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FACULTY OF BUSINESS AND MANAGEMENT SCIENCES

DEPARTMENT OF FINANCE & ACCOUNTING

POLICY BRIEF

RESEARCH	Corporate Governance and Modification of Audit Opinion: Evidence from State Owned Enterprises in Kenya By: Oruke M., Iraya C.M, Omoro N.O & Odhiambo L.O
SUMMARY	*State owned enterprises lack comprehensive legal framework policy to safeguard sound operations and performance. This is evidenced by over relying on the Mwongozo (2015) as a major guideline for its operations. This policy brief recommends that SOEs adopt other laws or high-level policy document that can help in enhancing corporate governance mechanisms with a view to reduce modified audit opinion among SOEs. This is due to the increasing trend in the reporting of modified audit opinion in SOEs in Kenya which has a greater impact on the stakeholders' decision making and level of integrity among the SOEs management. Modified audit opinion is caused by various factors but not limited to corporate governance mechanisms, hence, seriously need a comprehensive legal and institutional framework policy that can handle the negative trend in the modification of the audit opinion that may affect the investors' decisions negatively.* *Modified audit opinion has greater impact on stakeholder's reaction to investment decisions and upholding the integrity of the senior management and directors of these entities. The modified audit opinion is issued under the three forms; qualified, adverse and disclaimer opinions. All these forms show that the financial statements have discrepancies ranging from minor to pervasive ones. Hence, the research examined the relationship between board structure and audit opinion in commercial state-owned enterprises in Kenya with a view of coming up with comprehensive policy frame work for safe guiding reporting in the SOEs.*
INTRODUCTION	This policy brief is based on the research findings reported by the faculty staff extracted from a published PhD thesis at faculty of business and management sciences under the supervision of Faculty staff from the department of Finance and accounting. The research was informed by the debate over transparency and accountability that has gained significant attention both in the private and public sectors, as a response to a series of

scandals in several corporations globally. The epicenter of this debate is the role the board of directors' play through governance mechanisms to constrain these scandals and ensure transparency and accountability. SOEs in Kenya are mainly guided by Mwongozo (2015) code for state corporations and various legislations that gives direction on how these corporations should be controlled and directed. Conclusions from this study proves useful to boards of various state-owned enterprises and those charged with directing and control in SOEs. The findings are useful to the government for policy making and other stakeholders including parliamentary committees; public account's committee and public investments committees that oversight these SOEs. Other interested groups include state advisory committee, line ministries and investors. The key stakeholders mentioned draw benefit from the research recommendations on the best practices on board performance leading to increased transparency and accountability.

The government of Kenya has partially implemented reforms outlined in the Presidential Taskforce Report (2013) that can move State Corporations management and monitoring toward global best practice, but the remaining agenda is significant in the realization of this objective. In fact the government has made some strong efforts to implement important improvements in State Corporation oversight, such as the creation of the "Mwongozo" governance code. However, challenges in State Corporations performance monitoring, including low transparency in operations and relations with the government, challenges in the internal and external audit functions, as well as fragmentation and implementation gaps of the legal framework persist as reported from similar studies. Many of the far-reaching reforms have not been implemented fully. Reforms need to take into account what is politically feasible and institutionally manageable. Kenya may thus benefit from a sequenced reform approach that allows to build capacities and confidence over time to build towards far-reaching changes.

Based on our results of the research, board structure variables namely, board independence, board size, and audit committee meetings had a significant effect in predicting the odds of a firm receiving unqualified and qualified opinion when compared with the disclaimer opinion as the reference category. However, the results reveal worrying trend as majority of commercial state owned entities in Kenya received modified opinions; qualified opinion accounting for 64.7 % of the audit opinions, 0.7% of Commercial SOEs received adverse opinions and 2.5% disclaimer audit opinion. Only 32% of commercial state owned enterprises in Kenya received unqualified opinion or clean reports. Therefore, findings that board size significantly affects the reporting quality, is in agreement with other empirical results that were reviewed.

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KEY RECOMMENDATIONS	The likelihood of the Auditor General issuing modified opinion among SOEs is bound to be on the increasing trend if a number of issues are not addressed bringing to doubt the effectiveness of governance mechanism in place of these entities. This higher numbers is an indication of lack of accountability and transparency in these SOEs. The recommendations are as follows: 1. Prompt action by the policy makers is needed to protect the SOEs from this adverse effect from poor accountability and transparency. This can be achieved through full implementation of the reforms in the public sector e.g. Presidential Task Reforms of 2013. 2. Appointment of board members should be in line with corporate governance requirement accepted globally but also within the legal framework to avoid litigation cases. 3. Provide short – term measures by vigorously adhering to the Mwongozo guidelines of the 2015 code. The relevant oversight institutions need to ensure compliance, strengthen and revise the Mwongozo accordingly to bridge the gaps identified since its adoption. Enforcing Mwongozo more vigorously and make compliance with it public. 4. Full implementation of corporate governance and procedures by state owned enterprises in Kenya. 5. Continuous training and sensitization of staff on relevant corporate governance regulations and practices, monitoring and evaluation procedures. 6. Strict enforcement of recommendations emanating from legal or financial audits. 7. Realignment of the role played by the oversight bodies in Kenya with a view of removing duplication of roles. 8. Management of stakeholders' relationship in a proactive manner.
POLICY IMPLICATIONS	• Develop sound legal framework and institutional structures to control or manage issues leading to the qualification of the audit report by the auditor general. • Develop and institutionalize a broad risk management framework and strengthen internal controls framework. • Put in place stringent policy on various types of audit conducted in the public sector in general. The policy should not be limited to regulatory/ financial audits only. • Strengthen public audit accountability in Kenya by harmonizing all the relevant Acts, regulations and laws • Revisiting the level of implementation of the presidential taskforce report of 2013 and identify challenges emanating from the full implementation.
CONCLUSION	We have found out that SOEs boards in Kenya are bloated, and mostly had not complied with the requirements of Mwongozo code. The implication is that despite the presence of Mwongozo, majority of SOEs boards had not adhered to Mwongozo code requirement, thus level of compliance was

	very low, with the number of committee meetings recording below the minimum standard set by Mwongozo (2015) code of at least four meetings per annum implying that the SOEs had not complied with Mwongozo code. Therefore, the low level of committee meetings shows lack of thoroughness among the committee members. Hence, the conclusion that audit committee did not diligently undertake their roles of oversight. However, on the boards, size lowered the likelihood of an auditor issuing both unqualified and qualified opinion relative to disclaimer opinion increases. Therefore, on the basis of our findings, we recommend that SOEs vigorously comply with Mwongozo (2015) or simply adopt government policy document that outline governance procedures by the board of directors and top management which ensures that all state owned enterprises delivers the desired outcomes. We further found out that independent directors were negative but significant predicting both unqualified and qualified opinion when compared to receive a disclaimer opinion as a reference category. This means unit increase in percentage of independent directors significantly lowered the odds of receiving both unqualified and qualified opinion when compared with disclaimer opinion as reference category. We therefore recommend the adoption of policy which will strengthen the appointment of independent directors in SOEs.