

**THE EFFECTS OF EXTERNAL AUDIT QUALITY ON THE
FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN
KENYA**

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DECLARATION

I, the undersigned, declare that this research project is my original work and it has not been presented for academic award to any other institution or university.

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This research project has been submitted for examination with my approval as the university supervisor.

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DEDICATION

I dedicate this project to my family and friends and especially my mother who has been a pillar and source of inspiration throughout my life.

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LIST OF ABBREVIATIONS

| | |
|-------|---|
| CBK | Central Bank of Kenya |
| CMA | Capital Markets Authority |
| GPM | Gross Profit Margin |
| IAASB | International Auditing and Assurance Standards Board |
| IAS | International Auditing Standards |
| ICAEW | Institute of Chartered Accountants in England and Wales |
| ISQC | International Standard on Quality Control |
| NSE | Nairobi Securities Exchange |
| ROA | Return on Assets |
| ROE | Return on Equity |
| ROS | Return on Sales |

ABSTRACT

The objective of this study was to find out the correlation between external audit quality and financial performance of commercial banks in Kenya. The specific objectives were: to evaluate the effect of auditor independence on financial performance of banks; to assess the effect of auditor's professional competence on the financial performance of banks; to examine the effects of providing non-audit services on the financial performance of banks and to determine the influence of auditor's compliance with auditing standards on financial performance of banks. The study was conducted among the 41 registered commercial banks in Kenya and since the sample size is small the researcher conducted the survey in all the banks. Three theories were reviewed to explain the need for audit including agency theory, lending credibility theory and inspired confidence theory. The study used descriptive research design. A structured questionnaire was administered to the sample to gather primary data. Secondary data was obtained from books and other relevant publications, annual financial reports and prior researches conducted in the area. The data was analyzed using statistical package of social sciences (S.P.S.S). The conclusion of this study is that the relationship between financial performance and audit quality is positive and substantial. Specifically, the study established that there is an affirmative correlation between financial performance and compliance with auditing standards, auditor independence, auditor professional competence and experience and a negative relation with provision of non-audit services. The study recommends that commercial banks should pay attention to the quality of audit they receive from external auditors since the findings showed that it influences financial performance. The study suggested further research to determine a universally acceptable definition and measure of audit quality.

CHAPTER ONE: INTRODUCTION

1.1 Background to the Study

External audit serves an important economic purpose to the public by reinforcing the confidence and trust in financial reporting and strengthening accountability (Institute of Chartered Accountants in England and Wales (ICAEW), 2005). Auditing also protects the concerns of the different stakeholders to a business. Stakeholders expect that external audit should enhance the credence of the financial statements, that the information so contained does not contain material error and fraud because an audit has been conducted by an independent professionally competent auditor who possess sound knowledge of the company's business and the requirements of financial reporting (Dawkins, 2015). Audit quality is known to affect financial reporting and to significantly influence investor's confidence in the management of the firm. This provides stakeholders with reasonable assurance that their investments is safe as well as act as a deterrence to the management from distorting the financial reports. Audit quality enhances financial performance of firms by attracting new investors as well as retaining the existing ones because the prospects of financial growth are high.

Different theories have been formulated to validate the need for audit functions. The agency theory is a valuable economic concept based on the need for accountability which supports the emergence and growth of audit (ICAEW, 2005). The theory addresses the divergent interests of shareholders and management of a company. The lending credibility theory implies that stakeholders' confidence in management stewardship of the company is enhanced by the audit of financial statements (Mahdi, 2011). The theory of inspired

confidence stipulates that stakeholders demand for management accountability in exchange for their contribution to the company. According to the theory auditors should perform their duties in compliance with the general auditing norms anticipated by a rational third party without creating greater expectation than the audit justifies (Duits, 2012).

The practice of external audit is regulated by bodies formed to ensure that the function is conducted professionally and in line with set standards. These regulatory bodies have a responsibility of upholding audit quality with the expectation that the confidence of the public in the audit process and financial reporting will be intensified. Audit firms would be better placed when the quality of audit they conduct is beyond reproach. Notwithstanding this expectation, when regulatory bodies carry out inspections on the conduct of audit work, there are many instances where audit quality is found to be below standard (Association of Chartered Certified Accountants (ACCA), 2015). The importance and contribution of audit quality to the stability of financial markets is stressed by the failure of some of world renowned companies such as Enron and WorldCom and the 2007-2008 global financial crises (Martinov-Bennie, 2014). These financial crises have awakened the consciousness of the importance for companies to produce reliable financial reports as they are critical for their economic well-being. The realization have also espoused the fact that high audit quality fosters overall market confidence. The present study aims to contribute to the growing body of literature in the area of audit quality and financial performance and inform further inquiries on the subject.

1.1.1 External Audit Quality

DeAngelo (1981) defines audit quality as the combined probability of the independent auditor discovering and reporting a material misstatement in the clients' financial statement. According to this definition, the probability of the auditor's detecting a misstatement depends on the auditor's competence while the independence determines whether the auditor will report it. Auditor independence is indicated by qualitative factors such as an auditor having the right mindset to exercise professional skepticism which facilitates making objective judgements in the audit process (Hooper, Fornelli, & Chipman, 2016). Auditor's competence is connoted by the engagement team's set of knowledge, skills and behavior that enable them to perform the audit work appropriately.

According to the Institute of Auditing and Assurance Standards Board (IAASB) framework to achieve audit quality, it's important to create an environment that promotes quality at the levels of engagement team, the firm as well as national wide. The audit work must be carried out independently, competently and with amicable interactions between the auditor and the company's representatives. Audit quality can be perceived from three basic viewpoints including input, output and contextual issues (IAASB, 2015). Input requires that auditors possess suitable values, attitudes and ethics, be amply skilled, knowledgeable, and experienced. Auditors must also dedicate adequate time to perform the audit work. The audit process should be rigorous and performed in accordance with quality control procedures that conform to regulation, appropriate standards and laws. The output of a quality audit process is relevant and timely reports. Despite the fact that the auditor is

responsible for audit quality its best achieved in a supportive environment that enhances cordial interactions among the different participants in the financial reporting supply chain.

Audit quality is important for commercial banks as it is an important indicator of the quality of the management's stewardship. A high audit quality increases the confidence of the stakeholders and the public on the financial reports generated by the managers thus reducing the expectation gap (ACCA, 2015). In addition, it reduces audit risk and the likelihood of the audit firm issuing an inaccurate audit opinion. The significance of audit quality is demonstrated by the attention given by regulatory bodies, audit firms and different organizations (IAASB, 2015). For example, the IAASB has formulated a framework for audit quality for purposes of cognizance of key features of audit quality; encouraging stakeholders to reflect on how to enhance audit quality; and to facilitate more conversation among stakeholders on audit quality. In addition to the framework, the Board has issued two quality control standards to promote audit quality. The two standards are ISQC 1: *Quality Control for Firms that Perform Audits and Reviews of Financial Statements and other Assurance and Related Services Engagements* and IAS 220: *Quality Control for an Audit of Financial Statements*. IAASB and other regulatory bodies, such as, the UK Financial Reporting Council have a responsibility of upholding audit quality that augments public confidence in the audit functions as well as financial reporting.

In the present study, audit quality was the independent variable and since the elements of audit quality are unobservable, it was measured using four quality surrogates including

auditor's independence, professional competence, provision of non-audit services and compliance with auditing standards.

1.1.2 Financial Performance

Financial performance refers to the degree of achievement or realization of financial objectives expressed in financial values. It is a process of evaluating the outcome of a firm's policies and operations using monetary terms (Wangithi, Njangiru, & Ngungu, 2016). It involves an evaluation of the results of a firm over a specified period of time, a comparison of the results of several firms operating in the same industry or comparison of industries or sectors in an economy. Financial statements are the principal sources of information and are used to convey a company's financial results to both internal and external stakeholders (Brooks, 2013). They provide information on a firm's financial position at a specific point in time and the outcome of its operations and variations in the financial positions for a specified duration of time (Dawkins, 2015). When analyzed together the various financial statements give the financial performance over time and enable future financial projections.

The importance of good financial performance for commercial banks cannot be overstated because of the crucial role that banks play in the economy of the country which to a great extent depend on the stability of banks. The indicators commonly used to measure financial performance, i.e. profitability, include return on assets (ROA), return on investments (ROI), return on equity (ROE), return on sales (ROS) and gross profit margins (GPM). The ratios are used to measure profitability which is an evaluation of the effectiveness of the company in turning sales or assets into income. In the present study financial performance was the

dependent variable and was appraised using Return on Assets (ROA) a measure that is frequently used in industries and in commercial banks.

1.1.3 Quality of External Audit and Financial Performance

Information and accountability play a significant role in the present-day economy. As such, the information provided by management must be accurate and credible. This intensifies the importance of high audit quality of a firm's financial statements as the service provided by external auditors is depended upon by various stakeholders who use the audited financial information to make economic decisions. Audit quality enhances user's confidence that the financial results reported in the financial statements do not comprise significant omissions and fraud since the auditor is an impartial and independent professional who has knowledge of the firm's business and is conversant with financial reporting standards (Dawkins, 2015). The importance of high audit quality and its contribution in sustaining financial markets stability is emphasized by the failures of well-known companies like Enron and WorldCom and banks in Kenya such as Chase, Imperial and Dubai bank. These happenings have drawn attention to the fact that reliable financial reporting by firms is necessary for healthy economic status and that high quality audit enhances market confidence (Martinov-Bennie, 2014).

In previous studies conducted on audit quality and financial performance by Matoke and omwenga (2016) on companies listed in the Nairobi Securities Exchange, Farouk and Hassan (2014) on quoted cement firms in Nigeria and Hua, Hla and Isa (2016) on construction firms in Malaysia the outcome indicated that audit quality has both positive and significant effect on financial performance.

1.1.4 Commercial Banks in Kenya

The role played by commercial banks is imperative for the economy of countries especially in the development of industries and trade. Banks perform the biggest part of financial intermediation and generate resources which are crucial for development. They also act as custodians of the countries' wealthy. The major functions of banks include capital formation, provision of credit, distribution of funds to productive investments, finance to governments, employment creation, enables flow of funds between savers and borrowers, among others.

The Kenyan finance sector is dominated by commercial banks. This dominance has significant implication on the economy of the country because major failures would have spiraling negative effects on the other sectors of the economy. Therefore, the banks financial performance is critical for sustainable economic growth. When banks are profitable, shareholders investments are rewarded and in turn they are encouraged to invest more thus stirring further economic growth (Ongore & Kusa, 2013). On the other hand, due to the mutual interdependences among banks, financial failure of a major bank is likely to provoke a contagion effect which may cause other banks to experience unsustainable losses and eventual failure (Bessis, 2002). A general poor financial performance by banks is likely to lead to general economic failures and financial crises as was witnessed during the global financial crisis in 2007 to 2008. Because of the crucial role that banks play in the country, the government, through the Central Bank, has put in place laws and regulations to control their operations, protect depositors' funds and ensure safety of the banking system. The Central Bank of Kenya Act Cap 491 and Banking Act Cap 488 are

two laws in Kenya that regulate and control the operations of commercial banks. The Central Bank of Kenya performs supervisory role for commercial banks in order to promote financial stability by establishing and sustaining a sound financial system.

The Banking Act requires that all registered commercial banks hire qualified external auditors approved by the Central Bank and to submit to it annually the audited financial statements plus the audit report (CBK, 2015). The external auditors are compelled to conform to the provisions of the Banking Act and are supposed to report any breach of regulations, cases of fraud and significant losses that are likely to be unfavorable to the financial performance of the banks. The Act stipulates those who qualify to be appointed as auditors and pays particular attention to auditor independence and professional competence; parameters used in this study as proxies of audit quality. In addition to the Central Bank, banks listed in the Nairobi Securities Exchange are subject to acts, regulations and guidelines issued by the Capital Markets Authority. The rules, regulations, standards and guidelines issued by the different regulatory bodies together create an environment that enhances financial reporting and audit quality.

1.2 Research Problem

The demand for external audit in the present economic environment exist in the communication of financial information to the various interested stakeholders. The external auditors' major concern is risk management since any risk capable of adversely affecting a firm has the potential to impact the results reported in the financial statements, audit planning and conduct (Knechel, Salterio & Ballou, 2007).

There is widespread criticism of the work done by external auditors mainly due to the failure to perform the expected responsibilities or to execute them to the anticipated standards. Auditors have been accused of conducting poor quality audits due to lack of professional competence and independence, failure to dedicate enough time to the audit process and to comply with applicable standards and regulations. Many reports have emerged on loss of confidence in the work done by external auditors which results in a decline of society's confidence in the audit profession in its entirety and by implication the functions of audit (Porter & Gowthorpe, 2004). These negative views have resulted from a discrepancy between the expectations the society have about audit work and what it perceives they deliver otherwise referred to as the "audit expectation-performance gap" (Porter, Baskerville & Hogartaigh, 2012).

The collapse of eminent companies such as Enron, Parmalat, Xerox, Cable and Wireless, and WorldCom that were enjoying healthy financial performance throughout the 1990s led to a growing apprehension about the quality of audit work (BPP Learning Media, 2015). In 2001, it was revealed that the management of WorldCom and Enron colluded with their auditors to engage in "creative" financial reporting and in using questionable accounting practices and they manipulated their financial statements to allude growth and profitability while in reality they were losing money (Brooks, 2013). Financial statements tell stories, and with diligent investigation and analysis, it was discovered that the stories did not add up.

The Institute of Certified Public Accountants (ICPAK) in 2015 issued stringent regulations on external auditing in Kenya due to growing numbers of fraud cases by companies. Among the companies implicated in the purported financial scandals included Imperial Bank, CMC Holdings, Mumias Sugar and Kenya Airways. External auditors are required to identify cases of fraud and other financial malpractices and report the same to the Board of Directors and Management, but sometimes they fail to perform this duty as expected. PKF, Deloitte & Touche and Ernst & Young are some of the audit firms that have been investigated by ICPAK on suspicions of misconduct.

Several studies have been undertaken on audit quality, both on internal and external audit. Kwabena (2017) undertook a study of the effects of internal audit quality on financial performance of firms listed in the Nairobi Securities Exchange. Suraj Ali (2017) researched on the effects of internal audit on financial performance of microfinance institutions in Kenya. Matoke and Omwenga (2016) conducted a study to determine the association between audit quality and financial performance of listed parastatals in Kenya. These studies among others concluded that audit quality influence firms' financial performance. However, none of these studies focused on the impact of external audit quality on financial performance of commercial banks in Kenya. Consequently, there exist a research gap that was to be covered by the present study. The objective of this study was to respond to the question; what are the effects of external audit quality on financial performance of commercial banks in Kenya?

1.3 Research Objective

To determine the effects of external audit quality on financial performance of commercial banks in Kenya.

1.4 Value of the Study

The study will improve the efficiency of external auditing as it will identify parameters of audit quality that most influence financial performance of commercial banks and thus help focus management attention to them and inform resource allocation.

The study will inform policy formulation in the areas of external audit, audit quality and financial reporting.

For researchers and academicians, the study will make a contribution to the body of knowledge by adding to the existing theories on external audit quality and also inform further research in the areas of audit.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter gives attention to existing theories that support the need for audit function and a review of literature that has been developed on the subject by different authors. The sources of the literature reviewed include books, journal articles, and prior researches conducted in the area. Empirical studies conducted in the field of study are also presented in this chapter. The conceptual framework used to guide the empirical study concludes the chapter.

2.2 Theoretical Review

The present study reviewed three theories including agency theory, the theory of inspired confidence and lending credibility theory. These theories describe stakeholders' expectations of the auditors including providing a guarantee of the firm's financial health, safeguards against fraud, giving warning of future insolvency, protection of auditor independence and comprehending audit reports (Volosin, 2008).

2.2.1 Agency Theory

The agency theory is a positivist approach advanced by Jensen and Meckling in 1976. The theory is based on the affiliation between the principle and agent. Agency relationship is a contractual arrangement within which one or more parties (the principal) appoints and delegates authority to make decisions to another party (the agent) to perform agreed tasks on their behalf (Jensen & Meckling, 1976). The theory proposes that the firm entails

relationship between those who own economic resources i.e. the principals and the managers i.e. the agents who control and use the resources on behalf of the principals.

The agency theory is grounded on the premise that agents are privy to more information than the principals. This information lopsidedness has negative impact on the principal's capacity to effectively keep track as to whether the agent is appropriately serving their interests. In addition, it assumes that principals and agents are rational and will use the relationship to maximize their wealth. This implies that agents with self-seeking motives are likely to take advantage and act against the interests of those who own the firm (Adams, 2011). Adams (2011) argues that the other likely challenge of the principal-agent relationship is "adverse selection" which occurs when the owners cannot access all the existing information at the time of decision making and are therefore not able to conclude whether management actions generate the greatest benefits to the firm. According to Jensen and Meckling (1976) to reduce the possibility of the potential moral threat, principals and agents contract to attain the greatest benefits, which includes establishing monitoring functions such as auditing. The relationship between the principal and the agent is important in understanding how the auditor's role emerged and developed. The principal hires the agents and entrust some of the decision making rights to them and by so doing the principal relies on the agent to perform their role to achieve the greatest benefit for the principal. Auditing further aids to minimize information unevenness and to safeguard the stakes of the different concerned parties by reassuring them that the financial statements produced by management are devoid of significant errors (Matoke & Omwenga, 2016). The present study uses the agency theory to justify the need for independent audit of

financial statements as a contractual response, at minimum cost, to the potential conflicts of interests between the owners and the managers.

2.2.2 The Lending Credibility Theory

The theory states that audited financial statements enhance the confidence of the stakeholders in the management stewardship (Volosin, 2008). This theory proposes that auditing has a pivotal role of enhancing the credibility of financial statements (Mahdi, 2011). Consequently, credibility is the service the auditor offers to the client. Auditing of financial statements increases users' reassurance of the management assertions regarding financial performance.

When analyzing the financial health of a company, different stakeholders for varied reasons must make judgements grounded on the information carried in the financial reports, as such, they expect that the facts contained therein are truthful and fair regarding the financial status. In addition, the quality of investment decisions made by users of financial statements is expected to improve when based on reliable information (Ittonen, 2010). The lending credibility theory emphasizes the importance of objective audit of financial statements for purposes of making economic decisions by the different stakeholders.

2.2.3 Theory of Inspired Confidence

The theory was formulated by Professor Theodore Limperg in the 1920s. The theory supports the need and provision of audit services (Mahdi, 2011). According to the theory the demand for audit is a result of the involvement of stakeholders who are external to the company which calls for management accountability in exchange for their investment in

the company. Management accountability is accomplished by virtue of providing regular financial reports. Since the management may provide prejudiced information, which the external stakeholders have no direct way of verifying, external audit of information becomes necessary.

The theory provides a link between the societal needs for reliable financial statements with the practical prospects for auditing to fulfill the needs, it also incorporates the variation of the needs over time (Duits, 2012). This calls for external auditing to be conducted in such a way that it inspires public confidence in the financial information. The theory of inspired confidence is used in the current study to support the need for audit quality that strives to satisfy public expectations.

2.3 Determinants of Financial Performance of Commercial Banks in Kenya

The financial performance of banks is dependent on many factors existing within the bank and in the operating economic environment. This section focuses on four major aspects that influence banks' financial performance in Kenya including external audit quality, liquidity management, asset quality and capital adequacy.

2.3.1 External Audit Quality

External audit quality is achieved when all the concerned participants work together because every stakeholder including managers, regulators, those in governance have an important role to play. Equally important are the prevailing environmental factors, such as, the financial reporting standards, business laws, audit regulation, cultural elements,

corporate governance, information systems, etc., as they are likely to affect the inherent characteristics and quality of financial reporting and by implication the audit quality (IAASB, 2015). For external auditors to achieve audit quality there are attributes they should possess that are considered vital. The auditor's predisposition to apply ethics, values and standards, the attitude to the audit function, the knowledge and experience they possess, the tendency to dedicate adequate time to their work plus a laborious audit process are all necessary to attain audit quality (Martinov-Bennie, 2014).

A quality audit should be able to challenge the contents of financial statements for it to reach an opinion as to whether they are truthful and fair (Ernst & Young, 2013). The opinion given determines the shareholders confidence in the information provided by management and by extension the financial performance of the company. According to Neri and Russo (2014) audit quality is an important contributor to the stability of an efficient market environment.

2.3.2 Liquidity Management

Liquidity is the bank's ability to meet its customers' financial obligations maturing in the immediate future (Libby, R., Libby, P., & Short, 2014). The management of liquidity should take into account the bank's liquidity needs that are adequate to satisfy deposit outflows and upsurge in loans versus the actual and possible sources of liquidity from either selling its liquid assets or obtaining additional liabilities (Hempel & Simonson, 1998). A bank's ability to settle current obligations when they fall due is an essential aspect in evaluating the bank's financial strength in the short term. The evaluation for liquidity is done through liquidity ratios such as customers' deposit to total assets, customers' deposits

to short term securities, total loans to customers' deposits, and liquid assets to estimated cash flow demands over the next 30 days. A bank's liquidity ratio obligates it to retain extra short term assets than short term liabilities to enable it meet its short term needs (Bessis, 2002). Liquidity affects a bank's credit rating which determines the cost of funds. The cost of funds is a critical driver of profitability. According to Ongare and Kusa (2013) the level of liquidity is directly related to the bank's profitability.

Liquidity further determines the financial performance of banks because of the potential liquidity risk. According to Bessis (2002) acute scarcity of liquidity is fatal as it may lead to depositors 'run' and the subsequent huge withdrawals of funds or curtailing of credit lines by other financial institutions may result in liquidity crisis which may ultimately lead to bankruptcy.

2.3.3 Asset Quality

A bank's assets comprise of credit portfolio, fixed assets and current assets among other investments. Loans are the key assets from which banks make most of their income. As a result, the quality of loans is fundamental to the bank's performance as most bank failures are attributed to poor asset quality (Carelle, 2016). The bank's profitability depends to a great extent on the loan portfolio it possesses. Non-performing loans are considered the most appropriate measure of the quality of bank assets. Consequently, banks strive to keep the amount of non-performing loans at a minimum. A comparison of non-performing loans to total assets is one of the key indicators of the financial success of a bank's portfolio (Ongare & Kusa, 2013). When the amount of non-performing loans is high the bank's profitability is negatively affected.

2.3.4 Capital Adequacy

Capital adequacy is the legal minimum of capital reserves that financial institutions must maintain to be allowed to operate. It increases the bank's capacity to deal with potential risks such as credit, operational and market risks that it is exposed to in the course of business. Capital is the sum of funds owned and controlled by a bank that is available for funding its business and for cushioning it in case of financial distress. The level of risks at which banks operate should determine the amount of capital reserves, such that, banks with high tolerance for risks should maintain more capital compared to those operating at lower levels of risks. The requirement to retain adequate capital reserves is a mechanism used by regulators to protect depositors' investments as well as the economy as whole since bank failures have widespread adverse effects (Bessis, 2002). The amount of capital banks are expected to maintain is determined by the purposes of bank capital, the benefits of leverage to the owners and the regulatory requirements of capital adequacy (Hempel & Simonson, 1998).

Financial regulators require that commercial banks maintain adequate capital to protect investors' funds, provide safety of the banking system and ensure economic stability, for example, the Central Bank of Kenya Act Chapter 491 gives directives to the banks to establish a general reserve fund. Capital adequacy is measured by use of capital adequacy ratios that indicate the bank's strength to bear losses in times of uncertainty. A risk-based perspective to capital adequacy is adopted to associate capitalization to bank's vulnerability to risk with the risk-asset ratio used to compare qualified capital to weighed risk-based assets (Bessis, 2002). According to Ongare and Kusa (2013) capital adequacy favorably

impacts on the profitability of banks in addition to having a direct relation with bank's resilience to situations of crisis.

2.4 Empirical Studies

This section pays attention to the empirical studies on audit quality and financial performance that have been conducted by different authors both at the local and global level.

2.4.1 Local empirical Studies

Kwabena (2017) examined the effects of internal audit quality on the financial performance of the 65 firms listed on the Nairobi Securities Exchange. According to the study, the quality of internal audit influences the firms' financial performance. The auditor's professional competence, independence, the quality of audit work and support by senior management had positive and substantial influence on the financial performance of the firms.

Suraj (2017) carried out a study on how internal audit affects financial performance of microfinance institutions in Kenya. The study established that independence of internal audit accounted for 28.4% of the financial performance of microfinance institutions in Kenya. The independence of the internal audit function was found to relate significantly with finance performance. On the other hand, internal audit standards, controls and competence of the internal auditors do not have significant influence on financial performance.

Ondieki (2013) investigated the role of internal audit on financial performance on a sample of 20 of the 43 commercial banks in Kenya. Twenty senior managers were interviewed. The study established that internal audit standards, independence and professional competence of the internal auditor and internal controls positively relate with banks' financial performance.

Matoke and Omwenga (2016) conducted a study to find out the association between audit quality and financial performance of listed parastatals in Kenya. Financial performance was measured using net profit margin while audit quality was evaluated using audit size, attributes of audit team, and auditor experience as proxies of quality. The outcome of the study indicated a positive and substantial effect of audit quality on financial performance. According to the study the propensity of a firm to make substantial net profit margins increases with an increases in the degree of auditor's independence. The influence of auditor size was equally positive and substantial, though lesser than the independence of the auditor.

Munene, Njangiru and Ngungu (2016) conducted a study on the effect of auditing on financial performance of water and sanitation company in Kirinyaga County. A sample of 42 respondents was used. The study concluded that auditor independence positively affects financial performance of the company confirming the importance of auditors' independence on financial success.

2.4.2 Global Empirical Studies

Farouk and Hassan (2014) assessed the affiliation between audit quality and financial performance using auditor size and independence as proxies for audit quality and net profit margin as the measure for financial performance of quoted cement companies in Nigeria. The findings indicated that financial performance is affected by audit quality. A high degree of auditor's independence increased the predisposition for the firm to make significant profit margin. The effect of the size of the auditor's firm was likewise positive and noteworthy. According to the study a favorable link between the independence of the auditor and financial performance signify that the auditor's efforts upsurges in line with the audit fees paid and enhances the auditor's dedication and surveillance. Thus reducing the chances of incurring losses by an organization due to lack of compliance with accounting standards and waste of funds by management. The outcome of the study concluded that audit fees heightens auditors' commitment to their responsibility and the aspiration to provide audit service that guarantees the organization value for money.

Sayyar, Basiruddin, Zaleha, Rasid, & Elhabib (2014) examined the impact of audit quality on financial performance using a sample of 542 quoted companies in Malaysia. They found out that the relationship between audit fees and return on asset was adverse and considerable. The study also concluded that the rotation of audit firm positively and significantly relates to return on assets but it is irrelevant to firm value.

Hua, Ila and Isa (2016) did a case study on Malaysian Construction Sector on Malaysia Reporting Practices and Audit Quality Promote Financial Success. The sample was drawn

from construction firms listed in the Malaysian Stock Exchange for the period 2010-2013. According to the study audit quality both significantly and positively impact on business financial performance. Compliance with financial reporting standards and audit quality significantly contribute to higher financial performance.

Ani and Mohammed (2015) investigated the effects of auditor quality on firm performance in the finance, industrial, and service sectors in the Sultanate of Oman. The study analyzed the annual financial reports of 112 companies listed in the Muscat Securities Market for the period between 2009 and 2013. Auditor firm size was used as a substitute for audit quality. The outcome of the study showed that the size of the audit firm positively affects the financial and market performance of the firms

Most of the studies conducted in Kenya on audit and financial performance have focused on internal audit. For instance, Kwabena (2017); Suraj (2017) and Ondieki (2013) researched on how internal audit impacts financial performance. While internal audit plays an important role of monitoring the activities of the management, it is internal to the business and is therefore subject to internal control mechanisms that are under the very management internal auditors are expected to monitor. It may therefore not provide the necessary assurance of the credibility of financial reports expected by the shareholders. This creates the need for external audit as a legal requirement conducted by professionals who are independent of the company. The objectivity of external audit is assured by the existence of stringent regulations and standards and regulatory bodies that provide oversight to the audit practice. In addition, the consumers of audited financial statements

are wide-ranging and this elevates the prominence of external audit. The focus of the current study is external audit due to its crucial role in financial reporting especially for commercial banks.

The number of proxies used to measure audit quality limits the scope of study and the findings thereof. For example, the studies conducted by Ani and Mohammed (2015); Hua, Hla and Isa (2016) used only one element (the size of audit firm) while Sayyar, Basiruddin, Rasid and Elhabib (2014) used two elements (Audit fees and auditor rotation). The current study will use four key elements of audit quality including auditor independence, professional competence, compliance with auditing standards and provision of non-audit services. The choice of the four proxies was informed by the guidelines provided in the Framework for Audit Quality which specifies the key elements that are necessary for achieving audit quality, that is, input (the attributes of an auditor) and audit process (audit work conducted in line with quality control procedures that conform to applicable laws, regulations and procedures).

The research carried out by Matoke and Omwenga (2016); Munene, Njangiru and Ngungu (2016); and Farouk and Hassan(2014) have laid a foundation that supports further studies in determining how audit quality affects financial performance.

2.5 Conceptual Framework

The conceptual framework comprises of dependent, independent and control variables. Financial performance was the dependent variable while proxies of audit quality including auditor independence, professional competency, providing non-audit services and

compliance with auditing standards were the independent variable. Capital adequacy was used as a control variable.

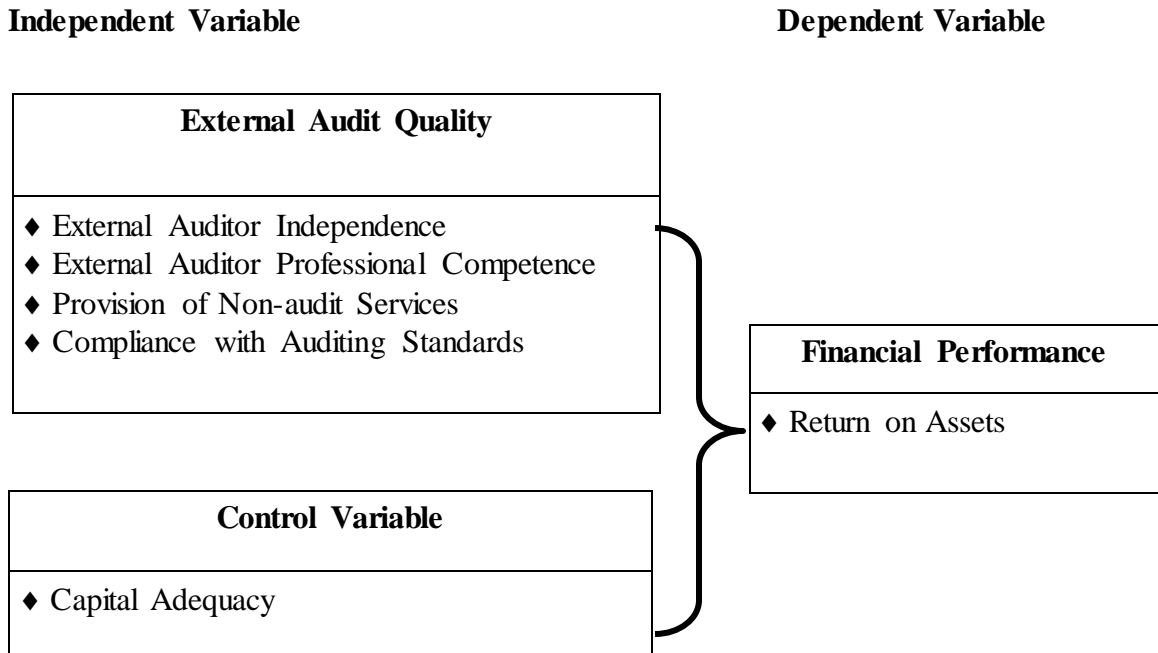


Figure 2.1: Conceptual Framework

2.6 Summary of Literature Review

In the literature reviewed a number of surveys have been undertaken in the areas of internal audit and financial performance in Kenya as well in other parts of the world. Kwabena (2017), Ondieki (2013) and Suraj (Suraj, 2017) all conducted studies whose focus was on the implication that internal audit have on financial performance. Other studies undertaken looked at audit quality, for instance, Matoke and Omwenga (2016), paid attention to financial performance of parastatals while Farouk et al (2014) focused on cement manufacturing companies. None of these studies paid attention to the impact of external audit quality on financial performance of commercial banks and specifically in Kenya.

The present study tested the effects of external audit quality measured using the parameters of external auditor's independence, professional competence, supply of non-audit services and the compliance with auditing standards on financial performance evaluated through return on assets.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

The section deals with the research philosophy, research design, population sampling, research instrument, collection of data and methods of data analysis.

3.2 Research Design

Kothari (2004) describes research design as the plans put in place for data collection and analysis that are relevant to the purpose of the research and at the same time are cost-effective. Research design is the theoretical framework that defines the confines which research is conducted; it establishes the plan for data collection, measurement and analysis. The present study applied descriptive survey design. Descriptive study is aimed at describing characteristics of specific individuals or groups within a population and thereafter the outcome is used to make conclusions about the entire population (Selvam, 2017). A questionnaire was used to collect the opinions and attitudes of the target study group. The data obtained was cleaned, summarized, tabulated and analyzed using descriptive statistics.

3.3 Population

Selvam (2017) refers to research population as the elements under study. According to (Polit & Hungler, 1995) population is the sum total of all the objects, subjects or members with specific sets of characteristics. A census of all the 41 registered banks in Kenya was used to enhance accuracy.

3.4 Data Collection

The views and perceptions on audit quality (compliance with auditing standards, provision of non-audit services, auditor independence and professional competence) were collected by use of a structured questionnaire. The questionnaires were issued to the finance managers or financial accountants where the finance manager was not available. The data for the dependent variable (financial performance) and the control variables (liquidity and capital adequacy) was obtained from the banks' annual financial reports. To facilitate a more in-depth comparative study, the researcher collected the information about the banks' financial performance for the period ranging from 2013 to 2017.

Secondary data was gathered from books and other relevant publications on how audit quality relates to financial performance.

3.5 Validity and Reliability

Validity indicates the extent of an empirical measure to replicate the meaning of concepts under study (Babbie, 2013). (Selvam, 2017) reiterates by saying that validity is the confidence that given outcome shows what it purports to show, that is, it's proximity to reality.

Reliability is a test of consistency of the results obtained by use of the measuring instrument. It is the assurance that given empirical results can be replicated. A study is reliable if when the study is repeated under the same circumstances, with the same population, using the same methods, it yields the same results (Selvam, 2017).

To ensure that the questionnaire measured what it was anticipated to measure, it was subjected to expert review in the field of research before it was used to gather data. Gaps or weaknesses identified in the instrument and the adopted survey technique were rectified before data collection.

3.6 Data Analysis

The quantitative and qualitative data obtained was edited to detect errors and omissions, coded, that is, the answers obtained were numerically categorized for efficient analysis, classified into appropriate groups with similar characteristics, summarized and tabulated. The likert type scale was the rating scale used in the questionnaire. The data was analyzed using multiple regression analysis to determine the interrelationship between financial performance and external audit quality. Financial performance was the dependent variable and was evaluated using Return on Assets (ROA). External audit quality was the independent variable and was measured using application of auditing standards, auditor independence, professional competence and provision of non-audit services.

3.6.1 Normality Test

Normality test is done to define if a data set follows a specific pattern of normal distribution. It is also used to estimate the probability for normal distribution of a random variable underlying the data set. Distortions of significance tests and relationships are likely to occur when variables are non-normally distributed. The Kolmogorov-Smirnov and Shapiro-Wilk test were applied to assess the normality of the data set.

3.6.2 Test of Multicollinearity

Multicollinearity occurs when there is a high degree of correlation between independent variables. This causes a problem in multiple regression analysis because it reduces the reliability of the regression coefficients as the degree of correlation between the independent variables increases. Multicollinearity was tested by use of tolerance levels and variance inflation factors (VIF).

3.6.3 Analytical model

The regression equation was modelled as follows:

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon$$

Where

Y - Dependent Variable (Financial performance ROA - PBIT/ Total Assets)

α - Regression Constant

X_1 - Independent Variable (External Audit Quality- Compliance with Auditing Standards, Auditor Independence, Auditor's Professional Competence, non-audit services).

X_2 - Control Variable (Capital Adequacy- Total Capital/Total Risk Weighted Assets)

β_1 - β_2 - Regression coefficient for each of the independent variable

ε - Estimation of Error

3.6.4 Measurement of Variables

Financial performance which is the dependent variable was evaluated using ROA and was calculated by dividing profit before interest and tax by total assets. The respondents' views to the independent variables consisting of compliance with external auditing standards,

provision of non-audit services, external auditor's independence and professional competence were measured by use of a questionnaire in which a 5-point scale was applied where 5 = strongly agree and 1 = strongly disagree. The control variable comprising of capital adequacy was computed by dividing total capital by total risk weighted assets.

3.6.5 Test of Significant

The T-test was applied to measure the significance of the variables. The analysis of variance (ANOVA) was used to assess whether there are outstanding differences between the independent variables. To test the implication of the link between the dependent and independent variables, the F-statistic was used.

CHAPTER FOUR

RESEARCH FINDINGS, ANALYSIS AND DISCUSSION

4.1 Introduction

The research findings, analysis, interpretation and discussion of the results obtained from the study were presented in this chapter. Descriptive statistics, that is, the mean and standard deviation were used to analyze quantitative data. To make inferences, inferential statistics were used. The presentation of the data was done using charts, tables and graphs.

4.2 Response Rate

The study was conducted among the 41 currently registered commercial banks in Kenya. The questionnaires were given to finance managers, accountants and supervisors in the finance department. The response rate is contained in figure 4.1 below.

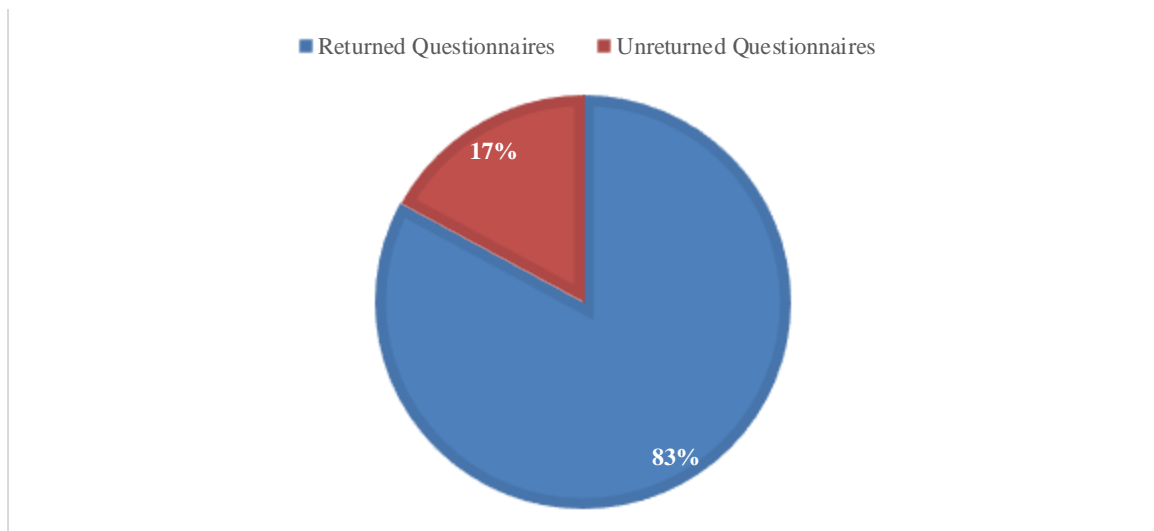


Figure 4.1: Response Rate

Of the 41 questionnaires, 34 were filled and returned giving a response rate of 83%. According to Bryman and Bell (2015), a rate of response of 50% is satisfactory for data analysis, a rate of 60% is good and a feedback rate above 71% is considered excellent. Therefore, according to Bryman the response rate of this study at 83% was excellent.

4.3 Test of Reliability Analysis

To test the internal consistency of the items used in the questionnaire the Cronbach's alpha was used. Cronbach Alpha is a measure of the interrelationship between a set of items that form a group. According to Selvam (2007) Cronbach's alpha values ranges from 0 to 1 with 1 as the highest score of reliability and 0 the lowest. A Cronbach value of 0.6 and above is considered acceptable. The results of the reliability analysis for this study are contained in table 4.1 below.

Table 4.1: Reliability Statistics

| Variable | Cronbach's Alpha (α) | N of Items |
|-----------------------------------|-------------------------------|------------|
| Application of Auditing Standards | .670 | 4 |
| Auditor's Independence | .701 | 5 |
| Auditor's Professional Experience | .662 | 4 |
| Provision of Non-Audit Services | .891 | 4 |

The Cronbach values in table 4.1 for the four variables are above 0.6 and are therefore within the acceptable limit of reliability. Specifically, the Cronbach alpha (α) values for the four independent variables are: compliance with audit standards .670, auditors' independence .701, auditor's professional competence and experience .662 and provision of non-audit services .891.

4.4 Profile of the Respondents

The study sought to find out information about the position held by the respondents in the respective banks. This information was relevant for it helped establish the extent to which the data collected was obtained from the targeted respondents, that is, finance managers and accountants.

4.4.1 Position held in the Bank

The study sought for information regarding the job designation of the respondents in the bank. The information was important for it helped establish whether the respondents were in a position to access the information required for this study. Specifically, the knowledge the respondent had on the bank's financial performance and the external auditors engaged by the bank. The findings are contained in figure 4.2 below.

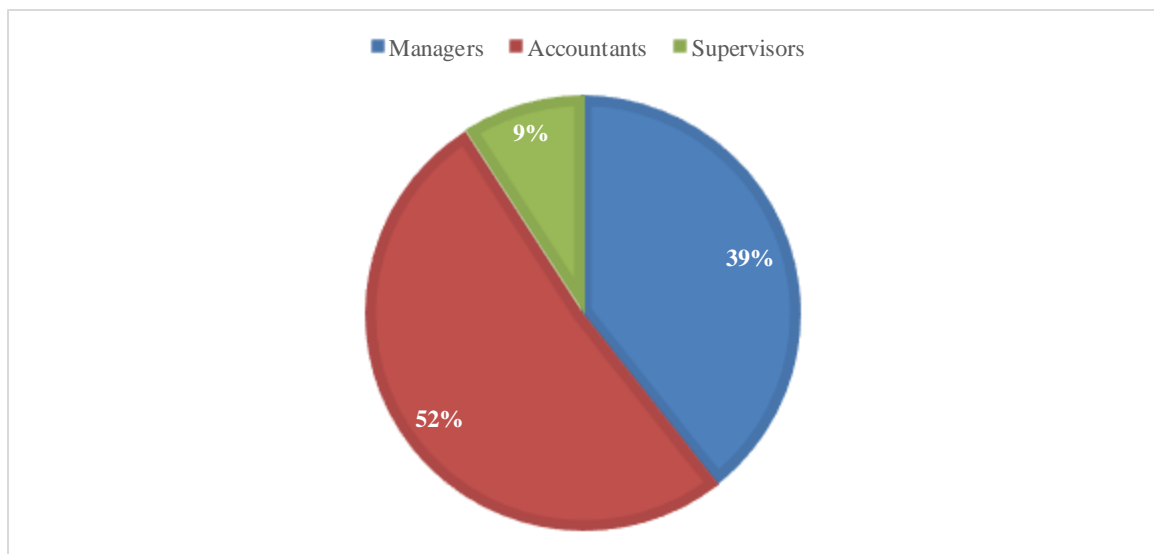


Figure 2.2: Position held in the Bank

Those who responded to the questionnaire comprised of 13 finance managers, 17 accountants and 3 supervisors, this translates to, 39%, 52% and 9% respectively. The subjects were well versed with external audit practice, especially in regard to the external auditors who audit their financial accounts, and financial performance of the banks since they were in positions where they could access such information.

4.5 Test of Normality

The Kolmogorov-Smirnov and Shapiro-Wilk tests were done to check the normality of the distribution of the data of the independent variable. In both the Kolmogorov-Smirnov and Shapiro-Wilk tests when the p-value is less than the predetermined threshold, which is normally 0.05 for a one-tailed test, there is enough evidence to reject the null hypothesis, that is, that the population is not normally distributed. When the p-value is more than 0.05, there is no sufficient evidence to discard the null hypothesis meaning that the distribution of the population is normal. The results of the tests are contained in table 4.2 below.

Table 4.2: Test of Normality

| | Kolmogorov-Smirnov ^a | | | Shapiro-Wilk | | |
|------------------------------------|---------------------------------|----|------|--------------|----|------|
| | Statistic | df | Sig. | Statistic | df | Sig. |
| Compliance with Auditing Standards | .292 | 31 | .200 | .857 | 31 | .466 |
| Auditor Independence | .233 | 31 | .001 | .873 | 31 | .002 |
| Auditor Professional Competence | .184 | 31 | .200 | .923 | 31 | .120 |
| Provision of Non-audit Services | .266 | 31 | .000 | .858 | 31 | .001 |

a. Lilliefors Significance Correction

The p-value of the Kolmogorov-Smirnov test in table 4.2 above are as follows: compliance with auditing standards .200, auditor independence .001, auditor professional competence and experience .200 and provision of non-audit services .000. These results showed that the data for compliance with auditing standards and auditor professional competence and experience were normally distributed as indicated by a p-value of .200 for both variables while the data for auditor independence and provision of non-audit services were not normally distributed because the p-values were less than 0.05 i.e. .001 and .000 respectively. This conclusion was affirmed by the outcome of the Shapiro-Wilk test with the following p-values: compliance with auditing standards .466, auditor independence .000, auditor professional competence and experience .120 and provision of non-audit services .000.

4.6 Test of Multicollinearity

Multicollinearity occurs when there is high correlation between variables that are expected to predict the dependent variable. In this study multicollinearity was tested by use of tolerance levels and variance inflation factors (VIF). Tolerance indicates the extent to which variability of a particular variable cannot explain the other predictor variables in a model. A tolerance value of less than .10 implies the possibility of high multiple correlations signifying existence of multicollinearity. Variance inflation factor (VIF) is the opposite of tolerance, a value of more than 10 indicates that there may be multicollinearity.

Table 4.3: Multicollinearity Coefficients

| Model | Collinearity Statistics | | |
|-------|--|------|-------|
| | Tolerance | VIF | |
| 1 | Compliance with Auditing Standards | .622 | 1.607 |
| | Auditor Independence | .717 | 1.395 |
| | Auditor Professional Competence and experience | .804 | 1.244 |
| | Provision of non-audit Services | .777 | 1.287 |
| | Liquidity | .871 | 1.148 |
| | Adequacy | .832 | 1.202 |

a. Dependent Variable: ROA

Table 4.3 above contains the results of multicollinearity tests for this study. The tolerance values were .622 for compliance with auditing standards, .717 for auditor independence, .804 for auditor professional competence and experience, .777 for provision of non-audit services, .871 for liquidity and .832 for capital adequacy. On the other hand VIF values were 1.607 for compliance with auditing standards, 1.395 for auditor independence, 1.244 for auditor professional competence and experience, 1.287 for provision of non-audit services, 1.148 for liquidity and 1.202 for capital adequacy. The test results revealed no multicollinearity between the variables.

4.7 External Audit Quality

The purpose of the study was to find out the attitude of the respondents drawn from commercial banks in Kenya towards external audit quality as measured by proxies including compliance with auditing standards, auditor independence, auditor professional competence and experience and provision of non-audit services. The respondents' views were collected by use of a questionnaire with a five point scale, with 1 representing

‘strongly disagree’, 2 ‘disagree’, 3 ‘neither agree nor disagree’, 4 ‘agree’ and 5 ‘strongly agree’. The responses were analyzed using descriptive statistics i.e. the mean and standard deviation and the results were represented in tables 4.4, 4.5, 4.6, and 4.7 below.

Table 4.4: Compliance with External Auditing Standards

| Observation | Mean | Standard Deviation |
|---|-------------|---------------------------|
| The external auditor complied with international auditing standards | 4.21 | .559 |
| The effectiveness of the audit resulted from performing the audit work in compliance with the applicable auditing standards | 4.07 | .753 |
| Compliance with the applicable external auditing standards affects the financial performance of the bank | 3.90 | .860 |
| Complying with auditing standards is a significant contributor to audit quality | 4.21 | .620 |

From the analysis in table 4.4 above, most of the respondents consented that the external auditors working for their banks comply with applicable international auditing standards as shown by the mean score of 4.21 and a standard deviation of .559; that an effective audit results from auditors performing their work in accordance with applicable auditing standards as evidenced by a mean score of 4.07 and a standard deviation of .753, that compliance with applicable auditing standards affects banks’ financial performance as shown by a mean of 3.90 and standard deviation of .860 and that complying with auditing standards contributes significantly to the achievement of a quality audit as proved by a mean score of 4.21 and standard deviation of .620.

Table 4.5: Auditor Independence

| Observation | Mean | Standard Deviation |
|---|-------------|---------------------------|
| There are safeguards in place to regulate the interactions between the auditors and management | 4.32 | .819 |
| The composition and size of the audit committee is adequate to provide support to the external auditor's work | 3.97 | .731 |
| The rotation of the senior audit partner is in compliance with the applicable auditing standards | 4.21 | .675 |
| The auditor's work is guided by a code of ethics | 4.31 | .471 |
| The external auditor rotation takes place as required by regulation and standards | 4.14 | .743 |

On the importance of auditor independence the results in table 4.5 above showed that the respondents concurred with the statements that there were safeguards to regulate the interactions between auditors and management with a mean of 4.32 and a standard deviation of .819; that the composition and size of audit committee was adequate to ensure support to the work of external auditors, mean of 3.97 and standard deviation of .731; that rotation of senior audit partner complies with standards, mean of 4.21 and standard deviation of .675, the work of the external auditors is guided by a code of ethics, mean of 4.31 and standard deviation of .471 and that external auditor rotation takes place as required by regulation and standards, mean of 4.14 and standard deviation of .743.

Table 4.6: Professional Competence and Experience

| Observation | Mean | Standard Deviation |
|--|-------------|---------------------------|
| The external auditors are professionally competent to perform the audit function effectively | 4.45 | .506 |
| Professional competence is a key consideration when hiring external auditors | 4.41 | .501 |
| Professional experience is a key consideration when hiring external auditors | 4.31 | .471 |
| The external auditor detects and report fraud and other financial misappropriations | 4.10 | .557 |

From table 4.6 above the results of the responses were: external auditors are professionally competent to perform the audit function effectively, mean of 4.45 and standard deviation of .506; when hiring external auditors' professional competence and experience are key considerations, mean of 4.41 and 4.31 and standard deviations of .501 and .471 respectively; while external auditor detects and reports fraud and other financial misappropriations, mean of 4.10 and standard deviation of .557.

Table 4.7: Provision of Non-audit Services

| Observation | Mean | Standard Deviation |
|---|-------------|---------------------------|
| Beside the audit of financial statements, the external auditors also provide non-audit services to the bank | 3.52 | 1.153 |
| A different department of the firm provides non-audit services | 3.52 | .986 |
| There are proper safeguards in place to check against possible conflict of interest | 3.90 | .900 |
| The non-audit services are conducted in compliance with applicable standards and regulations | 3.66 | .857 |

The responses obtained on the questions asked about provision of non-audit services were as shown in table 4.7 above. The question on whether the auditors provide other services beside audit scored a mean of 3.52 and a standard deviation of 1.153; for audit firms that provide audit as well as non-audit services having separate departments for providing the two services, mean of 3.52 and standard deviation of .986; there being proper safeguards to check against possible conflicts of interest, mean of 3.90 and standard deviation of .900 and the conduct of non-audit services is guided by standards and regulations, a mean of 3.66 and standard deviation of .857.

4.8 Financial Performance

The banks financial performance was evaluated using return on asset ratio (ROA) for the five years period from 2013 to 2017. The ROA was calculated as profit before interest and tax divided by total assets. The ROA descriptive statistics, that is, the mean, standard deviation, skewness and kurtosis are presented in table 4.8 below. Kurtosis was used to measure the peakedness or flatness of the distribution of the data. In a normally distributed data kurtosis $k=3$. When the data distribution forms a curve with a high peak kurtosis $k>3$. On the other hand, the distribution of data that results in a flat curve kurtosis $k<3$. Skewness was used to measure the symmetry or asymmetry of the data. When data is perfectly symmetrical the skewness is equal to zero. A normally distributed data has a skewness of zero.

Table 4.8: Return on Assets (ROA) Descriptive Statistics

| Year | N | Min | Max | Mean | Std. Deviation | Skewness | Kurtosis | | |
|----------------------------------|-----------|--------------|-------------|-------------|----------------|---------------|-------------|--------------|-------------|
| | Statistic | Statistic | Statistic | Statistic | Statistic | Statistic | Std. Error | Statistic | Std. Error |
| 2017 | 34 | -14.14 | 6.49 | 1.35 | 3.73 | -2.354 | .403 | 8.537 | .788 |
| 2016 | 34 | -7.01 | 7.91 | 2.38 | 2.91 | -1.068 | .403 | 2.317 | .788 |
| 2015 | 34 | -4.53 | 6.56 | 2.63 | 2.64 | -1.114 | .403 | 1.141 | .788 |
| 2014 | 33 | -2.78 | 6.42 | 2.65 | 2.26 | -.361 | .409 | -.362 | .798 |
| 2013 | 33 | -.98 | 7.65 | 3.27 | 2.19 | .011 | .409 | -.387 | .798 |
| Average (2013-2017/5) ROA | 34 | -5.89 | 6.09 | 2.46 | 2.34 | -1.230 | .403 | 3.505 | .788 |
| Valid N | 33 | | | | | | | | |

From table 4.8 above the ROA had a mean value of 2.46 and a standard deviation of 2.34.

The coefficient of skewness for the ROA was -1.230 which means that the distribution of the data was negatively skewed because the skewness is less than zero. The value of the

kurtosis was 3.505, denoting that the distribution of the data formed a leptokurtic curve, i.e. a curve with a high peak. This is because the kurtosis value was greater than 3.

4.9 Capital Adequacy

The capital adequacy ratio was used to appraise the banks' capital adequacy. The ratio was computed by dividing total capital by the total risk weighted assets. The data of the banks' capital adequacy ratio was collected for the period 2013 to 2017. The minimum statutory adequacy ratio required by the Central Bank of Kenya is 14.5%. The average and standard deviation were calculated and the results are presented in table 4.9 below.

Table 4.9: Capital Adequacy Descriptive Statistics

| Year | N | Min | Max | Mean | Std. Deviation | Skewness | | Kurtosis | |
|------------------------------|-----------|--------------|--------------|--------------|----------------|-------------|-------------|--------------|-------------|
| | Statistic | Statistic | Statistic | Statistic | Statistic | Statistic | Std. Error | Statistic | Std. Error |
| 2017 | 34 | .00 | 38.80 | 19.63 | 7.93 | .033 | .403 | .994 | .788 |
| 2016 | 34 | 7.20 | 43.30 | 22.09 | 7.83 | .865 | .403 | 1.312 | .788 |
| 2015 | 33 | 9.40 | 32.10 | 20.09 | 5.27 | .601 | .409 | -.056 | .798 |
| 2014 | 32 | .00 | 37.20 | 18.93 | 6.50 | -.038 | .414 | 2.656 | .809 |
| 2013 | 32 | .00 | 65.00 | 22.36 | 10.95 | 1.962 | .414 | 6.996 | .809 |
| Average (2013-2017/5) | 34 | 10.24 | 34.52 | 20.77 | 6.00 | .624 | .403 | -.237 | .788 |
| Valid N | 31 | | | | | | | | |

From table 4.9 above capital adequacy had a mean value of 20.77 and a standard deviation of 6.00. The skewness factor was .624 which means that the data is positively skewed because the coefficient for skewness is greater than zero. The value of the kurtosis was -.234 signifying a platykurtic curve i.e. the data distribution formed a flat curve since kurtosis value was less than 3.

4.10 Inferential Statistical

To establish the degree and nature of correlation between external audit quality and financial performance, the researcher conducted inferential statistical analysis including, regression analysis, correlation analysis and analysis of variance. The results of the analysis are presented below.

4.10.1 Correlation Analysis

Correlation analysis was conducted to establish the extent and direction of correlation between financial performance and audit quality as measured by proxies comprising of compliance with auditing standards, auditor independence, auditor professional competence and experience and provision of non-audit services. Correlation analysis was done to determine the relationship between financial performance and capital adequacy. The outcomes are contained in table 4.10 below.

Table 4.10: Correlation Coefficients

| | | ROA | Compliance with Auditing Standards | Auditor Independence | Auditor Professional Competence | Provision of Non Audit Services | Capital Adequacy |
|--|------------------------------------|---------------|------------------------------------|----------------------|---------------------------------|---------------------------------|------------------|
| ROA | Pearson Correlation Sig (2-tailed) | 1 | | | | | |
| Compliance with Auditing Standards | Pearson Correlation Sig (2-tailed) | .136 .472 | 1 | . | | | |
| Auditor Independence | Pearson Correlation Sig (2-tailed) | .455* .011 | .185 .328 | 1 | | | |
| Auditor Professional Competence & Experience Sig | Pearson Correlation (2-tailed) | .211 .262 | .291 .118 | .109 .251 | 1 | | |
| Provision of Non Audit Services | Pearson Correlation Sig (2-tailed) | -.277 .139 | -.709 .000 | -.648 .000 | -.257 .564 | 1 | |
| Capital Adequacy | Pearson Correlation Sig (2-tailed) | .282 .132 | .195 .302 | .445* .380 | -.020 .917 | -.186 .324 | 1 |

N=31; *P<.05; **P<.01

The results of correlation analysis in table 4.10 above indicates that there was a positive correlation between ROA with compliance with auditing standards with a Pearson correlation of .136, auditor independence with a Pearson correlation value of .455, auditor professional competence and experience, correlation value of .211 which means that as ROA increased the three variables increased as well. Provision of non-audit services had a negative correlation of -.277 meaning that as financial performance increased the provision of non-audit services decreased. The Pearson correlation between financial performance and auditor independence was .455 which was statistically significant as verified by a p-value of .011. However, the relationship between financial performance and compliance with auditing standards, auditor competence and experience and provision for non-audit services was insignificant at $p < .05$ because the p-values of the variables are .472, .262

and .067 respectively. In addition, capital adequacy had a positive correlation with financial performance with a Pearson correlation of .282 and p-value of .132.

4.10.2 Regression Analysis

Regression analysis is a quantitative method used in scientific research for predicting the behavior of a dependent variable in response to the behavior of the predictor variable or variables. In the current study, regression analysis was conducted to determine the relationship between financial performance, audit quality and capital adequacy.

Table 4.11: Model Summary

| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate |
|-------|-------------------|----------|-------------------|----------------------------|
| 1 | .632 ^a | .400 | .340 | 1.90235 |

a. Dependent Variable: ROA

b. Predictors: (constant), Audit Quality, Capital Adequacy

The results of the coefficient of determination (R^2) in table 4.11 was .400 which means that there was a change of 40% (.400 x 100) in the financial performance as a result of changes in audit quality and capital adequacy. The outcome of the study likewise showed a moderate correlation between commercial banks' financial performance and external audit quality as depicted by the correlation coefficient of .632

4.10.3 Analysis of Variance

Table 4.12: ANOVA

| Model | Sum of Squares | df | Mean Square | F | Sig. |
|--------------|----------------|----|-------------|-------|-------------------|
| 1 Regression | 72.303 | 2 | 24.101 | 6.660 | .001 ^b |
| Residual | 108.569 | 31 | 3.619 | | |
| Total | 180.872 | 33 | | | |

a. Dependent Variable: ROA

b. Predictors: (Constant), Audit Quality, Capital Adequacy

To determine if there was significant variation between the means of the groups, analysis of variance (ANOVA) was conducted. Table 4.12 above contains the results of the analysis of variance. From the findings the ANOVA analysis resulted in an F- significant p-value of .001. The ANOVA results indicate that the model provides a good basis of making conclusions on the variables as the significance level is less than 5% with a p-value of .001. As such, the model can be applied in predicting how audit quality affects financial performance of commercial banks in Kenya for it shows that there is less than 0.1% chance of the regression model giving incorrect information.

4.10.4 Regression Coefficients

Multiple regression analysis generates the significance of the coefficients of the effects of the respective predictor variables on the dependent variable. The significance or insignificance of each variable is evaluated. The values of beta (β) are also appraised to find out which variable makes the most contribution. The outcome of the regression coefficients are contained in table 4.13 below.

Table 4.13: Regression Coefficients

| Model | Unstandardized Coefficients | | Standardized Coefficients | t | Sig. |
|------------------|-----------------------------|------------|---------------------------|-------|------|
| | B | Std. Error | Beta | | |
| (Constant) | 2.698 | .333 | | 8.089 | .000 |
| 1 Audit quality | 2.579 | 2.791 | .191 | .924 | .363 |
| Capital adequacy | 3.495 | 2.706 | .331 | 1.291 | .206 |

a. Dependent Variable: ROA

The resulting regression equation is as follows based on the results contained in table 4.13 above. $Y=2.698+2.579X_1+3.495X_2+\varepsilon$

where Y- Financial performance (ROA), α - Regression Constant, X_1 - audit quality and X_2 - capital adequacy. β_1 - β_2 are the regression coefficient for each of the independent variable and ε - is the estimation of error.

Table 4.13 showed that a unit of audit quality would increase financial performance (ROA) of commercial banks by 2.579 while capital adequacy would increase financial performance by 3.495. At 5% level of significance audit quality had a p-value of .363 while capital adequacy had a p-value of .206 implying that the two variables were not statistically significant.

4.11 Discussion of Findings

External auditors have a crucial role of contributing to the authenticity of the financial statements on which they report. It is therefore imperative that the audit conducted is of high standard so as to build the trust and confidence of the public in the financial statements and in the entire financial reporting process. This study established that external audit

quality measured using four key parameters, that is, compliance with audit standards, auditor independence, auditor professional competence and provision of non-audit services influences financial performance of commercial banks. This was demonstrated by the resulting adjusted R of .400 which means that a variability of 40% of commercial banks' financial performance was a result of the independent variables while 60% of financial performance of the banks was the outcome of factors not covered by this study. The R value of .632 showed that there was a moderate relation between financial performance and audit quality. This denotes that the model provides an adequate basis for predicting correlation between financial performance and audit quality.

4.11.1 Compliance with Auditing Standards

The results obtained for correlation analysis in table 4.11 showed that the relationship between financial performance and compliance with auditing standards was affirmative as represented by a Pearson correlation of .136. The relationship was however not significant at the 0.05 level because the p-value was .472. The findings of this study are echoed in the conclusion of a research conducted on Compliance Audit and Corporate Financial Performance of banks in River State, Nigeria, Enofe, Fyneface and Oladeji (2013) concluded that complying with auditing standards i.e. all the applicable rules and regulations, gives an audit the mandate to settle corporate governance issues and enhance corporate financial performance.

4.11.2 Auditor Independence

The test results of the correlation between auditor independent and financial performance showed that there was significant positive correlation as demonstrated by a correlation

coefficient of .455 and a p-value of .011. Auditor independence increases the capacity of a firm to make considerable net profit margins (Matoke & Omwenga, 2016). This conclusion by Matoke and Omwenga affirms this study's findings on the importance of auditor independence in enhancing corporate financial performance.

4.11.3 Auditor Professional Competence and Experience

Auditor professional competence and experience correlates with financial performance at correlation value of .211. The relationship was however not significant statistically as the p-value was .262. Professional competence encompasses not only professional training, certification and licensing, but also builds up the people's expertise through technical training, stimulating knowledge and understanding of the business and the industry, establishing specialist networks and setting up efficacious consultation processes.

4.11.4 Provision of non-audit Services

Provision of non-audit services negatively correlates with financial performance at a correlation score of -.277. Nevertheless, the association between the two variable was not statistically significant as the p-value was .139. By providing both audit and non-audit services, audit quality is likely to be compromised because of familiarity with the client and the possible over-reliance on revenue from a single source. A previous study conducted on audit fees, non-audit service and financial performance by Santos, Cerqueira and Brandao (2015) supported this study for they discovered that providing audit and non-audit services to the same client simultaneously limits the functions of the auditor by compromising on auditor independence, and that may ultimately adversely affect financial performance.

4.11.5 Capital Adequacy

Capital adequacy correlates positively with financial performance as revealed by correlation coefficient of .282 and p-value of .132 in table 4.10. The regression coefficients in table 4.13 indicated that a unit of capital adequacy increased financial performance by 3.495. This conclusion is affirmed by a prior study conducted by Carelle (2016) on factors affecting the financial performance of commercial banks listed in the Nairobi Securities Exchange of which the findings indicated that as capital adequacy increased both ROA and ROE increased as well. Ongare and Kusa (2013) came to the same conclusion in a study they conducted on the determinants of financial performance of commercial banks in Kenya.

4.12 Conclusion

The intent of this study was to determine the effects of external audit quality on financial performance of commercial banks in Kenya. Four proxies of audit quality including compliance with auditing standards, auditor independence, auditor professional competence and experience and provision of non-audit services were surveyed. The respondents who participated in the study were composed of finance managers, accountants and supervisors in the finance department and they were all in agreement that audit quality influences financial performance of commercial banks.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter encompasses the synopsis of the findings, conclusion, recommendations and propositions for further studies.

5.2 Summary

The objective of this study was to determine the effects of external audit quality on financial performance of commercial banks in Kenya. Audit quality was measured using four proxies comprising of compliance with auditing standards, auditor independence, auditor professional competence and experience and provision of non-audit services. Of these proxies, auditor independence and auditors' professional competence and experience stood out as having strong relationship with financial performance.

Capital adequacy with a positive correlation of 0.282, shows that as capital adequacy increases financial performance also increases. Capital adequacy is the statutory minimum reserve that is used to fund a bank's operations and provide a caution in case of financial distress. It then follows that as the capital reserves are increased the ROA increases implying that the bank has available resources to fund its operations and generate more income.

5.3 Conclusion

Audit quality is an audit that is both systematic and an objective evaluation of financial accounts. Audit quality is achieved when performed by a competent and independent firm in accordance with current auditing standards. External audit quality is important to a company because when the accounts are found to be in good order, it is a demonstration of sound financial position and performance and this predisposes the company to investors and other venture partners. The main drivers of audit quality espoused by the findings of the current study are compliance with auditing standards and auditor independence.

Engaging audit firms that comply with auditing standards is likely to guarantee the clients audit quality. Auditing standards cover a wide range of issues because they are associated with professional conduct, quality control and independence (Gao et al., 2017). According to Knechel (2013) auditing standards have a role of keeping the audit profession relevant, receptive to the needs of the stakeholders, and improves audit quality. Therefore, compliance with auditing standards is an important element of audit quality and organizations when hiring external auditors should pay attention to their compliance levels.

The responsibility of an external auditor is to give an opinion on the financial reports prepared by the management. The opinion given is based on the judgement made after the audit process is complete. The auditor is expected to give an impartial and honest opinion to the shareholders. For this to happen, it is imperative that the auditor maintains independence to avoid undue influence and compromise of his/her work. Sufficient measures ought to be put in place to safeguard the independence of the external auditors,

for example, the appointment of independent audit committee, audit partner rotations and regulation on external auditor providing non-audit services (Ojo, 2009).

5.4 Recommendations

Auditor independence correlates significantly with compliance with auditing standards. External auditors would therefore gain competitive advantage by applying faithfully the acceptable auditing standards within their operating environment. Organizations would also be assured of audit quality by creating an environment that promotes auditor independence. Consequently, audit firms should strive to adopt and apply the applicable auditing standards in order to enjoy auditor independence which in the long terms leads to audit quality.

The study revealed that provision of non-audit services and auditor professional competence and experience positively correlate with financial performance. Audit firms should therefore pay attention to the professional training of their staff at all levels. In addition, audit staff should be given opportunities to practice so that they can gain the required experience and thus improve on the quality of their work. On the other hand, in the vetting process when hiring external auditors by organizations, professional competence and experience should be prioritized.

External auditors that provide non-audit services to their clients should comply with acceptable standards and should observe the laid down safeguards to avoid compromising on the quality of their work. The clients too have a key responsibility of ensuring that the

external auditors perform the non-audit services in accordance with policies and procedures.

5.5 Limitations of the Study

The study population was made up of the 41 registered banks in Kenya. Forty one questionnaires were distributed, one each to every bank. However, 34 questionnaires were returned leaving out 7 banks. Also, due to the sensitive nature of the information required, some respondents were skeptical and chose not to participate in the study. This may have diluted the quality of the outcome of the study.

The fact that there is no specific or discrete definition and measure of audit quality means that proxies had to be used at the discretion of the researcher. The different studies conducted on audit quality have used various proxies. Equally, the number of proxies used vary from one study to another which means that the studies conducted may not be comparable. The use of proxies may not satisfactorily represent audit quality thus constraining the study.

Time was a restricting factor which hindered a more in-depth study. The bank's working hours coincided with those of the researcher and it was sometimes difficult to distribute and collect the questionnaires because of work commitments. In addition, there are times the researcher had to go back and forth to collect the questionnaires which was very inconvenient.

5.6 Areas for further research

Although studies have been conducted to establish an acceptable definition and measure of audit quality, there is still no universally acceptable definition and measure of audit quality. Different researchers in the area of audit quality have had to use various proxies which limits the comparability of the studies conducted. This is, therefore, an area that would benefit from further researches in order to determine a universally acceptable definition and measure of audit quality.

This study focused on the effects of audit quality on financial performance of commercial banks in Kenya. This is an area that has not been explored by many researchers and it could be extended to other organizations in Kenya specifically because external audit plays a key role in enhancing public confidence in the financial reporting process.

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APPENDICES

Appendix One: Questionnaire

The purpose of the questionnaire is to gather data from commercial banks in Kenya with the goal examining “the effects of external audit quality on the financial performance of commercial banks”. The information obtained will be utilized strictly for academic purposes and utmost confidentiality will be exercised. Thank you for your participation in the study.

SECTION A: BACKGROUND INFORMATION

Respondents Details:

1. Bank Name:
2. Position Held:
3. Gender
Male Female
4. What is your age?
5. Number of years worked in the bank

SECTION B: EXTERNAL AUDIT STANDARDS

Kindly indicate the extent to which the following statements fits with the use of relevant auditing standards by the External Auditor where 1= Strongly Disagree; 2= Disagree; 3= Neither Agree nor Disagree; 4= Agree; 5= Strongly Agree

| Statement | Strongly Disagree | Disagree | Neither agree nor disagree | Agree | Strongly Agree |
|---|-------------------|----------|----------------------------|-------|----------------|
| The external auditor complied with international auditing standards | | | | | |
| The effectiveness of the audit resulted from performing the audit work in compliance with the applicable auditing standards | | | | | |
| Compliance with the applicable external auditing standards affects the financial performance of the bank | | | | | |
| Complying with auditing standards is a significant contributor to audit quality | | | | | |

SECTION C: AUDITOR INDEPENDENCE

Kindly indicate the extent to which you agree with the following statements in regard to auditor independence where 1= Strongly Disagree; 2= Disagree; 3= Neither Agree not Disagree; 4= Agree; 5= Strongly Agree

| Statement | Strongly Disagree | Disagree | Neither agree nor disagree | Agree | Strongly Agree |
|---|-------------------|----------|----------------------------|-------|----------------|
| There are safeguards in place to regulate the interactions between the auditors and management | | | | | |
| The composition and size of the audit committee is adequate to provide support to the external auditor's work | | | | | |
| The rotation of the senior audit partner is in compliance with the applicable auditing standards | | | | | |
| The auditor's work is guided by a code of ethics | | | | | |
| The external auditor rotation takes place as required by regulation and standards | | | | | |

SECTION D: PROFESSIONAL COMPETENCE AND EXPERIENCE

Kindly indicate the extent to which you agree with the following statements regarding the external auditors professional competence where 1= Strongly Disagree; 2= Disagree; 3= Neither Agree nor Disagree; 4= Agree; 5= Strongly Agree

| Statement | Strongly Disagree | Disagree | Neither agree nor disagree | Agree | Strongly Agree |
|--|-------------------|----------|----------------------------|-------|----------------|
| The external auditors are professionally competent to perform the audit function effectively | | | | | |
| Professional competence is a key consideration when hiring external auditors | | | | | |
| Professional experience is a key consideration when hiring external auditors | | | | | |
| The external auditor detects and report fraud and other financial misappropriations | | | | | |

SECTION D: PROVISION OF NON-AUDIT SERVICES

Kindly indicate the extent to which you agree with the following statements in regard to provision of non-audit services by the external auditor where 1= Strongly Disagree; 2= Disagree; 3= Neither Agree nor Disagree; 4= Agree; 5= Strongly Agree

| Statement | Strongly Disagree | Disagree | Neither agree nor disagree | Agree | Strongly Agree |
|---|-------------------|----------|----------------------------|-------|----------------|
| Beside the audit of financial statements, the external auditors also provide non-audit services to the bank | | | | | |
| A different department of the firm provides non-audit services | | | | | |
| There are proper safeguards in place to check against possible conflict of interest | | | | | |
| The non-audit services are conducted in compliance with applicable standards and regulations | | | | | |

Appendix Two: List of Commercial Banks in Kenya

1. African Banking Corporation Limited
2. Bank of Africa Kenya Limited
3. Bank of Baroda (K) Limited
4. Bank of India
5. Barclays Bank of Kenya Ltd
6. Charterhouse Bank Limited
7. Citibank N.A. Kenya
8. Commercial Bank of Africa Limited
9. Consolidated Bank of Kenya Limited
10. Co-operative Bank of Kenya Limited
11. Credit Bank Limited
12. Development Bank of Kenya Limited
13. Diamond Trust Bank Kenya Limited
14. DIB Bank (Kenya) Limited
15. Ecobank Kenya Limited
16. Spire Bank Ltd
17. Equity Bank Kenya Limited
18. Family Bank Limited
19. Fidelity Commercial Bank Limited
20. First Community Bank Limited
21. Guaranty Trust Bank (K) Ltd
22. Guardian Bank Limited
23. Gulf African Bank Limited
24. Habib Bank A.G. Zurich
25. Habib Bank Limited
26. Imperial Bank Limited
27. I&M Bank Limited
28. Jamii Bora Bank Limited
29. KCB Bank Kenya Limited

30. Middle East Bank (K) Limited
31. National Bank of Kenya Limited
32. NIC Bank Limited
33. M-Oriental Bank Limited
34. Paramount Bank Limited
35. Prime Bank Limited
36. Sidian Bank Limited
37. Stanbic Bank Kenya Limited
38. Standard Chartered Bank Kenya Limited
39. Trans-National Bank Limited
40. UBA Kenya Bank Limited
41. Victoria Commercial Bank Limited