

**THE EFFECT OF FIRM SIZE AND FINANCIAL STABILITY ON THE AUDIT
INDEPENDENCE OF AUDIT FIRMS IN NAIROBI COUNTY**

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DECLARATION

I hereby declare that this Research Proposal is my original work and has not been presented for any academic award in any university.

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This Research Proposal has been submitted for examination with my approval as the University Supervisor.

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Finally I thank my family for the moral support without which this study would have not been accomplished. A lot of thanks also should be conveyed to my other siblings including my sisters and brothers for encouraging me to finish this race so as to mentor academically other young siblings in the family.

DEDICATION

I dedicate this hard won project to my wife Ruth Nechesa and my son Mark for their appropriate support and humor accorded to me. This is not to forget my late parents, Father Wekesa Se-Chenonoi and Mother Tunai Khandasi who inspired me by noting that giving up for a good course leads to failure in one's life. This is because education is supposed to help the learner bounce back from failure.

ABSTRACT

This research sought to establish if there is any significant relationship between firm size, financial stability and audit independence. Audit independence refers to the probability that the auditor will refuse to support detected misstatements. Similar research on this topic is rare in Kenya. Empirical research on firm size effect on Audit Independence in Barbados recommended that it could be studied in developing countries such as Kenya. The research design was mainly quantitative in nature by using a questionnaire to gather primary data to help in establishing the extent of relationship between the variables. Secondary data on the other hand was uploaded from the internet. The source of data was solely drawn from ICPAK's website because it is the only institution with audit firms' records in the country besides depending on the nature of the problem that was being sought by the researcher. The period of study was sufficient enough for a plausible research, 5 years ranging from 2009-2013. 32 Audit firms out of 620 firms registered with ICPAK in Nairobi county as at August 2014 were stratified Sampled into large and small, each 50% and accessed from ICPAK Website. Simple random sampling method was used to capture the 16 firms from each stratum. The respondents were 13 small firms and 8 large firms giving a 65% response rate. Multiple regression analysis and correlation analysis were used to analyze the data so as to test the research objective. The coefficient of correlation (R) is 0.818 and coefficient of determination (R^2) is 0.669. This implies that 66.9% of the variation in AI can be explained by the independent variables while 33.1% of the Audit independence is explained by the error term and other factors not under study. Therefore the model is statistically significant as indicated by the F value of 18.2 significant value 0.000. The results of the study show that there is a relationship (an association) between Firm size, financial stability and Audit independence, thus the function is strong and reliable. This resonates well with the researcher expectations and previous studies, though the results did show a negative relationship between financial stability and audit Independence. The negative relationship according to the researcher was perhaps due to low response from large firms who considered some information in the questionnaire particularly on their liquidity and profitability as confidential information. ICPAK should ensure audit firms file annual financial statements with it in order for the public, researchers and other interested parties to be able to access their financial operations. This is likely to bring accountability, thereby enhancing independence plus giving ICPAK teeth to monitor proactively the operations of Audit firms in Kenya.

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ABBREVIATIONS/ACRONYMS

AC	Audit Committee(s)
AF	Audit Fees
AI	Audit Independence
AT	Audit Tenure
AICPA	American Institute of Certified Public Accountancy
C	Competition
CPA	Certified Public Accountant(s)
FS	Firm Size
ICAEW	Institute of Certified Accountants of England and Wales
ICPAK	Institute of Certified Public Accountants of Kenya
IFAC	International Federation of Accountants
KASNEB	Kenya Accountants and Secretaries National Examination Board
NAS	Non-audit services
PACOB	Public Company oversight Board
PAI	Perceived Audit Independence
SOX	Sarbanes Oxley Act
SPSS	Statistical Packages for the Social Sciences

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

An audit is an independent examination and expression of opinion on the financial statements of an entity by an appointed auditor in pursuance of that appointment and in compliance with the statutory requirements, (Coopers and Lybrand, 1988). An auditor is therefore a professionally qualified accountant who verifies accounting information in order to determine the accuracy and reliability of accounting statements and reports and also establish whether the accounts adhere to generally accepted accounting principles, management policies and statutory obligations. Auditing is analytical, investigative and critical. It is concerned with the basis of measurements and assertions. The major emphasis is proof and evidence which supports the financial statements and other reported information, hence the auditors' approach is based on logic as well as accounting principles. Auditing continues to be most acceptable measure to control public financial stewardship, (Harriettee, 2013). There is no good financial management without proper accountability of the same being mentioned. In their research paper, (Arnold et al, 1992) found that auditing played a big role as deterring mechanism in checking financial misreporting.

1.1.1 Firm Size

Audit firms operate in different sizes which can be classified as small, medium and large, where small size firms employ between 1 to 20, medium between 21 to 50 and while large over 50 employees (<http://www.nairobicity.go.ke>). Firm size can also be measured

by the market share, the amount of capital invested, market capitalization and sales turnover. Audit firm size has been the subject for research because it impacts on audit independence and as noted by, (Habib et al, 2007) larger firms with high demand for fees purchase more Non-Audit services than smaller firms. In a paper by,(Bengt, et al, 1971) on the relationship between Firm size and inventive activity it was concluded that firm size is a far better explanatory variable to variation in the frequency of patent application in the firm than variables such as market share, degree of diversification, working capital and cash flow. The researches went ahead to state that larger firms are associated with more resources, specializations and technological advancements. (Wincent, 2005) performed a study on whether size matters in a survey of firm behaviour among Small Medium enterprises and confirmed that indeed size matters in performance roles. On the other hand at times depending on situational factors such as gender and motivation size may not be a hindrance to performance. (Blomback et al, 2009) carried out a study on the challenging importance of size as a determinant for Corporate Social Responsibilities (CSR) activities. Their findings show that CSR activities can be explained by factors such as individual motivation and governance regardless of firm size.

1.1.2 Financial Stability

Financial stability reflects the ability of a firm to consistently meet both short term and long-term financial obligations as well as to continue on its growth path. This includes the ability to discharge the obligations with all stakeholders as well as attracting external investors, creditors and bank loans,(Swamy,2014).

There are a number of parameters applied to measure financial stability. Some of these include the following: the amount of cash in the bank that is the more cash an entity has in its account the more stability it is presumed to be. Annual turnover in relation to the value of projects in this case the higher the turnover of useful projects in the firm the greater the stability. This is synonymous with a good track record of profitability. The existence of a strong buying power of a company's products or services is a definite indicator of financial stability.

1.1.3 Audit Independence

In order to perform his/her duties, both the professional Code of Ethics and the Company's Act require the auditor to possess true independence. Professional independence refers to professional remoteness from the client, independence of mind, status and outlook. It is an important professional attribute because it enables the auditor to express an opinion without sub-ordination to the client's management. (Nur et al, 2005) stated that audit independence includes the qualities of integrity, objectivity and impartiality. The role of auditing is primarily to authenticate and to add credibility to financial statements by attesting as to the fairness of the presentations by management. The importance of this function has seen the number of Audit firms and professionals rise from 150 to 620 over the years 2000 to 2014 respectively in Kenya (Website: www.icpak.com). (Jasim, et al, 2011) defined audit Independence as "the ability to withstand pressure from management when conducting an audit or providing audit related services, so that the professional integrity of the audit is not compromised".

Further they stated that for an auditor to be independent, it is essential that the individual be independent in fact and appearance.

1.1.4 Effects of Firm Size and Financial Stability on Audit Independence

Audit independence has been given much attention for a very long time. This is because it acts as a gauge to ensure corporate business does not get mismanaged by owners' agents. In the recent past it has even been publicized with the demise of prominent firms such as Enron which resulted in the closure of Arthur Anderson one of the major accounting firms in the world. In their research paper, (Philmore, et al, 2006) concurs with Jasim by defining audit Independence as the ability to resist client pressure. Similar views are expressed by the Independent Standard Board as cited by (Philmore, et al, 2006).

Independence in fact refers to the actual objective state of the relationship between auditing firms and their clients. This is indeed unobservable. Therefore firms when doing research on this subject apply independence in appearance which refers to the subjective state of that relationship as perceived by clients and third parties. In spite of the requirements for audit independence it is quite possible for this state to be compromised. A study by (Philmore et al, 2006) revealed that audit independence can be compromised by many factors namely: non- audit services (NAS), audit fees, audit committee, audit competition for service, audit tenure and firm size.

(Philmore et al 2006) investigated ‘Perception of Auditor’s independence in Barbados. This study revealed that factors relating to the size, length of tenure-sole practitioner, small audit firm, Provision of non-audit services (NAS) among others negatively affect perceived audit independence. The writer concluded that this research is relevant in developing countries such as Kenya. The absence of audit independence has been addressed both globally and locally. At the international level, there is a glaring evidence of lack of independence in the case of Arther Andersen following the collapse of Enron in 2002. The audit firm (large audit firm) had been compromised by the management since no sooner had it issued a clean bill of health than the Enron collapsed. This led to the birth of SOX ACT of 2002 to be promulgated with a view to offer remedies through a number of provisions such as heavy fines, imprisonments, deletion from audit register of auditors who are not independent.

1.1.5 Audit Firms in Nairobi County

According to data obtained from ICPAK, there are 620 registered audit firms in Nairobi County as at August 2014. However, these firms have been dominated by the big five auditing firms comprising PWC, Delloite &Touch, Ernst & Young, KPMG and PKF. Most of the firms are small in size and financially unstable while the big five are large in size and financially stable. The researcher stratified the auditing firms into the two categories so as to get unique findings from each stratum and make generalizations of the population.

1.2. Research Problem

Audit independence that is the independence of internal or external auditors from parties that might have a financial interest in the business being audited is still highly recognized in the business world. In order to strengthen its applicability there are legislative amendments both internationally and locally in an effort to ensure it remains relevant in the accounting profession. The challenges on audit independence are an ongoing process. Research studies have been performed on factorial basis such as the effect of competition, NAS, audit firm size and tenure on audit independence as perceived by CPA firms, Loan officers, (Randolph A W 1981). The results indicated that audit operate in a highly competitive environments. In the ranking, competition was the most important factor affecting audit independence followed by NAS, audit firm size and tenure in that order.

Audit independence is thus important in a number of ways which includes: provision of an assurance to reliability of financial information since it act as a key control on the reliability of information. Credibility of financial information, an unqualified report by independent external auditors on the account gives credibility and enhances the appeal of the company to investors. Value for money audit work, lack of audit independence implies that important audit work is absent and shareholders are not receiving value for their audit fees. Threats to professional standards, lack of independence may lead to a failure to fulfill professional requirements to obtain enough evidence to form the basis of an audit opinion. Failure by an auditor to do this undermines credibility of the accountancy profession and standards it enforces.

1.2.1 Summary of the Research Problem

We have both global and local empirical studies on audit independence. The current state of audit independence and its importance shows how fundamental this concept is used and its evolving nature especially in developing countries. It is well established in developed countries being nurtured by respective institute of accountants. It is flourishing in Asian countries but very common or highly used in the USA and Europe. Concerning the research of this paper objective audit independence is hard to observe and therefore most research on this subject base their findings on appearance audit as researched by (Nur et al, 2005).

Globally audit independence has been addressed widely by the AICPA and PCAOB especially after the case of Enron collapse in 2002, where the auditor's independence was violated and Arthur and Anderson fell along with its client. Audit independent research features in (Habib et al, 2007), (Hayes et al, 2005) and many others. (Nur et al,2005) performed a research on factors influencing audit independence in Malaysia and narrowed on six fundamental factors that included the following: FS,C, AT serving the needs of a given audit client, AF received by audit firms, (NAS) and existence of AC. It was revealed that the larger the audit firm size the greater the auditor's independence. Lack of audit independence has triggered a number of provisions enacted by the Institute of Certified Public Accountants of Kenya through the Accountants Act 15 of 2008 to enhance audit independence. The Act empowers ICPAK to regulate the issuance of practicing certificates to individuals who are professionally qualified. Part IV of the Act on disciplinary provisions ensures that no one allows a person to practice in his name as

an accountant further any practicing accountant must observe ethical standards. Some relevant functions of the Institute on independence include promoting standards of professional competence and practice among members of the institute and advising KASNEB on standards and policies. ICPAK, the Kenyan Government and other stakeholders have come up with the financial oversight board (The Accountants Act 2012) with a number of objectives and provisions to address audit independence. Some of the objectives of the board include: protecting investors, employees, stakeholders and securing reliability and credibility of financial and non-financial information and promoting highest professional and ethical standards among auditors.

The (ICPAK), The Accountants' Act and The Companies Act attempt to secure Audit independence by prohibiting an audit firm from obtaining not more than 15% of its gross income from one client. This requirement implies that an audit firm should have many sources of income.. With increasing numbers of small audit firms and the resulting competition from both small and large firms, many small firms are increasingly relying on a few clients, thereby threatening their long term financial stability. This raises the following questions: Does firm size affect audit independence and in what direction (positively or negatively)?Are small audit firm in highly competitive environments perceived to be less independent due to increased likelihood of losing a client and revenue generated? (Nur et al, 2005). The other question is that do the other five factors affecting audit independence (tenure, audit fees, audit committee, audit competition and non-audit services) still hold? These three questions inspired the researcher to carry out a survey of audit firms in Nairobi County so as to empirically test the effects of firm size

and financial stability on audit independence. The questions are also based on the controversy between (Philmore et al, 2006) and (Nur et al, 2005).

In their findings the former stated that audit firm size negatively affects audit independence while the latter concluded that firm size especially large offices positively affect audit independence. Therefore the researcher will mediate the two conflicting findings (research gap) which are very attractive for research. Nairobi County was chosen because it is the main economic hub of the country and most audit firms are therefore located in Nairobi. No research has been carried out in Kenya to specifically examine the relationship between financial stability, firm size and Audit Independence. The research findings were expected to fill this gap.

1.3 Research Objective

The objective of the study is to establish the relationship between firm size, financial stability and audit independence. That is the influence of firm size and financial stability on audit independence.

1.4 Value of the Study

This study will firstly open-up more research/ and more knowledge for researchers on the relationship between firm size, financial stability and audit independence.

Secondly, the study will assist ICPAK in the regulation of audit firms particularly operations of small firms through legislation such as filing financial statement reports.

Thirdly, the study will ensure audit services needed in counties through registering more upcoming small firms. This will add more revenues to the exchequer besides creating employment opportunities. CPA practicing firms will operate in an environment that is well regulated in terms of the current changes in the professional of accountancy.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

The chapter presents a review of the literature on audit independence, firm size, financial stability and the gap to be closed by the study. What follows next regards a review on empirical studies on the three variables and winds up through the determination of the relationship between the same variables, in this case audit independence, firm size and financial stability.

2.2 Theoretical Literature

2.2.1 Audit Independence

There are two types of audit independence, actual and perceived independence. Actual independence is defined as the auditor's state of mind, his or her ability to make objective and unbiased audit decisions, (Dykhhoorn, et al, 1981). This refers to mental attitude of the auditor in terms of professional objectivity. Both actual and appearance are important in maintaining public confidence in the auditor independence. However actual independence cannot be observed. Therefore this study will focus on perceived audit independence (PAI), (Pany et al, 1983). Audit independence also refers to the probability that the auditor will refuse to support detected misstatements, Tong, (2006). The elements of an independent auditor were highlighted by many accounting professional bodies in the UK, American institute of certified public accountants (AICPA) and many others in Africa, Australia, and (Rocco et al, 1997).

All of them concur on the elements of an independent auditor. Examples of these are that an independent auditor must observe the accounting ethics and generally accepted Accounting practices. In addition they need to avoid conflict of interest such as avoiding serving as directors of the client company, avoiding accepting loans or guaranteeing loans, having no family relationship the company they audit.

(Kimeli, 2013) stated in his research that an audit has three roles: namely monitoring hypothesis, information hypothesis and insurance hypothesis. Monitoring hypothesis: it occurs when the principal delegates power to the agent who accepts if the benefits accruing are higher than the costs. Information hypothesis happens when information generated from financial statements has to be improved by the quality of audit.

Insurance hypothesis refers to a point where the public and other users of financial statements look at the audited statements immune from malpractices and therefore guarantee their assets security. According to the Accountants' Act 15 2008 of ICPAK, an independent auditor is an accountant, who needs to observe the following code of ethics as required by International standard auditing 570. These include: integrity, objectivity, professional competence and due care and confidentiality. Objectivity is a situation where the auditor is fair, unbiased and avoids conflict of interest plus undue influence. Professional competence and due care arise when an accountant should show competence and duty of care by keeping up- to date with developments in practice, legislation techniques.

Confidentiality concerns respect and confidentiality to information acquired during course of providing professional services. The accountant should not use the information acquired as a result of business and professional relationship for the personal advantage of the professional accountant or third parties. Professional behavior- a professional accountant should act in a manner consistent with the good reputation of the profession and desist from any acts which might bring discredits to the profession. Integrity refers to an auditor being honesty and straight forward in dealing with the clients. (Muthamia, 1990) carried out a study on factors affecting publicly quoted companies in Kenya in selecting an external auditor. In her research work she found out that the audit firm's image or reputation was the most important considered. Ironically auditor's qualification was the least.

2.2.2 Theories of Audit Independence

2.2.3 Agency theory

An agency relationship arises when one or more principals (e.g. an owner) engage another person as their agent (or steward) to perform a service on their behalf. Performance of this service results in the delegation of some decision-making authority to the agent. This delegation of responsibility by the principal and the resulting division of labour are helpful in promoting an efficient and productive economy. However, such delegation also means that the principal needs to place trust in an agent to act in the principal's best interests. (Hayes et al, 2005)

A simple agency model suggests that, as a result of information asymmetries and self-interest, principals lack reasons to trust their agents and will seek to resolve these concerns by putting in place mechanisms to align the interests of agents with principals and to reduce the scope for information asymmetries and opportunistic behaviour.

Agents are likely to have different motives to principals. They may be influenced by factors such as financial rewards, labour market opportunities, and relationships with other parties that are not directly relevant to principals. This can, for example, result in a tendency for agents to be more optimistic about the economic performance of an entity or their performance under a contract than the reality would suggest.

Agents may also be more risk averse than principals. As a result of these differing interests, agents may have an incentive to bias information flows. Principals may also express concerns about information asymmetries where agents are in possession of information to which principals do not have access. Differing motivations and information asymmetries lead to concern about the reliability of information, which impacts on the level of trust that principals will have in their agents. There are various mechanisms that may be used to try to align the interests of agents with principals and to allow principals to measure and control the behaviour of their agents and reinforce trust in agents.

Remuneration packages and incentives for agents can provide an effective mechanism, as can the market for corporate control and hiring and firing by the board of directors. Typically, the less trust there is in an agent the more likely it is that principals will opt for certain performance-related pay measures and incentives that will align interests. In such scenarios the basic salary is likely to be set at a relatively low level, but it would go hand in hand with a package of other benefits which might include bonuses and share options. Such mechanisms, however, create potential new agency problems related to the measurement of performance. Duties can be written into contracts and made the subject of enforcement and penalties or an alternative is to embody the duties of agents in statute (and introduce sanctions for those who do not comply), such as duties placed on directors under company law. An audit therefore provides an independent check on the work of agents and of the information provided by an agent, which helps to maintain confidence and trust.

2.3 Determinants of Audit Independence

The role of auditing was manifested by four fundamental theories of auditing. These theories include the following: Policeman theory, Lending credibility theory, inspired confidence theory and agency theory. Policeman theory, this theory is centered on searching, discovery finally preventing fraud. This was in existence up to beginning of 20th century. However the role of audit has dramatically shifted to promoting assurance and verifying truth and fairness of the financial statements. All the same fraud detection is still taken seriously thus giving more responsibilities to auditors for solutions.

Lending credibility theory- in this case audited financial statements are perceived by users as credible for use since they assume them to be of high quality. Theory of inspired confidence is a theory that addresses the demand and supply of audit services whereby third parties rely on audit report to make investment decisions. Therefore information in the statements should meet this expectation. Agency theory refers to a state where the Auditor is appointed both in the interest of third parties and the management. There is a network of agreements (contracts) which the company makes with 3rd parties as well as management. The role of management is to coordinate these groups with a view to control and harmonize their operations in terms of low prices for goods purchased high revenue for sold goods, low interest on loans from banks maximize share price and employees value for their labor. Thus management becomes the agent of the principals (Banks, Employers, shareholders and employees).

2.4 Empirical Review

Independence in appearance (PAI) relates to others' or public perception of the auditor's independence. PAI is the hallmark of many research theories in auditing profession. This is because independence in appearance relates to the Audit perceptions of the users of financial statements (Busse, 1977). (Pany et al, 1983) highlighted the concept of audit independence as originating from the reason for existence of auditing itself. Their conclusion was that the rationale for external auditor's work (independent audit) gives rise to a major justification for public accounting profession emanating from the need for reliable financial information.

(Gunz et al, 1991) found out that there is a relationship between independence and professional ethics especially the issue of conflicts of interest. There are many situations of conflicts of interest for example auditor's duty towards the public or either the client. In this case the auditor may breach his or her responsibility to maintain clients' confidentiality- by passing relevant information between partners. This can occur as a result of auditor's self-interest to avoid audit failure resulting in litigation against the auditor (Nur, 2005). Therefore most of the literature on audit independence, suggest that the credibility of financial statements depend on the perceived independence of the external auditor by the users of financial statements, (Firth et al, 1982).

As argued by (Firth, 1980) that if the auditor is not seen to be independent, users of the report will have less confidence in the financial statements and therefore the auditor's opinion on the company's financial statements will be of no value. Audit independence is fundamental to the auditor since it is regarded as one of the cornerstone principles underlying the auditor's work. The financial markets should have confidence in the integrity and objectivity of auditors. In the case where there is no definite independence, auditors may have no value. In the recent past, governors, CEO of blue chips, regulators and public have seriously paid attention to auditors' independence in the audit environment where dangerous audit collapsed for example Enron and World com occurred. This has triggered several bodies to establish new independent standards. This is because the general setting within which auditor independence perceptions are formed is subject to change (IFAK, ICAEW, 2001). The reform of the framework for auditing and accounting and ethical guidelines is a continuous process (Beattie et al, 1999).

Audit Independence can be affected both by audit committee and internal audit functions. A number of studies have examined how audit committees affect the selection of the company's external auditor, negotiate audit fees and enhance the auditor's independence. On the other hand AC may affect the very audit independence they are expected to safeguard. (Reinstein et al,1996) in their paper on "Testing for bias in the audit committee", the findings on 247 New York Stock Exchange firms revealed a significant relationships(at the 0.05 level of significance) between CPA firms selected by audit committees and the CPA firm which audits the audit committee member's own organization. That the members exhibited a conscious or unconscious biases in their selection or retention of their companies' auditors. This study was centered on large firms where size with audit committee can affect audit independence.

However auditing committee should not be taken as a panacea for corporate deficiencies this was postulated by Collier (1986). (Nur et al., 2005) performed a research on factors influencing audit independence in Malaysia and narrowed on six fundamental factors that included the following: size of audit firm, level of competition in the audit service market, tenure of audit firms serving the needs of a given audit client, size of audit fees received by audit firms, non-audit services (NAS) and existence of audit committee. It was revealed that the larger the audit firm size the greater the auditor's independence. They agreed that large firms are more resistant to client pressure than small firms. This is contrary to what happened to audit firm Arthur Anderson and its client Enron.

Competition, the level of competition in the audit service market negatively affects audit independence especially in the case of high level of competition in the audit market. Audit tenure as the length of time it has been filling the needs of a given client. Audit tenure has the risk of losing audit independence. A long association between a corporation and accounting firm may cause the independence of an accounting firm to become difficult. Audit fees, the accountants international study group (1976) recommended that the auditor be restrained from accepting engagements for which the fees constitute 10% or more of the auditor's total fee income. According to institute of certified accountants of England and Wales (ICAEW) audit fees of a major client should not exceed 15% of total fees to avoid impairment of audit independence this is also applicable in Australia, Kenya among others.

In this same paper it also mentioned that small audit firms are more dependent on one client if the size of the audit fees generated is a significant proportion of its overall revenue. Hence in a highly competitive environment the auditor is also perceived to be less independent due to increased likelihood of losing a client plus the revenue generated by the client. It was also stated that audit independence is negatively affected when NAS are performed for audit clients because close working relationship. Audit committee affects audit independence positively as concluded by (Nur et al, 2005). This is so in that Audit committee impacts in enhancing auditor's independence.

Internal audit function is crucial in assisting corporate governance. For this department to yield results it must be independent. Internal audit function safeguards a company's assets and its reports are relayed to management directly. In a study on the role of internal audit function on listed firms in Egypt, (Ibrahim et al, 2011) discovered that it was very much entrenched in the corporate sector. That their role was not yet pronounced making their role difficult thus negatively affecting their corporate governance. Sometimes the management affects internal audit independence by ensuring that it is not independent as it was confirmed by (Njeru, 2013) on "relationship between audit independence and corporate commercial banks".

To function effectively, internal auditors and customers of audit services should possess a similar understanding of what makes internal auditing a value added activity as envisaged by ,(Dale,2000).There are factors that ensure that internal audit of a corporate entity remains autonomous for excellence performance in its duties. This was exemplified in a research unpublished paper by (Ndirangu, 2012). In this paper on factors that enrich internal audit performance a case study of Public Universities Kenya it was found out that audit proficiency among other variables do affect internal audit independence (effectiveness) positively. Audit firm size does affect audit fees negatively as well. This study was clearly conducted by (Kimeli, 2013), when determining factors that affect audit fees in Kenya. In a study of the impact of corporate governance on the financial performance of saving and credit societies in Kenya it was found out that audit committee size had a positive relation to firms' financial performance (Otieno, 2013).

Financial statement users still rely on auditors' independence in making their financial decisions worldwide. A research paper was performed on perceptions of auditors' independence by auditors, banks and others by, (Jasim, 2011). Their findings denoted that there were four main threatening factors affecting auditors' independence namely Economic reliance of auditors on their clients, provision of non- audit services, competition and long tenure of audit services. (Thuneibat et al, 2011) carried out a study in Amman Jordan to find out whether extension of Audit client relationships (audit tenure) and firm size can affect audit quality thus audit independence.

Their research findings revealed that audit tenure affects audit quality negatively that is the longer the client relationship the lower the audit quality and that firm size insignificantly affects audit quality. Independence auditing is widespread in the whole world where in some countries accounting standards have been reinforced to uphold it. For instance in New Zealand, (Zhang et al, 2008) did a study on the effect of non-audit services and earning conservatism on auditor's independence. Their findings revealed that there was no association between the two variables. Thus audit independence was not affected by the provision of non- audit services and conservative earning management. In this case the author explains conservative earning management as the adoption of accounting policies that accelerate expenses towards the current period and or defer revenues to later periods.

This principle is still practiced in this country up to date to demystify audit independence in the corporate governance sector. (Habib et al, 2007) performed a study in Bangladesh on factors affecting non-audit services and their conclusion arrived at shown that larger audit firms with higher liquidity and international links purchased more non-audit services than the smaller ones. This implies that the bigger the audit firm size, the higher the provision of non-audit services. In a more litigious society the firms are concerned with reputation costs and effect on perceived audit independence. In a study on the effect of non-recurring and recurring on audit independence Deborah et al (2013) confirmed that companies that purchase any type of non-audit services from their auditors are larger than companies that purchase auditing only.

This implies size of clientele firm may affect the size of the audit firm. (Thuneibat, 2011) did a study on the effect of audit tenure and firm size on audit quality in Jordan, the findings revealed that audit tenure affects adversely audit quality while firm size had no impact on the correlation between audit tenure and quality. On pricing of audit fees (Meshari, (2008) concluded that audit firm size had little significance influence on external audit fees. This affirms that auditor's independence could not be compromised much.

Financial stability of an organization is key for its survival in a competitive environment. A firm with low cost –buyer or seller of unique products/services strategies, consistent growth and high demand products will achieve durable competitive advantage. According to Forbes magazine's "400 Richest American" 2009 the above strategies can

be derived from financial statements of a firm especially from the elements of Income statements, cash flow statements. The magazines concludes by stating that ratio analysis from the financial statements such as profitability, liquidity and coverage ratios are helpful in determining the financial stability of a company. Audit independence can play a big role in enhancing the performance or profitability of a firm independence of internal audit and profitability of the firms leading to positive earnings per share. Mugwe (2012) performed a study in Kenya on the relationship between the Independence and objective of the internal audit function and Earning per share in Companies listed on Nairobi stock exchange and found out that there is a positive relationship between Independence of internal audit and profitability of firms leading to positive earnings per share.

2.5 Summary of the Literature Review

(Philmore et al, 2006) on factors affecting perceptions of audit independence indicated that firm size affected audit independence negatively. On the other hand, (Nur et al, 2005) affirmed that large offices affect audit independence positively. Hence there was a gap that permitted further research. In the study by (Kimeli, 2013 the conclusion shown that there is a relationship between firm size and audit fees. (Mugwe, 2012) performed a study in Kenya on the relationship between the Independence and objective of the internal audit function and Earning per share in Companies listed on Nairobi stock exchange and found out that there is a positive relationship between Independence of internal audit and profitability of firms leading to positive earnings per share.

No study has been done on the effect of Firm size and financial stability on the independence of external auditors in Kenya. This study is therefore of its own kind in Kenya and has not been researched before. The researcher sought ways or strategies to establish if firm size and financial stability influence auditors' independence in Kenya.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This section outlines how the research was carried out and covers the research design, the target population, sampling technique, data collection and data analysis. Kothari (2012) defines a research design as a conceptual structure within which research is conducted: it constitutes the blueprint for the collection, measurement and analysis of data.

This chapter sets out the plan through which data was obtained particularly the method applied to draw data for analysis in order to answer the research questions)... it also shows the population framework, the instrument used and sampling procedures including data analysis approaches. With reference to (Kothari, 2012), there are three research designs namely: exploratory studies, descriptive studies and hypothesis testing (Experimental designs). Exploratory studies involve formulating a problem for more precise investigation developing a hypothesis from an operation point of view. The emphasis here is discovery of ideas and insights. Descriptive research and diagnostic studies refer to describing the characteristics of a particular individual or of a group and studies whether certain variables are associated respectively. Experimental studies involve three principles: the principle of replication (experiment conducted more than once), the principle of randomization (all extraneous factors combined under one heading, “chance”) and the principle of local control (where all the extraneous factors are allowed to vary as much as possible and their effects are eliminated) as stated by (Kothari, 2012).

3.2 Research Design

The researcher applied a mixed research design, both qualitative and quantitative techniques in a bid to establish if there is any relationship between audit firm size and financial stability as independent variables affecting auditors' independence (dependent variable) in Kenya. The researcher used multiple regression analysis (quantitative) in order to establish the nature and strength of the relationship between the three variables. Quantitative research was ideal because firm size and financial stability were measured numerically. Firm size represented the first independent variable (X_1), financial stability represented the second independent variable (X_2). Other factors were represented by the symbol (ϵ_1) while auditors' independence was represented by the dependent variable (Y). The number of employees was used as a measure of firm size. Financial stability was measured using the number of sources income while audit independence was established by the strength of empirical factors affecting audit independence. (Factors- AC, Competition, tenure, firm size and NAS) and by asking respondents their views about independence and rated on a likert scale.

The extent of the relationship between the variables based on empirical data helped the researcher in answering the research questions. The variables were coded and entered in excel in order to establish the nature and extent of relationship (R^2) i.e. the coefficient of determination. This measured the amount of variation in the dependent variable which was explained by the variation in the independent variables. Therefore it gives the percentage of the explanatory power of a regression model on a scale from zero to 100%. Generally the higher the value of R^2 , the better the Regression model. R^2 = Explained

Variation/Total Variation. Qualitative research therefore supported the researcher to capture the information about the respondents' perception of the study.

3.3 Target Population

According to (Maina, 2012), a Population is a set of complete individuals' cases or objects with some common observable characteristics. The population of interest therefore related to Registered Practicing auditors from the directory of ICPAK as at August 2014. This number totaled up to 620 CPA firms in Nairobi City County. A Survey of auditors in Nairobi County was earmarked due to proximity and well representation of nature of the data and statement of the problem.

3.4 Sampling technique

Sampling is the process of selecting things, items or objects from a population of interest so that by studying the sample, we may fairly generalize results to represent the characteristics of the population, (Maina, 2012). The sampling technique used was stratified sampling method consisting of two groups, large and small audit firms. For the purpose of this research, larger firms ranged from 21 employees and above (medium and large firms combined) while small firms ranged from 1-20 employees. Each stratum had 50% of the chosen sample in this case 16 audit firms. Simple random technique was applied to select the 16 items (Audit firms) from each stratum based on judgment and research experience. The population of interest was 620 out of which a sample of 32 firms (5%) was picked for the study. The sample size of 32 was representative as per the central limits theorem which states that when sampling from a population, the attributes

of the population assumes normal distribution as the sample size approaches 30, hence the findings were representative enough to allow generalizations to be made of the population.

3.5 Data Collection

This was mainly primary and secondary data. Primary data was collected through structured Questionnaires completed by senior staff of the respective institutions. The drop and pick method was employed since it was convenient in view of the fact that there was no time and managers had to fill them at their convenience. Moreover, the presence of the researcher would have intimidated the respondents hence the need to give them time to respond at their own convenience thereby getting unbiased responses. A follow up through telephone calls was also made in order to ensure complete information was collected. The questionnaires were well structured, simple and in a logical sequence in order to avoid any biases since they would be self-administered. The questionnaires were edited for accuracy, uniformity, consistency and completeness. Primary data on audit independence, firm size and financial stability was collected using a tailor made Questionnaire.

Secondary data was also collected in a structured sheet where possible in the form of annual reports and financial statements of audit firms for the five year period ranging 2009 to 2013 in order to establish the financial stability of the audit firms and audit independence. This sheet was inbuilt in the research questionnaire. Secondary data was also obtained from ICPAK and Audit firms Websites.

3.6 Data Analysis

The data was analyzed using descriptive statistics and SPSS, schedules, frequency distribution, charts, regression analysis, where $r < 0.5$ indicates a weak relationship between audit independence and firm size and $r > 0.5$ shows a strong positive relationship. Ranking of factors influencing auditors' independence was done. Multiple regression of Audit independence on firm size and financial stability was performed to examine the relationship between variables. The following Regression model was used in performing the research: This is because according to the research problem and objective of the study, firm size and financial stability were presumed to affect audit independence. Therefore there is a causal relationship between the three variables.

$$Y = B_0 + B_1X_1 + B_2X_2 + \epsilon_1$$

Where Y= Audit Independence

X_1 = Firm size

X_2 = Financial stability

B_0 = Y-intercept (Constant)

B_1 = Coefficient of X_1

B_2 = Coefficient of X_2

ϵ_1 = Error term of the model

Number of employees was used to measure firm size while financial stability was measured by number of sources of income. On the other hand audit independence was measured by the factors affecting audit independence on a likert scale 1-5. These factors included the following: AF,FS,AC,C,AT and NAS.

The significance of the model was tested as follows (ANOVA):

$F = \frac{\text{Explained variation (K-1)}}{\text{Unexplained variation/}}$

$n - k$

Where $n =$ sample size

$k =$ the number of parameters being estimated

$N - k =$ Degrees of freedom

If the computed F is greater than the critical value from the table, it shows the degree of association is strong and the function is reliable. This shows that the larger the value of F the better the predictive power of the model.

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSIONS

4.0 Introduction

This chapter presents the research findings in details by descriptive statistics, tables and charts. The collected data was further coded, validated and analyzed in order to answer the research Questions thereby achieving the objectives of the study. It also highlights the regression model, correlation statistics and discussions on which the findings are based. The study targeted a sample population of 32 audit firms out of the total population of 620 audit firms registered in Nairobi County. In the sample study of 32 firms, 21 firms were responsive giving a responsive rate of 65%. The data was analyzed to answer the following research questions: whether firm size affects audit independence, whether small firms are less independent than large firms due to relying on a few client(s) and whether other factors affecting audit independence besides firm size still hold in Kenyan audit market.

4.1 Demographic Profile of Respondents

Analysis of respondents' demographic characteristics shows that a majority of the respondents are males, who constitute 85.7% of the respondents. This can be illustrated in the Table below:

Table 4.1: Gender Profile

		Gender		
	Frequency	Percent	Valid Percent	Cumulative Percent
Valid	males	18	85.7	85.7
	females	3	14.3	100.0
	Total	21	100.0	100.0

Source: Research Data

The average working experience of the respondents in the present position was 5-10 years which accounted for up to 38.1% of the respondents. This showed that they had adequate knowledge of the firm and its activities. See Table below

Table 4.2: Frequency of Experience of Audit Firms

		Experience		
	Frequency	Percent	Valid Percent	Cumulative Percent
Valid	1-5years	7	33.3	33.3
	5-10years	8	38.1	71.4
	11-15 years	1	4.8	76.2
	above 15 years	5	23.8	100.0
	Total	21	100.0	100.0

Source: Research Data

A majority of the respondents have an experience of more than five years, representing 66.7% of the respondents. This implies that their responses are based on efficiencies gained after the learning effect/phenomenon.

Table4. 3: Level of Education Frequency

		Education			
		Frequency	Percent	Valid Percent	Cumulative Percent
	high school	1	4.8	4.8	4.8
Valid	college/University	20	95.2	95.2	100.0
	Total	21	100.0	100.0	

Source: Research Data

The respondents required to indicate level of education. From the study it was confirmed that an overwhelming majority of respondents had a University education representing 95.2%. This shows that audit firms are interested in highly qualified staff so as to gain credibility and reputation with their clients.

4.1.0 Number of sources of Income in a year

Table 4.4: Frequency on Number of Sources of Income

		Number of income sources			
		Frequency	Percent	Valid Percent	Cumulative Percent
	1-4 sources	8	38.1	38.1	38.1
Valid	5-10 sources	7	33.3	33.3	71.4
	above ten	6	28.6	28.6	100.0
	Total	21	100.0	100.0	

Research Data

In this case, respondents were asked to indicate the number of sources of income in a year. The results are as above. The results indicate that 38 % of firms have number of

sources of income between: 1-4, implying that small firms have limited sources of income which is likely to compromise audit independence. However, majority of the firms, 62% had more than 5 sources of income indicating financial stability.

4.1.1 Audit Independence

Audit independence was measured by perceptions of factors affecting it. These factors that can compromise audit independence include the following: AF, AC, NAS, AT, C and FS. The results from the study indicate audit independence was compromised by all the factors. The study revealed that firm size was among the best affecting audit independence. Audit independence was measured/estimated by adding all the above six factors affecting audit independence

4.1.2: Factors affecting Audit Independence

Table 4.5: Descriptive Statistics on Factors affecting Audit Independence

Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
Audit size	21	1.00	5.00	3.6667	1.19722
Audit tenure	21	2.00	5.00	3.7143	.95618
Audit committee	21	1.00	5.00	2.9048	1.26114
Audit fees	21	1.00	5.00	3.2381	1.09109
Non audit services	21	1.00	5.00	3.2381	1.37495
Audit competition	21	1.00	5.00	3.4762	1.24976
Valid N (list wise)	21				

In using a likert – scale, the respondents were asked to rate their extent of agreement with the factors affecting audit independence. These factors can be ranked as follows using their arithmetic mean from the above table.

1. audit tenure
2. audit firm size
3. audit competition
4. audit fees
5. non audit services
6. audit committee

This implies that audit tenure was highly ranked as being a factor affecting audit independence, closely followed with firm size and audit committee coming in last.

Table 4.6: Disciplinary Issue with ICPAK

Disciplinary

	Frequency	Percent	Valid Percent	Cumulative Percent
Yes	1	4.8	4.8	4.8
Valid No	20	95.2	95.2	100.0
Total	21	100.0	100.0	

Source: Researcher

The respondents were to state Yes/No, whether they had a disciplinary problem with ICPAK. 95.2 % of respondents had no disciplinary issue with ICPAK. This is a vote of confidence in the execution of their duties.

4.1.3 Firm Size

Firm size was measured by the number of employees in a firm. The findings indicate that small firms were more responsive to the research questions than large firms.

Table 4.7: Number of employees working within the Audit Firms

Employees

	Frequency	Percent	Valid Percent	Cumulative Percent
small firms	13	61.9	61.9	61.9
Valid large firms	8	38.1	38.1	100.0
Total	21	100.0	100.0	

Source: Research Data

Most of the large firms in the sample did not respond due to some information in the Questionnaire which they considered to be very confidential particularly on financial stability using financial ratios. 61.9% of the respondents were small firms. This skewed the findings since the data from small firms cannot be generalized on large firms.

4.1.4 Relationship between firm size and audit independence

Table 4.8: Descriptive Statistics on the Relationship between Firm size and Audit Independence.

Correlations

		Audit independence	Firm size
Spearman's rho	Audit independence	1.000	.749**
	Correlation Coefficient		
	Sig. (2-tailed)	.	.000
	N	21	21
	Firm size	.749**	1.000
	Correlation Coefficient		
	Sig. (2-tailed)	.000	.
	N	21	21

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

Source Research Data

The results indicate a strong positive correlation between firm size and audit independence($r=0.749$), hence as firm size increases, audit independence also increases.

4.1.5 Relationship between financial stability and audit Independence

Table 4.9: Descriptive Statistics on the relationship between Financial Stability and Independence

		Correlations	
		Audit independence	Financial stability
Audit independence	Pearson Correlation	1	.143
	Sig. (2-tailed)		.537
	N	21	21
Financial stability	Pearson Correlation	.143	1
	Sig. (2-tailed)	.537	
	N	21	21

Source: Research Data

There is a very low correlation between financial stability and audit independence($r=0.143$). This is because a majority of the respondents were small firms and therefore felt that financial stability does not enhance independence thereby skewing the results of the study. This is in agreement with the Enron's demise in 2002.

4.1.6: Measurement of Financial stability

A likert Point of scale was used. The question asked related to financial statements ratios such as liquidity and profitability as measures of financial stability and the results were as indicated in the following table:

Table 4.10: Liquidity Measurement

Liquidity

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid between 0,5 and 0,9	1	4.8	4.8	4.8
Valid between 1-1,4	9	42.9	42.9	47.6
Valid between 1.5-2.0	9	42.9	42.9	90.5
Valid above 2.0	2	9.5	9.5	100.0
Total	21	100.0	100.0	

Research Data

The majority of the firms had their liquidity ratio, 1-2. This shows that most firms were stable.

Table 4.11: Profitability measurement.

Profitability

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid less than 5%	1	4.8	4.8	4.8
Valid 10%-14%	9	42.9	42.9	47.6
Valid 15%-20%	11	52.4	52.4	100.0
Total	21	100.0	100.0	

Source: Researcher.

The table revealed that most firms have profitability between 10% and 20%. This indicates that their performance is average and above.

4.1.7 Relationship between audit tenure and Independence

Table 4.12: Audit Tenure and Independence

Correlations

		Audit tenure	Audit independence
Audit tenure	Pearson Correlation	1	.776**
	Sig. (2-tailed)		.000
	N	21	21
Audit independence	Pearson Correlation	.776**	1
	Sig. (2-tailed)	.000	
	N	21	21

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

Source: Research Data

There is a strong positive correlation between audit tenure and audit independence ($r=0.776$). This implies that the longer an auditor stays with a client, the more the auditor is likely to be independent. This is contrary to previous empirical research findings, (Philimore et al, 2006) and researcher expectation.

4.1.8 Relationship between audit committee and independence

Table 4.13: Audit Committee and Independence

Correlations

		Audit independence	Audit committee
Audit independence	Pearson Correlation	1	.731**
	Sig. (2-tailed)		.000
	N	21	21
Audit committee	Pearson Correlation	.731**	1
	Sig. (2-tailed)	.000	
	N	21	21

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

Source: Research Data

There is a strong positive correlation between audit committee and independence ($r=0.731$). This means that the existence of audit committees help in enhancing independence of the auditor. This research findings resonates well with previous empirical studies that AC enriches AI, (Nur et al, 2005)

4.1.9 Relationship between audit fees and independence

Table 4.14: Audit Fees and Audit Independence

Correlations

		Audit independence	Audit fees
Audit independence	Pearson Correlation	1	.914**
	Sig. (2-tailed)		.000
	N	21	21
Audit fees	Pearson Correlation	.914**	1
	Sig. (2-tailed)	.000	
	N	21	21

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

Source: Research Data

There is a very strong positive correlation between audit fees and audit independence($r=0.914$). This means that the higher the fees charged to perform audit services, the more the auditor is likely not to be compromised.

4.1.10 Relationship between non audit services and Independence

Table 4.15: Non-Audit Services and Audit Independence

Correlations

		Audit independence	Non audit services
Audit independence	Pearson Correlation	1	.836**
	Sig. (2-tailed)		.000
	N	21	21
Non audit services	Pearson Correlation	.836**	1
	Sig. (2-tailed)	.000	
	N	21	21

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

Source: Research Data

There is a very strong positive correlation between non audit services and independence($r=0.836$). This means that the more an auditor engages in other non audit services, the more they will be independent since they have several sources of income. However this should be handled with caution since NAS need not be run concurrently with the main audit activity to the client in order to avoid getting compromised.

4.1.11 Relationship between competition and audit independence

Table 4.16: Competition and Audit Independence

Correlations

		Audit independence	Audit competition
Audit independence	Pearson Correlation	1	.825**
	Sig. (2-tailed)		.000
	N	21	21
Audit competition	Pearson Correlation	.825**	1
	Sig. (2-tailed)	.000	
	N	21	21

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

Source: Research Data

The result shows a very strong correlation between audit competition and independence ($r=0.825$). This implies that as the number of audit firms competing for clients increases, auditors are likely to be more independent in order to win the confidence of their clients. In other words competition among audit firms increases audit independence.

4.2 Regression model

Table 4.17: Summary Model

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.818 ^a	.669	.632	3.37082

a. Predictors: (Constant), financial stability, firm size

Source: Researcher

Table 4.18: ANOVA Coefficients

Coefficients^a

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	10.816	3.187		3.393	.003
	Firm size	4.043	.681	.871	5.938	.000
	Financial stability	-1.026	.796	-.189	-1.288	.214

a. Dependent Variable: audit independence

Source: Researcher

The Regression line is $Y=10.816+4.043X_1-1.026X_2$

In the model adapted, the coefficient of correlation is 0.818 (Table 4.17 above). This shows that audit independence is positively related to the variables under study. The coefficient of determination (R^2) in the same table is 66.9% and the adjusted value of R^2 is 63.2%. This means that 66.9% of the variation in audit independence is explained by firm size and financial stability just like in the previous empirical studies (Nur et al, 2005). The remaining 33.1 % of variation in audit independence is explained by the error

term and other variables not part of the model. The standard error of estimate is 3.37082, which deviates from the regression line established by the model.

The F- statistics in the table below (Table4.19) is 18.186 and the critical value of F from the F-distribution table at 95% level of significance is 3.55. Therefore, I can conclude that the relationship between audit independence and the independent variables is significant.

This is illustrated by the ANOVA results in the Table below.

Table 4.19: F-Distribution Table

ANOVA^a

Model	Sum of Squares	Df	Mean Square	F	Sig.
Regression	413.285	2	206.643	18.186	.000 ^b
Residual	204.524	18	11.362		
Total	617.810	20			

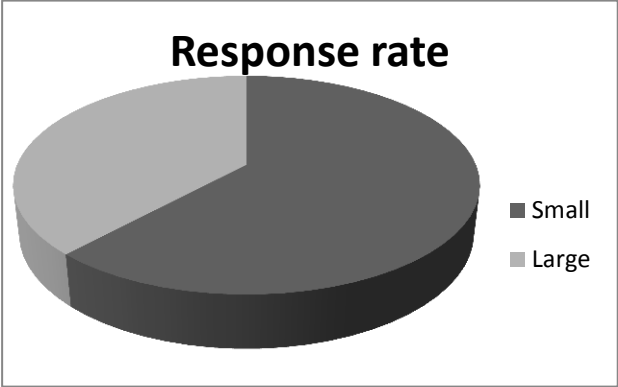
Dependent Variable: audit independence

Predictors: (Constant), financial stability, firm size

Source: Research Data

Figure 1: Pie Chart of Audit Firms Response Rate.

Firm	Response rate
Small	13
Large	8



Source: Research Data

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.0 Introduction

This chapter gives a brief summary of the findings of the study, conclusion and recommendation of the research. It also highlights the limitations and suggestions for further research.

5.1 Summary of the findings

The Research was carried out on the effect of firm size and financial stability on Audit independence of Audit firms in Nairobi County. The research instrument was mainly through questionnaires for primary data. Secondary data was gathered through firm's websites and ICPAK website. Data was analyzed by multiple regression and correlation. The target population was mainly audit firms in Nairobi of which majority of the responses came from small audit firms. Interestingly most small audit firm perceive that financial stability negatively affects audit independence. This is illustrated by the regression model in the study and previous research findings. Large firms represented a bigger percentage of non-response value (33%). From the summary data firm size positively affects audit independence (coefficient of 4.043) while financial stability inversely affects audit independence (coefficient,-1.026). The multiple linear regressions is 0.818 and the coefficient of determination, R^2 is .669 implying 66.9% of variations in audit Independence are explained by the variables in the study, that is changes in the independent variables. 33.1% of variation in the dependent variable is due to error term

of the model and other factors not in the model. The model is statistically significant as indicated by the F statistics 18.2 with a significant value of 0.000.

5.2: Conclusions

The research findings show that firm size and financial stability definitely affect audit independence. This is because large firms with enough resources and systems of operations are perceived to be more independent than small ones. They can withstand pressure from their clients and give an independent audit. They are therefore less likely to be compromised in the execution of their duties. This is in agreement with previous researches done abroad, (Nur et al, 2005). This resonates well with the group of researchers that postulated that firm size is positively related to audit independence.

The research findings also show that among the small firms, financial stability is a weak predictor of audit independence even though it affects it negatively. This is because small firms want to prove that despite their financial limitations, they can still be counted upon by giving independent audits so as to gain credibility of their clients. The more the firms become financially stable, the less worried they are likely to be about their future cash flows. This may lead to lack of independence. These are the outcomes from small audit firms which is in tandem with the collapse of Enron after being audited by a large firm, Arthur Anderson. In conclusion the study has revealed that there is a relationship between Firm size, Financial stability and audit Independence. On the other hand financial stability is recorded as negatively affecting AI. This is so in that more responses came from small firms who skewed the findings from the research. There are high

chances that if more responses came from large firms the results could be different if not opposite.

5.3 Recommendations

Small firms should diversify into other non-audit services so as to enhance their growth. This growth eventually translates into audit independence since there is a strong positive correlation between the two variables. As firms become financially stable, they should exercise a lot of caution so as not to lose independence. Their audits should remain independent by ensuring that the clients' financial statements reflect a true and fair view. They need to pay attention to the rules set by their respective regulatory bodies (see the case of Enron saga).

ICPAK should ensure audit firms file annual financial statements with it in order for the public, researchers and other interested parties to be able to access their financial operations. This is likely to bring accountability in the small firms thereby enhancing independence. In fact this legislation will ensure proactive monitoring of Audit firms in the Country. This is also due to the fact that audit firms records can only be found and regulated by ICPAK.

5.4 Limitations of the study

The study encountered a number of obstacles that affected the research findings. Non-response rate from large audit firms was very appalling, this really affected the results. This particularly made comparison between small firms and large firms to be difficult

since we had a few responses from this group. The reason given for non-response was that some information in the questionnaire was confidential.

Most of the questionnaire questions were based on self-evaluation since the users of financial reports were not included. The study was based on audit firms only. The inclusion of Liquidity and profitability ratios in the questionnaire to capture financial stability measures impaired data collections from some respondents' especially large firms. They still regard such information to be confidential. The sample used was small this might have hindered more research findings on this topic.

5.5 Suggestion for further Research

Future research should be done on this topic by including perceptions of users of financial statements such as Bank loan officers, lawyers among others. Further research also needs to be done on this topic to ensure that use from large audit firms is well represented. Future studies on this topic should include the respondents from Users of the Independent Audit report and increase sample size so as to as to have a perception of Audit independence from the users' point of view.

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APPENDICES

Appendix I: Research Questionnaire Guidelines

This Questionnaire is organized in Four Parts: Part A , B, C and Part D. Part A is for general information, Part B is on Audit Independence Part C is on Audit firm size while part D is on Financial stability.

PART A: GENERAL INFORMATION: PLEASE TICK THE APPROPRIATE ANSWER

1. Gender of the responded: Male() Female ()
2. Please indicate your position in the organization
.....
3. Number of years served in the organization Please tick a) 1-5() b) 5-10() c) 11-15 () d) above 15()
4. Level of education.....high school(), university/college()
5. Tick your Professional qualifications.. CPA(K)(), ACCA,() Others (specify).....
6. State the number of your employees
 - a) Between 1- 20() (b) Between 21-50() and c) Above 50()
7. State the average number of your sources of income in a year
 - a) 1-4 () b) 5-10() c) Above 10()

PART B: AUDIT INDEPENDENCE

(a) Use a Likert-scale of 1-5 where the numerical numbers mean the following 1- highly disagree, 2- disagree, 3- Average(Neutral), 4- Agree and 5- Highly agree. Hence please tick the appropriate number which refers to as indicated beside them.

- (i) Audit firm size affects audit independence
 - 1(), 2(), 3(), 4() and 5()
- (ii) Audit tenure affects audit independence

1(), 2(), 3(), 4() and 5()

(iii) Audit committee affects audit independence

1(), 2(), 3(), 4() and 5()

(iv) Audit fees affect audit independence

1(), 2(), 3(), 4() and 5()

(v) Non-audit services affect audit independence

1(), 2(), 3(), 4() and 5()

(vi) Audit competition affects Audit independence

1(), 2(), 3(), 4() and 5()

(b)

(i) State Yes or No, whether your firm has had any disciplinary issues with ICPAK over the last five years Yes () No ()

(ii) Have you ever issued a qualified report to your clients over the last five years?

Yes () No ()

(c)(i) Please state (tick in the boxes) whether each of the following factors has a positive(+ve) or a negative(-ve) relationship with audit independence

	+ve	-ve
Firm size	<input type="checkbox"/>	<input type="checkbox"/>
Tenure (the period the Audit firm has been with The client)	<input type="checkbox"/>	<input type="checkbox"/>
.Audit committee	<input type="checkbox"/>	<input type="checkbox"/>
Audit fees	<input type="checkbox"/>	<input type="checkbox"/>
Audit competition	<input type="checkbox"/>	<input type="checkbox"/>
Non-audit services	<input type="checkbox"/>	<input type="checkbox"/>

(iv) Please rank the following factors(firm size, audit committee, audit fees, tenure, audit competition and non-audit services) in terms of what you consider most important to least important using a scale-point 1-6, where 1- implies the most important and 6 the least important factor affecting audit independence.

Number	Factor
1
2
3
4
5
6

PART C: AUDIT FIRM SIZE

Using the scale 1-5, where the numerical numbers mean the following: 1-strongly disagree, 2-disagree, 3- average(neutral), 4-agree and 5- strongly agree please indicate the level of agreement or disagreement with the following statements.

(a). Larger firms provide quality audit service than small ones

1 (), 2 () 3(), 4() and 5()

(b). There is a relationship between firm size audit independence

1 (), 2 () 3(), 4() and 5()

(c).Small accounting practitioners issue independent audit reports

1 (), 2 () 3(), 4() and 5()

(d). The size of audit firm does not matter when issuing independent audit report

1(), 2(), 3(), 4() and 5()

(e). Audit firm size is not a major factor influencing audit independence

1(), 2(), 3(), 4() and 5()

(f). The larger the audit firm the higher the audit independence

1(), 2(), 3(), 4() and 5()

PART D: FINANCIAL STABILITY

(a). State (tick) which statement you agree with most in the relationship between financial stability and audit independence

Positive relationship () Negative relationship () and No relationship ()

(b).Using the scale 1-5, where the numerical numbers mean the following: 1-strongly disagree, 2-disagree, 3- average (neutral), 4-agree and 5- strongly agree please indicate the level of agreement or disagreement with the following statements:

(i) Financial stability of a firm is measured by financial statement ratios such as liquidity, profitability among other factors

1(), 2(), 3(), 4() and 5()

(ii) Performance of an audit firm or its profitability can enhance independence

1(), 2(), 3(), 4() and 5()

(iii) The number of sources of income per year of an audit firm affects its financial stability

1(), 2(), 3(), 4() and 5()

(c) The liquidity ratio of a firm refers to current assets ÷current liabilities. The resultant number measure the liquidity strength ranging from 2- very strong to <0.5 – very weak.

1.5-2.0- strong,1.0-1.4-Average and 0.5-0.9- weak. Recall the liquidity position of your firm over the last five years (Between 2009-2013). Kindly select(tick) the number that best reflects the position over those years.

2009 :	Liquidity	<input type="checkbox"/>
	Above 2	
	1.5-----2.0	<input type="checkbox"/>
	1.0-----1.4	<input type="checkbox"/>
	0.5..... 0.9	<input type="checkbox"/>
<0.5		<input type="checkbox"/>
2010	Liquidity	
	Above 2	<input type="checkbox"/>

		1.5-----2.0	<input type="checkbox"/>
		1.0-----1.4	<input type="checkbox"/>
		0.5..... 0.9	<input type="checkbox"/>
	<0.5		<input type="checkbox"/>
2011	Liquidity		
		Above 2	<input type="checkbox"/>
		1.5-----2.0	<input type="checkbox"/>
		1.0-----1.4	<input type="checkbox"/>
		0.5..... 0.9	<input type="checkbox"/>
	<0.5		<input type="checkbox"/>
2012	Liquidity		
		Above 2	<input type="checkbox"/>
		1.5-----2.0	<input type="checkbox"/>
		1.0-----1.4	<input type="checkbox"/>
		0.5..... 0.9	<input type="checkbox"/>
	<0.5		<input type="checkbox"/>
2013	Liquidity		
		Above 2	<input type="checkbox"/>
		1.5-----2.0	<input type="checkbox"/>
		1.0-----1.4	<input type="checkbox"/>
		0.5..... 0.9	<input type="checkbox"/>
	<0.5		<input type="checkbox"/>

(d). Please indicate the profitability of your firm over the years 2009-2013: where profitability=Net Profit after tax/sales *100%). The resultant percentage measure profitability strength ranging from above 20%-very high to <5%-very low, 15%-20%-high, 10%-14%-average, 5%-9%-weak and <5%-very weak. Kindly select (tick) the percentage that best reflects the profitability over those years in your firm

2009: Profitability:

	Above 20%	<input type="checkbox"/>
15%-----	20%	<input type="checkbox"/>
	10%----- 14%	<input type="checkbox"/>

5%----- 9%	<input type="checkbox"/>
< 5%	<input type="checkbox"/>
2010: Profitability:	
Above 20%	<input type="checkbox"/>
15%----- 20%	<input type="checkbox"/>
10%----- 14%	<input type="checkbox"/>
5%----- 9%	<input type="checkbox"/>
< 5%	<input type="checkbox"/>
2011: Profitability:	
Above 20%	<input type="checkbox"/>
15%----- 20%	<input type="checkbox"/>
10%----- 14%	<input type="checkbox"/>
5%----- 9%	<input type="checkbox"/>
< 5%	<input type="checkbox"/>
2012: Profitability:	
Above 20%	<input type="checkbox"/>
15%----- 20%	<input type="checkbox"/>
10%----- 14%	<input type="checkbox"/>
5%----- 9%	<input type="checkbox"/>
< 5%	<input type="checkbox"/>
2013: Profitability:	
Above 20%	<input type="checkbox"/>
15%----- 20%	<input type="checkbox"/>
10%----- 14%	<input type="checkbox"/>
5%----- 9%	<input type="checkbox"/>
< 5%	<input type="checkbox"/>

APPENDIX2: 32 SAMPLE LIST OF CPA FIRMS IN NAIROBI COUNTY

Bett & Associates 5th Transitional Plaza Telephone: 254202230330

City Hall Way Email: info@mgiadam.co.ke

P.O Box 72133-00200

Nairobi

C M Maingi & Company Shelter Afrique House Tel. 0202721267

Mamlaka Road Email: mmaingi@orange.co.ke

Box 23933-00100

Nairobi.

Deloitte & Touche Deloitte Place, Telephone: 4441344/05-2,4230000

Waiyaki Way, Muthangari Email: dmin@deloitte.co.ke

P.O Box 400092-00100

Nairobi

Dan & Associates Bruce House, 11th Floor Tel. 0202721267

Box 64023-00620

Email: mungaip@hotmail.com

Nairobi.

Ernst & Young Kenya-Re Towers 1st Floor, Upper Hill Telephone: 2715300

Off Ragati Road Email: info@ke.ey.com

P.O Box 44286-00100

Nairobi

Esther Muchemi & Co. Jubilee Insurance Exchange, 7th Floor Telephone 020-2213281,

Kaunda Street 0722-524835.

P.o. Box 16982

00619 Email: esymuchemi@kenyaweb.com

Nairobi.

G.C Patel & Company Monrovia Street, Tel. 316046
Opp. Jevanje Gardens Email: rajni-patel@hotmail.com
Box 43894-00100
Nairobi.

Gacheru & Company Bruce House,4th Floor Tel. 316046
Box 34940-00100 Email:
gacherus@yahoo.com
Nairobi.

Gad Wekesa & Associates Nacico-Plaza, Telephone:0711457598
Ground floor Rm 17 Email: gadwekesa@yahoo.com
Landhies Road,
P.O Box 34769-00100
Nairobi

Gakoi & Associates Nacico Plaza, Tel. 0722-602405
Ladhies Road Email:
gakoithuo@gmail.com
Box 18605-00100
Nairobi

P Rana Westlands Road Tel. 0722825359
Box 48079-00100 Email:
supplycentre@nbi.co.ke
Nairobi.

Hudson & Associates Bruce House, 10th Floor Telephone 0202224706
P.o Box 4984-00200 hnguu@yahoo.com
Nairobi.

J M Gitau & Company Utalii House,1st Floor Telephone:0721708649
P.O. Box100149-00101 Email:
jemagitau@yahoo.com
Nairobi

K.Wachira & Associates Kenda House,3rd Floor, Room C 5Telephone:0722-638864

Tom Mboya Street, Email:

Wachiraamos@hotmail.com

P.O Box 34278-00100

Nairobi.

Kago Mukunya & Associates Embassy House, 2nd Floor, Telephone: 020-343115

Harambee Avenue Email:

kagomukunya99@yahoo.com

P.O. Box 30362-00100

Nairobi

Kassim Bharadia & Co. Rehani House 4th Floor, Telephone: 2242170

Koinange Street, Email: kabharadia@apexafrica.com

P.O.Box 67815-00200

Nairobi

Kilaka & Associates Caxton House 2nd Floor Telephone: 0710756215

P.O.Box 15784-00100

Kenyatta Avenue

Nairobi

kilakaandassociates@yahoo.com

Kyalo & Associates Tempo Co-operative House Telephone 0722365306

Moi Avenue Email: kyaloandaassociates@yahoo.com

P.o Box 52531-00200

Nairobi.

KPMG Kenya ABC Towers 8th Floor Telephone: 25420280600

Waiyaki Way Email: info@kpmg.co.ke

P.O.Box 40612-00100

Nairobi

Maarifa & Associates 21st Floor, View Park Towers Tel. 0726525214

Utalli Lane, Email: johnchege@maarifa-cpa.com

Box 68644

Nairobi

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Haile Selassie Avenue Email: ongonge@yahoo.com
P.o Box 10055-00100
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Moi Avenue Email: mosopasociatete@yahoo.com
P.o Box 55685-00200
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P.O.Box51820-00200 Nairobi

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P.O.Box 61047-00200
Nairobi.

Ngari & Associates Ufundi coop. Plaza 9th Floor Telephone:0722846944
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P.O.Box74550-00200
Nairobi

Obusubiri @Associates Biashara Plaza Tel. 0733 901589
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3rd Floor Email: wangecilu@yahoo.com
Box 20906-00100
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