ISSN 2348-3156 (Print)
International Journal of Social Science and Humanities Research ISSN 2348-3164 (online)
Vol. 7, Issue 2, pp: (1240-1247), Month: April - June 2019, Available at: www.researchpublish.com

THE COMBINED EFFECT OF GOVERNANCE, INTERNAL AUDIT AND FINANCIAL REPORTING ON NG-CDFs PERFORMANCE: THE KENYAN EXPERIENCE

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Abstract: **The study conceptualized a relationship between governance, internal audit, financial reporting and NG-CDFs performance.The performance of most National Government Constituencies Development Funds (NG-CDFs) has been poor and the relationship between governance and performance of NG-CDFs has been lacking. A census survey was carried out on all the 290 NG-CDFs performance in Kenya. A positivistic research philosophy and a descriptive cross-sectional survey design were used. Data was collected using structured and unstructured questionnaire. The questionnaire was administered through a drop and pick method. Regression analysis was then used to test the hypotheses at 95 percent confidence level. The results of the study findings were established and compared to various theories anchoring the study and conceptual, contextual and empirical evidence. The study established that there is statistically significant combined effect of governance, internal audit and financial reporting on NG-CDFs performance.The study made contributions to policy formulation, managerial practice and theory. The study benefits policy makers and managerial practise in both public and private sector. At policy level the unnecessary bureaucracy common in the governance of public sector needs to be looked at to reduce its negative relationship between governance and performance. Further, formulators of policy in the NG-CDF regarding governance and financial reporting can benefit from the findings of this study. Managerial practitioners especially in NG-CDF may consider strengthening governance interaction and combination with the other variables of the study to enhance performance. The study can also be used in different contexts in order for researchers to draw different patterns showing the effect of governance on organisational performance outcome.**

Keywords: **Governance, Internal Audit, Financial reporting, governance, NG-CDFs, Performance.**

1. INTRODUCTION

Currently Governance is major debate in the world due to the various corporate financial scams and the resultant business failures which include the Asian financial crisis of the late 1990s, Enron, WorldCom, Global Crossing and Tyco in the USA as well as Vivendi, Parmalat and others in Europe. In Kenya the National cereals and produce board, Kenya Pipeline Company, Mumias Sugar Company, The standard Gauage railway just and so on are also involved in fraud and corruption scandals. The company's board and management must reaffirm or improve internal audit's independence and scope of inquiry (Centre for Governance, 1999) as well as financial reporting integrity.

Governance is defined according to British standard for governance, BS 13500 (2017) as the system and practices meant to ensure that overall direction, effectiveness, supervision and accountability of an organization are adhered to. Good governance ensures compliance with the law and proper utilization and management of organizational resources. Governance is the way in which power is affected in the control of a country's socio-economic resources in development (World Bank, 1991).

In comparison to the private sector, corporate governance in public sector is defined as a set of responsibilities, practices, policies and procedures, exercised by an agency's executive, to facilitate strategic direction, to ensure objectives are attained, manage perils and utilize resources responsibly and with accountability (ANAO, 2006). According to Cadbury Report (1992), corporate governance is the procedure in which organizations are controlled and directed. This is the universally used description of the context of governance.

Indicators of governance used by the researcher are organizational structures, transparency and disclosures. Organizational structures are the frameworks and pillars for practicing corporate governance (Semmar, 2012). They are the mechanisms for decisions making that are not clearly particular in initial contract between managers and owners (Hart, 1995).The governance structures encourage the efficient utilization of resources and accountability for the stewardship of those resources to stakeholders (Cadbury, 2000). Efficient use of resource and accountability enhances organizational performance.

According to IIA (2010) internal audit is an independent, objective assurance and consulting activity designed to add value and improve an organizations operations. It assists organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes (IIA, 2010).Another definition states that internal audit isa section of the internal control procedure that the management of an organization puts in place to ensure compliance to anticipated work process and an aid to management (Unegbu& Obi, 2007).

According to IIA(2010) the basis of an effective internal audit is assurance that the management systems are enough to identify and monitor important perils, confirmation of the effective operation of the established internal control procedures, credible means for feedback on risks management and assurance and objective confirmation from management and that information is reliable.

However according to the researcher, internal audit is part of internal structure that the organization's management put in place which must be independent, objective, consultative in nature that provides assurance services to the entity, adds value, and ensure that the organization has complied with the rules, regulations and laws that affect it and improve organizations operations leading to enhanced performance.

Financial reporting is the organization's annual report performance and progress that the management releases to the final users of accounting information which they use in making informed decisions. According to Chander (1992) financial reporting is actually dissemination of information to outsiders by business organization through media adopted such as prospectus, press releases, statutory reports, interim reports, financial dailies and magazines, interviews between management representatives and the professional financial analysts and the published accounts that is the annual report. Indicators of financial reporting in this study are; communication of results, benchmarking and budgeting.

The National Government-Constituencies Development Fund (NG-CDF) in Kenya was established through CDF Act (2003) and amended in 2007, 2013, 2015 and 2016.Through the Act 2015 of parliament its name changed from Constituency Development Fund(CDF) to National Government Constituencies Development Fund (NG-CDF). The NG-CDF is one of the devolved funds meant to attain rapid socio-economic development at constituency degree through financing of locally prioritized projects and enhance community participation.

Studies carried out across the country's210constituency by the CDF Board (2008) and National Anti-Corruption Steering Committee (NACS) (2008) showed that since its inception in 2003, NG- CDFs has facilitated the implementation of a number of local level development projects geared towards poverty reduction and socio – economic development of the citizens. It is against this background that the current study seeks to establish the combined effect of governance, internal audit and financial reporting on the relationship between governance and NG-CDFs performance in Kenya.

2. STATEMENT OF THE PROBLEM

Good governance improves organizational performance and enables access to outside capital which results to enhanced sustainable economic development (Maher et al., 2000). Governance ensures the formulation, monitoring and enforcement of institutional structures by individuals affected by such institutional structures (Rutherford, 1983). Organizational structures specify the existence of several departments, job hierarchical status of a person by virtue of their position.

Performance of state owned corporations is very critical for economic developments in Kenya (Ongeti, 2014). Therefore, all over the world, organizational performance is the main area of both empirical and conceptual research in business. Performance facilitates feedback about governance and the achievement of the business objectives. However, according to Awino (2011), performance cannot be explained by a single variable. Good governance has an influence on organizational performance (Rashid et al., 2008).

However, governance may require other variables to intervene or moderate the relationship between governance and organizational performance. The variables could be internal audit and financial reporting (AL Matari et al., 2014). Internal audit has the task of re-assuring the management of the adequacy and efficiency of internal control systems (IIA, 2009). However there is continued poor performance in organizations where budgets are not followed and compliance with rules and regulations on the efficient utilization of finances and other resources leading to massive frauds and low efficiencies. This has made entities to suffer from risk of financial inadequacy, employee dissatisfaction and poor organizational performance (Mikes & Kaplan, 2014).

Corporate scandals, financial crisis and poor organizational performance are caused by poor governance. This has made the NG-CDFs to turn their focus on increased requirement for disclosures on governance issues resulting to higher demand for internal audit provision of assurance services on governance practices and processes that include internal controls and management of risks (Awino, 2011).

Most research studies on the relationship between governance and organizational performance have been conducted in most developed countries of the world (Bhagat& Black, 2001; Schimdt, 2006; Lehn et al., 2007; Bauer et al, 2008) while less studies have been conducted in less developed countries, Kenya (Lamport & Sannassee, 2011).

Contextually, some research studies in organization entities have been carried out. Hassan et al. (2012) established that there was a positive association role among stakeholders in performance of CDF funded projects in Kenya. In their case study about the role of CDF in rural development; experiences from North Mugirango Constituency, Kenya, Auya and Oino (2013) found that CDF had played a pertinent function than ever before in the provision of education and health care. They also found that misappropriation of funds by the entrusted people, lack of empowering community participation and week sustainability strategies hindered service delivery. The current study was an attempt to address the gaps demonstrated along conceptual, contextual, methodological and theoretical.

3. OBJECTIVE OF THE STUDY

The main objective of the study was to determine the combined effect of governance, internal audit and financial reporting on the relationship between governance and NG-CDFs performance in Kenya.

4. LITERATURE REVIEW

The combination and interaction of governance, internal audit and financial reporting enhance organizational performance. Governance installs organizational structures to monitor the use of resources bythe agents thus promote better performance of the organization (Mallin, 2010). The agency theory posits that corporate governance can be used to mitigate managerial opportunism hence minimizing agency problem (Hanniffa & Hudaib, 2006). It also advocates for building an institution of governance structures through the establishment of internal controls to monitor managers. Within the organizational structure, internal audit is one of the pillars of good governance (IIA, 2004). According to IIA (2010b) internal audit function is one of the four pillars of high quality corporate governance together with management, audit committee and external audit. The internal audit function has the main responsibility in checking of the management actions including those touching on external final reporting (Prawit et al., 2009). It assists governance since it plays a critical function in monitoring the internal control techniques of the company (Khas, 2000). The Institute of Internal Auditing (IIA, 2004) observes that internal audit role is one of the four parts in the good governance alongside the board, the executive management and external audit. Good governance brought about by internal audit's checks and balances lead to enhanced organizational performance.

The interaction between internal audit and governance improves organizational performance through tight internal controls and disclosure of financial reporting. Internal control systems reduce the manager's opportunities to participate in self-interested behavior like fraudulent reporting (Patterson & Smith, 2007; PCAOB, 2007). The tight monitoring enhances corporate governance that offers best quality accounting information that plays a crucial role in ensuring reliable financial reporting (Habib & Azim, 2008). Credible financial reporting information attracts investors who bring their resources to the business which are invested in income generating activities that enhance performance.

Another important combination of internal audit, governance and financial reporting is that internal audit plays an important role in monitoring financial quality reporting (Cohen et al., 2004). while governance practice impacts the quality of financial reporting (Cohen et al., 2004), quality financial reporting helps governance in the formulation of new strategies to enhance performance since the financial reporting information discloses organizational performance which is used as a measuring yard of achievement of organizational targets and then compare and bench mark with the similar well performing firms in the same industry. The comparison and bench marking enable the organization to innovate new organizational strategies. Organizational performance strategies may include new product innovation, change in leadership and so on that enhance performance.

Ochieng et al. (2012) carried a case study on the effectiveness of supervising and evaluation process on CDF projects in Ainamoi Constituency, Kenya. A case study was used where the target population comprised Constituency Development Fund committee members, selected constituents, project management committee and district development officer. The findings were that project management committee, constituency development fund committee and external assessors were included in examining and evaluation of projects with limited participation of the constituents. The study also found out that meaning of the recommendations from monitoring and evaluation were utilized under the guidance of CDF office.

The study was comprehensive and informative. However, it has conceptual, contextual, mythological and theoretical gaps. Contextually the research was a case study of Ainamoi constituency in UasinGishu County which investigated the effectiveness of supervising and evaluating process of projects funded by CDF. The study did not investigate the relationship between governance and performance of NG-CDFs neither did it investigate the effect of internal audit and financial reporting as intervening and moderating variables respectively on the relationship between governance and the performance of the 290 NG-CDFs in Kenya.

This created conceptual and contextual gaps. There is also methodological gap. The study used only primary data. The study did not use any theory; therefore, the study would have been richer if it had addressed the above mentioned contextual and conceptual gaps. It should have also used secondary data and some theories such as stakeholder's theory, stewardship theory, legitimacy theory and agency theory since one of its objectives was to assess the degree of involvement of stakeholders in the practice of monitoring and evaluation. The secondary data should have assisted in comparing the previous involvement of stakeholders in the procedure of monitoring and evaluation.

Auya and Oino (2013) examined the function of Constituency Development Fund in rural development, experiences from North Mugirango Constituency, Nyamira County, Kenya. The objective of the study strived to establish the function of CDF on social development. The study employed quasi experiment research design to give qualitative and quantitative data required to respond to research hypothesis using questionnaire and interviews.

The findings were that CDF had played a significant role than ever before in the provision of education and health services. The study also found out that there were some challenges such as embezzlement of funds by MPS and committees managing the funds, absence of community participation and involvement, and poor sustainability strategies that hindered the delivery of services. The study suggested that the government should increase the projects in the area, promote community participation encompassing efficiency through accountability and transparency aiming to achieve the goal of equity in resource distribution.

The study demonstrated the role of CDF in service delivery in the area under study. However, it failed to address the conceptual, contextual, theoretical and methodological gaps. Conceptually, the study didn't investigate the relationship between governance and organizational performance as well as the effect of internal audit and financial reporting as intervening and moderating variables respectively on the relationship between governance and performance of NG-CDFs.

ISSN 2348-3156 (Print)
International Journal of Social Science and Humanities Research ISSN 2348-3164 (online)
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Contextually the relationship between governance and performance of NG-CDFs in Kenya is lacking. Methodologically, the research was a case study in north Mugirango Constituency, Nyamira County, Kenya. Finally, the study did not use any theory to get more relevant information to enrich the study. Therefore, the study would have improved if it had addressed the above gaps. The current study addressed the mentioned gaps.

5. RESEARCH METHODOLOGY

This study thus adopted cross-sectional survey design which is a social survey structured research or structured observation on a sample at a single point in time (Bryman& Bell, 2011). This exploratory survey design is ideal for this study since it has clearly stated hypotheses or investigative questions (Cooper & Schindler, 2006).It was also suited for the study because NG-CDFs in Kenya are spread in all parts of the country.

The target population comprised all the constituencies in Kenya that is the two hundred and ninety NG-CDFs in Kenya and the unit of analysis was NG-CDFs management. Therefore, the study was a census of the 290 NG-CDFs in Kenya as per NG-CDFs Act (2016) since the NG-CDFs are few but spread in the entire country, Kenya. Either the chairperson or the secretary or the treasurer or the Fund accounts manager or a registered voter answered the questions.The research study used both primary and secondary methods of data collection because both data reinforce each other (Cooper & Schindler, 2006, Saunders et al; 2007). Primary data was collected by self-administered, pre-arranged questionnaire. The main source of secondary data was reports on evaluation.

Data collected was cleaned, edited, validated, coded and checked for any coding errors and omissions. Thereafter it was run through the statistical package for social sciences (SPSS) Version 22 and analysed through descriptive and inferential statistics adopting Sekaran (2004). . Data was analysed by use of descriptive statistics such as mean scores, standard deviation, frequencies and percentages and correlation coefficient for likert scale variables in the questionnaire covered all the reaction variables and provided impetus for further analysis (Mugenda & Mugenda, 2003).Data was presented in form of tables. The relationships between variables was investigated through hypothesis testing using quantitative techniques specifically Pearson's product moment correlation coefficient. The performance of NG-CDFs was measured using DEA model specified by Charnes et al, (1978) on target population.

6. RESEARCH FINDINGS AND DISCUSSIONS

The Joint Effect of Governance, Internal Audit, Financial Reporting and NG-CDFs Performance

The fourth study objective was to determine the joint effect of governance, internal audit and financial reporting on performance of NG-CDFs in Kenya and arising from this objective, the following hypothesis was formulated and tested – ***H_1**: The combined effect of governance, internal audit and financial reporting on the performance of NG-CDFs in Kenya is not significant. The hypothesis was tested using multiple regression analysis.*

In the regression model, performance was the dependent variable, while governance, internal audit and financial reporting were predictor variables. The joint effect was then established by regressing predictor variables on performance.

Table 1: Joint Effect of Study Variables

Model Summary					
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	
1	.447[a]	.200	.191	.17402	
a. Predictors: (Constant), Financial Reporting, Internal Audit, Governance					
ANOVA[a]					

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	1.978	3	.659	21.774	.000[b]
	Residual	7.904	261	.030		
	Total	9.882	264			
a. Dependent Variable: Performance (Efficiency Score)						
b. Predictors: (Constant), Financial Reporting, Internal Audit, Governance						

Coefficients[a]						
Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	73.538	12.206		6.025	.000
	Governance	4.452	6.439	.180	.691	.000
	Internal Audit	2.172	4.069	.133	.534	.002
	Financial Reporting	2.838	5.120	.163	.554	.000
a. Dependent Variable: Performance (Efficiency Score)						

Source: Field Data (2018)

The regression results presented in Table 1 shows that the influence of governance, internal audit and financial reporting jointly on NG-CDFs performance was significant (R^2=0.200, F=21.774, P<0.05) implying that the predictor variables jointly explains 20.0% of variation in NG-CDFs performance while the other 80% is explained by other factors not considered in this study.

The co-efficient β were also significant and (P < 0.05) suggesting that independently governance, internal audit and financial reporting are significant in explaining NG-CDFs performance. The joint effect was thus higher and significant (R^2 =0.200, F= 21.774, P< 0.05) compared to the individual effect of individual variables. In view of this finding, the hypothesis that there is a significant joint effect of governance, internal audit and financial reporting on NG-CDFs performance was supported.

This model suggests that even in the absence of all three variables NG-CDFs performance in Kenya will perform by 73.538 units. However, for a unit increase in governance, internal audit and financial reporting, NG-CDFs will perform by 4.452 units, 2.172 units and 2.838 units respectively, when all other factors are held constant.

From this regression model, it is thus evident that performance of NG-CDFs in Kenya is influenced to a high degree by the combination of the predictor variables – governance, internal audit and financial reporting, whose beta coefficients were all positive and statistically significant. Based on the results, the regression model for hypothesis four can be fitted as follows:

The original model: $Y_0 = \beta_0 + \beta_1 G + \beta_2 IA + \beta_3 FR + \varepsilon$The new model: Y= 73.538+4.452G +2.172IA +2.838FR

Where:

$Y_=$ Performance

G= Governance

IA= Infernal audit

FR= Financial reporting

Ɛ = error term

The model implies that NG-CDF performance represents .73.538 units in absence of governance, internal audit and financial reporting. However when governance, internal audit and financial reporting are added each contributes 4.452, 2.172 and 2.838 respectively. This implies that governance, internal audit and financial reporting jointly contribute significantly on NG-CDFs performance.

Performance of NG-CDFs in Kenya

Data envelopment analysis was used to examine performance of NG-CDFs in Kenya using input/output relationship. DEA is a non-parametric linear programming technique that computes a comparative ratio of outputs to inputs for each unit, which is reported as the relative efficiency score. The efficiency score is usually expressed as either a number between 0±1 or 0±100%. A decision-making unit with a score less than 100% is deemed inefficient relative to other units. In this study, DEA was used to measure the technical efficiency (TE) of DMUs as shown in table 2.

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International Journal of Social Science and Humanities Research ISSN 2348-3164 (online)
Vol. 7, Issue 2, pp: (1240-1247), Month: April - June 2019, Available at: www.researchpublish.com

Table 2: Performance of NG-CDFs in Kenya

Range/Statistic	Frequency	Value
0.0 to 0.3	102	38.20%
0.31 to 0.6	124	46.44%
0.61 to 0.9	39	14.61%
0.91-1	2	0.75%
Mean		0.389278
Standard Error		0.0118
Median		0.357503
Mode		0.504587
Standard Deviation		0.192815
Sample Variance		0.037178
Kurtosis		0.053153
Skewness		0.647806
Range		0.93745
Minimum		0.06255
Maximum		1
Sum		103.9372
Count		267
Confidence Level (95.0%)		0.023233

Efficiency is defined as the ratio of outputs to the resources used/inputs. In this study, DEA Model inputs were: budget allocations, projects proposed, operational costs incurred and employee remunerations. The outputs were projects completed projects efficiency, employee efficiency and operational efficiency.

The findings shown in table 2 indicates that majority (46.44%) of NG-CDFs were moderately inefficient with efficiency score of between 0.31 and 0.6. It was also established that 38.2% of NG-CDFs were inefficient with efficiency score of 0.3 and below. Further findings indicate that the performance of 14.61% of NG-CDFs was above average with efficiency score ranging from 0.61 and 0.9. Only 2 NG-CDFs representing 0.75% were found to be efficient with efficiency score of 1. The mean efficiency score was 0.389278 which is below average. In order to increase efficiency, NG-CDFs should decrease the level of resources and investments and/or increase the production factors.

7. CONCLUSION

The main objective of the study was to establish the relationship among governance, internal audit, financial reporting and performance of NG-CDFs in Kenya. To achieve this, specific objectives and matching hypotheses were stated.

The study showed governance, internal audit and financial reporting jointly influenced performance of NG-CDFs in a significant way. The three variables jointly accounted for 20 percent performance of NG-CDFs in Kenya. In the joint effect financial reporting was found to have the lowest contribution at 15.9 percent. Therefore, the lower percentage was most likely explained by the fact that some NG-CDFs lack competent personnel to prepare quality financial reports. Therefore, the study concluded that the combined influence of governance, internal audit and financial reporting complement each other and significantly influence the performance of NG-CDFs in Kenya. As a result, the combined influence of the independent variables creates synergy that delivers superior performance. In conclusion therefore, the study results confirm some conceptual and empirical studies while refuting others. They have also supported several theoretical postulations and refuted some.

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