International Journal of Science and Research (IJSR)
ISSN (Online): 2319-7064
Index Copernicus Value (2015): 78.96 | Impact Factor (2015): 6.391

Financial Factors Affecting Growth of Audit Firms in Kenya: A Survey of Audit Firms in Nairobi City County

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Abstract: ***Auditing firms increasingly face challenges when performing their work, with the challenges emanating from both the internal and external environment, thus causing deterred growth in the industry. Therefore this study focused on some selected internal factors which affect the growth of auditing firm. The specific objectives were to establish the effects of internal control and the effect of audit fee on audit firms' growth in Kenya. The study applied descriptive research design. The population was 122 audit firms in Nairobi County given that Nairobi is the capital city of Kenya and the hub of business, many firms are located there.For sampling three cluster were identified, that is; large firms, medium firms and small firms based on the market share.From each of the cluster random sampling was adopted. Primary data was used for analysis, to describe the relationship between the study variables.The findings revealed that internal control and audit fee significant effect the growth of audit firms in Kenya. The regression results showed that all the variable had a positive significant effect on the growth of the firm. The correlation results indicated that there was a strong positive relationship between the independent variables and the dependent variable. Based on the finding, the study concluded that internal control and audit fee were major determinants on growth of audit firms in Kenya. The study recommended that the management of audit firms should put emphasis on audit internal control measure and audit fee when strategizing the growth of their firms as the two are key determinants to growth of a firm.***

Keywords: Internal control, Audit fee, Firm growth

1. Introduction

Auditing did not start 'yesterday'; it was in use in all ancient countries and during the time of agrarian revolution. The main objective of auditing was to detect and prevent errors and frauds. Auditing evolved and grew rapidly after the industrial revolution in the 18th century with the growth of the joint stock companies. The ownership and management become separate that, the shareholders needed a report from an independent expert on the accounts of the company managed by the board of directors appointed by them. An audit is an investigation or search for evidence to enable an opinion to be formed on truth and fairness of financial and other information by independent person or persons (Gray and Manson, 2008). The person(s) are independent of the preparer and persons likely to gain directly from the use of the information and the issue of a report on that information with the intention of increasing its credibility and therefore its usefulness. The main objective of auditing was to detect and prevent errors and frauds.

Over the years the precise role of auditing shifted and was expected to ascertain whether the accounts were true and fair rather than detection of errors and frauds. After the 2nd world war many countries became independent and started focusing on business and commerce. Many industries have come up and the need for accounting and auditing increased. It is through this transition period for industrialization where the developed and developing countries adopted the auditing principles to provide a fair view of the books of account. The environment within which audit firms operate has been very volatile. The political anxieties, competition from new entrants, social reforms, technological advancement and globalization are some of the challenges that have greatly affected the growth of this sector (Leggatt and Martin, 2003). These challenges cannot be ignored because the industry plays a significant role in our economy. The challenges posed have serious strategic threats to existing firms and a good number of these firms are not able to survive the new turn of events and those that are still surviving have had to adopt urgent measures in form of strategies. According to Githae (2004), many audit firms in Kenya are quick to affirm that doing business is more difficult than was the case in the past eras. They cite numerous factors like increased competition; undercutting and increasing need for more compliance as more and more legislations is enacted. This is aggravated by inadequate government support among other reasons. The business environment in which the small and medium size audit firms operate has been very volatile. The political anxiety, competition from new entrants, social reforms, technological advancement and the global challenges are some of the challenges that have greatly affected the growth of this industry (Nyakang'o, 2007).

1.1 The growth of auditing firms in Kenya

Kenya being a developing country, and experiencing a high rate of industrialization, the demand for audit has also increased. This has led to formation of audit companies to serve the demanding market. The audit companies which are also referred to as audit firms are forms of sole proprietorship or partnership businesses which provide audit, accountancy, and consultancy services to clients who may be individuals or other firms and companies. Auditing is one of the largest professional services in Kenya today. ICPAK estimates that there are about 18,000 qualified professional in this area with about a third of them being registered with ICPAK. The distribution of the ICPAK membership is as follows: private practice 40%, commerce and industry 50%, and others including public sector and academia, 10% (ICPAK Annual Report, 2015). In addition, estimates show that there are over 20,000 qualified accounting technicians. It is further estimated that the Kenyan auditing/accountancy sector has more than 700 firms at the moment.

The audit industry in Kenya is dominated by five of the largest auditing firms in the country also known as big five, all of which have international backgrounds. These five firms are the auditors of practically all the publicly traded companies in Kenya. The partners of these firms, both local and expatriate actively participate in various committees of the local professional accountancy body, The Institute of Public Accountants of Kenya (ICPAK). Many of the audit firms fall under the category of small and medium enterprises with only the top five firms - PWC, Ernst & Young, Deloitte & Touche and KPMG therefore the audit industry is still growing. However Medium-sized audit firms in Kenya are facing stiff competition and are operating under a highly turbulent environment (Kimeli, 2013). According the IPACK Report (2015) the audit industry in Kenya has been experiencing deterred growth, with most of the firms quitting the market.

1.2 Statement of the problem

The fact that the world has become a global village has forced local firms across all industries to improve their efficiency and effectiveness in order to survive in a dynamic environment (Kimeli, 2013).This being the case, a lot is expected from the auditor who is the sole proprietor of the audit firm. Generally, the challenges that audit firms face are fraudulent financial reporting and audit failures, new legislation, regulation and standards, audit costs and audit fees, staff training, transformation and retention, auditor independence and the provision of non-audit services, the audit expectation gap, auditor litigation and changes in technology. This has forced audit firms to come up with new strategies to counter these challenges and improve their performance. Many of the audit firms in Kenya are categorized in to small firms with few medium size firms and only five large in the industry over the decades. This pose a question as to why the many small firms do not growth to fit the medium or large size firm, or the medium firms growing to large firms. Management of internal factors in the audit firms such as policy adherence, auditor's independence, and audit fee management affect operations in the audit firm. Lack of proper internal control measures in the audit firm has led to not only improper adherence to policies but also poor management of resources leading to high employees' turnover this many of the audit firms in Kenya. The aspect of high employee turnover in any firm reduces clients' confidence hence growth of the audit firm.

Most research on growth and performance of Audit firms has been done on developed nations, with no or very little done locally. Agina (2013) did a study on adoption and implementation of key performance indicators by auditing firms in Kenya in their International Operations, Barongo (2012) conducted a study on competitive strategies adopted by small and medium audit firms in Nairobi City County, Kenya, Polle (2012) did a study challenges of strategy implementation facing audit firms in Nairobi, Kenya, Nyakang'o (2007) did a study on competitive strategies adopted by audit firms in Nairobi. Despite of this recognition and awareness of the deterred growth of local audit firms, little research has been conducted in Kenya with regard to the factors that affect the growth of audit firms. This study therefore sought to investigate factors affecting growth of audit firms in Kenya with reference to a few selected firms stationed in Nairobi County.

1.3 Research objective

1) To establish the effect of internal control on the growth of audit firms in Kenya.
2) To determine the effect of audit fee on growth of audit firms in Kenya.

1.4 Scope of the study

This study was confined to audit firms in Nairobi County in Kenya. The research was based in Nairobi because is the hub of business in Kenya and thus many auditing firms are registered and based there. The study population involved the proprietors of the audit firms and other staffs within the audit firm's environment.

2. Theoretical Review

2.1 Gibrat's Law on Growth of the Firm

Gibrat (1931) suggested that proportionate growth rate of a firm is completely random and independent of firms' initial size or previous growth rates. This is known as Gibrat's Law or the Law of Proportionate Effect. Factors that influence firm growth such as increase in demand, management talent and innovation, organizational structure and luck, are distributed across firms in a manner which cannot be predicted from information about firm's current size or its previous growth performance (Goddard et al ., 2001). In fact, firm growth is the result of a multiplicative process that affects the initial size. The factors that can affect firm growth relate not only to the firm, but also to its environment. This theory supports the dependent variables of the study in explanation about firm's growth.

2.1.1 The Agency Theory

Agency theory describes firms as necessary structures to maintain contracts, and through firms, it is possible to exercise control which minimizes opportunistic behavior of agents. The theory recognizes the incomplete information about the relationship, interests or work performance of the agent described as adverse selection and moral hazard. Moral hazard and adverse selection affects the output of the agent in two ways; not doing exactly what the agent is appointed to do, and not possessing the requisite knowledge about what should be done. This affects the overall performance of the relationship as well as the benefits of the principal in the form of cash residual. Other related reviews include The Sarbanes-Oxley Act of 2002 (SOX) which requires companies to report on the effectiveness of their internal controls over financial reporting as part of an overall effort to reduce fraud and restore integrity in the financial reporting process. It is further asserted that software vendors that market Enterprise Resource Planning (ERP) systems have taken advantage of this new focus on internal controls by emphasizing that a key feature of ERP systems is the use of "built-in" controls that mirror a firm's infrastructure (Morris, 2011).

2.2 Conceptual framework

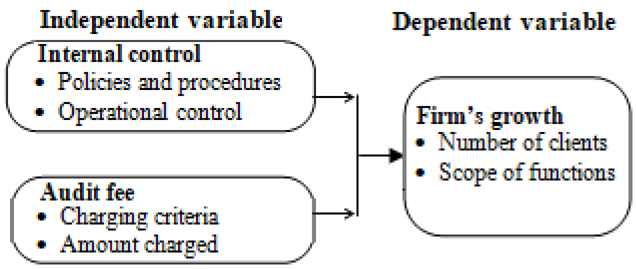

Figure 2.1: Conceptual Framework

2.3 Empirical review

2.3.1 Internal Control

Mire and Mukhongo (2015), assert that internal controls refer to the measurers instituted by an organization so as to ensure attainment of the entity's objective, goals and missions. They are a set of policies and procedure adopted by an entity in ensuring that an organization's transactions are processed in the appropriate manner to avoid waste, theft and misuse of organization resources.

Uwaoma, & Ordu (2015), note that an internal control comprises of the plan of the organization and all co-ordinates methods and procedures that are concerned with operational efficiency and adherence to management policies and directives. When the internal controls are weak, operational efficiency can be undermined regardless of the nature of the organization. If there are no audit systems in place, organization financial management tends to end in anarchy. Financial internal control ensures that; the assets of the company is protected, protecting improper disbursement of the assets for the company and securing the accuracy and reliability of all accounting, financial and other operational information of the company.

Internal Controls are processes designed and affected by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of the financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations (David, 2001). Increasingly, reliability of financial reporting in accounting context is very important for the investors who use the information for decision management (Jenning et al., 2008). According to Mawanda (2008), a sound internal control system helps the firm to prevent frauds, errors and minimize wastage. The increase of business units has encouraged the use of internal control as it ensures orderly and efficient conduct of business including adherence to internal policies. The completeness and accuracy of accounting records, timely preparation of financial information, can only be achieved if the proper internal control system is in place.

2.4 Audit Fees

Audit fees refer to the remuneration payable to an auditor for audit services rendered (Kimeli, 2013). When entering into negotiations regarding professional services, a professional accountant in public practice may quote whatever fee deemed to be appropriate.There is a significant branch of literature dedicated to the understanding of audit pricing. Simunic (1980) developed a representative model of the process by which audit fees are determined, and since then various authors have continued to bring forth empirical results that show which factors concur to the setting of audit fees. In this segment some of those contributions relevant to this study are reviewed.

Theoretically, the amount of fees for audit services that a client firm pays to its audit firm reflects the level of audit work the latter has to perform in the auditing process. The definition of this level of work embodies the auditor's assessment of the process's complexity and the desired level of risk. In other words, all other things considered, if an auditor wishes to decrease the risk of issuing a clean opinion when there are materially relevant distortions in the client's financial statements, he generally acts on the nature, extent and timing of audit procedures, which, naturally, influence the final amount of required fees. Low audit fees can restrain audit firms, by restricting compensation (to audit staff). Part of the problem is that many clients fail to recognize the intrinsic value of an audit, regarding it purely as a compliance exercise (Izma, 2011).

An interesting recent finding is that audit fees reflect the client's future performance, because auditors have access to some information that contains forward-looking judgments (e.g., uncollectible receivables, obsolete inventory, pension and warranty costs) (Stanley, 2011). Moreover, the disclosed audit fee is also found to be related with errors in forecasts of earnings made by financial analysts, which could indicate a superlative precision in the predictions of auditors when compared with the predictions of financial analysts. The potential usefulness of this evidence is a sign embed in the disclosed audit fee of the firm's future economic condition other market participants could pay attention to. Many audit firms in Kenya depend on audit fee as the main source of revenues. Therefore the performance and growth of the firm will greatly be dependent on their returns from the services provided.

2.5 Audit firms Growth

Firm growth is typically defined and measured using absolute or relative changes in sales, assets, employment, productivity, profits and profits margins (Davidson et al, 2005; Allinson et al, 2006). Firm growth is one of the most analysed fields in economics. Its impact on employment, industry concentration, firm survival and economic activity are reasons enough for it to be considered an issue of crucial interest. According to Gichuke (2013) First, firm growth is related very closely to firm survival. Specifically, firm growth is positively correlated with the likelihood of survival and firms that experience continuous growth have a higher probability of surviving in the market. Second, firm growth is related to employment. A positive rate of growth implies a net creation of new jobs, and the vice versa is true. The third factor is the effect of business growth on economic growth. The economic dynamics are related to the growth of the firm. Fourth, firm growth is a way to introduce innovation and is a leading factor leading to technological change. Firm growth varies widely depending on business age, size and industry (Koech, 2015).

3. Research Methodology

The overall objective of the study was to find out the financial factors affecting growth of audit firms in Kenya. This study applied both descriptive and quantitative research design both primary and secondary data were explored to make sufficient data available for analysis. The population of interest for the study was 122 audit firms in Nairobi County. Randomly selected from all audit firms registered with ICPACK. The respondents in each of the audit firms involved the Managing Partner of each firm. The regression model is as follows:

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \varepsilon$$

Where:

Y = Audit firm Growth

X_1 = Firm size

X_2 = Audit Fees

4. Research Findings and Discussion

4.1 Descriptive statistics

The study used a regression model in the analysis to explain the relationship of the study variables. The study was guided by two objectives that is to find out the effect of internal control on growth audit of audit firms in Kenya and the second objective was to find out the effect of audit fee on growth of audit firms performance. The application of the two study objectives vary from one audit firm to another depending on the size. In order to get the variation on the effect of internal control and audit fee on growth of audit firms, the study classified audit firms in Kenya into three categories, that is large, medium and small firms based on the size of the firms and market coverage. Large firms constitute the ‘ big five’ auditing firms in Kenya, the medium size constitutes the 25 audit firms in ranked to be average in terms of assets and market dominance where the small firm constituted 92 audit firms. The total sample for the study was 122 audit firms however the study was responded by 3 big five audit firms, 16 medium size audit firms and 73 small size audit firm in Nairobi County. Analysis of data commenced by undertaking a descriptive analysis of the study variables aimed at obtaining the general profile of the data. Regression was conducted to provide and interpretation of the results performed using inferential statistics. Summary of statistics that encapsulate the measures of central tendency such as the mean, the measures of dispersion such as standard deviation were used.

Table 4.1: Response on internal control and audit fee

	Large		Medium		Small	
Variable	Mean	Std. Deviation	Mean	Std. Deviation	Mean	Std. Deviation
Internal Control	4.3	0.477	3.9	1.279	2.9	1.733
Audit fee	4.2	1.414	3.8	1.207	3.5	1.337

From table 4.1 show the summary statistics for the primary data observations of the response provided on the study variables. The results shows that the means and standard deviations for internal control and audit fee in the large firms were between mean score of 4.29 and 4.20 respectively for all the variables. With a standard deviation of 0.477 and 1.414 respectively. The high mean of 4.29 and 420 of the three large firm signified that large Auditingfirms adopted internal control measures in the firms and that determination of audit fee was not a problem given that they have a predetermined criteria for charging their clients.

The results shows that the means for internal control and audit feein the medium firms were 2.9 and 3.8 slightly lower than that of large firms for both internal control and audit fee respectively. this implied that the measured of internal control and audit fee were adopted in the medium auditing firms but not fully implemented as compared to the large auditing firms. The standard deviation of the two study variables was 1.279 and 1.207 respectively. This findings show that the medium firm have adopted internal control and audit fee measures. This imply that there are strategies objected to the future success of the firm and expansion. However there were few technicalities in adherence. The finding further indicates that despite having internal policies and procedure there not dully followed as expected. The small firms had the least mean of 2.9 and 3.5 respectively. The standard deviation was 1.733 and 1.337. The results for small audit firms show that only a few had put in place internal control measure. The finding further reveals that audit fee was a critical issue to this category of firms. They respondents were quick to assert that they lack clear procedures to determine audit fee which led to either under-charge or overcharge of their clients. The overall results explain that small firms’ slow growth is due to lack of internal control measures and strategies of expansion. Audit fee is the main source of revenue in the audit firms. Lack of charging criteria lower firms’ income hence no enough funds for expansion. These results, supports those ofJones (2008), who found that internal control effects the performance of a firms, Kimeli (2013) observed that and audit fee had a positive or negative impact on performance of firm.

4.2 Correlation Analysis

Table 4.2: Correlation Analysis

		Internal control	Audit fee	Audit Firm growth
Internal control	Pearson Correlation	1		
	Sig. (2-tailed)			
audit fee	Pearson Correlation	0.23	1	
	Sig. (2-tailed)	0.090		
audit firm growth	Pearson Correlation	0.186	0.271	1
	Sig. (2-tailed)	0.603	0.579	
N=92				
**Correlation is significant at the 0.05 level (2-tailed).				

From table 4.2 it can be observed that the correlation between the independent variables and the dependent variable was high and positive at 0.603, and 0.579 for internal control And Audit fee. The key goal of the correlation analysis is to assess the level of relationship between the dependent variables and the independent variables.The results show a weak positive relationship between internal control and audit fee of 0.090. This impliesthe absence of multicollinearity hence the influence of each variable in the regression model could be isolated individually. However there strong positive relationship between the independent variables for this case internal control and audit fee and the dependent variable which is growth of audit firm implies that internal control and audit fee strongly affects growth of audit firms in Kenya.

4.3 Regression Analysis

Table 4.3: Regression Analyses

Variables			t-Statistic	P-Value
	Coefficients	Std. Error		
(Constant)	0.280	0.036	7.778	0.000
Internal Control	0.257	0.049	5.253	0.000
Audit Fee	0.172	0.051	3.407	0.001
F-statistic 167.87, p-value 0.000, R-square was 0.88				

The fitted regression model is

$$Y = 0.284 + 0.257\,X_1 + 0.172X_2 + \varepsilon$$

$$Where;\ Y = Firm\ Growth, X1 = Internal\ controls, X2 = Audit\ Fee$$

From the above regression model in table 4.3,it was revealed that the constant coefficient was 0.280. Internal controls have a positive and significant effect on the growth of auditing firms in Kenyawith a regression coefficient of 0.257 and a p value of 0.000.This value shows that holding other variables in the model constant, an increase in internal controls by one unit causes the audit firm growth to increase positively by 0.257 units. The positive effect implies that internal control in the audit firms are very critical and important to effect growth of the audit firms in Kenya. This implies that policies and procedures, objective and goal of the audit firms are key to her success. Large firms were noted to have underlying policies and procedure and thus their growth was noticeable in terms of firms' size, market coverage and scope of functions. However small and medium size audit firm which did not have clear policies and procedures, they lacked visions and mission had a low growth rate for the time they have been in operations. The finding are in support of the argument by Jones (2008) and Simunic and Stein, (1996)that internal control that is well underlined policies and procedures affect the performance of a firm positively if fully implemented.

The regression results indicate that audit fee had positive significant effect on growth of auditing firms in Kenya with a regression coefficient of 0.172 and a P-value of 0.001. This implies that holding all other variables in the model constant, a unit increase in audit fee would lead to 0.172 units increase in audit firm growth. Thecoefficient was positive implying that audit fee leads to growth of the firm positively. Audit firms such as 'big five' with proper criteria and predetermined amount of audit fee to change their clients had a noticeable growth. However the small firms had slow growth since they lack adequate funding to enhance growth. These finding supports those of Kimeli (2013) who observed that audit fee was the main source of finance in auditing firms and that it is a key determinant to performance of the firm.

5. Conclusion and Recommendation

5.1 Conclusion

The study concluded that internal control and audit fee are the key determinants of audits firms' growth in Kenya. The results from the regression model revealed that the factor's that influenced audit firms growth were statistically significant. On the overall the study concludes that there is a strong positive and statistically significant relationship between the two factors and audit firms in Kenya. The audit firms are therefore encouraged to focus on the internal control and audit fee factors since their influence was established in this research.

5.2 Recommendation

Internal control was found to be statistically significant and therefore it is recommended that managers should be keen on the status of internal control in their audit firms. The management of these audit firms should be focused towards bringing new policies aimed at enhancing the internal controls of the firms, since this would in turn lead to the better financial performance of the audit firm hence growth.

Audit fee was found to be statistically significant and therefore it is recommended that managers should be keen on the status of audit fee in their audit firms. The management of these audit firms should be focused towards bringing new policies aimed at enhancing the collection of audit fee, since this would in turn lead to the better financial performance of the audit firm hence growth.

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