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# EFFECTS OF CORPORATE GOVERNANCE ON AUDIT QUALITY OF PUBLIC FINANCIAL INSTITUTIONS IN KENYA

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## Abstract

*There is expectation that corporate governance presence improves audit quality but studies that done so far shows no conclusive evidence on how corporate governance influences audit quality. Census survey was applied for the study. Primary data was collected using structured questionnaire, distributed to respondents by researcher in person as well review of available literature covering four year period of 2012-2015. The data collected was summarized using descriptive statistics. Correlation survey design was used to determine relationship between corporate governance and audit quality of public financial institutions in Kenya and the data was analyzed using social package for social sciences software (SPSS). The study found out that in most public financial institutions in Kenya, CEO duality doesn't exist, audit committee and board composition have average of seven members while board independence is composed of less than one percent of outside directors. Furthermore 91.2% changes in audit quality of public financial institutions in Kenya could be due to audit committee, board size, board composition, board independence, board size and CEO duality while only 8.8% were caused by other factors not covered by the study.*

Keywords: Corporate governance, audit quality, public financial institutions

## 1.0 Introduction

The study sought to find out the effects of corporate governance on audit quality of public financial institutions in Kenya. Corporate governance and audit quality are two terms that are undergoing transformations in the modern world (Soliman & Elsalam, 2012). This has led to corporate governance being considered as the most important instrument of management since it has influence in several internal control systems in firms like

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internal and external audit, financial performance among other financial management schemes (Micheni, 2014). Therefore, this research study sought to find out the influence that corporate governance have on audit quality of public financial institutions in Kenya.

### 1.1 Objectives of the study

The general objective of the study was to examine the effects of corporate governance on audit quality of public financial institutions in Kenya. The specific objectives include:

i. To determine the effect of board independence on audit quality of listed financial institutions in Kenya

ii. To examine the effect of CEO duality on audit quality of public financial institutions in Kenya

### 1.2 Research hypotheses

The following hypotheses were formulated to guide the study

i. Board independence has no significant effect on audit quality of public financial institutions in Kenya.

ii. CEO duality has no significant effect on audit quality of listed financial institutions in Kenya.

### 1.3 Scope of the study

The study focused on public financial institutions located in Kiambu, Nairobi, Kericho and Bomet Counties in Kenya. The secondary date collected covered the period between 2012 to 2015 which is chosen due to spectacular economic happenings in Kenya and actual implementations of the provisions of 2010 constitution particular those pertaining to the financial accountability in public sector.

## 2.0 Empirical literature review

Soliman and Elsalam (2012) did an empirical study of the listed companies in Egypt with a title of research study as "Corporate Governance Practices and Audit Quality". They gathered data for analysis from the top 50 most active companies in the Egyptian Stock Exchange, covering the three year period 2012-2014. Logistic regression was used in investigating the questions that were raised in the study. Findings from the study show that corporate governance significantly have influence audit quality.

Zengin Karaibrahimoğlu (2013) carried out a study a study on Turkey companies with the main aim of the study was to investigate the association between corporate governance and auditor choice by using a sample of 805 firm observed from Istanbul Stock Exchange (ISE) between the years 2005-2009. Overall findings show that, firms' auditor choice in terms of big-4 and audit firm industry specialization is affected by the firm-level corporate governance mechanisms of firms, particularly, board of directors' composition and ownership structure. This results confirmed the influence of corporate governance on audit quality where the audit is improved when the corporate governance principles are implemented.

Abdullah *et al.* (2008) did a study on total of 655 listed companies in Malaysia. Their study focused on the impact of board composition, board independence ownership and CEO duality on Audit Quality: The Malaysian Evidence. They applied logistic regression on their analysis to find out the relationship between dependent and independent variables of the study. Their results shows that board independence has significant relationship with the audit firm size which leads to the improvement of audit quality. They further found out that board independence improves decision-making process to be more transparent and enhance

the independence of selecting quality of external auditor. The study suggested that when CEO duality exist, the interests of shareholders are not catered for well as the chairman of the board and CEO of board will be the same person hence leading to conflict of interests which finally leads to compromising of shareholders input in the management and they can't be able to manage the firm effectively.

Deis and Giroux (1992) carried out a study titled "determinants of audit quality in the public sector", which they used combination of several study methodologies among regression analysis, t-test (test of significance) and adjested $R^2$ which audit quality is a dependent variable and several explanatory variables, they found out that all regression results were significant at 0.10 level or better in the expected relation to audit quality. Board turnover (board size) and size of audit firm were among the explanatory variables. They found out that the audit changes are caused majorly by the predictors of the study like board independence had great impact on audit quality.

## 3.0 Methodology

The study assumed descriptive research design which is a process of collecting data in order to test hypotheses or answer questions relating to the current issues of subjects in the study (Mugenda & Mugenda, 2003). Descriptive research design determines and reports the way things are which means no manipulation in terms of variables being investigated in the study (Kothari, 2004). The main focal point of this study is quantitative with the help of secondary data collected from annual reports. Board independence was measured as the percentage of non-executive directors while CEO duality was measured by ranking binary numbers whereby 1 represented yes which is existence of CEO duality and 0 represented no. Correlation survey design was applied in order to determine the relationships between variables (Kothari, 2004).

## 4.0 Data analysis and presentation

### 4.1 Regression analysis

The analysis of study covered regression analysis whereby the results were used to find out the effect of corporate governance on audit quality of public financial institutions in Kenya. The results are represented on the Table 1 below.

*Table 1: Regression analysis results*

| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate |
|---|---|---|---|---|
| 1 | 0.832[a] | 0.602 | 0.912 | 0.003472 |

Adjusted R squared coefficient was used to determine variation between dependent variable and independent variable because of changes in the independent variable as presented on the above table. From the study, the results for the adjusted R squared was 0.912, an indication that there was a variation of 91.2% on the audit quality of public financial institutions in Kenya due to changes in board independence and CEO duality at 95% confidence interval. This shows that 91.2% changes in audit quality of public financial institutions in Kenya are due to board independence and CEO duality while only 8.8% changes is caused by other factors not covered by the study and on the other hand R is the correlation coefficient that shows the relationship between the study variables as in this study, the results show that there was a strong positive relationship between the study variables of 0.832[a]. This had impact on audit quality since the variables have significant influence on audit quality. Nasser DAA, E. (2015) states that when members are independent, there is effectiveness in the organizations' internal and external control mechanisms which leads to higher audit quality.

*Table 2: Regression model results*

| Model | Unstandardized Coefficients | | Standardized Coefficients | t | Sig. |
|---|---|---|---|---|---|
| | B | Standard Error | Beta | | |
| 1 (Constant) | 0.016 | 0.082 | 0.000 | 0.195 | 0.001 |
| Board Independence | 0.124 | 0.512 | 0.354 | 2.242 | 0.025 |
| CEO Duality | 0.274 | 0.621 | 0.623 | 1.441 | 0.016 |

Source: Research Findings

i. **Dependent variable :** Audit Quality (AQ)

ii. **Independent Variables [Predictors]:** Board independence (BI), CEO duality (CEOD).

The regression analysis constant was 0.016 which indicate that if all the independent variables are all rated as zero, the audit quality of public financial institutions in Kenya would be rated as 0.016 at 95% confidence level which was applied in the study. Furthermore, the P- value less than 0.05 inculpate that the independent variable is significant. From the study findings, regression results imply that audit quality of public financial institutions in Kenya is significantly influenced by board independence according to this study with p-value as 0.025 while CEO duality is significant with p-value of 0.016. The existence of regression coefficients indicates the kind of relationship between the variables. Positive regression coefficients shows a direct relationship that exist between independent and dependent variables. The independent variables in the regression model which have negative coefficients have inverse relationship with the dependent variable. Therefore, increase in board independence and CEO duality lead to increase in audit quality in public financial institutions in Kenya.

## 5.0 Conclusion

From the study, the results have indicated that corporate governance is very important in the improvement of audit quality of public financial institutions in Kenya. Board independence should be of the right percentage of independent directors as according to various literature for the board to be considered independent, the third of board members should be of independent directors (Nasser DAA. E, 2015) in this study, the results indicated positive results which conclude that if the board of organization is not adequately composed and no right percentage of independent directors then the quality of audit will be compromised. This renders credibility of financial statements unreliable and firm value questionable. The results of this study supported separation of roles of chairman and CEO of the board which minimizes conflict of interests.

From the research findings, the relevance of corporate governance structures is practical because it influences audit quality hence there is need to make sure all principles of corporate governance are implemented in order to make audit function of the organization reliable, effective and financial accountability will make public and other stakeholders, have confidence in their public financial institutions and projects done by government will not face financial pilferage. CEO duality had a great impact on audit quality of public financial institutions in Kenya. This created a better understanding of corporate governance where when governance structures are attained, there will be improvement in audit function.

The findings of the study are in agreement with the results of Zengin Karaibrahimoğlu Y. (2013) that concluded that adoption and adherence to good corporate governance practices can greatly stabilize and improve the activities of financial institutions irrespective of their size which is by introducing

better management practices, strong internal control mechanisms and greater opportunities for growth. Corporate governance brings new strategic outlook through external independent directors and separation of roles between chairman and CEO of board. The findings of this study endorsed findings by Micheni, K.S. (2014) which says good governance mechanisms increase public confidence in addition to enhanced audit activities and greatly raise the standard of audit quality. Local and international investors including Kenyan public would consider investing more where there is a culture of good corporate governance because of reduced risk and a higher assurance of returns on their investment through better audit quality.

Nasser DAA, E. (2015 pp. 11-15). Also concluded that "earnings quality is positively associated with audit committee independence, but the relationship is weakened by the existence of CEO duality". "Their results indicated that when CEO a CEO has excessive e control over the decisions of board of directors by holding the positions of chairman, the monitoring function of independent audit committees to assure quality of earnings in financial statements becomes ineffective" (Nasser DAA, E. 2015 pp. 11-15). This findings are also the results of this study which firmly backed separation of roles of chairman and CEO of the board.

### 5.1 Recommendations

The study has indicated that putting in place good corporate governance structures positively impacts public financial institutions and could benefit from the findings of this study. For higher level of audit quality, the board independence should have a third of members being independent directors who are also called non-executive directors since this group will bring in external experience which executive directors don't have like the trends in market, economy and the country at large since they are the group who work in various organizations outside unlike executive directors who work in the board of the public financial institution knowing only internal trends of where they are working in. They also provide a more objective oversight over the decision making, expertise and links to markets (Moenga, 2015). This study firmly recommends that CEO duality should not exist as this can lead to conflict of interests, fraudulent practices and constraint of board independence (Bliss, M.A., 2011).

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