RELATIONSHIP BETWEEN COMPLIANCE AUDITING AND FINANCIAL REPORTING QUALITY AMONG COMMERCIAL STATE CORPORATIONS IN KENYA

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DECLARATION

This research project is my original work that has never been presented in any University for a ward of a degree

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CA	Compliance Auditing
CSCs	Commercial State Corporations
FRQ	Financial reporting quality
KPLC	Kenya Power and Lightning Company

ABSTRACT

The study sought to determine the relationship between compliance auditing and financial reporting quality among CSCs in Kenya. Mixed approach of descriptive survey and correlational design was embraced targeting 33 CSCs in Kenya and census was used. Both primary and secondary data was gathered and using data collection sheet and questionnaire respectively. The analysis of the gathered data was done through means and standard deviations, correlation and regression and presented through tables. The study observed that board independence (β=0.454, $p<0.05$ & $t>1.96$) had the greatest significant effect on financial reporting quality of the CSCs followed by corporation age (β=0.339, $p<0.05$ & $t>1.96$), corporation size (β=0.319, $p<0.05$ & $t>1.96$) and lastly compliance auditing (β=0.254, $p<0.05$ & $t>1.96$). It was concluded that compliance auditing plays an instrumental role as far as financial reporting quality of the firm is concerned. The study recommends that policy makers working in CSCs in Kenya should review the existing policies and regulations to ensure they comply with the established standards. Since board independence was significant, this study recommends that the government being a key shareholder among these CSCs should demand for a balance between executive and independent directors to enhance the effectiveness of the boards in discharging the duties.

CHAPTER ONE: INTRODUCTION

1.1 Background to the Study

Financial reporting quality (FRQ) has attracted significant attention among scholars because of the critical role it plays in informing decision making by shareholders and other interested stakeholders in the firm (Renkas, Goncharenko & Lukianets, 2015). Poor financial reporting quality may therefore lead to wrong decision making among managers that may in turn adversely affect the financial health of the firm (Góis, 2009). Compliance auditing plays an instrumental role as far as FRQ of the firm is concerned. From the corporate governance perspective, compliance auditing (CA) can be seen as one of the checks and balance a firm can put in place to mitigating poor financial reporting quality in the firm (Khalil, 2022). Thus, a negative theoretical nexus is anticipated between CA and FRQ.

The agency theory and stewardship theory supported the inquiry. The signaling theory by Spence (1973) predicts that the information presented in the financial reports and any other communication by the management of the firm can relay varied signals to shareholders who in turn will undertake suitable actions. Thus, reporting wrong information would send a wrong signal to shareholders who may in turn undertake worst investment decisions (Spence, 1973). The agency theory argues that managers are guided by selfish interests that results into conflicts of interest with the owners of the firm (Meckling & Jensen, 1976). As such, it is predicted on the basis of this the agency theory that the existing agency costs would include presenting overstated financial reports by the management of the firm (Donaldson & Davis, 1989).

Commercial State Corporations (CSCs) are entities that are formed by a specific Act of the Parliament and their essence is to generate surplus to the government in addition to provision of

specific service to the general public. Most of these CSCs do operate as monopolies for instance, the Kenya Power and Lightning Company (KPLC) (National Treasury, 2022). Funding of these institutions is done by the government and their surplus they generated is directly remitted to the National Exchequer. There has been growing concerns regarding the quality of financial reports of these CSCs as demonstrated by consistent drop in their reported profits from Kshs. 31.7 million to Kshs. 5.1 million posted in the financial years 2019/2020 and 2018/2019 respectively. This was equivalent to a drop in profits reported in the two financial years of Kshs. 26.6million (Kimeo & Achuora, 2021). This has raised a hotly debatable issue as to whether the financial reports by these CSCs reflect the actual state of financial position and thus justifies the need for the present study.

1.1.1 Compliance Auditing

Compliance audit (CA) is an assessment that is conducted independently with the aim of determining of a given subject issue is within the applicable criteria. It is a comprehensive review of the extent which the firm has adhered to the established regulatory guidelines (Holder & Miller, 1989). CA can be defined as checks that an organization has put in place to ensure that it attains any internal provisions or legal guidelines for instance the by-laws at corporate level, policies as well as controls. CA is done to ascertain of the firm working towards the needed standard. When conducting CA, the operations and procedures of the firm are comprehensively reviewed to ensure they are in line with the applicable standards, regulations, laws and rules (Islam, 2015).

Literature has pointed out a number of constructs of CA, which include its types, principles as well as its elements. In terms of types of CA, Slobodianyk, Shymon and Adam (2018) identify

internal as well as external compliance audits. The underlying difference between these two types of CA is that external CA is conducted by a third party selected out of the organization while an internal audit unit is the one charged with carrying out internal CA. In addition to its types, CA audit can also be examined in terms of its principles that include communication, documentation, materiality, audit risk, audit team management, quality control as well as professional judgment and skepticism (Ghose & Koliadis, 2007). The other way of looking at CA can be in terms of elements as provided by ISSAI 100 which include authorities, criteria, subject matter, three parties as well as assurance. Building on this background, the present study will measure CA using authorities, criteria, subject matter and the three parties.

1.1.2 Financial Reporting Quality

FRQ relates with the accuracy that the financial reports of the firm reflect the operating performance state. Improving the quality of financial reports provide accurate information to shareholders of the firm to inform reliable decisions (Góis, 2009). This may in turn contribute towards reduction of information asymmetry between the management of the firm and the outside parties including shareholders (Herath & Albarqi, 2017). Quality financial reports can increase the ability of the firm to access external funds which in turn would increase the level of investment (Renkas et al., 2015).

Financial reporting quality can be measured in qualitative as well as quantitative terms. Qualitatively, financial reporting quality can be represented by the accuracy, reliability, timeliness as well as consistency among other indicators of the financial information prese4nted in financial statements of the firm (Shroff, 2015). The quantitative measures of financial reporting quality include the use of earnings management that is proxied by discretionary

earnings (Pitenoei, Gerayli & Abdollahi, 2021). The present study will use qualitative measures of timeliness, accuracy, clarity, completeness, credibility and reliability as measures of financial reporting quality of the firm.

1.1.3 Compliance Auditing and Financial Reporting Quality

From theoretical point of view of the agency theory, a positive relationship is anticipated between compliance auditing and financial reporting (Meckling & Jensen, 1976). This is to mean that an increase in compliance auditing would improve financial reporting quality. As such, firm with compliance auditing would provide quality financial reports will always in the public domain of the firm (Meckling & Jensen, 1976). On the other hand, the information asymmetry theory predicts a negative nexus between compliance auditing and financial reporting quality (Spence, 1973). This means that as compliance auditing increases, quality financial statements will be reported in the public domain which would in turn send positive signals to shareholders of the firm to undertake relevant actions (Spence, 1973).

Empirically, the nexus between compliance auditing and financial reporting quality is mixed and inconsistent. For instance, Gaynor et al. (2016) observed that the nexus between auditing and financial reporting quality is recursive. In Pakistan, Khalil (2022) shared that compliance auditing has an insignificant nexus with financial reporting quality. Ogbeifun and Adeniran (2020) noted existence of a significant link between compliance auditing and financial reporting quality. On the other hand Otuya (2019) noted existence of a positive but insignificant link between compliance auditing and financial reporting quality. It is against this background of mixed evidence that the present study seeks to explore the exact link between compliance auditing and financial reporting quality.

1.1.4 Commercial State Corporations in Kenya

CSCs are institutions that are formed by a specific Act of Parliament and a Presidential order to undertake a specific mandate like offering referral health services like for the case of Moi Teaching and Referral Hospital (MTRH) or Kenya National Hospital (KNH). They are government institutions that are formed with the aim of correcting a specific market failure as well as correction of some specified social and political goals (Kimeo & Achuora, 2021). The funding of these institutions is done through the national treasury especially when they are financially constrained. The surplus generated by these institutions is directly remitted to the National Exchequer to finance government projects.

However, in the recent past, the quality of financial statements reported by these CSCs in Kenya has been presented considerable attention. For instance, as of the financial year 2019/20, these institutions reported a profit of Kshs. 5.1 as compared to Kshs. 31.7 million reported in the financial year 2018/19 respectively (Nyansimora & Deya, 2022). Such significant fluctuations in the reported profits of the CSCs is undesirable and could be a possible pointer of the concerns in regard to their financial reporting quality and thus the motivation of this proposed study. Therefore, against this background, the present study is motivated to explore the nexus between compliance auditing and the financial reporting quality of these CSCs.

1.2 Research Problem

Compliance auditing describes the checks and balance that a firm has put in place aimed at determining the extent which the firm abides by the existing regulations and rules. On the other hand, financial reporting quality comprises of some aspects like timelines, reliability and accuracy of the information presented in the financial statements of the firm. The theoretical

nexus between compliance auditing and financial reporting quality is mixed. While the stewardship theoretical point of view predicts a positive link between compliance auditing and financial reporting quality, the information content (signaling) theory anticipates existence of an inverse nexus (Spence, 1973 & Meckling & Jensen, 1976). Empirically, the link between compliance auditing and financial reporting quality is also mixed.

The CSCs in Kenya have been facing issues with regard to their financial reporting quality as demonstrated by inconsistent trends in the reported financial statements. For instance, as of the financial year 2019/20, these institutions reported a profit of Kshs. 5.1 as compared to Kshs. 31.7 million reported in the financial year 2018/19 respectively (Nyansimora & Deya, 2022). Given the fact that the government relies to these CSCs to generate surplus that is used to bridge the budget deficits, concerns about financial reporting quality of these institutions would have unfavorable implication on the overall growth and development of the Kenya as a country in terms of the Gross Domestic Product (GDP).

The existing studies include Khalil (2022) who used the context of Pakistan to explore the link between the choice of the auditor and the financial reporting quality within the banking industry where a significant nexus was reported. Gaynor, Kelton, Mercer and Yohn, (2016) explored the nexus between financial reporting quality and audit quality where a recursive relationship was identified. Ogbeifun and Adeniran (2020) did an appraisal of audit quality attributes and their link with financial reporting quality with a focus on some identified commercial banks in Nigeria and pointed out existence of a significant nexus.

Locally in Kenya, Mwangi, Oluoch, Muturi and Florence (2017) did an analysis of the diversity of the audit committee and the nexus with financial reporting with a focus on non-commercial

state corporations in Kenya and a statistically significant link was reported. Okumu and Otinga (2020) did an assessment of financial auditing practices and the nexus with audit quality of the Kenyan firms and a significant link was noted. Gaitho (2018) did an assessment oif financial reporting and the link with auditing practices in Kenyan Counties. It was observed that incomplete financial reports are kept by Kenyan counties which espouse concerns about financial reporting quality of the government institutions that also include the CSCs.

The aforementioned studies create gaps as some like Khalil (2022) were done in other contexts like Pakistan and not in Kenya. Other studies like Gaynor et al (2016) adopted financial reporting quality as the independent variable unlike in the present study where it will be used as the dependent variable thus creating conceptual gap. It is against these gaps that the study sought to provide responses to: What is the nexus between compliance auditing on FRQ among CSCs in Kenya?

1.3 Research Objective

The study sought to determine the relationship between compliance auditing and financial reporting quality among commercial state corporations in Kenya

1.4 Value of the Study

Policy makers working in the CSCs in Kenya would be able to implement sound CA practices that seek to safeguard the quality of financial information reported by these institutions. The policy makers at the National Treasury would be able to come up with policies in regard to financial reporting quality. The policy makers working at the Auditor General would be in position to develop relevant policies to guide financial reporting quality of the CSCs.

The management team of the CSCs would be in position to develop relevant checks and balances in regard to compliance auditing. The internal audit unit of the CSCs would be in position to strengthen the existing practices in regard to compliance auditing of the firms. The external auditors including the Auditor General would be in position to enhance compliance auditing practices of the CSCs in Kenya.

The study would contribute to the available and existing literature and information as far as compliance auditing and financial reporting quality is concerned. The study would either support or disagree with the available theories as far as compliance auditing and FRQ is concerned.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

The theories for the inquiry are pointed out in this chapter. Other past inquiries and the conceptual diagram are also illustrated.

2.2 Theoretical Review

The signaling and agency theory were used to anchor the proposed study.

2.2.1 Signaling Theory

Ross (1977) proposed it and its main argument that there exists information asymmetry which can be adopted as a good motive as to why firms should leverage financial information to relay signals to the market. Information that managers disclose to the market contribute towards reduction of information asymmetry and the market interprets the same as a good signal. Although originally developed for clarification of asymmetry of information in labor markets (Spence, 1973), it has also been embraced in explaining voluntary disclosure in reporting of the firm (Ross, 1977). The theory predicts that presentation of financial statements in a timely manner wills enhance the quality of financial report since reliable information would be provided to users. Financial reporting is viewed a way of demonstrating accountability of the management to owners of the firm. Through financial reports, shareholders will be in position to carry out monitoring and make informed investment decisions.

Poor financial reporting of the firm arises because of the existing information asymmetry between the manager and the owners who are external to the firm. Because management may

have some privileged information concerning the true picture and financial health of their firm, they may take an advantage of the same to relay signals that may inappropriately interpreted by the market participants.

2.2.2 Agency Theory

The proponent of this agency theory was Meckling and Jensen (1976) and it demystifies the manner which the information quality by those in management to owners of the firm could bridge the implication of information asymmetry between the agent and the principal. The theory provides information on how the agents (managers) and the principal (shareholders) interact with each other. The theory seeks to resolve issues that are occasioned by inadequate goal congruence and objectivity between these two parties. The theory argues that the principals engage in actions that seek to reduce costs depending on the premise that all the agents are guided by selfish interest with high level of risk aversion. In light of this agency theory, compliance auditing can only be effective when there is support from the top management.

The existing conflicts of interest between management and the owners may provide more incentive for managers to report compromised financial statements so as to earn fame and recognition. However, compliance auditing was anticipated to play an instrumental in mitigating these conflicts of interests.

2.3 Determinants of Financial Reporting Quality

The present study sought to review literature on the determinants of financial reporting quality.

2.3.1 Corporation Age

Older corporations are believed to have operated lower discretion in its FRQ as well as their accrual variability. Corporations having long period of time are characterized by strong conditions of operation nd thus will have small variability in the accruals. The age of the corporation is a strong predictor of the strength of the internal controls in place and this strong system of control is key when it comes to quality financial reporting. It is assumed that as time goes by, the internal control of the firm is also strengthened which is likely to contribute to the quality financial reporting. Thus, a positive relationship is anticipated between compliance auditing and financial reporting quality.

2.3.2 Corporation Size

The financial transactions and operations of the firm are affected by its size. Within a specific industry, the size of the firm can be reflected in the cost of production it incurs per unit of the products (Coase, 1937). Size also reflects the assets that are in place as well as the sale volume and the market share. The nature of information disclosed by the firm to the public by extent is determined and influenced by the size. Large and stable firms are obliged to disclose accurate information so as to access funds from lenders (Williamson, 1986). The study will adopt the logarithm of assets as a measure of corporation size.

2.3.3 Board Independence

Board independence is reflected in the proportion of non-executive and outside directors against the overall sum of directorship to the board. Board independence is a strong component of the corporate governance mechanisms in the firm that has attracted significant attention (Gillan,

2006). Jensen (1993) shared that independent directors may be free from manipulation by the executive and the senior management of the firm and this may improve the quality of financial information. In measuring board independence, the study will leverage the ratio of independent against total directors in place.

2.4 Empirical Literature Review

The study conducted in Pakistan by Khalil (2022) was done in the context of commercial banks. The horizon covered 2011 all to 2018. The analysis of the evidence from the gathered information in auxiliary sources was supported by regression. It emerged that whether compliance auditing is being conducted by Big-4 or non-big-4 auditing firms, non-significant differences exists as far as FRQ is concerned. This means that the choice of auditor in execution of CA in the firm is irrelevant in regard to FRQ. Kabwe, Mwanaumo and Chalu (2021) did a study whose focus was on antecedents of compliance with internationally established accounting standards with audit quality as a moderator. The study was conducted in Zambia and information was obtained from secondary sources over the time frame 2012-2018. This was a longitudinal study that was executed through adoption of panel data. It emerged from analysis that the size of the firm and compliance with internationally established accounting standards were significantly linked with each other.

Shahzad, Rehman, Hanif, Asim and Baig (2019) conducted a study in Pakistan whose focus was on FRQ, audit quality and efficiency when it comes to investments. The horizon of consideration by the study was 2007-2014.The analytical method that was embraced was pooled ordinary least squares. The inquiry observed that greater financial reporting quality and audit quality significantly increases the level of efficiency when it comes to investments. Alzeban

(2019) did a study in Saudi Arabia whose focus was on compliance with internally established standards of auditing and financial reporting quality. The study obtained information from 142 chief executive officers from listed entities in Saudi. Financial reporting quality was proxied using accrual quality and discretionary accruals. It emerged from analysis that those firms demonstrating greater compliance with internally established standards of auditing are characterized by better financial reporting quality.

Gaynor et al. (2016) focused on FRQ and audit quality. While adopting desk research methodologies, the inquiry observed that FRQ is a strong predictor of the audit quality of the firm. Oladutire and Oladeji (2013) did an appraisal of CA and financial performance with emphasis on commercial banks in Nigeria. The embraced design was quasi-experimental research and information was sought from primary sources. Correlation aided the analysis of the evidence. It emerged that the procedures and rules of conducting CA are positive and significant correlates of financial performance.

Locally in Kenya, Kibunja (2017) did an analysis of compliance review audit and its implication on financial performance focusing on organizations that are funded by donors in Nyeri. The variables covered in the study included compliance with regulations and rules, internal systems of control and capacity development. In total, 84 respondents were drawn from 42 organizations. Information was obtained in its first hand form through the questionnaire. It emerged from analysis that complying with donor regulations and rules significantly enhanced financial performance. Gitonga and Alexander (2021) conducted an inquiry whose focus was on compliance audit of the procurement system and the implication on performance of supply chains of state corporations in Kenya. The adopted design was descriptive and participants were

46 staff from procurement and audit departments. The inquiry registered existence of significant link.

Lekamario (2017) focused on bringing out the key issues that share FRQ in Kenyan counties. The adopted variables covered the capacity of staff, expertise from the management, the quality of the internal audit function and the integrated financial management system (IFMS). Exploratory research design was the one that was adopted. Noted from the findings was the fact that staff, expertise from the management, the quality of the internal audit function and the IFMS is key predictors of FRQ in Kenyan counties. Wekesa and Malenya (2020) placed emphasis on auditing practices and the implication on financial performance. The specific attention of the inquiry was on Kenya Pipeline Company Limited. Leveraging information from first hand means, it was pointed that outsourcing of the services of auditor, carrying out auditing electronically, reporting of the audit results and the composition of the committee for auditing are key predictors of financial performance. The study by Mwangi (2018) placed focus on attributes of the committee for auditing and the implication FRQ with emphasis to non-commercial CSCs in Kenya. The variables included the independence, meetings, diversity and competence in financial matters of the committee responsible for auditing. Leveraging descriptive design and information in its primary form, it was observed that the independence, meetings, diversity and competence in financial matters of the committee responsible for auditing are critical enablers of FRQ.

2.5 Conceptual Framework

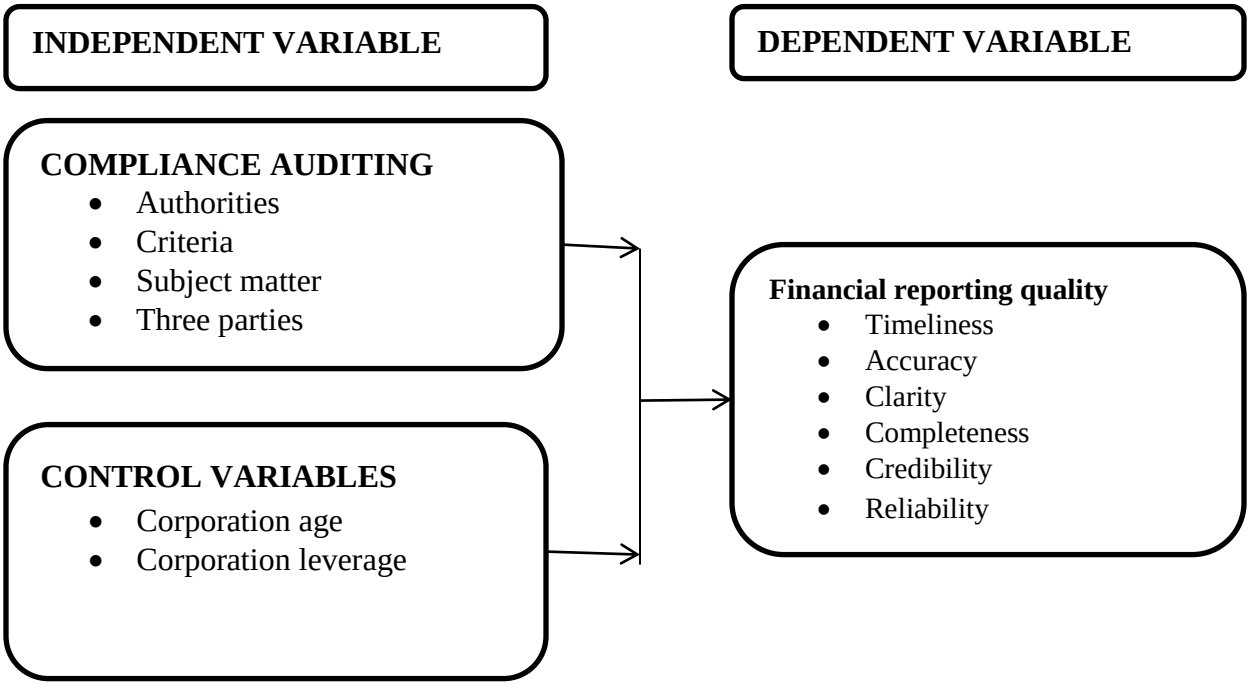

Figure 2.1: Conceptual Framework

2.6 Summary of Literature and Gaps

Table 2. 1: Summary of Literature and Gaps

Author & year	Study	Key finding	Knowledge gap	Focus of present study
Kabwe, Mwanaumo and Chalu (2021)	antecedents of compliance with internationally established accounting standards with audit quality as a moderator	size of the firm and compliance with internationally established accounting standards were significantly linked with each other	The study had an additional moderator variable being audit quality	The study utilized age and leverage as control variables
Alzeban (2019)	compliance with internally established standards of auditing and financial reporting quality	those firms demonstrating greater compliance with internally established standards of auditing are characterized by better financial reporting quality	Internally established standards of auditing was the independent variable	Compliance audit will be the independent variable
Kibunja	compliance review	complying with	The study	FRQ was the

(2017)	audit and its implication on financial performance focusing on organizations that are funded by donors in Nyeri	donor regulations and rules significantly enhanced financial performance	focused on financial performance as the dependent	dependent variable
Gaynor, Kelton, Mercer and Yohn (2016)	financial reporting quality and audit quality	FRQ is a strong predictor of the audit quality of the firm.	It adopted desk review methodology	The present study was empirical reinforced with field work

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Research Design

The study adopted mixed approach of descriptive survey and correlational design. Descriptive design helped to offer an explanation of the present state of affairs as far as compliance auditing and FRQ among CSCs in Nairobi are concerned. On the other hand, a correlation design helped the researcher to test the formulated hypotheses are establish the cause effect nexus between compliance auditing, age and leverage in respect to financial reporting quality. Thus, correlation design allowed the study to embrace correlation and regression that are key in testing of the hypotheses.

3.2 Population of the Study

The study targeted 33 Kenyan CSCs (appendix III) and census was embraced. The justification for adoption of census was because it ensured that all sufficient information was obtained from all the CSCs to support the analysis. This also allowed the adoption of inferential statistics like regression analysis which required 30 data points and above.

3.3 Data Collection

Information was obtained in its primary and secondary form using data collection sheet and questionnaire respectively. The justification gathering both types of data was to complement each other and counter the limitations from each source. The questionnaire was used to obtain information on compliance auditing and financial reporting quality. The design of the items in sections B and C was guided by a 5-point Likert scale where 1-strongly disagree and 5-strongly agree. Data collection sheet was used to obtain information on leverage and age which as the

control variables. The study gathered annual data on a period of 5 years 2017-2021. Secondary data was gathered publication of the National Treasury, the Auditor General and the respective financial reports from the corporations.

3.4 Diagnostic Tests

The study performed diagnostic tests like normality (Shapiro wilk), multicolinearity (Variance of Inflation Factors) and Heteroscedasticity test (Levene's test). The resultant outputs from these tests were appropriately interpreted.

3.5 Data Analysis

Means and standard deviations, correlation and regression analysis were adopted during analysis of the findings through SPSS version 24 tool. The following is the regression model that was adopted during the analysis:

3.5.1 Analytical Model

The following model will be adopted;

$$\mathbf{FRQ= \beta_0 +\beta_1 CoA+\beta_2 CA +\beta_2 CS +\beta_2 BI +\varepsilon}$$

Where;

FRQ-Financial reporting quality (as a composite of timeliness, accuracy, clarity, completeness, credibility and reliability)

CoA- Compliance Auditing (as a composite score of authorities, criteria, subject matter, three parties as well as assurance)

CA-Corporation Age

CS-Corporation size

BI- Board independence

ε is the error term

β_0 is the regression beta coefficient

Table 3.1: Operationalization of Variables

Variable	Indicators	Scale	Data Collection
Compliance auditing	Authorities, criteria, subject matter and three parties	Ordinal scale	Questionnaire, section B
Corporation age	No. of years in operation	Continuous scale	Data collection sheet
Corporation size	Natural logarithm of total assets	Continuous	Data collection sheet
Board independence	Independent directors/Total board size	Ratio	Data collection sheet
Financial reporting quality	Timeliness, Accuracy, Clarity, Completeness, Credibility and Reliability	Ordinal scale	Questionnaire, section C

3.5.2 Test of Significance

The study relied on p-values from regression analysis to draw inferences determined at 5% level of significance. Any p-value less than 0.05 implied significant relationship. The value of R-square was interpreted to represent the proportionate variation in FRQ that was explained by variation in CA. The ANOVA results were used to predict the significance of the overall regression model of the inquiry.

CHAPTER FOUR: DATA ANALYSIS AND DISCUSSION

4.1 Introduction

Results from data processing are detailed in this chapter. This was executed descriptively and inferentially.

4.2 Response Rate

In this inquiry, 33 study tools were issued out and 31 got retuned translating to a rate of 93.9% consistent with Zha, Alabousi, Katz, Su and Patlas (2020).

4.3 Descriptive Statistics

The subsequent sections detail the findings on descriptive statistics.

4.3.1 Compliance Auditing

Table 4.1: Compliance Auditing

		Mean	Std. Dev
Authorities	Compliance auditing ascertains adherence with the Public Finance Management Act	3.74	.728
	Compliance auditing ascertains adherence with the Public Audit Act of 2015	3.67	.747
	Compliance auditing ascertains adherence with the Public procurement and Disposal Act	3.70	.824
	Average	**3.70**	**.766**
Criteria	There are formal criteria to guide compliance auditing	4.00	.730
	The existing criteria provide the frame of reference during compliance auditing	3.87	.921
	The existing criteria guiding compliance auditing are suitable	3.93	.727
	Average	**3.93**	**.793**
Subject Matter	The subject matter in the compliance auditing is guided by the audit scope	3.67	.707
	Some of the subject matters in the compliance auditing are more subjective in nature	3.67	.832
	Some of the subject matter in the compliance audit are easily measureable	3.80	.601
	Average	**3.71**	**.714**
Three Parties	Credibility of the financial statements is established through the Auditor General	3.98	.926
	All transactions captured in the financial statements are reliable	3.56	.573
	Information presented in the financial statements can be verified against objective evidence	3.80	.909
	Average	**3.78**	**.803**

Table 4.1 shows that criteria (M=3.93, SD=0.793), three parties (M=3.78, SD=0.803), subject matter (M=3.71, SD= 0.714) and authorities (M=3.71, SD=0.714) were key components of

compliance auditing in the studied organizations. This means that compliance auditing was conducted in the studied corporations.

4.3.2 Financial Reporting Quality

Table 4.2 is a breakdown of the findings on financial reporting quality.

Table 4.2: Financial Reporting Quality

		Mean	Std. Dev
Timeliness	There is timely financial reporting	3.68	0.599
	The final audit reports are availed to users on time	3.77	0.990
	Average	**3.73**	**0.795**
Clarity	The financial reports are clear	3.71	. 643
	The financial reports capture all material information	4.03	0.547
	Average	**3.87**	**0.273**
Completeness	The financial reports capture all transactions	3.55	0.850
	All the transactions that have occurred in a given financial year are included in the financial statements	3.97	0.752
	Average	**3.76**	**0.801**
Credibility	The financial statements are audited by independent external auditors to establish their credibility	3.74	0.682
	Credibility of the financial statements is established through the Auditor General	3.48	0.926
	Average	**3.61**	**0.804**
Reliability	All transactions captured in the financial statements are reliable	4.06	0.574
	Information presented in the financial statements can be verified against objective evidence	3.81	0.910
	Average	**3.94**	**0.742**

The findings in Table 4.2 indicate that FRQ in the studied corporations was highly characterized by reliability (M=3.94, SD=0.742), clarity (M=.87, SD=0.273), timeliness (M=3.73, SD=0.795) as well as credibility (M=3.61, SD=0.804). This implies that the CSCs in Kenya generated reliable, clear, timely and credible financial reports to the public.

4.3.3 Presentation of Secondary Data

Table 4.3 is an overview

Table 4.3: Presentation of Secondary Data

	n	Minimum	Maximum	Mean	Std. Dev
Corporation Age	31	.42	1.99	1.50	.333
Corporation Size	31	3.83	5.79	4.77	.597
Board Independence	31	.20	.59	.263	.066

The findings in Table 4.3 indicate that corporate age, size and board independence averaged at 1.50, 4.77 and 0.263 respectively among the CSCs across the period covered. This means that 26.3% of the directors on boards of the CSCs were independent.

4.4 Diagnostic Tests

4.4.1 Autocorrelation Test

Table 4.4: Autocorrelation Test

Model	Durbin-Watson
1	2.012

The findings in Table 4.4 shows the value of d=2.012. As observed by Poole and O'Farrell (1971), values of d closer or equal to 2 shows absence of serial correlation in the study.

4.4.2 Multicolinearity Test

VIF values were determined and summarized as shown in Table 4.5.

Table 4.5: Multicolinearity Test

	Collinearity Statistics	
	Tolerance	VIF
Compliance Auditing	.968	1.033
Corporation Age	.848	1.179
Corporation Size	.920	1.087
Board Independence	.923	1.083
Average	**.915**	**1.096**

Table 4.5 shows that the VIF value average as 1.096 which fall within the range of 1-10. This is consistent with Meuleman, Loosveldt and Emonds (2015) who shared that VIF values less than 10 provide an indication of severe and it can therefore be ignored.

4.4.3 Normality Test

Normality assumption was tested through Shapiro-Wilk (Berry, 1993) as shown in Table 4.6.

Table 4.6: Normality Test

	Shapiro-Wilk		
	Statistic	df	Sig.
Compliance Auditing	.895	4	.406
Corporation Age	.963	4	.798
Corporation Size	.966	9	.860
Board Independence	.868	5	.257
Financial reporting quality	.987	3	.780

The findings in Table 4.6 indicate that p-values across the variables are all above 0.05. This is consistent with the assertion of Osborne and Waters (2002) who shared that p>0.05 in a Shapiro-Wilk test signify presence of normality assumption.

4.4.4 Test of Homogeneity of Variances

Heteroscedasticity test was done through Levene statistics (Williams, Grajales & Kurkiewicz, 2013) as shown in Table 4.7.

Table 4.7: Test of Homogeneity of Variances

	Levene Statistic	df1	df2	Sig.
Compliance Auditing	1.645	8	21	.172
Corporation Age	1.715	8	21	.153
Corporation Size	1.086	8	21	.410
Board Independence	4.566	8	21	.602

Table 4.7 shows that all the p-values are above 0.05 and according to Casson and Farmer (2014), this is an indication of absence of Heteroscedasticity which is desirable for regression analysis to proceed.

4.5 Correlation Results

Table 4.8: Correlation Results

		FRQ	Compliance Auditing	Corporation Age	Corporation Size	Board Independence
FRQ	Pearson Correlation	1				
	Sig. (2-tailed)					
	N	31				
Compliance Auditing	Pearson Correlation	.326	1			
	Sig. (2-tailed)	.003				
	N	31	31			
Corporation Age	Pearson Correlation	.431	.189	1		
	Sig. (2-tailed)	.016	.309			
	N	31	31	31		
Corporation Size	Pearson Correlation	.652	.265	.643	1	
	Sig. (2-tailed)	.000	.150	.000		
	N	31	31	31	31	
Board Independence	Pearson Correlation	.297	.073	.020	.077	1
	Sig. (2-tailed)	.005	.694	.913	.682	
	N	31	31	31	31	31

Table 4.8 indicate that compliance auditing (r=0.326), corporation age (r=0.431), corporation size (r=0.652) and board independence (r=0.297) all had positive correlation with financial reporting quality among CSCs n Kenya. This positive relationship means that an improvement in compliance auditing would lead to an enhancement in financial reporting quality.

4.6 Regression Results and Hypotheses Testing

The findings of regression analysis were determined and summarized as shown in the subsequent sections.

Table 4.9: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.721[a]	.520	.446	2.23611

The findings in Table 4.9 indicate that on overall, 52% variation in FRQ of the CSCs in Kenya is explained by compliance auditing (R^2=0.520). This means that in addition to compliance

auditing, there are still other factors with an effect on FRQ that future studies should focus on. The ANOVA findings were determined and presented as shown in Table 4.10.

Table 4.10: AOVA Findings

	Sum of Squares	df	Mean Square	F	Sig.
Regression	140.833	4	35.208	7.041	.001[b]
Residual	130.005	26	5.000		
Total	**270.839**	**30**			

The findings in Table 4.10 shows that on overall, the regression model was significant (F=7.041, $p<0.05$). Table 4.11 is a breakdown of the coefficients and significance.

Table 4.11: Regression Beta Coefficient

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	β	Std. Error	Beta		
(Constant)	3.798	1.418		2.768	.000
Compliance Auditing	.254	.108	.191	2.352	.019
Corporation Age	.339	.103	.098	3.291	.034
Corporation Size	.319	.113	.160	3.823	.001
Board Independence	.454	.192	.131	2.365	.003

From Table 4.11, the following is the predicted regression equation model:

FRQ= 3.798+0.254CoA+0.339CA +0.319CS +0.454BI

Where;

FRQ-Financial reporting quality (as a composite of timeliness, accuracy, clarity, completeness, credibility and reliability)

CoA- Compliance Auditing (as a composite score of authorities, criteria, subject matter, three parties as well as assurance)

CA-Corporation Age

CS-Corporation size

BI- Board independence

From Table 4.11, the study observed that board independence (β=0.454, $p<0.05$ & $t>1.96$) had the greatest significant effect on financial reporting quality of the CSCs followed by corporation age (β=0.339, $p<0.05$ & $t>1.96$), corporation size (β=0.319, $p<0.05$ & $t>1.96$) and lastly compliance auditing (β=0.254, $p<0.05$ & $t>1.96$). This implies that compliance auditing plays an instrumental role as far as financial reporting quality of the firm is concerned.

4.7 Discussion

The study observed that there was financial reporting quality in the CSCs in Kenya. This was characterized by reliability, clarity, timeliness as well as credibility. Thus, it can be generalized that the CSCs in Kenya generated reliable, clear, timely and credible financial reports to the public. This finding is consistent with Shroff (2015) who noted that qualitatively, financial reporting quality can be represented by the accuracy, reliability, timeliness as well as consistency among other indicators of the financial information prese4nted in financial statements of the firm. The study observed that from descriptive statistics that criteria, three parties, subject matter and authorities were key components of compliance auditing in the studied organizations. These concurs with the elements of CA as provided by ISSAI 100 which include authorities, criteria, subject matter, three parties as well as assurance Thus, compliance auditing was conducted in the studied corporations. This CA according to Islam (2015) largely focuses on determining if the firm working towards the needed standard.

The relationship between the variables was explored through correlation analysis. From the findings, the study observed that compliance auditing, corporation age, corporation size and

board independence all had positive correlation with financial reporting quality among CSCs n Kenya. This positive relationship means that an improvement in compliance auditing would lead to an enhancement in financial reporting quality. This finding concurs with the agency theoretical point of view where a positive relationship is anticipated between compliance auditing and financial reporting (Meckling & Jensen, 1976). However, the finding disagrees with the information asymmetry theory that predicts a negative nexus between compliance auditing and financial reporting quality (Spence, 1973).

Regression analysis was used to predict compliance auditing on FRQ. It was observed that over half variation in FRQ of the CSCs in Kenya is explained by compliance auditing. The study observed that board independence had the greatest significant effect on financial reporting quality of the CSCs followed by corporation age, corporation size and lastly compliance auditing. This implies that compliance auditing plays an instrumental role as far as financial reporting quality of the firm is concerned. The findings are inconsistent with Gaynor, Kelton, Mercer and Yohn (2016) who observed that the nexus between auditing and financial reporting quality is recursive. Khalil (2022) shared that compliance auditing has an insignificant nexus with financial reporting quality. However, the finding agrees with Ogbeifun and Adeniran (2020) who noted existence of a significant link between compliance auditing and financial reporting quality. On the other hand Otuya (2019) noted existence of a positive but insignificant link between compliance auditing and financial reporting quality.

CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

A summary of the analyzed results and conclusion are presented in this chapter. The recommendations, limitations and areas requiring further research are also pointed out in the chapter.

5.2 Summary of the Findings

The study observed that there was financial reporting quality in the CSCs in Kenya. This was characterized by reliability, clarity, timeliness as well as credibility. Thus, it can be generalized that the CSCs in Kenya generated reliable, clear, timely and credible financial reports to the public. The study observed that from descriptive statistics that criteria, three parties, subject matter and authorities were key components of compliance auditing in the studied organizations. Thus, compliance auditing was conducted in the studied corporations.

The relationship between the variables was explored through correlation analysis. From the findings, the study observed that compliance auditing, corporation age, corporation size and board independence all had positive correlation with financial reporting quality among CSCs n Kenya. This positive relationship means that an improvement in compliance auditing would lead to an enhancement in financial reporting quality.

Regression analysis was used to predict compliance auditing on FRQ. It was observed that over half variation in FRQ of the CSCs in Kenya is explained by compliance auditing. The study observed that board independence had the greatest significant effect on financial reporting quality of the CSCs followed by corporation age, corporation size and lastly compliance

auditing. This implies that compliance auditing plays an instrumental role as far as financial reporting quality of the firm is concerned.

5.3 Conclusion

Based on descriptive statistics, it can be summed up that FRQ has been widely considered among the commercial state corporations in Kenya. This has allowed them to generate reliable, clear, timely and credible financial reports. This conclusion is consistent with the signaling theory where it can be hypothesized that managers of these corporations have a strong incentive to report quality financial information so as to send positive signals to the concerned stakeholders. The study also concludes that the managers in the CSCs have recognized and appreciated the need for compliance auditing and thus the same has been adopted. Compliance auditing among these corporations revolved around criteria, three parties, subject matter and authorities.

From the correlation results, the study conclude that compliance auditing, corporation age, corporation size and board independence were all positive correlates of financial reporting quality among CSCs in Kenya. In view of the regression results, it is concluded that board independence had the greatest significant effect on financial reporting quality of the CSCs followed by corporation age, corporation size and lastly compliance auditing. These findings resonate with the agency theory that regards the independence of the board as strong monitoring mechanisms that enhances the functioning of the board for quality financial reporting mechanisms in a corporation.

5.4 Recommendations of the Study .

There exists significant interaction between compliance auditing and financial reporting quality. Thus, this study recommends that policy makers working in CSCs in Kenya should review the

existing policies and regulations to ensure they comply with the established standards. Since board independence was significant, this study recommends that the government being a key shareholder among these CSCs should demand for a balance between executive and independent directors to enhance the effectiveness of the boards in discharging the duties. The study recommends that the top management team in CSCs should play their active role in ensuring there is quality financial reporting systems and mechanisms in place.

5.5 Limitations of the Study

The small sample of 33 CSCs limited the generalization of the findings to the wider State Corporations in Kenya. The time period of 5 years (2017-2021) limits the study as similar studies done with extended periods can yield different outcomes. Methodologically, both longitudinal and cross sectional designs were adopted as information was obtained from first hand as well as second hand sources.

5.6 Suggestions for Further Research

In this study, R-square was represented by 0.522, which means that there exist other additional factors aside from compliance auditing that have an effect on FRQ. Hence, the focus of future inquiries should be on how to bring on board these other additional factors. Other organizations aside from the CSCs for instance, the Independent Constitutional Offices in Kenya need to be studied in future inquiries.

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APPENDICES

Appendix I: Questionnaire

SECTION A: GENERAL INFORMATION

1. Kindly indicate the nature of operation of your corporation

Manufacturing allied ( )

Service oriented ( )

Other ( )

2. Kindly estimate the total number of employees in your corporation

Less than 100 staff ( )

101-200 staff ( )

201-300 staff ( )

Above 301 staff ( )

SECTION B: COMPLIANCE AUDITING

2. Given below are statements on authorities, criteria, subject matter, three parties and assurance which are components of Compliance auditing. Kindly indicate your extent of agreement with these statements. Use the scale of 1-5, where 1=strong disagree, 2=disagree, 3=neutral, 4=agree and 5=strongly agree

Statements on authorities	**1**	**2**	**3**	**4**	**5**
Compliance auditing ascertains adherence with the Public Finance					

Management Act					
Compliance auditing ascertains adherence with the Public Audit Act of 2015					
Compliance auditing ascertains adherence with the Public procurement and Disposal Act					
Statements on criteria	**1**	**2**	**3**	**4**	**5**
There are formal criteria to guide compliance auditing					
The existing criteria provide the frame of reference during compliance auditing					
The existing criteria guiding compliance auditing are suitable					
Statements on subject matter	**1**	**2**	**3**	**4**	**5**
The subject matter in the compliance auditing is guided by the audit scope					
Some of the subject matters in the compliance auditing are more subjective in nature					
Some of the subject matter in the compliance audit are easily measureable					
Statements on three parties	**1**	**2**	**3**	**4**	**5**
The auditor is among the three parties in the compliance auditing process					
The responsible party guides the subject matter during compliance audit					
The users of the final compliance audit reports are part of the three parties in the compliance audit					

SECTION C: FINANCIAL REPORTING QUALITY

3. Given below are statements on timeliness, accuracy, clarity, completeness, credibility and reliability which are components of financial reporting quality. Kindly indicate your extent of agreement with these statements. Use the scale of 1-5, where 1=strong disagree, 2=disagree, 3=neutral, 4=agree and 5=strongly agree

Statements on timeliness	**1**	**2**	**3**	**4**	**5**
There is timely financial reporting					
The final audit reports are availed to users on time					
Statements on clarity	**1**	**2**	**3**	**4**	**5**
The financial reports are clear					
The financial reports capture all material information					
Statements on completeness	**1**	**2**	**3**	**4**	**5**
The financial reports capture all transactions					
All the transactions that have occurred in a given financial year are included in the financial statements					
Statements on credibility	**1**	**2**	**3**	**4**	**5**
The financial statements are audited by independent external auditors to establish their credibility					
Credibility of the financial statements is established through the Auditor General					
Statements on reliability	**1**	**2**	**3**	**4**	**5**
All transactions captured in the financial statements are reliable					

Information presented in the financial statements can be verified against objective evidence					

END

THANK YOU

Appendix II: Data Collection Sheet

Year	Total assets	No of board members	No of independent directors	Age
2017				
2018				
2019				
2020				
2021				

Appendix III: List of Commercial State Corporations in Kenya

1. Agro-Chemicals and Food Company
2. Chemelil Sugar Company
3. East African Portland Cement Company
4. Gilgil Telecommunications Industries
5. Jomo Kenyatta Foundation
6. Kenya Airports Authority
7. Kenya Broadcasting Corporation
8. Kenya Civil Aviation Authority
9. Kenya Electricity Generating Company
10. Kenya Electricity Transmission Company
11. Kenya Literature Bureau
12. Kenya Ordinance Factories Corporation
13. Kenya Pipeline Company
14. Kenya Ports Authority
15. Kenya Power and Lighting Company
16. Kenya Railways Corporation
17. Kenya Safari Lodges and Hotels
18. Kenya Seed Company Limited
19. Kenya Wine Agencies
20. Kenyatta International Convention Center
21. National Cereals and Produce Board
22. National Housing Corporation
23. National Oil Corporation of Kenya
24. National Water Conservation and Pipeline Corporation
25. New Kenya Co-operative Creameries Ltd
26. Numerical Machining Complex
27. Nzoia Sugar Company
28. Postal Corporation of Kenya
29. Pyrethrum Board of Kenya
30. School Equipment Production Unit
31. South Nyanza Sugar Company
32. Telkom Kenya Limited
33. University of Nairobi Enterprises and Services Limited

Source: State Corporations Advisory Committee

Appendix IV: Raw Data Collected

Firm	Compliance Auditing	Corporation age	Corporation size	Board independence	Financial reporting quality
Kenya Electricity Transmission Company	38	0.996	5.460	0.205	36
New Kenya Co-operative Creameries Ltd	46	1.202	5.502	0.276	39
University of Nairobi Enterprises and Services Limited	48	1.361	5.617	0.311	39
Telkom Kenya Limited	47	1.300	5.482	0.301	39
South Nyanza Sugar Company	46	1.633	5.672	0.274	43
School Equipment Production Unit	46	1.633	5.790	0.259	37
Pyrethrum Board of Kenya	45	0.416	4.872	0.227	40
Postal Corporation of Kenya	43	1.321	5.340	0.245	36
Nzoia Sugar Company	46	1.613	5.444	0.239	34
National Water Conservation and Pipeline Corporation	46	1.491	4.694	0.226	41
National Oil Corporation of Kenya	43	1.544	4.775	0.288	37
National Housing Corporation	44	1.732	4.798	0.245	38
National Cereals and Produce Board	46	1.531	4.959	0.236	32
Kenyatta International Conference Center	47	0.836	5.074	0.250	40
Kenya Wine Agencies	45	1.699	5.422	0.256	35
Kenya Seed Company Limited	42	1.799	4.990	0.224	38
Kenya Safari Lodges and Hotels	48	1.724	4.455	0.255	32
Kenya Railways Corporation	47	1.623	5.063	0.255	43
Kenya Power and Lighting Company	49	1.987	4.780	0.268	38
Kenya Ports Authority	45	1.613	4.207	0.275	36
Kenya Pipeline Company	44	1.613	4.005	0.264	37
Kenya Ordinance Factories Corporation	49	1.342	4.430	0.242	43
Kenya Medical Supplies Agency	46	1.144	4.145	0.226	40
Kenya Literature Bureau	45	1.857	4.239	0.593	38
Kenya Electricity Generating Company	46	1.813	3.939	0.218	37
Kenya Broadcasting Corporation	44	1.763	4.203	0.248	35
Kenya Airports Authority	49	1.447	4.482	0.208	40

Jomo Kenyatta Foundation	46	1.707	3.825	0.260	39
Gilgil Telecommunications Industries	44	1.321	4.050	0.232	37
East African Portland Cement Company	47	1.934	4.004	0.292	32
Agro-Chemicals and Food Company	47	1.613	4.256	0.274	41