

**RELATED DIVERSIFICATION AS A STRATEGIC ORIENTATION AMONG
MID-TIER AUDIT FIRMS IN KENYA**

BY

MWANDO JAMES

**A RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILLMENT OF THE
REQUIREMENTS FOR THE AWARD OF THE DEGREE OF MASTER OF
BUSINESS ADMINISTRATION SCHOOL OF BUSINESS OF UNIVERSITY OF
NAIROBI**

SEPTEMBER 2012

DECLARATION

This research project report is my original work and has not been submitted for any degree in any other University.

Signature:

Date:

JAMES MWANDO

D61/7103/2006

This research project report has been submitted for examination with my approval as a university supervisor.

Signature:

Date:

DR. MOHAMED

SCHOOL OF BUSINESS

UNIVERSITY OF NAIROBI

ACKNOWLEDGEMENT

I owe a lot to those who were generous with time and expertise especially Prof. Aosa and Dr. Mohamed without them, I would not have written a single word.

I am grateful to all my colleagues and especially David Makau, James Kimani and Ann Nyaguthie for their encouragement when college life was unbearable.

And to Virginia Ndunge for teaching me the life skills for survival.

DEDICATION

I dedicate this work to my wife Cugu –
though she does not know!

- for her patience and encouragement even when shadows of doubt eclipsed my life . ..

... to our daughters Michelle and Annette

- for being the joy of my life ...

... my mother, Margaret Njeri for her courage in life...

... my brother Samuel Muchiri, for whom and what I am today,

to David Makau for the priceless time that we spent together in college ...

... and Ann Nyaguthie for her enduring friendship.

TABLE OF CONTENTS

DECLARATION	i
ACKNOWLEDGEMENT	ii
DEDICATION	iii
LIST OF TABLES	vi
ABBREVIATIONS AND ACRONYMS	vii
ABSTRACT	viii
CHAPTER ONE: INTRODUCTION	1
1.1 Background of the study	1
1.1.1 Diversification Strategy	3
1.1.2 Related Diversification	4
1.1.3 Auditing function	4
1.1.4 Mid-tier Audit Firms in Kenya	5
1.2 Research Problem.....	8
1.3 Research Objectives.....	10
1.4 Value of the Study	10
CHAPTER TWO: LITERATURE REVIEW	11
2.1 Introduction.....	11
2.2 The Concept of Strategy	12
2.3 Strategic Management and Diversification Strategy	14
2.3.1 Diversification Strategies	15
2.3.2 Related Diversification as a Strategic Orientation.....	18
CHAPTER THREE: RESEARCH METHODOLOGY	20
3.1 Introduction.....	20
3.2 Research Design.....	20
3.3 Target Population	20
3.4 Sampling.....	21
3.5 Data Collection	21
3.6 Data Analysis	22

CHAPTER FOUR: DATA ANALYSIS AND INTERPRATION	23
4.1 Introduction.....	23
4.2 Results of the Study	23
4.3 Discussion of Findings	29
CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATIONS..	31
5.1 Introduction.....	31
5.2 Summary of Findings.....	31
5.3 Conclusions.....	32
5.4 Recommendations	32
5.5 Limitations of the Study	33
5.6 Suggestions for Further Research.....	33
5.7 Implication on Policy, Theory and Practice	33
REFERENCES	34
APPENDICES	36
APPENDIX 1: QUESTIONNAIRE.....	36
APPENDIX 11: LETTER OF INTRODUCTION	41

LIST OF TABLES

Table 1:	Audit Services: Number of establishments and employees	7
Table 2:	Provision of Non-audit Services	23
Table 3:	Provision and Independence of Non-audit services as SBUs	24
Table 4:	Reasons for Offering Non-audit Services	25
Table 5:	Turnover	25
Table 6:	Contribution of Non-audit Services to Turnover	26
Table 7:	Level of Satisfaction with Contribution of Non-audit Services	27
Table 8:	Stability of Firms with Non-audit Services	27
Table 9:	Motivation to Diversify Outside Related Areas	28
Table 10:	Reasons for Further Unrelated Diversification	28

ABBREVIATIONS AND ACRONYMS

CPA	-	Certified Public Accountants
CPE	-	Continuing Professional Education
IASs	-	International Accounting Standards
ICPAK	-	Institute of Certified Public Accountants of Kenya
IFAC	-	International Federation of Accountants
IFs	-	International Financial Standards
IPO	-	Initial Public Offer
IT	-	Information Technology
KASNEB	-	Kenya Accounting and Secretaries Examination Board
PKF	-	Pannell Kerr Forster
PWC	-	PriceWaterhouseCoopers
RAB	-	Registration of Accountants Board
R&D	-	Research & Development
SMEs	-	Small and Mediums Enterprises

ABSTRACT

The effects of globalization have opened up markets all over the world. As a result, competition has increased a notch higher virtually in all sectors of the economy. The auditing sector has not been left behind. Small and medium sized audit firms are now encroaching into lucrative sectors that were previously dominated by the big multinational auditing firms by diversifying into related and unrelated markets. In addition, some of the medium firms have sought affiliation with big global audit firms while others have merged. As a result, they have started to build a brand name in the market and at the same time, developing the human capital required to compete in the market. The objectives of this study were: to determine the extent of related diversification in mid-tier audit firms in Kenya and to determine the effect of diversification on the growth of the aforementioned firms. A descriptive survey design was used in this study. The population was all the 700 audit firms registered by the ICPAK. A sample of 70 firms was selected for the study using convenience sampling method. Primary data was collected using semi-structured questionnaires which were administered to the managing partners through drop and pick later method. Data was analysed using descriptive statistics with the aid of SPSS. The study found that all the firms had adopted related diversification strategy. Other than the audit business, all the firms had diversified into taxation services. The firms had diversified into offering company secretarial services, consulting services and accounting services. The results also showed that most of the respondents agreed that related diversification lead to firm growth. The study concludes that all the audit firms had adopted related diversification strategy where related non-audit services such as taxation services, company secretarial services, consulting services and accounting services were provided as an SBU or as a

non-strategic business unit. The study also concludes that related diversification led to growth of audit firms as majority of respondents agreed. The study recommends that there is need for mid-tier audit firms to diversify more into business advisory services to complement the audit business as this is important in stabilising the earnings from these firms. The study also recommends that mid-tier audit firms should rigorously exploit their potential in offering these non-audit services in order to improve their contribution to overall revenues of these firms.

CHAPTER ONE: INTRODUCTION

1.1 Background of the study

The audit industry in Kenya has about 700 audit firms including the top four firms - PWC, Ernst & Young, Deloitte & Touche and KPMG, about 100 mid tier firms and the rest being the small audit firms. This classification is based on the revenue, number of partners and number of staff.

Though the industry has scant data on the market shares, industry players estimates that the small and medium sized firms control only five percent of the market by deal value despite their huge numbers. The dominance of the “big four” has been contributed to their growing brand power, unique capacity to harness expertise through global professional network.

Medium-sized audit firms in Kenya are facing stiff competition and are operating under a highly turbulent environment. The fact that the world has become a global village has forced local firms across all industries to improve their efficiency and effectiveness in order to survive in a dynamic environment. Players in the financial service sector have been pressured to adopt International Accounting Standards (IASs) crafted by the IFAC in order to improve the quality of the services offered. Following the collapse of Enron in the USA, the push to adopt the IFSs has been stepped up and audit firms all over the world have called to boost their quality control systems by hiring top notch financial experts as well as install quality IT systems to ensure adherence to professional,

regulatory and legal standards. The high cost of complying with new accounting benchmarks is driving local medium-sized audit firms out of business.

To survive in the market and to have a cutting edge over competitors, the mid-sized audit firms are adopting various strategies. Some of the firms have sought international affiliation with global auditing firms such as HLB Consultants of Germany, RSM of UK, SCI International of UK, PKF International of UK, Nexia international of USA & UK, Baker Tilly International, Grant Thornton International among others. Out of the top fifteen global firms, eleven have formed partnership with local auditing firms. By gaining international affiliation, the local audit firms are able to enjoy professional expertise and ability to compete with the “big four”.

The firms have also been forced by the prevailing economic environment to merge in order to get additional human resources and technical muscle to face competition. In addition, medium-sized audit firms have expanded the scope of their services and ventured into related and unrelated market sectors. In the past, mid-sized audit firms concentrated on bookkeeping, accountancy, audit and preparing tax returns for SMEs. However, this has changed and the firms are now engaging in the provision of other financial services including tax consulting, financial advisory, advisory on mergers and acquisition, IPOs advice, crisis management, performance improvement, due diligence, corporate restructuring, corporate finance, debt advisory, forensic services, independent business review, IT & security risk services, human capital consultancy, government risk & compliance services, real estate transaction advisory services, dispute services among

others. By doing so, the firms are able to compete effectively, widen their market share, and increase their turnover and more important, increase the shareholders' value.

1.1.1 Diversification Strategy

Due to the vulnerability of the specialized firm to the fast and unexpected changes in the environment, diversification has been an essential basis for growth and survival of firms in the second half of the twentieth century (Penrose 1959, Marris, 1964). This increased relevance of diversification in explaining the changing profile of firms and industries led to the development of a vast body of research in various fields of social science (Chandler, 1962). In business history, the seminal work of Alfred Chandler in *Strategy and Structure: Chapter in the History of the Greatest American Enterprise* (1962) created interest in this topic. In international business, Mark Casson and Peter Buckley's "Internalisation Theory" later developed by Casson in a "System View" also explored this issue of growth of diversified firms, though placing greater emphasis on the determinant role of the global environment. Based on the statistical analysis of the world's largest multinationals in the early 1980s, Robert Pearce introduced the concept of double diversification.

Simply put, diversification refers to the increase by a firm in the kinds of businesses which it operates, that diversity being either related to products, geographical markets or knowledge (Lopes, 1987). Diversification is one of the twelve principal grand strategies that a firm can adopt as a basis for achieving major long-term objectives of a single business. Grand strategies, which are often called master or business strategies are intended to provide basic direction for strategic action. Thus, they are seen as basis of

coordinated and sustainable efforts directed toward achieving long-term objectives (Pearce 2002). According to Pearce (2002) strategies indicates how long-range objectives will be achieved. Thus a grand strategy can be defined as a comprehensive general approach that guides major action. Grand strategies involving diversification represent distinctive departures from a firm's existing base of operations, typically the acquisition or internal generation (spin-off) of a separate business with synergetic possibilities counterbalancing the two businesses' strengths and weaknesses.

1.1.2 Related Diversification

Companies implements related diversification strategies in order to achieve and exploit economies of scope and build a competitive advantage by building on existing resources, capabilities, and core competencies.

For companies that operate in multiple industries or product markets, economies of scope represent cost savings attributed to entering an additional business using capabilities and core competencies developed in another business that can be transferred to a new business without significant additional costs. In other words, companies that successfully transfer core competencies from one business to another without incurring significant additional costs will realize economies of scope.

1.1.3 Auditing function

Auditing is as an independent examination of the books of accounts and vouchers of a business, with a view of forming an opinion as to whether these have been kept properly according to the Companies Act and as to whether the statement drawn therefrom portray a true and fair view of the company's state of affairs as at a given date (Manas'she 1993).

Audit is an evaluation of a person, organization, system, process, project or product. Audits are performed to ascertain the validity and reliability of information and to provide an assessment of a system's internal control. The goal of an audit is to express an opinion on the person, organization, system in question, under evaluation based on work done on a test basis. Due to practical constraints, an audit seeks to provide only reasonable assurance that the statements are free from material error. Hence, statistical sampling is often adopted in audits. In the case of financial audits, a set of financial statements are said to be true and fair when they are free of material misstatements - a concept influenced by both quantitative and qualitative factors.

Audit can be classified into two categories namely: according to the nature of work done and according to the method of approach to the work done. Accordingly, we have statutory audit, private audits, internal audit, continuous audit, interim audit, procedural audits, management audit, standard audits, balance sheet audit and periodic audit. The most common is the internal and external auditing. Internal auditing is an independent appraisal of activities within an organization aimed at ensuring that the management operates efficiently so as to manage the business better. On the other hand, external auditors are independent staff assigned by an auditing firm to assess and evaluate financial statements of their clients or to perform other agreed-upon evaluations.

1.1.4 Mid-tier Audit Firms in Kenya

Professional services are becoming increasingly important in the production of goods and services. Thus, the fundamental transformation of the mode of production involving the

substitution of service inputs for material inputs has seen world employment and output in professional services grow faster than the entire economy since the 1950s (Noyelle 1989).

Auditing is one of the largest professional services in Kenya today. ICPAK estimates that there are about 15,000 qualified professional in this area with about a third of them being registered with ICPAK. The distribution of the ICPAK membership is as follows: private practice 40%, commerce and industry 50%, and others including public sector and academia, 10%. In addition, estimates show that there are over 20,000 qualified accounting technicians. It is further estimated that the Kenyan auditing/accountancy sector has more than 700 firms at the moment. Kenya has a much larger pool of auditors compared with Uganda and Tanzania whose registered members are around 300 and 1,200 respectively.

The Accountancy profession in Kenya is regulated through the Accountants Act (Cap. 531) of the Laws of Kenya. The Act was enacted in 1977 and brought into being three bodies, namely: ICPAK, KASNEB and RAB. ICPAK serves as the umbrella body that oversees the activities of qualified and registered Certified Public Accounts in Kenya. On the other hand, KASNEB administers qualifying examinations for both accountants and company secretaries while RAB deals with registration and licensing of persons who have qualified to become CPAs after completion of the examinations of KASNEB.

In Kenya, it is a legal requirement of the Companies Act (Cap. 486) for all limited companies to appoint an auditor who oversees the company’s financial affairs for a given financial period. The appointment, duties, qualification, remuneration, rights and removal of auditors is regulated by Section 159 (1)-(6) of the Companies Act (Cap. 486).

The demand for the accounting and auditing services has continued to rise in the last four decade as seen here below:

Table 1: Audit Services: Number of establishments and employees

Year	No. of Audit Firms	Number of Employees
1970	30	723
1980	195	2085
1990	258	4330
1995	304	7,234
2000	490	9,462
2009	700	12,345

Source: Government of Kenya, *Statistical Abstract*, (various years)

Audit firms in Kenya can be classified into three categories: The “Big four” firms, mid-sized (tier) firms and the small local audit firms. The top-four include multinational firms of PWC, Deloitte & Touché - a member of the global Deloitte Touché Tohmatsu, Ernst & Young and KPMG. In addition to the big four firms, the number of home-grown audit firms has grown from 450 firms to 601 in the last four years. In terms of revenue, number of partners and staff, 100 out of the 700 firms, can be grouped as mid-tier audit firms. Some of the prominent firms in this group includes: PKF Kenya, DCDM Associates, Nexia Carr Stanyer Gitau, RSM Ashivir, SCI Koimhuri Tucker & Co., Grant Thornton

among others. Some of these firms have borrowed tricks from the old book in the global accounting scene by either buying a franchise license so as to be associated with the world's biggest and most prestigious firms or by selling a sizeable stake.

These partnerships are not only giving mid-sized firms instant name recognition, but are getting them into the lucrative and small club of auditing and consulting for global multinationals. In recent years, eleven of the top fifteen firms, excluding the big four, have formed partnerships with local accounting firms as they seek to spread their foothold across the globe with the emerging markets like Kenya being their focus.

1.2 Research Problem

The effects of globalization have opened up markets all over the world. As a result, competition has increased a notch higher virtually in all sectors of the economy. The auditing sector has not been left behind. Small and medium sized audit firms are now encroaching into lucrative sectors that were previously dominated by the big multinational auditing firms by diversifying into related and unrelated markets. In addition, some of the medium firms have sought affiliation with big global audit firms while others have merged. As a result, they have started to build a brand name in the market and at the same time, they developing the human capital required to compete in the market.

However, much remains to be understood about the relationship among diversification strategy, industry, and performance. It is worth noting that even more remains to be

understood about why firms diversify and the proper management of different patterns of diversity. Research examining diversification and firm performance has been ongoing for over three decades and has intensified in the last ten years. Yet there is no common accepted theoretical framework that explains antecedents of diversification and the relationship between diversification and firm performance. Reed and Luffman (1986) indicated that confusion has grown concerning the nature of the diversification-performance relationship. Hoskisson and Hitt (1990) examined relationship by focusing on three theoretical perspectives (economic, strategic management and agency theory).

However, confusion regarding empirical or measurement issues remains. Venkatraman and Grant (1986) suggested that measurement problems are contributing to the confusion. In recent studies, on market structure and firm performance, Montgomery (1985) and Montgomery and Wernerfert (1988) suggest that diversified firms may not have a higher market share in their respective markets than less diversified firms and that the strategy of diversification does not contribute to firms' performance.

In Kenya, a number of studies have been done, for example Thuo (2003) in his study on Diversification Strategy: Case for Nation Media Group, Munga (2006) in his study; Building Competitive Strategies: A Case Study of Kenol/Kobil Oil Corporation and Mushati (2003) on his study; A Study of Related Diversification within East Africa Building Society. However, none of these was able to fully conclude on whether or not there is a relationship between diversification, growth and performance. In addition, none of these focused on the audit industry.

Thus, the research study specifically focused on the audit industry and the aim was to establish the relationship between related diversification and performance by finding solutions to the following questions: What was the level of related diversification in the mid-tier audit firms? What was the relationship between related diversification and growth? How was related diversification influencing growth of mid-tier audit firms?

1.3 Research Objectives

- i. To establish the extent of related diversification in mid-tier audit firms in Kenya.
- ii. To determine whether related diversification lead to growth of mid-tier audit firms in Kenya.

1.4 Value of the Study

This study will be useful to scholars and researchers since the research finding will be used as points of reference and a basis for further studies in the research area. In addition, audit practitioners will get an insight into the nature of the industry and use the research findings to improve their businesses. The government will use the finding to formulate statutory framework to control and develop the industry. The study will be of benefit to the regulatory bodies in putting place the regulatory framework necessary to regulate and develop the sector.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

The growth of any firm is critical for its survival. According to Pearce (1991) strategies in single-business or dominant-business firms face a choice of grand strategies as they seek strategy alternatives that offer a stronger fit with a firm's overall growth situation.

In an attempt to analyse the strategic fit, various literature - theories and models have come up. Some of the popular models are the BCG Growth/share matrix, the GE Nine-cell planning Grid among others. Literature by Chandler, Wringley and Rumelt have further expounded on the issue. Chandler (1962) for example observed that firms changed their growth strategies in response to environmental changes. He further observed that there was a common sequence of evolution in strategy adopted by firms. The sequence reflected the increasing scope of firms. Most firms began by adopting volume expansion, then geographical expansion, vertical integration and finally, the product diversification. Wringley built on Chandler's work and identified four growth strategies namely; single-product businesses, single dominated businesses, related diversified business and unrelated diversification business. Rumelt extended the work of Chandler and Wringley in later years. More research in recent years has extended the understanding of strategy and growth.

While attempting to explore the various issues that exist in literature of diversification and growth, it is necessary to understand the concept of strategy as a contemporary and dynamic issue. Secondly, it is important to demonstrate the relationship that exists between strategic management and related diversification. And finally, it is necessary to

look at the concept of diversification in broad manners and its relevance in the growth of firms.

2.2 The Concept of Strategy

Strategy is the pattern of organizational moves and managerial approaches used to achieve organizational objectives and to pursue the organization's mission. Organization needs strategy to guide how to achieve objectives and how to pursue the organization's mission. Strategy making is all about how - how to reach performance target, how to out compete rivals, how to seek and maintain competitive advantage, how to strengthen the enterprises long-term business position (Thompson & Stickland, 1970).

Strategy in an organization is shaped by various situational factors, both internal and external. External factors include the societal, political, regulatory, industry attractiveness and the company's opportunity and threats. While internal factors include organizational strengths and weaknesses, business philosophies, ethical principals of key executives, shared values and company culture among others. Strategy making, implementation, evaluation and the follow up task is not a prerogative of the senior executive. Rather, it is a process that involves all and sundry. Consequently, we have strategies for the company and all its business as a whole (corporate strategies). There is strategy for each business the company has diversified into (business strategy). Then there is strategy for each specific functional unit within a business (functional strategy) and finally there is strategy for basic operating units (operating strategies).

Corporate strategy is the overall managerial game plan for a diversified company (Thompson & Stickland (1970)). It consists of the moves made to establish a business position in different industries and the approaches used to manage the company's group of businesses. Corporate strategy is concerned with the overall purpose and scope of the organization to meet the expectation of the owner or major stakeholders and add value to the different parts of enterprises (Johnson, 1984). On the other hand, business strategy's central thrust is on how to build and strengthen the company's long-term competitive position in the market. Functional strategies concern the managerial game plan for running a major functional activity within a business - R&D, production, marketing, customer service, distribution, human resource among other major functions within a business. Finally, the operating strategy concerns the game plan for managerial key organizational units within a business (plants, sales regions, distribution centres).

Once organizations diversify their product or service line, they tend to create distinct structure divisions to deal with each distinct business. This relationship was perhaps carefully documented in the classic study by Alfred D. Chandler, *Strategy and structure: Chapter in the history of the greatest American Enterprise* (1962). Chandler traced the origins of diversification in Du Pont and General Motors in the 1920s which were followed later by other major firms.

As diversification become popular strategy among large corporations in the 1960s and 1970s, a number of techniques were developed to analyze strategies at the corporate level. Among these were the "Portfolio" analyses such as the "growth-share Matrix"

2.3 Strategic Management and Diversification Strategy

Strategic management is a systematic approach to a major and increasingly important responsibility of general management: to position and relate the firm to its environment in a way which will ensure its continued success and make it secure from surprises (Ansoff, 1990).

Generally, a company has a general plan of major actions or statement of means - through which a firm intends to achieve its long-term objectives in a dynamic environment. There are various approaches which a firm can use in order to achieve its objectives. Among these approaches is the diversification strategy. There are two approaches to diversification strategy namely: related and unrelated diversification. Unrelated diversification involves acquiring or generating internally a business that is unrelated to the core business of a firm. Occasionally, firms acquire a business that represents the most promising investment opportunity available with the sole principle being the profit pattern of the acquired business. The main concern is usually to create a financial synergy rather than creating a product a product-market venture. This type of diversification is based principally on profit consideration. On the other hand, related diversification involves acquisition of businesses that are related to the acquiring firm in terms of technology, markets or products. The new business selected usually possesses a high degree of compatibility with the firm's current business. The ideal related diversification occurs when the combined company profits increase strengths and opportunities and decreases weaknesses and exposure to risk.

However, regardless of the approach taken, the motivation for diversification is generally to increase the growth rate of a firm, improve stability of earning, balance the product line, and acquire resources, increase efficiency and profitability especially if there is synergy.

2.3.1 Diversification Strategies

Most companies begin as small single business enterprises serving a local or regional market. During a company's early years, its product line tends to be limited, its capital base thin and its competitive position vulnerable. Usually, a young company's strategic emphasis is on increasing sales volume, boosting market share, and cultivating loyal clientele. Profits are reinvested and new debt is taken on to grow the business as fast as conditions permit. Prices, quality service and promotion are tailored more precisely to customer needs. As soon as practical, the product line is broadened to meet variations in customer want and end-use applications (Thompson, 1978).

Opportunities for geographical markets expansions are normally pursued next. The option is to expand to the local market first, then to the regional markets, the international market before finally going global. Somewhere along the way, the potential for vertical integration, diversification into related and unrelated markets, need to merge and acquire firms in the same or different markets may arise.

A decision to diversify raises the question of "what kind and how much to diversify?" A company can diversify in to closely related or totally unrelated businesses. It can

diversify to a small extent, it can move into one or two large businesses or a greater number of small ones. Over time, once diversification is achieved, the management may consider divesting or liquidating business that are no longer attractive. The underlying purpose of diversification is to build shareholder value. However, diversification as a strategy doesn't create shareholder value unless a group of business performs better under a single corporate umbrella than they would perform operating as independent stand-alone business.

There are two fundamental approaches to diversification - into related business and into unrelated business. The rationale for related business diversification is strategic: diversify into businesses with strategic fit, capitalize on the strategic fit relationships to gain competitive advantage to achieve the desired impact on the shareholder value. On the other hand, the reasons for diversifying into unrelated businesses hinges almost exclusively on opportunities for attractive financial gain- there is nothing strategic about unrelated diversification.

There are various diversification options that a firm may choose. One, it may opt to acquire company in the target industry, form a joint venture with another company to enter the target industry, or alternatively, start a new company/division internally and to try grow it from the ground up. Consequently we have various diversification strategies. Some of these strategies are: acquisition, start-up and joint ventures, related diversification strategies, unrelated diversification strategies, divesture and liquidation strategies among others.

The chosen strategy for the firm will depend upon three factors namely; the goal which the organization is pursuing the current performance of the firm relative to its performance expectation, the balance of threats and opportunities in any individual product-market area and finally, the overall strength or weakness of the business in the market.

There are various reasons why firms diversify. According to Ansoff, firms diversify when they can not achieve their current objectives by continuing to operate in their existing market, secondly where a business has excess financial resources beyond those necessary to satisfy its expansion plan its existing markets, then rather than retain these resources in liquid form, the business may invest them in new market areas and thirdly, if greater opportunities are presented to the firm in new market area than it accrue from its existing activities, then a diversification programme may be undertaken to benefit from these.

The major reason for a business adopting a strategy of diversification is therefore to allow it to reduce its dependence upon a single market area by avoiding undue dependence upon a small number of customers and maintaining an adequate supply of liquid financial resources. When a firm adopts the diversification strategy various issues may arise as a result. Some of these problems may due to lack of a diversification guideline and lack of sufficient preparation in handling different requirement for different business

2.3.2 Related Diversification as a Strategic Orientation

Also known as concentric diversification, is one of possible reaction to the major problem attaching to horizontal expansion - that is, the difficulty of securing continued expansion in a market which itself is not growing rapidly or where competitors are also following a strategy of horizontal growth. The problem of growth under these conditions arises from the need to expand by way of price or product competition - a problem which may not be overcome by acquiring competitors.

Concentric diversification occurs when a firm adds related products or markets. The goal of such diversification is to achieve strategic fit. Strategic fit allows an organization to achieve synergy. In essence, synergy is the ability of two or more parts of an organization to achieve greater total effectiveness together than would be experienced if the efforts of the independent parts were summed. Synergy may be achieved by combining firms with complementary marketing, financial, operating, or management efforts.

Related diversification involves the acquisition of businesses that are related in terms of technology, markets, or products. The new business selected possesses a high degree of compatibility with the firm's current business. The ideal related diversification occurs when the combined firm's profit increases the strengths and opportunities and decreases weaknesses and exposure to risk. The acquiring firm usually searches for new businesses whose products, markets, distribution channels, technologies and resources required are similar to but not identical with its own, whose acquisition results in synergies and not complete interdependence.

Related diversification allows a business to escape from a possible war with existing competitors while minimizing product market adjustment costs in terms of having to adopt new technologies among others. Firms may thereby increase rates of return by moving into related markets offering better prospects than existing ones, and also achieve a greater spread of interest and reduce exposure of profitability to the fortune of individual market. Firms pursuing this type of strategy may broadly exploit their existing technology in new products, market areas, seek new markets for existing products, or capitalize upon existing distribution system to increase their range of products with the aim of increasing sales, achieving growth, reduce dependence upon a single product area and entry into a new market.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

The objective of this study as outlined in Chapter 1 was twofold. The first objective was to determine the extent of related diversification in mid-tier audit firms in Kenya and the second objective was to determine the effect of diversification on the growth of the aforementioned firms.

A number of studies have been done in the past in Kenya, for example Thuo (2003) in his study on Diversification Strategy: Case for Nation Media Group, Munga (2006) in his study; Building Competitive Strategies: A Case Study of Kenol/Kobil Oil Corporation and Mushati (2003) on his study; A Study of Related Diversification within East Africa Building Society.

3.2 Research Design

The descriptive survey design was used to find out the relationship between related diversification and performance of the mid-tier audit firms. Kerlinger (1969) points out that descriptive studies are not only restricted to fact findings but may often result in the formulation of important principles of knowledge and solutions to significant problems. They are more than just a collection of data. They involve measurement, classification, analysis, comparison and interpretation of data.

3.3 Target Population

The population of interest for this study consisted of all audit firms in Kenya that are duly registered with ICPAK. According to the ICPAK website, there are approximately 700

audit firms that are duly registered. These firms consist of the big four - PWC, Ernest & Young, KPMG and Deloitte & Touché, the mid-sized audit firms and the small audit firms. A list of the registered audit firms was obtained from the website of ICPAK-
www.icpak.com.

3.4 Sampling

A sample of 10% of the firms was obtained through convenience sampling method because of time and resource constrains and the possibility that some of the decision makers would not be available and information might not be forthcoming. Cooper and Schindler (1998) concur that a sample of 30 and above is considered representative of the population for the purpose of data analysis and generalisation.

3.5 Data Collection

Primary data collection using semi-structured questionnaires method was used. The respondents in each of the audit firms were the Managing Partner of each firm. The Managing Partners are responsible for strategic decision making and have access to resourceful information. The questionnaires were dropped and picked later. Follow up calls and visits were made to ensure that the response rate is high.

In the past, there has been little research in this field specifically focusing on audit firms and therefore, secondary data that is available is minimal and not conclusive. The issues that are raised in the questionnaires were derived from the objectives of the study and the literature that had been reviewed.

3.6 Data Analysis

Before the responses were processed, data obtained from the questionnaires was edited for completeness and consistency. The responses were subjected to preliminary data presentation stages in order to establish relationship. The data was analysed using descriptive statistics. Data was presented by use of tables, percentages and frequencies to display a visual presentation of the data, for ease of understanding and analysis. The analysis was done using SPSS.

CHAPTER FOUR: DATA ANALYSIS AND INTERPRATION

4.1 Introduction

This chapter presents the results of the analysis of data collected through questionnaires. The questionnaires were distributed to 70 audit firms. A total of 23 questionnaires were returned. The response rate was therefore 32.9%. Given that this is a qualitative study, the response rate is considered satisfactory.

This chapter is organised as follows: section 4.2 presents the results of the study; section 4.3 presents the discussion of findings while section 4.4 is a summary of the chapter. The results are presented in terms of frequencies and percentages.

4.2 Results of the Study

The respondents were asked to state whether some non-audit services were offered by their firms. The results are shown in Table 2.

Table 2: Provision of Non-audit Services

Non-audit services	Frequency	Percent
Taxation	23	100
Company secretarial	20	87
Consulting	20	87
Accounting	21	91

The results show that all the firms surveyed offered taxation, 87% offered company secretarial services while another 87% offered consulting services. The results also showed that 91% of the firms surveyed offered accounting services. It was noted that all

the respondents perceived that there was a linkage between non-audit services and the core business of the firms – audit.

The respondents were asked whether the non-audit services were offered as Strategic Business Units (SBUs). For those who agreed that the services were offered as SBUs, they were asked to state whether such SBUs operated independently. The results are shown in Table 3.

Table 3: Provision and Independence of Non-audit services as SBUs

	Independent		Not Independent		Total	
	Frequency	Percent	Frequency	Percent	Frequency	Percent
Yes	8	73	3	27	11	48
No	-	-	-	-	12	52
Total	8	73	3	27	23	100

The results show that 48% of the firms offered non-audit services as SBUs while 52% did not offer them as SBUs. Of the 11 firms that offered non-audit services as SBUs, 73% of such SBUs were operated independently while 27% were not.

The respondents were also asked to score the reasons for offering non-audit services. The results are shown in Table 4.

Table 4: Reasons for Offering Non-audit Services

Reason	Very important (%)	Important (%)	Not important (%)
To enter profitable markets	74	26	0
To stabilise profits	22	70	8
For growth	43	30	17
Increase customer convenience	30	57	13
In reaction to competition	26	30	44

The results show that the most important reason for offering non-audit services was to enter profitable markets. The second most important reason was to stabilise profits. The third reason was to increase customer convenience while the fourth reason was to grow the business. The last reason was to react to competition. Thus it is clear that the audit firms were doing related diversification in order to enter other markets as well as to stabilise their profits in the audit industry.

The study sought to determine the overall turnover of the audit firms. The results are shown in Table 5.

Table 5: Turnover

	Frequency	Percent
5 – 10 million	10	44
11 – 20 million	12	52
Above 20 million	1	4
Total	23	100

The results reveal that 44% of the firms had a turnover of Ksh 5-10 million, 52% of the firms had a turnover of Ksh 11-20 million while 4% had a turnover of over Ksh 20 million.

The study sought to find out the contribution of non-audit services to the overall turnover of the audit firms. The results are shown in Table 6.

Table 6: Contribution of Non-audit Services to Turnover

Turnover		<Sh 2 M	Sh 2-3M	Sh 3-4 M	> Sh 4M
5-10 M	Count	4	3	2	0
	% within Turnover	44.4%	33.3%	22.2%	0.0%
11-20 M	Count	2	0	0	2
	% within Turnover	50.0%	0.0%	0.0%	50.0%

The results show that for firms that had a turnover of Sh 5-10 million, non-audit services contributed less than Sh 2 million in 44.4% of such firms, Sh 2-3 million in 33.3% of the firms and 3-4 million in 22.2% of the firms. For the firms with turnover of Sh 11-20 million, non-audit services contributed less than Sh 2 million in 50% of the firms and over Sh 4 million in another 50% of the firms.

Table 7 shows the results on whether the contribution of non-audit services to overall turnover of the firms was satisfactory or not.

Table 7: Level of Satisfaction with Contribution of Non-audit Services

	Frequency	Percent
Excellent	0	0
Very good	3	13
Good	18	78
Satisfactory	2	9
Unsatisfactory	0	0
Total	23	100

The results show that 13% of the firms considered the contribution very good, 78% considered them good while 9% considered them satisfactory. Thus the firms were of the opinion that the contribution of non-audit services was good.

Table 8 shows the results on the comparison of the stability of firms with non-audit services to those with audit services.

Table 8: Stability of Firms with Non-audit Services

	Frequency	Percent
Excellent	0	0
Very good	4	17
Good	15	65
Satisfactory	4	17
Unsatisfactory	0	0
Total	23	100

The study found that 17% of the firms noted that the stability was very good, 65% noted that it was good, and 17% noted that it was satisfactory.

Table 9 shows the results for whether the audit firms would wish to diversify outside related business areas.

Table 9: Motivation to Diversify Outside Related Areas

	Frequency	Percent
Yes	23	100
No	0	0
Total	23	100

The results show that all the firms were in agreement that they were interested in diversifying outside the related areas. The reasons for doing the same are shown in Table 10.

Table 10: Reasons for Further Unrelated Diversification

Reason	Very important (%)	Important (%)	Not important (%)
Increase revenue	65	35	0
Increased customers' loyalty	14	59	27
Increased customers' convenience	36	32	32
Improved profitability	64	23	14

The study found that 65% of the firms considered increased revenue very important while 35% considered it important. Increased customers' loyalty was considered very important by 14% of the firms, important by 59% if the respondents and not important by 27% of the respondents. Increased customer convenience was considered very important by 14%

of the respondents, important by 32% of the respondents and not important by 32% of the respondents. Improved profitability was considered very important by 64% of the respondents, important by 23% and not important by 14% of the respondents.

4.3 Discussion of Findings

The study sought to establish the extent of related diversification in mid-tier audit firms in Kenya. From the results in the study, it can be noted that all the firms had adopted related diversification strategy. Other than the audit business, all the firms had diversified into taxation services, 87% had diversified into offering company secretarial services, 87% were offering consulting services while 91% of the firms were also offering accounting services. The study also revealed that 48% of the firms operated the non-audit services as strategic business units.

The study sought to determine whether related diversification lead to growth of mid-tier audit firms in Kenya. The results showed that 77% of the respondents agreed that related diversification lead to firm growth. Thus related diversification in the audit firms was meant to help the firms growth into other profitable markets and this was also instrumental in enhancing stability of the firms.

The study received responses from 23 mid-tier audit firms in Nairobi. This represented 33% response rate. Data was entered into SPSS and analysed using descriptive analysis where frequencies and cross-tabulations were mainly used.

The results show that audit firms have diversified to provide other non-audit services such as taxation, company secretarial, consulting, and accounting. It was revealed that 48% of these non-audit services were operated as SBUs. Of these, 73% were independent SBUs.

The most important reasons for offering non-audit services were to enter profitable markets and to stabilise profits. Non-audit services contributed more to the turnover of firms with a turnover between Sh 11-20 million where they contributes up to Sh 4 million. This contribution was seen as good by 78% of the firms. Further, 65% of the firms that offered non-audit services regarded themselves as more stable than the ones that did not offer such services.

CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter presents the summary of the study in section 5.2, conclusions in section 5.3, recommendations in section 5.4, limitations of the study in section 5.5, and the suggestions for further research in section 5.6.

5.2 Summary of Findings

The objectives of this study were: to determine the extent of related diversification in mid-tier audit firms in Kenya and to determine the effect of diversification on the growth of the aforementioned firms. A descriptive survey design was used in this study. The population was all the 700 audit firms registered by the ICPAK. A sample of 10% (or 70 firms) was selected for the study using convenience sampling method. Primary data was collected using semi-structured questionnaires which were administered to the managing partners through drop and pick later method. Of the 70 firms sampled, 23 firms finally responded to the questionnaires (response rate of 33%). Data was analysed using descriptive statistics with the aid of SPSS.

The results show that audit firms have diversified to provide other non-audit services such as taxation, company secretarial, consulting, and accounting. It was revealed that 48% of these non-audit services were operated as SBUs while 52% were not. Of these, 73% were independent SBUs while 27% were not. The most important reasons for offering non-audit services were to enter profitable markets and to stabilise profits. Non-audit services contributed more to the turnover of firms with a turnover between Sh 11-20

million where they contributes up to Sh 4 million. This contribution was seen as good by 78% of the firms. Further, 65% of the firms that offered non-audit services regarded themselves as more stable than the ones that did not offer such services.

5.3 Conclusions

The study sought to establish the extent of related diversification in mid-tier audit firms in Kenya. The study concludes that all the audit firms had adopted related diversification strategy where related non-audit services such as taxation services, company secretarial services, consulting services and accounting services were provided either as SBUs or not.

The study sought to determine whether related diversification lead to growth of mid-tier audit firms in Kenya. The study concludes that related diversification led to growth of audit firms as majority of respondents agreed. Related diversification in the audit firms was therefore meant to help the audit firms grow into other profitable markets.

5.4 Recommendations

The study recommends that there is need for mid-tier audit firms to diversify more into business advisory services to complement the audit business as this is important in stabilising the earnings from these firms.

The study also recommends that mid-tier audit firms should rigorously exploit their potential in offering these non-audit services in order to improve their contribution to overall revenues of these firms.

5.5 Limitations of the Study

The study only focused on mid-tier audit firms in Kenya. Thus, as far as application of these results is concerned, such attempts should be made within the confines of the scope of the study. The results of this study are therefore limited to the audit firms in general and to the mid-tier audit firms specifically.

5.6 Suggestions for Further Research

There's need to undertake a similar study but on the entire audit industry and not specific to mid-tier audit firms. A similar study should also be carried out in other industries. Further, there is need to do a correlational study with the use of performance data from secondary sources to study whether a relationship exists between performance and related diversification strategy.

5.7 Implication on Policy, Theory and Practice

From the conclusion it can be observed that related diversification strategy lead to growth of firms more specifically in the audit industry. There is need therefore that the strategies be inculcated in the policy framework and especially on the rules and regulations that govern the operations and performance of the firms. In addition, there is a need for the firms and the regulators to implement the strategies in order to enhance vibrant growth of the firms.

REFERENCES

- Ansoff, H. I. (1978). *Corporate Strategy*. New York: McGraw-Hill.
- Chandler, A. D. (1969). *Strategy and structure*. Cambridge, Mass: MIT Press.
- Hoskisson, R. E., & M. A. Hitt. (1990). Antecedents and performance outcomes of diversification: A review and critique of theoretical perspective. *Journal of management*, 16/2, 461-509.
- Kay, N. M. (1998). *Pattern in corporate evolution*. Oxford: Oxford University Press.
- Kotler, P. (2006). *Marketing management*. N.J.: Prentice-Hall.
- Lenz, R.T. (1980) "Determinant of organizational performance: An interdisciplinary review. *Strategic management Journal*, 131-54.
- Manas'she, P.N. (1993). *Principles of Auditing*. Nairobi: Focus Publishing Limited.
- Marris, R. (1964). *The economic theory of managerial capitalism*. London: Macmillan Publishers.
- Montgomery, C. A. (1985). Corporate diversification. *Journal of Economic Perspective*, 8,163-78.
- Montgomery, C. A. (1988). The measurement of firm diversification: Some more empirical evidence. *Academy of management Journal*,25, 299-307.
- Mwindi, P. K. (2003). "An analysis of the application of unrelated diversification strategy by the major oil companies in Kenya", MBA Management project, University of Nairobi.

Mwau, P. M. (2003). "A study of related diversification within East Africa Building Society", MBA Management project, University of Nairobi.

Njoroge, I. M. (2006). "Building competitive strategies: A case study of Kenol/Kobil corporation", MBA management Project, University of Nairobi.

Noyelle, T. (1989). "Business services and the Uruguay round negotiations on trade in services", in UNCTAD.

Pearce, J. A. II. (1991). *Strategic Management: Strategy formulation and implementation*. Delhi: AITBS Publishers.

Penrose, E. (1959/1995). *The theory of the growth of the firm*. Oxford: Oxford University Press.

Reed, R. & G. A. Luffman, (1986). "Diversification: The growing confusion". *Strategic Management Journal*, 7, 29-36.

Rumelt, R. P. (1974). *Strategy, Structure and economic performance*. Cambridge, Mass: Harvard University Press.

The Accountant Act, Cap 531 Laws of Kenya.

Thompson, A. A. (1978). *Strategic Management: Concept and cases*. N.J.: Oxford University Press.

Thuo, J. (2003). "Diversification strategy, case for Nation Media Group", MBA Management project, University of Nairobi.

Venkatraman, N. & J. H. Grant, (1986). "Construct measurement in organizational strategy research: A critique and proposal. *Academy of management review*, 11, 71-87.

APPENDICES

APPENDIX 1: QUESTIONNAIRE

To be completed by the Managing Partner or his equivalent. Please answer the following questions by placing a tick where provided and/or giving the required details.

Section A:

Date: _____

Name of Company: _____

Name of respondent (optional): _____

Position held in the organization: _____

Section B:

1. Which year was your organization established? _____

2. Which of the following non-audit services do you offer?

Taxation

Company Secretarial

Consulting

Accounting

Others (specify) _____

3. Do you perceive there to be any linkage between the non-audit services and you core business (audit).

Yes ()

No ()

4. Are the above services offered as SBUs?

Yes ()

No ()

5. If yes, do the SBUs operate independently?

Yes ()

No ()

6. Please score the following reasons for the decision to offer the above services to their level of importance.

Very important Important Not Important

To enter profitable markets

To stabilize profits

For growth

Increase customer convenience

In reaction to competition

Others (specify)

7. What challenges has your company encountered in the process of implementation of the non-audit services in your firm? Name at least three if any:

8. What is your company's annual turnover? Please tick against the appropriate range.

- Below Ksh. 5 million
- Between Kshs. 5 million and Kshs. 10 million
- Between Kshs. 11 million and Kshs. 20 million
- Above 20 million

9. What is the contribution of the earnings of non-audit businesses to the above turnover?

Kshs _____

10. Is the level of contribution in item 11 above:

- Excellent
- Very good
- Good
- Satisfactory
- Unsatisfactory

11. How would you compare the stability of firms with non-audit services to those with audit services only? Please tick on the appropriate attribute.

- Excellent
- Very good
- Good

- Satisfactory
- Unsatisfactory

12. What are the key resources which are shared by share with your sister companies? Name at least three:

13. Do you wish to diversify outside the related areas?

Yes ()

No ()

14. If yes please indicate the key linkages by ticking the appropriate attribute below.

Very important	Important	Not Important		
Increase revenue		<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Increased customers' loyalty		<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Increased customers' convenience		<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Improved profitability		<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Others (specify)	<hr/>			

15. Give a general comment on the related diversification strategy that you have taken:

Note: the above information shall be treated with utmost confidence and shall not be divulged to any other party without seeking prior authority form you.

Thank you for your co-operation

APPENDIX 11: LETTER OF INTRODUCTION

James Mwando
P O Box 100778-00101
Nairobi

Dear Respondent,

REF: RESEARCH PROJECT QUESTIONNAIRE

I am a student at University of Nairobi undertaking a Master of Business Administration degree and I am expected to conduct a research project. Therefore, I kindly request your assistance in filing this questionnaire on Related Diversification as a Strategic Orientation in Mid-tier Audit firms in Kenya.

The information is confidential and will only be used for educational purposes only. Company name and/or contact information will not be disclosed in any way. After the study is finished and properly approved by the university, the result will be shared with the participants and public in general.

Your participation will be highly appreciated.

Yours faithfully,

Mwando James
MBA Student