Audit Quality, Audit Firm Size and Financial Performance of Listed Commercial Banks in Kenya

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***Abstract*: This study is out to determine the influence of audit quality on financial performance of commercial banks in Kenya. The objectives are to determine; the influence of audit quality on financial performance and to ascertain the influence of capital structure on financial performance. A theoretical and conceptual framework is formed on the basis of previous research. The theories that were reviewed include; agency theory and resource based theory. The study adopts a descriptive research. The study population 'comprises; of "all the 11 commercial banks enlisted at NSE. The data was mined from financial statements for the period 2014-2019. Both descriptive and inferential statistical analysis is applied. Descriptive statistics is used to summarize the observable characteristics of the group in question using metrics such as means standard deviations and variance while inferential statistics such as multiple linear regressions is used in testing the constructed statistical study hypothesis. The results indicate that the independent variables Capital structure and audit quality can be used to explain and can therefore predict financial performance of commercial banks listed in the NSE. The study concludes that audit quality leads to improved financial performance of commercial banks listed in the NSE and thereby can be generalized to the whole banking industry. The study findings indicate that capital structure and audit quality when strategically aligned in combination they will all result in improved performance.**

***Key words*: Capital structure, audit quality, financial performance**

I. INTRODUCTION

Audit quality plays a very significant role in efficient running of any business venture by improving transparency, financial reporting integrity, boost investors' confidence and accountability in allocation of resources to maximize shareholders wealth. Since the emergence of global and local corporate scandals like Enron, Tyco, World Com and famous chase bank in Kenya which resulted to decrease in firm's value and loss of investors' confidence, audit function as a business monitoring tool has gained traction over time (Yahya, Abdullah, Hanim, and Ebrahim, 2012). As pointed out by Jensen and Meckling (1976) in their agency theory, decoupling of management control from firms ownership results to principal-agent conflicts where firm agents act for their interests and give little attention to maximize shareholders wealth. This phenomenon has resulted to huge loss of company resources, poor performance and loss of investors' confidence. Many stakeholders have expressed their concerns on firm's performance and the application of audit has been recognized as one of the ways to enhance firm's value (Sayyar, Basiruddin, Abdulrasid, and Elhabib, 2015).

The study will be anchored on the following theories; agency theory, stewardship theory and resource based theory. Agency theory is founded on the belief of Jensen and Meckling (1976) that unless managers are closely monitored by the shareholders, they will not act in the best interest of the shareholders. The theory posits that separation of firm ownership from managerial control often results to agency conflicts in which manager's act in their best interest and do little if any to maximize the wealth of the firm. This situation diminishes firm's value and lower share holders wealth. To counter this situation, the theory suggests that management should closely be observed by the shareholders. Audit plays a sacrosanct role in monitoring the activities of the management by checking how shareholders' funds have been expended over a given stint of time. Resource based theory opines that board provides critical resources that are required for well-functioning of any firm while stewardship theory assets that people are always pro organization and endeavor to work tirelessly towards accomplishment of its objectives. Because of this belief, the theory regard audit function as unnecessary service that adds to organization costs and diminish the firm value (Donaldson and Davis, 1989).

In Kenya, Cytonn (2018) posits that accept 5 main commercial banks who registered growth in assets, customer base and profits accounting to about 78% of the total profits, all other commercial banks registered a paltry 22%. For instance, in the year 2019, National bank of Kenya and HF group issued profit warnings to its existing and potential shareholders as results of its declining performance (Guguyu, 2019). Moreover, significant numbers of firms quoted at NSE have missed the financial reporting deadlines while others have gone into administration for an assortment of internal and external reasons. In quest to find out the real cause behind this poor performance of quoted commercial banks at NSE, innumerable scholars and practitioners have strived to investigate the issues and turnaround the performance cases of listed commercial banks with no success as evidenced by many profit warnings up to date (Muhatia, 2018). This phenomenon besides lack of an empirical study examines the influence that audit quality does have on performance of commercial banks at NSE has triggered the demand for this inquiry.

II. LITERATURE REVIEW

Ilaboya and Okoy (2015) made inquiry on the nature of the association among audit firm size, non-audit services and audit quality from 2013-2015. The study population comprised of commercial banks enlisted at NISE. A sample of 18 commercial banks participated in the inquiry. The study applied primary data which was collected via use of structured questionnaire which was personally administered to respondents who were picked using purposive sampling approach. Survey design was applied and least square method was used to estimate the relationships. The findings divulged that audit firm size and non –audit services were statistically significant and positively related to audit quality. The study revealed that large sized audit firm enables the auditor to carry out a thorough audit work and acquire comprehensive knowledge of business thus enhancing the quality of audit conducted.

Speckbacher *et al.,* (2003) examined the implication of organization growth and size on firm's performance. In this study, Speckbacher *et al.,* (2003) argued that expansion of the firm size is more likely to lead to more dispersed and complicated management processes. He further postulated that big firms are highly decentralized and scattered over different operating locations which give rise to information overloads to management. Consequently, large firms require a systematic, specialized, formal and sophisticated management control system which give rise to more operational overhead costs and lower the value of the firm. A similar study supporting this negative association between firm size and performance includes studies done by Kartikasari and Merianti (2016).

Moradi, Salehi and Shirdel (2011) researched on relationship between size of audit firm and earning management in quoted companies in Tehran Stock Exchange from 2005 to 2009. The study used survey research design and collected secondary data. The findings revealed that no significant difference companies audited by audit firms and those audited by other members of SCA in Iran. Similarly, Naslmosavi, Sofian and Mohamed Saat (2013) indicated that audit firm size doesn't have any impact on audit opinion though some specific factors such as competence, experience, education and skills do have.

Choi *et al.,* (2004) asserted that the percentage of audit committee members with financial expertise indicates the quality of the AC members in conducting their responsibilities have an impact on firms value. Previous research suggests that financial competency is one of the most important qualities that an AC should possess because all of the major duties of AC members are concerned with accounting, finances and auditing issues (Xie et al., 2003; Tsui and Gul, 2003). The percentage of Independent Non-Executive Directors (INEDs) in an audit committee is another important element of the structure of the AC. The existence of INEDs in an AC enhances the independence of the committee (Tsui and Gul, 2003; Blue Ribbon Committee, 1999; Razaee et al., 2003; Zhang, Zhou and Zhou, 2007). Because a Non-Executive Director (NED) may have business or family relationships with the company's controlling shareholders, an AC composed of more INEDs is perceived to be more independent from management and the largest shareholder and is likely to be more effective.

Muturi and Githire (2015) evaluated the implication of capital structure composition on the profitability of quoted entities at NSE. The study involved all the 67 quoted firms and garnered data for five year tenure starting from 2008 to 2013 from published financial reports. Explanatory research design was applied. Profitability was operationalized using return on asset accounting ratio while capital structure was captured by debt ratios. The data was analyzed using multiple regression analysis and the findings showed that long term loan and equity has a positive implication on the business value. They further avers that long term debt provides ample financial resources which enable the firm to make the most of the investment chances in the market place and enhance its value.

Mwangi and Birundu (2015) tested the role on capital structure on the profitability of small and medium businesses situated at Thika town, Kiambu County. Descriptive research design was applied. The study gathered data from 40 SMES at Thika town for the period commencing from 2009 to 2013. The primary data garnered was subsequently analyzed using multiple regression models. The independent variable was capital structure while asset structure and turnover were applied as control variables. The findings showed that capital structure, asset tangibility and sales turnover have no influence on the way in which small and medium businesses perform.

Mwangi (2018) carried out a study on the influence of business size on value of the commercial banks in Kenya for the period 2007-2016. Size was measured using the natural logarithm of the total firm assets while firm value was operationalized using return on firm assets. The study utilized descriptive research design and relied on secondary data from the published financial statements of 43 commercial banks in Kenya. The results showed that firm's size has a positive implication on the value of the firm. According to Mwangi (2018), large firm size results to lower transaction costs due to benefits associated with economics of scale which boost the financial results.

Research questions: The following research questions guided the study:

1. What is the influence of audit size on financial performance of listed commercial banks in kenya?
2. What is the influence of capital structure on financial performance of listed commercial banks in kenya?

Problem of research

Audit function has significant role in enhancing credibility, transparency and integrity, reliability among other quality of financial information. However, the auditor's role has been a controversial topic in financial sphere since the auditors independence can be impaired by financial and non-financial threats such as auditor's interest in the client business, poor supervision of audit work, provision of non-audit services to the clients among others. This has resulted to creative accounting which has in most cases led to huge loss and collapse of some commercial banks such as chase banks. Regardless of this, audit opinion enhances credibility, quality and improves the consumption of financial information (Mgbame, *et al*., 2012).

Commercial banks in Kenya due to increased competition from the telecommunications industry that have ventured into the preserve of commercial banks (lending and money transfer) which has resulted in drop in profits of tier 2 and tier 3 commercial banks in Kenya (CBK, supervisory report, 2017). Besides the introduction of interest rates capping (2016) has had a negative impact on the revenues of the commercial banks. Under such conditions it is therefore important for commercial banks to at internal factors that can be applied or improved to boost their financial performance.

III. METHODOLOGY OF RESEARCH

General background of research

This study adopted a descriptive research because it provides an objective approach of testing the formulated hypotheses and relationships which falls broadly within the positivist school of thought that posits that the best way to comprehend reality is through the application of the quantitative approaches, scientific and statistical procedures.

Sample of research

The study population 'comprised; of "all the 11 commercial banks enlisted at NSE

Instruments and procedures

The study use secondary data. The data is extracted from financial statements for the period 2014-2019. The study period 2014-2019 is chosen because most commercial banks enlisted at NSE reported huge losses in their financial reports and hence the study would like to investigate whether there is any relationship between audit quality and performance during this period

Data analysis

The study employs Cross sectional data in seeking answers to the research questions. Both descriptive and inferential statistical analysis is utilized. Descriptive statistics is applied in summarizing the observable characteristics of the group in question using metrics such as means standard deviations.

Multiple linear regressions are used in testing the constructed statistical study hypothesis. T test, f-test and p-value are used in testing variable relationships. The findings are presented using tables. The following economic model is used in estimating the relationship between the independent and dependent variables; $Y= \beta0+ \beta1X1+ \beta2X2 +\beta3X3+ \boldsymbol{\varepsilon}$**.** Where Y= Performance – ROA and Efficiency-X1=Audit quality - X2= Capital structure- X3 = Firm size- B1-B3 = Regression Coefficients and **ε**t = error term

IV. RESULTS OF RESEARCH

The populations of under study were all the 12 Banks listed in the Nairobi stock exchange (NSE). The annual financial reports available at the Capital Markets Authority offices were however for 11 Banks companies. This therefore constituted a response rate of 91.6%. Reliability Statistics was carried out and Cronbach's Alpha Cronbach's Alpha was 0.894

Descriptive Statistics

The study examined the relationship between size, discretional accruals, liquidity and firm performance of listed ban in the Nairobi Stock Exchange.

Table 1: Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
ROA 2015	11	.0120	.0560	.031727	.0146976
ROA 2016	11	.0040	.0670	.028818	.0186431
ROA 2017	11	-.0100	.3900	.086727	.1395071
ROA 2018	11	-.0040	.0470	.023364	.0170310
LIQUIDITY 2015	11	.3130	.5290	.405455	.0631496
LIQUIDITY 2016	11	.3000	.7370	.437091	.1551331
LIQUIDITY 2017	11	.2400	.5460	.367091	.0903399
LIQUIDITY 2018	11	.2300	.7370	.387545	.1633275
SIZE 2015	11	7.4090	8.5090	7.963727	.3672648
SIZE 2016	11	7.5180	8.5760	8.086545	.3477089
SIZE 2017	11	7.0610	8.6700	8.048091	.5011412
SIZE 2018	11	7.0000	8.7030	8.061091	.5256726

DIS. ACCRUALS 2015	11	.00	1.00	.8182	.40452
DIS. ACCRUALS 2016	11	.00	1.00	.8182	.40452
DIS.ACCRUALS 2017	11	.00	1.00	.8182	.40452
DIS.ACCRUALS 2018	11	.00	1.00	.8182	.40452

Of the Banks studied, the mean performance indicator was highest at 0.086727 for the year 2017 suggesting that the banks in the Nairobi Stock Exchange are relatively moderated by factors since it is lower before 2017 and after. The mean of the board sizes is highest at 8.061091 for 2018 with a minimum mean7.963727 for 2015. The Bank sizes are relatively clustered around the mean at an average 3 standard deviation away from the mean thereby implying that the commercial banks were averagely had similar sizes. All the banks displayed a similar trend as far as discretionary accruals are concerned mean=0.8182 with a standard deviation of 0. 40452 meaning that on average all banks had provision for audit activity

Regression Analysis

The study applied correlation and regression analyses. The model summary table below reports the strength of the relationship between the model and the dependent variable.

Table 2: Model Summary

Model Summary									
Model	R	R Square	Adjusted R^2	Std. Error	Change Statistics				
					R^2 Change	F Change	df 1	df 2	Sig. F Change
1	.992[a]	.984	.918	.0053400	.984	14.986	8	2	.004
a. Predictors: (Constant), Discreational Accruals 2018, Liquidity 2016, Liquidity 2015, Liquidity 2018, Size 2015, Liquidity 2017, SIZE 2018, SIZE 2016									
b. Dependent Variable: ROA									

As shown in Table 2, the significance value of the F statistic is less than 14.986 (95% confidence interval). This implies that the variation explained by the model is not due to chance. This signals the models' efficiency in estimating the relationship between the dependent and the independent variables. Table 2 further shows that R, the correlation coefficients has a value of 0.992 this signify a linear correlation between the observed and model-predicted values of the dependent variable. R square, the coefficient of determination yielded a value of 0.984. This implies that 98.4% of the variation in ROE is explained by the model or that the model is 98.4 % efficient in estimating the relationship.

Table 3: ANOVA

ANOVA[a]						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.003	8	.000	14.986	.004[b]
	Residual	.000	2	.000		
	Total	.003	10			
a. Dependent Variable: ROA						
b. Predictors: (Constant), Discreational Accruals 2018, Liquidity 2016, Liquidity 2015, Liquidity 2018, Size 2015, Liquidity 2017, Size 2018, Size 2016						

Results in table 3 give the analysis of variances in the regression model. These results indicate that the model had an f-ratio of 14.986 which was significant at 95% level of significance. This result indicates that the overall regression model is statistically significant and is useful for prediction purposes. The ANOVA yielded a P value where p>0.5 at 0.04. This led to the conclusion that there is a statistically significant relationship between Bank performance and audit quality.

Coefficients

The contribution of each independent variable in the model is shown by the size of the coefficient. Table 4 shows the coefficients of the independent variables in the model. The analysis provided results of analysis of variance giving coefficients of the variables. On examining the p-values of these variables, no variable was statistically significant where the level of significance is 0.05.

Table 4: Coefficients

Coefficients[a]						
Model		Unstandardized Coefficients		Stand. Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-.470	.116		-4.055	.050
	LIQUIDITY 2015	-.006	.032	-.022	-.205	.857
	LIQUIDITY 2016	.065	.037	.541	1.741	.224
	LIQUIDITY 2017	-.068	.070	-.328	-.968	.435
	LIQUIDITY 2018	.101	.026	.886	3.958	.058
	SIZE 2015	-.016	.020	-.309	-.789	.513
	SIZE 2016	.021	.046	.393	.457	.692
	SIZE 2018	.053	.023	1.492	2.340	.144
	DIS.ACCRUALS 2018	-.016	.011	-.349	-1.421	.291
a. Dependent Variable: ROA 2016						

The t-ratio for value ROA was -4.055 which was significant at 95% level of significance with a corresponding p value of 0.050 which is equal to 0.5%. This indicates that value of ROA is a significant predictor of profitability of commercial banks. This indicates that as value of liquidity, size and audit quality increases profitability.

The analysis suggests that amongst all the other variables only size 2016, size 2018 and liquidity 2016, liquidity 2018 were positively related to ROA. In summation the linear model for estimating the effect of audit quality and firm size on performance in terms of other variables can be expressed thus: -.470 = 006 + 0.065 – 0.68+ 101 -0.016 +0.021+0.053 3.328 Audit comp + εit

V. DISCUSSION

According to the findings, ROA was an indicator of the proportion of profitability as an indicator of performance for the 11 commercial banks listed at NSE. However the findings indicate that the banks did reflect an upward increase over the 4 year period except 2017, with the highest for liquidity being .437091 in 2016. In addition, the standard deviation depicts a variation in the proportion of size while the discretionally accruals remain the same for the different commercial banks listed at NSE.

The findings further depict the relation between audit quality and performance as a dichotomous variable and assume that since the size of the banks is relatively similar then performance is also associated with capital structure. Although performance is captured by discretionary accruals that are estimated using a cross sectional version of the Jones 1991 model, this study assumes that the fact that all the 11 banks quoted in the NSE depict similar size characteristics then the value of discretionary accruals is therefore equal. Based on the findings of this study, the study concludes that audit size has a significant effect on the financial performance of commercial banks listed in the NSE and capital structure on the affects the performance of banks listed in the NSE.

VI. CONCLUSION

Despite the fact that clears performance measures, coordination, managerial ability and marketing mix are factors leading to overall Bank performance. From the study findings, this study concludes that audit quality leads to improved financial performance of commercial banks listed in the NSE and thereby can be generalized to the whole banking industry. The study findings indicate that a combination of size, capital structure and audit quality when strategically aligned in combination they will all result in positive performance.

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