RELATIONSHIP BETWEEN RISK BASED AUDIT AND CORPORATE GOVERNANCE OF STATE CORPORATIONS IN KENYA

BY

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DECLARATION

This research project is my original work and has not been submitted for a degree in any other university.

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DEDICATION

My study is dedicated to the following: My loving family for support and patience during the entire period of my study. For their encouragement and continued prayers towards successful completion of this course. Finally I pay glowing gratitude and tribute to my employer and colleagues for understanding me during the entire period of study.

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ABSTRACT

The emergence of new business risks has compelled many organizations to reformulate strategies and to elevate the status of internal auditing. Thus, risk-based internal auditing has emerged as an important contributor to effective risk management and improvement of Corporate Governance of state corporation. The Corporate Governance effectiveness requires appropriate risk based audit practices hence effective and efficient internal audit. For the purpose of this study, the researcher sought to find out how Risk Based Auditing relate with Corporate Governance of state corporations in Kenya.

This study adopted descriptive research design. Simple random sampling technique was adapted to select sample size of 40 respondents from 40 selected state corporations. Descriptive statistics such as mean, standard deviation and frequency distribution were used to analyze the data. Data presentation was done by the use of percentages and frequency tables for easy of understanding and interpretation.

The study found that there is a strong positive relationship between Corporate Governance and Risk Based Audit Practices such as Risk Assessment, Risk Management, Annual Risk Based Planning, Internal Auditing Standards and Internal Auditing Staffing. These practices should be enhanced to be able to detect risks on time and concentrate on high risk areas leading to increased transparency and accountability. From the findings, the study recommends that management in state corporations should adopts effective risk based audit practices to enhance effective and efficient Corporate Governance in State Corporation.

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ABBREVIATIONS

ANOVA	- Analysis of Variance
CEO	- Chief Executive officers
CEOs	- Chief Executive officers
CFOs	- Chief Finance Officers
CR	- Control Risk
GOK	- Government of Kenya
IADs	- Internal Audit Departments
IIA	- Institute of Internal Auditor
IR	- Inherent Risk
ISO	- International Organization for Standar
NSE	- Nairobi Stock Exchange
OECD	- Organisation for Economic Co-operation and Development
PPF	- Professional Practice Framework
RBA	- Risk Based Audit
RBIA	- Risk Based Internal Auditing
SAS	- Statements of Auditing Standards
SOX	-Sarbanes-Oxley Act
TCE	-Transaction cost economics
UK	- United Kingdom

CHAPTER ONE

INTRODUCTION

1.1 Background to the Study

Increased concerns regarding corporate accountability in various developed nations have been associated with the need for appropriate Risk Based Audit which involves risk management and internal control systems (Beekes and Brown, 2006). This has been reflected through recent voluntary corporate governance guidelines. The subjectivity of this area has given rise to different levels of emphasis on risk management and internal control and is correspondingly reflected in the governance guidelines of developing countries (Basel Committee on Banking Supervision, 2006). While these voluntary guidelines that have originated in each organization may provide different levels of focus on Risk based Audit and governance, it is uncertain as to what extent these different levels of focus exert an influence either direct or indirect on a state corporation's risk management and internal control practices (Sarens and De Beelde, 2006).

According to Organization for Economic Co-operation and Development, (2004) the main corporate governance themes that are currently receiving attention are adequately separating management from the board to ensure that the board is directing and supervising management, including separating the chairperson and chief executive roles; ensuring that the board has an effective mix of independent and non-independent directors; and establishing the independence of the auditor and therefore the integrity of financial reporting, including establishing an audit committee of the board. Corporate governance also includes the relationships among the many players involved (the stakeholders) and the goals for which the corporation is governed. The principal players are the shareholders, management and the board of directors. Other stakeholders include employees, suppliers, customers, bankers and other lenders, regulators, the environment and the community at large (Klapper and Love, 2003).

Corporate governance has become one of the major issues in the promoting governance and accountability in the world. For organizations to gain competitive advantage firms in developing countries like Kenya required to improve coporate governance, to promote governance and acountability for the purposes of attracting capital, gain sustainability and curb vice such as corruption. An internal audit function could be viewed as a "first line defense" against inadequate corporate governance and financial reporting. With appropriate support from the Board of Directors' Audit Committee, the internal audit staff is in the best position to gather intelligence on inappropriate accounting practices, inadequate internal controls, and ineffective corporate governance (Sarens and de Beelde, 2006).

For many years, risk 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 (Sarens and De Beelde, 2006). However, the emergence of new business risks has compelled many state corprations to reformulate strategies and to elevate the status of internal auditing (Szpirglas, 2006). Thus, risk-based internal auditing has emerged as an important contributor to effective governance and risk management. The study seek to assess the effects of Risk based audit on corporate governance in state corprations in Kenya.

1.1.1 The Concept of Risk Based Audit

Risk based audit (RBA) is a term derived from the Institute of International Audit (IIA) research foundation based in the USA (IIA, 2004). In 1999, the board of directors of IIA voted to approve a new definition of internal auditing and a new Professional Practice Framework (PPF). The board through deliberation came to a conclusion that a significant gap existed between available guidance and current practise of internal auditing, and that a new framework was needed to carry the profession into the 21st century (IIA, 2004). Ideally, RBA is a paradigm shift from traditional approach of pre-auditing or transactional audit to systems audit and finally to RBA. 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. Therefore, for internal audit to be effective and efficient, risk based audit was introduced (IIA, 2004).

Internal Auditing is defined by Institute of Internal Auditors (IIA) as an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes (IIA , 2003). This definition is designed to embrace the expanding role of internal audit which in recent years has evolved from a narrow focus on control to include risk management and corporate governance (Brody and Lowe, 2000). This definition is used as a framework to develop hypotheses concerning the characteristics of companies that use internal audit, while there is considerable overlap between the areas of risk management, control and governance (Chola, 2000).

Risk-based internal auditing focuses on strategic analysis and business process evaluation and on assessing the goals, risks and controls that must coalesce for an organization's success (Raghunandan, *et al*, 2001). By identifying, assessing, and monitoring a company's risk, internal auditing helps assure that resources are adequate and focused on priorities (Kunkel, 2004). Generally, risk-based auditing assesses areas of heightened risk (Griffiths, 2006), and importantly, conducts continuous risk assessments (O'Regan, 2002). The knowledge gained from a comprehensive annual risk assessment as well as from risk assessments undertaken at the outset of every internal audit engagement should be shared with management and the board (Imhoff, 2003).

Risk-based auditing derives largely from models that assume that inherent risk (IR) and control risk (CR) are distinct concepts and that IR arises from attributes of the audit environment that are completely independent of attributes that determine the level of control risk. Operationalizing the distinction between IR and CR has however, proved troublesome as the literature review below indicates. There appears to be little consensus regarding attributes that may identify IR and there is little published evidence regarding how IR is considered by practitioners. Also, it is not yet clear neither does it make good logical sense to try to separate IR and CR in the manner demanded by standard setters (DeFond *et al*, 2000).

1.1.2 The Concept of Corporate Governance

Corporate Governance is concerned with creating a balance between economic and social goals as well as individual and communal goals while encouraging efficient use of resources, accountability in the use of power and stewardship and as far as possible, to align the interests of individuals, corporations and society (Brownbridge, 2007). 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).

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 (Sarens and De Beelde, 2006).. 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 and exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances (Goodwin and Kent, 2004). 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 for example 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, (Solomon and Solomon, 2004).

1.1.3 State Corporations

State Corporations are independent bodies partially or wholly owned by government. They perform specific functions and operate in accordance with a particular Act. Like a private enterprise, the organizational structure and decision-making of a state corporation reflects the interests and involvement of its shareholders, and hence, their strengths and weaknesses. Because these enterprises are part of the public administration, and thus subject to its governance schemes and leadership, they can either benefit or be affected by the performance of its bureaucracy. Government corporations remain a complex and unique organizational mode, caught between the norms of public sector governance and corporate governance (Whincop, 2005). Hence, although mimicking private enterprise arrangements in state owned corporations might cause significant improvements in management, it can also contribute to the consolidation of corruption and the lack of accountability in those enterprises with little controls and vested interests from governing stakeholders.

1.1.4 Determinants of Good Corporate Governance

1.1.4.1 Independent Directors

The focus on board independence is grounded in agency theory . In fact, it has long been argued in the finance literature that boards with a majority of independent directors are more effective in monitoring management (Bhagat and Black, 2002) and are more likely to replace poorly performing CEOs (Weisbach, 1988). More independent boards are also more likely to opt for a clean slate when company performance deteriorates significantly, and to hire a replacement CEO from outside the firm rather than promote an internal candidate (Borokhovich et al., 1996; Huson, 2001).

1.1.4.2 Independence of Committees

Similarly, independence is also considered important for a board committee to be an effective monitor (Klein, 1998). John and Senbet (1998) report empirical evidence showing that the presence of monitoring committees (audit, nomination, and compensation committees) is positively related to factors associated with the benefits of monitoring. However, the presence of insiders in the compensation committees increases the probability of making decisions in favor

1.1.4.3 Board Size

The size of the board has been shown to have a material impact on the quality of corporate governance. Several studies support the idea that large boards can be dysfunctional. Hermalin and Weisbach (2003) believe that board size proxies for the board's activity, explaining why smaller board sizes are better than larger ones that may be plagued with free rider and monitoring problems. For example, Yermack (1996) and Eisenberg *et al.* (1998) find a negative relation between board size and firm value, indicating that smaller boards are more effective since they experience fewer communication and coordination problems.

1.4.4.4 Split Chairman/CEO Roles

The question of whether the chairman and CEO positions should be separate has been controversial. The advantages and the drawbacks of separating the chairman and CEO positions have been studied extensively. Jensen (1993) argues that separating CEO and chairman roles is in the shareholders' interest. Similarly, large firms that separate the two functions trade at higher price-to-book multiples (Yermack, 1996) and have higher return on assets and cost efficiency ratios than firms where the same person holds both titles. In addition, bestowing the CEO and chairman duties on one individual makes it harder for a board to replace a poorly performing CEO (Shivdasani and Zenner, 2004), which can reduce the flexibility of a board to address sizable declines in performance (Goyal and Park, 2002

1.1.4.5 Board Meetings

Boards should be ready to increase meetings frequency if the situation requires a high supervision and control (Shivdasani and Zenner, 2004). Other studies suggest that boards should balance the costs and benefits of frequency. For example, if the board increases the frequency of its meetings, the recovery from poor performance is faster (Vafeas, 1999).

1.1.4.6 Auditing

Audit is an important element of efficient equity markets, because audits can enhance the credibility of financial information, directly support better corporate governance practices through transparent financial reporting in state owned enterprises (Conyon,1997) and therefore ultimately influences the allocation of resources (SEC, 2000). Theoretically, a large public firm with greater investment in reputational capital has more reason to minimize audit errors via "auditor-reputation effects". In addition, Dye (1993) argues that large audit firms are inclined to supply a higher quality audit compared to small firms, as more wealth is at stake in large audit firms. They will also experience a greater loss through reputation damage if the quality of their audit does not meet the accepted quality standards (Heath and Norman, 2004).

1.1.5 Relationship Between Risk Based Audit and Corporate Governance

Corporate governance is linked to economic performance. The way management and control are organized affects the company's performance and it's long run competitiveness. It determines the conditions for access to capital markets and the degree of investors' confidence (Brownbridge, 2007).

Yatim *et al.* (2006), examined the relationship between corporate governance and audit fees, finding that external audit fees are positively and significantly associated with good corporate governance (the board of directors' and audit committee's, independence, expertise, and meeting frequency). Cohen *et al.* (2007) examined the effect of the role of the board of directors in monitoring management (agency role) and/or the role of the board in helping to formulate corporate strategies (resource dependence role) on the auditors' planning judgments, and showed that auditors respond to the role of the board when making judgments with respect to control risk assessments and the planned scope of audit tests .

1.1.6 Risk Based Audit and Corporate Governance in State Corporations in Kenya

The Kenya government forms state corporations to meet both commercial and social goals. They exist for various reasons including to correct market failure, to exploit social and political objectives, provide education, health, redistribute income or develop marginal areas. At independence in 1963, parastatals were retooled by sessional paper no 10 of 1965 into vehicles for the indigenization of the economy. Some parastatals that exist today were established in the 1960s and 1970s. State Corporations in Kenya have been experiencing a myriad of problems, including corruption, nepotism, and mismanagement (GOK, 2003).

Management of State corporations in Kenya is faced with many problems including; Politicization and poor corporate governance – boards of parastatals are appointed by political powered as are the chief executives thus many operational decisions are not necessarily non partisan. Weak supervisory mechanism – the role of the state corporation advisory committee is just advisory yet it could play a more powerful as a monitor and evaluator performance. Prosecution of chief executives for abuse of office and misappropriation of funds is usually not carried out (Kihara, 2006). For RBA to provide good gorvernance in public institutions in Kenya, they must embrace the International Auditing Standards that guide the internal audits ethics of work and maintain professional auditing standards. The internal audit should identify the elements of corporate governance controls such as factors of internal control environment, risk management, control activity, information and communication and finally monitoring .They should also identify the limitations of internal control and factors which override control activities (Kihara, 2006)

1.2 Statement of the Problem

Recent state corporation inefficiency and financial scandals have provoked world-wide concern with corporate governance highlighted apparent failures of accountability, and subsequent new laws, regulations in response to them (Sanda, *et al*, 2005) provide compelling evidence that risk based audit, serves as part of sound corporate governance framework (Shivdasani, Zenner, 2004), matters and is important. More recently, Institute of Internal Auditors (IIA)-UK and Ireland Position Statement on Risk Based Internal Auditing (RBIA) and the Standards for the Professional Practice of Internal Auditing reveal that focal point of internal auditing and the role of this function in organizations has moved from traditional control and compliance orientation to a more risk-based focus (IIA, 2004, IIA, 2003).

Brody and Lowe, (2000) investigated the relationship between Risk Based Internal Audit and corporate governance structures. It was found that there existed a significant positive relationship between the level of risk based audit used and corporate governance corporate's board size used. The findings of this study indicated a significant negative correlation existed suggesting that a small board size seems to be more effective, and is more likely to use risk based audit, as a complementary mechanism. On contrary Krishnan. (2005) carried out an emphirical analysis on the role of risk based audit on internal corporate governance and found that the percentage of non-executive directors and supervisors on the board of directors was significant negative associated with the use of risk based audit indicating that the higher level of independent directors and supervisors on the board presents better corporate governance, hence may not employ higher percentage of risk based audit for monitoring of risk management. The top level management in state corporations such as chief executives officers is accused of abuse of office and misappropriation of funds. For RBA to provide good gorvernance in state corporations in Kenya, guide the internal audits ethics of work and maintain professional auditing standards. The internal audit should identify the elements of corporate governance controls such as factors of internal control environment, risk management, control activity, information and communication and finally monitoring .They should also identify the limitations of internal control and factors which override control activities (Kihara, 2006)

An effective risk management by state corporations and effective risk-based supervision by regulators is highly dependent both on the implementation of adequate corporate governance and on the risk based audit (Klapper, and Love, 2003). In Kenya, state corporations had been reported to be ineffective and corruption has led to closure such as

Kenya Cooperative Creameries and Kenya Meat Commission which were revised with enactment of Narc Government in 2002 (GOK, 2010). There has been occurent of fraudulent acts in state corporations that have continued to challenge the performance of the state corporations in Kenya. Risk based auditing is found to assess risks facing state corporations on time and concertrate on high risk areas in order to increase trasparency and accountability, hence enhancing good governance. Locally, studies focusing on auditing have also been carried out. 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. To the best of researcher knowledge, none of the known local and international studies have ever focused on the relationship between internal risk-based audit and corporate governance of state corporation in Kenya. This is despite the fact that there has been occurent of fraudulent acts that have continued to challenge the service delivery and performance of the state corporations in Kenya. It is in this light that the study sought to fill the existing gap by carrying out a research on the relationship between risk-based audit and corporate governance to answer the question what is the relationship between risk-based audit and corporate governance of state corporations in Kenya?

1.3 Objective of the Study

To determine the relationship between risk-based audit and corporate governance in state corporations in Kenya.

1.4 Significance of the Study

This research will be significant to the state corporations in Kenya by providing an insight into the various approaches towards internal risk-based audit to ensure efficient utilization of resources and minimization of fraudulent actions. Government auditing is a cornerstone of good governance. By providing unbiased, objective assessments of whether state resources will be responsibly and effectively managed to achieve intended results, risk based audit will help state corporations achieve accountability and integrity, improve operations, and instill confidence among citizens and stakeholders.

The study will be significant as it will offer insight toward effective decision-making process by providing an independent assessment of government programs, policies, operations, and results. Foresight identifies trends and emerging challenges improving service derivery in state corporations.

The study will also be significant to the researchers and scholars as it will forms a background reference for future studies and contribute to the existing knowledge of literature.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter summarizes the information from other researchers who have carried out their research in the same field of study. Specific emphasis has been put on the major issues in governance of state corporations. The specific areas covered here are theoretical orientation, empirical review.

2.2.Theoretical Review

2.2.1 Agency Theory

A significant body of work has built up in this area within the context of the principal-agent framework. The work of Jensen and Mecklin (1976) in particular and of Fama and Jensen (1983) are important. Agency theory identifies the agency relationship where one party, the principal, delegates work to another party, the agent. The agency relationship can have a number of disadvantages relating to the opportunism or self interest of the agent: For example, the agent may not act in the best interests of the principal, or the agent may act only partially in the best interests of the principal. There can be a number of dimensions to this including for example, the agency misusing his power for pecuniary or other advantage, and the agent not taking appropriate risks in pursuance of the principals interests because he (the agent) views those risks as not being appropriate and the principal may have different attitudes to risks. There is also the problem of information asymmetry whereby the principal and the agent have access to different levels of information; in practice this means that the principal is at a disadvantage because the agent has more information.

In the context of financial institutions and issues of corporate control, agency theory view corporate governance mechanisms especially the board of directors, as being an essential monitoring device to try to ensure that any problems that may be brought about by the principal-agent relationship, are minimized. Blair(1996) states; managers are supposed to be the 'agents' of a financial Institutions 'owners' but managers must be monitored and institutional arrangements must provide some checks and balances to make sure they do not abuse their power. The costs resulting from managers misusing their position, as well as the costs of monitoring and disciplining those to try to prevent abuse have been called 'agency costs'. Much of agency theory, as related to financial Institutions is set in the context of the separation of ownership and control as described in the work of Berle and Pears (1992).In this context, the agents are the managers and the principals are the shareholders ,and this is the most important commonly cited agency relationship in the corporate governance context.

2.2.2 Transaction Cost Economics

Transaction cost economics (TCE) as expounded by the work of Williamson (1975, 1984) is often viewed as closely related to agency theory. Transaction cost economics views the firm as a governance structure whereas the agency theory views the firm as a nexus of contracts. Essentially, the latter means that there is a connected group or series of contracts amongst the various players, arising because it is seemingly impossible to have a contract that perfectly aligns the interests of principal and agents in a corporate control situation.

As firms grow in size, whether caused by the desire to achieve economies of scale, or by technological advances, or by the fact that natural monopolies have evolved, they have increasingly required more capital which needed to be raised from the capital markets and wider shareholder base needed to be established. The problem of the separation of ownership and control and the resultant corporate governance issues have thus arisen. Coase (1937) examines the rationale for the firm's existence in the context of a framework of the effectiveness of internal as opposed to external contracting. The entrepreneur has to carry out his function at less cost, taking into account the fact that he may get factors of production at a lower price than the market transactions which he supersedes. Williamson (1975) builds on the earlier work of Coase, and provides a justification for the growth of larger firms and conglomerates, which essentially provide their own internal capital market. He states that the costs of any misaligned actions may be reduced by judicious choice of governance structure rather than merely realigning incentives and pricing them out.

Hart (1995) states there are a number of costs to writing a contract between principal and agent, which include the cost of thinking about and providing for all the different eventualities that may occur during the course of the contract, the cost of negotiating with others, and the costs of writing the contract in an appropriate way so that it is, for example, legally enforceable. These contracts tend to mean that contracts are apt to be incomplete in some way and so contracts will tend to be revisited as and when any omissions or required changes come to light. Hart indicates that,'in a world of incomplete contracts (where agency problems are also present), governance structure can be seen as a mechanism for making decisions that have not been specified in the initial contract.

2.1.3 Stakeholder Theory

Stakeholder theory takes into account of a wider group of constituents rather than focusing on shareholders. A consequence of focusing on shareholders is that the maintenance or enhancement of shareholders' value is paramount whereas when a wider stakeholder group such as employees, providers of credit, customers, suppliers, government and the local community is taken into account the overriding focus on shareholder value become less self evident. Nonetheless many companies do strive to maximize shareholders value whilst at the same trying to take into account the interests of the wider stakeholder group. One rationale for effectively privileging shareholders over other stakeholders is that they are recipients of the residual free cash flow (being the profits remaining once other stakeholders such as loan creditors, have been paid).This means that the shareholders have vested interest in trying to ensure that resources are used to maximum effect, which in turn should be to the benefit of the society.

Stakeholder theory is managerial in that it reflects and directs how managers operate rather than primarily addressing management theorists and economists. The focus of stakeholder theory is articulated in two core questions (Freeman, 1994). First, it asks, what is the purpose of the firm? This encourages managers to articulate the shared sense of the value they create, and what brings its core stakeholders together. This propels the firm forward and allows it to generate outstanding performance, determined both in terms of its purpose and marketplace financial metrics. Second, stakeholder theory asks, what responsibility does management have to stakeholders? This pushes managers to articulate how they want to do business—specifically, what kinds of relationships they want and need to create with their stakeholders to deliver on their purpose. Managers must develop relationships, inspire their stakeholders, and create communities where everyone strives to give their best to deliver the value the firm promises. Certainly shareholders are an important constituent and profits are a critical feature of this activity, but concern for profits is the result rather than the driver in the process of value creation.

2.2 Measures that can Enhance RBA in Corporate Governance

As an essential element of a strong public sector governance structure, RBA supports the governance roles of oversight, insight, and foresight (Phil and Griffiths, 2006). Because government's success is measured primarily by its ability to deliver services successfully and carry out programs in an equitable and appropriate manner, government audit activities should have the authority and the competency to evaluate financial and program integrity, effectiveness, and efficiency (Verschoor, 1992). Below are some of the factors that enhances good Corporate Governance.

2.2.1 Risk Assessment

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 (Verschoor, 2002). 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 (Spira and Page 2003).

Risk-based auditing derives largely from models that assume that inherent risk (IR) and control risk (CR) are distinct concepts and that IR arises from attributes of the audit environment that are completely independent of attributes that determine the level of control risk. Operationalizing the distinction between IR and CR has however, proved troublesome as the literature review below indicates. There appears to be little consensus regarding attributes that may identify IR and there is little published evidence regarding how IR is considered by practitioners. Also, it is not yet clear neither does it make good logical sense to try to separate IR and CR in the manner demanded by standard setters (DeFond et al.,2000).

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. Raghunandan, Read and Rama. (2001) asserts 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" (Sarens and de Beelde, 2006). Consistent with Walker *et al* (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.

2.2.2 Risk Management

Risk management includes identifying and assessing inherent risks and then responding to them . According to IIA (2006)- Role of auditing in corporate Governance , 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.

Risk management is an explicit tool for business, public sector organizations and regulators to identify evaluate and manage both risk and opportunity. It is a logical and systematic process which can be used when making decisions and in managing performance. It is a means to an end and should be integrated into everyday work. Many jurisdictions have developed what is referred to as a "systems" audit, which is designed to assess the full scope of the organization's financial and performance control systems and to identify deficiencies and recommend corrective actions (Wade, 2002). There is no such thing as a risk -free environment, but many risks can be avoided, reduced or eliminated through good risk management. Good risk management also takes advantage of opportunities while analyzing and dealing with risks.

Through Risk based audit sound risk management strategies which are forward looking and helps to improve business decisions (Fatemi and Glaum, 2000). It is not just about avoiding or minimizing losses, but about dealing positively with opportunities. It is a powerful tool for public sector managers (Drzik, 2000). Good risk management is based on a well-planned, logical, comprehensive and documented strategy. This strategy provides general policy guidance, and plans and procedures that can be used as part of the organization's everyday work to manage risk (OECD, 2005).

2.2.3 Annual Risk Based Planning

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 (Sanda, Milkailu and Garba, 2005). 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 (Karapetrovic, 1999).

In planning the engagement and determining its scope, the external auditor's main objective is to gather evidence to support giving an opinion on the financial statements. When planning the engagement, the internal auditor is not required to design procedures specifically to gather information to report to the governance body (Karapetrovic, 1999). Rather, matters to be communicated are those which come to the auditor's attention in the course of the engagement and which the auditor deems to be significant and relevant to the governance body.

Millichamp (2002) suggests, in order to avoid materiality, it should be taken into account at the planning stage of an audit and re-evaluated if the outcomes of tests, enquiries or examinations differ from expectations.

2.2.4 Internal Auditing Standards

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.

Liebesman (2004) strongly advocates that ISO 9000 and ISO 14000 can be used to reduce risks with compliance with the Sarbanes-Oxley Act (SOX, 2002): Because of SOX, the CEOs and CFOs of public companies must certify their financial statements, and each year they must certify the effectiveness of their systems of internal controls mandated by the law. Top management needs to obtain better information about the effectiveness of their organizations.

2.2.5 Internal Auditing Capacity

Events since mid 1970s have contributed to the growth of internal auditing. Public compa maintain effective internal accounting controls to provide reasonable assurance that assets are safeguarded and that transactions are properly authorized and recorded. To accomplish this, many companies established internal audit functions, increased internal audit staffing, and strengthened internal audit independence. Beasley et al. (2000) show that these investments in internal auditing have been effective, as companies with internal audit staffs are less prone to financial fraud than companies without internal auditing. Also, Coram et al. (2008) find that organizations with internal audit staffs are more likely than those without internal auditing to detect and self-report occurrences of fraud. The number and magnitude of errors requiring adjustment by the external auditors have been found to be substantially lower for entities that had an internal audit departmanent compared to those that did not have an internal audit department, (Wallace and

Kreutzfeldt, 1991). The internal audit function si important because it adds value and therefore reduces detected errors (Goodwin and Kent, 2004).

2.3 Empirical Review

Recent scandals and bankruptcy in Public Institutions revealed huge gaps between boards of directors, executive management, internal control and organizational performance. For instance, the Corporate Governance 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 Corporate Governance 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 organisation, to form a robust strategic business management tool.

Chen, (2003) investigated the relationship between corporate governance and risk-taking behavior in Taiwanese Banking Industry sample consists of all of the 39 domestic state corporations, and of the 39 surveys mailed, 24 completed responses were returned for a response rate of 61.54%. Of the 24 survey responses, 13 (54.1%) of the credit unions report that more than 60% of their internal audit activities are risk oriented. It was found that 8 of 24 (33.3%) respondents indicating that they use a relatively high level of RBIA, about 61%-80%, while 6 (25%) of the domestic banks report that about 21%-40% of their internal audit work are risk-based (Sarens and de Beelde, 2006).

Liebesman (2004) strongly advocates that ISO 9000 and ISO 14000 can be used to reduce risks with compliance with the Sarbanes-Oxley Act (SOX, 2002): Because of SOX, the CEOs and CFOs of public companies must certify their financial statements, and each year they must certify the effectiveness of their systems of internal controls mandated by the law. Top management needs to obtain better information about the effectiveness of their organizations. Quality and environmental people should be at the table when the internal financial auditors develop their reports to top management and the board of directors (Verschoor, 2002).

Kibara (2007) in his study on a survey of internal auditors risk management practices in the banking industry in Kenya found out that, most state corporations in Kenya were in process of drafting the Early Rate Mode process and strategies. Kibet (2008) concluded that internal audit function played a role in corporate governance. The limitations of the study were time constraints, restriction to state owned corporations and having to make prior arrangement in order to meet the heads of IADs. Recommendations of further study were effectiveness and contribution of internal audit in promoting corporate governance for companies listed in the NSE. Additionally, a study on the influence of internal audit and audit committee on financial reporting quality was recommended

The Sarbanes-Oxley Act of 2002 has also contributed to the growth of risk based auditing. Internal auditors have enjoyed increased prominence, higher salaries, and a greater public appreciation for the role that internal auditing can play in a well-governed organization (Hermanson, 2006)." In particular, companies are using internal auditors to strengthen and evaluate their internal control systems to comply with the internal controls provisions of Sarbanes-Oxley. A 2003 survey by.The Institute of Internal Auditors indicated that 20% of companies included in the Fortune 1,000 did not yet have internal audit departments but 50% of the Fortune 1,000 companies planned to increase their internal audit staffs to comply with Sarbanes-Oxley (Harrington, 2004). A later survey of 117 chief audit executives of public companies subject to the provisions of Sarbanes-Oxley indicated that 111 reported their companies increased internal audit budgets from 2002 to 2005 (Kaplan & Schultz, 2006). Of these 111, 32% increased internal audit budgets by more than 50%. Another survey of 402 companies reports that more than half of them increased internal audit resources as a result of Sarbanes-Oxley, with 15% indicating more than a 50% increase (PricewaterhouseCoopers, 2006).

According to Heath and Norman, (2004), when senior managers were given multiple objective to achieve it may become almost impossible to measure their success in improve the firm performance through accountability for achieve firm value leading to failure. Several studies suggest that firms with more independent directors perform worse than those with relatively fewer independent directors. For example, Agrawal and Knoeber (1996) reported a negative correlation between the proportion of outside directors and Tobin's Q index (which is a measure of growth prospects of assets, defined by the future profitability of the asset in relation to its replacement cost). This is consistent with evidence established by Bhagat and Black (1997) that a high proportion of independent directors is strongly correlated with slower past growth across a number of accounting variables, but not so with future performance. Evidence from Bhagat and

Black (1997) and Klein (1997) also shows that a high proportion of independent directors correlates with lower past profitability.

2.4 Relationship Between Risk Based Auditing And Corporate Governance

Prior research has examined the effect of corporate governance on auditors' decisions (judgments). Cohen and Hanno (2000) find that management control philosophy and corporate governance structure affect auditors' pre-planning (client acceptance) and planning (extent and timing of testing) judgments; specifically, auditors were more willing to recommend client acceptance and more likely to reduce substantive tests in the presence of a stronger corporate governance or management control philosophy. Bedard and Johnstone (2004) examined auditors' assessments of and planning and pricing decisions related to earnings manipulation risk and corporate governance risk, and showed that auditors plan increased effort and billing rates for clients with earnings manipulation risk and that the positive relation between earnings manipulation risk and both effort and billing rates are greater for clients that have heightened corporate governance risk. Lee *et al.* (2004) found that an independent audit committee and board members who are concerned about incurring legal liability and harming reputation support external auditors in accomplishing their assurance duties.

Governments around the world face a number of challenges in meeting the changing expectations and needs of their citizens. Responses to these challenges typically include setting up and delivering service delivery reforms, fiscal management, seeking to operate more effectively, efficiently and openly and developing new capabilities for civil society participation, partnership and resource management (Brownbridge, 2007). 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).

2.5 Conclusion

This study seeks to establish the relationship between RBA and corporate governancc on State Corporation in Kenya. To understand the relationship of RBA and corporate governance, this study will examines whether the use of RBA practices risk management, risk assessment, annual risk planning, audit staffing affects service delivery of the state corporations. RBA is seen as the process and structure used to direct and manage the business affairs of the state corporation towards enhancing public service delivery, prosperity and corporate accountability with the ultimate objective of realizing long-term shareholder value, whilst taking into account the interest of other stakeholders. 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 state corporations 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. RBA helps in defining the relation between the state corporations and its financial market enviroment, the social and political systems in which it operates. RBA is linked to corporate governance of state instituions.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

The chapter presents the research design and methodology of the study.

3.2 Research Design

This study adopted a descriptive design meant to investigate the relationship between RBA and Corporate Governance of State Corporations in Kenya. This study focused mainly on quantitative research and adopted a descriptive research design which was meant to investigate the Relationship between RBA and Corporate Governance of state corporations in Kenya.

3.3 Study Population

This research study targeted all the 168 state corporations in Kenya which are categorised in 8 categories including, financial, commercial, regulatory, public universities, training and research, service, regional development authorities and tertiary education and training.

3.4 Sampling Design and Procedure

For the purpose of this study, 40 state corporations were selected for this study where simple random sampling technique was adopted to select 5 respondents from each of the 8 categories. Mugenda and Mugenda (2003), indicated that a sample of 10% to 20% of the population is sufficient for a study and 40 state corporations were sufficient for the study in determining the relationship between RBA and Corporate Governance for a period of 5 year from year 2007 to year 2011.

3.5 Data Collection

The study used both primary and secondary data. Primary data was collected using semi-structured questionnaires. The questionnaires were administered using drop and pick method. Thus secondary data was collected from the written journals and books to collect information on risk base audit and corporate governance.

3.5.1 Validity and Reliability

Piloting was carried out to test the validity and reliability of the instruments. Validity indicates that degree to which the instrument measures the constructs under investigation (Mugenda and Mugenda, 2003). This study used content validity because it measured the degree to which the sample of the items represents the content that the test was designed to measure

3.6 Data Analysis

The collected data was thoroughly be examined and checked for completeness and comprehensibility. The researcher used qualitative and quantitative techniques in analysing the data. After receiving questions from the respondents, the responses were edited, classified, coded and tabulated to analyze quantitative data using Statistical Package for Social Science (SPSS version 17). Tables and charts were used for further representation of the data for easy understanding and analysis. The inferential statistic such as regression and correlation analysis was carried to establish the strength of the relationship between risk based audit and the corporate governance in state corporation for 5 years from 2007 to 2011.

The study used a Tobit model, which is a regression technique suited to analyse limited (censored) dependent variables (Spekle´ *et al.* 2007). This model identifies factors that are associated with a state corporation's use of risk-based internal auditing where corporate governance was measured using Tobin Q. A score from 1 to 5, likert scaled was maximized with value in the likert scale, reflecting the extent of disclosures about risk base audit practices in state corporate which are risk management, internal Auditing capacity, accomplishing of Annual Risk Based Planning and compliance with internal Auditing Standards. The Total number scores will be measured by computing the mean of questionnaires, representing the extent of technical competence of internal auditors in the internal audit department in state corporations to measure corporate governance .

$$Y = \beta_0 + \beta_1 ARA + \beta_2 RM + \beta_3 ARP + \beta_4 IAS + \varepsilon_{it}$$

Where Y = Corporate governance, RA= Risk Assessment, RM = Risk Management

ARP = Annual Risk Based Planning, IAC = Internal Auditing Standards

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DICUSSION

4.1 Introduction

This chapter presents the findings of the study on the relationship between risk-based audit and corporate governance focusing on state corporations in Kenya. The respondents were from 40 selected state corporations. However, out of thc total 40 questionnaires distributed to the respondents, a total of 38 questionnaires were filled and returned. This represented a response rate of 95%.

4.2 Correlation Analysis Of the Study Varibles

Table 4.1:Correlation of the Study Variables

Independent Variables	Analysing Factor	Risk Assess ment	Risk Manage ment	Annual Risk Based Planning	Internal Auditing Standards
Risk Assessment	Pearson Correlation	1	.765(**)	.612(**)	.491(**)
	Sig. (2-tailed)		.000	.001	.007
	N	31	26	28	29
Risk Management	Pearson Correlation	.765(**)	1	.490(**)	.382(*)
	Sig. (2-tailed)	.000		.007	.037
	N	26	32	29	30
Annual Risk Based Planning	Pearson Correlation	.612(**)	.490(**)	1	.730(**)
	Sig. (2-tailed)	.001	.007		.000
	N	28	29	35	33
Internal	Pearson	.491(**)	.382(*)	.730(**)	1

Auditing Standards	Correlation				
	Sig. (2-tailed)	.007	.037	.000	
	N	29	30	33	36
Internal Auditing Staffing	Pearson Correlation	.425(*)	.277	.635(**)	.063
	Sig. (2-tailed)	.030	.162	.000	.726
	N	26	27	33	33
Corporate Governance	Pearson Correlation	.881(**)	.669(**)	.534(**)	.416(*)
	Sig. (2-tailed)	.000	.000	.003	.028
	N	26	26	28	28

Source: Author (2012)

** Correlation is significant at the 0.01 level (2-tailed).* Correlation is significant at the 0.05 level (2-tailed).

From Table 4.1 above, the study shows that corporate governance has a strong positive correlation with risk assessment, risk management, annual risk based planning, internal auditing standards. Risk assessment scored a correlation coefficient of 0.881 and a 99% precision level. The correlation was statistically significant since it had a P- Value of less than 0.005. Risk management had correlation coefficient of 0.669 and a 99.9% precision level. The correlation was statistically significant since it had a P- Value of less than 0.005. This implied that adoption of risk management practices in the state corporation would have greater positive effects on corporate governance. Annual risk based planning had a correlation coefficient of 0.534 and a precision level of 99.9%. This correlation was statistically significant since its P- Value was less than 0.005.

Internal auditing standards had a fairly strong and positive correlation coefficient of 0.416 and a 95% precision level. The correlation was not statistically significant since it had a P- Value of more than 0.005.

Risk assessment had a strong positive relationshiop with risk management with a correlation coefficient of 0.765 at 99.9 % confindence level. Annual risk based planning and risk assessment had correlation coefficient of 0.612 at 99.9% confindence level and a P-Value less that 0.005. The study further found that there exists a strong positive relationship between annual risk based planning and internal auditing standards with correlation coefficient of 0.730 at 99.9% confindence level while there was a weak positive relationship between internal auditing standards and risk management with a correlation coefficient of 0.382 at 95.0% confindence level.

4.3 Risk Assessment and Corporate Governance

4.3.1 Extent to which Adoption of Risk Assesment Affect Corporate Gorvenance

A multivariate regression model was applied to determine the relationship between Risk Assesment and Corporate Gorvernance

The regression model was as follows:

$Y = \beta_0 + \beta_1 ARA + \varepsilon_n$

Where: Y = Corporate Govemance; β_0 =; β_1 = Estimated coefficients; RA_1= Risk Assessment; e= Error rate

The resulting model is as follows:

Table 4.2: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				
					R Square Change	F Change	df1	df2	Sig. F Change
1	.780(a)	.584	.564	0.60877	.005	3.640	5	1	.001(a)

Source: Author (2012)

a) Predictors: (Constant), Risk Assessment

b. Dependent Variable: Corporate Governance

The R^2 is called the coefficient of determination which shows how Risk Assessment in auditing influence corporate governance in in state corporations. From table 4.2 above, the value of R^2 is .584. This implies that, there was a variation of 58.4% influence of risk assessment on corporate governance and the variation was significant as p> 0.05 at 0.001

4.3.2 Analysis of variance on Risk Assesment and Corporate Governance

Table 4.3: Analysis of Variance on Risk Assesment and Corporate Governance

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	2.132	5	183.522	8.640	.000(a)
	Residual	3.810	12	21.241		
	Total	5.942	17			

Source: Author (2012)

a. Predictors: (Constant), Risk Assesment,

b. Dependent Variable: Corporate Governance

An analysis of variance (ANOVA) is used to test whether there is a significant linear relationship between the Risk Assesment components and Corporate Governance in state Corporations. According to Table 4.3, the *p*-value is .000, indicating that the Risk Assesment carried out through auditing significantly influence corporate governance

Table 4.4: Coefficient of Risk Assesment and Corporate Governance

Variables	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta	B	Std. Error
Corporate Gorvanance	4.142	0.511		.401	.0019
Risk Assesment	0.812	0.754	0.793	1.730	.0020

Source: Author (2012)

a. Predictors: (Constant), Risk Assesment

b. Dependent Variable: Corporate Governance

The resulting model is as follows:

$Y = \beta_0 + \beta_1 ARA + \varepsilon_{it}$

Regression coefficients; X_1= Risk Assessment

From the above regression model in Table 4.4, holding Risk Assesment constant Corporate Governance would be 4.142. The study found that a unit increase in Risk Assesment would lead to an increase in Corporate Governance by a factor 0.812 with a

P value> 0.05 at 0.024 in state corporations. The implied that Risk Assesment influence Corporate Governance to a great extent as indictaed by a coefficent of 0.812.

4.4 Extent to which Risk Management Influences Corporate Governance

A multivariate regression model was applied to determine the relationship between Risk management and Corporate Gorvenance

The regression model was as follows:

$Y = \beta_0 + \beta_1 ARM + \varepsilon_{it}$

Where: Y = Corporate Governance; β_0 =; β_1 = Estimated coefficients; RM_1= Risk management; ę= Error rate

The resulting model is as follows:

Table 4.5: Model Summary of Variation Between Risk Management Corporate Governance

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				
					R Square Change	F Change	df1	df2	Sig. F Change
1	.884(a)	.781	.765	0.456	.006	2.260	5	1	.000(a)

Source: Author (2012)

a) Predictors: (Constant), Risk Management

The study sought to establish whether there existed variation beween Risk Management and Corporate Governance. From table 4.5 above, the value of R^2 is .781. This implies that, there was a variation of 78.1% influence of Risk Managemet on Corporate Governance and the variation was significant as p> 0.05 at 0.001

4.4.1 Analysis of Variance

Table 4.6: Analysis of Variance on Risk Management and Corporate Governance

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	2.132	5	183.522	8.640	.002(a)
	Residual	3.810	12	21.241		
	Total	5.942	17			

Source: Author (2012)

a. Predictors: (Constant), Risk Management

b. Dependent Variable: Corporate Governance

An analysis of variance (ANOVA) is used to test whether there was a significant linear relationship between the Risk Management components and Corporate Governance in state corporations. According to Table 4.6, the *p*-value is .002, indicating that the Risk Mnagement influences Corporate Governance carried out through auditing significantly influence Corporate Gorvernance.

Table 4.7: Coefficients on Risk Management and Corporate Governance

Variables	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta	B	Std. Error
Corporate Govenance	2.830	0.418		.701	.001

Risk Management	0.775	0.329	0.601	2.714	.001

Source: Author (2012)

a. Predictors: (Constant), Risk Management

b. Dependent Variable: Corporate Governance

The resulting model is as follows:

$Y = \beta_0 + \beta_1 ARM + \varepsilon_{it}$

Regression coefficients; X_1= Risk Management

From the above regression model in Table 4.7, holding Risk Management constant Corporate Governance would be 2.830. The study found that a unit increase in Risk Management would lead to an increase in corporate governance by a factor 0.775 with a P value> 0.05 at 0.001 in state corporations. The implied that Risk Management influence corporate governance to a great extent as indictaed by a coefficent of 0.775.

4.5 Influence of Risk Based Audit Planning Factors on Transparency and Accountability

The study sought the extent to to which Risk Based Audit Planning Factors Affect Transparency and Accountability in State Corporation

The regression model was as follows:

$Y = \beta_0 + \beta_1 RBAP + \varepsilon_{it}$

Where: Y = Corporate Governance; β_0 =; β_1 = Estimated coefficients; RBAP= Risk Based Audit Planning e= Error rate

The resulting model is as follows:

Table 4.8: Variation of Risk Based Audit Planning on Transparency and Accountability

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				
					R Square Change	F Change	df1	df2	Sig. F Change
1	.607(a)	.368	.352	0. 150	.002	3.571	5	1	.003(a)

Source: Author (2012)

a) Predictors: (Constant), Risk Based Audit Planning

The study sought to establish whether there existed variation beween Risk Based Audit Planning and Corporate Governace (transparency and accountability). From table 4.8 above, the value of R^2 is .368. This implies that, there was a variation of 36.8% influence of Risk Based Audit Planning on Corporate Governance and the variation was significant as p> 0.05 at 0.003

4.5.1 Analysis of Variance on RBA Planning and Corporate Governance

Table 4.9: Summary Model on RBA Planning nd Corporate Governance

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	3.002	5	183.522	8.640	.002(a)
	Residual	4.361	12	21.241		
	Total	7.363	17			

Source: Author (2012)

a. Predictors: (Constant), Risk Based Audit Planning

b. Dependent Variable: Corporate Governance

An analysis of variance (ANOVA) is used to test whether there was a significant linear relationship between the Risk Based Audit Planning and (transparency and accountability) in state corporations. According to Table 4.9, the *p*-value is .003, indicating that the Risk Based Audit Planning influences on Corporate Governance was significant.

Table 4.10: Coefficients of Variation Between RBA Planning and Corporate Governance

Variables	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta	B	Std. Error
(Constant)	3.532	0.311		.578	.000
Risk Based Audit Planning	0.507	0.439	0.301	2.325	.002

Source: Author (2012)

a. Predictors: Risk Based Audit Planning

b. Dependent Variable: Corporate Governance

The resulting model is as follows:

$Y = \beta_0 + \beta_1 RBAP + \varepsilon_{it}$

Regression coefficients; $X_1 = 0.507$

From the above regression model in Table 4.10, holding Risk Based Audit Planning constant Corporate Governance would be 3.532. The study found that a unit increase in Risk Based Audit Planning would lead to an increase in Corporate Governance, tranparenct and accountability by a factor 0.507 with a P value> 0.05 at 0.002 in state corporations. The implied that Risk Based Audit Planning influence Corporate Governance to a great extent as indictaed by a coefficent of 0.507

4.6 Extent to which Risk Based Auditing Standards Affect Corporate Governance

The study sought the extent to to which Risk Based Auditing Standards factors affect Corporate Governance in State corporation

The regression model was as follows:

$Y= \beta_0 + \beta_1 RBAS + \varepsilon_{it}$

Where: Y = Corporate Governance; β_0 =; β_1 = Estimated coefficients; RBAS= Risk Based Auditing Standards e= Error rate

The resulting model is as follows:

Table 4.11 Model Summary on Variation Between RBA Standards Affect Corporate Governance

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				
					R Square Change	F Change	df1	df2	Sig. F Change
1	.607(a)	.368	.352	0. 150	.002	3.571	5	1	.003(a)

Source: Author (2012)

a) Predictors: (Constant), Risk Based Auditing Standards

The study sought to establish whether there existed variation beween Risk Based Auditing Standards and corporate governace .From table 4.11 above, the value of R^2 is

0.368. This implies that, there was a variation of 36.8% influence of Risk Based Audit Standards on Corporate Governance and the variation was significant as p> 0.05 at 0.003

4.6.1 Analysis of Variance Between RBA Standards nd Corporate Governance

Table 4.12: Significance of the Relationship Between RBA standardsand Corporate Governance

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	3.002	5	183.522	8.640	.002(a)
	Residual	4.361	12	21.241		
	Total	7.363	17			

Source: Author (2012)

a. Predictors: (Constant), Risk Based Audit Standrds

b. Dependent Variable: Corporate Governance

An analysis of variance (ANOVA) is used to test whether there was a significant linear relationship between the Risk Based Auditing Standards and Corporate Governance in state corporations. According to Table 4.12, the *p*-value is .002, indicating that the Risk Based Auditing Standards influences on Corporate Governance was significant.

Table 4.13: Coefficients of Variation Between RBA Standards and Corporate Governance

Variables	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta	B	Std. Error
Corporate Gorvanance	0.871	0.403		.373	.000
Risk Based Audit Planning	0.712	0.287	0.695	3.310	.002

Source: Author (2012)

a. Predictors: (Constant), Risk Based Auditing Standards

b. Dependent Variable: Corporate Governance

The resulting model is as follows:

$Y = \beta_0 + \beta_1 RBAS + \varepsilon_{it}$

Regression coefficients; = 0.507

From the above regression model in Table 4.13, holding Risk Based Auditing Standards constant Corporate Governance would be .871. The study found that a unit increase in Risk Based Auditing Standards would lead to an increase in Corporate Governance, by a factor 0.712 with a P value> 0.05 at 0.002 in state corporations. The implied that Risk Based Auditing Standards influence corporate governance to a great extent as indictaed by a coefficent of 0.712

4.7 Risk Based Audit and Corporate Governance

A multivariate regression model was applied to determine the Relationship Between Risk Based Audit and of each of the five Risk based Audit variables on the Corporate Governance in state corporations

The regression model was as follows:

$Y = \beta_0 + \beta_1 ARA + \beta_2 RM + \beta_3 ARP + \beta_4 IAS + \varepsilon_{it}$

Where: Y = Corporate Governance; α = Intercept; β_1 _ β_5= Estimated coefficients; RA_1= Risk Assessment; X_2= Risk Management; X_3= Internal Auditing Standards; X_5= Annual Risk Based Planning; ҫ= Error rate

The resulting model is as follows:

Table 4.14 Summary Model on Variation between Risk Based Audit Varibles and Corporate Gorvanance

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics				
					R Square Change	F Change	df1	df2	Sig. F Change
1	.885(a)	.783	.692	4.60877	.009	8.640	5	1	.001(a)

Source: Author (2012)

a) Predictors: (Constant), Annual Risk Based Planning, Risk Management, Internal Auditing Staffing, Risk Assessment, Internal Auditing Standards

Adjusted R^2 is called the coefficient of determination which shows how risk based audit influence corporate governance in relation with annual risk based planning, risk management, risk assessment and internal auditing standards

From table 4.14 above, the value of adjusted R^2 is .783. This implies that, there was a variation of 78.3% influence of risk based audit in corporate governance in relation with annual risk based planning, risk management, risk assessment and internal auditing standards at a confidence level of 99.9%.

4.7.1 Analysis of Variance of the Variables

Analysis of variance (ANOVA) is a collection of statistical models and their associated procedures in which the observed variance in a particular variable is partitioned into components attributable to different sources of variation. In its simplest form ANOVA provides a statistical test of whether or not the means of several groups are all equal, and therefore generalizes *t*-test to more than two groups. ANOVAs were helpful because they possess an advantage over a two-sample t-test and they are useful in comparing three or more means.The relatioship between the regression and the sum of squares of the variables was 917.611 at 99.9 % significant level.

Table 4.15: Summary Model on Analysis of Variance on Risk Based Audit Variables

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	917.611	5	183.522	8.640	.001(a)
	Residual	254.889	12	21.241		
	Total	1172.500	17			

Source: Author (2012)

a) Predictors: (Constant), Annual Risk, Risk Management, Risk Assessment, Internal Auditing Standards

b) Dependent Variable: Corporate Governance

Table 4.16: Coefficients of the Risk Based Audit Variables

Variables	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta	B	Std. Error
(Constant)	3.838	0.511		.207	.039
Risk Assessment	1.750	0.754	1.564	3.729	.017
Risk Management	1.850	0.258	1.020	097	.025
Annual Risk Based Planning	1.181	0.733	0.714	1.010	.033
Internal Auditing Standards	1.765	0.317	1.588	1.006	.024

Source: Author (2012)

a) Predictors: (Constant), Risk Assessment, Risk Management, Annual Risk Based Planning and Internal Auditing Standards

b) Dependent Variable: Corporate Governance

The resulting model is as follows:

$Y = \beta_0 + \beta_1 ARA + \beta_2 RM + \beta_3 ARP + \beta_4 IAS + \varepsilon_{it}$

Regression coefficients; X_1= Risk Assessment; X_2= Risk Management; X_3= Internal Auditing Standards; X_5= Annual Risk Based Planning; ę= Error rate

From the above regression model in Table 4.16, holding risk assessment, risk management, internal auditing standards, internal auditing staffing and annual risk based planning constant public sector governance would be 3.838. The study found that a unit increase in risk assessement would lead to an increase in corporate governance by a factor 1.750, a unit increase in risk management would improve corporate sector governance by a factor of 1.850. An increase in annual risk based planning increase in corporate governance in state corporations by 1.181 while increase in internal auditing standards lead to an improvement in corporate governance with a P value 0.024 in state corporations.

The study further found that a unit increase in internal auditing standards would improve corporate governane by a factor of 1.181 while a unit increase in annual risk based planning would improve corporate govermnance by 0.917. This clearly shows that an increase in risk assessment, risk management, internal auditing standards and annual risk based planning, would lead to improve corporate governance.

From the above regression model, the coefficient of determination is 0.956 indicating that the independent variables explain 95.6 % of the variability in the dependent variable. This shows a very strong correlation between the independent variables and the dependent variable. Judging from the coefficients of the variables, it can be seen that risk assessment had the greatest influence towards corporate governance though with a P-value of more than 0.005 and a coefficient of 1.750 while annual risk based planning had the lowest influence with a P-value of 0.359 and a coefficient of 0.917. The results indicate that risk based audit influence corporate governance in state corporations in Kenya.

4.8 Discussion of the Findings

The results indicates that corporate governance has a strong positive correlation with risk assessment, risk management, annual risk based planning, internal auditing standards. Risk assessment scored a correlation coefficient of 0.881 and a 95% precision level. The correlation was statistically significant since it had a P- Value < 0.005. The findings were similar to prior empirical studies Goodwin and Kent, (2004) who indicated that which found that the internal audit function si important because it adds value and therefore reduces detected errors

Risk management had a positive association with corporate goverance with correlation coefficient of 0.669 and a 95% precision level. The correlation was statistically significant since it had a P- Value <0.005. This implied that adoption of risk management practices in the state corporation would have greater positive effects on corporate governance. Annual risk based planning had a correlation coefficient of 0.534 and a precision level of 99.9%. This correlation was statistically significant since its P-Value was less than 0.005.

The reasults also indictaed that Internal auditing standards had a positive correlation coefficient of 0.416 and a 95% precision level. The correlation was not statistically significant since it had a P- Value > 0.005.

From the results, risk assessment had a strong positive association with corporate governance with a correlation coefficient of 0.765 at 99.9 % confindence level while association between annual risk based planning and risk assessment had was strong and positive. The study further found that there exists a strong positive relationship between annual risk based planning and corporate governance with correlation coefficient of 0.730 at 99.9% confindence level

The results of the tobit regression are shown in Table 6. This model identifies factors that are associated with a state Corporations's use of risk-based internal auditing. The model is significant at $p < 0.001$ with R_2 of 0.783. As expected, all of risk management variables were significant. Risk Assessment, Risk Management, Internal Auditing Staffing, Annual Risk Based Planning, Internal Auditing Standards are positive and significant.

The three variables that are significant and positive indicated that state corporations are more sensitive to risks and are more likely to employ higher percentage of RBIA. The use of RBIA is significantly positively associated with the existence of a risk management board. The finding support that state corporations with an integrated risk management framework are more likely to have a higher percentage of RBIA with increase transparency and disclosure of information in the corporations the findings concurred with Sarens and de Beelde, (2006) who indicated that use a relatively high level of RBIA, increased the level of corporate governance in the firm.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter discusses the interpretation of data analysis in the previous chapter and gives conclusions and recommendations of the research based on the findings obtained and interpreted from the data collected. The objective of the study was to determine the relationship between risk based audit and corporate governance with reference to fourty selected state corporations in Kenya.

5.2 Summary of Findings

The specific variables were risk assessment, risk management, risk based planning, internal auditing standard and internal auditing staffing. From the findings, the study established that adoption of risk assessment affected the safeguarding of assets, reliability and integrity of financial and operational information, affects the compliances with laws, regulations and contracts as well as effectiveness and efficiency of operations to a very great extent.

From the correlation analysis, risk assessment had a strong positive relationship with risk management with a correlation coefficient of 0.765 at 99.9 % confindence level. Annual risk based planning and risk assessment had correlation coefficient of 0.612 at 99.95% confindence level and a P-Value less that 0.005. The results also indicate that there exists a strong positive association between risk based audit and corporate governance in state corporations.

The models tested in this study find empirical support that state corporations use a relatively high level of RBIA when disclose more information about financial risk management, compliance risk management, technology risk management and have a higher ratio of financial performance.

The results indicate that the level of RBIA employed is positively associated with the state corporation's risk assessment. However, the results present that the use of RBIA is negatively correlated with information disclosure about environmental and safety risk management, internal process risk management, and change management risk management. Results indicated that use of RBIA is positively correlated with the existence of a risk management. This finding is consistent with findings from prior empirical research investigation voluntary demand for internal auditing (Goodwin-Stewart and Kent, 2006).

Results from the present study suggest that a state corporation's risk management framework is highly associated with the role of internal auditing in the state corporations. The study found that change in risk based audit planning would lead to high level of corporate governance, tranparenct and accountability in state corporations.

The results indicates that Risk Based Auditing Standards would lead to an increase in corporate governance, by a factor 0.712 with a P value >0.05 at 0.002 in state corporations. The implied that Risk Based Auditing Standards influence corporate governance to a great extent as indictaed by a coefficent of 0.712

From the regression model, the coefficient of determination was 0.692 indicating a very strong and positive correlation between the RBIA factors and the corporate governance. Judging from the coefficients of the variables, it can be seen that risk management had the greatest influence towards corporate governance while Annual Risk Based planning had the least effects on the Level of coprate governance in state corporations

5.3 Conclusion of the Study

The study found that there is a positive relationship between Risk based Auditing and Corporate Governance. Risk based auditing influence risk management reducing high risk facing the state corporations, increase trasparency and accountability, hence enhancing good governance. The study found that risk based auditing should be enhanced to be able to detect risks on time and concentrate on high risk areas leading to increased transparency and accountability hence enhancing governance.

The study also found that risk based audit should help management in assessing the risks and recommend corrective measures for improvement. Implementation of audit recommendation is still the prerogative of management and should be undertaken on a timely manner to enhance corporate governance.

From the results, the study found that the management should be able to embrace proper annual audit planning so as to improve efficiency, accuracy, completeness, timeliness, convenience and clarity. This is beacause if the annual audit planning are complied with can create transparency and accountability in the state corporations hence influence corporate gorvernce

5.3 Limitations of the Study

The result of this study should be considered in light of two limitations. First, the measure of dependent variables, the percentage of RBIA employed by the state corporations is derived from questionnaire and subject to subjective judgments of each state corporation's respondents.

The other limitation of the study was inability to include more goverment organizations. This study concentrated only on state corporations. The study would have covered more institutions across public sectors so as to provide a more broad based analysis. However, resource constraints placed this limitation. The study also faced challenge of time resource, limiting the study from collecting information for the study particularly where the respondents delayed in filling the questionnaire and travelling for collection of the the filled questionnaire.

The study also faced limitation where the management were failing to reveal the information and sometime delayed in filling of the questionnaire. The reseacher did follow up to ensure data was collected without further delays.

5.4 Recommendations

From the findings of this study, risk based internal audit should be enhanced through adoption of better risk assessment, internal auditing standards and annual risk based planning practices so as to achieve success in corporate governance in the state corporations. The study recommends that risk management should be implemented in the state corporations as it positively influences corporate governance leading to better performance.

The study recommends that risk assessment, internal auditing standards and annual risk based planning should be implemented effectively as they had positive influnce on corporate governace. Corporate Governance would improve with adoption of risk assessment, internal auditing standards and annual risk based planning and lead to susseess in public sector govervance improving transparency and accountability. The management should collaborate with internal audit and expedite the implementation of recommendations that are in the audit reports.

5.5 Recommendations for Further Study

The study recommends that a further study should be carried out to investigate the challenges of risk-based audit on corporate governance.

A further study should be carried out to determine strategies that should be adopted to implement risk-based audit practices in state corporation.

The study recommends a further research should be carried out to determine other relationships between the risk-based audit and corporate governance in other institutions in Kenya.

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APPENDIX

Appendix I: Questionnaire

SECTION A: MAIN ISSUES ON CORPORATE GOVERNANCE

1. Indicate the extent to which adoption of risk assessment affect the following corporate governance issues. Use a scale of 1 to 5 where: 1 = No extent at all; 2 = little extent; 3 = Moderate extent; 4 = Great extent; 5 = A very great extent

	Very great extent	Great extent	Average extent	Low extent	Very low exten
Reliability and Integrity of Financial and Operational Information					
Effectiveness and Efficiency of Operations					
Safeguarding of Assets					
Compliances with Laws, Regulations and Contracts					

2. Indicate the extent to which risk auditing evaluation influences the following corporate governance issues. Use a scale of 1 to 5 where: 1 = No extent at all; 2 = little extent; 3 = Moderate extent; 4 = Great extent; 5 = A very great extent

	Very great extent	Great extent	Average extent	Low extent	Very low extent
Detection of errors and material reporting					
Understanding of the state corporation's risks					
Complexity to assess risks facing the organization					
High cost of risks assessment					
Management in risk evaluation process.					
Identification of external changes					
Recognition of risk assessment					

3). Indicate the level of significance that risk management have on the following corporate governance issues. Use a scale of 1 to 5 where: 1 = Insignificant; 2 = Slightly significant; 3 = Moderately significant; 4 = Significant; 5 = Very significant

	Very significant	Significant	Moderately significant	Slightly significant	Insignificant
Effective controls					
Management of financial resources					
The complexity of operations					
The quality of personnel in internal audit					

4. Indicate the extent to which following risk based audit planning factors affect transparency and accountability in the state corporation? Use a scale of 1 to 5 where: 1 = No extent at all; 2 = little extent; 3 = Moderate extent; 4 = Great extent; 5 = A very great extent

	Very Great Extend	Great Extend	Moderate Extend	Little Extend	No Extend
Accuracy					
Completeness					
Clarity					
Timeliness					
Convenience					
Annual audit planning					
auditing codes					

5. Indicate the extent to which the following risk based auditing standards affect Corporate Governance. Use this scale of 1 to 5 where; 1 = very low extent; 2 = low extent; 3 average extent; 4 = Great extent; 5 = very great extent

	Very great extent	Great extent	Average extent	Low extent	Very low extent
Auditors technical and professional skills					
Auditors Readiness to embrace change					
Quality audit reports					
Quality criteria to measure internal auditors performance					

Section B Risk Based Audit and Corporate Governance

6. Indicate the extent to which below features of auditors competency level affects corporate governance. Use scale of 1 to 5 where; 1= very low extent; 2 = low extent; 3 average extent; 4 = Great extent; 5 = very great extent

Factors	Very great extent	Great extent	Avera ge extent	Low exte nt	Very low exte nt
Qualifications of the internal auditor					
limited staffing					
Experience of auditors					
Specialization of auditor					
Level of education					

7. Indicate the extent to which the following risk based audit practices affect corporate governanance? Use scale of 1 to 5 where; 1 = very low extent; 2 = low extent; 3 average extent; 4 = Great extent; 5 = very great extent

	Very great extent	Great extent	Average extent	Low extent	Very low extent
Risk Based Audit Reports in time					
Assessment of risks					
Risk Based audit Annual planning					
audit drafting reports					
Time response of audit queries					
Implementation of audit recommendation					
Adequate resources for risk based audit					

Appendix II: List of State Corporations

1.Agricultural Development Corporation

2.Agricultural Finance Corporation

3.Consolidated Bank of Kenya

4.Development Bank of Kenya

5.Industrial & Commercial Development Corporation

6.Industrial Development Bank

7.Kenya Broadcasting Corporation

8.Kenya Post Office Savings Bank

9.Kenya Power and Lighting Company Ltd

10.Kenya Railways Corporation

11.Kenya Re-Insurance Corp.

12.National Oil Corporation of Kenya

13.National Social Security Fund

14.National Housing Corporation

15.National Hospital Insurance Fund

16.New Kenya Cooperative Creameries Ltd

17.Postal Corporation of Kenya

18.Safaricom Limited

19.Telkom Kenya Ltd

20.Tea Board of Kenya

21.Coffee Board of Kenya

22.Cooperative College of Kenya

23.East African Portland Cement Company

24.Higher Education Loans Board

25.Jomo Kenyatta Foundation

26.Kenya Airports Authority

27.Kenya College of Communications and Technology

28.Kenya Industrial Estates

29.Kenya Meat Commission

30Kenya Medical Supplies Agency

31.Kenya Water Institute

32Kenya Wine Agencies Ltd

33.National Cereals & Produce Board

34.National Bank of Kenya Ltd

35.Retirement Benefits Authority

36.Kenyatta National Hospital

37.Kenya Wildlife Service

38Kenya Tourist Development Corporation

39.Kenya Pipeline Company

40. Local Authorities Provident Fund

Appendix III: State Corporations and Determinants of Corporate Governance

State Corporations		2007 -2011		
		Board Size	%of shareholdings held by institutional shareholders	% of Disclosure
1.	Agricultural Development Corporation	6	0.12	0.01
2.	Agricultural Finance Corporation	7	0.34	0.03
3.	Consolidated Bank of Kenya	10	0.23	0.12
4.	Development Bank of Kenya	8	0.15	0.17
5.	Industrial & Commercial Development Corporation	5	0.06	0.01
6.	Industrial Development Bank	11	0.10	0.03
7.	Kenya Broadcasting Corporation	7	0.17	0.11
8.	Kenya Post Office Savings Bank	9	0.21	0.15
9.	Kenya Power and Lighting Company Ltd	8	0.08	0.10
10.	Kenya Railways Corporation	14	0.12	0.16
11.	Kenya Re-Insurance Corp.	6	0.13	0.16
12.	National Oil Corporation of Kenya	10	0.17	0.10
13.	National Social Security Fund	10	0.16	0.14
14.	.National Housing Corporation	6	0.08	0.11
15.	.National Hospital Insurance Fund	6	0.12	0.14

16.	New Kenya Cooperative Creameries Ltd	4	0.12	0.02
17.	Postal Corporation of Kenya	7	0.11	0.14
18.	18.Safaricom Limited	9	0.05	0.17
19.	Telkom Kenya Ltd	11	0.08	0.16
20.	Tea Board of Kenya	12	0.35	0.04
21.	Coffee Board of Kenya	9	0.14	0.12
22.	Cooperative College of Kenya	7	0.33	0.210
23.	East African Portland Cement Company	6	0.19	0.10
24.	Higher Education Loans Board	6	0.11	0.15
25.	.Jomo Kenyatta Foundation	5	0.17	0.18
26.	Kenya Airports Authority	7	0.03	0.15
27.	.Kenya College of Communications and Technology	5	0.12	0.04
28.	Kenya Industrial Estates	10	0.45	0.11
29.	Kenya Meat Commission	8	0.12	0.03
30.	Kenya Medical Supplies Agency	7	0.14	0.11
31.	.Kenya Water Institute	10	0.22	0.12
32.	Kenya Wine Agencies Ltd	11	0.31	0.13
33.	.National Cereals & Produce Board	14	0.24	0.11
34.	.National Bank of Kenya Ltd	7	0.31	0. 07
35.	Retirement Benefits Authority	8	0.14	0.01
36.	Kenyatta National Hospital	7	0.12	0.14
37.	Kenya Wildlife Service	11	0.22	0.01
38.	Kenya Tourist Development Corporation	10	0.11	0.11
39.	Kenya Pipeline Company	9	0.11	0.01
40.	Local Authorities Provident Fund	9	0.04	0.05