reports in particular the King III report which also provides guide for financial cooperatives in South Africa. The King reports have greatly influenced corporate governance practices in Africa. The three countries therefore provide a good sample that we can draw experience from and further considering that the structure of SACCOs is unique to cooperatives which comparison can then only made to other SACCOs/Credit Unions/Financial Cooperatives in other parts of the world.

The Audit Committee is a construct that has developed historically as a manifestly critical necessity within the workings of the board of directors. According to Rickard, the responsibility of an Audit Committee is to safeguard the independence of the internal

audit function and ensure continual improvement in management performance and accountability by seeking action on internal audit and external audit reports<sup>226</sup>.

Marrian also states that an Audit Committee's has no operating responsibility in financial management<sup>227</sup>. She states that its primary tasks are to review the financial statements, the effectiveness of the company's accounting and internal control systems, and the findings of the auditors, and to make recommendations on the appointment and remuneration of the external auditors.

Further studies show that the most important roles of the Audit Committee are: to review the internal audit programme, processes and the results of the internal audit report; to review and monitor the effectiveness of the company's risk assessment procedures; and the review and analysis of the adequacy and effectiveness of the internal accounting and financial controls of the company<sup>228</sup>.

One of the areas where it has been accepted that Audit Committee plays an important role is the appointment of external auditor, in the case of Sacco regulations the Audit Committee only recommends to the boards three names. Studies have shown that quality of financial reporting is greatly reduced where the boards of directors have a hand in appointment of external auditors. The majority of respondents in the study on effectiveness of Audit Committee in Malaysia indicated that Audit Committee effectiveness and independence would be greatly enhanced if the Audit Committee were to appoint the external auditors<sup>229</sup>.

The study further revealed that if the Audit Committee determined and reviewed the auditor's scope and duties, there would be a more cost-effective and thorough audit. The increase in cost effectiveness when a thorough audit is conducted is measured in terms of the benefit that the shareholders gain in the long term through good and reliable financial

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<sup>226</sup> Rickard, P. (1993) "Audit Committees, the Next Generation", *Australian Accountant*, Vol.63, Iss.10 p. 35.

<sup>227</sup> Marrian, I. (1988) *Audit Committees The Institute of Chartered Accountants of Scotland*, Edinburgh, p. 2.

<sup>228</sup> Sori, Z.M. (2007) "Audit Committee Authority and Effectiveness: The Perceptions of Malaysian Senior Managers" *International Research Journal of Finance and Economics ISSN 1450-2887 Issue 8*, @ Euro Journals Publishing, p. 54.

<sup>229</sup> *Ibid*, p. 51.

reporting. However, where the Audit Committee is part of the board, the appointment of the external auditor through them remains a decision of the board since the committee works on delegated powers. It is therefore important to note that this can only be achieved where the committee is independent. In the SACCO context, the Supervisory would then be best suited to perform that role.

It is important to have an Audit Committee charter or terms of reference outlining the committee's duties and responsibilities, which they are expected to achieve or pursue. The disclosure of the charter in the annual report would greatly or partly enhance the perceptions of users of financial statements concerning the effectiveness and role of the committee. The charter would signal the seriousness of the committee's intent to undertake appropriate measures to ensure shareholders' and stakeholders' interests are protected, and would also indicate that they are pursuing good corporate governance consistent with international best practice<sup>230</sup>.

## 4.2 Brazil

The Audit Committee of cooperatives in Brazil is a statutory body and is independent from the cooperative administration, it reports direct to the General Assembly hence less subject to conflict of interest. Its main purpose is to supervise the acts of both the strategic and executive administrators, and verify the performance of their duties, either legal or established in the cooperative by laws<sup>231</sup>. In addition it examines the management and administration acts that have an impact on the cooperative achievements. This strengthens the role of the statutory Audit Committee as the most important body of supervision and control by members since it is not subordinated to the cooperative administrative body which is equivalent to board of directors but performs as representative of the cooperative members.

The duties of the statutory Audit Committee in Brazil are centered on supervision, preparation of special reports and financial or accounting statements. Members of the

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<sup>230</sup> *Ibid*, p. 53.

<sup>231</sup> Brazil (2008) *Guidelines on Good Practices of Financial Cooperative Governance*, p. 45.

committee have responsibilities paired with that of an administrator and may be liable for legal actions started by members or third parties<sup>232</sup>.

The effectiveness of Audit Committee as noted in early chapters of this study depends on its independence; the Brazilian legislation has provision that members of statutory Audit Committee shall not have business beyond those transacted as cooperative member<sup>233</sup>. Members of the committee are not be employees or hold relevant participation in any entity or company that may offer a service or product to the cooperative, and may not be, in addition, spouses or relatives up to the second degree of the members of such entity or company<sup>234</sup>. It is further noted in the code that allowing any cooperative member to be a member of Audit Committee without limitation establishes possibility of conflict between interests of a member of the committee and interests of the cooperative, jeopardizing supervision work.

Other duties that are recommended to be performed by the Audit Committee in Brazil by the Code of Pest Practices in Good Corporate Governance include to review the financial statements, supervise and promote financial area accountability, ensure that the management develops reliable internal controls (which the committee should fully understand and adequately monitor), Internal Audit performs its role satisfactorily, and independent auditors review and assess Management and Internal Audit practices. The committee should also ensure compliance with the organization's Code of Conduct.

Just like in Kenya, United States and South Africa, at least one member of the Audit Committee in the financial cooperatives in Brazil should have proven experience in the accounting and auditing fields<sup>235</sup>. The Audit Committee and the Board of Directors perform joint duties. For example, the Board of Directors and the Audit Committee is required to continuously monitor the assessments and recommendations of the independent auditors and internal auditors on the controls and risks environment. The

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<sup>232</sup> Article 1,070, Brazilian Law, No. 10406 of 2002.

<sup>233</sup> *Ibid*, Article 1,060 Paragraph 1.

<sup>234</sup> Brazil (2008) Article 5.1 *Cooperative Governance Guidelines for Good Practices of Financial Cooperative Governance*, P. 47.

<sup>235</sup> *Ibid*, Article 2. 30, p. 45.

Board of Directors and the Audit Committee is also required to ensure that the Directors account for actions taken on these recommendations<sup>236</sup>.

The scope of the Statutory Audit Committee in Brazil is not limited to analyzing accounting, economic and financial data. It extends to examining and issuing opinions on all facts belonging to the cooperative management. The law itself amplifies the scope of the Statutory Audit Committee by establishing the competence of the committee to issue opinions on proposals made by the administration bodies to be submitted to the General Assembly, related to changes in capital, investment plans and capital budget, incorporation and split and mergers<sup>237</sup>.

The Statutory Audit Committee in Brazil proposes appointment of external auditors to the general meeting and monitor independence of external auditors. They have supervisory duties of ensuring implementation of governance rules, legislation.

The Statutory Audit Committee in Brazil is required to deliver to cooperative members whenever requested, information on matters of its competence<sup>238</sup>. One member of the committee is required to attend the General Assembly of the Cooperative and answer requests for information formulated by cooperative members. The guideline ensures that the cooperative uses institutional channels so that its members may follow and make demands on the work of the Statutory Committee, the Committee members of which are to report to the members and the general assembly as the sovereign body of the cooperative. The workings of the Audit Committee in Brazil has been made effective through provisions in the law and clear guidelines to guide their working procedures making it one of the successful countries in embracing internally accepted good corporate governance practices among cooperatives.

It is considered under the Brazilian code that the Statutory Audit Committee be sufficiently compensated to attract qualified individuals. The statutory Audit Committee in the cooperative hierarchy has similar powers to those of strategic administrative body

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<sup>236</sup> *Ibid*, p. 46.

<sup>237</sup> Brazilian Law, No. 6404 of 1976.

<sup>238</sup> Brazil (2008) *Guidelines No. 11 on Good Practices of Financial Cooperative Governance*, p. 50.

and may be liable for its acts and omissions, before both civil and criminal courts. Article 56 of Law no.5764/1971 determines that cooperatives shall be supervised permanently and meticulously. Supervision with such in depth and frequency shall only be possible when performed by qualified individuals, who will only provide their services for a sufficient and attractive remuneration<sup>239</sup>. The perception among cooperatives that boards of directors are superior to Supervisory Committee has made some Supervisory Committee members feel intimidated greatly compromising their independence in performance of their duties.

Under the Brazilian law the internal audits works with the board to protect audit activities in case of conflict of interest arise. Further example of governance structure in Brazil relating to companies is that they have: the Board of Auditors, the Audit Committee and Internal Audit who are all bodies covered by the bylaws, which ensure the inspection and control of the Organization's management. The Board of Auditors functions on a permanent basis, and consists of five full -time members elected at the General Shareholders Meeting for a mandate of one year. The Audit Committee which is part of the Board has the responsibility, among others set out in the legislation, of advising the Board of Directors in the exercising of its inspection role. It consists of three full-time members and one substitute elected by the Board of Directors for a mandate of one year, which can be renewed for up to five years. The Internal Audit reports to the Board of Directors, and has the main mission of advising the Board of Directors, The Board of Auditors and the Executive Board in the carrying out of audits, with a focus on risk. Its head, the Auditor General, is chosen among the active employees and is appointed or dismissed by the Board of Directors<sup>240</sup>.

### **4.3. United States of America (U.S.A)**

The first meaningful wave of active Audit Committees appearing in boards of corporations in the U.S.A was in the 1960's<sup>241</sup>. However, their influence was generally

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<sup>239</sup> *Ibid*, Article 10, p. 50.

<sup>240</sup> [http://www.wda.ie/index.php?option=com\\_content&view=article&id=81&Itemid=98](http://www.wda.ie/index.php?option=com_content&view=article&id=81&Itemid=98). Accessed on 2<sup>nd</sup> November, 2013.

<sup>241</sup> Pomeranz, Felix (1997) "Audit committees: where do we go from here?" *Managerial Auditing Journal*, Vol. 12 No. 6, p. 281.

considered to be limited and their necessity was questioned until the NYSE required all of its listed companies to establish them by June 30, 1978<sup>242</sup>. An Audit Committee is defined as a standing committee of Board of Directors established to work directly with the auditors, both independent and internal, as well as with the representatives of other accounting-related activities as seems appropriate<sup>243</sup>.

The comparison of Audit Committees in company's is significant in this study since Audit Committee first started in companies, it is therefore important to understand how they have functioned, the challenges they have faced and any best practice that can be borrowed and customized to suit SACCOs own specific circumstances. It will also offer lessons on what should be avoided to ensure effective function of the committees.

The Audit Committee in the US was nonetheless widely recommended and promoted by external agents such as researchers, regulators, and the audit profession in the later part of the 20th century. It received broad recognition through a historical endorsement in 1987 from the National Commission on Fraudulent Financial Reporting, commonly referred to as the Treadway Commission<sup>244</sup>.

The Blue Ribbon Committee in the US formed by the NYSE and National Association of Securities Dealers (NASD) was specifically to make recommendations for improving Audit Committees in their listed corporations. In its published report, the Committee concluded:

“A key element of board oversight is working with management to achieve corporate legal and ethical compliance. Such oversight includes ensuring that quality accounting policies, internal controls, and independent and objective outside auditors are in place to deter fraud, anticipate financial risks and promote accurate, high quality and timely disclosure of financial and other material information to the board, to the public markets, and to shareholders. This

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<sup>242</sup> Vanasco, Rocco R. (1994) “The Audit Committee: An International Perspective”, *Managerial Auditing Journal*, Vol. 9 No. 8, p. 18-19.

<sup>243</sup> Mautz, R.K. & Neumann, F.L. (1977) *Corporate Audit Committees, Policies and Practices*, Urbana: University of Illinois, p. 7.

<sup>244</sup> Pomeranz (1997) *Supra* p. 281. The Commission's Chairman was James C. Treadway, Jr. who was also Chief Legal Counsel of a Major Wall Street Securities Brokerage and Investment Firm.

oversight function is typically delegated by the full board to the Audit Committee, pursuant to the board's general ability under state law to delegate certain of its duties to Committees<sup>245</sup>”.

Just like in Brazil, Kenya and South Africa, it is provided in the US law that the committee must appoint one person with financial expertise in the Audit Committee of a credit union<sup>246</sup>. The person must have additional knowledge of financial reporting, internal controls, and auditing issues. The composition of Audit Committees with independent and qualified individuals in the USA is considered as the crucial factor of monitoring effectiveness<sup>247</sup>.

The Public Company Accounting Reform and Investor Protection Act (otherwise known as the Sarbanes-Oxley Act) enacted by US Congress in 2002 assigned key duties and authority to the Audit Committee of US nationally listed and traded public corporations. The Securities and Exchange Commission (SEC) regulations adopted in response to the legislation state:

“Under Section 3(a)(58) of the Exchange Act, as added by Section 205 of the Sarbanes-Oxley Act, the term Audit Committee is defined as:

“A committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and if no such committee exists with respect to an issuer, the entire board of directors of the issuer<sup>248</sup>.”

The role of Audit Committees in the US continues to evolve based on the Sarbanes-Oxley Act of 2002 (SOX) and involves oversight of regulatory compliance and risk management activities, overseeing the financial reporting and disclosure process, monitoring choice of accounting policies and principles, overseeing hiring, performance and independence of the

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<sup>245</sup> Blue Ribbon Committee Report (1999) *Supra*, p. 20.

<sup>246</sup> Section 407, Sarbanes-Oxley Act 2002 *Supra*.

<sup>247</sup> Scheffler.(2003) *European Company Law Review* – “Aufgaben und Zusammensetzung von Prüfungsausschüssen (Audit Committees), Zeitschrift für Unternehmens- und Gesellschaftsrecht” 32, *Supra*, p. 245.

<sup>248</sup> United States Securities and Exchange Commission, (2003) *Supra*, Release Nos. 33- 8220; 34-47654.

external auditors, oversight of regulatory compliance, ethics, and whistleblower hotlines, monitoring the internal control process, overseeing the performance of the internal audit function and discussing risk management policies and practices with Management<sup>249</sup>.

The Sarbanes Oxley Act 2002 (SOX) attaches a great deal of importance to the role of the Audit Committee. It dramatically expands the scope of Audit Committees by providing for new responsibilities such as pre-approving non-audit services and increasing the monitoring effectiveness of the committee by such measures as providing whistle-blower protection. SOX require that all members of Audit Committees be independent<sup>250</sup> and that companies disclose whether or not there is at least one financial expert in the Audit Committee<sup>251</sup>.

Klein posits that SOX enhanced the regulation on Audit Committee by legislating federal requirements and responsibilities of the Audit Committee<sup>252</sup>. The Audit Committee pre-approves most non-auditing services<sup>253</sup>. It is directly responsible for the appointment, compensation, and oversight of the auditor, who must directly report to the Audit Committee<sup>254</sup>. Further section 301 gives the Audit Committee the authority to engage independent counsel and other advisors as necessary to carry out its duties and requires each Audit Committee to establish procedures to deal with complaints regarding accounting and auditing related matters.

However, the requirement in SOX that the composition of Audit Committees must be completely independent has not been met with unanimous agreement by different authors<sup>255</sup>. Although applauded by many as a necessary step to improve Audit Committee effectiveness,

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<sup>249</sup>Okpala, K.E. (2012)"Audit Committee and Integrity of Financial Statements: A Preventive Mechanism for Corporate Failure" *Australian Journal of Business and Management Research Vol.2 No.08, November 2012*, p. 34.

<sup>250</sup> Section 301, Sarbanes -Oxley Act, 2002.

<sup>251</sup> *Ibid*, Section 407.

<sup>252</sup> Klein, A. (2003)"Likely Effects of Stock Exchange Governance Proposals and Sarbanes-Oxley on Corporate Boards and Financial Reporting" *Accounting Horizons, Vol 17 (4)*, p. 345.

<sup>253</sup> SOX, *Supra*, Section 202.

<sup>254</sup> *Ibid*, Section 301.

<sup>255</sup> Klein, A. (2003) *Supra*, See also an article by Bronson S.N: *Are fully Independent Audit Committees Necessary?* p , 1.

some have conversely argued that this requirement of SOX may have been an overreaction and too restrictive. They argue that allowing some non-independent members on the Audit Committee may be helpful as the costs of having an Audit Committee that is completely independent of management might outweigh the potential benefits in some cases<sup>256</sup>. In the authors view, the Audit Committee requires independence to be effective and efficient without any conflict of interest that might jeopardise their judgement in execution of their critical mandate.

The New York Stock Exchange (NYSE) 2008 standards require that Audit Committee should comprise at least members who must be independent of the company and be financially literate. In addition at least one Audit Committee member must be a financial expert. It defines independence as freedom from relationship to the company that may interfere with the exercise of the director's independence of management and company, while financial literacy refers to committee member's ability to understand fundamental financial statements such as balance sheet, income statement and cash flow statement<sup>257</sup>.

While in Brazil and South Africa credit unions/ SACCOs have Audit Committees that are independent of the financial cooperatives, United States & Kenya's Audit Committees are not completely independent of the cooperative administration. This is because the members of the Audit Committee of SACCOs in Kenya are drawn from the Board of Directors who may influence the decisions of the Committee.

Additionally, in the US, Audit Committees have various roles and duties. Their main purpose is to provide assistance to the Board of Directors in fulfilling their oversight responsibility to the shareholders, potential shareholders, the investment community, and others relating to: (i) the integrity of the Company's financial statements; (ii) the effectiveness of the Company's internal control over financial reporting; the Company's compliance with legal and regulatory requirements; (iv) the independent registered public accounting firm's qualifications and

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<sup>256</sup> Okpala, K.E. (2012) "Audit Committee and Integrity of Financial Statements: A Preventive Mechanism for Corporate Failure", *Australian Journal of Business and Management Research Vol.2 No.08, November 2012, Supra*, p. 34.

<sup>257</sup> Miettiner, J. (2008) *Supra*, p, 17.

independence; (v) and the performance of the Company's internal audit function and independent registered public accountants<sup>258</sup>.

Cobb investigated the purposes of the Audit Committee in the US during the 1980s and found some disagreement among commentators regarding such purposes. However, the author was able to identify four main objectives for the formation of such committees, namely, reduction of board liability, establishing links between the external auditor and the board, the reduction of illegal activity and the prevention of fraudulent financial reporting<sup>259</sup>.

Treadway Commission in the US ranked the reduction of illegal activity and the prevention of fraudulent financial reporting as the primary roles of the Audit Committee<sup>260</sup>. Al-Lehaidan states that Audit Committee responsibilities are diverse and appear to be expanding, which makes it very hard for Audit Committee members to understand all these responsibilities especially in the absence of an Audit Committee charter. In addition, oversight of financial reporting, auditing and controls were the most important Audit Committee oversight responsibilities<sup>261</sup>.

Audit Committees provide a focus and means for a fuller view and analysis of the matters relating to auditing, internal controls and financial reporting. Wolnizer summarised the functional Audit Committee recommendations of corporate governance commissions and committees in the US, UK, Canada and Australia<sup>262</sup>. He demonstrated that Audit Committees are expected to perform almost exclusively in the technical areas of auditing, internal control and financial reporting. In fulfilling its purpose, it is the responsibility of the Committee to maintain free and open communication between the Committee, independent registered public accountants, the internal auditors, and Management of the Credit Union or Sacco and to determine that all parties are aware of their responsibilities.

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<sup>258</sup> Ernst & Young (2009) *The Audit Committee Member Toolkit*, p. 2.

<sup>259</sup> Cobb, L. (1993) *an Investigation into the Effect of Selected audit Committee Characteristics on Fraudulent Financial Reporting*, Doctoral Dissertation, University of South Florida, p. 1.

<sup>260</sup> United States Tread Way Commission Report of 1987, p. 1.

<sup>261</sup> Al-Lehaidan, J. (2006) *Audit Committee Effectiveness: Australia and Saudi Arabia*, a Doctoral Dissertation, Victoria University, p. 48.

<sup>262</sup> Wolnizer, P. (1995) *Supra* "Are Audit Committees Red Herrings?" *ABACUS*, Vol.31, Iss.1, p. 46.

Supervisory Committee in the US refers to a Supervisory Committee as defined in the Federal Credit Union Act<sup>263</sup>. The Committee is appointed by the board of directors and should consists of not less than three members not more than five members, one of whom may be a director other than the compensated officer of the board<sup>264</sup>. A record of the names and addresses of the executive officers, members of the Supervisory Committee, credit committee, and loan officers, shall be filed with the Administration within ten days after their election or appointment. The structure of the Supervisory Committee of credit unions in US is similar to that of Audit Committee in Kenya.

The National Credit Union Association Rules and Regulation §715.4-§715.8 set forth the minimum requirements for a Supervisory Committee audit and verification consistent with the Federal Credit Union Act<sup>265</sup>. Supervisory Committees often engage external auditors to assist them in meeting this requirement<sup>266</sup>. The Electronic Code of Regulations further provide that for some federally-insured state chartered credit unions, the Audit Committee designated by state statute or regulation is the equivalent of a Supervisory Committee<sup>267</sup>.

The electronic Code of Regulations further provides for both the general and specific of the Supervisory Committee. Its basic responsibility is to ensure that the Board of Directors and Management of the credit union meet required financial reporting objectives and establish practices and procedures sufficient to safeguard members' assets<sup>268</sup>.

The Supervisory Committee in the US has the specific responsibility to determine whether: Internal controls are established and effectively maintained to achieve the credit union's financial reporting objectives which must be sufficient to satisfy the requirements of the Supervisory Committee audit, verification of members' accounts and its additional

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<sup>263</sup> Section 111(b), Federal Credit Union Act, US Congress, (1934) as amended in April, 2013 12 U.S.C. 1761(b).

<sup>264</sup> *Ibid*, Section 1761(b).

<sup>265</sup> United States Credit Union Examiners Guide, Chapter 5 (2013), p. 5-4.

<sup>266</sup> Section 115 Federal Credit Union Act of United States of America (1934), *Supra*.

<sup>267</sup> The Electronic Federal Code of Credit Union Regulations of United States (2013) Clause 715.2(accessed on 10<sup>th</sup> September 2012 at [www.ecfr.gov](http://www.ecfr.gov)).

<sup>268</sup> *Ibid*, Clause -715.3.

responsibilities; the credit union's accounting records and financial reports are promptly prepared and accurately reflect operations and results; the relevant plans, policies, and control procedures established by the board of directors are properly administered; and Policies and control procedures are sufficient to safeguard against error, conflict of interest, self-dealing and fraud<sup>269</sup>.

Another additional role that the Supervisory Committee in credit unions play in regard to audit is to obtain an annual Supervisory Committee audit which occurs at least once every calendar year (period of performance) and must cover the period elapsed since the last audit period (period effectively covered)<sup>270</sup>.

The regulation further provide that any federally-insured credit union, whether Federally- or State-chartered and regardless of asset size, may choose to fulfill its Supervisory Committee audit responsibility by obtaining an annual audit of its financial statements performed in accordance with Generally Accepted Accounting Standards (GAAS) by an independent person who is licensed to do so by the State or jurisdiction in which the credit union is principally located<sup>271</sup>. A financial statement audit is distinct from a Supervisory Committee audit, although a financial statement audit is included among the options for fulfilling the Supervisory Committee audit requirement<sup>272</sup>.

A federally insured credit union which does not choose to obtain a financial statement audit as permitted by subsection (b) must fulfill its supervisory audit responsibility under either of § 715.5 or § 715.6 of the regulations.

The Supervisory Committee of credit unions in the USA has responsibilities beyond the audit and verification functions. These additional duties as provided in Chapter 4 of the Supervisory Committee Guide of credit unions and includes: resolution of member

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<sup>269</sup> Section 1761d Federal Credit Union Act, 2013. See also the Electronic Federal Code of Credit Union Regulations of United States (2013), *supra*, Clause 715.3, (accessed on 10<sup>th</sup> September 2012 at [www.ecfr.gov](http://www.ecfr.gov)).

<sup>270</sup> Clause -715.4 The Electronic Federal Code of Credit Union Regulations of United States (2013), *Supra*.

<sup>271</sup> Clause 715.4 The Electronic Federal Code of Credit Union Regulations of United States (2013), *Supra*, (accessed on 10<sup>th</sup> September 2012 at [www.ecfr.gov](http://www.ecfr.gov)).

<sup>272</sup> The Electronic Federal Code of Credit Union Regulations of United States (2013) *Supra*, Compare clauses 715.2(c) and (j) (Accessed on 10<sup>th</sup> September 2012 at [www.ecfr.gov](http://www.ecfr.gov)).

complaints; strengthening internal controls; authority to call special membership meetings and remove officers, directors, or credit committee members; and reviewing management's corrective action. These are extensive powers that have been given to the Supervisory Committee in the credit unions in USA.

The Premier America Credit Union in the US engages the external auditor to audit the financial records of the Credit Union and the Internal Audit Department report directly to the Committee. The Supervisory Committee is not part of the Board<sup>273</sup>. Another credit union of San Diego County has its Supervisory members independently evaluating the strength and soundness of CU's operations and activities. The primary focus of the Committee include: an independent audit is performed annually; the account balances of members verified; adequate policies and procedures exist to protect the CU's resources; governing policies and regulations and procedures are followed and that the financial statements reflect the CU's results of operations. The Supervisory Committee collaborates with the internal auditor, board of directors and Management to ensure the assets are safeguarded by upholding policies, procedures and regulatory requirements<sup>274</sup>.

#### **4.4. South Africa**

The Audit Committee in South African Corporations and Financial SACCOs is composed of three independent members who have internal audit responsibilities. The company's again are reviewed for comparison purpose since corporate governance principles that different countries apply are generally the same save for the practices that each country embraces. The Financial Service Cooperatives (FSC) are guided by the Cooperatives Societies Act, No 14 of 2005. Clause 13 of the FSC guidelines provides that the Audit Committee shall consist of three members elected at the general meeting. The term of office of each member shall be three years. The Committee has extra powers of taking action against any director or committee member not acting in the interest of the institution. Any such action taken must be reported to the regulatory agency.

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<sup>273</sup> [www.premier.org/home/fi/files/static/documents/membershipnAgreement Final.pdf](http://www.premier.org/home/fi/files/static/documents/membershipnAgreement%20Final.pdf). Accessed on 2<sup>nd</sup> November, 2013.

<sup>274</sup> [https://www.sdccu.com/pdf/Credit –union/2012-Annual Report](https://www.sdccu.com/pdf/Credit%20union/2012-Annual%20Report). Accessed on 2<sup>nd</sup> November 2013.

The vital role of the Audit Committee in South Africa is emphasized in ensuring the integrity of financial controls and integrated reporting (both financial and sustainability reporting), and identifying and managing financial risk<sup>275</sup>. This sentiment is confirmed in the Companies Act of South Africa No. 71 of 2008. The appointment of an Audit Committee is regulated as part of the enhanced accountability and transparency requirements.

Although the Companies Act of South Africa only requires public companies and state owned companies (as well as other companies that voluntarily include this requirement in their Memorandum of Incorporation) to appoint an Audit Committee, King III Code which became effective from 1<sup>st</sup> July 2010 proposes that all companies should have an Audit Committee and define its composition, purpose and duties in the memorandum of incorporation<sup>276</sup>.

In contrast to the King I and II codes, King III also applies to all entities (including SACCOs) regardless of the manner and form of incorporation or establishment and whether in the public, private sectors or non-profit sectors<sup>277</sup>. The manner of application differs for each entity and is likely to change as the aspirational nature of the Code drives entities to continually improve governance practices. It is important to understand that the 'apply or explain' approach requires more consideration, application of the mind and explanation of what has actually been done to implement the principles and best practice recommendations of governance.

A recent development is the fact that the Audit Committee is now obliged to also report to shareholders. The Audit Committee is required to report to shareholders by including in the annual financial statements the Audit Committee's report describing how the committee carried out its functions, stating whether the auditor was independent, and commenting on the financial statements, accounting practices and internal financial control measures of the company. This is closely similar to the Brazilian case where the Audit Committee is expected to give opinion on recommendations made by the Board to the general assembly.

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<sup>275</sup> Institute of Directors (2009) *The King III Report of Governance for South Africa*.

<sup>276</sup> Institute of Directors (2009) *King III Code on Best Practice of Corporate Governance*, *Supra* Clause 2.23.5.

<sup>277</sup> *Ibid*, Perambulatory Clause.

The King III which financial cooperatives in South Africa are also subject to proposed a number of additional functions of Audit Committees including<sup>278</sup>:

- a) overseeing;
- b) financial risks and reporting;
- c) internal financial controls;
- d) fraud and IT risks as they relate to financial reporting;
- e) ensuring that a combined assurance model is applied to provide a coordinated approach to all assurance activities. In terms of this model, assurance should be done on three levels, i.e. management, internal assurance providers and external assurance providers;
- f) overseeing integrated reporting (both financial and sustainability reporting);
- g) satisfying itself with regard to the expertise, resources and experience of the finance function;
- h) overseeing the internal audit function;
- i) playing a key role in the risk management process; and
- j) Overseeing the external audit process.

The Republic of South Africa Cooperative Amendment Bill 2012 which is intended to amend the cooperative Act, 2005 provides<sup>279</sup> that Audit Committee members must be elected at a general meeting where board of directors are being elected, secondly the Committee must consist of members who are not directors, thirdly the committee is responsible for supervising the board of directors by representing the interest of members and finally the Committee can call a special meeting of members if there are issues warranting one. This provision has a lot of similarity with the Brazilian model.

From the above comparison it can be said that the roles of Audit Committee in the three jurisdiction are materially similar except in Kenya SACCOs where some roles critical to be performed by the Audit Committee are not included in the legislation such as appointment of external auditors, negotiation of their fees and supervising the board of directors. It is noted that the term Audit and Supervisory Committee refer to the same organ in USA. However, supervision of the board by Audit Committee which is part of the Board is not effective in the

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<sup>278</sup> *Ibid*, Article 3.4 - 3.10.

<sup>279</sup> Section 27, South Africa Cooperative Amendment Bill, 2012.

view of the author. The principle of collective responsibility coupled by common interest could weaken their oversight role over the board. The best organ therefore suited to undertake this role is the Supervisory Committee as constituted under the Kenyan laws and borrowing from the structure from Brazil and the proposed 2012 amendments in South African cooperative legislation which seeks to have Audit Committee members not being part of the Board. Strengthening the Supervisory and redefining their roles will enhance corporate governance in DTS's.

#### **4.5 Challenges Facing Audit and Supervisory Committees in Performing their Functions and Duties**

Corporate governance in cooperatives is complex due to management structure in SACCOs owing to the democratic principle for decision making. This is compounded by the fact that in most SACCOs employees are also members hence separation of ownership and control thinly apply in SACCOs. Elected board members are in some instances keen to serve their own interest at the expense of the members who elect them into office. There are instances where their actions are aimed more at securing future elections and would break policies and procedures to please the electorate. Audit Committee members who are part of the board would not be an exception in this context especially where they are subject of any impunity. This challenge may be resolved where independent directors are brought on board to enhance accountability and transparency.

Waweru states that the matters concerned with management of risk, internal control, additional regulatory requirements, external auditor independence, as well as the move to international accounting standards, are potentially creating extra headaches for the members of such committees<sup>280</sup>. The inclusion of Audit Committee reports in the proxy statements presents challenges for Audit Committees as well. It raises concerns that Audit Committee members are not thoroughly involved in the preparation of financial statements and, thus, this requirement increases their liability<sup>281</sup>. The increased oversight function and associated liability may ultimately result in higher compensation for Audit Committee members or fewer qualified directors willing to serve on Audit Committees. The expectation calls for

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<sup>280</sup> Waweru, P. N. & Kamau, R. G. (2008) *Audit Committees and Corporate Governance in a Developing Country*, Research Working Paper, Atkinson, York University. Faculty of Liberal and Professional Studies, Toronto Canada, p. 16.

<sup>281</sup> *Ibid*, p.17.

Audit Committee members who understand their work and can effectively interrogate matters presented to them. The issue on qualification remains a major challenge for SACCOs where Committee membership is restricted to members of the SACCO who may not have the requisite skills.

Waweru further notes that Audit Committees have the challenge of the rapidly changing environment coupled with the increased local and international regulations as well as frequent changes in management structures<sup>282</sup>. Further, the Audit Committee idea as a new concept in many jurisdictions creates a problem in the setting of boundaries in SACCOs and Credit Unions, while some dominant senior managers would interfere with the work of Audit Committee if they are not closely monitored.

Others feel that Audit Committees were being asked to take major responsibilities over the financial reports although their involvement in the preparation of the accounts was minimal. Other challenges include many stakeholders interested in SACCO/Credit Union activities, additional regulatory requirements and greater visibility and expectations of Audit Committees. Audit Committees in Kenya seem to be facing extra challenges like the changes in legal and operating environment, increased liability and the problem of setting the boundary between the committee and the management<sup>283</sup>.

Additionally, the independence of the Audit Committee may be impaired due to previous/current relationships of Audit Committee members or the Audit Committee as a whole and their political standing, among other factors. The other challenge facing Audit Committees is the inadequacy of persons with the requisite skills to serve in the Audit Committees. This is a major challenge where only members serve in the board of SACCOs and therefore cannot tap on skills available outside the membership except through employment, while employees do not serve in the Board of SACCOs.

Finally, the challenge that Supervisory Committee may face is access to information from Board and Management since they are not part of the Board. A structured way of communication therefore needs to be put in place to address such challenge.

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<sup>282</sup> *Ibid*, p. 30.

<sup>283</sup> *Ibid*, p. 31

#### **4.6 Proposals for Solving the Challenges Facing Audit & Supervisory Committees**

It is essential for Audit and Supervisory Committee of SACCOs and Credit Unions to focus on a process that supports effective oversight. The process should go beyond mere compliance with the new rules and regulations. This requires an oversight framework that facilitates the coordination of the activities and information needed to support the committees' understanding and monitoring of financial reporting processes. Audit Committees especially should avoid becoming unduly focused on compliance for the sake of compliance potentially at the expense of a quality oversight process which in their case is over Management to effectively advice the Board of Directors.

Measures should be put in place to assess independence of Audit Committee members prior to appointment. Their independence should also be assessed on an ongoing basis throughout their term of office. Declarations of interest should be completed by Audit Committee members at every meeting as part of best corporate governance practice.

The Audit and Supervisory Committee members should go through an interview process where they can display the skill and expertise necessary to fulfill the role. Both the Audit and Supervisory Committee members should display an enquiring mind and the ability to question management and service providers in a manner that will, if applicable, uncover all information. Audit and Supervisory Committee members should be inducted prior to the new members' first meeting. The induction process should not only involve taking the new members through the latest annual report, it should also involve presentations by each head of division in the organization, providing sufficient information on the running of the division and its contribution to the entity's responsibilities including the division's specific risks.

The annual evaluation of the Audit and Supervisory Committee should take all of the above into consideration and should focus specifically on whether the current Audit and Supervisory Committee has the necessary level of knowledge, skills and experience. The relevant governing body should pay attention to the results of the evaluation so that the necessary corrective action can be taken for development areas identified. The members of the Audit and Supervisory Committees should be remunerated sufficiently in order to attract sufficiently skilled and experienced individuals.

KPMG consultants state that Audit and Supervisory Committee members must have expertise, or access to expertise, that goes beyond mere familiarity with financial statements<sup>284</sup>. They must be able to understand the rules, and, more importantly, the principles that underpin the preparation of financial statements. They must be prepared to invest the time necessary to understand why critical accounting policies are chosen, how they are applied and satisfy themselves that the end result fairly reflects their understanding.

It is important to balance formal qualifications with consideration of personal qualities and relevant experience<sup>285</sup>. The members of the Audit and Supervisory Committee should, as a group, possess a wide range of knowledge, skills and personal attributes including:

- a) integrity and high ethical standards;
- b) strong interpersonal skills;
- c) sound judgement;
- d) the ability and willingness to challenge and probe; and
- e) the time and personal commitment to perform effectively.

Change is never-ending, not only in the area of financial reporting but also in regulatory compliance, technology and business risk. It is essential that members have sufficient training to enable them to keep abreast of such developments. The SACCOs and Credit Unions should ensure that their Audit and Supervisory Committees have continuing professional development training that enhance their financial literacy and make it possible for them to fulfill their fiduciary responsibilities.

Additionally, Audit and Supervisory Committee should strive to add value in addition to achieving basic compliance in order to discharge their audit and oversight responsibilities more effectively. An effective Audit and Supervisory Committee should set agendas ahead of its meetings. The meeting agendas should be carefully linked to the Committee's terms of reference and detailed annual work plan. A wide-ranging work plan helps members stay focused on their job. The Committee should assess what is currently important and develop its agenda accordingly.

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<sup>284</sup> KPMG (2006) *A Practical Guide, Audit Committee Institute UK*, p. 7.

<sup>285</sup> *Ibid*, p, 10.

The Audit and Supervisory Committee should meet as often as its role and responsibilities require. The Smith Guidance for Audit Committees recommends that there should be no fewer than three meetings during the year, held to coincide with key dates within the financial reporting and audit cycle<sup>286</sup>. The Supervisory should have no less than four meetings in any financial year.

The chair of the Audit and Supervisory Committee should assess the performance of individual Committee members on an annual basis. This assessment should be part of the overall evaluation of individual members. The Audit Committee should further implement a formal and rigorous assessment process that links to the SACCO's/Credit Union's board evaluation process and performance management process.

The Audit Committee must remain alert to management's approach to earnings management. Some high-profile irregularities are sometimes attributed to various inappropriate earnings-management practices. Such practices include questionable revenue recognition, inappropriate deferral of expenses, misuse of the materiality concept and misconstrued recognition, reversal, or use of provisions and allowances without events or circumstances to justify such actions.

Cooperatives contribute significantly to economic and social development in virtually all countries of the world. Their documented resilience to crisis and thus sustainability, and their particularity of being principles-based enterprises that are member-controlled and led are increasingly drawing the attention of governments, policy-makers and citizens around the world. The fact that cooperatives serve their members and as such balance the need for profitability with the needs of their members makes them different from stock companies and thus requires laws that recognize their specificities<sup>287</sup>.

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<sup>286</sup> Smith R (2003) Guidance on Audit Committees (The Smith Guidance), January 2003.

<sup>287</sup> Hagen, H. (2012) Guidelines for Cooperative Legislation, Third Revised Edition 2012 ILO. p, 133.

#### **4.7. Conclusion**

The Chapter has provided comparison on the composition, role and challenges of the Audit and Supervisory Committee which informs the conclusion and recommendations that are made in Chapter five. It is important to note that the term Supervisory is used in the US for what is the equivalent of Audit Committee in Kenya, whereas in Brazil the Statutory Audit Committee is the equivalent of the Kenyan Supervisory Committee performing oversight role and dealing with external audit. The author considers this as a good structure and will largely inform the proposals made in chapter five. South Africa is also moving towards having the Audit Committee elected by the general meeting whom they will be answerable to as opposed to the Audit Committee being part of the Board of Directors.

## CHAPTER FIVE

### 5.0 CONCLUSION AND RECOMMENDATIONS

#### 5.1 Introduction

This chapter provides the conclusions made by the researcher from the findings made in chapter four. It provides summary of proposals made towards strengthening and redefining the role of Audit and Supervisory Committee to enhance corporate governance in Kenyan DTS.

#### 5.2 Conclusion

This research has examined the roles of both the Audit and the Supervisory Committee with a view to strengthening and redefining their role to enhance corporate governance of deposit taking SACCOs in Kenya. The deposit taking SACCOs were singled out by the government of the Republic of Kenya in 2008 for supervision, licensing and regulation. This was done through the enactment of a specific legislation that caters for Deposit-Taking SACCOs. These institutions play a major role of ensuring cooperative society members pool financial resources together as savings and offer affordable credit facilities.

The study sought to find out how the committees carry out their mandate to achieve the set objectives. The research made a comparison on the workings of the two Committees to determine how their roles can be strengthened to enhance corporate governance in deposit taking SACCOs. The research reveals that the main responsibilities for the Audit Committee include: oversight over Management; review of financial reporting; risk management and internal controls, audit work and compliance activities. The Audit Committee carries out its audit to assist the Board in their oversight role over Management, while the Supervisory Committee provides oversight over the Board and Management and all other officers of the Society on behalf of members to ensure safety of their funds and prevent abuse of corporate power.

The availability of new standards for corporate governance coupled with new legislations and regulations, makes it paramount for deposit-taking SACCOs to change their corporate behaviour and values in accordance with these standards, laws and regulations. Deposit

taking SACCOs in Kenya must embrace best corporate governance practices which must be nurtured and encouraged to ensure that the interest of the cooperative members and other stakeholders are protected. The DTS in Kenya have made a lot of stride in enhancing their corporate governance since the enactment of the Sacco Societies Act in 2008. However, there is room for continuous improvement to reduce or totally eliminate governance challenges facing SACCOs.

SACCOs in Kenya can learn from Brazil that an improvement in governance practices of a cooperative brings not only individual benefits but also favours the whole financial cooperatives segment by improving security, reducing supervision and controlling costs, furthering the image and strengthening the cooperative spirit of participation, collective action and belonging.

Though the Supervisory and Audit Committee in Brazil are bodies under the same supervising and controlling structure, their functions within cooperatives are distinct and complimentary. Supervisory Committee is a supervision instrument and reports to the annual general meeting, while the works of Audit Committee are subordinate to the board of directors and reports to the board<sup>288</sup>. The main aim is to enhance corporate governance and the audits help in inspection of activities in the organisation.

One of the ways of strengthening Sacco governance is by strengthening and redefining the role of the Audit and Supervisory Committees as provided in the Sacco Societies (Deposit Taking Sacco Business) Regulations 2010 and in the Cooperative Societies Rules 2004. Regulation 57 of the Sacco Societies (Deposit Taking Sacco Business) Regulations 2010 provides for establishment of Audit Committee by every deposit taking Sacco whereas the Cooperative societies Act cap 490 retains the provision for the establishment of Supervisory Committee by Cooperatives. The end result is an administrative structure of Sacco governance constituting of both the Audit and the Supervisory Committee in DTS. It is noted that the structure as it is in practice leads to duplication of roles between the two Committees.

One noted role that Audit Committee has in jurisdictions examined like Brazil and United States is the appointment of external auditors and negotiation of their fees though the

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<sup>288</sup> Banco Central Do Brazil (2008) *Supra*, p. 49.

structure of the Statutory Audit Committee in Brazil is more independent from the Board as it is not part of the Board. The Committees in these jurisdictions report on their recommendation to the general meeting direct while in Kenya the Audit Committee recommends to the board who then forwards the names to the general meeting. In addition they have provisions that allow the Audit Committee to review plans and strategies to be presented to the general meeting and give their independent opinion to the general meeting. These are critical components of the role performed by the Audit Committee or the Supervisory Committee as the case may. It is therefore important to consider how best it can be undertaken by the Committees in SACCOs.

SACCOs are member controlled and have certain unique characteristics. The use of Supervisory Committee is widely recognised within the cooperative movement and in USA for example the Supervisory Committee is equivalent of Audit Committee. However, the name may not matter much but what remain important are their composition and the role performed by each organ. In the researchers view the Supervisory Committees role in cooperatives should be redefined in the legislation to set demarcation between its role and that of the Audit Committee; this will be similar to what Brazil has done.

Supervisory Committee reports to the members and their allegiance is to the members while Audit Committee owes their allowance to the board of directors who appoint them hence their independence compromised. In addition Audit Committee being a committee of the board is not exempted from the collective responsibility of the board for their acts or omission. This aspect may compromise the position of the Audit Committee who may shy away from exposing any faults touching on the board. The Supervisory Committee will be stronger in overseeing the operations of the entire Sacco.

Though arguments have been advanced that it is expensive to have both committees, it is the researchers view that achieving excellence and good internal controls comes at a cost which the long term benefits outweighs if proper structures are put in place. Members will be assured of safety of their funds and good corporate governance structures will attract more capital inflows once members' confidence is high. The effectiveness of SC and AC will prevent abuse of corporate power and enhance conformance and compliance.

In overall perspective, both the Audit and Supervisory Committees are important in enhancing corporate governance of SACCOs in Kenya. They are necessary to ensure that the Board and Management meet their mandates as provided by the cooperative laws, regulations and their respective by laws. Supervisory Committee offers additional oversight and assurance to the members whom they are accountable to. To the researcher the more oversight bodies there are the better for the institution so long as there is no duplication of roles and their operational costs are kept at bare minimum. This enhances checks and balance.

The current requirement for the Audit Committee members is to be independent to be able to exercise objectivity, have the required skills be defined, have continuous education; succession planning and terms of reference in place. Their main responsibility can in summary include: review of internal controls; audit work; financial reporting; risk management; governance and compliance activities. Supervisory on the other hand has supervision mandate over the Board and Management to prevent abuse of power. The Brazil model offers example of good corporate governance practices for cooperatives that the researcher has adopted in some of the recommendations.

### **5.3 Recommendations**

It should be noted that cooperatives which is the legal form for SACCOs have unique systems in the governance structure with Supervisory Committee being appointed by the general members and remains accountable to them. This is not the case in companies where the idea of Audit Committee may have been borrowed from and adopted within the deposit taking Sacco governance. It is therefore the author's position that whereas Audit Committees are accepted world over to enhance internal control, the structure of cooperative having Supervisory Committee offers additional oversight in the operations of the SACCO by its members being drawn outside the board of directors. This makes the Supervisory members independent from the Board and less subject to conflict of interest. The Committee can be made more effective by strengthening and redefining its role.

The SACCOs can retain the Audit Committee, but be renamed Internal Audit Committee to serve as advisors to the Board on internal controls, risk management and governance to assist the Board in its oversight role over Management and operations of the Sacco.

It is recommended that the role of Supervisory Committee which is a supervision instrument be strengthened and redefined to make it more effective. The scope of their duties to include: oversight over the Board of directors; Management and other officers to prevent abuse of corporate power. It will act solely as bridge between the Board and members. Some of the duties to include: Evaluation and shortlisting external auditors for appointment by the general meeting, it can further negotiate their fees to ensure independence and objectivity of the external auditors; giving independent opinion on proposals made by the Board to the general meeting on strategic matters that are core to the operations of the SACCO. This proposal will require amendment of the Sacco Societies Act to introduce Supervisory Committees under the Sacco Act and redefine their duties. Studies discussed in this research have shown that external auditors recommended to the general meeting by independent Committee members rather than the Board is more objective and independent.

This can well be like the Statutory Audit Supervisory Committee of Brazil whose membership is not from board of directors. The Supervisory Committee in the Kenyan situation can also play a critical role in enhancing oversight role by the regulator. There are Supervisory reports that have helped in unearthing malpractices in SACCOs, hence submission of their reports to the regulator on regular basis will immensely help enhance transparency and accountability.

It is further proposed that the Supervisory Committee submits its report to the Board of directors and the Sacco Societies Regulatory Authority on a quarterly basis and report to the general meeting annually.

Other power that can be given to the committee is that of calling a special meeting. The committee must if there is fair and reasonable information that any act or omission by the board of directors may impact negatively on the cooperative or a member or members thereof, call a special meeting of members to discuss such act or omission. A report of such meeting to be forwarded to the regulator, board of directors and members affected or concerned within seven days after the meeting.

It is further recommended that there should be limitation on who can serve in the Audit and Supervisory Committee to ensure their independence. Minimum qualification on members

who can serve in the Audit and Supervisory Committee and the level of independence required should be set out borrowing from the example of the cooperative legislation of Brazil which requires that Committee members only engage in Sacco business and not hold relevant participation in an entity that may offer a service or product to the Sacco, in addition where either the spouses or relatives up to second degree of members of such Sacco. Braiotta also suggests that the membership of the Audit Committee should consist of both financial and nonfinancial people so that the committee can draw upon members from various professionals such as accounting, economics, education, psychology, and sociology<sup>289</sup>. This is a good recommendation that can similarly apply to SACCOs to be able to benefit from a pool of professionals of diverse backgrounds.

From the study, the researcher establishes that it is important to have independent members to serve in the Audit Committee. Though this may be a good requirement for the Audit Committee, it does not have immediate backing under the Sacco Act. The law as it is now requires that the Committee members be drawn from the board of directors who are elected from the Sacco membership and are part of the Board which raises serious issues on conflict of interest. The Audit Committee members sometimes serve in several committees of the Board where they make decisions that they are supposed to audit. In addition the board members together with the Committees of the Board are jointly and severally liable as board members. The Committee act on delegated powers from the Board. This therefore makes the Audit Committee members loose independence and objectivity that is required of the Committee. It is therefore recommended that Audit Committee members in Sacco should not serve in any other substantive Committee of the Board.

A SACCO Society can only transact business with members as a requirement of the law hence only members of the SACCO can be elected to serve as Board of Directors. In this regard the only body in the SACCO governance structure that can provide oversight role free of conflict of interest within the Board is the Supervisory Committee. While other institutions seek to get members who are not part of the Board as independent, SACCOs already have the Supervisory Committee that can effectively play the oversight role over Board and Management. It will only require strengthen and redefining of its role to effectively carry out its mandate.

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<sup>289</sup> Braiotta, L. (1999) *The Audit Committee Handbook* 3<sup>rd</sup> Ed John Wiley and Sons Inc, New York.

In terms of having financial skills, it can be made mandatory by legislation that board of directors, Audit and Supervisory Committee members who do not possess the requisite skills attend specified courses in cooperative sector, finance and governance within one year of election. This consideration will assist cooperative societies who do not have such skills among their membership or if it exists such members are not keen to serve further; since the election are done democratically people with qualification may not get the numbers to win elections. In Malaysia, this has been made mandatory and board members who fail to take their officials for mandatory courses are removed from office.

The members of the Audit and Supervisory Committee should, as a group, possess a wide range of knowledge, skills and personal attributes including:

- a) integrity and high ethical standards;
- b) strong interpersonal skills;
- c) sound judgement;
- d) the ability and willingness to challenge and probe; and
- e) the time and personal commitment to perform effectively.

The AC and SC should be established with written terms of reference which clearly defines their authority and duties and the Board as a whole should have a Board Manual/Charter. This is very key tool for governance which can be used for inducting new Board members.

Further there is need for election guidelines to be issued that provides a process of giving candidates profile before elections and only have those qualified to effectively serve the cooperative presented to the annual general meeting. The SACCOs should in addition develop a code of conduct for Supervisory Committee members and their vetting be done in line with those of the Board and Management.

The allowances paid to the Supervisory Committee should be made equal to that of the Board of directors. They both report to the same organ and have distinct roles under the Act. This will remove the perception that Supervisory Committee is subordinate to the Board.

To address concerns of the Supervisory Committee working against the Board to seek their elective positions in the Board, there should be a provision prohibiting those who have served

in the Supervisory from immediately seeking elective positions as Board members immediately after expiry of their term. The period could be set to three years succeeding their term as supervisory member.

The Board of directors and Supervisory Committees should not have business with the SACCO beyond those transacted as a member.

Finally, the SC and AC Should establish a structured system of communication between the Committees and Management as well as the Board. The success of the organs of the SACCO depends on availability of information to reduce information asymmetry. There should be open disclosures where weaknesses identified are objectively brought to the meetings for discussion and solutions found to enhance internal controls, compliance and reduction of risks in the organization. The Committees should not be reduced to a witch hunting tool.

It is therefore proposed that:

1. Section 43 of the Sacco Societies Act be amended to provide for establishment of Internal Audit Committee and the role redefined to include:
  - a) The Board of directors of every licensed Sacco shall appoint among their number an Audit Committee which shall consist of at least three directors;
  - b) The Members of the Committee shall not serve in any substantive Committee of the Board;
  - c) The directors elected to the Internal Audit Committee without requisite skills shall attend a course on understanding financial accounting within one year of being elected into office;

The main duties to include:

- i) The duties to include review of internal control, risk management and compliance with the law, policies of the Sacco and governance practices.
- ii) Review reports from internal audit Department;
- iii) At least every three months examine the financial statements of the Sacco;
- iv) Make quarterly reports to the Board with a copy to the Supervisory Committee;
- v) Consider whether reports submitted to the regulatory bodies are in accordance with reports submitted to the Board;

- vi) The Committee can engage independent counsel and advisors for purpose of carrying out their duties;
- vii) The Committee is an advisor to the Board on effectiveness of internal control, risk management and governance systems; and
- viii) Any other duties as may be prescribed.

2. To have the Sacco Act amended to establish Supervisory Committee. Section 47 of the Sacco Societies Act be amended to include:

- a) Establishment of Supervisory Committee consisting of three members elected by general members and reports to the general meeting.
- b) The directors elected to the Supervisory Committee without requisite skills shall attend a course on understanding financial accounting within one year of being elected into office;

The main function to include:

- i) Oversight over board of directors and management and report to members and the regulator;
- ii) Recommending names of external auditor to the general meeting for appointment, re-appointment and negotiation of their fees;
- iii) Review reports from external auditor;
- iv) Liaising between the Sacco and the external auditor;
- v) Considering scope and process of audit by external auditors;
- vi) Receive half yearly reports from the external auditors;
- vii) Discuss the external audit report findings with the Board before presentation to general meeting;
- viii) Report errors or fraud found suggesting measures useful to the Society, where Board fails to take action report made to the general meeting;
- ix) Investigate specific issues arising out of reports reviewed from the Board, external auditor and internal audit;
- x) Investigate members complaints;
- xi) Review the results of the discussion with the external auditors to ensure that proper follow up action has been undertaken;
- xii) Provide independent opinion on proposal made by the Board to the general meeting on strategic issues including risk management and governance;

- xiii) The Supervisory by unanimous vote may recommend to the Board to suspend or remove any officer or member of the board;
- xiv) Submit quarterly reports to the board of directors and the Sacco Societies Regulatory Authority;
- xv) To call special general meeting where the operations of the Sacco is materially under threat.

The supervisory duties by the Supervisory Committee need to be comprehensive to be able to critically watch over the whole operations and activities of the Sacco. In this regard the Committee should have unlimited access to information that pertains to its supervisory function. The Committee in carrying out its function requires reviewing Board reports, opinions and recommendations from both internal and external auditors.

The duties for the Committees can be incorporated in the regulations while establishment of the Committees provided in the Act. The recommendations which are part of best practice can be through guidelines issued to SACCOs from time to time.

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