African Development Finance Journal http://journals.uonbi.ac.ke/index.php/adfj
August Vol 5 No.2, 2021 PP 1-14 ISSN 2522-3186

Corporate Governance and Modification of Audit Opinion: Evidence from State Owned Enterprises in Kenya

Mongeri Oruke[1], Cyrus Mwangi Iraya (PhD)[2], Nixon Oluoch Omoro (PhD)[3] and Luther Odhiambo Otieno(PhD)[4]

Abstract

Purpose: *The purpose of this study was to examine the relationship between corporate governance and modified of audit opinion in commercial state owned enterprises in in Kenya.*

Methodology: *The study analyzed data from 25 state owned enterprises covering the period 2014 to 2016. The study employed logistic regression to analyze the relationship among the research variables.*

Findings: *The study established that majority of state owned enterprises received modified audit opinion, accounting for 68% of audit reports issued to commercial state owned enterprises in Kenya. The results on logistic regression indicate that the number of audit committee meetings as proxy for audit committee diligence had a negative and significant effect on the likelihood of a firm receiving modified audit opinion. The result on the effect of board independence was negative but not statistically significant. This result suggests that the contribution of independent directors was not significant. The results for firm size as control variable were also significant.*

Implications: *The conclusion that corporate governance mechanisms influenced the quality of financial reporting will interest policy makers, and those charged with corporate governance to reinforce effective mechanisms to promote accountability.*

Value of Study: *The study has contributed to literature on how to operationalize and test hypotheses on corporate governance and audit opinion in the public sector where minimal literature was available.*

Key works: *Corporate Governance; Modified Audit Opinion; Firm Characteristics*

[1] PhD Student, Department of Finance and Accounting , University of Nairobi, Email: mongerioruke@gmail.com, Tel: +254724668358

[2] Professor, Department of Finance and Accounting , University of Nairobi.

[3] Lecturer, Department of Finance and Accounting, University of Nairobi.

[4] Senior Lecturer, Department of Finance and Accounting, University of Nairobi.

1.0 Introduction

Corporate governance is a highly debated topic in the public sector rivaling the private sector. Public sector entities have suffered losses and failures that has bought to question the subject of accountability and transparency in these entities. In response concerted, efforts have been made to address gaps in corporate governance through reforms. The efforts to address this challenge are diverse including: legislations and codes of corporate governance. The efforts to better corporate governance is spearheaded by global institutions including OECD (2015) that has provided corporate governance guidelines for state corporations. In Kenya the government has responded to corporate government woes by developing Mwongozo (2015) code for state corporations. The code highlights how through effective corporate governance, SOEs could enhance accountability and transparency.

The agency theory by Jensen and Meckling (1979) predicts that separation of ownership and control may lead to agency problem as results of information asymmetry. The theory advocates that through corporate governance mechanism agency problem can be resolved. Other theories including stakeholder theory by Freeman (1984), stewardship theory by Donaldson and Davis (1991) offers diverse and contrasting perspective how through corporate governance accountability can be enhanced.

The subject of accountability and transparency is important to investors and other stakeholders. Firms that receive modified audit opinion will find it difficult to attract investors and lenders, leading the organization to financial difficulties. Modified audit opinion will signal lack of accountability in these entities resulting to negative consequences for State owned entity. World Bank (2014) report outlined that SOEs played critical roles in an economy by providing critical services. Failure and losses resulting from lack of accountability and transparency would have devastating effect to the economy and lead to loss on provision of critical services.

1.1 State Owned Enterprises in Kenya

Mwongozo (2015) defines a state owned enterprise as entities whereby the state exercised control or a case whereby specific legislation state the entity to be state owned. The Mwongozo code further defines how these entities should be governed to ensure transparency and accountability. Specifically, Mwongozo states that board of directors have the responsibility for promoting corporate governance in these entities.

The code proposes that an effective board should have board size of 7-9 members. In addition, the board should have at least 30% independent board members. The board should also have diligent audit sub-committee that meet at least quarterly to deliberate on financial information. The Office of the auditor general of Kenya as per the constitution of Kenya 2010 article 296 is the mandated supreme audit institution to independently audit all state owned entities in Kenya. The audit reports are further forwarded to parliamentary committees for oversight roles. Modification of audit opinion by the auditor general is likely to attract consequences for the state entity, this may lead to loss of investors and funding.

1.2 Research Problem

The audit opinion signals the quality of financial information contained in financial statements. Firms that receive unmodified audit opinion or clean report will create confidence among investors thus attract funding and investments. In contrast, firms that receive modified the audit opinion by independent auditors will signal to investors poor quality of financial statements and lack of accountability. This may likely have negative consequences including a firm failing to attract investors, funding even decline in share returns.

The agency theory argues that, through corporate governance mechanisms effective monitoring will ensure that opportunistic behaviors by the agents that affect the quality of financial reporting including earnings management are constrained. Thus, well governed entities are less likely to receive modified audit opinion. However empirical evidence on effectiveness of corporate governance mechanism in ensuring quality of financial reporting is inconclusive. Some studies supporting the argument (Saaydah, 2019; Farinha & Viana, 2009). In other instances, results were inconsistent (Jouri,2016). These means the problem remains unresolved and hence need further research.

Prior research and testing of hypothesis on subject of corporate governance and audit opinion has mainly focused on listed companies, this has left a gap in the public sector where minimal literature is available. Public owned entities also receive funding from government and other investors who will be concerned about the quality of financial reporting. The government of Kenya through Mwongozo has outlined corporate governed structures to promote accountability and transparency in state owned enterprises. It is on this background that this study sought to establish effectiveness of corporate governance mechanisms on modification of audit opinion in commercial state owned enterprises in Kenya.

1.3 Study Objectives

This study sought to:

I. To determine the effect of audit committee diligence on modification of audit opinion in commercial state owned enterprises in Kenya.
II. The determine effect of board independence on modification of audit opinions in commercial state owned enterprises in Kenya.
III. To establish the effect of firm size on relationship between corporate governance and modification of audit opinion in commercial state owned enterprises in Kenya.

2.0 Literature Review

The study takes a critical review of theory and empirical literature with the objectives of developing research gaps and formulating hypothesis to be tested.

2.1 Theoretical Foundation

The agency theory by Jensen and Meckling (1979) argues that separation of ownership and control may result to conflict of interest. The proponents of the agency theory argue that effective board can reduce information asymmetry through effective monitoring of the agent. Consequently, the agency theory favors boards dominated by independent directors as opposed to CEO duality. Historical review on corporate governance in the public sector established that agency theory was the dominant theory (Hay & Cordery, 2017).

However, citiques of the agency theory points out, that the theory only focuses on economic perspective, but fails to address other perspectives that affect corporate governance including social and institutional factors (Yusof, 2016).Other supporting theories have also attempted to offer diverse perspective how through effective boards , corporate governance can be developed. The stakeholder theory by Freeman (1984), prefers a board representative of all stakeholders to ensure accountability. The stewardship theory by Donaldson and Davis (1991) favoring boards that aim to support the steward and CEO duality as opposed to control and monitoring advocated by agency theory.

2.2Empirical Evidence

A number of studies have examined the relationship between corporate governance and modification of audit opinion with mixed results. Saaydah (2019) examined the relationship between corporate governance and modified audit opinion in Jordan. The study examined data from 104 listed firms in Amman securities market in the year 2015. To draw conclusion, the study employed logistic regression. The study established that institutional board members and firm profitability significantly reduced the likelihood of a firm receiving modified audit opinion. In contrast, board size was positively related to audit opinion. The results for board activity and board independence were statistically insignificant. The inconsistent results for board activity and board independence create a conceptual gap.

Jouri (2016) investigated audit opinion for 90 companies listed in Tehran securities market for a period of eight years. The study tested the hypothesis that entities that have stronger corporate governance will have quality financial reporting. In addition, they are less likely to be associated with fraud and irregularity consequently, attracting unmodified audit opinion from independent directors. The study concluded that firms with moderate and low corporate governance influence modification of audit opinion. However, the results for strong corporate governance were inconsistent. This study leaves contextual gaps as it only relied on data from listed companies.

Habib (2013) examined the determinants of modification of audit opinion. The study employed meta-analysis technique to draw conclusions about the variables. The using meta-analysis technique the study examined results from 73 prior studies covering the period 1982 to 2011 to draw conclusions. The study established that firm specific characteristics significantly contributed to modification of audit opinion. The effects of auditor related characteristics on modification of audit opinion were not conclusive. Meta-analysis technique used in the is to prone to bias leading to a methodological gap.

In another study, Farinha and Viana (2009) examined the relationship between board structure and modified audit opinion in Portuguese listed companies. The study employed logistic regression to examine the relationship among the research variables.The study collected data from 171 firm observations covering the period 2002 to 2005. The study established that firms that had dilligent and more independent directors were less likely to receive modified audit opinion.

Hsiao, Lin and Hsu (2010) examined the relationship between corporate governance, earnings management and audit opinion. The study hypothesized that financial distressed companies were most likely to manipulate their financial information resulting to modification of audit opinion. The study used data from 100 de-listed firms covering the period 1997 -2007.The study established that financially distressed companies engaged in earnings management. The results further indicating that audit opinion was a predictor of financial distress. However, the study did not test the link between financial distress and corporate governance.

Ballesta and García-Meca (2005) investigated the link between corporate governance and modified audit opinion. The study sampled data from Spanish listed firms covering the period 1999 -2002.The study established that insider ownership improved corporate governance thus reducing the likelihood of receiving modified opinion. The study further established that family dominated boards were most likely to receive modified audit opinion.

Lin, Jiang and Xu (2011) investigated reasons why significant number of firms received modified audit opinion in China. The study sampled audit opinion covering the period 1992 and 2009. The study established that earnings management reduces the quality of financial reporting.

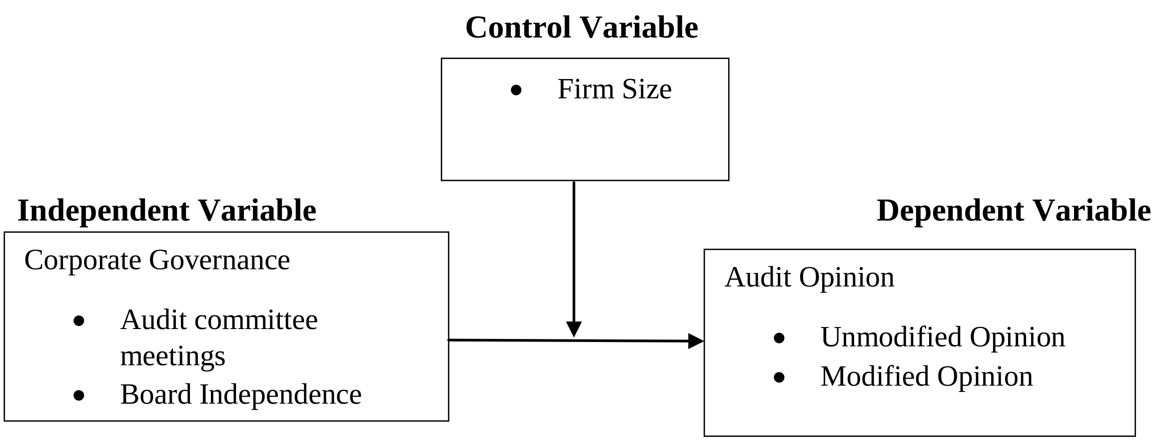
The study also established that modified audit opinion did not constrain credit borrowing. The study did not address the corporate governance aspect leaving a conceptual gap.

Ahmadi, Sedghiani and Jamali (2014) investigated the consequences of modified audit opinion. The study sampled 120 listed firms at Tehran securities market covering the period 2004 to 2010. The study established a positive relationship between modified audit opinion and expected returns. However, no relationship was established between modified opinion and access to credit funding.

Based on the empirical evidence the results are mixed and inconclusive suggesting that the subject remains unresolved. This means that the hypothesis should be further be tested to develop on available literature. Further, most of studies conducted were based on data from listed firms leaving contextual gap in the public sector that need to be researched.

2.3 Conceptual Framework

Based on theoretical framework it is predicted that through corporate governance mechanisms monitoring will be effective. This will improve the quality of financial reporting. Consequently, will be reflected in independent auditors issuing unmodified opinion.



2.4 Study Hypothesis

H$_1$: The number of audit committee meetings as proxy for board diligence has negative and significant effect on modified audit opinion.

H_2: Board independence has negative and significant effect related on modified audit opinion.

H_3: Firm size as a control variable has negative significant effect on the relationship between corporate governance and modified audit opinion.

3.0 Research Methodology

3.1 Research Design

This study applied correlational research design to describe and measure the degree of association among the study variables (Creswell, 2014).

3.2 Data Collection

Data was obtained from 25 state owned enterprises in the commercial and manufacturing sector based on categorization by (SCAC, 2021). Data on relation to audit opinion both modified and unmodified opinion was obtained from audit reports prepared by the auditor general of Kenya. Data relating to the number of audit committee meetings and number of non-executive directors were obtained from governance statement contained in annual reports. Data on firm size was computed from annual financial statements found in annual reports.

3.3 Operationalization of Study Variables

Table 1: Operationalization of Study Variables

Audit Opinion	Modified opinion= 1 unmodified opinion =0
Board Independence	Number of non-executive directors
Audit committee diligence	Number of audit committee meetings
Firm Size	Log of total assets

3.3 Model Specification

To measure the level of association among the study variables, the study adopted logistic regression. Aziz, Ali, Nor, Baharum and Omar (2016) observed that logistic model is a flexible to accommodate to categorical dependent variable.

$AO = \alpha + \beta_1 ACmeetings + \beta_2 PerIND + \beta_3 Fsize + \varepsilon$---(1)

AO: The audit opinion

A: the intercept, β: the coefficient, ε: the error term

ACmeetings: the number of audit committee meetings as proxy for audit committee activity

PerIND: the percentage on independent directors.

4.0 Results and Findings

4.1. Descriptive Statistics

Table 2 : Audit opinion

	Frequency	Percent	Valid Percent	Cumulative Percent
Unmodified opinion	24	32.0	32.0	32.0
Modified opinion	51	68.0	68.0	100.0
Total	75	100.0	100.0	

Table 2 presents the results of audit opinion. The result indicates that majority of SOEs received modified opinion accounting for 68% of audit reports. Only 32 % of firms received unmodified or clean audit opinions. This suggests lack of quality financial reporting in majority of commercial state owned entities.

Table 3: Descriptive Statistics Corporate Governance

	N	Minimum	Maximum	Mean	Std. Deviation
Board Independence	75	.0000	.8182	.418494	.1935925
Audit committee activity	75	0	10	3.73	1.766
Firm Size	75	19.9718	26.6293	23.291889	1.7522101

Table 3 presents descriptive statistics for corporate governance. The results indicate board independence had a mean of 41.8% above the Mwongozo target of 30%. Audit committee activity had mean of 3.73 below the minimum target of 4 set by Mwongozo.

Table 4 below presents the Pearson correlation results among the independent variables for the study. The results do not indicate high correlations less than +(-) 80 among the independent variables. This suggests that multi-collinearity problem did not exist, and could not interfere in interpretation of the results.

4.2 Correlation Analysis

Table 4: Pearson Correlations

	Audit committee activity	Board Independence	Firm Size
Audit committee activity	1		
Board Independence	.104	1	
Firm Size	.507	.499	1

4.3 Diagnostic Tests

4.3.1 Hosmer and Lemeshow Test

Table 5: Hosmer and Lemeshow Test

Step	Chi-square	df	Sig.
1	9.641	7	.210

Table 5 presents the Hosmer and Lemeshow test results. The results indicate Chi- square value of (9.641) not statistically significant with p -value (0.21> 0.05). The test results suggest that the model fit was good when compared with the null model. The results mean that the model was good in predicting the dependent variable.

4.3.2 Omnibus Tests of Model Coefficients

Table 6: Omnibus Tests of Model Coefficients

	Chi-square	df	Sig.
Step	20.075	3	.000
Block	20.075	3	.000
Model	20.075	3	.000

Table 6 presents the omnibus test coefficient results. The results indicate chi square value (20.075) that is statistically significant p- values < 0.05. The result suggests that the model fit was good compared with null model. This means that the model was effective in predicting dependent variable.

4.3.3 Accuracy Prediction Test

Table 7: Classification Table

	Predicted		
	Audit opinion		
Observed	unmodified opinion	modified opinion	Percentage Correct
Unmodified Audit opinion	8	16	33.3
modified opinion	6	45	88.2
Overall Percentage			70.7

Table 7 presents the classification statistic. The results indicate that the model had overall prediction accuracy of 70.7%. The classification table proving that the model had a high prediction accuracy of the dependent variable.

4.4 Logistic Regression Results

Table 8: Model Summary

Number of obs	75

LR chi2(3)	20.08
Prob > chi2	0.0002
Pseudo R2	0.2135

Table 8 presents the model summary on testing the hypothesis. The results indicate chi -square value of 20.08 that is statistically significant based on p – values 0.0002< 0.05. In addition, the results indicate Pseudo value of 0.2135 meaning that 21.35% changes in modification of the audit opinion could be explained by the explanatory variables.

Table 9: Model Equation Results

	B	S.E.	Wald	df	Sig.	Exp(B)
ACmeetings	-1.039	.319	10.634	1	.001	.354
PerIND	-2.832	1.689	2.812	1	.094	.059
Fsize	.576	.252	5.207	1	.022	1.778
Constant	-7.322	4.662	2.467	1	.116	.001

a. Variable(s) entered : ACmeetings, PerIND, Fsize.

Table 9 presents the logistic regression model equation results. The results indicate that audit committee meetings had negative coefficient (β-1.039) with an exponential beta (0.354) that was statistically significant with p values < 0.005. The result suggest that number of audit committee meeting as proxy for audit committee diligence negatively and significantly influenced the likelihood of a firm receiving modified audit opinion. The results for board independence indicate (β -2.832) and exponential beta (0.59) that was negative but not statistically insignificant with (p values > 0.05). The result suggest that board independence had negative effect on the likelihood of a firm receiving modified audit opinion in commercial state owned entities although the results were not statistically significant. The results for log of total assets as a measure for firm size and a control variable indicate (β-7.322) with (Exp 1.778) that is statistical significant with P values < 0.05. The result suggesting that firm size a control variable had significant influence on relationship between corporate governance and the modification of audit opinion commercial state owned enterprises in Kenya.

4.5 Conclusions

Overall logistic regression results in model summary in table 8 indicate chi –square value of (20.08) statistically significant with p – values < 0.05). This mean that corporate governance had significant overall effect on modified audit opinion. Results on contribution of each independent variable to the equation indicate; audit committee meetings as proxy for audit committee diligence, negatively and significantly influenced the likelihood of a firm receiving modified audit opinion. The results for board independence indicate negative relationship with modified opinion but not statistically significant. The results further indicating that firm size a control variable significantly influenced relationship between corporate governance and the modified audit opinion commercial state owned enterprises in Kenya.

The conclusion that through corporate governance mechanisms the modified audit can be avoided will interest policy makers and those charged with corporate governance to double their efforts to achieve this. Consequently, ensuring that state owned entities are seen to be accountable and transparent. This will help to attract investors and finding to state owned entities and thus improve their financial performance.

However, this study was only limited to commercial state owned entities in Kenya. It will be important that future studies consider conducting research in non-commercial state owned entities and comparative studies with other countries.

References

Ahmadi,, M. R., Sedghiani, B. A., & Jamali, K. (2014). Economic Consequences Qualified Audit Opinions: Evidence from listed Companies in Tehran Stock Exchange. *Research Journal of Recent Sciences, 3*(10), 89-95.

Aziz, N. A., Ali, Z., Nor, N. M., Baharum, A., & Omar, M. (2016). Modeling multinomial logistic regression oncharacteristics of smokers after the smoke free. *AIP Conference Proceedings.* Sains-Malaysia. Retrieved from https://doi.org/10.1063/1.4954625

Ballesta, J. P., & García-Meca, E. (2005). Audit qualifications and corporate governance in Spanish listed firms. *Managerial Auditing Journal, 20*(7), 725 - 738.

Creswell, J. W. (2014). *Research design : qualitative, quantitative, and mixed methods approaches* (Fourth ed.). London: SAGE Publications, Inc.

Donaldson, L., & Davis, J. (1991). Stewardship theory or agency theory: CEO governance and shareholder returns. *Academy Of Management Review*.

Farinha, J., & Viana, L. F. (2009). Board Structure and Modified Audit Opinions: Evidence from the Portuguese Stock Exchange. *International Journal of Auditing*, 237–258. doi:10.1111/j.1099-1123.2009.00394.x

Habib, A. (2013). A meta-analysis of the determinants of modified audit opinion decisions. *Managerial Auditing Journal, 28*(3), 184-216.

Hay, D., & Cordery, C. (2017). The Value of Public Sector Audit: Literature and History. *Journal of Accounting Literature*, 1-47. Retrieved from https://doi.org/10.1016/j.acclit.2017.11.001

Hsiao, H. F., Lin, S. H., & Hsu, A. C. (2010). Earnings management, corporate governance, and auditor’s opinions: a financial distress prediction model. *Investment Management and Financial Innovations, 7*(3), 29-40.

Jensen, M. C., & Meckling, W. H. (1979). Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of Financial Economics, 3*(4), 305-360.

Jouri, A. (2016). The relationship between auditor's opinions, corporate governance and accounting information quality. *International Journal of Advanced Biotechnology and Research*, 404-408.

Lin, Z., Jiang, Y., & Xu, Y. (2011). Do modified audit opinions have economic consequences? Empirical evidence based on financial constraints. *China Journal of Accounting Research*, 135-154.

Mwongozo. (2015). *Mwongozo the code of governance for state corporations.* Nairobi: Government of Kenya.

OECD. (2015). *The OECD Guidelines on Corporate Governance of State Enterprises.* Paris: Organisation for Economic Co-operation and Development .

Saaydah, M. (2019). Corporate Governance and The Modification of Audit Opinion: A Study in The Jordanian Market. *International Journal of Applied Research in Management and Economics*, 28-46.

SCAC. (2021). *State Corporations Advisory Committee- State Corporations.* Nairobi: Government of Kenya.

World Bank. (2014). *Corporate goevernance of state owned enterprises: Tool Kit.* Washington DC: World Bank.

Yusof, N. Z. (2016). Context Matters: A Critique of Agency Theory in Corporate Governance Research in Emerging Countries. *International Journal of Economics and Financial Issues*, *6*(7), 154-158.