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EFFECT OF SOUND FINANCIAL AUDITS IN BUILDING FINANCIAL CONFIDENCE: A CASE OF THE DEPARTMENT OF ENTERPRISE DEVELOPMENT IN KENYA

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Abstract

The study sought to establish the effect of sound financial audits with special reference to fraud detection and audit opinion; on building financial confidence. The study was conducted on Department of Enterprise Development Head Quarter in the Ministry of Industrialization and Enterprise Development, Kenya. A cross sectional descriptive design was used. The target population consisted of all the 418 employees of the Department of Enterprise Development. A sample of 81 respondents was selected. It was established that both fraud detection and audit opinion had positive and statistically significant relationship with financial confidence. The study concluded that audit independence is crucial in ensuring effective detection of fraud. In addition, it was noted that the management of the Department of Enterprise Development should promote detection of fraud. The study concluded that audit opinion is not well received by all stakeholders. The audit opinion ought to be impeccable and in line with the Generally Accepted Accounting Principles. Given that audit opinion plays a fundamental role in influencing financial confidence, all stakeholders ought to embrace it. Lastly, organizations are advised to have in place sound financial audits in order to enhance financial confidence amongst all stakeholders.

Keywords: Audit opinion, financial audits, financial confidence, fraud detection, Kenya

INTRODUCTION

Robust financial reporting and auditing framework plays a critical role in instilling confidence to the users of the financial reports. An independent and quality audit provides a necessary external check on the integrity of financial statements. Transparent and credible financial reporting together with an effective audit function underpins confidence in our financial system and is essential for sound economic growth, (Krogstad, Ridley & Rittenberg, 1999). According to Best *et al.* (2001) the importance of the credibility and integrity of the financial reporting and independent audit process has been manifested by the global financial crisis. It is asserted that many countries in the world have been experiencing an increase in corporate failures, financial scandals and audit failure. The foregoing has resulted in dwindling financial confidence amongst the stakeholders. This is due to widening gap between what the stakeholders expect from auditors and the actual audit activity (Dewing & Russel, 2002).

Following the collapse of Enron and other high profile corporate scandals and the subsequent collapse of the accounting firm Arthur and Anderson, doubts have been raised over the benefits of auditing compared to its cost. In addition, there lies an expectation gap between the users of financial statements and the auditing profession, which could damage the essence of the auditing profession, that is, trust and these led to the responsibility and quality of audit came under intense scrutiny on an international scale (Fadzly & Ahmad, 2004). Government, regulators and other stakeholders asked many hard questions about audit and the auditing profession. The very public debate that ensued on the role and quality of audit brought the auditing profession centre stage and resulted in significant changes in how auditors are regulated and the way in which auditors communicate and interact with regulators and other stakeholders.

The Kenyan Companies Act (Chapter 486, Laws of Kenya), like most Commonwealth countries, is based on and is substantially the same as the UK Companies Act of 1948 (Ogola, 2000). The Kenyan Companies Act sets the general framework for financial accounting and reporting by all registered companies in Kenya, and stipulates the basic minimum requirements with regard to financial reporting. Due to the limited details of the Act, financial reporting and regulation are supplemented by pronouncements of the Institute of Certified Public Accountants Kenya (ICPAK), extensively manifested in the adopted International Financial Reporting Standards. Kamau (2013) examined the determinants of audit expectation gap as evidenced by limited companies in Kenya. The author noted that the auditor’s role is to provide objective assurance regarding whether the books of accounts and financial statements of an organization reflect a true and fair view. Financial confidence can be enhanced by effectiveness of audit activities.

In a study on the impact of risk-based audit on financial performance in commercial banks in Kenya, Mutua (2012) underscored the importance of enhancing internal audit standards and internal audit staffing. The argument of enhancing the foregoing stemmed from the reasoning that this would enable an organization to detect risks timely and also concentrate on high risk areas. This would then result in increased transparency and accountability, therefore, enhancing financial performance.

The Department of Enterprise Development formerly the Ministry of Cooperative Development and Marketing (MOCDM) is situated at the NSSF Building Upper Hill, Nairobi, Kenya. In the Department, the internal and external auditors have the mandate from the Treasury and the Kenya National Audit Office (KENAO) to oversee the activities of the Department of Enterprise Development. The Internal Audit Department is one of the departments within the National Treasury. It supports Accounting Officers and AIE Holders in the Ministries, Departments, and Districts in the effective discharge of their responsibilities by measuring, evaluating and reporting on the effectiveness of the internal control systems, implemented by the Accounting Officers and AIE on appropriate assessment of risk and adoption of strategies to manage risks to within acceptable levels; compliance with applicable policies, procedures, laws and regulations (Mutiri, 2013).

Statement of the Problem

Independent audit of financial statements has long been associated with the role of assurance, from which the credibility of information presented by the management is, to a certain extent, guaranteed. This distinctive role of audit, however, has led to varying perceptions over the level of assurance that could be expected from auditors. It is indeed, ironical that whilst the auditing profession enunciates the importance and high quality nature of independent audit, users of financial statements perceive that auditors provide a “perfect” assurance. Most commonly, users would hold auditors legally liable for a “perfect” assurance, and they are not fully to blame for having high expectations of audit.

A number of challenges facing organizational auditor’s reported opinion including and not limited to loss of revenue, market internalization, inability to keep pace with IT development, and inability of the auditors (internal and external) to advice management on best internal controls (Keitany, 2000). A question is left unanswered as to whether auditors should be among the ones to blame when organizations are at the point of collapsing due to the significant role the play of auditing and evaluating financial information. In most state owned organization; the external auditors are mostly accused for failure to alert the public on the financial status of the supermarket despite them giving the company a clean audit report on the published accounts.

Some financial issues that lead to the collapse of companies include; external auditors mistakes, corporate governance issues, accounting issues and derivative issues. However, nothing was mentioned on effects sound financial audits in building financial confidence which is where auditing functions falls (Jickling, 2002). However, there is no study hitherto carried out on the effect of sound financial audits in building financial confidence; a factor that necessitated the present study.

Research Objectives

General Objective

To determine the effect of sound financial audits on building financial confidence in the Department of Enterprise Development in Kenya

Specific Objectives

i. To establish the effect of fraud detection on building financial confidence in the Department of Enterprise Development in Kenya.
ii. To establish how audit opinion affects in building financial confidence in the Department of Enterprise Development in Kenya

Research Questions

i. What is the effect of fraud detection on building of financial confidence in the Department of Enterprise Development in Kenya?
ii. How does audit opinion affect building financial confidence in the Department of Enterprise Development in Kenya?

THEORETICAL REVIEW

Policeman Theory

James (2003) contends that the auditor is responsible for searching, discovering and preventing fraud. In the early 20th century this was certainly the case. However, more recently the main focus of auditors has been to provide reasonable assurance and verify the truth and fairness of the financial statements. The detection of fraud is, however, still a hot topic in the debate on the auditor’s responsibilities, and typically after events where financial statement frauds have been revealed, the pressure increases on increasing the responsibilities of auditors in detecting fraud (Krishnan, 2005).

Agency Theory

Jensen and Meckling, (1976) suggested that the auditor is appointed in the interests of both the third parties as well as the management. A company is viewed as a web of contracts. Several groups (suppliers, bankers, customers, employees) make some kind of contribution to the company for a given price. The task of the management is to coordinate these groups and contracts and try to optimize them: low price for purchased supplies, high price for sold goods, low interest rates for loans, high share prices and low wages for employees. In these relationships, management is the agent, which tries to gain contributions from principals such as bankers, shareholders, employees amongst others (Watts & Zimmerman 1986).

EMPIRICAL REVIEW

Fraud Detection and Financial Confidence

In recent years the importance of good corporate governance has received significant public and regulatory attention. A crucial part of an entity's corporate governance is its internal audit function. At the same time, there has been significant public concern about the level of fraud within organizations. According to global Common Body of Knowledge (2006) there is a paradigm shift in the activities performed by internal auditors. The increasing complexity of business transactions, a more dynamic regulatory environment and significant advances in information technology have resulted in opportunities and challenges for internal auditors. Although there has been a response to the changing organizational environment by updating the professional practices framework, more work needs to be done to prepare internal auditors for the expanded set of skills and knowledge required to perform audits of the future (Ghosh & Lubberink, 2006).

According to Fadzly and Ahmad (2004), organizations with an internal audit function are more likely than those without such a function to detect fraud within their organizations. Further, organizations that rely solely on outsourcing for their internal audit function are less likely to detect fraud than those that undertake at least part of their internal audit function themselves. These findings suggest that internal audit adds value through improving the control and monitoring environment within organizations to detect fraud. These results also suggest that keeping the internal audit function within the organization is more effective than completely outsourcing that function. The guidelines of ISA 240 Fraud and Error ensure accountability is achieved since there will be detection of frauds or establish that there is no fraud at all and this is majorly due to the existence of effective audits.

Audit Opinion and Financial Confidence

An auditor's report is considered an essential tool when reporting financial information to users, particularly in business. Since many third-party users prefer, or even require financial information to be certified by an independent external auditor, many auditees' rely on auditor reports to certify their information in order to attract investors, obtain loans, and improve public appearance. Some have even stated that financial information without an auditor's report is "essentially worthless" for investing purposes. It is important to note that auditor's reports on financial statements are neither evaluations nor any other similar determination used to evaluate entities in order to make a decision. The report is only an opinion on whether the information presented is correct and free from material misstatements, whereas all other determinations are left for the user to decide as the Auditor's Report on Financial Statements.

Guided by ISA 700 (Revised) there are four common types of auditor's reports, each one presenting a different situation encountered during the auditor's work. Unqualified Opinion is regarded by many as the equivalent of a "clean bill of health" to a patient, which has led many to call it the clean opinion, but in reality it is not a clean bill of health. This type of report is issued by an auditor when the financial statements presented are free from material misstatements and are represented fairly in accordance with the Generally Accepted Accounting Principles (GAAP), which in other words means that the company's financial condition, position, and operations are fairly presented in the financial statements. It is the best type of report an auditee may receive from an external auditor.

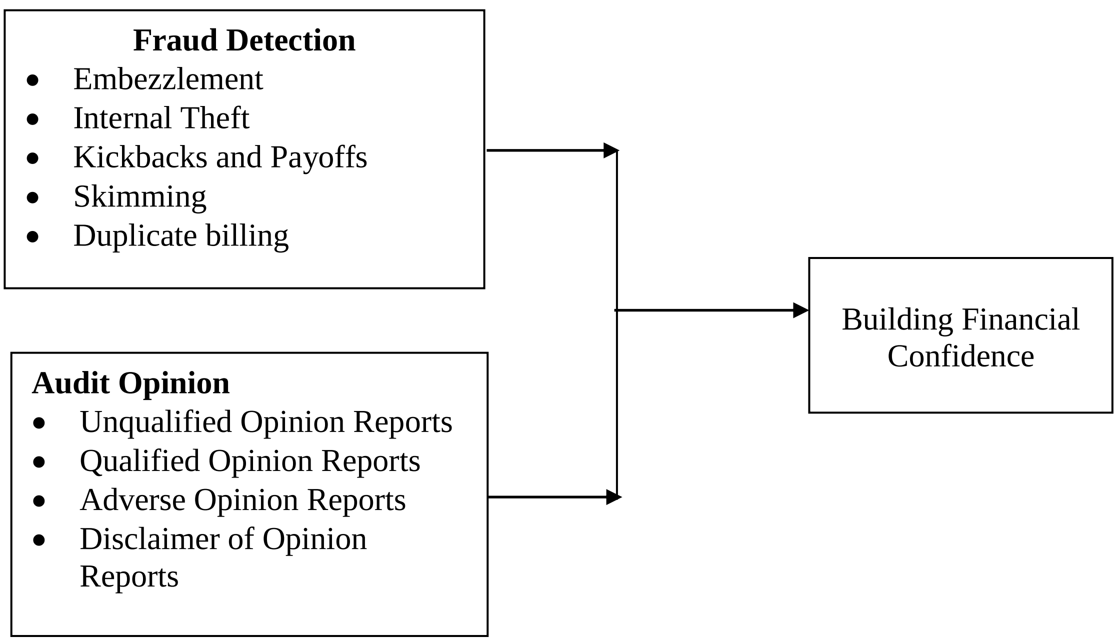
Qualified opinion report is issued when the auditor encountered one of two types of situations which do not comply with Generally Accepted Accounting Principles, however the rest of the financial statements are fairly presented. This type of opinion is very similar to an unqualified or "clean opinion", but the report states that the financial statements are fairly presented with a certain exception which is otherwise misstated. According to Hodge *et al* (2004) this type of opinion is issued when one or more areas of the financial statements do not conform with GAAP, but do not affect the rest of the financial statements from being fairly presented when taken as a whole and when there is limitation of scope occurs when the auditor could not audit one or more areas of the financial statements, and although they could not be verified, the rest of the financial statements were audited and they conform GAAP.

Adverse opinion is issued when the auditor determines that the financial statements of an auditee are materially misstated and, when considered as a whole, do not conform to GAAP. It is considered the opposite of an unqualified or clean opinion, essentially stating that the information contained is materially incorrect, unreliable, and inaccurate in order to assess the auditee's financial position and results of operations. Investors, lending institutions, and governments very rarely accept an auditee's financial statements if the auditor issued an adverse opinion, and usually request the auditee to correct the financial statements and obtain another audit report. Disclaimer opinion is issued when the auditor could not form, and consequently refuses to present, an opinion on the financial statements. This type of report is issued when the auditor tried to audit an entity but could not complete the work due to various reasons and does not issue an opinion.

Conceptual Framework

Rudestam and Network (1992) define conceptual framework as a less developed form of theory and consisting of statements that link abstract concepts to empirical data. The conceptual model shown in Figure 1 outlines the relationship between each of the two independent variables (fraud detection and audit opinion) and the dependent variable (building financial confidence).

Figure 1: Conceptual Framework



RESEARCH METHODOLOGY

Research Design

Research design provides the conceptual framework within which research is conducted; it constitutes the blueprint or roadmap for the collection, measurement and analysis of data (Kothari, 2008). The research design adopted was a cross sectional descriptive design. According to Cooper and Schindler (2000), a descriptive research design is concerned with finding out the; who, what, where, when and how much. The design was appropriate because the main interest was to explore the viable relationship and describe how the factors support matters under investigation. A cross sectional study looks at data collected across a whole population to provide a snapshot of that population at a single point in time. Descriptive design method provides quantitative data from cross section of the chosen population. This design provided further insight into research problem by describing the variables of interest.

Target Population

Target population constitutes of all elements sharing similar characteristics. In simpler terms, it is the population to which the study findings are generalized. This population consisted of all the 418 employees of the Department of Enterprise Development in the Ministry of Industrialization and Enterprise Development that are based at the headquarters.

Sampling Frame

A sampling frame outlines an exhaustive list of all members of the target population from which the sample is drawn. Table 1 outlines the distribution of target population or in other words, the sampling frame.

Table 1: Sampling Frame

Category	Population (N)	Percentage (%)
Managers	56	13.4
Middle level employees	94	22.5
Junior employees	268	64.1
Total	**418**	**100.0**

Sample Size and Sampling Technique

Sampling is the process of selecting a sufficient number of elements from the population so that a study of the sample and an understanding of its properties would make it possible to generalize such properties. A good sample is said to be a representative of the entire population (Kothari, 2004). Stratified random sampling was adopted to draw a sample from the target population since the latter constituted three distinct groups or strata (managers, middle-level employees and junior employees). According to Cooper and Schindler (2001), stratified sampling gives increase in statistical efficiency on a sample and provides adequate data for analyzing various sub-populations thus enabling the uses of different research methods and procedures to be used in different strata. The study employed Nassiuma's (2000) formula to determine the sample size as outlined hereunder

$$n = \frac{NC^2}{C^2 + (N-1)e^2}$$ Where

n = sample size;

N = population size;

C = coefficient of variation which is 50%

e = error margin which is 0.05.

Substituting these values in the equation, estimated sample size (n) was:

$$n = \frac{418\,(0.5)^2}{0.5^2 + (418-1)0.05^2}$$

n = 80.85

n = 81 respondents

Data Collection Instrument

The study employed a structured questionnaire to collect data from the sampled respondents. A questionnaire is a useful tool for collecting data from respondents because of the need to provide a means of expressing their views in a structured manner. The questionnaire consisted of both open and closed ended questions designed to elicit specific responses for analysis. Likert scale was chosen since these types of questions are easy for respondents to answer and also facilitate effective analysis of the collected data. The data collected from the sampled respondents was on a 5-point Likert scale ranging from 1 to 5 which represented strongly disagree, disagree, neutral, agree, and strongly agree respectively.

Pilot Testing

A pilot study that involved a section of the target population was conducted. The participants were essentially excluded from the main study. That is, the group of respondents in the pilot study was not interviewed in the final study. In cases where the researcher found out that some parts of the data collection instrument were not meeting their intended purpose or not understood by the pilot respondents, they were modified. The major essence of piloting the research instrument was to assess both its reliability and validity.

Reliability, according to Gregory (2006) refers to consistency in measurement providing a measure to determine how repeatable the results are. The Cronbach alpha was used to test for reliability where all the five study constructs (fraud detection, audit system, controls, audit opinion and building financial confidence) returned alpha values greater than 0.7 (α > 0.7). Therefore, the instrument was deemed reliable. In addition, the content validity of the instrument was determined by seeking expert opinion of the assigned university supervisor since this type of validity could not statistically be determined (Kimberlin & Winterstein, 2008).

The data collected was processed in order to check out for completeness, inconsistencies, degree of uniformity and also check for irrelevant data. The data was then coded and fed to the computer in order to facilitate necessary analysis. The study employed two types of data analyses namely descriptive and inferential analysis. The descriptive analysis incorporated frequencies, percentages, means and standard deviations. Inferential analysis was in form of Pearson's correlation. The study findings were in form of statistical tables.

ANALYSIS

Descriptive Analysis for Fraud Detection

Table 2: Descriptive Statistics for Fraud Detection

		n	Min	Max	Mean	Std. Dev
i.	Audit independence is paramount for effective fraud detection	67	2	5	4.72	.813
ii.	Detection of fraud by the internal and external audits regularly affects users	67	3	5	4.40	.629
iii.	Effective audits are very important in the department	67	2	5	4.31	.891
iv.	Leadership in the department promotes detection of fraud during auditing	67	2	5	3.70	.969
v.	Auditing environment promotes and recognizes the importance of effective audits	67	2	5	3.36	.900
vi.	I am satisfied with the departments audit in view of building financial confidence	67	2.0	5.0	3.36	.829

The study indicated that the respondents strongly agreed (mean = 4.72; std dev < 0.813) that audit independence is paramount for effective fraud detection. In the same light, they were in agreement (mean ≈ 4.00; std dev < 1.000) that detection of fraud by the internal and external audits regularly affects users; effective audits are very important in the department; and that leadership in the department promotes detection of fraud during auditing. However, the respondents were non-committal (mean ≈ 3.00; std dev < 1.000) whether auditing environment promotes and recognizes the importance of effective audits; and if the respondents were satisfied with the departments audit in view of building financial confidence.

Descriptive Analysis for Audit Opinion

Table 3: Descriptive Statistics for Audit Opinion

		n	Min	Max	Mean	Std. Dev
i.	The issuance of unqualified opinions by the auditors of financial statements affects the users' financial confidence	67	4	5	4.66	.478
ii.	Adverse opinions of internal controls affect the users' financial confidence	67	4	5	4.60	.494
iii.	Audit opinion is in line with Generally Accepted Accounting Principles (GAAP)	67	3	5	3.66	.617
iv.	Our department regularly receives audit opinion	67	1	5	3.58	.708
v.	Qualified audit opinion report tallies with the department's internal controls	67	1	5	2.66	.993
vi.	Audit opinion is well received by all stakeholders in the department	67	1	5	2.10	1.304

Respondents strongly agreed (mean ≈ 5.00; std dev < 1.000) that the issuance of unqualified opinions by the auditors on financial statements affects the users' financial confidence, and that adverse opinions of internal controls affect the users' financial confidence. In addition, it was concurred (mean ≈ 4.00; std dev < 1.000) that audit opinion is in line with Generally Accepted Accounting Principles; the Department regularly receives audit opinion; and that qualified audit opinion report tallies with the Department's internal controls. However, it was disputed (mean = 2.10; std dev = 1.304) that audit opinion is well received by all stakeholders in the Department.

Descriptive Analysis for Financial Confidence

Table 4: Descriptive Statistics for Financial Confidence

		n	Min	Max	Mean	Std. Dev
i.	Audit opinion is valued in respect of user's financial confidence	67	2	5	4.64	.829
ii.	The effectiveness of audit system enhances users' financial confidence	67	2	5	4.27	.809
iii.	Financial confidence is influenced by fraud detection	67	2	5	4.27	.898
iv.	Controls affect user's financial confidence	67	2	5	4.04	.706

It was strongly agreed (mean = 4.64; std dev = 0.829) that audit opinion is valued in respect of user's financial confidence. It was further agreed (mean ≈ 4.00; std dev < 1.000) that the effectiveness of audit system enhances users' financial confidence; financial confidence is influenced by fraud detection; and that controls affect user's financial confidence.

Inferential Analysis

Effect of Fraud Detection on Financial Confidence

Table 5: Correlation between Fraud Detection and Financial Confidence

		Financial Confidence
Fraud Detection	Pearson Correlation	.697**
	Sig. (2-tailed)	.000
	n	67

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

It was established that there exists a strong, positive and statistically significant relationship between fraud detection and financial confidence ($r = 0.697$; $p < 0.01$). The results indicated that the more fraud is detected the more stakeholders of the Department of Enterprise Development will have financial confidence and the reverse is true. The results underscored emphasis on fraud detection in light of financial confidence.

Effect of Audit Opinion on Financial Confidence

Table 6: Correlation between Audit Opinion and Financial Confidence

		Financial Confidence
Audit Opinion	Pearson Correlation	.834
	Sig. (2-tailed)	.000
	n	67

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

It was established that there exists a strong, positive and statistically significant relationship between audit opinion and financial confidence ($r = 0.834$; $p < 0.01$). In other words a change in audit opinion had strong and similar ramifications on financial confidence.

Effect of Sound Financial Audits on Financial Confidence

Generally, the study examined how sound financial audits affect financial confidence at the Department of Enterprise Development. This was achieved by regressing the various components of financial audits (fraud detection and audit opinion) against financial confidence. Table 7 outlines the results of the foregoing regression analysis.

Table 7: Results of Multiple Regression Analysis

Coefficients[a]

Model	Unstandardized Coefficients B	Unstandardized Coefficients Std. Error	Standardized Coefficients Beta	t	Sig.
1 (Constant)	2.920	.465		6.280	.000
Fraud Detection	1.250	.104	1.038	12.021	.000
Audit Opinion	1.672	.014	1.198	15.840	.000

a. Dependent Variable: Financial Confidence

Regression model: $Y= \beta_0 + \beta_1X_1+ \beta_2X_2 + \varepsilon$

The model is interpreted as shown:

Financial Confidence = 2.920 + 1.250 Fraud Detection + 1.672 Audit Opinion

The results of the regression analysis implied that all the two elements of sound financial audits had positive implication on financial confidence at the Department of Enterprise Development. However, it is clear that the audit opinion was the most consequential on financial confidence at the Department. The analytical results indicate that it is crucial to ensure soundness of financial audit since the undertaking is bound to enhance significantly the financial confidence amongst the stakeholders of the aforesaid Department.

SUMMARY

The study indicated that the respondents strongly agreed that audit independence is paramount for effective fraud detection. In the same light, they were in agreement that detection of fraud by the internal and external audits regularly affects users; effective audits are very important in the department; and that leadership in the department promotes detection of fraud during auditing. However, the respondents were non-committal whether auditing environment promotes and recognizes the importance of effective audits; and if the respondents were satisfied with the departments audit in view of building financial confidence. It was established that there exists a strong, positive and statistically significant relationship between fraud detection and financial confidence ($r = 0.697$; $p < 0.01$).

It was strongly agreed that the issuance of unqualified opinions by the auditors on financial statements affects the users' financial confidence, and that adverse opinions of internal controls affect the users' financial confidence. In addition, it was concurred that audit opinion is in line with Generally Accepted Accounting Principles; the Department regularly receives audit opinion; and that qualified audit opinion report tallies with the Department's internal controls. However, it was disputed that audit opinion is well received by all stakeholders in the Department. There exists a strong, positive and statistically significant relationship between audit opinion and financial confidence ($r = 0.834$; $p < 0.01$).

It was strongly agreed that audit opinion is valued in respect of user's financial confidence. It was further agreed that the effectiveness of audit system enhances users' financial confidence; financial confidence is influenced by fraud detection; and that controls affect user's financial confidence. The results of the regression indicated that sound financial audits had positive implication on financial confidence at the Department of Enterprise Development.

CONCLUSIONS

The study concluded that audit independence is crucial in ensuring effective detection of fraud. In addition, it was noted that the management of the Department of Enterprise Development should promote detection of fraud. Moreover, it was inferred that fraud detection plays an important role in enhancing financial confidence. The study inferred that the issuance of unqualified opinions by the auditors on financial statements affects the users' financial confidence. The audit opinion was found to tally with the Generally Accepted Accounting Principles. Though the Department of Enterprise Development receives audit opinion and the same concurs with the Department's internal controls, the study concluded that audit opinion is not well received by all stakeholders. This is in spite of the audit opinion being very important in influencing financial confidence.

RECOMMENDATIONS

i. It is vital to acknowledge and appreciate the role played by auditing in detecting fraud. The foregoing is based on the argument that by auditing financial books, an entity is at a vantage position to detect fraud.

ii. The audit opinion ought to be impeccable and in line with the Generally Accepted Accounting Principles. Given that audit opinion plays a fundamental role in influencing financial confidence, all stakeholders ought to embrace it.

iii. Lastly, organizations and/or corporations are advised to have in place sound financial audits in order to enhance financial confidence amongst all stakeholders.

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