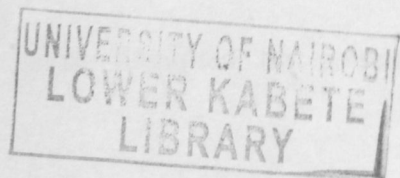


THE RELATIONSHIP BETWEEN RISK BASED AUDIT AND
CORPORATE GOVERNANCE IN THE CENTRAL GOVERNMENT
OF KENYA

BY:

PETER OTIENO/ATIENO



A RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILMENT
OF THE REQUIREMENTS FOR THE AWARD OF THE DEGREE
OF MASTER OF BUSINESS ADMINISTRATION IN THE
UNIVERSITY OF NAIROBI

OCTOBER, 2012

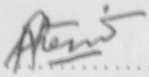
University of NAIROBI Library



0459645 8

DECLARATION

This Research Project is my original work and has not been presented in any other University.

Signed.......... Date ..7.11.2012.....

PETER OTIENO ATIENO

D61/61442/2010

This Research Project has been submitted for presentation with my approval as University Supervisor.

Signed.......... Date ..8.11.2012.....

Supervisor: Mr. H. Ondigo

Lecturer, Department of Finance and Accounting

School of Business, University of Nairobi

DEDICATION

I dedicate this work to my family and those who supported me throughout the completion of this project.

Without the support of a number of people, who in one way or the other steered me towards my ultimate goal, I would not have been able to express my appreciation to them and especially to the following:

I wish to express my sincere gratitude to my project supervisor Mr. M. Odingo for his tireless guidance, advice, encouragement and assistance in making this project a reality. I also wish to acknowledge the contribution of the staff of the University of Nairobi, particularly the library staff, MCA examination officer and moderation officer to the success of this project.

My sincere appreciation goes to my lovely wife, parents and siblings for their moral support and encouragement and understanding when I was not there for them during the project period. I would not have made it without you.

Most important of all I extend my gratitude to the Almighty God for strength, good health, wisdom and guidance throughout this journey.

To all, I remain forever grateful.

ACKNOWLEDGMENT

This Research Project would not have been possible without the cooperation and support of a number of people, who in one way or the other steered me towards my ultimate goal. I would like to express my appreciation to them and especially to the following:-

I wish to express my sincere gratitude to my project supervisor, Mr. H. Ondigo, for his tireless guidance, selfless dedication and encouragement in making this project a reality. I also wish to acknowledge the contribution of the rest of university of Nairobi fraternity especially the library staff, MBA coordination office and moderators to the success of this project.

My sincere appreciation goes to my lovely wife, parents and siblings for their moral support and encouragement and understanding when I was not there for them during the project period; I wouldn't have made it this far without you.

Most important of all I extend my gratitude to the Almighty God for strength, good health, knowledge and vitality that helped make this project a reality.

To all, I remain forever grateful

ABSTRACT

Corporate Governance (CG) is a way in which stakeholders assure themselves of getting a return on their investment following the separation between those who control and those who own the residual claims. Effective corporate governance practices are essential to achieving and maintaining public trust and confidence in the Central government System, which are critical to the proper functioning of the Government and economy as a whole. Poor corporate governance can contribute to poor service delivery to the citizens and massive corruptions to an economy. Corporate governance and external audit therefore assist investors by aligning the objectives of management with the objectives of shareholders, thereby enhancing the reliability of financial information and the integrity of the financial reporting process.

The objective of the study was to investigate the relationship between risk based audit and corporate governance in the Central Government of Kenya. The study adopted a descriptive research design. The target population was 42 ministries in Kenya which formed the sample because only one respondent was expected from each ministry. Primary data was collected using a questionnaire comprising both open-ended and close-ended questions while secondary data was collected from ministries publications including service charters and strategic plans. The researcher selected a pilot group of 5 individuals from the target sample of the staff working in the ministries to test the reliability of the research instrument. Data collected was analyzed using regression analysis. The findings was presented using tables and charts, percentages, tabulations, frequencies, means and other measures of central tendency.

The study found that risk assessment practices, risk management practices, annual risk based planning and risk based internal auditing standards affected corporate governance at the central government ministry. The study recommends that most organizations' internal audit offices should develop a strategic plan that would enable the audit staff to evaluate risk and identify high-risk areas that deserve audit attention. This exercise should enable the head of internal audit to ensure the appropriateness of resources by projecting requirements in a timely fashion thus enhancing good governance. The internal audit should adhere to the guidelines stipulated by the Institute of Internal Auditors (IIA) which is recognized as the internal audit profession's leader in certification, education, research, and technical guidance. The study recommends that future scholars and academicians explore the findings of this study to take it further taking into account the changes in the operating environment

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

2.2 Theoretical Framework

2.3 Empirical Evidence

2.4 Relationship between Corporate Governance and Risk Based Audits

2.5 Corporate Risk

2.6 Internal Audit

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

TABLE OF CONTENTS

DECLARATION	ii
DEDICATION	iii
ACKNOWLEDGMENT	iv
ABSTRACT.....	v
LIST OF TABLES.....	ix
ABBREVIATIONS.....	x
 CHAPTER ONE	 1
INTRODUCTION	1
1.1 Background of the Study	1
1.1.1 Risk based Audit.....	2
1.1.2 Corporate Governance	4
1.1.3 Relationship between Risk-Based Audit and Corporate Governance	6
1.2 Research Problem	10
1.3 Research Objective	13
1.4 Value of the Study	13
 CHAPTER TWO	 15
LITERATURE REVIEW	15
2.1 Introduction.....	15
2.2 Theoretical Review	15
2.3 Corporate Governance	23
2.4 Relationship between Corporate governance and Risk based Audits	24
2.5 Empirical Review	30
2.6 Chapter Summary	37
 CHAPTER THREE.....	 38
RESEARCH METHODOLOGY	38
3.1 Introduction.....	38

3.2 Research Design	38
3.3 Population	38
3.4 Data Collection	39
3.5 Data Analysis	41
CHAPTER FOUR	43
DATA ANALYSIS, RESULTS AND DISCUSSION	43
4.1 Introduction.....	43
4.2 Auditing Standards	43
4.3 Risk Assessment	44
4.4 Annual Risk Based Planning	48
4.5 Risk Management	51
4.6 Corporate Governance	53
4.9 Regression Analysis.....	53
4.10 Interpretation of Findings	56
CHAPTER FIVE	59
SUMMARY, CONCLUSION AND RECOMMENDATIONS	59
5.1 Introduction.....	59
5.2 Summary	59
5.3 Conclusions.....	61
5.4 Recommendations for Policy	62
5.5 Limitations of the Study	63
5.6 Area for Further Research.....	63
REFERENCES	65
APPENDICES.....	71
Appendix I: Questionnaire.....	71
Appendix II: List of Ministries	78
Appendix III: Letter of Introduction.....	80

LIST OF TABLES

Table 4. 1: Statements Relating To Auditing Standards.....	44
Table 4. 2: Extent an Inherent Risk Assessment Affected Governance	45
Table 4. 3: Statements on the Effect of Inherent Risk Assessments on Governance	47
Table 4. 4: Factors Influencing Judgments of Inherent Risk at the Ministry	48
Table 4. 5: Annual Risk Based Planning	48
Table 4. 6: Extent Annual Risk Based Planning Process Affected Governance	49
Table 4. 7: Statements on Annual Risk Based Planning and its Effect on Governance	50
Table 4. 8: Transparency in Risk Based Audit Management Affected Governance	51
Table 4. 9: Statements on Risk Management and Its Effect on Governance.....	52
Table 4. 10: Extent Auditing Standards Affect Governance	53
Table 4. 11: Corporate Governance	53
Table 4. 12: Model Summary	54
Table 4. 13: ANOVA.....	55
Table 4. 14: Coefficient of Determination.....	55

ABBREVIATIONS

CCG	Centre for Corporate Governance
CEO	Chief Executive Officer
CG	Corporate Governance
CSR	Corporate Social Responsibility
IAF	International Accreditation Forum
IIA	Institute of Internal Auditors
KENAO	Kenya National Audit Office
NSE	Nairobi Stock Exchange
RBA	Risk Based Audit
RBIA	Risk Based Internal Auditing
SAS	Statements of Auditing Standards

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Corporate Governance (CG) is a way in which stakeholders assure themselves of getting a return on their investment following the separation between those who control and those who own the residual claims (Shleifer & Vishny, 1997). This separation of ownership from control implies that the stakeholders cannot exercise full control over managerial actions. Therefore, stakeholders hire managers to make decisions that are in the best interest of the stakeholders. Jensen and Meckling (1976) define this relationship as agency relationship in which shareholders engage managers to manage and direct their investment on their behalf.

In addition, agency theory assumes an opportunistic behavior where both individuals want to maximize their own expected interests leading to a constant conflict of interest between managers and shareholders. Furthermore, there will be an information asymmetry between the shareholders and managements because the managers have the competitive advantage of information within the company over that of the owners (Zubaidah, 2009). Effective corporate governance practices are essential to achieving and maintaining public trust and confidence in the Central government System, which are critical to the proper functioning of the Government and economy as a whole. Poor corporate governance can contribute to poor service delivery to the citizens and massive corruptions to an economy.

Agency theory predicts that corporate governance and external audit enhance the convergence of interests between shareholders and managers. Auditors work directly and more closely with the audit committee than the board (Abdullah, 2004). In their work, the auditors scrutinize the operations of the firm as run by the managers who have been engaged by the board. To ensure board representation in the verification process as to whether the financial statements prepared actually portray a true and fair view of the organization's financial position as at a given date, the external auditors who are independent work closely with the audit committee. One important monitoring system is corporate governance whose primary objective is not to directly improve corporate performance, but to resolve agency problems by aligning management's interests with the interests of shareholders (Cohen *et al.*, 2007). External audit is perceived to be another important monitoring system that may help to align the interests of managers and shareholders and reduce the potential for opportunistic managers' behavior. Cohen *et al.* (2007) note that the auditor bears great responsibility for reliable financial reporting when the audit committee's role is primarily ceremonial, although the committee's symbolic efforts can lead to effective questioning of management. Corporate governance and external audit therefore assist investors by aligning the objectives of management with the objectives of shareholders, thereby enhancing the reliability of financial information and the integrity of the financial reporting process (Watts and Zimmerman, 1986).

1.1.1 Risk Based Audit

A risk-based audit approach is the method the auditor follows to determine the audit procedures to be performed; that is, based on risk; or the indication that there is a greater

likelihood that the transactions or classes of transactions, accounts or balances, and/or disclosures is misstated, to enable the auditor to achieve the audit objective (Prinsloo, 2008). Risk based audit is a process, an approach, a methodology and an attitude of mind rolled into one. Risk-based audit conceptually implies auditing the things that really matter to an organization especially those areas that pose the greatest risks. Clearly, if risks have not been formally identified and assessed then there is a real opportunity for you to work with management to help create this information. Another way of looking at risk-based audit is as a process. Traditionally audits begin and end by looking at controls, often regarded as the main expertise that the function has.

RBA involves high-level risk profiling of the audit portfolio over time; thus it facilitates strategic use of scarce audit resources, aligns audit efforts with management objectives, facilitates institutional development, and reduces risk exposure by focusing attention on areas of weakness. In RBA, risk is measured by assessing the ethical climate, competence of personnel, size of assets and of operations, materiality, and results of previous audits. Direct probability estimates, normative tables, and comparative risk ranking are typically used to identify risk. Risk factors are then converted from conceptual and subjective (qualitative) data into quantitative data. An overall risk score is derived by scoring and weighing the risk factors. The result is a risk-based engagement plan that guides the deployment of audit resources to high-risk areas (Prinsloo, 2008).

Audit services are considered to have an important role in reducing information asymmetry as well as in mitigating agency problems between managers and stakeholders (Willenborg, 1999). Auditing is designed to lessen the agency problems resulting from

the separation of ownership and control by ensuring that the managers act in the interest of their principals. Auditors could be successful only if their audit opinion represents the true findings of the audit engagement to promote corporate governance in an institution. Simultaneously, from an agency perspective, auditors can be considered as part of the CG structure because they monitor the quality of the financial reporting process (Beasley & Salterio, 2001). Therefore, the interaction between CG and external audit services often suggests that they are complementary and the purpose of both is to protect stakeholders' interest. Hence, auditors must work with other factors in the CG structure to ensure that stakeholders receive the highest quality financial reports as well as help to protect the interests of current and future stakeholders.

The essence of risk-based audit is therefore customer-focused, starting with the objectives of the activity being audited, then moving on to the threats (or risks) to achievement of those goals and then to the procedures and processes to mitigate the risks. Risk-based audit is therefore an evolution rather than a revolution, although the results obtained can be revolutionary in their magnitude.

1.1.2 Corporate Governance

The Cadbury (1992) provide the five pillars of corporate governance: efficiency and effectiveness, integrity and fairness, accountability, responsibility and transparency. The pace at which corporate governance has developed has been set by the introduction of corporate governance codes, nationally and internationally. These codes have been drawn up in reaction to events and have been composed by practitioners pressed for time and responding to immediate political and public concerns (Clarke, 2004). Allen and Gale

(2002) states that corporate governance is used in two distinct ways: In Anglo-Saxon countries like the US and UK good corporate governance involves firms pursuing the interests of shareholders. In other countries like Japan, Germany and France corporate governance involves pursuing the interests of all stakeholders. The Centre for Corporate Governance in Kenya (2005) defines corporate governance as the process by which corporate entities are directed, controlled and held accountable.

Governance is concerned with the processes, systems, practices and procedures that govern institutions and the manner in which these rules and regulations are applied and followed and the relationships they create. Essentially it addresses the leadership role within the institutional framework (Cadbury, 1992). Corporate governance influences the flow of capital, and the lack of it may negatively impact on capital markets. One of the recommendations of the King Report on Corporate Governance for South Africa 2002 was that pension funds should be obliged to indicate the extent to which corporate governance issues are taken into consideration in investment decisions relating to funds under their control (Centre for Corporate Governance in Kenya, 2005).

Good corporate governance requires appropriate and effective legal, regulatory and institutional foundations. A variety of factors, including the system of business laws, stock exchange rules and accounting standards, can affect market integrity and systemic stability. Such factors, however, are often outside the scope of banking supervision. Supervisors are nevertheless encouraged to be aware of legal and institutional impediments to sound corporate governance, and to take steps to foster effective foundations for corporate governance where it is within their legal authority to do so.

Where it is not, supervisors may wish to consider supporting legislative or other reforms that would allow them to have a more direct role in promoting or requiring good corporate governance.

1.1.3 Relationship between Risk-Based Audit and Corporate Governance

As a sub-committee of the board, the audit committee has, at least in theory, the explicit responsibility to ensure sound auditing and financial reporting. However, recent evidence suggests audit committees have not fulfilled these responsibilities, either because of lack of commitment (e.g., meeting infrequently), knowledge, and/or independence (Beasley *et al.*, 2000).

Recent findings indicate that audit committees meet with external auditors about twice a year, with limited two-way (i.e., passive) communications (Cohen *et al.* 2002) and that the audit committee members are often the more junior members of the board (Vafeas, 2001). Thus, to date audit committees in most instances do not appear to have served as an effective corporate governance mechanism. The importance of corporate governance in the audit process will likely increase as firms move toward an audit strategy that is more holistic and focuses on business processes and business risks.

In this regard, Bell *et al.* (1997) state that "today's auditor should place more weight on knowledge about the client's business and industry, and its interactions with its environment, when forming an opinion about the validity of financial-statement assertions." Since a key role of corporate governance is often to facilitate interactions with the environment and to help the firm reduce its business and global risks, it appears

imperative that auditors focus on the strength and functioning of the board of directors and its support for the audit committee when evaluating the risk that the financial statements are materially misstated.

Management and boards in today's organizations face more dramatic demands, challenges, and opportunities than ever before in fulfilling their commitment to oversight of stakeholder investment. Corporate accountability, governance, risk mitigation are just a few concerns that pepper the thoughts of senior management and boards of directors in contemporary organizations. The ensuring of organization ethics, efficiency, economy, and effectiveness requires a much broader approach today than even as recently as five years ago.

Corporate governance is the organization's strategic response to risk. The choice is simple: Either keep up or get out; playing "catch up" is no longer an option. The stakes are too high, the potential losses too great. The laws and regulations of most countries in the world have required organizations to set up the internal audit activity in order to strength the effectiveness of organizations' corporate governance. Corporations are also beginning to be aware of the contribution made by the internal audit to corporate governance. The Institute of Internal Auditors redefined the internal audit in June 1999 to include evaluation and improvement of governance process as part of the scope of work of the internal audit

According to Kurihama (2005), auditing addresses the fallibility and limited rationality of human beings. That is, auditing corrects people's mistakes including fraud, errors and

illegal acts, leading them in the right direction. It also reinforces and expands the relationship between corporations and stakeholders who have far less knowledge and capability than corporations. Auditing is not only a medium to ensure a good relationship between corporations and society in a true sense but is also an infrastructure to build up public trust as a social capital. Auditing as an institution enables the users to secure autonomy as well as freedom in their decision-making. By building up public trust, auditing is essential to the society. Kurihama (2005) notes that: Corporate Social Responsibility (CSR), corporate governance, and auditing are interactively related and cooperate with each other. In order to fulfill CSR and to ensure sustained growth and development, the corporation must establish and operate corporate governance. In order to achieve corporate governance effectively, auditing plays an important role in corporate governance and then the implementation of CSR.

1.1.4 The Central Government

Kenya's central government is structured through the Constitution. Wielding all administrative and policy-making powers, the central government consists of three branches: Executive, Parliament and Judiciary. These branches enact the laws and policies that govern the country. The need for a reform of the public finance system was emphasized in the Economic Recovery Strategy for Wealth and Employment Creation for 2003-2007, as a key element to achieve: fiscal sustainability and balance in the public economy; restructuring and reallocations for growth and poverty alleviation; and improved public sector performance, efficiency and effectiveness in the public sector, leading to improved service delivery and results for Kenyans. A number of relevant and

important reforms have since been initiated for example related to an improved budget process and documents, automation of payroll and financial management systems, legal reforms of financial management, ethics and procurement, introduction of improved audit techniques and the clearing of audit backlogs with the aim of improving corporate governance among Government institutions. Institutional reforms have also been undertaken to promote good governance and fight corruption (Public financial Management Reforms, 2012).

An important part of a transparent and well functioning Public financial Management system is an independent and effective oversight function. The Kenya National Audit Office (KENAO) is the main institution for oversight of public expenditure in Kenya. Originally the Office was referred to as the Exchequer and Audit Department which with time changed to the Office of the Controller and Auditor-General. During this period, the Office derived its mandate from the Exchequer and Audit Act which provided for the audit of the Central Government by the Controller and Auditor General. Later the Act was amended to also provide for audit of Local Authorities and State Corporations. The Public Audit Act, 2003 established a more independent office of the Controller and Auditor General and renamed it KENAO.

The overall goal for the institution is to improve Government's accountability to the public through enhanced External Audit capacity. As part of the mandate, the Auditor-General may audit and report on the accounts of any entity that is funded from public funds which includes all funds of the national and county governments, accounts of all courts, commissions and independent offices established by the Constitution as well as

the national assembly, the senate and the county assemblies. The audit report confirms whether or not public money has been applied lawfully and in an effective way, and reports are submitted to parliament or the relevant county assembly. Within three months after receiving an audit report, parliament or the county assembly must debate and consider the report and take appropriate action (Public financial Management Reforms, 2012).

KENAO also strives to strengthen institutional cooperation between external audit and other accountability agencies in the Kenya government, including Internal Audit, Efficiency Monitoring Unit, Inspectorate of State Corporations, and the Kenya Anti-Corruption Commission. Further, KENAO carries out value for money audits, procurement audit, environmental audit, public debt audit and audit of donor funded projects

1.2 Research Problem

Over the decades internal auditing was confined to assisting organizations safeguard assets and check established control procedures. The main focus of risk based internal auditing is on governance, monitoring and control. Internal auditors are tolerated, but are not deemed essential in organizational governance and control. However, the emergence of new business risks has compelled many organizations to reformulate strategies and to elevate the status of internal auditing (Spirglas, 2006). Thus, risk-based internal auditing has emerged as an important contributor to effective governance and risk management.

The governance structures in the Kenya government ministries are not very efficient and there are also cases of unsatisfactory adherence to basic governance principles that increase the risk of public corruption. Even though corporate governance principles have always been important for getting good rating scores for large and publicly held firms; they are also becoming much more important for investors, potential investors, creditors and governments (Gompers *et al.*, 2003). Because of all of these factors, corporate governance receives high priority on the agenda of policymakers, financial institutions, investors, firms and academics (Heracleous, 2001).

Prior internal audit research has explored objectivity issues (Brody and Lowe, 2000; Gibson, 2003), the relationships between internal and external auditors (Carey *et al.*, 2000) and the trend of outsourcing internal audit activities. Some recent studies have also explored the relationship between internal audit and the audit committee (Goodwin, 2003). None of these researchers have focused on the influence of risk based audit on the governance. Thus, research examining why organizations choose to use risk based internal audit has been scant.

In Kenya, a number of studies have been conducted on corporate governance and auditing. Muting (1987) did a comparative analysis of judgmental & statistical sampling technical in auditing in Kenya. Chola (2000) studied the status of computer auditing in Kenya. Kariuki (2002) carried out a survey of the use of assessment centers in multinational auditing firms in Nairobi. Jebet (2001) conducted a study of corporate governance the case of quoted firms in Kenya and established that because of the

responsibility placed on the quoted companies by law, they were following the laid down rules and procedures pertaining to corporate governance.

Matengo (2008) did a study on the relationship between corporate governance practices and performance: the case of banking industries in Kenya. Matengo found out those banks with the highest level of corporate governance reported high performance and were more stable compared to those banks with weak corporate governance while Wandabwa (2010) did a study on the relationship between corporate governance and financial performance among broadcasting stations in Kenya. He found out that corporate governance was high in privately owned broadcasting stations compared to those which were owned by the government. To best of the researchers Knowledge, none of the known local and international studies have ever focused on the relationship between risk-based audit and corporate governance within the public sector and for that matter the Central Government of Kenya in particular. From the literature above, it is clear that there exists a gap in the Central Government since the structure and operations of central Government are very different and unique compared to those of private sector studied above. This study therefore sought to fill this research gap by exploring the relationship between risk based audits and corporate governance in the Central Government of Kenya. This study therefore sought to answer the following research question; what is the relationship between risk based audit and corporate governance in the Central Government of Kenya?

1.3 Research Objective

1.3.1 Main Objective

To investigate the relationship between risks based audit and corporate governance in the Central Government of Kenya.

Specific Objectives

- i. Determine the effects of risk assessment in the Central government governance.
- ii. Establish the effect of risk management on the governance of the central government.
- iii. Determine the extent to which annual risk based planning influence the governance of the central government. and
- iv. Determine the effect of internal audit standards on the central government governance.

1.4 Value of the Study

The study would be of importance to policy makers and government regulators as it would provide information for further analysis and development of new policies governing the auditing sector and encourage quality financial reporting which in turn influences corporate governance.

This study would be important to audit sector players as it gives more insight in the relationship between external independent audits that encourage provision of quality financial reporting statements. This would help promote quality corporate governance

and external audits thus enable investors invest appropriately without fear of losing their investments.

LITERATURE REVIEW

The study would also be of great value to researchers and scholars as it would act as source of reference and suggest areas for further research especially where auditing, quality financial statements and are concerned.

2.1 Theoretical Review

Theoretical perspectives relevant to the study of corporate governance and accounting audit are based on the governance structures, processes and practices. The theoretical perspectives that is relevant for this study include the Agency theory, stakeholder theory and stakeholder theory is main concepts of corporate governance and stakeholder theory is main concepts of corporate governance.

2.1.1 Stakeholders Theory

Stakeholder theory is a concept of corporate governance that focuses on the relationship between the organization and its stakeholders. Stakeholder theory is a concept of corporate governance that focuses on the relationship between the organization and its stakeholders. Stakeholder theory is a concept of corporate governance that focuses on the relationship between the organization and its stakeholders.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter conducts a review of the literature on corporate governance audit. From this review the theoretical framework has been developed upon which this study was built. The chapter further discussed the literature on corporate governance and auditing as studied by other scholars. It then summarized by looking at the chapter summary and the research gap.

2.2 Theoretical Review

Theoretical perspectives relevant to the study of corporate governance and risk based audit are based on the governance structures, processes and practices. The theoretical perspectives that is relevant for this study, drawn on agency theory, stewardship theory and stakeholder theory as main corporate governance theories and institutional theory as one of the organisational and economic theories.

2.2.1 Stakeholders Theory

There are two main theories of stakeholder governance: the abuse of executive power model and the stakeholder model. Current Anglo-American corporate governance arrangements vest excessive power in the hands of management who may abuse it to serve their own interest at the expense of shareholders and society as a whole (Hutton, 1995). Supporters of such a view argue that the current institutional restraints on

managerial behaviour, such as non-executive directors, the audit process, the threat of takeover, are simply inadequate to prevent managers abusing corporate power. Shareholders protected by liquid asset markets are uninterested in all but the most substantial of abuses. Incentive mechanisms, such as share options, are means through which managers can legitimise their abnormal overpayment (viewed by some as a symptom of the breakdown of governance (Keasey *et al.*, 1997). The abuse of executive power is particularly embedded in the problem of executive overpay since executive remuneration has risen far faster than average earnings and there is at best a very weak link between compensation and management performance (Conyon *et al.*, 1995; Gregg *et al.*, 1993). The only restraint on executive pay seems to be the modesty of executives themselves, and the creation of so-called independent remuneration committees by large companies is not effective. What is worse is that it legitimises self-serving managerial behaviours.

The independence is generally a sham, not for restraining excess of pay, but for justifying it (Kay and Silberston, 1995, p. 85, 94). The supporters of this model do not believe that the main lines of corporate governance reform, such as non-executive directors, shareholder involvement in major decisions and fuller information about corporate affairs, are suitable monitoring mechanisms (Kay and Silberston, 1995, p. 94). Instead, they propose statutory changes in corporate governance, under which hostile takeovers are not possible to effect, since ownership of shares no longer brings the right to appoint executive management. The basic objective of corporate governance in this guise is "managerial freedom with accountability", to allow executive management the power to

develop the longer term business, while holding them rigorously responsible to all stakeholders involved in the business.

Perhaps the most fundamental challenge to the orthodoxy is the stakeholder model, with its central proposition is that a wider objective function of the firm is more equitable and more socially efficient than one confined to shareholder wealth (Keasey *et al.*, 1997, pp. 8-9). The well-being of other groups such as employees, suppliers, customers and managers, who have a long-term association with the firm and therefore a "stake" in its long-term success, is recognised. The goal of corporate governance is to maximise the wealth creation of the corporation as a whole. Specifically, a stakeholder is defined as "any group or individual who can affect or is affected by the achievement of the firm's objectives" (Freeman, 1984, p. 25), and this is "meant to generalise the notion of stockholder as the only group to whom management need to be responsive" (Freeman, 1984). These definition were formulated form the base that modern corporation is affected by a large set of interest groups, including at a minimum shareholders, lenders, customers, employees, suppliers and management, which are often referred to as the primary stakeholders, who are vital to the survival and success of the corporation.

To these the corporation adds secondary stakeholders, such as the local community, the media, the courts, the government, special interest groups and the general public, that is society in general. From this perspective, corporate governance debates often proceed with a fixation on the relationship between corporate managers and shareholders, which presupposes that there is only one right answer. In fact, shareholders are difficult and reluctant to exercise all the responsibilities of ownership in publicly held corporations,

whereas other stakeholders, especially employees, may often too easily exercise their rights and responsibilities associated as owners. This is a compelling case for granting employees some form of ownership.

2.2.2 Agency Theory

Agency theory argues that in the modern corporation, in which share ownership is widely held, managerial actions depart from those required to maximize shareholder returns (Pratt and Zeckhauser, 1985). In agency theory terms, the owners are principals and the managers are agents and there is an agency loss which is the extent to which returns to the residual claimants, the owners, and fall below what they would be if the principals, the owners, exercised direct control of the corporation (Jensen and Meckling, 1976). Agency theory specifies mechanisms which reduce agency loss (Eisenhardt, 1989). These include incentive schemes for managers which reward them financially for maximizing shareholder interests. Such schemes typically include plans whereby senior executives obtain shares, perhaps at a reduced price, thus aligning financial interests of executives with those of shareholders (Jensen and Meckling 1976).

Other similar schemes tie executive compensation and levels of benefits to shareholders returns and have part of executive compensation deferred to the future to reward long-run value maximization of the corporation and deter short-run executive action which harms corporate value. In like terms, the kindred theory of organizational economics is concerned to forestall managerial "opportunistic behaviour" which includes shirking and indulging in excessive perquisites at the expense of shareholder interests (Williamson, 1985). A major structural mechanism to curtail such managerial "opportunism" is the

board of directors. This body provides a monitoring of managerial actions on behalf of shareholders. Such impartial review will occur more fully where the chairperson of the board is independent of executive management where the chief executive officer is chair of the board of directors.

An implication of agency theory is that where CEO duality is retained, shareholder interests could be protected by aligning the interests of the CEO and the shareholders by a suitable incentive scheme for the CEO, i.e. by a system of long-term compensation additional to basic salary. Where CEOs hold the dual role of chair, the presence of long-term compensation will align their interests with shareholders and forestall the loss in shareholder benefit which otherwise will result from the dual role. Any superiority in shareholder returns observed among dual CEO chairs over independent chairs would be explained away by agency theory as being due to the spurious effects of financial incentives. By contrast, stewardship theory would hold that any observed superiority in shareholder returns from CEO duality was not a spurious effect of greater financial incentives among CEO-chairs than among independent chairs. Thus, agency theory yields two hypotheses regarding CEO governance:

2.2.3 Stewardship Theory

To the degree that an executive feels their future fortunes are bound to their current corporate employers through an expectation of future employment or pension rights, then the individual executive may perceive their interest as aligned with that of the corporation and its owners, even in the absence of any shareholding by that executive. These theoretical considerations argue a view of managerial motivation alternative to agency

theory and which may be termed stewardship theory (Donaldson 1990a, 1990b; Barney 1990). The executive manager, under this theory, far from being an opportunistic shirker, essentially wants to do a good job, to be a good steward of the corporate assets. Thus, stewardship theory holds that there is no inherent, general problem of executive motivation.

Given the absence of an inner motivational problem among executives, there is the question of how far executives can achieve the good corporate performance to which they aspire. Thus, stewardship theory holds that performance variations arise from whether the structural situation in which the executive is located facilitates effective action by the executive. The issue becomes whether or not the organization structure helps the executive to formulate and implement plans for high corporate performance (Donaldson, 1985). Structures will be facilitative of this goal to the extent that they provide clear, consistent role expectations and authorize and empower senior management.

By contrast to the agency theory, stewardship theory yields two opposite hypotheses regarding CEO governance: CEO duality leads to higher return to shareholders and the positive effects of CEO duality are not due to the spurious effects of long-term compensation. Stewardship theory of management and agency theory have both focused on the leadership philosophies adopted by the owner's of an organization. It grew out of the seminal work by Donaldson and Davis (1989, 1991) and was developed as a model where senior executives act as stewards for the organization and in the best interests of the principals. The model of man in stewardship theory is based upon the assumption that the manager will make decisions in the best interest of the organization, putting

collectivist options above self-servicing options. This type of person is motivated by doing what's right for the organization, because she believes that she will ultimately benefit when the organization thrives. The steward manager maximizes the performance of the organization, working under the premise that both the steward and the principal benefit from a strong organization (Mallin, 2010).

2.2.4 Institutional Theory

Institutional theory adopts a sociological perspective to explain organizational structures and behaviour. It draws attention to the social and cultural factors that influence organizational decision-making (Scott, 2001), and in particular how rationalized meanings or myths are adopted by organizations (Meyer & Rowan, 1977). These myths become taken for granted and so are followed in a rule-like fashion when making decisions. They become the institutionalized logic that guides organizational behaviour.

Meyer and Rowan's (1977: 343-344) definition of rationalized myths: "they are rationalized and impersonal prescriptions that identify various social purposes as technical ones and specify in a rulelike [sic] way the appropriate means to pursue these technical purposes rationally." For these mutual funds, socially responsible factors are taken for granted as being legitimate criteria, and they become part of the normal evaluation process for identifying potential investments.

Applications of institutional theory in governance have been advocated in business literature (Aldridge 2004; Kondra & Hinings 1998). According to Weir and McKnight (2002), institutional corporate governance consists of external governance mechanisms and internal governance mechanisms and linked this concept with institutional theory.

Institutional theory has usually been associated with path dependence and inertia. In international corporate governance, it has been used as an explanation for the supposed continued divergence of national systems (Chizema & Buck 2006; Chizema & Kim 2010). Recent developments in institutional theory, however, identify the circumstances in which change is likely to occur (Chizema & Buck 2006). According to Ritzer (2004), institutional theory attends to explain the deeper and more resilient aspects of social structure. This theory considers the “processes by which structures, including schemas, rules, norms and routines, become established as authoritative guidelines for social behaviour” (Ritzer 2004, p. 408). It inquires into how these elements are created, diffused, adopted and adapted over space and time, and how they fall into decline and disuse.

Accounting scholars using institutional theories challenge ‘economics-inclined colleagues’ beliefs that organizations are bounded, relatively autonomous and economically rational (Aldridge, 2004). Basically, institutional theory asserts that organizational structures and procedures are adopted because important external institutions prefer them. Institutional networks are not merely control and coordinating mechanisms for economic transactions, they socially construct rules and beliefs, exert social pressures for conformity, and are founts of legitimacy and hence reward (Major & Hopper 2004). Although the ostensible subject is stability and order in social life, (stakeholders)” ... of institutions must perforce attend not just to consensus and conformity but to conflict and change in social structures” (Ritzer 2004, p. 409).

Early researchers (Dacin, Goodstein & Scott 2002; Powell 2003; Scott 2005; Scott & Christensen 1995) resolved the conundrum between institutional and market forces by restricting its claims to governmental and non-for profit organizations and they argued that organisations were dichotomised as facing either institutional or technical (efficiency) demands (Powell 2003).

2.3 Corporate Governance

Governance refers to the manner in which power is exercised in the management of economic and social resources for sustainable human development initiative (McCord, 2002). The definition of corporate governance may vary in different contexts or different countries (Solomon and Solomon, 2004). In very simple terms, corporate governance refers to how a corporation is governed. Laws, regulations or formal policy play a significant role in determining this, of course. For example, legally, a board of directors is vested with the authority to manage or supervise the management of the business and affairs of a corporation.

Each director and officer, in exercising their powers and discharging their duties, is required by law to: act honestly and in good faith with a view to the best interests of the company (otherwise known as the director's fiduciary duty); and exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances (otherwise known as the director's duty of care). While these duties are deliberately broad in their scope, what has occurred in the last several years is that specific duties and responsibilities have been imposed on, and expected of, directors, by regulations, shareholder guidelines and otherwise, in a broad variety of areas (e.g., board

structure and composition, director qualifications and financial, risk and compensation oversight by the board) in order to ensure that boards of directors adequately oversee the management of the organization and act in the best interests of the company and all of its shareholders at all times.

Corporate governance systems may be therefore thought of as mechanisms for establishing the nature of ownership and control of organizations within an economy. In this context, corporate governance mechanisms are economic and legal institutions that can be altered through the political process – sometimes for the better (Shleifer and Vishny, 1997). Company law, along with other forms of regulation (including stock exchange listing rules and accounting standards), both shape and is shaped by prevailing systems of corporate governance.

2.4 Relationship between Corporate governance and Risk based Audits

Prior research provides evidence that strong governance is associated with improved financial reporting quality in terms of a lower incidence of fraud (DeChow et al. 1996; McMullen 1996; Abbott et al. 2000; Beasley et al. 2000; and Farber 2005), fewer restatements (Abbott et al 2004), and lower levels of earnings management (Klein 2002; Xie et al. 2003; and Bédard et al. 2004). Therefore, the nature and strength of corporate governance is expected to impact the audit process (e.g., risk assessments and extent of audit tests), since professional standards dictate that the audit be tailored to the risk of misstatements (SAS 47 1984). Further, corporate governance actors such as the audit committee are responsible for overseeing the quality of financial reporting and the audit

Cohen et al. 2007 examined the affect of different roles of the board on the audit process. Specifically, they focus on an agency role where the board places attention on monitoring management and a resource dependence role where the board emphasizes proactively assisting management in setting corporate strategy and in helping to provide access to external resources. Cohen et al. found that both board roles affect audit planning judgments (risk assessment and extent of testing).

Yatim, Kent and Clarkson (2006) extended the study to a Malaysia setting for the relationship between audit fees and board and audit committee characteristics. Other than audit committee characteristics and internal audit, they additionally examined the board characteristics. Thus, their study "Governance structures, ethnicity, and audit fees of Malaysian listed firms" reflected more comprehensively the relation between level of corporate governance and audit fees. They hypothesized that good corporate governance practices reduce auditors' risk assessments, resulting in lower audit fees. They found that external audit fees are positively and significantly related to board independence, audit committee expertise, and the frequency of audit committee meetings.

Regarding the effect of CG on audit process, Beasley and Salterio (2001) believe that the board's success in discharging its fiduciary duties and, in working closely with the management, would be predicted to increase financial reporting quality and consequently auditors investigate the lower audit risk and less efforts in auditing. In addition, Krishnan (2005) finds a positive relationship between independency of audit committee and quality of internal control. Firms which do not have an effective audit committee are more likely to have an internal control weakness and need more efforts in audit process (Zhang et al.

2007). Felo et al. (2001) believe that CG information is important for allocating decisions of professional staff and efforts in an audit planning. Cohen and Hanno (2000) examine how auditors consider CG structure when they are planning an audit program.

Carcello, Hermanson, Neal and Riley (2002) examined the relations between three board characteristics (independence, diligence, and expertise) and audit fees for Fortune 1000 companies. They expected a positive relation between audit fees and the board characteristics, and audit fee increases as auditor's additional costs are passed on to the client. They found significant positive relations between audit fees and board independence, diligence, and expertise. And they obtained the persistent results when similar measures of audit committee quality were included in the model.

In a balance sheet model of the firm, Gillan (2006) argues that the board of directors is the apex of internal governance system and is responsible to monitor and compensate management. Important characteristics for a good board of directors found in previous research include board independency, directors' ownership and CEO duality (Zubaidah, 2009). In addition, an effective independent audit Committee is one of the factors that determine the audit quality (Dhaliwal et al. 2006). This committee recommends external auditors and directs the relationship between them and the company.

Blue Ribbon Committee (1999) identified the audit committee characteristics on improving the effectiveness of corporate audit committee. The report of "Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees" addressed the characteristics include audit committee independence, audit committee expertise,

audit committee size and audit committee diligence. The results proved that a more independent, diligent, expert, and larger audit committee is better able to objectively evaluate management's accounting and reporting practices. These elements of an audit committee are likely to contribute to a higher quality of corporate governance within a company. From the view of an external auditor, these characteristics are likely to reduce a company's inherent and control risks with the company's financial statements and disclosures (Beasley, Carcello, Hermanson and Lapides, 2000). These studies thus offered explanations for variations of audit fees from a corporate governance perspective where it argues that different level of corporate governance can results in different amount of external audit fees charged.

Hussein (2003) examined the effect of audit committees on major disclosures and other non-financial characteristics of companies listed at the Nairobi Stock Exchange (NSE). However the study did not address the issue of how audit committees operate, their relationship with management or whether the committees were effective in the performance of their duties. Goddard and Masters (2000) stated that audit committees have become more important and prevalent in recent years but there is a relative paucity of empirical research concerning their value. Kalbers and Fogarty (1993) indicated that the issue of whether audit committees are actually discharging their important responsibility remains insufficiently understood. Therefore, there is need for a study to be carried out to examine the way audit committees operate in developing countries.

The Blue Ribbon Committee (1999) stated that quality financial reporting can only be achieved through open and candid communication and close working relationships

among the company's board of directors, audit committee, management, internal auditors and the external auditors. The success of audit committees in fulfilling their oversight responsibilities depends on their working relationships with other participants of corporate governance. Zabihollah (2003) stated that the more effective approach is the audit committee to work diligently with management and auditors to identify the most complex business activities, assess their relative risks, determine their accounting treatment, and obtain complete understanding of their impact on fair presentation of financial performance conditions. Audit committee members should be sufficiently knowledgeable to ask management as well as the internal and external auditor's tough questions regarding quality, transparency, and reliability of financial reports

2.5 Empirical Review

Risk is defined as uncertainty of outcome, whether positive opportunity or negative threat, of actions and events. The risk has to be assessed in respect of the combination of the likelihood of something happening, and the impact which arises if it does actually happen. The approach concerned with the effectiveness of inherent risk (IR) assessments is typified by Griffiths, (2006). Each of these studies considered the role of risk assessment in the detection of errors. It was also suggested that auditors who have a good understanding of their auditee's business can accomplish such an assessment with relative ease. In addition to the auditee's previous history of errors, Houghton and Fogarty found that non-systematic transactions and industry characteristics were associated with the incidence of errors. Contrary to the presumption in Statements of

Auditing Standards (SAS) that IR is difficult and costly to assess, these studies suggest that some IR factors can and should be assessed.

All government audit activities require attempts to understand IR assessment processes. O'Regan, (2002) described the development of a conceptual model of how auditors assess inherent risk in a normal audit environment and its implementation as a knowledge-based (expert) system. Peters et al. asserted that the auditor begins the inherent risk evaluation process by generating expectations of accounts balances. The auditor identifies changes that have occurred in the firm or its environment and determines how those changes should interact with historic trends to produce an expected balance in the account.

Consistent with Walker, Shenkir, and Barton (2003) conceptual model included both historical firm data and the historic evaluation of management and control as essential factors contributing to the auditor's assessment of inherent risk. This study demonstrated that particular inherent risk factors are explicitly assessed by practitioners. However, Choo, (1988) concluded that auditors do not consider it appropriate to generate numerical estimates of risk on an account by account basis, but reason about a client's financial statements using knowledge about changes in the industry and/or the client, management's motivations, prior track record and so on.

Fogarty, (1997) experimental study found four factors (turnover of controllers, financing pressure, the complexity of overhead in inventory and the quality of personnel responsible for inventory calculation) to be significant in influencing judgments of IR.

Subjects were generally unfamiliar with formal IR assessment processes, there may be some intuitive (rather than learned) effects associated with in the IR assessment process.

Risk management includes identifying and assessing inherent risks and then responding to them. According to IIA- Role of auditing in Public Sector Governance (2006), auditors assess the adequacy of corporate governance and the control environment; the effectiveness of processes to identify, assess, and manage risks; the assurance provided by control policies, procedures, and activities; the completeness and accuracy of information and communication systems and practices; and the effectiveness of management's monitoring and evaluation activities.

The Risk Based Internal Auditing (RBIA) approach involves management to a far greater extent. The risks to be covered in audits will exist in all parts of the organization and audits will therefore involve managers in departments never visited before. Many risks will be very significant to the organization and the discussion of their controls will involve more senior managers and directors than might be involved in traditional finance orientated audits. RBIA emphasizes management's responsibility for managing risks. Audits will involve more discussion with managers about their risks and their responses to them. There will be an initial meeting with managers, possibly involving a risk workshop to examine risks in greater depth, and contact throughout the audit to discuss issues (Schnatterly, 2001).

The government fully recognizes that accelerating and deepening the reform agenda in the areas of governance and anti-corruption is critical for consolidating the on-going

broad-based economic recovery and reducing poverty. The implementation of risk based auditing in public sector is expected to improve governance, transparency, accountability and efficiency in the management of public affairs, and make the public sector more effective in the delivery of services. Its implementation will also deepen the facilitation of private sector participation in the economy by encouraging investments, job creation and development of business initiatives to reduce poverty.

Planning is generally considered a vital internal audit activity and it includes preparing a strategic plan, annual plans and programs for individual risk based audit assignments. The operational standard of the Internal Audit of many governments, dealing with the planning aspects of the internal audit, requires the preparation of a strategic plan – usually a five-year plan, a periodic (annual) plan and plans for individual audit assignments (Karapetrovic, 1999). Most organizations' internal audit offices do not develop a strategic plan, the exercise of which would have enabled the audit staff to evaluate risk and identify high-risk areas that deserve audit attention. It could also have been an exercise by which the head of internal audit ensures the appropriateness of resources by projecting requirements in a timely fashion thus enhancing good governance.

Proper planning enables accomplishment of a large number of audits in a given period by improving efficiency. In some cases the numbers of the audit engagements are completed in the budgeted time and the number of actual audits performed in a period is usually less than the number of audits stated in the annual audit plan. This is usually caused by adhoc audit assignments by the management and urgent requests by external parties. Adhoc

audit assignments signify the relevance of internal audit to management (Van Gansberghe, 2005), and reflect positively on audit effectiveness and also in good governance. The supply side argument suggests that during the audit planning stage, auditors assess corporate governance risk and plan procedures or charge risk premiums based on their assessment.

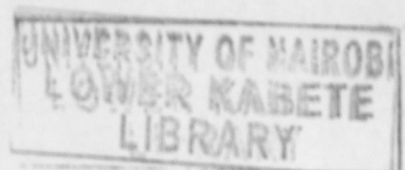
Since the demand for internal audit and their objectives are distinct from those of external audit, the planning and scope of the two types of engagements also vary. Internal auditors typically plan engagements which are different in nature and much broader in scope than those of their external colleagues. However, in pre-audit, management abdicated their responsibilities to internal audits; there were no audit reports and no review of the system by management. On the other hand, systems audit was passive and reactive control based audit with no involvement of management in audit planning (Seddon, 2000). Therefore, for internal audit to be effective and efficient, Risk Based Audit (RBA) was introduced.

The principles of good governance transparency and accountability, fairness and equity, efficiency and effectiveness, respect for the rule of law and high standards of ethical behavior represent the basis upon which to build open government (OECD, 2005). For Risk Based Audit (RBA) to provide good governance in public sector they must embrace the International Auditing standards that guide the internal audits ethics of work and maintain professional auditing standards. The Committee of Sponsoring Organizations of the Tread way Commission (COSO) is a voluntary private-sector organization, established in the United States, dedicated to providing guidance to executive management and governance entities on critical aspects of organizational governance,

business ethics, internal control, enterprise risk management, fraud, and financial reporting.

COSO has established a common internal control model against which companies and organizations may assess their control systems. The internal audit should identify the elements of COSO controls such as factors of internal control environment, risk management, control activity, information and communication and finally monitoring (Karapetrovic, 1999). They should also identify the limitations of internal control and factors which override control activities. They should also adhere to the guidelines stipulated by the Institute of Internal Auditors (IIA) which is recognized as the internal audit profession's leader in certification, education, research, and technical guidance.

Recent scandals and bankruptcy in large corporations revealed huge gaps between boards of directors, executive management, internal control and organizational performance. The importance of internal control and audit is aggravated even more after accounting firms are being sued by shareholders for their inability to detect fraud. Since then, the changes involved strengthening internal control in organizations. At the same time, several authors proposed that quality and corporate governance (CG) should be dealt as inseparable areas. For instance, the CSR/CG framework published by British Standards Institution (Castka et al., 2004) makes a significant contribution to this trend. This work offers organizations a framework for establishing, maintaining, improving and documenting their CSR/CG management system. The authors assert that these concepts cannot be mutually exclusive but merge together, each offering a different yet



complementary perspective on the activities of an organization, to form a robust strategic business management tool.

Clearly, a profound change in third party verification practices is necessary. The efforts so far suggest that there is willingness for change and in fact some changes are in progress. The International Accreditation Forum (IAF) and ISO has attempted to address the criticism by revision of requirements for accreditation bodies that accredit conformity and for auditor competences yet IAF asserts that the profound changes will need more time (Feary, 2005). In the meanwhile, some accreditation bodies have already challenged the management systems paradigm and offer new approaches to ISO management systems certification.

Locally several studies have been done on the effect of corporate governance on financial performance. Muriithi, (2004) studied the relationship between corporate governance mechanisms and performance of firms quoted on the NSE and found that the size and the composition of the board of directors together with the separation of the control and the management have the greatest effect on the performance.

Ngugi (2007) did a study on the relationship between corporate governance structures and the performance of insurance companies in Kenya and found that inside directors are more familiar with the firm's activities and they can act as monitors to top management especially if they perceive the opportunity to advance into positions held by incompetent executives. The study also found that the effectiveness of a board depends on the optimal

mix of inside and outside directors concluding that an optimal board composition lead to better performance of the companies.

Gatauwa (2008) studies the relationship between corporate governance practices and stock market liquidity for firms listed on the Nairobi Stock Exchange. The study found that greater disclosure enhances stock market liquidity, thereby reducing the cost of capital. The commitment of management teams to increase the level of disclosure also lower the information asymmetry between managers and shareholders and lower the cost of capital. Matengo (2008) also conducted a study on the relationship between corporate governance practices and performance the case of banking industries in Kenya. The study found that good corporate governance will lead to lower firm risk and subsequently to a lower cost of capital.

2.6 Chapter Summary

This chapter reviewed literature related to the concept of corporate governance and risk based audits. It started with a review of the theories on which the study is to be built, four theories including the agency theory, stakeholders' theory, institutional theory and stewardship theories. The chapter then reviewed the concept of corporate governance clearly concluding that Company law, along with other forms of regulation both shape and is shaped by prevailing systems of corporate governance (Shleifer and Vishny, 1997). The studies that have been done have majorly covered private organizations as opposed to Central Government. Based on the findings of previous studied discussed, this study seeks to establish the relationship between risk based audit and corporate governance in Central Government in Kenya.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter sets out various stages and phases that were followed in completing the study. In this stage, most decisions was about how research was going to be executed and how respondents was approached, as well as when, where and how the research was completed.

The following subsections were included; research design, target population, data collection instruments, and data collection procedures and data analysis.

3.2 Research Design

The study adopted a descriptive research design aimed at discussing the relationship between risks based audit and corporate governance in the Central Government of Kenya. Descriptive research design was concerned with the description of the phenomenon including the what, whom and where. The variables measurement was based on qualitative research which utilized qualitative data.

3.3 Population

Target population for in statistics is the specific population about which information is desired. According to Ngechu (2004), a population is a well defined or set of people, services, elements, events, group of things or households that are being investigated. The target population for this study constituted 42 respondents from the 42 ministries in Kenya. The study specifically targeted administrators because they were the ones

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter sets out various stages and phases that were followed in completing the study. In this stage, most decisions was about how research was going to be executed and how respondents was approached, as well as when, where and how the research was completed.

The following subsections were included; research design, target population, data collection instruments, and data collection procedures and data analysis.

3.2 Research Design

The study adopted a descriptive research design aimed at discussing the relationship between risks based audit and corporate governance in the Central Government of Kenya. Descriptive research design was concerned with the description of the phenomenon including the what, whom and where. The variables measurement was based on qualitative research which utilized qualitative data.

3.3 Population

Target population for in statistics is the specific population about which information is desired. According to Ngechu (2004), a population is a well defined or set of people, services, elements, events, group of things or households that are being investigated. The target population for this study constituted 42 respondents from the 42 ministries in Kenya. The study specifically targeted administrators because they were the ones

involved in the day to day running of the Ministries hence were better placed to provide information necessary for this study.

All the 42 ministries were included in the sample because only one respondent was expected from each ministry. Following the small number of ministries, the study conducted a census where all target respondents was included in the study.

3.4 Data Collection

The study collected both primary and secondary data to obtain information on the relationship between risks based audits and corporate governance in the Central Government of Kenya. Primary data was collected using a questionnaire while secondary data was collected from ministries publications including service charters and strategic plans.

3.4.1 Research Instrument

The data collection instrument was a semi-structured questionnaire comprising both open-ended and close-ended questions. The questionnaire consisted of two parts: A and B representing respondents' bio data and the relationship between risk based audits and corporate governance, respectively. The researcher delivered the questionnaires to the respondents and collected them after they had been filled. The questionnaire was designed in line with the objectives of the study. To enhance quality of data obtained, Likert type questions were included whereby respondents indicated the extent to which the variables were practiced on a five point scale.

The structured questions was used in an effort to conserve time and money as well as to facilitate easier analysis as they were in immediate usable form; while the unstructured questions was used so as to encourage the respondent to give an in-depth and respond without feeling held back in revealing of any information.

3.4.2 Validity and Reliability of Research Instrument

The researcher carried out a pilot study to pretest the validity and reliability of data collected using the questionnaire. According to Berg and Gall (1989) validity is the degree by which the sample of test items represented the content the test was designed to measure. Content validity which was employed by this study was a measure of the degree to which data that was collected using a particular instrument represents a specific domain or content of a particular concept.

According to Shanghverzy (2003) reliability refers to the consistency of measurement and is frequently assessed using the test-retest reliability method. Reliability was increased by including many similar items on a measure, by testing a diverse sample of individuals and by using uniform testing procedures. Nunnally (1978) stated that reliability of a research instrument is indicated at a minimal Alpha value of 0.6.

The researcher selected a pilot group of 5 individuals from the target sample of the staff working in the ministries to test the reliability of the research instrument. The pilot study was allowed for pre-testing of the research instrument. The clarity of the instrument items to the respondents was necessary so as to enhance the instrument's validity and reliability. The aim was to correct inconsistencies arising from the instruments, which

ensured that they measured what was intended. The pilot data was not included in the actual study.

3.5 Data Analysis

Before processing the responses, the completed questionnaires were edited for completeness and consistency. The data was then coded to enable the responses to be grouped into various categories. Data collected was purely quantitative and it was analyzed by descriptive analysis techniques. The descriptive statistical tools such as SPSS helped the researcher to describe the data and determine the extent used. The findings was presented using tables and charts, percentages, tabulations, frequencies, means and other measures of central tendency. Tables were used to summarize responses for further analysis and facilitate comparison. This generated quantitative reports for this study.

3.5.1 Analytical Mode

The following model guided the regression analysis:

$$Y = \beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \beta_4X_4 + \varepsilon$$

Where;

Y = Corporate governance in the Central Government

β_0 = Constant

X1 = Risk assessment practices

X2 = Risk Management Practices

X3 = Annual Risk Based Planning

X4 = Risk based Internal Auditing Standards

ε = Error term

Corporate governance in the Central Government was measured by the level of adherence to the laid down best practices of corporate governance in organization. Risk assessment practices were measured by checking the risk assessment practices at use in the various departments and ministries of the Central Government and their effectiveness. Risk Management Practices was measured by assessing the risk management practices put in place at the Central Government in order to manage risks. Several statements were used to assess the risk management practices used. Annual Risk Based Planning was measured by looking at the frequency of risk planning and reviewed in order to minimize chances of risks occurring in their different areas of operations. Risk based Internal Auditing Standards was measured by checking the Risk based Internal Auditing Standards observed by the departments in their risk management.

To test for the strength of the model and the relationship between risk based audit and corporate governance, the researcher conducted an Analysis of Variance (ANOVA). On extracting the ANOVA table, the researcher looked at the significance value. The study was tested at 95% confidence level and 5% significant levels. If the significance number found was less than the critical value (α) set 2.4, then the conclusion was that the model was significant in explaining the relationship. Else the model was regarded as non significant.

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter presents an analysis and findings of the study as set out in the research objective and research methodology. The study findings were presented on the relationship between risk based audit and corporate governance in the Central Government of Kenya. The data was gathered from primary data using a questionnaire.

4.1.1 Response Rate

The study targeted 42 ministries out of which 29 responded giving a response rate of 69%. This commendable response rate was made a reality after the researcher made personal visits to remind the respondents to fill-in and return the questionnaires. This response rate was good and representative and conforms to Mugenda and Mugenda (1999) stipulation that a response rate of 50% is adequate for analysis and reporting; a rate of 60% is good and a response rate of 70% and over is excellent.

4.2 Auditing Standards

The study sought to establish the respondents' level of agreement with the statements relating to auditing standards and their effect on governance in the central government ministries. From the findings, the respondents strongly agreed to the fact that compliance with standardization could be used to reduce risks thus enhancing good governance at a mean of 4.8889. They also agreed that standardization could be substituted by other quality framework, such as national quality award that was better in enhancing good

governance at a mean of 4.2222. However, they were neutral to the fact that the importance of risk based audit was aggravated even more after accounting firms were being sued by shareholders for their inability to detect fraud with a mean of 3.3333 as summarized in table 4.1 below.

Table 4. 1: Statements Relating To Auditing Standards

	Mean	Std. Deviation
Compliance with Standardization can be used to reduce risks thus enhancing good governance	4.8889	0.33333
Standardization can be substituted by other quality framework, such as National Quality Award that is better in enhancing good governance	4.2222	1.39443
The importance of risk based audit is aggravated even more after accounting firms are being sued by shareholders for their inability to detect fraud	3.3333	0.70711

Source: Research Data, 2012

The study also required the respondents to indicate their view on how auditing standards affected governance in the central government ministries. The respondents noted that auditing standards enhanced quality of good auditing reporting, such reports effected changes in governance behavior and systems.

4.3 Risk Assessment

On the extent to which an inherent risk assessment affected governance in the Central government ministries, 46% said to a great extent followed by 34% who indicated to a

very great extent while those who cited little extent and moderated recorded 10% each as shown in table 4.2 below.

Table 4. 2: Extent an Inherent Risk Assessment Affected Governance

	Frequency	Percent
Great Extent	13	46
Very Great Extent	10	34
Little Extent	3	10
Moderate Extent	3	10
Total	29	100

Source: Research Data, 2012

Regarding the respondents' opinion on how auditing standards affected governance in the central government ministries, they indicated that issues of concern and areas of governance threats were mapped out, weaknesses were identified, threats were neutralized and strong controls were enhanced.

The respondents were also required to rate their level of agreement on statements that relate to the effect of inherent risk assessments on governance in the central government ministries. According to the findings, the respondents strongly agreed to the facts that auditors at the ministry had a good understanding of their auditee's business and therefore could accomplish risk assessment with relative ease at a mean of 4.7778; and the auditor identified changes that had occurred in the firm or its environment and determined how those changes should interact with historic trends to produce an expected balance in the account with a mean of 4.7778. They also agreed that the ministry considered the role of risk assessment in the detection of errors at a mean of 4.4444; non-

systematic transactions and ministry characteristics were associated with the incidence of errors at a mean of 4.3333; and there was a preference for qualitative risk assessment at the government ministries with a mean of 3.6667.

On the other hand, the respondents were neutral to the facts that the auditors at the ministry began the inherent risk evaluation process by generating expectations of accounts balances at a mean of 2.7778; and the auditors didn't consider it appropriate to generate numerical estimates of risk on an account by account basis, but reason about the ministry's financial statements using knowledge about changes in the government and/or the ministry's, management's motivation and prior track record at a mean of 2.7778. They also disagreed that inherent risk at the ministry was difficult and costly to assess with a mean of 2.2222 as summarized in table 4.3 below.

Table 4. 3: Statements on the Effect of Inherent Risk Assessments on Governance

	Mean	Std. Deviation
Auditors at the ministry have a good understanding of their auditee's business and therefore can accomplish risk assessment with relative ease	4.7778	0.66667
The auditor identifies changes that have occurred in the firm or its environment and determines how those changes should interact with historic trends to produce an expected balance in the account	4.7778	0.44096
The ministry considers the role of risk assessment in the detection of errors.	4.4444	1.13039
Non-systematic transactions and ministry characteristics are associated with the incidence of errors.	4.3333	1.32288
There is a preference for qualitative risk assessment at the government ministries	3.6667	0.5
The auditors at the ministry begin the inherent risk evaluation process by generating expectations of accounts balances.	2.7778	0.66667
Auditors do not consider it appropriate to generate numerical estimates of risk on an account by account basis, but reason about the ministry's financial statements using knowledge about changes in the government and/or the ministry's, management's motivation and prior track record.	2.7778	0.83333
Inherent risk at the ministry is difficult and costly to assess	2.2222	0.83333

Source: Research Data, 2012

The study aimed to establish the significance of the following factors in influencing judgments of inherent risk at the ministry. The respondents indicated that financing pressure was very significant in influencing judgments of inherent risk at the ministry at a mean of 4.6667. They also indicated that turnover of controllers, the quality of personnel

responsible for inventory calculation and the complexity of overhead in inventory were significant in influencing judgments of inherent risk at the ministry with means of 4.4444, 4.3333 and 4.2222 respectively as shown in table 4.4 below.

Table 4. 4: Factors Influencing Judgments of Inherent Risk at the Ministry

	Mean	Std. Deviation
Financing pressure ..	4.6667	1
Turnover of controllers	4.4444	1.33333
The quality of personnel responsible for inventory calculation	4.3333	1.41421
The complexity of overhead in-inventory	4.2222	1.56347

Source: Research Data, 2012

4.4 Annual Risk Based Planning

On whether annual risk based planning affected corporate governance at the central government ministry, majority of the respondents said yes at 79% while those who said no were 21% as illustrated in table 4.5 below.

Table 4. 5: Annual Risk Based Planning

	Frequency	Percent
Yes	23	79
No	6	21
Total	29	100

Source: Research Data, 2012

On the extent to which the annual risk based planning process affected governance in the Central government ministries, 69% agreed to a great extent, 21% said to a little extent while 10% agreed to a very great extent as indicated in table 4.6 below.

Table 4. 6: Extent Annual Risk Based Planning Process Affected Governance

	Frequency	Percent
Great Extent	20	69
Little Extent	6	21
Very Great Extent	3	10
Total	29	100

Source: Research Data, 2012

On the respondents' level of agreement with the statements on annual risk based planning and its effect on governance in the central government ministries, the respondents were neutral to the facts that planning was generally considered a vital internal audit activity and it included preparing a strategic plan, annual plans and programs for individual risk based audit assignments at a mean of 3.1111; for Risk Based Audit (RBA) to provide good governance in public sector they must embrace the International Auditing standards that guided the internal audits ethics of work and maintained professional auditing standards with a mean of 2.6667; proper planning enabled accomplishment of a large number of audits in a given period by improving efficiency at a mean of 2.6667; and adhoc audit assignments signified the relevance of internal audit to management, and reflected positively on audit effectiveness and also in good governance with a mean of 2.3333 as summarized in table 4.7 below.

Table 4. 7: Statements on Annual Risk Based Planning and its Effect on Governance

	Mean	Std. Deviation
Planning is generally considered a vital internal audit activity and it includes preparing a strategic plan, annual plans and programs for individual risk based audit assignments	3.1111	1.16667
For Risk Based Audit (RBA) to provide good governance in public sector they must embrace the International Auditing standards that guide the internal audits ethics of work and maintain professional auditing standards.	2.6667	1.32288
Proper planning enables accomplishment of a large number of audits in a given period by improving efficiency	2.6667	0.86603
Adhoc audit assignments signify the relevance of internal audit to management, and reflect positively on audit effectiveness and also in good governance.	2.3333	1.32288

Source: Research Data, 2012

The respondents also explained in their view the effect of annual risk based planning on the corporate governance within the central government ministries in that a ARBAP (Annual Risk Based Audit Planning) helped the internal audit activity to be more proactive and it only identified the core threats of the activities in the ministry and acceptable to the management. In addition, ARBAP should be done frequently as an effective control too rather than after a long period of time and in case of any corrections it could be done on timely basis.

4.5 Risk Management

The study aimed to determine the extent to which transparency in risk based audit management affected governance in the central government ministries. From the responses, 55% said to a great extent, 34% said to a very great extent while 10% said to no extent as shown in table 4.8 below.

Table 4. 8: Transparency in Risk Based Audit Management Affected Governance

	Frequency	Percent
Great Extent	16	55
Very Great Extent	10	34
No Extent	3	10
Total	29	100

Source: Research Data, 2012

On the respondents' level of agreement with the statement on risk management and its effect on governance in the government ministries, the respondents were neutral to the facts that the implementation of risk based auditing in public sector was expected to improve governance, transparency, accountability and efficiency in the management of public affairs, and made the public sector more effective in the delivery of services at a mean of 2.7778; and the role of auditing in Public Sector Governance (2006), auditors assessed the adequacy of corporate governance and the control environment at a mean of 2.5556. They also disagreed that its implementation would also deepen the facilitation of private sector participation in the economy by encouraging investments, job creation and development of business initiatives to reduce poverty with a mean of 2.4444 as summarized in table 4.9 below.

Table 4. 9: Statements on Risk Management and Its Effect on Governance

	Mean	Std. Deviation
The implementation of risk based auditing in public sector is expected to improve governance, transparency, accountability and efficiency in the management of public affairs, and make the public sector more effective in the delivery of services	2.7778	0.66667
Role of auditing in Public Sector Governance (2006), auditors assess the adequacy of corporate governance and the control environment	2.5556	1.13039
Its implementation will also deepen the facilitation of private sector participation in the economy by encouraging investments, job creation and development of business initiatives to reduce poverty.	2.4444	0.88192

Source: Research Data, 2012

The respondents also explained that risk management affected corporate governance in the ministry by enhancing transparency, eliminating inefficiency in service delivery through improved accountability in managing public affairs. It was tailored to short term results and applied managerial approach rather than integral approach.

The study sought to find out the extent to which auditing standards affected governance in the Central government ministries. The findings revealed that most (79%) of the respondents cited to a great extent, 10% said to no extent while another 10% indicated to a little extent as shown in table 4.10 below.

Table 4. 10: Extent Auditing Standards Affect Governance

	Frequency	Percent
Great Extent	23	79
No Extent	3	10
Little Extent	3	10
Total	29	100

Source: Research Data, 2012

4.6 Corporate Governance

Different offices of the Central Government had different extents of corporate governance and thus the study sought to establish the level of corporate governance in the Ministry. it was revealed that 79% of the respondents indicated that corporate governance was to a great extent, 10% indicated to a very small extent whereas another 10% indicated to a moderate extent as shown in table 4.11 below.

Table 4. 11: Corporate Governance

	Frequency	Percent
Great Extent	23	79
Very Small Extent	3	10
Moderate Extent	3	10
Total	29	100

Source: Research Data, 2012

4.9 Regression Analysis

A multiple regression analysis was conducted in this study so as to test relationship between variables (independent) and bank performance. The research used statistical package for social sciences (SPSS V 17.0) to code, enter and compute the measurements

of the multiple regressions. Coefficient of determination explains the extent to which changes in the dependent variable can be explained by the change in the independent variables or the percentage of variation in the dependent variable (Corporate governance) that is explained by all the independent variables (Risk assessment practices, Risk Management Practices, Annual Risk Based Planning and Risk based Internal Auditing Standards).

4.9.1 Model Summary

Table 4. 12: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.8921	0.7958	0.738	1.0021

Source: Research Data, 2012

The four independent variables that were studied explain only 79.58% of the corporate governance in the Central Government as represented by the R^2 . This therefore means that other factors not studied in this research contribute 20.42% of corporate governance in the Central Government. Therefore, further research should be conducted to investigate the other factors (20.42%) that affect corporate governance in the Central Government.

4.9.2 ANOVA

Table 4. 13: ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	12.326	2	3.457	5.262	.027
	Residual	21.173	34	1.052		
	Total	33.499	36			

Source: Research Data, 2012

The significance value is 0. 027 which is less that 0.05 thus the model is statistically significance in predicting the relationship between risk based audit and corporate governance in the Central Government of Kenya. The F critical at 5% level of significance was 3.01. Since F calculated is greater than the F critical (value = 5.262), this shows that the overall model was significant.

4.9.3 Coefficient of Determination

Table 4. 14: Coefficient of Determination

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	2.398	.300		5.264	.371
	Risk assessment practices	0.494	0.097	0.181	2.132	0.048
	Risk Management Practices	0.518	0.118	0.146	1.398	0.057
	Annual Risk Based Planning	0.557	0.136	0.105	2.138	0.035
	Risk based Internal Auditing Standards	0.543	0.123	0.130	1.379	0.044

Source: Research Data, 2012

As per the SPSS generated table above, the equation ($Y = \beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \beta_4X_4 + \varepsilon$) becomes:

$$Y = 2.398 + 0.494X_1 + 0.518X_2 + 0.557X_3 + 0.543X_4$$

The regression equation above shows that taking all factors into account (Risk assessment practices, Risk Management Practices, Annual Risk Based Planning and Risk based Internal Auditing Standards) constant at zero, performance will be 2.398. The findings presented also shows that taking all other independent variables at zero, a unit increase in risk assessment practices will lead to a 0.494 increase in corporate governance in the central government; a unit increase in risk management practices will lead to a 0.518 increase in corporate governance in the central government; a unit increase in annual risk based planning will lead to a 0.557 increase in corporate governance in the central government while a unit increase in risk based internal auditing standards will lead to a 0.543 increase in corporate governance in the central government.

This depicts that annual risk based planning contribute most to performance followed by risk based internal auditing standards. At 5% level of significance and 95% level of confidence, risk assessment practices had a 0.048 level of significance; risk management practices showed a 0.057 level of significance, annual risk based planning had a 0.035 level of significance and risk based internal auditing standards showed a 0.044 level of significance; hence the most significant factor is annual risk based planning.

4.10 Interpretation of Findings

Risk based auditing and corporate governance is an important aspect of management of public resources for the delivery of public goods and services. Through auditing

standards, the parastatals ensured compliance with standardization to be used to reduce risks thus enhancing good governance and service delivery to the citizens. Standardization could be substituted by other quality framework, such as national quality award that was better in enhancing good governance so that the organization can better deliver on its mandate. The importance of risk based audit is aggravated even more after accounting firms are being sued by shareholders for their inability to detect fraud because this inability causes huge losses to shareholders.

Issues of concern and areas of governance threats were mapped out, weaknesses were identified, threats were neutralized and strong controls were enhanced. Auditors at the ministries had a good understanding of their auditor's business and therefore could accomplish risk assessment with relative ease. The auditors at the ministries began the inherent risk evaluation process by generating expectations of accounts balances and the financing pressure was very significant in influencing judgments of inherent risk at the ministry.

Planning was generally considered a vital internal audit activity and it included preparing a strategic plan, annual plans and programs for individual risk based audit assignments. Risk Based Audit (RBA) to provide good governance in public sector they must embrace the International Auditing standards that guided the internal audits ethics of work and maintained professional auditing standards. Adhoc audit assignments signified the relevance of internal audit to management, and reflected positively on audit effectiveness and also in good governance. The effect of annual risk based planning on the corporate governance within the central government ministries in that a ARBAP (Annual Risk

Based Audit Planning) helped the internal audit activity to be more proactive and it only identified the core threats of the activities in the ministry and acceptable to the management.

For efficient operations of Government business and optimum utilization of government resources, it is important that the government officials are put to task to account for their resource utilization to reduce the chances of misappropriation.

5.2 Summary

On finding standards the study established that the respondents strongly agreed to the fact that compliance with standards could be used to reduce risk and enhancing good governance and agreed that standardization could be substituted by other quality framework and an optional quality award that was better in enhancing good governance. On risk assessment, the study found 46% of the respondents indicated that inherent risk assessment affected governance in the Central government ministry to a great extent. The respondents strongly agreed to the fact that risk assessment had a great impact on the understanding of the nature, magnitude and risk of the activities in the ministry and the nature of the activities in the ministry. They also agreed that the ministry considered the risk of the activities in the ministry to a great extent.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter provides the summary of the findings from chapter four, and also the conclusions and recommendations of the study based on the objectives of the study. The objective of this study was to investigate the relationship between risk based audit and corporate governance in the Central Government of Kenya in NSE.

5.2 Summary

On auditing standards, the study established that the respondents strongly agreed to the fact that compliance with standardization could be used to reduce risks thus enhancing good governance and agreed that standardization could be substituted by other quality framework, such as national quality award that was better in enhancing good governance. On risk assessment, the study found 46% of the respondents indicated that inherent risk assessment affected governance in the Central government ministries to a great extent. The respondents strongly agreed to the facts that auditors at the ministry had a good understanding of their auditee's business and therefore could accomplish risk assessment with relative ease; and the auditor identified changes that had occurred in the firm or its environment and determined how those changes should interact with historic trends to produce an expected balance in the account. They also agreed that the ministry considered the role of risk assessment in the detection of errors; non-systematic

transactions and ministry characteristics were associated with the incidence of errors; and there was a preference for qualitative risk assessment at the government ministries.

On annual risk based planning, 79% indicated that annual risk based planning affected corporate governance at the central government ministry to a great extent. The respondents were neutral to the facts that planning was generally considered a vital internal audit activity and it included preparing a strategic plan, annual plans and programs for individual risk based audit assignments; for Risk Based Audit (RBA) to provide good governance in public sector they must embrace the International Auditing standards that guided the internal audits ethics of work and maintained professional auditing standards; proper planning enabled accomplishment of a large number of audits in a given period by improving efficiency; and adhoc audit assignments signified the relevance of internal audit to management, and reflected positively on audit effectiveness and also in good governance.

On risk management, 55% indicated that transparency in risk based audit management affected governance in the central government ministries to a great extent. Most (79%) of the respondents cited auditing standards affected governance in the Central government ministries to a great extent. The respondents were neutral to the facts that the implementation of risk based auditing in public sector was expected to improve governance, transparency, accountability and efficiency in the management of public affairs, and made the public sector more effective in the delivery of services; and the role of auditing in Public Sector Governance (2006), auditors assessed the adequacy of corporate governance and the control environment. They also disagreed that its

implementation would also deepen the facilitation of private sector participation in the economy by encouraging investments, job creation and development of business initiatives to reduce poverty.

5.3 Conclusions

From the findings the study concludes that compliance with standardization can be used to reduce risks thus enhancing good governance and standardization can be substituted by other quality framework, such as national quality award that was better in enhancing good governance.

The study also concludes that inherent risk assessment greatly affects governance in the Central government ministries. Auditors at the ministry has a good understanding of their auditee's business and can accomplish risk assessment with relative ease; the auditor identifies changes that has occurred in the firm or its environment and determines how those changes should interact with historic trends to produce an expected balance in the account; the ministry considers the role of risk assessment in the detection of errors; non-systematic transactions and ministry characteristics are associated with the incidence of errors; and there is a preference for qualitative risk assessment at the government ministries.

In addition, the study concludes that annual risk based planning greatly affect corporate governance at the central government ministry; transparency in risk based audit management affects governance in the central government ministries and auditing standards affects governance in the Central government ministries.

implementation would also deepen the facilitation of private sector participation in the economy by encouraging investments, job creation and development of business initiatives to reduce poverty.

5.3 Conclusions

From the findings the study concludes that compliance with standardization can be used to reduce risks thus enhancing good governance and standardization can be substituted by other quality framework, such as national quality award that was better in enhancing good governance.

The study also concludes that inherent risk assessment greatly affects governance in the Central government ministries. Auditors at the ministry has a good understanding of their auditee's business and can accomplish risk assessment with relative ease; the auditor identifies changes that has occurred in the firm or its environment and determines how those changes should interact with historic trends to produce an expected balance in the account; the ministry considers the role of risk assessment in the detection of errors; non-systematic transactions and ministry characteristics are associated with the incidence of errors; and there is a preference for qualitative risk assessment at the government ministries.

In addition, the study concludes that annual risk based planning greatly affect corporate governance at the central government ministry; transparency in risk based audit management affects governance in the central government ministries and auditing standards affects governance in the Central government ministries.

5.4 Recommendations for Policy

The study recommends that audit committee should employ a more effective approach to work diligently with management and auditors to identify the most complex business activities, assess their relative risks, determine their accounting treatment, and obtain complete understanding of their impact on fair presentation of financial performance conditions. Audit committee members should be sufficiently knowledgeable to ask management as well as the internal and external auditor's tough questions regarding quality, transparency, and reliability of financial reports.

The study also recommends that most organizations' internal audit offices should develop a strategic plan that would enable the audit staff to evaluate risk and identify high-risk areas that deserve audit attention. This exercise should enable the head of internal audit to ensure the appropriateness of resources by projecting requirements in a timely fashion thus enhancing good governance.

In addition, organizations should have proper planning which enables accomplishment of a large number of audits in a given period by improving efficiency. For Risk Based Audit (RBA) to provide good governance, organization must embrace the International Auditing standards that guide the internal audits ethics of work and maintain professional auditing standards. The internal audit should adhere to the guidelines stipulated by the Institute of Internal Auditors (IIA) which is recognized as the internal audit profession's leader in certification, education, research, and technical guidance.

5.5 Limitations of the Study

The respondents were reluctant in giving information fearing that the information asked would be used to intimidate them or paint a negative image about them or the company. The researcher handled this problem by carrying an introduction letter from the University and assured the respondents that the information they gave would be treated with confidentiality and was used purely for academic purposes.

The study faced both time and financial limitations. The duration that the study was to be conducted was limited hence exhaustive and extremely comprehensive research could not be carried out. However, the researcher countered this limitation by carrying out the research across the department and management level in the organization to enable a generalization of the study findings.

5.6 Area for Further Research

This study investigated the relationship between risk based audit and corporate governance in the Central Government of Kenya. This is a unique operating environment with completely different accounting principles compared to the private sector accounting. This study therefore recommends that a similar study should be done on the relationship between risk based audit and corporate governance in all the private companies listed in the NSE to facilitate the generalization of the findings.

The study also recommends that another study on the relationship between corporate governance practices and the performance of organizations needs to be carried out to determine the influence of corporate governance on the financial performance of organizations in Kenya.

The study further recommends that another study be done on the influence of risk based auditing on the levels of corruption and misuse of public resources in order to promote accountability and productivity of government offices.

REFERENCES

- Abdullah S. N. (2004). Board composition, CEO duality and performance among Malaysian listed companies. *Corporate Governance* 4(4): 47-61.
- Aldridge, I 2004, *Why Are Financial Markets Regulated? An Empirical Investigation of Validity of Regulation Theories.*, Working Paper, Rotman School of Management, University of Toronto, viewed 12/8/08 at http://www.rotman.utoronto.ca/aldrIDGE/research/Aldridge_finreg41304.pdf.
- Beasley M. & Salterio S. (2001). The relationship between board characteristics and voluntary improvements in the capability of audit committees to monitor, *Contemporary Accounting Research* 18 (4): 539-70.
- Brody, R.G., Lowe, D.J. (2000), The new role of the internal auditor: *Implications for internal auditor objectivity*, *International Journal of Auditing*, Vol. 4 No.3, pp.169-76.
- Carey, P., Simnett, R., Tanewski, G. (2000), Voluntary demand for internal and external auditing by family businesses, *Auditing: A Journal of Practice & Theory*, Vol. 19 No. Suppl., pp.37-51.
- Chizema, A & Buck, T 2006, 'Neo-institutional Theory and Institutional Change: Towards Empirical Tests on the "Americanization" of German Executive Pay', *International Business Review*, vol. 15, no. 5, pp. 488-504.
- Chizema, A & Kim, J 2010, 'Outside Directors on Korean Boards: Governance and Institutions', *Journal of Management Studies*, vol. 47, no. 1, pp. 109-29.
- Choo, F. (1988), Audit risk model: some technical limitations, *ICA Journal*, April, pp.38-41.

- Cohen J. & Hanno D. 2000. Auditors' consideration of corporate governance and management control philosophy in preplanning and planning judgments, *Auditing: A Journal of Practice and Theory* 19 (3): 133-46.
- Cohen J. & Krishnamoorthy G. & Wright A. (2007). Auditor experiences of corporate governance in the post Sarbanes-Oxley Era. *Auditing: A Journal of Practice & Theory* (forthcoming).
- Conyon, M.J. (1995) 'Institutional Arrangements for Setting Directors' Compensation in UK Companies', in Keasey et al (1997). Op cit.
- Dacin, M, Goodstein, J & Scott, W 2002, 'Institutional Theory and Institutional Change: Introduction to the Special Research Forum', *Academy of Management Journal*, vol. 45, no. 1, pp. 43-56.
- Davidson, R., Goodwin, J., Kent, P. (2005), Internal governance structures and earnings Management , *Accounting and Finance*, Vol. 45 No.2, pp.241-67.
- DeFond, M.L., Francis, J.R., Wong, T.J. (2000), Auditor industry specialization and market segmentation: evidence from Hong Kong, *Auditing: A Journal of Practice & Theory*, Vol. 19 No.1, pp.49-66.
- Eisenhardt, K. (1985). Control: Organizational and economic approaches. *Management Science*, 31(2): 134-149.
- Feary, S. (2005). Effective accreditation is essential for audit competence, *ISO Management Systems*, Vol. 5 pp.18-22.
- Fogarty, T, Zucca, L, Meonske, N, Kirch, D (1997), Proactive practice review: a critical case study of accounting regulation that never was, *Critical Perspectives on Accounting*, Vol. 8 pp.167-87.

- Freeman, RE 1984, *Strategic Management: A Stakeholder Approach*, Pitman Publishing, Boston.
- Gibson, M.S. (2003), Is corporate governance ineffective in emerging markets? , *Journal of Financial and Quantitative Analysis*, Vol. 38 No.1, pp.231-50.
- Gillan S.L. (2006). Recent Developments in Corporate Governance: An Overview. *Journal of Corporate Finance* 12: 381–402
- Goodwin, J. (2003), The relationship between the audit committee and the internal audit function: evidence from Australia and New Zealand, *International Journal of Auditing*, Vol. 7 No.3, pp.263-76.
- Gregg P., Conyon, M, and Machin S (1993). Taking care of business: Executive Compensation in the United Kingdom, *Economic Journal*, 105, 704-714.
- Griffiths, D. (2006), *Risk Based Internal Auditing: An Introduction*, available at: www.internalaudit.biz (accessed February 12, 2008),
- Hutton, W. (1995), *The State We're In*, Jonathan Cape, London
- IIA (2004), *International Standards for the Professional Practice of Internal Auditing*, Institute of Internal Auditors, Altamonte Springs, FL,
- Jensen, M.C. & Meckling, W.H. 1976. Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure. *Journal of Financial Economics* 3(2):305-360.
- Karapetrovic, S. (1999), ISO 9000: the system emerging from the vicious circle of compliance, *The TQM Magazine*, Vol. 11 pp.111-20.
- Kariuki r.n. (2002) The Use of Assessment Centers in Multinational Auditing Firms in Nairobi. Unpublished MBA project. University of Nairobi.

- Kay J and Silberston A (1995) "Corporate Governance", *National Institute Economic Review*, August, pp. 84-95, reprinted in XXX.
- Keasey, K., Thompson, S. and Wright, M., (1997) *Corporate Governance: Economic, Management and Financial Issues*, Oxford University Press.
- Kondra, A & Hinings, C 1998, 'Organizational Diversity and Change in Institutional Theory', *Organization Studies*, vol. 19, no. 5, pp. 743-67.
- Kunkel, J. (2004), The changing role of internal audit, *Chain Store Age*, September, pp.4-5.
- Kurihama, R. (2005). Corporate Social Responsibility, Corporate Governance and Auditing in Japan: an on line research publication: available at: <http://www.iae.univ-poitiers.fr/EURO-ASIE/Docs/Asia-in-Extenso-RKurihamamars2005.pdf>
- Major, M & Hopper, T 2004, 'Extending New Institutional Theory: Regulation and Activity-Based Costing in Portuguese Telecommunications', paper presented to Fourth Asia Pacific Interdisciplinary Research in Accounting Conference, Singapore, 4 to 6 July
- McCord, C. (2002), The assessment: corporate governance and corporate control, *Oxford Review of Economic Policy*, Vol. 8 No.3,
- Mugenda, O. M and Mugenda, A. G (2003). *Research Methods: Quantitative and Qualitative approaches*. Nairobi, Acts Press.
- Muting M (1987). A comparative analysis of judgmental & statistical sampling technical in auditing in Kenya. Unpublished MBA project. University of Nairobi.

- O'Regan, D. (2002), The CPA's transition to the world of internal auditing , *The CPA Journal*, August, pp.11-13.
- Powell, W 2003, 'Neither Market nor Hierarchy ,Network Forms of Organization', in MJ Handel (ed.), *The Sociology of Organizations: Classic, Contemporary, and Critical Readings*, Sage Publications, Inc, Thousand Oaks.
- Prinsloo, J., (2008) The Development And Evaluation Of Risk-Based Audit Approaches. Unpublished thesis submitted in the faculty of economic and management sciences (centre for accounting) at the University Of The Free State
- Ritzer, G 2004, *Encyclopedia of Social Theory*, Sage Publications, Inc, Thousand Oaks.
- Schnatterly, K. (2001), Internal corporate governance as a source of firm value: the impact of internal governance on the incidence of white collar crime , University of Michigan, Dearborn, MI, PhD thesis, .
- Scott, W & Christensen, S 1995, *The Institutional Construction of Organizations: International and Longitudinal Studies*, Sage Publications, Inc, Thousand Oaks.
- Scott, W 2005, 'Institutional Theory: Contributing To a Theoretical Research Program', in *Great minds in management: The process of theory development*, K G Smith Michael A. and Hitt E ,Oxford University Press., Oxford pp. 460-84.
- Seddon, J. (2000), *The Case Against ISO 9000*, Oak Tree Press, Dublin
- Sherer, A., Turley, R.W. (1998), A survey of corporate governance, *Journal of Finance*, Vol. 52 No.2, pp.737-83.
- * Shleifer, A., Vishny, R.W. (1997), A survey of corporate governance, *Journal of Finance*, Vol. 52 No.2, pp.737-83

- Solomon, J., Solomon, A. (2004), *Corporate Governance and Accountability*, John Wiley, New York, NY.
- Szpirglas, M. (2006), Gestion des risques et quiproquos, *Revue Française de Gestion*, February, pp.67-88.
- Abbott, L.J., Parker, S., Peters, G.F. (2004), Audit committee characteristics and restatements, *Auditing: A Journal of Practice & Theory*, Vol. 23 No.1, pp.69-87.
- Tsaklaganos, M. (2003), Risk management: the reinvention of internal control and the changing role of internal audit, *Accounting, Auditing & Accountability Journal*, Vol. 16 No.4, pp.640-61.
- Van Gansberghe, C.N. (2005), Internal auditing in the public sector: a consultative forum in Nairobi, Kenya, shores up best practices for government audit professionals in developing nations , *Internal Auditor*, Vol. 62 No.4, pp.69-73.
- Walker, P.L., Shenkir, W.G., Barton, T.L. (2003), ERM in practice, *The Internal Auditor*, Vol. 60 No.4, pp.51-5.
- Weir, CM, Laing, D & McKnight, PJ 2002, 'Internal and External Governance Mechanisms: Their Impact on the Performance of Large UK Public Companies', *Journal of Business Finance and Accounting* vol. 29, no. 5 & 6, pp. 579-611.
- Willenborg, M. (1999). Empirical analysis of the economic demand for auditing in the initial public offering market, *Journal of Accounting Research* 37: 225-238.
- Zubaidah Z.A., Nurmala M.K. & Kamaruzaman J. 2009. Board structure and corporate performance in Malaysia. *International Journal of Economic and Finance* 1(1): 150-164

APPENDICES

APPENDIX I: QUESTIONNAIRE

SECTION A: MAIN ISSUES

AUDITING STANDARDS

1. What is your level of agreement with the following statement that relate to auditing standards and their effect on governance in the central government ministries? Use a scale of 1-5 where 5= strongly agree and 1 = strongly disagree

	5	4	3	2	1
The importance of risk based audit is aggravated even more after accounting firms are being sued by shareholders for their inability to detect fraud					
Compliance with Standardization can be used to reduce risks thus enhancing good governance					
Standardization can be substituted by other quality framework, such as National Quality Award that is better in enhancing good governance					

2. In your own opinion, how does auditing standards affect governance in the central government ministries?

RISK ASSESSMENT

1. To what extent does an inherent risk assessment affect governance in the Central government ministries?

- No extent at all []
- Little extent []
- Moderate extent []
- Great extent []
- Very great extent []

2. Explain your opinion of the effect of risk assessment on the governance of the central government ministries.

.....

.....

.....

3. What is your level of agreement with the following statements that relate to the effect of inherent risk assessments on governance in the central government ministries?

	Strongly agree	Agree	Neutral	Disagree	Strongly disagree
The ministry considers the role of risk assessment in the detection of errors.					
Auditors at the ministry have a good understanding of their auditee's business and therefore can accomplish risk assessment with					

relative ease					
Non-systematic transactions and ministry characteristics are associated with the incidence of errors.					
Inherent risk at the ministry is difficult and costly to assess					
The auditors at the ministry begin the inherent risk evaluation process by generating expectations of accounts balances.					
The auditor identifies changes that have occurred in the firm or its environment and determines how those changes should interact with historic trends to produce an expected balance in the account					
There is a preference for qualitative risk assessment at the government ministries					
Auditors do not consider it appropriate to generate numerical estimates of risk on an account by account basis, but reason about the ministry's financial statements using knowledge about changes in the government and/or the ministry's, management's motivations and prior track record.					

4. How significant are the following factors in influencing judgments of inherent risk at the ministry?

	Very significant	Significant	Moderately significant	Slightly significant	Insignificant
Turnover of controllers					
Financing pressure					
The complexity of overhead in inventory					
The quality of personnel responsible for inventory calculation					

ANNUAL RISK BASED PLANNING

- Does annual risk based planning affect corporate governance at the central government ministry?

Yes [] No []

- To what extent does the annual risk based planning process affect governance in the Central government ministries?

No extent at all []

Little extent []

Moderate extent []

Great extent []

Very great extent []

- What is your level of agreement with the following statement that relate to annual risk based planning and its effect on governance in the central government ministries? Use a scale of 1-5 where 5= strongly agree and 1 = strongly disagree

	1	2	3	4	5
For Risk Based Audit (RBA) to provide good governance in public sector they must embrace the International Auditing standards that guide the internal audits ethics of work and maintain professional auditing standards.					
Planning is generally considered a vital internal audit activity and it includes preparing a strategic plan, annual plans and programs for individual risk based audit assignments					
Proper planning enables accomplishment of a large number of audits in a given period by improving efficiency					
Adhoc audit assignments signify the relevance of internal audit to management, and reflect positively on audit effectiveness and also in good governance.					

4. Explain your own view of the effect of annual risk based planning on the corporate governance within the central government ministries.

.....

.....

.....

RISK MANAGEMENT

1. To what extent does transparency in risk based audit management affect governance in the central government ministries?

No extent at all []

Little extent []

Moderate extent []

Great extent []

Very great extent []

2. What is your level of agreement with the following statement that relate to risk management and its effect on governance in the government ministries? Use a scale of 1-5 where 5= strongly agree and 1 = strongly disagree

	1	2	3	4	5
The implementation of risk based auditing in public sector is expected to improve governance, transparency, accountability and efficiency in the management of public affairs, and make the public sector more effective in the delivery of services					
Its implementation will also deepen the facilitation of private sector participation in the economy by encouraging investments, job creation and development of business initiatives to reduce poverty.					
Role of auditing in Public Sector Governance (2006), auditors assess the adequacy of corporate governance and the control environment					

3. In your own words explain how risk management affects corporate governance in the ministry.

.....

.....

.....

4. To what extent does auditing standards affect governance in the Central government ministries?

No extent at all []

Little extent []

Moderate extent []

Great extent* []

Very great extent []

CORPORATE GOVERNANCE

1. Different offices of the Central Government have different extents of corporate governance. Using a scale of 1 to 5, (where 1= very small extent, 2= small extent, 3= moderate extent, 4= great extent and 5= very great extent), please indicate the level of corporate governance in your Ministry.

Very small extent []

Small extent []

Moderate extent []

Great extent []

Very great extent []

!!!!!!!!!!!!!!!!!!!!END!!!!!!!!!!!!!!!!!!!!

APPENDIX II: LIST OF MINISTRIES

- Ministry of Agriculture
- Ministry of Co-operatives Development
- Ministry of Development of Northern Kenya & other Arid Lands
- Ministry of East African Community
- Ministry of Education
- Ministry of Energy
- Ministry of Environment and Mineral Resources
- Ministry of Fisheries Development
- Ministry of Foreign Affairs
- Ministry of Forestry and Wildlife
- Ministry of Gender and Children Affairs
- Ministry of Higher Education, Science Technology
- Ministry of Housing
- Ministry of Industrialization
- Ministry of Information and Communication
- Ministry of Justice, National Cohesion and Constitutional Affairs
- Ministry of Labour
- Ministry of Lands
- Ministry of Livestock Development
- Ministry of Medical Services
- Ministry of Nairobi Metropolitan Development

- Ministry of Public Health and Sanitation
- Ministry of Public Works
- Ministry of Regional Development Authorities
- Ministry of Roads
- Ministry of Special Programmes
- Ministry of Tourism
- Ministry of Trade
- Ministry of Transport
- Ministry of Water and Irrigation
- Ministry of Youth and Sports

TO WHOM IT MAY CONCERN

I am a student in the Master of Business Administration (MBA) degree program at the University of Nairobi.

I am currently working on a research project titled "The Impact of the 2008/2009 Financial Crisis on the Kenyan Economy". I would like to request your assistance in providing information and data for my research. I would be grateful if you could provide me with any relevant documents or reports.

I am sure that your assistance will be greatly appreciated. I am sure that your contribution will be of great value to my research.

Yours faithfully,
 [Signature]
 [Name]
 [Address]
 [Phone Number]

APPENDIX III: LETTER OF INTRODUCTION



UNIVERSITY OF NAIROBI

SCHOOL OF BUSINESS

MBA PROGRAMME

Telephone: 020-2059162
Telegrams: "Varsity", Nairobi
Telex: 22095 Varsity

P.O. Box 30197
Nairobi, Kenya

DATE.....

TO WHOM IT MAY CONCERN

The bearer of this letter

Registration No.....

is a bona fide continuing student in the Master of Business Administration (MBA) degree program in this University.

He/she is required to submit as part of his/her coursework assessment a research project report on a management problem. We would like the students to do their projects on real problems affecting firms in Kenya. We would, therefore, appreciate your assistance to enable him/her collect data in your organization.

The results of the report will be used solely for academic purposes and a copy of the same will be availed to the interviewed organizations on request.

Thank you.

IMMACULATE OMANO
MBA ADMINISTRATOR
MBA OFFICE, AMBANK HOUSE