Effect of Audit Quality On The Financial Performance Of Listed Parastatals In Nairobi Securities Exchange

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ABSTRACT

Financial statement audit is an important tool for reducing information asymmetries and maintaining an efficient market environment. However, if the audit is to improve financial performance, there must be credibility and reliability as regards audited financial information. This research work was designed to examine the effect of audit quality on financial performance of listed parastatals in NSE. The study specifically investigated the relationship between, the auditor's independence; size of the audit firm; Attributes of the audit team and experience of the auditor and Financial Performance of Listed Parastatals in NSE. The study was descriptive in nature with data drawn from certified public accountants working for listed State Corporations. Primary data was collected by the use of semi-structured questionnaires whereas secondary data was obtained basically from the published annual reports and financial statements, and notes to the financial statements of the listed state corporations in NSE. Descriptive statistics such as mean, standard deviation and frequency distribution was used to analyze the data. Data presentation was done by the use of pie charts and tables for ease of understanding and interpretation. Multiple regression analysis using the SPSS Version 20.0 was employed in analysing the data and testing the research questions. Findings of the study indicate that the effect of audit quality on financial performance is positive and significant and the greater the degree of an auditors independence, the greater the propensity of a firm making substantial net profit margins. The impact of auditor size is also positive and significant, although, its impact is lesser that of auditor independence.

Key Words: Audit Quality, Financial Performance, Parastatals, Nairobi Securities, Performance

Introduction

An auditor has the responsibility for the prevention, detection and reporting of fraud, other illegal acts and errors (Oluwagbemiga, 2010). This is one of the most controversial issues in auditing, and has been one of the most frequently debated areas amongst auditors, politicians, media, regulators and the public. This debate has been especially highlighted by the collapse of both small and big corporations across the globe.

The financial statement audit is a monitoring mechanism that helps reduce information asymmetry and protect the interests of the various stakeholders by providing reasonable assurance that the management's financial statements are free from material misstatements. The societal role of auditors should be a key contribution to financial performance, in terms of reducing the risks of significant misstatements and by ensuring that the financial statements are elaborated according to preset rules and regulations (Heil, 2012). Lower risks on misstatements increase confidence in capital markets, which in turn lowers the cost of capital for firms (Heil, 2012). The quality of reported earnings and the ability of audit quality to effectively constrain earnings misrepresentation and financial statement manipulations of companies across the world and Kenya in particular, have become considerably questionable due to recent corporate accounting scandals (Badawi, 2008; Enofe, 2010).

Zureigat (2010), examined the effect of financial structure among Jordanian listed firms on audit quality. Using a sample of 198 companies, his analysis of logistic regression shows a significant positive relationship between audit quality and financial structure. Nam (2011), examined the relationship between audit fees as a proxy for auditor independence and audit quality of firms in New Zealand. Employing three multiple regression models for a sample of New Zealand companies, his study discovered that the provision of non-audit services by the auditors of a firm comprises the auditor's independence, abnormal audit fee change rate is negatively associated with audit quality and auditor's independence of the previous year impacts on the audit fee that is negotiated in the current year.

Statement of the Problem

Increased concerns regarding corporate accountability in various developed nations have been associated with the need for appropriate Audit which involves risk management and internal control systems (Beekes & Brown, 2006). Audit Quality is recognized to influence financial reporting and strongly impact on investors' confidence (Levitt, 2008). Conventionally, external auditors play critical and highly challenging roles in assuring the credibility of financial reports.

Geiger and Raghunandan (2002) measured audit quality as whether the auditor had issued a going-concern qualification in the prior year for US clients that declared bankruptcy. They found that auditors are less likely to issue a going concern opinion during the initial years of engagement but not in later years, contrary to the expressed concern that a long auditor-client relationship negatively affects audit quality. Zureigat (2010) examined the effect of financial structure among Jordanian listed firms on audit quality. Using a sample of 198 companies, his analysis of logistic regression shows a significant positive relationship between audit quality and financial structure.

Maiteka (2010) undertook a study of the influence of risk based audit on corporate governance in public sector in Kenya focusing on selected ministries. From the findings, risk based auditing was found to assess risks facing government ministries on time and concentrate on high risk areas in order to increase transparency and accountability, hence enhancing good governance. Kasiva (2010) carried out a study on the impact of risk based audit on financial performance in commercial banks in Kenya.

None of these studies looked at the relationship between Audit Quality and Financial Performance in Listed State Corporations in Kenya. Therefore there existed a research gap that was to be filled by this study on the effects of the quality of audit on the financial performance of listed state corporations.

Objectives of the Study

General Objective

The general objective of the study was to establish the effect of audit quality on the financial performance of listed parastatals in Nairobi Securities Exchange.

Specific Objective

1. To examine the influence of size of the audit firm on the financial performance of listed parastatals in NSE.

Theoretical Review

Essentially, agency theory, signalling theory, and auditors' theory of inspired confidence justify the key function of auditing as a mechanism for mitigating information asymmetries among related parties. The demand for audit of companies' accounts is created by the agency problems which are related to the separation of corporate ownership from control (Eilifsen & Messier, 2000; Gerayli, et al, 2011).

Auditors' Theory of Inspired Confidence

The auditors' theory of inspired confidence offers a linkage between the users' requirement for credible and reliable financial reports and the capacity of the audit processes to meet those needs. It sees through the development of these needs of the public (stakeholders) and the audit processes over time. Developed by the Limperg Institute in Netherlands in 1985, the theory of inspired confidence states that the auditor, as a confidential agent, derives his broad function in society from the need for expert and independent examination as well as the need for an expert and independent judgement supported by the examinations.

Thus, accountants and auditors are expected to know and realize that the public continues to expect a low rate of audit failures. This requires that the auditors must plan and perform their audit in a manner that will minimize the risk of undetected material misstatements. The accountant is under a duty to conduct his work in a manner that does not betray the confidence which he commands (Limperg Institue, 1985).

The importance of the theory of inspired confidence is that the duties and responsibilities of the auditors are a derivation from the confidence that are bestowed by the public on the success of the audit process and the assurance which the opinion of the accountant conveys. Since this confidence determines the existence of the process, a betrayal of the confidence logically means a termination of the process or function. Carmichael (2004) in discussing the social significance of the audit stated that when the confidence that society has in the effectiveness of the audit process and the audit report is misplaced, the value relevance of that audit is destroyed.

Therefore, auditors are expected to maintain reasonable quality assurance especially given that an audit failure is effectively a career-ending event. Audit provides assurance to the owners and management of companies and to investors and stakeholders, and along with financial reporting, corporate governance and regulations, supports confidence in the capital markets.

Agency Theory

Agency theory has been widely used in literature to investigate the information asymmetry between principals (shareholders) and agent (management). This study uses the agency theory to determine the impact of audit quality on the financial performance of listed state corporations in Kenya. Sarens and Abdolmohammadi (2007), states that according to the agency theory, a company consists of a set of linked contracts between the owners of economic resources (the principals) and managers (the agents) who are charged with using and controlling these resources. Jensen and Meckling (1976), states that in agency theory, agents have more information than principals and this information asymmetry adversely affects the principals' ability to monitor whether or not their interests are being properly served by the agents.

Sarens and Abdolmohhamadi (2007), opines that an assumption of agency theory is that principals and agents act rationally and use contracting to maximize their wealth. A consequence of this is the moral hazard issue. Jensen and Meckling (1976), opine that moral hazard constitutes a situation where to maximize their own wealth, agents may face the dilemma of acting against the interests of their principals. Since principals do not have access to all available information at the time a decision is being made by an agent, they are unable to determine whether the agent's actions are in the best interest of the firm. To reduce the likelihood of the moral hazard, principals and agents engage in contracting to achieve optimality, including the establishment of monitoring processes such as auditing. Watts (1998), observes that auditing is considered as a bonding cost paid by agents to a third party to satisfy the principals' demand for accountability. Like any other cost of running the business, the cost of auditing is borne by principals to protect their economic interests. Defond (1992), discusses the importance of the separation of ownership and control. He states that the more diffused the ownership of a company, the higher the divergence in preferences of the owners and managers, and the higher the observability and control of agents' actions by the principals. Thus, as the diffusion of ownership increases, so does the demand for monitoring. Thus, numerous auditing processes will be needed to monitor the agent's actions in more diffused ownership structures. Louise (2005), states that audits serve as a fundamental purpose in promoting confidence and reinforcing trust in financial information. The principal-agent relationship as depicted in agency theory is important to understanding how the role of an auditor has developed. Principals appoint agents and delegate some decision making authority to them. In so doing, the principals place their trust in their agents to act in the principals' best interests. However, as a result of information asymmetries between principals and agents differing motives, principals may lack trust in their agents and may therefore need to put in place mechanisms, such as the audit, to reinforce this trust. Agency theory therefore, is a useful economic theory of accountability, which helps to explain the development of audit quality.

Stakeholder Theory

Stakeholders can be defined as any group or individual who can affect or is affected by the achievement of the organization's objectives. Stakeholder theory is managerial in that it reflects and directs how managers operate rather than primarily addressing management theorists and economists. It begins with the assumption that values are necessarily and explicitly a part of doing business. It asks managers to articulate the shared sense of the value they create, and what brings its core stakeholders together. It also pushes managers to be clear about how they want to do business, specifically what kinds of relationships they want and need to create with their stakeholders to deliver on their purpose. Wheeler et al, (2003), posits that the stakeholder theory was derived from a combination of sociological and organizational disciplines. Stakeholder theorists suggest that managers in organizations have a network of relationships to serve – these include the suppliers, employees, lenders and other business partners. Therefore, this network is as important as the agency relationship. Accordingly, Sundaram and Inkpen (2004) acknowledge that the stakeholder theory attempts to address the group of stakeholders that require management's attention. Many firms have developed and run their businesses in terms highly consistent with stakeholder theory. Firms such as J & J, eBay, Google, Lincoln Electric, AES, and the companies featured in Built to Last and Good to Great (Collins 2001, Collins & Porras, 1994) provide compelling examples of how managers understand the core insights of stakeholder theory and use them to create outstanding businesses.

Stakeholder theory has been praised for overcoming the narrow view which says that the company's sole purpose is to maximize economic value for shareholders (Freeman, 2008). Introducing value creation for all stakeholders broadens the framework of management, bringing it closer to a more realistic economic optimum, generating new cooperative value creation capabilities, and overcoming some conflicts. So long as the focus remains on economic value, however, any solutions adopted will be insufficient, because the processes of capturing that value will always be liable to conflicts of all kinds. If the amount of economic value generated in the company increases, some will wonder why they cannot have a bigger share and, if they can't, why they shouldn't appropriate the share of othe

Research Methodology

Introduction

This chapter includes the research design, the population, sampling Technique, Data collection and analysis procedures (Kothari, 2004). This section of the research project report therefore presents the methodology the researcher used in gathering the findings. The chapter explains the nature of data that was collected, the target population, the sampling methods, the data collection methods and the data analysis methods.

Research Design

This study adopted a descriptive research design. The choice of this method stemmed from the fact that it has been successful in research of this nature. Farouk and Shehu (2014) used it to study Audit Quality and Financial Performance of Quoted Cement Firms in Nigeria. Leung and Cooper (1995) used it in Australia, Naser (1993) in U.K, Amat and Blake (1996) in Spain, Amat, Blake and Dowds (1999) in New Zealand. This paper therefore adopted the research procedure in these studies so as to ensure the validity and reliability of the research instrument. According to Zikmund (2003) descriptive research design is the process of collecting and analysing data in order to provide answers to questions concerning the correct status of the topic under study.

Study Population

The target population for this study comprised of Certified Public Accountants of all the nine listed state corporations. A population refers to all elements within a group that a researcher intends to collect data about (Cohen et al., 2002). It is according to Ngechu (2004), a well-defined set of people, services, elements and events. The target population refers to a computed set of individuals, cases or objects with some common observable characteristics of a particular nature distinct from other population. The ICPAK membership as at December 2014 was 9,968, out of which; 5,283 were in business, 3,391 in public practice, 697 were retired while 597 were based overseas. Out of the 3,391 in public practice, 826 work for the 9 listed parastatals.

Sampling Frame

A sampling frame is a list of the sampling units that is used in the selection of a sample (Bryman 1995). The sampling frame of this study was drawn from directories of the Nairobi Securities Exchange Limited; consisting of all the 9 listed state corporations in Kenya. The sampling frame describes the list of all population units from which the sample would be selected (Cooper & Schindler, 2003). Data from the ICPAK indicate that there are a total of 826 CPAs working in the 9 listed state corporations in Kenya. Ngechu (2004) underscores the importance of selecting a representative sample through making a sampling frame.

Sample and Sampling Technique

The study used simple random sampling to select 89 respondents since the study population was homogenous. A sample must represent well the characteristics of the population. It has to be accurate as studying the entire population (Kothari, 2004). According to Mugenda and Mugenda (2003) the sample size is a function the total population and is acquired as follows:

n =N/ (1+Ne2)

Where; n is the sample size. N is the total target population and e is the acceptable significance level and 10% will be used.

N= 826/ (1+826(0.1)2

n = 826 / (1+8.26)

n= 826/ (9.26)

n= 89

According to Kothari (2005) and Mugenda (2008) in a descriptive research, a sample enables a researcher to gain information about a population. Therefore, Mugenda and Mugenda (2003), augment that a sample size of between 10% and 30% of the population size is adequate for analysis and reporting. Statistically, in order for generalization to take place, a sample of at least 30 elements (respondents) must exist (Cooper & Schindler, 2003).This sample represents 10.98 % of the target population.

Data Collection Instruments

In this study, primary data was collected through semi-structured questionnaires with both open and closed ended questions. The choice of a tool and instrument depends mainly on the attributes of the subjects, research topic, problem question, objectives, design, expected data and results. Flick (2009), considers this tool best placed to collect a lot of data being justifiable for use in a qualitative study. Secondary data was collected by way of review of published materials and the published Annual Reports from the selected listed State Corporations. The works reviewed and the relevant content to be used in this study was identified purposively.

Data Collection Procedure

The researcher administered the questionnaire personally (assisted by two research assistants) and through e-mail system to the firms. The study used both primary and secondary data in analysing the relationship between the study variables. Primary data for the study was collected by use of semi-structured questionnaires that were administered by the researcher. On the other hand, secondary data was acquired through a review of data from Nairobi Securities Exchange Limited (NSE), regarding the financial performance of the selected listed state corporations for the period between 2009 and 2013.

Pilot Test

Piloting was carried out to test the validity and reliability of the instruments. Validity indicates that degree to which the instrument measures the constructs under investigation (Mugenda & Mugenda, 2003). There are three types of validity test which include content, criterion and related construct validity. This study used content validity because it measures the degree to which the sample of the items represents the content that the test is designed to measure.

A pilot study was conducted by the researcher taking some questionnaires to selected Certified Public Accountants in Nairobi. From this pilot study the researcher was able to detect questions that needed editing and those that were ambiguous. The final questionnaire was then printed and used to collect data for analysis.

Validity of the research instruments

Somekh and Cathy (2005) postulate that validity is the degree by which the sample of test items represents the content the test is designed to measure. Content validity which was employed by this study is a measure of the degree to which data collected using a particular instrument represents a specific domain or content of a particular concept. Mugenda and Mugenda (2003) contend that the usual procedure in assessing the content validity of a measure is to use a professional or expert in a particular field. To establish the validity of the research instruments the researcher sought the opinion of experts in the field of study.

Reliability of the research instruments

According to Walliman and Nicholas (2001), reliability refers to the consistency of measurement and is frequently assessed using the test–retest reliability method. Reliability is increased by including many similar items on a measure, by testing a diverse sample of individuals and by using uniform testing procedures. The study used Cronbach (Alpha – α) model to test the reliability of the data. Brown (2002) noted that the Cronbach's alpha reliability coefficient normally ranges between 0 and 1.0. The closer the coefficient is to 1.0, the greater the internal consistency of the items in the scale. SPSS application was used in the calculation of the Cronbach's alpha for reliability analysis.

Data Analysis and Presentation

Quantitative and qualitative data collected using questionnaires was inspected for errors and gaps. The data was then well examined and checked for completeness and comprehensibility. After inspection, the data was coded and analysed by the use of descriptive statistics using SPSS.

Data Analysis

The study used the Likert type scale as the rating scale in questionnaires. According to Mugenda and Mugenda (2003), Likert scales are often used with matrix questions. The items that are used in Likert scales are usually declarative in form. Kumar (2005) claims that Likert scales are the easiest to construct and are based upon the assumption that each statement/item on the scale has equal attitudinal value, importance or weight in terms of reflecting an attitude towards the issue in question. The numbers in a Likert scale are ordered such that they indicate the presence or absence of a characteristic being measured. Data collected will be mostly quantitative in nature and will be analysed by descriptive analysis techniques using tools such as Statistical Package for Social Sciences (SPSS). Qualitative data will be analyzed descriptively. Below is a description of the key characteristics and terms of measurement for each variable. This study will focus on Audit Quality characteristics namely Size of the Audit Firm, Independence of the Auditor, Qualifications of the audit team and the auditor's experience and how they affect financial performance. Dependent and independent variables will be grouped into components; namely, independent variables which consist of; Size of the Audit Firm, Independence of the Auditor, Qualifications of the audit team and the auditor's experience and dependent variables which consist of financial performance indicators namely, Return on Assets and Return on Equity. The terms of measurement to be used are described as in table below.

Terms of measurement

Terms of Measurement	Variables
Extent of Management Influence	Independence of the Auditors'
No of Partners/ Branch Network	Size of the Audit Firm
Partners' Qualifications	Qualification of the Audit Team
No of years in existence	Auditor's Experience
ROE/ROA	Financial Performance

Correlation Analysis

Correlation analysis is the statistical tool that can be used to determine the level of association of two variables (Levin & Rubin, 2013). This analysis can be seen as the initial step in statistical modelling to determine the relationship between the dependent and independent variables. Prior to carrying out a multiple regression analysis, a correlation matrix will be developed to analyse the relationships between the independent variables as this would assist in developing a prediction multiple model. Correlation analysis will help to detect any chance of multi-collinearity. Correlation value of 0 shows that there is no relationship between the dependent and the independent variables whereas, a correlation of ±1.0 means there is a perfect positive or negative relationship (Hair et al., 2010). The values will be interpreted between 0 (no relationship) and 1.0 (perfect relationship). The relationship will be considered small when $r = \pm 0.1$ to ± 0.29, while the relationship will be considered medium when $r = \pm 0.3$ to ± 0.49, and when $r = \pm 0.5$ and above, the relationship will be considered strong.

Regression Analysis

Multiple regression analysis is a statistical method utilized to determine the relationship between one dependent variable and one or more independent variables (Hair et al., 2010). This study will employ a multiple linear regression analysis using Return on Assets (ROA) and Return on Equity (ROE) as proxy for the firm's financial performance as dependent variables and independent variables comprising of Size of the Audit Firm, Independence of the Auditor, Qualifications of the audit team and the auditor's experience.

Data Presentation

Data presentation will be done by the using of pie charts, bar charts and graphs, percentages and frequency tables. This being a descriptive research, descriptive statistical measures including, frequency distribution and percentages will be used to present the quantitative data. The qualitative data will be analysed using indepth descriptive analysis. This will entail relating pertinent information through interpretative analysis and presenting the data using qualitative matrices.

The study adopted a descriptive survey design aimed at investigating strategic management practices and performance in the hotel industry in Kenya. The study population comprised of 82 Hotels in Nairobi County (NCC, 2016). According to Kothari (2008), a target population in statistics is the specific population about which information is desired and results generalized. The target population for this study was all the employees of 82 Hotels in Nairobi County, the hotel was stratified into class of five star, four star and three star hotels. Sampling frame was the list of all the respondent working with 82 hotels in Nairobi County in the class of five star, four star and three stars' hotels respectively, from where the respondents were selected. The study selected a sample of 68 hotels using Fisher, Laing and Stoeckel (1983) formula.

Sample Size

Category	Population	Proportion	Sample hotels	Sample size
Five Star	28	82.9%	23	46
Four Star	36	82.9%	30	60
Three Star	18	82.9%	15	30
Total	82	82.9%	68	136

Primary data was collected using pre-determined questionnaires. Both open and closed ended questions were used to collect primary data. The researcher first conducted a pilot study in order to test validity of the questionnaire to be used. A pre-test sample of 10% of the sample size was used as advocated by Mugenda and Mugenda (2003). Quantitative data collected was analyzed by the use of descriptive statistics using Statistical Package for Social Sciences (SPSS) computer software version 20 which allows the researcher to follow clear set of quantitative data analysis procedures that lead to increased data validity and reliability and demonstrates the relationship between the research variables. Quantitative data was presented through statistical tools such as frequency distribution tables, pie-charts, bar-graphs and in prose form for easy understanding.

Research Findings and Discussion

Size of the Audit Firm

Findings from the study indicate that majority of the respondents (86%) are of the opinion that the audit firm size has an influence on the firm's profitability reporting. Findings are summarised in the table below. The findings of the study augment with the findings of Bouaziz (2012), who examined the relationship between auditor size and financial performance on a sample of 26 Tunisian firms listed on the Tunis Stock Exchange. The result shows that auditor size has an important impact on the financial performance of firms in terms of return on assets and return on equity.

	Strongly agree	Agree	Neither agree nor disagree	Disagree	Strongly disagree
The audit firm size has an influence on the firm's profitability reporting	62%	24%	14%	0%	0%

The audit firms branch network affects the firm's profitability reporting	48%	46%	5%	1%	0%
The audit firms number of partners has an impact on the firm's profitability	42%	51%	6%	1%	0%

Recommendations

It is recommended that the management of listed parastatals should employ the services of one of the big audit firms and where this is not possible, management should go for an audit firm whose character and integrity is beyond question. Audit firms who have a solid reputation will be less likely to employ auditors who will be willing to compromise their stand; the audit firm itself would not like to engage in any activity that will soil its name. This is a plus for the management of the parastatals and the Government alike, because rest assured, their interests will be duly protected.

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