

**RELATIONSHIP BETWEEN COMPLIANCE AUDITING AND  
FINANCIAL REPORTING QUALITY AMONG COMMERCIAL BANKS  
IN KENYA**

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**D61/27785/2019**

**A RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILLMENT OF  
THE REQUIREMENTS FOR THE AWARD OF THE DEGREE OF  
MASTER OF BUSINESS ADMINISTRATION, FACULTY OF BUSINESS  
AND MANAGEMENT SCIENCES, UNIVERSITY OF NAIROBI**

**2023**

## DECLARATION

This research project is my work and has not been submitted for any other academic accreditation at any university

Signature.....

Date.....23/11/2023.....

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**D61/27785/2019**

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

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## **DEDICATION**

To my family for the support they gave me

## **ACKNOWLEDGEMENT**

I thank Allah for His grace that helped me to complete this project. I also thank my supervisor, Dr. Kennedy Okiro for the support, mentorship and guidance, I deeply appreciate that.

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## **ABBREVIATIONS**

<b>CA</b>	Compliance Audit
<b>CBK</b>	Central Bank of Kenya
<b>FRQ</b>	Financial Reporting Quality

## **ABSTRACT**

CA and FRQ were explored in this inquiry borrowing evidence from Kenya's commercial banks. Correlational design was used targeting 39 commercial banks in Kenya. Census aided the inquiry. The period 2018-2022 guided the gathering of primary data. SPSS guided the descriptive as well as inferential processing of evidence. The study noted that internal compliance audit ( $\beta=0.720$ ,  $p<0.05$ ) greatly affected FRQ of commercial banks in Kenya then followed by firm leverage ( $\beta=0.534$ ,  $p<0.05$ ), firm size ( $\beta=0.515$ ,  $p<0.0$ ) and lastly external CA ( $\beta=0.424$ ,  $p<0.05$ ). Hence, CA is a significant predictor of FRQ of commercial banks in Kenya. It was recommended that the management team working among commercial banks in Kenya should invest the returns generated from their use of debts into compliance auditing to improve on their financial reporting quality. The policy makers working with CBK in Kenya should enact strict regulations and guidelines to shape compliance auditing practices in these institutions.

# CHAPTER ONE: INTRODUCTION

## 1.1 Background to the Study

Financial reporting quality (FRQ) enhances the level of trust and confidence of shareholders of the firm in the published financial statements (Irwandi, 2020). Creditors and other lenders are interested in the FRQ as a way of fostering trust in financial statements of the firm (Mungai & Muturi, 2019). Thus, concerns about financial reporting of the firm have potential to threaten its viability and may have result into corporate financial distress in the long run. Compliance audit (CA) has emerged as the best mechanisms that can help the firm to public quality financial reports for public consumption. Through compliance auditing, shareholders are able to establish the extent which managers are adhering to disclosure requirements that support quality financial reporting (Nehmo, 2022).

The study was guided by the agency theory and the stewardship theory. Proposed by Jensen and Meckling (1976), the agency theory will be used to demystify how quality financial reporting mechanisms put in place by managers of the firm can fill the gaps presented by information asymmetry between management and shareholders who are owners of the firm. The theory provides a framework to illustrate how self-interested and opportunistic behavior managers as agents can provide an incentive for them to publish compromised financial statements. On the other, the stewardship theory developed by Davis et al. (1997) is in sharp contrast with the agency theory where it is believed that managers are stewards and lack the opportunistic behavior. As such, it is anticipated from this stewardship theory that CA has an insignificant implication on FRQ.

In Kenya, commercial banks operate in a turbulent and competitive environment. These institutions are regulated by the c (CBK). In the past decade, these institutions have been marred with concerns about their financial reporting qualities (Ngumo, K. Collins & David, 2020). These concerns are demonstrated by collapse of some of the institutions like Chase Bank, Imperial Commercial Bank among others (Harrison, 2021). Given the instrumental role that these institutions play to the economy by facilitating financial inclusion, it is imperative that a study is done to determine the implication of compliance audit on their FRQ hence the motivation of the proposed study.

### **1.1.1 Compliance Auditing**

Compliance audit (CA) is an exercise carried out for assessing and determining the weaknesses of the firm in adherence to established regulations (Bonful, Addo-Lartey, Aheto, Ganle, Sarfo & Aryeetey, 2020). It is defined as a detailed review of the ability of the firm to adhere to established regulations and guidelines. There are various benefits associated with CA, these include helping the firm to determine weaknesses in its ability to comply with regulations. CA provides an avenue where the procedures, policies and operations of the firm can be reviewed comprehensively (Alzeban, 2019).

There are different measures of CA; these include internal and external compliance audits. Internal CA is conducted by staff of the firm and its essence is to provide determination of the total risks involved in compliance and in determination of whether internal guidelines are being adhered to by the firm (Breger, Edmonds & Ortegren, 2020). Internal compliance audit seeks to

determine the objectives established by enterprises versus the established risks and other outputs. On the other hand, external CAs are formal where independent third parties are engaged to conduct the assessment. In external CAs, specified formats are adhered to during the exercise (Bonful et al. 2020). In this study, CA was measured using internal and external compliance audit.

### **1.1.2 Financial Reporting Quality**

FRQ is the attribute that characterizes credibility of the published financial statements in the firm (Ojuwa & Mwangi, 2023). Effective FRQ contribute towards reduction in the information asymmetry between shareholders and managers as per the legal obligations of the firm (Nehmo, 2022). FRQ is defined as faithfulness of accounting related information published by the firm. FRQ can be gauged and determined through qualitative and quantitative approaches. Publication of quality financial statements provides assurance among shareholders and creditors of the firm (Ayinla, Aliyu & Abdullah, 2022).

There are several qualitative measures of FRQ; these include timeliness, relevance, understandability, reliability and accuracy (Sitienei, 2022). Firms should always ensure that accounting information available is relevant to support effective decision making by users. Reliability of financial information implies that there is no biasness thus neutral. Understandability of financial information of an enterprise implies that its users can clearly comprehend it. Timeliness of accounting information is where the company has communicated the same to users in a manner that is timely (Mungai & Muturi, 2019). FRQ in the present study was measured using timeliness, relevance, reliability and understandability.

### **1.1.3 CA and FRQ**

In theory, the relationship between CA and FRQ is mixed. For instance, as per the agency theoretical lenses, a positive or negative but significant nexus is anticipated between these two variables. This is because CA may help to establish the self-interest behavior of managers thus preventing possible compromising of the financial statements (Jensen & Meckling, 1976). The stewardship theoretical lenses indicate that CA has an insignificant implication on FRQ since managers are assumed to lack self-interested behavior (Davis, Schoorman & Donaldson, 1997). Empirically, Nehmo (2022) established that CA has significant effect on FRQ of the firm. Breger, Edmonds and Ortegren (2020) observed that compliance with internal audits standards improves FRQ of the enterprise. Alzeban (2019) indicated that complying with internal audit standards has positive contribution towards FRQ of the enterprise. Ismail (2021) noted that CA significantly influences FRQ. Thus, there exists a relationship between CA and FRQ.

### **1.1.4 Commercial Banks in Kenya**

Commercial banks in Kenya do operate in the larger banking industry. It is the CBK that engage in regulation of these institutions. The role that these institutions play towards the economy of Kenya cannot be underscored (Kori, Muathe & Maina, 2020). This is because they contribute towards financial inclusion, supporting savings and investment. They also contribute towards creation of employment opportunities besides payment of taxes to the government. These institutions also contribute towards overall financial development of Kenya as a country (Ngumo, Collins & David, 2020).

However, in the past decades, some of these institutions had been criticized for publishing controversial financial statements. These include Chase Bank and Imperial Commercial banks among others (Nyabaga & Wepukhulu, 2020). The persistence of this trend of poor financial reporting quality of some of the said commercial banks resulted into their imminent collapse. Given the above stated critical role that these institutions play to the economy, it is imperative to salvage the entire industry from possible collapse (Harrison, 2021). Thus, it is important that an analysis of CA and FRQ of these banks is conducted.

## **1.2 Research Problem**

FRQ is important in helping shareholders and creditors among other stakeholders of the firm to make informed decision making. Publication of quality financial reports is critical in allowing investors to make accurate predictions and investment decisions to maximize their wealth (Breger, Edmonds & Ortegren, 2020). A firm can improve its FRQ through adoption of both internal and external CA. In fact, CA helps a firm to detect the extent of adherence with disclosure requirements (Nehmo, 2022). Hence, a relationship is anticipated between CA and FRQ.

In the past decade, Kenya has experienced corporate collapse of commercial banks like Chase Bank and Imperial Bank. Although this collapse could have been an interaction of a set of factors, Harrison (2021) points out poor FRQ as possible cause of their corporate failure. Although some efforts have been made by CBK to have in place relevant regulations of strengthening their FRQ (Ngumo, Collins & David, 2020), these efforts are yet to bear fruits



given the said corporate collapse of some of these banks. Thus, urgent measures should be made to save other commercial banks from imminent collapse.

The available studies include Breger, Edmonds and Ortegren (2020) who focused on compliance with standards of internal auditing and its link with FRQ and a significant nexus was noted. Alzeban (2019) borrowed evidence from Saudi Arabia and determined the link between compliance with internal standards of auditing and FRQ. It was noted that firms where there are higher compliance with internal audit standards are linked with better outcomes in regard to FRQ. Among small firms in Turkey, Ismail (2021) aimed at providing a determination of compliance and the image at the corporate level where significant interplay was established.

Locally in Kenya, while focusing on commercial state Corporations, Nehmo (2022) covered CA and FRQ where a positive nexus was noted. Machora and Oluoch (2019) focused on attributes of audit committee and the link with FR with emphasis on identified savings and credit cooperatives in Kissi. It emerged that the independence of auditors and FR are negatively linked with each other. Gaitho (2018) did an analysis of FRQ and the practices involved in auditing among Kenya's counties. The study revealed that incomplete financial reports were being maintained by counties which were also unreliable to support the auditing exercise.

However, Ismail (2021) and Alzeban (2019) focused on Turkey and Saudi Arabia and not in Kenya. Other studies like Ismail (2021) focused on corporate image as dependent variable and not FRQ. The study by Nehmo (2022) was done among commercial state corporations and not

specifically commercial banks in Kenya. Thus, to fill these gaps, the below research question was answered: is there a link between CA and FRQ with focus on Kenya's commercial banks?

### **1.3 Research Objective**

The study sought to establish the relationship between compliance auditing and financial reporting quality among commercial banks in Kenya

### **1.4 Value of the Study**

Relevant policies to support effective FRQ would emerge. Policy makers at CBK will be guided in formulation of policies on CA and FRQ among commercial banks in Kenya. This will in turn contribute towards overall stability of the banking sector in general.

Commercial banks in Kenya would be guided coming up with relevant systems to support effective FRQ. Management team working at CBK would utilize findings from this study to make sound decision that enhance FRQ of commercial banks in Kenya. All these are expected to allow commercial banks to achieve financial inclusion in the country.

The study would contribute to theories already in place on these two variables. This has an implication that scholars engaged in related studies in future will have a good opportunity to review information from this inquiry.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.1 Introduction**

Theories that underpinned the variables, the determinants of FRQ and past empirical studies are detailed here. Gaps and conceptual framework are also provided.

#### **2.2 Theoretical Review**

##### **2.2.1 Stewardship Theory**

Davis, Schoorman, and Donaldson (1997) developed this theory and it regards managers are people who lack the selfish behavior. This theory views managers of the firm as stewards who engaged in actions that help to meet the interests of shareholders (Torfinn & Bentzen, 2020). This theory argues that by managers engaging in actions that drive success of the firm, it helps them to achieve their sense of pride (Chrisman, 2019). The argument of this theory is that directors of the firm are guided by similar goals. It also indicate that the level of expertise of every manager is linked with realization of the established goals at firm level (Löhde, Campopiano & Calabrò, 2021).

Being stewards, this theory indicates that managers may not be motivated to misuse and mismanage their firms. The theory is premised on the notion that those in management, directors and shareholders of the are guided by similar goals (Murtaza, Mahmood, Saleem, Ahmad, Sharif & Molnár, 2021). Since managers are regarded to be self-driven, they are unlikely to engage in actions that threaten FRQ. As such, the theory renders CA as insignificant.

### **2.2.2 Agency Theory**

Jensen and Meckling (1976) are its proponents and it offers a framework that helps in analyzing the interaction between those in managerial position and shareholders of the enterprise. The theory regards managers as agents who are obliged to engage in actions that are well aligned with what shareholders being principal's desire (Foreman, Bendickson & Cowden, 2020). However, due to the self-interested behavior of managers, the theory predicts that conflicts of interests may be evident in the course of decision making by managers on behalf of owners of the enterprise (Steinfeld, 2023). An example of the conflicts of interests may arise when managers engage in actions that create a false impression on the quality of the financial reports published by an enterprise. These actions may have long term negative effect on FRQ of the enterprise (Rooly, 2021).

Thus, in effort to curb the said conflicts of interest, shareholders in most firms advocate for CA as well as having in place board of directors (Vitolla, Raimo & Rubino, 2020). Thus, according to this agency theory, the role of CA is to help in curbing negative activities that managers may be motivated to engage like publishing wrong or inaccurate financial statements for public consumption (Naz, Ali, Rehman & Ntim, 2022). This theory guides shareholders to put in place checks and balances like CA aimed at disciplining the actions of management to achieve effective FRQ.

### **2.3 Determinants of FRQ**

The subsequent sections provide discussions on the issues that determine FRQ.

### **2.3.1 Internal and External Compliance Auditing**

Through CA, an organization is able to establish weaknesses in its adherence to disclosure requirements as well as financial reporting requirements. CA helps in determination of whether established accounting standards are being adhered to by the firms ((Nehmo, 2022). External CA being independent can provide a good opportunity for the firm to improve on its FRQ. Hence, CA is expected to influence FRQ of an enterprise (Breger, Edmonds & Ortegren, 2020).

### **2.3.2 Firm Size**

Literature on firm size and FRQ provide mixed results. For instance, Mahboub (2017) established existence of insignificant nexus. Majiyebo, Okpanachi, Nyor and Yahaya (2018) established existence of negative relationship between size of the enterprise and FRQ. Firm size will be measured using logarithm of assets.

### **2.3.3 Firm Liquidity**

Adebayo (2022) indicated that managers in highly liquid firms are unlikely to compromise the quality of information presented in their financial statements compared to less liquid firms. According to Nirwana and Haliah (2018), most firms engage in actions that threaten their FRQ because of low levels of liquidity.

## **2.4 Empirical Review**

Breger, Edmonds and Ortegren (2020) determined how complying with compliance with standards for internal auditing and the implication it has on FRQ. This was a study that was done through systematic review of literature. It emerged that adhering with internal audit

standards contributes towards effective FRQ. Alzeban (2019) did a study on compliance with standards for internal auditing and the link with FRQ borrowing evidence from Saudi Arabia. The inquiry covered listed entities and respondents were the CEOs from these entities. Processed information gave an indication that adherence with internal standards of auditing is linked with better FRQ of the firm.

Focusing on small firms in Turkey, Ismail (2021) did a study covering compliance and the implication it has on the image of a corporate. Information gathering was aided by questionnaire guided by online means. Processed information gave an indication that compliance is strongly connected with the image of the firm. Gerged, Mahamat and Elmghaamez (2020) did a study with focus on compliance with corporate governance and the interlink with selection and quality of the auditors. The context of the study was in United Kingdom (UK) and the period was from 2012-2017. The study noted that in deed, complying with corporate governance has an influence on auditor quality.

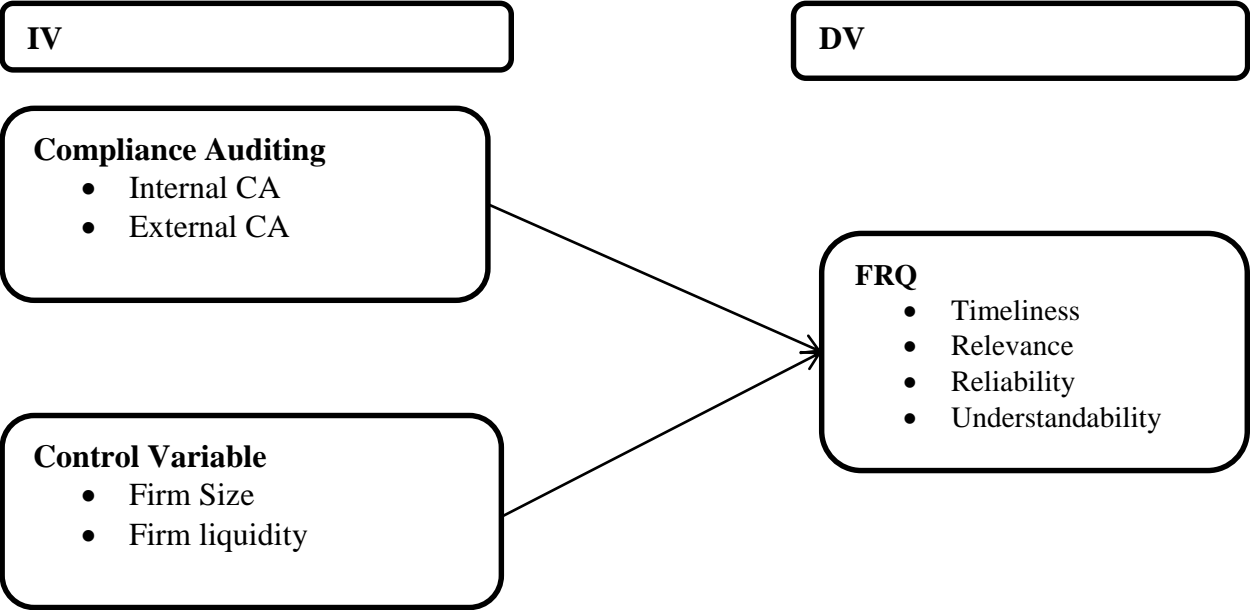
In Kenya, Machora and Oluoch (2019) did a study that focused on attributes of the audit committee and FRQ taking evidence from some established SACCOs in Kisii. Descriptive design was embraced with 166 staff from the said SACCOs being targeted. Processed information was that independence of the auditor and FRQ are negatively connected with each other. Gaitho (2018) carried out an investigation of FRQ and the practices involved in auditing focusing on Kenya's Counties. This study was conducted through desk review and the review of literature showed that auditing practices in the studies counties had a lot of weaknesses.

Mwangi (2018) covered noncommercial state corporations and determined the interplay between the attributes of audit committee and their link with FRQ. In total, 72 enterprises were targeted and included in analysis. The analysis indicated existence of significant link between attributes of audit committee and their link with FRQ.

**2.5 Summary of Literature and Knowledge Gaps**

Breger, Edmonds and Ortegren (2020) adopted systematic review of literature. Alzeban (2019) did a study in Saudi Arabia and not in Kenya. Ismail (2021) used image of a corporate as the dependent variable and not FRQ. Gerged, Mahamat and Elmghaamez (2020) focused on UK and while Machora and Oluoch (2019) used attributes of the audit committee as the independent variable and not CA. Gaitho (2018) used auditing practices as dependent variable.

**2.6 Conceptual Framework**



**Figure 2.1: Conceptual Framework**

## **CHAPTER THREE:**

### **RESEARCH METHODOLOGY**

#### **3.1 Introduction**

The adopted design and participants are covered. The means for gathering and processing of hard statistics are also detailed.

#### **3.2 Research Design**

This study embraced correlational design. As observed by Cresswell and Cresswell (2017), correlational studies are interested in establishing cause and effect nexus in the variables. Through correlational design, the study was therefore in position of establishing the relationship existing between CA and FRQ.

#### **3.3 Study Population**

A total of thirty nine commercial banks operating in Kenya as of December, 2022 were targeted (CBK, 2022) and census were embraced.

#### **3.4 Data Collection**

Information in its first hand and auxiliary nature was obtained in this inquiry. Questionnaire was designed to gather information on CA and FRQ. On the other hand, information on control variables got received from CBK and the banks in question. This information will be gathered on annual basis for a period of 5-years (2018-2022).



### 3.5 Data Analysis

SPSS version 25 aided the processing of data both descriptively and inferentially. The model that helped in analysis is as specified below:

#### 3.5.1 Model Specification

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon$$

Where Y is FRQ (as a composite of using timeliness, relevance, reliability and understandability

$B_0$  = Constant

$\beta_1$ ,  $\beta_2$ , and  $\beta_3$  are Coefficients

$\varepsilon$  = error term

$X_1$  = Internal CA

$X_2$  = External CA

$X_3$  = Firm size

$X_4$  = Firm leverage

$\varepsilon$  = error term

#### 3.5.2 Diagnostic Test

The study tested for multicollinearity, autocorrelation and normality before engaging in regression analysis. These tests were aimed at validating the regression analysis assumptions.

## CHAPTER FOUR: DATA ANALYSIS AND DISCUSSION

### 4.1 Introduction

The chapter details the response rate, descriptive statistics, diagnostic tests and regression analysis results. At the end, discussion is provided in view of the literature reviewed is also provided.

### 4.2 Response Rate

Thirty nine questionnaires were issued out and 33 returned meaning a rate of 84.6 per cent consistent with Babbie (2010).

### 4.3 Descriptive Statistics

Means and standard deviations are shown below.

#### 4.3.1 Internal Compliance Auditing

Table 4.1 is a breakdown.

**Table 4.1: Internal Compliance Auditing**

<b>Statements on Internal Compliance Auditing</b>	<b>Mean</b>	<b>Std. Dev</b>
ICA has strengthened adherence to disclosure requirements in this bank	3.87	.875
ICA has contributed towards adherence to financial reporting requirements in this bank	3.73	.776
ICA is done to establish if this bank has adhered to the established regulations	3.75	.773
During ICA, the operations of this bank are reviewed comprehensively	3.81	.866
<b>Average</b>	<b>3.79</b>	<b>.823</b>

Source: Survey Data (2023)

Table 4.1 shows that on overall, internal compliance auditing was conducted (M=3.79, SD=0.823). It was noted that this internal audit compliance was beneficial to the studied banks through strengthening adherence to disclosure requirements (M=3.87, SD=0.875) and in ensuring comprehensive review of operations (M=3.81, SD=0.866). Internal compliance audit also established if this bank had adhered to the established regulations (M=3.75, SD=0.773) besides contributing towards adherence to financial reporting requirements (M=3.73, SD=0.776).

### 4.3.2 External Compliance Auditing

Table 4.2 gives an overview

**Table 4.2: External Compliance Auditing**

<b>Statements on External Compliance Auditing</b>	<b>Mean</b>	<b>Std. Dev</b>
Independent third parties auditors are engaged to conduct the audit assessments in this bank	4.09	.889
Specific formats are adhered to during ECA in this bank	3.97	.766
The independence of the ECA has improved financial reporting quality in this firm	3.63	.772
ECA aims at determining adherence to the established accounting standards in this bank	3.71	.862
<b>Average</b>	<b>3.85</b>	<b>.822</b>

Source: Survey Data (2023)

Table 4.2 show that external compliance auditing was in place in the studied banks (M=3.8, SD=0.822). Independent third parties auditors were engaged to conduct the audit assessments (M=4.09, SD=0.889) and that specific formats were adhered to during ECA in the banks covered in this study (M=3.97, SD=0.766). ECA aimed at determining adherence to the established

accounting standards in the bank (M=3.71, SD=0.862) and that the independence of the ECA had improved financial reporting quality in the firm (M=3.63, SD=0.772).

### 4.3.3 Analysis on Control Variables

Data on firm size and leverage across the banks that responded to the questionnaire was gathered in a period of years. Thereafter, an average figure across this period of years was taken for the two variables before descriptives were obtained as shown in Table 4.3.

**Table 4.3: Analysis on Control Variables**

	<b>n</b>	<b>Min</b>	<b>Max</b>	<b>Mean</b>	<b>Std. Dev</b>
Firm leverage	33	.22	.70	.4178	.13800
Firm size	33	3.66	8.28	7.2329	1.08378

Source: Survey Data (2023)

From Table 4.3, while firm size had average of 7.2329, firm leverage had 0.4178. This means that while most of the banks were not highly levered, they had a huge proportion of assets in their balance sheets.

## 4.4 Diagnostic Tests

These tests are as presented below:

### 4.4.1 Multicollinearity Test

Table 4.4 is a breakdown of the findings on multicollinearity that were determined through VIF values.

**Table 4.4: Multicollinearity Test**

	Collinearity Statistics	
	Tolerance	VIF
Internal Compliance Audit	.186	5.387
External Compliance Audit	.220	4.547
Firm Size	.881	1.135
Firm leverage	.630	1.587

Source: Survey Data (2023)

Table 4.4 shows that the VIF values for the four variables are all in the range of 1-10, implying absence of multicollinearity assumption.

#### 4.4.2 Autocorrelation Test

Table 4.5 summarizes findings on autocorrelation test

**Table 4.5: Autocorrelation Test**

Model	Durbin-Watson
1	1.506 <sup>a</sup>

Source: Survey Data (2023)

The findings in Table 4.5 show that the value of Durbin Watson Statistic is 1.506 which is closer to 2. This signifies data set was not serially correlated.

#### 4.4.3 Normality Test

Table 4.6 give outline

**Table 4.6: Normality Test**

	<b>n</b>	<b>Skewness</b>		<b>Kurtosis</b>	
	<b>Statistic</b>	<b>Statistic</b>	<b>Std. Error</b>	<b>Statistic</b>	<b>Std. Error</b>
Internal Compliance Audit	33	1.720	.409	2.336	.798
External Compliance Audit	33	.868	.409	-.273	.798
Firm leverage	33	-.988	.409	.914	.798
Firm Size	33	1.000	.409	.075	.798
Finance Reporting quality	33	2.144	.409	2.350	.798

Source: Survey Data (2023)

The Skewness and Kurtosis values are within range +/-3, which means data normally distributed.

#### 4.5 Regression Analysis Results

Table 4.7 gives summary model

**Table 4.7: Model Summary**

<b>Model</b>	<b>R</b>	<b>R Square</b>	<b>Adjusted R Square</b>	<b>Std. Error of the Estimate</b>
1	.867a	.751	.716	.28234

Source: Survey Data (2023)

71.6% variability in FRQ among commercial banks in Kenya was explained by their CA. The ANOVA findings are as shown in Table 4.8.

**Table 4.8: ANOVA Findings**

	<b>Sum of Squares</b>	<b>df</b>	<b>Mean Square</b>	<b>F</b>	<b>Sig.</b>
Regression	6.738	4	1.684	21.131	.000b
Residual	2.232	28	.080		
<b>Total</b>	<b>8.970</b>	<b>32</b>			

Source: Survey Data (2023)

Table 4.8 indicates (F=21.131, p<0.0) meaning model significance Table 4.9 summarizes findings on beta coefficients and significance.

**Table 4.9: Coefficients and Significance**

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	8.927	2.642		3.379	.002
Internal Compliance Audit	.720	.117	.861	6.166	.000
External Compliance Audit	.424	.093	.714	4.552	.000
Firm Size	.515	.114	.868	4.517	.000
Firm leverage	.534	.146	.718	3.662	.001

Source: Survey Data (2023)

From Table 4.9, the following equation is formulated between CA and FRQ:

$$Y=8.927+ 0.720X_1+0.424X_2+0.515X_3+0.534X_4+\varepsilon$$

Where Y is FRQ (as a composite of using timeliness, relevance, reliability and understandability

$\varepsilon$  = error term

X<sub>1</sub>= Internal CA

X<sub>2</sub>= External CA

X<sub>3</sub>= Firm size

X<sub>4</sub>= Firm leverage

ICA compliance audit ( $\beta=0.720$ , p<0.05) had the greatest effect on FRQ of commercial banks in Kenya then followed by firm leverage ( $\beta=0.534$ , p<0.05), firm size ( $\beta=0.515$ , p<0.0) then external compliance audit ( $\beta=0.424$ , p<0.05). It then follows that CA is a significant predictor.

#### **4.6 Discussion**

The findings were that compliance auditing was practiced in the studied banks. More specifically, internal compliance auditing had been greatly adopted by the studied banks compared to external compliance auditing. The finding agrees with Breger, Edmonds & Ortegren, (2020) who noted that there are different measures of CA; these include internal and external compliance audits. Internal CA is conducted by staff of the firm and its essence is to provide determination of the total risks involved in compliance and in determination of whether internal guidelines are being adhered to by the firm. On the other hand, external CAs are formal where independent third parties are engaged to conduct the assessment.

Regression analysis provided an indication that ICA had the greatest effect on FRQ of commercial banks in Kenya then followed by firm leverage, firm size and lastly external compliance audit. Thus, when the size and financial leverage positions of the banks are controlled, compliance auditing would significantly improve their financial reporting. The finding agree with Breger, Edmonds and Ortegren (2020) who focused on compliance with standards of internal auditing and its link with FRQ and a significant nexus was noted. Alzeban (2019) borrowed evidence from Saudi Arabia and determined the link between compliance with internal standards of auditing an FRQ and noted that firms where there are higher compliance with internal audit standards are linked with better outcomes in regard to FRQ., Ismail (2021) aimed at providing a determination of compliance and the image at the corporate level where significant interplay was established. Nehmo (2022) covered CA and FRQ where a positive nexus was noted. Machora and Oluoch (2019) focused on attributes of audit committee and the link with FR with emphasis on identified savings and credit cooperatives in Kisii where it



emerged that the independence of auditors and FR are negatively linked with each other. Gaitho (2018) did an analysis of FRQ and the practices involved in auditing among Kenya's counties and revealed that incomplete financial reports were being maintained by counties which were also unreliable to support the auditing exercise.

## **CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATIONS**

### **5.1 Introduction**

Summarization, concluding and recommending remarks are presented here. Limitations and areas needing more future inquiries.

### **5.2 Summary of the Study**

The findings were that compliance auditing was practiced in the studied banks. More specifically, internal compliance auditing had been greatly adopted by the studied banks compared to external compliance auditing. It was shown that the studied banks had accumulated huge asset base although low degree of financial leverage in the capital structures. This could be an indication that as compared to debts, majority of the studied relied on their assets and perhaps equities to finance lending operations. Regression analysis provided an indication that IAC greatly affected FRQ of commercial banks in Kenya then followed by firm leverage, firm size and lastly external compliance audit. Thus, when the size and financial leverage positions of the bank are controlled, compliance auditing would significantly improve their financial reporting.

### **5.3 Conclusion**

Commercial banks in Kenya have adopted compliance auditing to enhance their operations. These banks have invested more in external as compared to internal compliance auditing. The adoption of compliance auditing has significantly enhanced financial reporting quality of most commercial banks in Kenya. This conclusion rests in the agency theory where compliance

auditing is expected to reduce possible conflicts of interest between shareholders and managers and thus improved financial reporting in the institution.

Firm size and leverage were two variables that controlled the influence of compliance auditing on financial reporting quality. Thus, as compared to small banks, larger ones have a lot of resources to invest in both external and internal compliance auditing so as to enhance their FRQ. Similarly, highly levered firms can optimize the benefits of their debts in terms of interest tax shield to invest in compliance auditing for better financial reporting.

#### **5.4 Recommendations for Management, Policy and Practice**

The management team working among commercial banks in Kenya should invest the returns generated from their use of debts into compliance auditing to improve on their financial reporting quality. These institutions should balance between debts and equities in their capital structures even as they invest in compliance auditing for better financial reporting and maximization of owners' wealth. Recommendations from compliance audits should be fully implemented by the management team working with commercial banks in Kenya. The policy makers working with CBK in Kenya should enact strict regulations and guidelines to shape compliance auditing practices in these institutions.

#### **5.5 Limitations of the Study**

Two indicators of compliance auditing being internal and external CA were covered. It was further limited to a small population of 39 commercial banks making it hard to generalize

evidence to entire financial industry in Kenya. The study was further limited to firm size and leverage as control variables.

### **5.6 Areas for Further Research**

Apart from FRQ, further studies can be conducted to related CA with aspects like operating performance or earnings management. There are other factors which also have an effect on FRQ aside from CA that future studies should seek to establish. Away from commercial banks, other contextual settings .e.g. insurance should be covered in future.

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## APPENDICES

### Appendix I: Questionnaire

#### SECTION A: GENERAL INFORMATION

1. How long has this bank been operation?

Less than 20 years

21-40 years

Over 41 years

2. Kindly indicate the relevant classification of your respective bank based on the three tiers below:

Tier I

Tier II

Tier III

#### SECTION C: COMPLIANCE AUDITING

3. To what extent do you agree with the following statements on compliance auditing Where: 1= Strongly Disagree (SD) 2=Disagree (D) 3= Neutral (N) 4= Agree (A) 5= Strongly Agree (SA)

<b>Statements on Internal Compliance Auditing (ICA)</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
ICA has strengthened adherence to disclosure requirements in this bank					
ICA has contributed towards adherence to financial reporting requirements in this bank					
ICA is done to establish if this bank has adhered to the established regulations					
During ICA, the operations of this bank are reviewed comprehensively					
<b>Statements on External Compliance Auditing (ECA)</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>

Independent third parties auditors are engaged to conduct the audit assessments in this bank					
Specific formats are adhered to during ECA in this bank					
The independence of the ECA has improved financial reporting quality in this firm					
ECA aims at determining adherence to the established accounting standards in this bank					

#### SECTION D: FRQ

4. To what extent do you agree with the following statements on FRQ where: 1= Strongly Disagree (SD) 2=Disagree (D) 3= Neutral (N) 4= Agree (A) 5= Strongly Agree (SA)

<b>Statements on FRQ</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
Financial statements are availed to users on time in your bank					
Relevant information is captured in the financial statements of this bank					
Information included in the financial statements of this bank is reliable					
Details captured in the financial statements of this bank can easily be understood by users					

END

## Appendix II: Data Collection Sheet

<b>Year</b>	<b>Debts</b>	<b>Equities</b>	<b>Total assets</b>
2018			
2019			
2020			
2021			
2022			

### Appendix III: List of Commercial Banks in Kenya

1. NCBA Bank Kenya Plc
2. Equity Bank Kenya Ltd
3. KCB Bank Kenya Ltd
4. Co-operative Bank of Kenya Ltd
5. ABSA Bank Kenya Plc
6. Diamond Trust Bank (K) Ltd
7. Stanbic Bank Kenya Ltd
8. Standard Chartered Bank (K) Ltd
9. I & M Bank Ltd.
10. Family Bank Ltd
11. National Bank of Kenya Ltd
12. Ecobank Kenya Ltd
13. Bank of Africa Kenya Ltd
14. Bank of Baroda Ltd
  
15. Prime Bank Ltd
16. Bank of India
17. Citibank N.A. Kenya
18. HFC Limited
19. Sidian Bank Limited
20. SBM Bank (Kenya) Ltd.
21. Kingdom Bank Limited
22. Access Bank (Kenya) PLC

23. Gulf African Bank Ltd
24. First Community Bank Ltd
25. Consolidated Bank of Kenya Ltd
26. Credit Bank Plc
27. African Banking Corporation Ltd
28. Spire Bank Limited
29. Guaranty Trust Bank (Kenya) Ltd
30. Guardian Bank Limited
31. Paramount Bank Ltd
32. UBA Kenya Bank Ltd
33. M-Oriental Bank Ltd
34. DIB Bank Kenya Ltd
35. Habib Bank A.G. Zurich
36. Middle East Bank Ltd
37. Victoria Commercial Bank Plc
38. Mayfair CIB Bank Ltd
39. Development Bank of Kenya Ltd

Source: CBK (2022)

**Appendix IV: Raw Secondary Data**

<b>Bank</b>	<b>leverage</b>	<b>Firm Size</b>
Equity Bank Kenya Ltd	0.703	8.021
KCB Bank Kenya Ltd	0.697	7.474
Co-operative Bank of Kenya Ltd	0.690	7.631
ABSA Bank Kenya Plc	0.680	7.570
Diamond Trust Bank (K) Ltd	0.590	7.996
Stanbic Bank Kenya Ltd	0.574	7.484
Standard Chartered Bank (K) Ltd	0.569	8.058
I & M Bank Ltd.	0.542	5.283
Family Bank Ltd	0.520	7.647
National Bank of Kenya Ltd	0.464	7.563
Ecobank Kenya Ltd	0.401	8.016
Bank of Africa Kenya Ltd	0.388	7.088
Bank of Baroda Ltd	0.388	7.921
Bank of India	0.383	6.552
Citibank N.A. Kenya	0.375	7.702
Sidian Bank Limited	0.373	7.582
SBM Bank (Kenya) Ltd.	0.367	8.098
Kingdom Bank Limited	0.358	7.164
Access Bank (Kenya) PLC	0.353	7.965
Gulf African Bank Ltd	0.344	6.678
First Community Bank Ltd	0.334	7.726

Consolidated Bank of Kenya Ltd	0.320	7.594
Credit Bank Plc	0.318	8.137
African Banking Corporation Ltd	0.308	7.589
Guaranty Trust Bank (Kenya) Ltd	0.306	8.280
Guardian Bank Limited	0.285	6.678
Paramount Bank Ltd	0.280	7.880
UBA Kenya Bank Ltd	0.279	7.607
M-Oriental Bank Ltd	0.271	6.626
Habib Bank A.G. Zurich	0.218	7.618
Middle East Bank Ltd	0.322	4.541
Victoria Commercial Bank Plc	0.376	3.658
Development Bank of Kenya Ltd	0.411	5.260