INTERNATIONAL JOURNAL OF SOCIAL Sciences and Information Technology
ISSN 2412-0294 www.ijssit.com
http:// www.ijssit.com

# EFFECT OF OUTSOURCING OF ACCOUNTING SERVICES ON QUALITY OF FINANCIAL REPORTING AMONG SMALL MICRO ENTERPRISES IN KENYA

## (A Survey of Nairobi County)

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***Abstract*****:** *This study examined whether the financial reporting quality is related or associated with outsourcing accounting services. The study singled out on SMEs in Nairobi County, this was found appropriate because of the high number of SMEs and diversity in businesses conducted in the County. Existing evidence have shown that outsourcing the accounting services has a significant impact on the quality of financial reporting. Outsourced book keeping, outsourced tax returns and outsourced internal audits have proved to be positively impact the quality of financial reporting.*

***Objectives:*** *The study was guided by To examine the impact of outsourcing of book-Keeping; To analyze the impact of outsourcing of internal audit services effect; To the investigate of outsourcing Tax reporting on quality of Financial Reporting among SMEs in Kenya.*

***Methodology:*** *Through descriptive districts and Chi-square analysis methods, the study will test the effects of outsourced accounting services with data collected through questionnaires with a sample of 284. The study was limited to Nairobi County and only sought registered businesses.*

***Finding:*** *This study finds that there is significant relation between outsourced accounting services and quality of financial reporting. From the analysis, it is vivid that outsourcing accounting services, the quality of financial reporting is increased making it more reliable and understandable.*

**Keywords**: *Accounting Services, Book Keeping, Internal Audit, Quality Financial reporting*

## 1. INTRODUCTION

The most important objective of financial reporting is delivering financial information to various stakeholders concerning the performance of the accounting entity. The statements prepared need to meet qualitative characteristics as defined by International Accounting Standards Board (IASB) (2008). In 2003 the Kenyan government through the Ministry of Planning issued a strategic blue print that identified the contribution of SMEs in elevating the Kenyan economy to a medium sized economy through implementation of four key pillars one the pillars being industrialization, nevertheless, 15 years down the road the status of small and medium sized business has worsened because of high failure rate.

There is no clear model of classifying SMEs, some authors classify businesses based on assets others on the employees' number. In developing economies businesses are classified with respect to the number of employees. A business with 50 to 99 employees is a medium sized establishment, 10 to 49 employees is a small business while that with less than 10 employees is a micro establishment. A survey by the Kenya National Bureau of Statistics (2016) identified that only 1.56 million businesses were registered by the 47 county governments in Kenya while 5.85 million businesses were not registered. Most of these businesses are in the service industries ranging from merchandizing, financial sector and hospitality. The survey further identified that in the period between 2010 and 2016 2.2 million businesses closed down, most of these businesses closed down between the first and the fourth of establishment. Two main reason were identified as reasons for closure; high operating expenses and competition from other business.

Njeri (2016) identified that among the most successful businesses in Kenya on thing is eminent, that these small businesses have resulted to outsourcing their accounting services to professions who assist them in preparing their financial records. Quality of the financial reports prepared is a major concern to whether outsourcing helps the businesses make better decisions after relying on financial statements prepared. Le, Bui, & Tran (2017) In their work in investigating factors influencing the intention of accounting outsourcing in Vietnam acknowledged that outsourcing of accounting services in an emerging trend where out of 181 businesses that took part in the survey 94 businesses fully or partly outsourced their accounting functions.

To explain the economic relevance of outsourcing, Everaert, Sarens and Rommel (2010) use the transaction cost theory of a firm to indicate that the essence of cost account not just to calculate costs but to minimize them. Primarily, outsourcing involves hiring another firm to do some functions that were initially being done internally for the sake of utilizing resource use Everaert, Sarens, & Rommel (2010; Olumbe, 2015). In other words, outsourcing seeks to help the company utilize its finances, human resources and time in such a way that those functions that can be considered as production overheads are assigned to other firms or individuals that perform them as mainstream activities so as to save on the transactional cost. This reasoning can be drawn back to the theory of competitive advantage as suggested by Adam Smith and fine-tuned by David Ricardo Costinot, Donaldson, Vogel, & Werning, (2015). However, despite outsourcing being advantageous in terms of cutting the overhead costs associated with in-house accounting, regulators on the global scale are skeptical about the readiness of firms in absolving the risk associated with assigning third parties the role of dealing with key internal matters of a company such as accounts.

A key area of concern about outsourcing of accounting services is its effects on financial reporting quality. Other questions that researchers have attempted to answer revolve around the technical competency of the accountant, size of the firm, and relationship between outsourcing and firm performance among others Kamyabi & Devi, (2011). The results of most of the studies conducted about the effectiveness of outsourcing accounting functions show a mixed signal. In fact, most of the studies in this area only cite economic benefit in terms of reducing overheads but not effectiveness in maintaining internal control. One of the risks identified with outsourcing accounting functions is that of the threat of opportunistic behavior by the external accountant Hafeez, & Andersen (2014).

**Statement of the Problem**

Privation of managerial capabilities, limited finances and human resources in medium and enterprises thrusts these firms in outsourcing accounting services. Accounting process begins with preparation of the source documents to book keeping and ends with preparation of financial statements. One of the main problems fronting accounting function in SMEs is lack of expertise Ismail (2002).

Source documents are prepared as transactions happen which is throughout the accounting period while financial statements are prepared at the end of the accounting period. Professional accountants cannot prepare quality financial statements without source documents therefore source documents are a pre-requisite to preparing quality financial statements. Most SMEs lack a defined accounting department responsible for book keeping, leaving these firms to outsource accounting services from accounting firms. Quality financial statements are important in performance analysis and soliciting for funds.

**Research Hypothesis**

The research's null hypothesis were framed to evaluate the impact of outsourcing of accounting services on the quality of financial reporting among SMEs in Kenya.

i. $H_0$: There lacks a significant relationship between outsourcing book keeping services and Financial reporting Quality among SMEs in Kenya?

ii. $H_0$: There lacks a significant relationship between outsourcing Internal Audit services and Financial reporting Quality among SMEs in Kenya?

iii. $H_0$: There lacks a significant relationship between outsourcing Tax Reporting services and Financial reporting Quality among SMEs in Kenya?

**Critique of the existing literature relevant to the study**

Yahya, Tariq, & Ramayah (2014) investigated the effect of accounting on the Iranian SME performance. The variables of concern included trust, asset specificity and competition degree. Additionally, the study aimed to find out whether outsourcing of accounting services was positively related to trust of an accountant, whether outsourcing of accounting services have positive effect on financial performance of SME's. The findings revealed that the relationship between outsourcing of the accounting services and SME financial performance have a positive effect. The study further revealed that, the financial performance of the SME's improved directly depending on the extent to which they outsource accounting services. Additionally, the study revealed that outsourcing of accounting services mediates between the SME and the external accountant and the firms' performance. This means that, when the accountants act with utmost faith while offering their hired services, there are minimal errors supporting proper financial reporting. The study therefore demonstrates that outsourcing of accounting services is critical and more benefits yield from it and has more positive effects on financial reporting.

According to an Australian report on the uptake of accounting services, SME's in Australia, a country that is recognized for its well established accounting standards, it was revealed that compared to other countries in the world, most SME's outsource a large percentage of accounting services (Solakivi, Toyli, & Englobom, 2008). The outsourcings of accounting services are expected to increase further in future. Notably, the most outsourced services included the accounts payable, accounts receivables, auditing and tax related services which are easy to automate. However, the higher-value- adding activities for example, risk management and decision crafting were least outsourced and were likely to remain so even in future.

(Kanodia & H, 2016) Conducted a study on the effectiveness of outsourcing of internal audit and financial reporting by SME's in India. The study aimed at seeking an understanding of how outsourcing of internal audit and tax reporting affect the SME's financial reporting. Through the findings of the study timeliness while filling tax compliance and reporting was found to be highly effective and efficient. Further, through outsourcing of accounting services a more transparent compliance system had been established, it also helped in keeping in check the morality of those entrusted with the various functions such as book-keeping, auditing and tax reporting within the enterprises. However, the study revealed that as a result of outsourcing of the accounting services, vital information would be lost to competitors which may in return could cause negative effect on the overall performance of the SME's.

(Albana, N, & M, 2008) Conducted a study investigating the effect of tax reporting in financial reporting in Albania. The main goal of the study was finding out how necessary tax reporting service was among growing medium sized enterprises. The study revealed that among the many importance of having accurate tax report was for the purpose of avoiding conflict with tax authorities. This is because through using financial statements, income tax payable to state bodies is correctly calculated. It further revealed that, through tax reporting, the amortization calculated beyond the allowed limits by tax constitute a non-deductible expenditure element. Thus it's important to calculate accounting amortization and fiscal amortization so as to certify the tax reporting materials that affect financial reporting of any business entity.

According to a PWC reporting and compliance 2017 in Kenya, tax reporting has become a complex issue which most businesses and companies are struggling with. This has therefore hindered companies from being able to do more with less through driving out their taxes and financial obligation. Due to centralization of the accounting functions, small businesses and middle sized companies are finding it a real challenge when tackling complex local rules, manual process and disparate technologies while acting in compliance. This eventually results in compliance failure and the SME's left with minimal time for strategic forecasting/planning. In effort to amicably handle the issue, companies and SME's have opted to change their approach to compliance and reporting by outsourcing the services. This is seen as a strategy and a means to better tax function.

Wanyama (2008) in his study on the sustainability of SME's in Kenya found that many of them suffer mainly due to lack of qualified personnel, insufficient resources, and inefficient systems and have corrupt and egocentric managers. To make it worse, the firms are financially incapacitated to afford outsourced auditors. The findings further indicated that majority of the businesses are only audited yearly. Nonetheless, the study proposes the need to ensure compliance among individuals who have been subjected to auditing at least for one years. Those to be subjected to audit at least once a year. The study also recommended that standardized reporting and accounting should be adhered to so as to improve their financial reporting capability and spur growth. The study additionally recommended that through outsourcing, the SME's could stand to gain more while at the same time improve on efficiency, transparency and minimize wastage.

## 2. RESEARCH METHODOLOGY

This research adopted descriptive research design in its quest to determine the effects of outsourcing of accounting services on financial reporting quality among SMEs in Kenya. This type of design allowed the study to provide a description on the relationship between the dependent and the independent variable. According to Kenya Bureau of Statistics Kenya National Bureau of Statistics (2016) there are 50,043 registered SMEs in Kenya, 2,367 registered SMEs in Nairobi. According to Nabweire, (2015) Nairobi has the highest concentration of small and medium sized businesses who outsource their non core business activities due to this reason Nairobi county formed the studys' population. Sampling involve selection a representative to the population for the study. The formula below was employed;

$$n = \frac{Z^2 pq}{e^2}$$

Where n is the sample size, e is the margin of error, Z is the value from Normal distribution table, p is the proportion the population which outsource accounting services, q is obtained by 1-p. $n_0 = \frac{1.96^2(0.3)(0.7)}{0.05^2}$

$n_0 = 323$

$$n = \frac{n_0}{1+\frac{(n_0-1)}{N}}$$

$$n = \frac{323}{1+\frac{(323-1)}{2367}}$$

$n = 284$

## 3. RESEARCH FINDINGS AND PRESENTATIONS

After data was collected it was keyed and analyzed through the use of descriptive statistics and inferential statistics using Statistical Package for Social Science (SPSS) version 22 software. This section therefore presents empirical outcomes and results using the procedures provided in the previous section two.

### Reliability Analysis

The study also went ahead to establish the reliability of the collected data as shown in table 1.

**Table 1: Reliability Analysis**

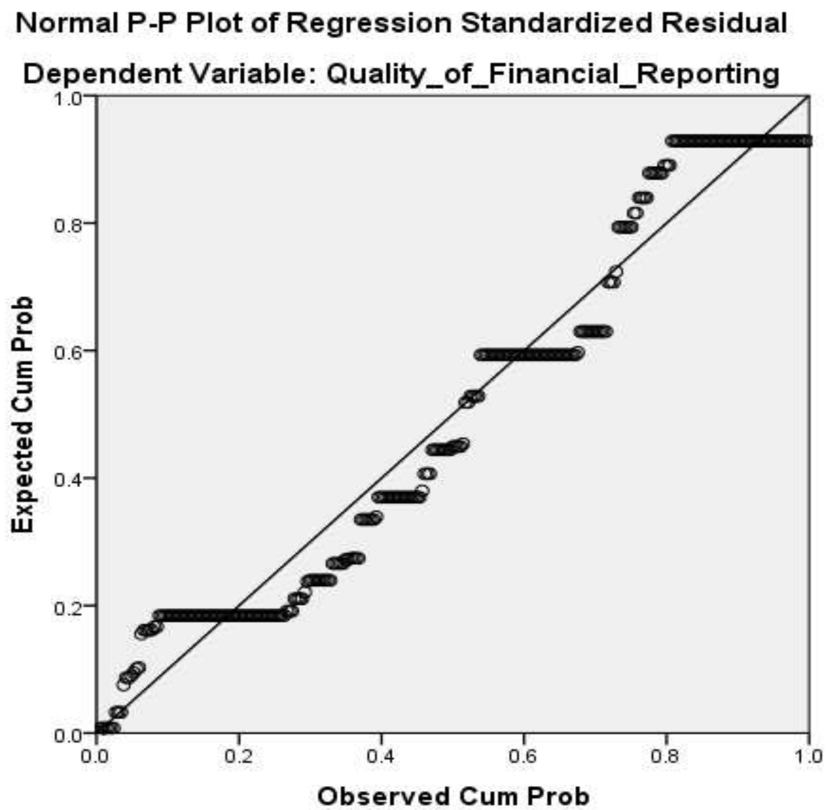
| Cronbach's Alpha | Cronbach's Alpha Based on Standardized Items | N of Items |
|---|---|---|
| .913 | .936 | 4 |

In order to assess internal consistency of the study data collection instrument Cronbach's alpha is calculated. Cronbach alpha was computed to indicate how reliable data was. In this case Cronbach Alpha obtained from the data gathered is 0.913. The criteria of assessing reliability is when the coefficient is 0.70 or more, high degree of data reliability which was the case with this study results which indicated a Cronbach's Alpha coefficient of 0.913 ad therefore the variables were reliable for the study, Cooper & Schindler (2011).

### Normality Test

According to McClave, Benson, & Sincich (2014) before fitting any data into a regression model, it is important to check whether two assumption are met under normal distribution, these are the data set has a constant error variance and that errors are normally distributed. To test the two assumptions the study used Normal P-P plot and a scatter plot. The Plot below tests the normality on the data on a scale of observed cumulative probability on the X axis and Expected cumulative probability on the X axis.

***Figure 1 Normal P-P Plot***

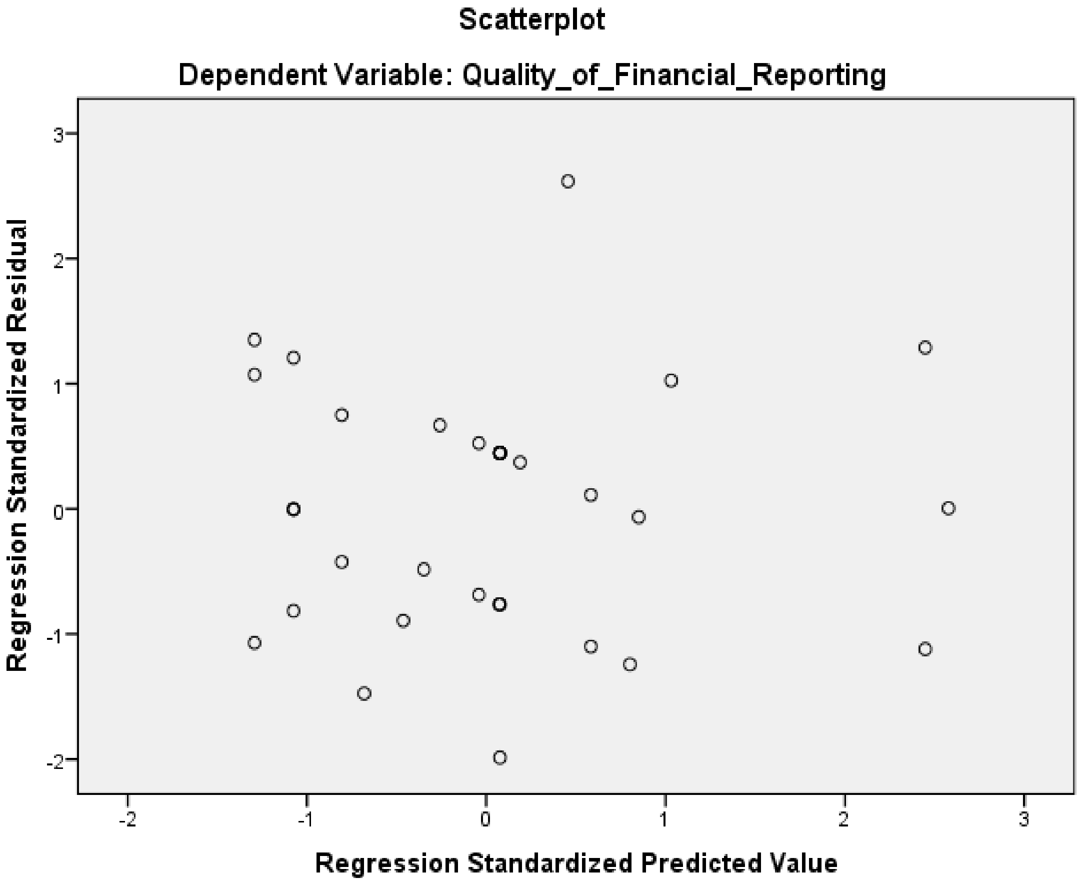



All the value represented by the dots approached the linear line, it can also be noted that the dots fall between both sides of the line. According to McClave, Benson, & Sincich (2014) this implies that the data set was well-modeled by normal distribution from the underlying random variables. Thus, the null hypothesis that distribution of variables was normally distributed was accepted hence qualifying the data to have met the assumption that errors have a constant error.

***Figure 2 Scatter Plot***

The figure below is a scatter plot of the dependent Variable on a scale of Standardized Regression Predicted Value on the X axis and Regression Standardized Residual on the Y axis. Under the second assumption, it will be expected that 95 percent of residuals lie within 2 standard deviations of the mean of zero and all the residuals lie within 3 standard deviations of the mean of zero.

International Journal of Social Sciences and Information Technology
ISSN 2412-0294
Vol IV Issue X, October 2018




This tests aims qualifying the model to having errors that are normally distributed and the independence of the model to predict the dependent variable. It can be clearly seen that all values of the dependent variable predicted by the model fall within the scale. According to Saunders, Lewis, & Thornhill (2012) the model qualify to predict the dependent values all the values occur within the scale of -2 and +3 on both axis.

**Regression Analysis**

The researcher finally carried out regression analysis to establish the relationship and whether the independent variables under study jointly affected the dependent variables. The study obtained the model summary upon conducting the multiple linear regression as indicated in table 2:

**Table 2: Regression Model Summary**

The F-Test done below is based on the hypothesis H0 = the model lacks explanatory power over the dependent variable while it's alternative H1= The Model has explanatory over the dependent variable

**Model Summary[b]**

| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate | Change Statistics | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | R Square Change | F Change | df1 | df2 | Sig. F Change |
| 1 | .848[a] | .720 | .717 | .220 | .720 | 235.457 | 3 | 275 | .000 |

The Model summary reveals that the R square is 0.720 and the Adjusted R square is 0.717. This implies that the changes in the variance of the dependent variable (Quality Financial reporting) is explain by the independent variables (Outsourcing of Tax Reporting, Outsourcing of Internal Audit and Outsourcing of Book-Keeping service).

Table 2 shows the summary of the model from the data gathered. R is the regression value between dependent and independent variables, from the model summary regression value is 0.848. This value shows there is a high positive correlation between the dependent and independent variables. R Squared indicates the level which our models represent the data, in this case its 72 percent. Adjusted R Squared represents the extent to which independent variable predict the depend variable in this study it stands at 71.7 percent with an R squared change of 12.8 percent. 72 percent of the total variability in Quality of financial statements is explained by outsourcing of book-keeping, outsourcing of internal auditing and outsourcing of tax reporting. At 95 percent confidence interval our model has a P value of 0.000 which is below 0.05 which is the study critical value. With this finding we reject the null hypothesis and accept the alternative that the model has explanatory power. This means that at 95 percent confidence level our model can be used to represent the relationship between the two sets of variables.

**Correlation Matrix**

Persons Correlation looks at the relationship among variables.

**Table 3 Correlation Matrix**

**Correlations**

| | | Quality of Financial Reporting | Outsourcing of Book Keeping service | Outsourcing of Internal Audit | Outsourcing of Tax Reporting |
|---|---|---|---|---|---|
| Quality of Financial Reporting | Pearson Correlation | 1 | .840** | .845** | .842** |
| | Sig. (2-tailed) | | .000 | .000 | .000 |
| | N | 279 | 279 | 279 | 279 |
| Outsourcing of Book Keeping service | Pearson Correlation | .840** | 1 | .990** | .979** |
| | Sig. (2-tailed) | .000 | | .000 | .000 |
| | N | 279 | 279 | 279 | 279 |
| Outsourcing of Internal Audit | Pearson Correlation | .845** | .990** | 1 | .977** |
| | Sig. (2-tailed) | .000 | .000 | | .000 |
| | N | 279 | 279 | 279 | 279 |
| Outsourcing of Tax Reporting | Pearson Correlation | .842** | .979** | .977** | 1 |
| | Sig. (2-tailed) | .000 | .000 | .000 | |
| | N | 279 | 279 | 279 | 279 |

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

This table represent the correlations between the variables. There is a very high positive correlation between the independent and the dependent variables 0.84 between outsourcing of bookkeeping and quality of financial reporting, 0.845 between outsourcing of internal audit and quality of financial reporting and 0.842 between outsourcing of Tax reporting and quality of financial reporting. This is in line with the study done by Hafeez & Anderson, (2014). It can also be noted that there is very high positive correlation between the independent variables. This means that from the findings, the activities around each of the independent variables highly correlated or the output of each activity affects the other.

**Coefficients of model**

The table below shows the analysis of the model coefficient and the result of student T-test on the independent variables. The null hypothesis for the T-test is that the coefficient of the independent variable is zero, the alternative hypothesis suggest that the coefficient of the independent variable is not zero. The obtained regression coefficients of the model were as indicated in table 4.

**Table 4: Regression coefficients**

| Model | | Unstandardized Coefficients | | Standardized Coefficients | t | Sig. |
|---|---|---|---|---|---|---|
| | | B | Std. Error | Beta | | |
| 1 | (Constant) | 68.234 | 1.972 | | 34.316 | .000 |
| | Bookkeeping | .96 | .029 | .211 | 3.841 | .000 |
| | Internal Audit | .849 | .021 | .190 | 4.020 | .000 |
| | Tax reporting | .942 | .027 | .187 | 3.510 | .001 |

Outsourcing of Book-keeping t-test statistics is 3.841 and a significance level of 0.00. Outsourcing of internal Audit occurs with a t-test statistic value of 4.02 and a significance level of 0.00. Outsourcing of tax reporting has a t-test statistic value of 3.51 and a significance level of 0.01. The critical value for the t-test is 0.05, considering the significance value for the three variables we reject the H0 stating that the three coefficients are equal to zero and accept the alternative.

The following model was applied:

$Y=\beta_0+\beta_1X_1+\beta_2X_2+\beta_3X_3+e$

The results were as indicated in the following equation:

$Y= 68.234 + .96X_1 + .849X_2 +.942X_3 + \varepsilon$

Where:

Y=Quality of Financial Reporting.

X1=Outsourcing of Book keeping

X2=Outsourcing of Internal Audit.

X3=Outsourcing of Tax Reporting.

$\beta_0$=constant.

$\beta_1$, $\beta_2$, $\beta_3$=Regression Coefficient

ε=Error term

The variables in the analysis were significant values at less than 0.05%. Therefore, a one percentage change in outsourcing of bookkeeping will lead to 0.96% increase in Financial Reporting Quality. A one percentage change in outsourcing internal audit results to 0.849% increase in Financial Reporting Quality. Correspondingly, one percentage change in outsourcing tax reporting results to 0.942% increase in Quality of Financial Reporting. Therefore, this result asserted that if all the above; book keeping services, internal audit services and tax reporting are put into consideration that SMEs outsource accounting services through quality financial reporting will be improved.

## Discussion of the Findings

### Outsourcing of book keeping

The respondents were asked to give their opinion based on their level of disagreement or agreement on outsourcing of book keeping service. The study conducted summary statistics for quality financial reporting using mean and standard deviation on a five- point Likert scale where strongly agree (5.0000-4.500), agree (4.499-3.500), neutral (3.4999-2.500), disagree (2.499-1.500) and strongly disagree (1.499-1.000) as indicated in table 5.

**Table 5 Descriptive statistics for Outsourcing of book keeping**

| Outsourcing of Book Keeping service | Mean | Std. Deviation | Covariance |
|---|---|---|---|
| I rely on the outsourced firm to post in the ledger accounts | 4.36 | .750 | 0.172 |
| Feedback is given on time by the outsourced firm on financial status of my business | 3.44 | .717 | 0.165 |
| The outsourced accountant have visited my business in adequate number of time to give an accurate report | 4.30 | .641 | 0.149 |
| The outsourced duties were satisfactorily carried out | 2.25 | .577 | 0.156 |
| Outsourcing of book keeping activities helps my organization maintain proper books of accounts. | 4.38 | .713 | 0.163 |

From the findings, majority of respondents, as shown by the mean of 4.36, agreed that they relied on the outsourced firm to post in the ledger accounts. This implied that bookkeeping is involved in ledger positing which enhances quality financial reporting. Also, respondents were neutral with a mean of 3.44 on the statement that feedback was given on time by the outsourced firm on financial status of their business. This denotes that not all employees received the feedback on financial status in time, thus affected the outsourcing of accounting services. Further, respondents with a mean of 4.30 agreed that outsourced accountant had visited their business in adequate number of time to give an accurate report. This suggests that accountants are responsible for accurate report that enhances quality financial reporting. Respondents with a mean of 2.25 disagreed on the fact that outsourced duties were satisfactorily carried out. This implies that the outsourcing of accounting services was not satisfactory thus affecting quality financial reporting. Last but not least, the respondents with a mean of 4.38 agreed that outsourcing of book keeping activities helped their organization to maintain proper books of accounts.

The findings are in line with Hafeez (2016) who points out that trust in bookkeeping is an influential factor when deciding accounting outsourcing. Business owners or employees must adopt accruals basis and duality concept of accounting to produce a complete image of the activities of bookkeeping and enhance quality financial reporting. Mutua (2015) argued that some business fails to keep complete accounting records due to lack of accounting knowledge and the cost of hiring professional accountants. As a result, there was inefficient use of accounting information to support financial performance measurement. This makes it difficult for the business owners to outsource accounting information efficiently. The study further tested the null hypothesis that the coefficient of outsourcing of bookkeeping is zero using students T-test where the alternative was accepted, stating outsourcing of bookkeeping has a significant effect on quality of financial reporting

**Outsourcing of internal Audit**

The respondents were asked to give their opinion based on their level of disagreement or agreement on outsourcing of internal audit. The researcher conducted summary statistics for quality financial reporting using mean and standard deviation on a five- point Likert scale where strongly agree (5.0000-4.500), agree (4.499-3.500), neutral (3.4999-2.500), disagree (2.499-1.500) and strongly disagree (1.499-1.000) as indicated in table 6.

**Table 6 Descriptive statistics of Outsourcing of internal Audit**

| | Mean | Std. Deviation | Covariance |
|---|---|---|---|
| That outsourcing of internal audit functions helps the business perform better | 4.28 | .645 | 0.151 |
| Review of the accounting systems and internal control is carried out in our business | 4.37 | .770 | 0.176 |
| That testing of transactions and balances was done | 2.37 | .636 | 0.142 |
| Review of operations effectiveness and efficiency and its costs was done | 4.28 | .720 | 0.168 |
| A recommendation to improve operational efficiency is offered | 4.38 | .678 | 0.155 |

From the findings, respondents with a mean of 4.28 agreed that outsourcing of internal audit functions helps the business perform better. This implies that outsourcing internal audits is a way of performance appraisal and it enhances both the firm’s profitability and quality financial reporting. Also, respondents with a mean of 4.37 agreed that review of the accounting systems and internal control was carried out in their business. Further, respondents were neutral with a mean of 2.37 on the fact that testing of transactions and balances was done. This denotes that respondents were not aware of how internal audit was done. In addition, respondents agreed with a mean of 4.28 on the statement that review of operations effectiveness and efficiency and its costs was done. Lastly, respondents agreed with a mean of 4.38 on the fact that recommendation to improve operational efficiency is offered. This shows that improvements in needed in outsourcing internal audits in SMEs to enhance quality financial reporting.

This findings affirms to Carey et al., (2016) who found out that positive association between technical competence of external service provider and outsourcing of internal audit. Therefore internal audit involves high qualified accountants to outsource the audits, effective and efficient internal control systems as well as proper audit tests. Uncertainty of SMEs about the offshore outsourcing requirements make the transaction unattractive. To improve this outsourcing requirement, proper planning, accuracy, completeness, timeliness, accessibility and clarity should be enhanced. The study further tested the null hypothesis that outsourcing internal audit have no significant effects on quality of financial Reporting. Where the alternative was accepted.

The finding therefore indicated outsourcing internal audit functions is paramount in enhancing quality of financial reporting, this finding agrees with Hafeez & Anderson (2014). Therefore, credible audit reports, auditor independence should be identified in SMEs and audit errors rectified. Also, accounts should implement audit recommendations and compliance policies with accepted audit standards to enhance quality financial reporting.

**Outsourcing of Tax report**

The respondents were asked to give their opinion as per the level of disagreement or agreement on outsourcing of internal audit. The researcher conducted summary statistics for quality financial reporting using mean and standard deviation on a five- point Likert scale where strongly agree (5.0000-4.500), agree (4.499-3.500), neutral (3.4999-2.500), disagree (2.499-1.500) and strongly disagree (1.499-1.000) as indicated in table 4.5

**Table 7 Descriptive statistics of Outsourcing of tax report**

| | Mean | Std. Deviation |
|---|---|---|
| Outsourcing tax reporting has helped in prompt tax filling | 4.34 | .697 |
| I often use external experts to prepare tax accounts such as VAT among other taxes | 4.35 | .743 |
| Outsourcing of tax reporting has improved tax compliance | 4.27 | .706 |
| I am contented that the following was thoroughly done; Statutory deduction, Information return and Tax planning | 4.40 | .707 |
| Outsourcing tax reporting is better than conducting it in-house | 3.27 | .755 |

From the finding in table 7 respondents agreed with a mean of 4.34 on the fact that Outsourcing tax reporting has helped in prompt tax filling. This denotes that tax report outsourcing enhances impromptu tax filling. Also, respondents were neutral on the fact that they used external experts to prepare tax accounts such as VAT among other taxes. This shows that SMEs business had inadequate knowledge on preparation of tax reports. Further, respondents with a mean of 4.37 agreed on the fact that outsourcing of tax reporting has improved tax compliance. This denotes that through frequency tax reporting the SMEs compliance with tax laws has been increased. Moreover, respondents agreed with a mean of 4.40 on the fact that statutory deduction, Information return and Tax planning is thoroughly done at SMEs firms. Lastly, respondents were neutral with a mean of 3.27 on the statement that outsourcing tax reporting is better than conducting it in-house. This shows that most of employees were not aware of the differences between outsourcing tax reporting and in-house outsourcing.

This finding confirms the study of Kaya and Koch (2015) who argues that various national accounting and tax systems adopted in Kenya affects the accounting service. Adoption of outsourcing of tax reporting by SMEs leads to a higher collection of taxes by the government since the employees keeps track of the tax report and accounting services. The study further tested the null hypothesis that outsourcing tax reporting have no significant effects on quality of financial Reporting and the findings show that outsourcing of tax reporting is important in enhancing quality financial reporting.

**Descriptive statistics on Quality Financial Reporting**

The respondents were asked to give their opinion as per the level of disagreement or agreement. The researcher conducted summary statistics for quality financial reporting using mean and standard deviation on a five- point Likert scale where strongly agree (5.0000-4.500), agree (4.499-3.500), neutral (3.4999-2.500), disagree (2.499-1.500) and strongly disagree (1.499-1.000) as indicated in table 8.

**Table 8 Descriptive statistics on Quality Financial Reporting**

| Quality of Financial Reporting | Mean | Std. Deviation |
|---|---|---|
| To what extent are valid arguments provided to support the decision for certain assumptions and estimates in the annual report? | 4.67 | .605 |
| To what extent do the reported results provide feedback to users of the annual report as to how various market events and significant transactions affected the company? | 4.77 | .475 |
| To what extent are the notes to the balance sheet and the income statement sufficiently clear? | 4.80 | .490 |
| What is the size of the Appendix Pages? | 4.06 | .594 |
| Which type of auditors' report is included in the annual report? | 5.00 | .000 |
| To what extent does the company, in the discussion of the annual results, highlight the positive events as well as the negative events? | 4.75 | .509 |
| To what extent do the notes to changes in accounting policies explain the implications of the change? | 4.75 | .445 |
| To what extent does the company provide a comparison of the results of current accounting period with previous accounting periods? | 2.97 | .568 |

From the findings, respondents strongly agreed on the fact that the valid arguments offered to support the decision for particular estimates and assumptions in the annual report enhanced financial reporting in a great extent. Also, respondents strongly agreed with a mean of 4.77 on the fact that reported results provided feedback to users of the annual report as to how various market events and significant transactions affected the business. Also, respondents with a mean of 4.80 strongly agreed that notes to the balance sheet and the income statement was sufficiently clear. Further, respondents with a mean of 4.75 strongly agreed that the business highlighted both the positive events as well as the negative events. Also, respondents with a mean of 4.75 strongly agreed that notes regarding the changes in accounting policies did explain the effects of the change. Lastly, respondents were neutral with a mean of 2.97 on the fact that their business provided a comparison of the results of current accounting period with previous accounting periods.

This study concurs with, Kamyabi & Devi, (2011) which states that the financial reporting quality is important since it positively influences capital providers and stakeholders in making investment, credit, and equal resource allocation decisions which enhances the overall market efficiency. To enhance quality financing reporting factors such as sufficient reporting of transaction, audit reports, comparison checks as well as tax report should be considered.

## 4. SUMMARY

To obtain data for the study 284 questionnaires were issued and 279 were filled and returned for analysis. Research output shows that the model is an adequate fit to the data, this is evident from the regression analysis, the relationship between the independent variable and the dependent variable has a positive relationship and a regression value of 84.8 percent. Eight five percent of variations in quality of financial reporting among small and medium sized enterprises can be explained by the model. F-Test on the data intends to determine whether the model can be used to explain the relationship between the independent and the dependent variables and from this test it is clear that the model has explanatory power to the two sets of variables.

Regression analysis was important in establishing the relationship between the quality of financial reporting and outsourcing financial accounting and whether the outsourcing accounting operation impacted the quality of financial reporting. A regression analysis on the data collected shows that this model can be used to predict the dependent variable $Y= 68.234 + .96X_1 + .849X_2 +.942X_3 + \varepsilon$. This findings showed that outsourcing book keeping services, tax reporting and internal audit services improves the quality of financial reporting. A T-test on each of the three independent variables exhibits that the three variables are relevant to in the prediction of the dependent variables. The study further conducts an analysis on residuals to test whether regressions assumptions are met. This analysis shows that residuals are normally distributed have a constant variance and a mean of zero.

**Outsourcing Book Keeping**

The study used descriptive statistics to analyze and understand the effect of outsourcing book keeping on financial reporting quality. The findings depict that majority of the participants (mean=4.36) agreed that they depended on outsourced firms to post in ledger accounts implying that bookkeeping is a part of ledger positing hence enhancing the financial reporting quality. Additionally, majority of respondents (mean=4.38) that trust in outsourced book keeping and believed that it aided their firms in proper maintenance of account books. Using the Chi-square test, the study managed to test the hypothesis that outsourcing book keeping had no significant impact the quality of financial reporting.

**Outsourcing Internal Audit**

With respect to the findings from the descriptive statistics of outsourcing internal audit, respondents with a 4.28 mean agreed that outsourcing of internal audit functions aided a firm in performing better. Additionally, many respondents agree that their firms reviewed internal control and accounting systems. Likewise, majority of respondents agreed that reviewing of operations efficiency and effectiveness as well as its cost was conducted. From this result it is vivid that outsourcing internal audit functions improves the quality of financial reporting. Chi-square test on quality of financial reporting and outsourcing internal credit also affirmed that internal edit is important in improving financial reporting quality.

**Outsourcing Tax Reporting**

Results from the descriptive statistics of outsourcing tax reports showed that many respondents who agreed that outsourcing tax reporting aided in prompt tax filling. Additionally, they also agreed that they it did improve the tax compliance of organization. However, respondents remained neutral on the statement that outsourcing tax reporting is better compared to in house. A Chi-square test on outsourcing tax returns and quality of financial reporting showed there exists a relationship between quality of financial reporting and outsourcing tax returns. This vividly indicates that outsourced tax reporting is vital in improving quality of financial reporting.

**Quality of financial reporting**

Many respondents agreed with the major statements about quality of financial reporting. They agreed that the valid arguments offered to support decision for particular estimates and assumptions in the annual report improved financial reporting. They also agreed that reported results offered feedback to users on how various transactions and events impacted the business. Respondents also agreed that quality financial reporting has highlighted both negative and positive events. However, it was evident that most respondents did not uses financial reports to compare results of the present accounting period with initial accounting periods. This makes it clear that quality financial reports are vital in positively influencing capital providers as well as stakeholders in the decision-making process improving the overall marketing efficiency.

## 5. CONCLUSION

The study sought to look into effect of outsourcing accounting services on quality of financial reporting of small medium and sized enterprises that lack internal managerial capacity to undertake accounting services in house. The study revealed that outsourcing of accounting services; Book keeping, internal audit and tax reporting has a positive effect on the quality of financial reporting.

It is important to note that from the study conducted each of the independent variable analyzed partially impact on the financial reporting quality among medium and small sized firms differently. The main reason a firm would outsource any of its function would be because it lacks capacity to conduct it in-house. However, with defined standards it is important for businesses to prepare quality financial reports to support in decision making processes by users of this statements. One of the assumptions made by the study was the cost of outsourcing accounting services by small and medium sized businesses in Kenya.

### Limitation to the Study

The study sought to explore the effect of outsourcing of accounting functions on quality of financial reporting, in this quest the study was only able to cover registered businesses in Nairobi County. Kenya National Bureau of Statistics (2016), recognizes that more than 60% percent of SMEs are not registered by the relevant authorities this proved a challenge while conducting convenient sampling where majority of this businesses were left out. Secondly, the study only covered Nairobi County, with devolution businesses are picking up in other counties extending the study to cover other counties would have a given the study a broader view.

## 6. RECOMMENDATIONS

After the analysis and conclusions made by the study, a number of recommendations have been arrived at. To start with, the study focuses on a segment of the economy that is largest employer yet lacks managerial capability to perform accounting functions in-house. Notwithstanding the study acknowledge the important of preparing quality financial reports. From the findings of the study, the small firms that outsource their accounting services end up preparing quality financial reports. The study can recommend medium and small sized enterprises that lack capacity to prepare financial reports in-house to outsource accounting services.

Authorities endowed with the mandate to support small businesses, such as the Ministry of industrialization and enterprise development need to come up with programmes to support these businesses in management and administration, as a result these businesses will be able to main quality financial reports that can be relied on in making financial decisions.

### Suggestion for further Studies

The study will recommend future studies to compare experience in business against quality of the statements prepared and also measure the strength of internal control systems against quality of the statements prepared. One of the assumptions made by this study was to overlook the cost of outsourcing of accounting services. The study covered only two sub counties in Kenya, further study can be done to cover a larger scope, in addition, there is need to look into cost versus benefits associated with outsourcing of accounting services.

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